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## **MODEL FOR UKRAINE'S INTEGRATION INTO EUROPE IN THE FRAME OF THE EU-UKRAINE FREE-TRADE AREA OPERATION**

*The objective of this article is to analyze potential effects of the UA-EU free trade area formation on business, households and the public sector, and to determine further areas of cooperation between our state and the European Union. The article deals with advantages and threats of the UA-EU free trade area formation. It proves that the free trade area operation will facilitate competitive capacity of the domestic enterprises and the national economy in general.*

**Key words:** *free trade area, the European Union, integration, competitive capacity, customs duties, tariff-rate quota, export, import.*

Ukraine's integration to the European Union has been our government's strategic target for many years. Geopolitical preconditions for transition from collaboration to integration are substantially of objective nature, for the EU expansion to the East and appearance of a joint border with Ukraine (the largest among its neighboring states) a priori changed the geopolitical situation in Europe. Development of a new security concept in the frame of the EU expansion underpinned by security along the EU geographic perimeter contributed to development of certain collaboration enhancing initiatives based on the European Neighborhood Policy. Continuous EU-Ukraine collaboration resulted in execution of the Ukraine-European Union Association Agreement where formation of the UA-EU free trade area is outlined.

The objective of the article is to analyze potential effects of the UA-EU free trade area formation on business, households and the public sector, and to determine further areas of cooperation between our state and the European Union.

**Literature review.** A problem of Ukraine's integration to the EU was studied by a number of Ukrainian scholars, among which the papers of Emerson M. [3], Jakubiak M. and Kolesnichenko A. [4], Burakhovskiy I. [2], Burakhovskiy I. and Movchan V. [6] and others.

**Research methods.** In our study we used such methods of economic analysis as expert evaluation method, comparison technique, system analysis approach, induction and deduction methods. We selected the analysis method as the primary method of studying effects of the free trade area formation on business, households and the public sector.

**Research results.** The Association Agreement between Ukraine, on the one part, and the European Union, the European Atomic Energy Community and their member-states, on the other part, was signed by the parties in 2014. The political provisions of the Agreement were signed on March 21, 2014, the economic part – on June 27, 2014. The economic part of the Agreement proposes to form the Deep and Comprehensive Free Trade Area. The three quarters of the Association Agreement are the Deep and Comprehensive Free Trade Area Agreement (hereinafter referred to as the DCFTA or FTA). Let's discuss the basic provisions of this Agreement [1].

The free trade area (FTA) between Ukraine and the EU is designed to form the Ukraine-EU Single Economic Space. European integration in the economy offers an advantage of gradual achieving the European standards of life, securing macroeconomic stability of the economy, creating proper conditions for free flow of commodities, services, capital and work force within the European Common Market.

Moreover, integration of Ukraine to the European Economic Space is an important factor which should encourage enhancement of competitive capability both in individual industries, and in the economy of the country in general [1].

An integral part of the Deep FTA will be bringing the Ukrainian legislation and practice into harmony with the EU legislation and regulations, and commoditization

of the future FTA will be aimed at achievement of the maximum deep economic integration in all the areas (trade in goods and services, direct foreign investment environments, state procurement, etc.).

Provisions concerning the Deep and Comprehensive Free Trade Area are outlined in 15 Chapters, 25 Annexes and 2 Protocols.

The Agreement suggests cancelling customs duties, charges and other fees.

Summary of the arrangements:

- Ukraine and EU agreed upon formation of the free-trade area (FTA) within the transition period not exceeding 10 years according to provisions of article 24, GATT as modified in 1994;

- according to the arrangements, every Party will reduce or cancel customs duties on goods according to the established schedules with Ukraine's transition period lasting up to 10 years, while the EU tariff schedule will change once it is made effective by the Agreement;

- gradual reduction will apply to the basic customs duty rate specified in the Agreement.

For most sensitive goods traded by Ukraine and the EU, so-called tariff-rate quotas were introduced, they set up a zero rate for the import duty within the quota, and a nonzero rate beyond the quota. Ukraine set up tariff-rate quotas applicable to pork meat, poultry and sugar. The EU list of tariff-rate quotas covers 36 items and primarily contains agricultural products and manufactured food.

