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Ukraine's Economic Benefits from Integration Into the Euro-Atlantic Community

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"The heart of Europe is in Ukraine and Europe cannot live without its heart."¹ These words, spoken by Ukrainian President Viktor Yushchenko in London in 2005, summarize the relationship between Ukraine and Europe. Europe and its humanistic tradition have always been central to Ukrainian civilization, and Ukraine has been indispensable for Europe. Again, Yushchenko said it best, during his 2005 inaugural address, "Our way to the future is the way of a united Europe. We, along with the people of Europe, belong to one civilization. We share similar values. Our place is in the European Union. We are no longer on the edge of Europe. We are situated in the centre of Europe."²

As the geographical center of Europe,³ Ukraine has an historic desire to integrate into the Euro-Atlantic community. Ukraine was the first post-Soviet state to express the intention of joining the European Union (EU).⁴ Yet not everyone in Ukraine understands the benefits of such integration. For example, according to a 2003 survey, of the 93 percent of Ukrainian citizens who indicated that entering the European Union would be useful for Ukraine, only half were able to explain what the benefits of such integration might be.⁵

Integration into the EU

The European Union presents huge market opportunities. Its 450 million consumers together comprise 27 percent of the world's gross domestic product (GDP). The EU accounts for about 18 percent of the world's trade in goods, and about 24 percent of its

Talking Points

- Europe and its humanistic tradition have always been central to Ukrainian civilization, and Ukraine has been indispensable for Europe.
- The European Union has become Ukraine's largest trading partner. Ukraine will benefit from EU integration through two main mechanisms. First, Ukraine will benefit from joining a single market. Second, it will benefit from a cohesive customs union.
- Ukraine's accession to the World Trade Organization (WTO) will bring protection from unfair and monopolistic competition, including protection against dumping and against unfair trade barriers such as those created by cartels.
- Ukrainian integration into the Atlantic and European community must start at home. Regardless of whether Ukraine ultimately joins the European Union or the WTO, it will benefit from those extensive domestic reforms, as Turkey has done on its path to European integration.

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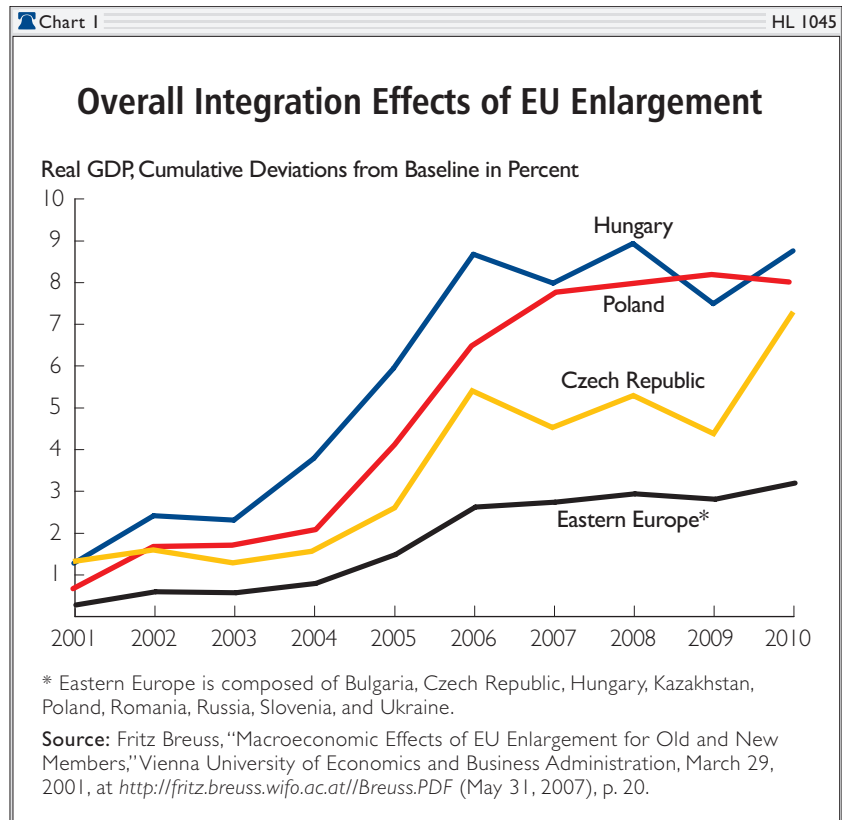
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trade in services. Because of its geographical and cultural proximity, the EU would be the first market of impact for Ukraine at every stage of its integration into the Euro-Atlantic community.

