POLICY BRIEF

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Ukraine and the EU: turning the Association Agreement into a success story[1]

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BACKGROUND

It is paradoxical and symbolic that it has taken Ukraine two waves of mass protests to conclude a new agreement with the EU. One of the concessions to Ukraine following the Orange Revolution of 2004 was to open negotiations on the Association Agreement (AA) in 2007. It took a second revolution, with over 100 killed, to pave way for the signing of the AA after deposing President Viktor Yanukovych in February 2014.

The Association Agreement (AA) with Deep and Comprehensive Free Trade Area (DCFTA) between Ukraine and the EU is the longest and most detailed agreement of its kind. It contains detailed and binding provisions on Ukraine to align its laws and policies with those of the EU (*acquis*). Under the DCFTA, advanced economic integration is not just about tariffs but, above all, legal and regulatory convergence with EU standards. The AA goes beyond purely 'trade issues', also influencing the quality of democracy, governance and the rule of law. Therefore the agreement carries a promise of a major transformative effect on the Ukrainian state and economy.

The concerted 'export of the *acquis*' through association is modelled on the pre-accession agreements which envisaged the alignment of candidate countries' legal framework with the *acquis*. In essence, the implementation of the DCFTA would make Ukraine a 'shadow member state'. However, the modelling has been very sketchy: both the *finalité* and operationalisation are missing for this 'shadowing scenario'.

First, no membership is envisaged even in the long term. This means that the rationale for Ukraine to approximate the *acquis* is different from the accession countries. Therefore the scale and pace of approximation envisaged by the AA must be under-written by sustainable benefits in modernisation, economic growth and welfare generation.

Second, the process of approximation has not been fully operational. There is no road map to facilitate Ukraine's economic integration even though the AA envisages Ukraine's approximation of 80-90% of the *acquis*.

Why no strategy so far?

The lack of strategy reflects the lack of a political blueprint for relations with the eastern neighbours. The formula of 'political cooperation and economic integration' left many EU officials with the challenge of translating ambitious yet vague proclamations into practical arrangements. As Helen Wallace observed, the neighbourhood policy 'has been developed without the benefit of a solid template based on previous experience, not least given the lack of workable and tested alternatives to a membership perspective'. In practical terms, the EU officials lacked a 'guiding framework' to indicate clearly what elements of internal market legislation are essential to its functioning, both from the perspective of new participants and existing ones and which elements can be left aside by new participants to facilitate their integration. Hence, EU officials preparing the AA were confronted with two risks of getting it wrong: either over-regulation and

1 This paper is based on research conducted by a collaborative research project entitled 'Exploring the Role of the EU in Domestic Change in the Post-Soviet States' jointly funded by the ESRC and ANR as part of the scheme called 'Open Research Area in Europe' (ESRC research grant (RES-360-25-0096), ANR-10-ORAR-014-01), see http://euimpacteast.org. It also draws on the following study: L. Delcour and K. Wolczuk, "Approximation of the national legislation of Eastern Partnership countries with EU legislation", European Parliament, 2013 www.europarl.europa.eu/delegations/fr/studiesdownload.html?languageDocument=EN&file=93110

overburdening new participants, or 'hollowing out the internal market' by inadequately prepared participants. Faced with this conundrum, the EU officials opted for a low-risk strategy for the EU, but at the same time increasing the risk of 'regulatory overload' of the Eastern partners, such as Ukraine.

This strategy is not surprising from a practical point of view. In terms of trade alone, the EU has little interest in concluding DCFTAs with the eastern partners. Even Ukraine – the largest of the countries in the Eastern Partnership – is rather insignificant as a trade partner for the EU (accounting for 1.4% of EU exports) to justify such an agreement. The DCFTA appears to be being extended to the eastern neighbours primarily for political reasons, rather than reflecting their trade salience for the EU. Nevertheless, the DCFTA negotiations were approached in terms of what the single market can absorb rather than focussing on the interests and needs of the partner country to make integration into the single market a feasible prospect.

The long and wide-ranging negotiations on the AA were not preceded nor accompanied by screening or analysis of the likely sectoral impact. There were no estimates of the overall or sectoral cost to Ukraine of the implementation of the AA. Without this, the practical sequencing of integrating the partner countries into the single market has not been worked out. This is a major weakness in the EU's strategy, which could undermine the AA as a tenet of EU's approach to the eastern partners, especially against the backdrop of Russia's own policy in the region.

Why is the strategy needed?

The lack of an effective strategy for implementation undermines the EU policy in the eastern neighbourhood for two key reasons: first, the sheer scale the approximation required from eastern partners and, second, the wide gap between the EU's regulatory framework and partner countries' actual needs and capacities in the short- to medium term.