In our assessment of potential effects of the FTA operation, we should mention that they are different for business, households and the public sector.

According to the preliminary evaluation, FTA introduction is expected to affect business. In the Agreement, the parties agreed upon a significant liberalization of import duty rate for commodities, with over 90% of final rates equaling zero. Meanwhile, for sensitive commodity items, either import duty will be maintained, or tariff-rate quotas with zero rate within the quota, or nonzero rate beyond the quota will be introduced. Reduction of tariff limitations by the EU in industries such as light industry, chemical industry, engineering, food industry which will facilitate

improvement of Ukrainian manufacturers' access to the respective markets will have most significant meaning for Ukrainian manufacturers. Introduction of tariff-rate quotas allowing a zero-duty export to the EU within the quota will create opportunities for the Ukrainian business to take on the market. At the same time, Ukraine is gradually opening its market for commodities manufactured in the EU. As compared with other industries, the greatest reduction of import duties will take place in the light industry, in particular, in clothes manufacturing, manufacture of other non-metallic mineral products, food industry, and furniture production. And Ukraine will keep nonzero, but low import duty rates for certain engineering products.

Effects of FTA introduction on the households are evaluated predominantly positively. Reduction of Ukrainian import duties will create opportunities to cut internal prices for certain goods. According to assessment of the Institute for Economic Research (IER) based on the applied general equilibrium model for Ukraine, liberalization of Ukraine-EU trade by way of reduction or cancellation of import duties will in general give rise to increase of overall wealth of households by 1.3% in midterm and by 4.6% in long term with all other conditions being equal. At the same time, reduction of non-tariff restrictions on trade will yield higher economic benefit.

According to IER's assessment, growth of trade flow and economic activity due to changes in the regulatory environment to be implemented by Ukraine under the Agreement will compensate for the losses in budget receipts from gradual reduction or cancellation of import duties [2].

In our assessment of possible effects on business, we may state that gradual cancellation of export duties with other conditions being equal will stimulate export of those commodities which will at the same time result in growth of their internal prices. Due to the long transition period, manufacturers will be able to adjust to changes. It is expected that cancellation of export duties might have negative effect on metallurgy and, to less extent, on oil production from oil crop seeds and leather production.

Meanwhile, for the households, cancellation of import duties on oil crops might adversely affect the cost of oil, though this effect will be very insignificant considering high level of competition at the market and availability of numerous substitute products.

Alongside with that, for the public sector, cancellation of export duties will cut yields for the state budget, they possibly might be fully compensated for by export growth.

In the Agreement, parties also undertook not to maintain in force, or introduce or reimpose other equivalent measures regulating trade in agricultural goods intended to be sold at the territory of the other Party.

In our assessment of potential effects on business, we should note that since Ukraine employs no export subsidies, this obligation will not change status quo in the agricultural product trade. At the same time, cancellation of EU export subsidies for manufacturers of agricultural products exported to Ukraine will make competitive conditions between Ukrainian and European manufacturers even, this will make it possible to partially compensate for the effect of import duty reduction.

For households, cancellation of export subsidies for EU agricultural products might cause certain raise of their prices at the Ukrainian market, though this factor will be gradually smoothed over by reduction of import duties by Ukraine and due to enhancement of competitive positions of national manufacturers.

For the state, cancellation of EU export subsidies will mean increase in costs of agricultural goods imported from EU which, with other conditions being equal, will mean growth of budget receipts [2].

This Agreement doesn't prevent from maintaining or forming customs unions, free trade areas or border trade arrangements, except when they come into conflict with trade arrangements outlined in this Agreement.

The Parties are entitled to give advice on matters related to execution of agreements with other states to address Ukraine's and EU's mutual interests.

At the same time, to date, R&D organizations have carried out the following studies upon request of the Ministry of Economy to assess effects of FTA formation:

- “The Prospect of Deep Free Trade between the European Union and Ukraine”, Center for European Policy Studies, Institute for the World Economy and Center for International Prospective Studies (CEPS model) [3];

- “Analysis of Prospective Trade Relations between Ukraine and EU in the Frame of Negotiations Concerning Extended Agreement” ECORYS and Center for Social and Economic Research (CASE model) [4];

- “Investigation of Economic Preconditions and Assessment of Possible Consequences of Free-Trade Area Creation between Ukraine and the EU”, Institute for Economic Research and Policy Consulting (IER model) [2].

In general, despite a great difference between assessed scales of effects from liberalization of trade with EU, all models give positive evaluation to its consequences for the welfare of the Ukrainian people. Maximum growth of welfare will be achieved subject to the deepest integration with the EU free market. The key constituent of Ukraine’s trade policy capable of improving the welfare significantly turned out to be reduction of non-tariff barriers, as import duty rates are low and cancellation thereof will have no perceptible effect on the Ukrainian policy in general. If all the three models explicitly give positive evaluation to the effect of liberalization of the EU-Ukraine trade on Ukrainian economy, those evaluations substantially differ for its individual sectors. The reason therefore may lie in a system of hypotheses as to the scope of changes in tariff and non-tariff barriers and export and import, as well as in various base years used in the models.

Tab. 1 presents evaluations of FTA formation effects for the major industries of Ukraine by each of the above models.

The most solid is analytical study “Effect from Formation of the EU-Ukraine Free Trade Area on Ukrainian Economy” developed by the Center for International Prospective Studies in 2013.

Assessment of economic impact of Ukraine-EU FTA formation was developed on a variant basis according to three scenarios:

Scenario 1 – reduction of tariff restrictions.

Scenario 2 – reduction of tariff and non-tariff restrictions.

Scenario 3 – reduction of tariff and non-tariff restrictions and increase in inflow of investments to the most attractive Ukrainian industries [5].

**Tab.1. Influence of the Free Trade Area on Output Volume of the Major Ukrainian Industries**

Industry	IER		CEPS		CASE	
	FTA	FTA+	FTA	FTA+	FTA	FTA+
Agriculture	1.3%	2.2%	-8.6%	-22.6%	-1.4%	-0.5%
Mining Industry	10.1%	10.6%	-7.3%	-47.6%	-2.2%	-3.6%
Food Industry	-13.2%	-15.7%	34%	55.2%	-4.6%	8.1%
Metallurgy	10.3%	10.6%	54.1%	93.1%	4.1%	8.2%
Textile Industry	55.4%	56%	22.4%	34.2%	27.3%	50.4%
Engineering	-13.1%	-14.8%	13.9	29%	13.3%	20.2%

Source: authors elaboration on the basic [2, 3, 4].

According to Scenario 1, results of the calculations suggest that, with other conditions being equal, the expected effect from reduction of customs duties both for Ukraine and for the EU member-states on the Ukrainian economy will be insignificant both in general, and on individual economic activities. In short-to-medium terms, new opportunities for export of domestic products to the EU states will be formed due to reduction of tariff barriers for the EU market access. However, given the high level of high-quality production in the EU and because of limitation of its own resource base (the EU is a net importer of diverse raw and semi-raw products), Ukraine will have certain advantages in respect of trade in raw products and materials, in other words only products with low portion of added value (in particular, plant products, oils and fats, non precious metals and products made of them, mineral and food products).

As a result, increase in the scope of export and, consequently, production, is expected, mainly in such foreign trades as agriculture, food and light industries [5].

According to Scenario 2, results of the calculations suggest that, with other conditions being equal, the expected effect from reduction of non-tariff barriers will be greater than from tariff regulation both in general, and on certain economic activities. Reduction of losses caused by antidumping investigations and relaxation of tariff barriers for export of domestic products to the European markets will contribute to increase in scopes of export against a backdrop of distribution area expansion. The

agroindustrial sector and textile industry will enjoy the greatest advantages. Engineering and metallurgy will enjoy fewer benefits; their production operations and active growth of foreign trade volumes will be stimulated, just as in Scenario 1, by the level of competitive capacity of the domestic products [5].