Under the DCFTA, eastern partners are to approximate the bulk of EU trade *acquis* (80-90%). So the DCFTA envisages wide-ranging, far-reaching and costly approximation. In exchange, the eastern partner countries are offered the promise of access to EU markets. In the long-term, this provides a clear template for reforms. If and when implemented, the AA agreements would not only integrate Ukraine with the EU in economic terms but also anchor the reforms of the economy and the state institutions.

However, the *acquis* was not devised as a blueprint for the modernisation of non-member states. The intricate and dynamic system of EU rules was developed for market economies in the process of formation of the single market and not as a blueprint for reforming the countries at a lower level of development. This issue was already raised during eastern enlargement but the imperatives of membership justified the wholesale convergence with the *acquis* to new member states. Needless to say, this rationale is much weaker *vis-à-vis* the eastern neighbours.

The Agreement is asymmetric in favour of Ukraine as Kyiv will open its borders to EU goods in a progressive way. This is a positive feature, but asymmetry is not sufficient to ensure Ukraine's readiness to withstand competitive pressures from the EU once the transition periods are over. After all, the DCFTA is not so much about tariffs as 'deeper' governance issues.

It is argued that the Association Agenda is a form of operationalised plan for approximation. Yet in practice, like its predecessor – the Action Plan – the Agenda remains too vague to guide the approximation process. For example, the monitoring of state aid, which is one of the most complex and intricate parts of the *acquis*, requiring the creation of a robust and effective system controlling the politically-sensitive process of granting and recovering state aid, is addressed in very general terms in the Association Agenda: 'The Parties shall cooperate in the establishment of an effective system of state aid control and monitoring in Ukraine'.

There is no doubt that the prospect of integration into the EU single market offers the best chance for the neighbouring countries, including Ukraine, to modernise and foster economic growth. But the *acquis* is not easily transposed to the eastern partners, given their political, economic and administrative context. Using the AA-DCFTA as a template for reforms in Ukraine raises some formidable challenges, at the very time when successes and failures have high-profile political geopolitical stakes, owing to Russia's efforts to undermine European integration as a viable option for all the eastern partner countries in general and Ukraine in particular.

STATE OF PLAY

Key Challenges

Political and Economic Costs

The DCFTA requires considerable short-term and medium-term efforts and impose noteworthy costs on Ukraine, while tangible benefits are expected to accrue in the longer term. Regulatory approximation with EU *acquis* requires Ukraine to bear up-front political and economic costs (which the new Ukrainian authorities may not be able to afford nor cope with the domestic and external ramifications) as they embark on challenging reforms in pursuit of long-term benefits from modernisation.

For example, to meet EU requirements in the area of food safety (SPS), Ukraine has to create laboratories, introduce inspections and carry out extensive training. The costs of implementing the DCFTA in a comprehensive way are likely to be prohibitively high for the Ukrainian state agencies, especially given their current low capacity, inadequate staffing and lack of resources. Moreover, the costs of approximation are borne not only by state authorities but also by non-state actors, i.e. business. It is estimated that during enlargement around half of the overall costs of legal harmonisation was incurred by non-state actors who needed to adjust to new regulations (e.g. SPS standards by introducing the HACCP system).

Expertise and Capacity

The very nature of the negotiations – secretive and technical, requiring an advanced level of insights into the *acquis* – did not stimulate public discussions and understanding amongst key stakeholders and the wider public. An information campaign was only launched in September 2013, i.e. two months before the Vilnius Summit, thereby leaving vacuum for stirring fears and anxiety about costs and losses amongst Ukrainian businesses. Despite the profound implications of the AA for state institutions and business, so far there has been little engagement with these key stakeholders inside Ukraine. For example, the Ukrainian state officials so-called 'in-line ministries' often have little, if any, understanding of what is required of their ministries under the AA and any related cost. Smaller food producers are concerned about the new SPS standards. The secretive, complex and highly technical approach of the EU has created something of a barrier and disincentive for the key stakeholders in Ukraine to engage with the process and grasp the significance and opportunities arising from the DCFTA.

Assistance

The actual costs of implementing the *acquis* are not reflected in the current EU level of assistance to Ukraine, even with the extra funds made available to Ukraine since March 2014.

Access to the market needs to off-set the costs of approximation. But, as it is, the costs of approximation in the agricultural sector are not reflected in the quotas and tariffs for key agricultural products which Ukraine exports to the EU. For example, Ukraine is to adopt EU SPS for all diary production, whether for domestic consumption or for export to the EU. Adopting such standards is clearly desirable from the point of view of food safety, but is not feasible for all domestic producers. At the same time, access to the single market remains restricted, as the EU offered relatively low quotas in the AA for these products, in light of Ukraine's capacity.

The Russian 'factor'

The implementation of the AA is a challenge on its own. But Russia's policy towards Ukraine increases the challenge immensely. Russia can and will work to undermine Ukraine's European choice while depicting the AA as a 'suicidal pact' for Ukraine. The extent to which Russia is prepared to go to 'punish' Ukraine for its westward orientation is already evident. Therefore, above-mentioned challenges, omissions and risks now have acquired a particular geopolitical salience.