As with the two above scenarios, in Scenario 3 the driving factor of additional increase in domestic product manufacturing volume will be reduction in tariff and non-tariff restrictions, in other words liberalization of access to the European markets. Though, the national economy will get the greatest benefits under this scenario from active expansion of the investment demand. This very factor will generate fast pace of growth as compared to the previous two scenarios. Direct foreign investments from the EU member-states to Ukraine are predominantly aimed at metallurgical production and financial activity, and at real estate transactions.

However, this scenario suggests that in presence of manufacturing activity, growth of internal demand, in particular, investment demand, will be met mainly by the imported products, meanwhile the domestic industrial production will be aimed at export. If domestic enterprises supply predominantly raw products with low degree of treatment to the external markets, they will import primarily high-performance products, analogues of which are not manufactured in Ukraine, or are far behind the foreign ones. In midterm, those processes will gradually fade, given the extensive modernization of and structural shifts in the economy. Inflow of financial resources in the form of investments will create conditions for improvement of technical and technological situation of the domestic industrial complex and for enhancement of competitive capacity of Ukrainian economy [6].

The main reason for differences between assessments of impact of free trade with the EU on the Ukrainian economy in general and its main industries in particular lies in different scenarios of Ukraine's integration to the EU market and different hypotheses as to the trade policy configuration. This gives grounds for the statement that liberalization with the EU trade will undoubtedly have a positive effect on the Ukrainian economy and growth of its welfare.

Full-scale implementation of the EU-Ukraine Deep and Comprehensive Free Trade Area (DCFTA) will result in cumulative increase in the actual GDP by 14.1% in long term. Those are updated results of DCFTA formation impact modeling based on the applied general equilibrium model.

The study was conducted in 2014 by the Institute for Economic Research and Policy Consulting (IER) within “Influence of Deep and Comprehensive Free Trade Area between Ukraine and the EU on Various Population Categories: Micromodeling Based on Applied General Equilibrium Model” with financial support from the International Renaissance Foundation. Calculations based on the new statistic base (2012) and updated details of the arrangements subject-matter proved the positive effect from DCFTA formation with the EU once again [6].

As before, the key factor for GDP growth is reduction of non-tariff restrictions in the trade which will be achieved due to harmonization of the Ukrainian legislation with the European legislation, rather than cancellation of import duties.

**Discussion of results.** Analysis of DCFTA formation impact suggests that though all categories of households benefit from DCFTA formation, those benefits are distributed non-homogeneously. In particular, the gap between poor and non-poor households is the most obvious (these are the non-poor households who will feel relatively better), and depending on a number of people within that household (those with more than three persons will benefit less).

At the same time, it should be mentioned, that the free-trade mode is being introduced within the Deep and Comprehensive Free Trade Area in “FTA+” format with special focus on regulatory collaboration, reforms aimed at preparing the internal market for operation in enhanced competition should be carried out in Ukraine. For this purpose, the Ukrainian Government is taking steps to harmonization of the national legislation and necessary institutional changes which will facilitate improvement of the Ukrainian economy’s competitive capacity within the EU-Ukraine Single Economic Space.

**Conclusions.** Ukraine-EU integration has been a priority for the external policy of our state since proclamation of its independence. However, analysis of

preconditions for transitions from the international cooperation to the brand new level of international economic relations – initial or even preliminary stage of trade and economic integration – requires major changes of respective economic preconditions, because Ukraine is not capable of assuming obligations of the EU member-state in legislative, economic or institutional terms.

It is obvious, that arrangements made in the outlined areas of negotiations will become de-facto a roadmap of the domestic economy reformation.

It won't be exaggeration to say that the Ukraine-European Union Association Agreement is the major large-scale package of arrangements in the history of the independent Ukraine. The economic part of the Agreement, in one way or another, covers main areas and industries of the economy. The very fact that the Parties reached an agreement upon such a diverse set of actions in terms of subject matter and number of mutual arrangements proves that Ukraine and the EU strongly intent not only to shift their collaboration to the brand new level, but to bring the Ukrainian economic system closer to the EU's economic system based on mutual liberalization, primarily, flow of commodities, capitals and services, harmonization of approaches and principles which underlie industrial policies and systems regulating manufacturing and business activities.

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