Russia endeavours to build the Eurasian Economic Union by 2015 and create a single Eurasian market. This development presents Ukraine with the prospect of being increasingly excluded from this market. Russia is and will remain an important trading partner: Russia attracts 20.7% of Ukrainian exports (just below the EU, 21.8%). Russia will utilise a full spectrum of punitive measures to exploit Ukraine's dependency on the Russian market, aside from any other forms of direct intervention.

Re-orientation away from Russia will be politically painful and economically costly for Ukraine. This poses a major challenge for the EU's strategy in the eastern neighbourhood. What was a technical matter is now a political and geopolitical matter. The temporary lifting of tariffs for most Ukrainian products till November 2014 by the EU is certainly a step in the right direction. But the current level of quotas for Ukraine, especially for agricultural products, needs further revising on a unilateral basis. For instance, in cases where the EU restricts market access for key agricultural products (such as, for example, dairy products) from Ukraine, the Ukrainian producers have no choice but to rely on access to the Russian/Eurasian market', despite arbitrary restrictions imposed by Russia. Not only they will be forced to adapt to regulations of the Russian/Eurasian market but will remain highly sensitive to the political aspects of relations with Russia. The economic and social costs for the electorate in eastern and southern Ukraine will have repercussions for Ukrainian domestic politics.

Like the EU, the Eurasian project entails deep economic integration and relies on *ex-ante* approximation. This means that at least in the short term, the Ukrainian producers find themselves already caught in two different regulatory regimes. To prevail, European integration has to be attractive and feasible to compensate for the loss of the Russian market and punitive energy pricing.

Russia is well positioned and highly determined to undermine Ukraine's European integration in three respects. First, Russia can draw upon a much broader spectrum of instruments than the EU and, unlike the EU, does not hesitate to deploy punitive measures, even by transgressing domestic and international law. Second, Russia exploits the above-mentioned weaknesses in the EU strategy by stressing the short-term costs and benefits from integration with the Eurasian regime, as opposed to the long-term benefits derived from integration with the EU. Russian officials refer to the DCFTA as a 'suicidal' for the Ukrainian economy and will miss no opportunity to highlight any losses and disruptive effects. Third, Russia exploits specific needs and vulnerabilities of the countries in the 'near abroad'. Russia carefully selects its instruments from the wide array at its disposal to target specific countries, domestic actors, regions, sectors etc. As a result, the price imposed by Moscow for 'moving away' from Russia further increases the already high costs of closer economic integration with the EU for Ukraine.

During the DCFTA negotiations with Ukraine, the role of Russia was not factored in to any significant extent. In essence, the EU had glossed over not only the political and economic costs that the EaP countries had to pay for complying with EU's own offer *but also the costs imposed by Russia for moving towards the EU*. The new political context in the eastern neighbourhood needs to be fully reflected in the EU's strategy and the adoption of Autonomous Trade Preferences is a very good first step in this direction.

PROSPECTS

The EU needs to refine its approach to ensure that the AA-DCFTA actually works in and for Ukraine. The conclusion of the AA is just a first step in terms of economic integration of Ukraine with the EU. The EU should focus on the following aspects:

First, while the DCFTA is being concluded, the attention ought to be on facilitating cost-effective implementation. This requires careful sequencing and prioritisation of the implementation process to avoid overburdening the Ukrainian state with unnecessary or excessively costly regulations in the short-to-medium term.

The EU needs to promote institutional and interim regulatory solutions which are most attuned to the current needs and context of Ukraine and hence likely to result in actual, rapid, though selective, implementation in order to make the DCFTA not only desirable but also a feasible prospect.

Second, an effective and wide-ranging information campaign needs to be launched. The EU must work to ensure that the substance and importance of AA and DCFTA is known beyond a narrow group of officials and experts and reaches out to key stakeholders: state officials, business and civil society.

Third, the current level of assistance is clearly inadequate to facilitate the implementation of the DCFTA. It is unlikely to be significantly increased. So, in practice, Ukraine needs to adopt vast sways of regulations with a fraction of the assistance that accession countries receive. It is at the time when Ukraine's trade with the EU has just started to recover after a sharp decrease in 2009 as a result of the global financial crisis. Limited funds means they have to be spent in the most efficient way through appropriate sector-specific sequencing and prioritisation of approximation process. Focusing on selected sectors would help turn them into early successes of Ukraine's integration into the single market.

The AA-DCFTA carries great transformational potential, but to ensure that it lives up to expectations, the EU cannot afford to gloss over the domestic and geopolitical context in the eastern neighbourhood. In so many respects, success will depend on crafting a detailed and viable strategy for cementing these countries pro-European orientation.

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