Ukraine has already begun to reap the benefits of integration. Ukraine's total trade with the European Union has steadily grown since 1998. Following the 2004 enlargement, the EU has become Ukraine's largest trading partner. In 2005, the EU accounted for about 32 percent of Ukraine's total trade.⁶ In 2005, Ukraine exported €7.7 billion of goods and services to the 25 countries of the European Union, and imported €13 billion.⁷ By 2006, Ukraine's total trade with the 27 EU members was €28 billion. These economic benefits are significant, and they will only grow with further integration.

Here is an example of how other Eastern European countries have integrated into the EU. Chart 1 shows the real GDP, in terms of cumulative deviations from zero, of Hungary, Poland, and the Czech Republic, which joined the European Union in 2004. Although they had been outperforming EU economic growth before accession, after accession their performance reached much higher levels. Their integration, by the way, also benefited Ukraine. As a result of the 2004 enlarge-



ment, tariffs on Ukrainian exports into the EU decreased from 9 percent to 4 percent on average.⁸ So when Central European countries join the Euro-Atlantic community, Ukraine benefits.

Ukraine will benefit from EU integration through two main mechanisms. First, Ukraine will benefit from joining a single market. Second, it will benefit from a cohesive customs union.

1. "Yushchenko: 'The Heart of Europe Is in Ukraine,'" *Pravda*, October 17, 2005, at <http://newsfromrussia.com/world/2005/10/17/65426.html> (June 1, 2007).
2. Askold Krushelnicky, "Yushchenko Puts Ukraine at the Heart of Europe as He Takes Presidential Oath," *The Independent* (London), January 24, 2005, at http://findarticles.com/p/articles/mi_qn4158/is_20050124/ai_n9697494 (June 1, 2007).
3. Ministry of Foreign Affairs of Ukraine, "Ukraine Info," at www.mfa.gov.ua/main/en/29.htm (May 31, 2007).
4. Kataryna Wolczuk, "Integration Without Europeanization: Ukraine and Its Policy Towards the European Union," European University Institute *Working Papers*, RSCAS No. 2004/15 (October 2004), at www.eui.eu/RSCAS/WP-Texts/04_15.pdf (May 31, 2007).
5. *Ibid.*, p. 9.
6. European Commission, "EU-Ukraine Relations," at http://ec.europa.eu/external_relations/ukraine/intro/index.htm (June 1, 2007).
7. *Ibid.*
8. European Commission's Delegation to Ukraine, "The EU's Relations with Ukraine—Present State and Future Prospects," at www.delukr.ec.europa.eu/page36474.html (June 1, 2007).

EU: A Single Market

Let us look at the single-market effect. First, and most substantially, there are positive trade effects. Abolition of existing tariffs will reduce final product costs by an estimated 5 percent to 10 percent.⁹ This presents a significant advantage. Lower costs will attract more trade, and the increased trade flow will more than make up for the loss of domestically captured tariff revenue, which the government kept for itself in the first place.

Second, Ukrainian businesses and foreign businesses in Ukraine will become more efficient and more price competitive. Companies will be able to choose their workers from a larger and more diverse workforce, increasing productivity due to economies of scale. The lowered transaction costs will attract competition into Ukraine and force Ukrainian firms to improve quality and lower prices, operating closer to at-cost levels.

Finally, there are economic benefits to having a single business environment. When manufacturing companies in the 27 EU member countries produce goods according to the same standards, that means less red tape, a smaller regulatory burden, and faster consumer adaptability.

Table 1 shows how other Eastern European countries have gained from joining the EU single market.¹⁰ These studies estimate that Eastern European countries have received welfare gains of anywhere from 3.4 percent to 18.8 percent of GDP.

The latest survey among EU members prior to the 2004 accession¹¹ shows that many components

Table 1		HL 1045
Single Market Benefits		
Study	Elements of Single Market	Estimated Benefit from Single Market, Percentage of GDP
Baldwin et al. (1997)	All	CEEC-7*: 1.5–18.8 (the more optimistic case involves reduction of risk premium) EU-15: 0.2
Lejour et al. (2001)	All	Hungary: 9 Poland: 5.8 CEEC-7*: 5.3 EU-15: 0–0.17
Maliszewska (2004)	Common external tariff; Elimination of border costs and delays; Reduced cost of compliance with national standards and regulations	Hungary: 7 Poland: 3.4 EU-15: 0–0.17

* The CEEC-7 countries are Poland, Hungary, Czech Republic, Slovak Republic, Slovenia, Bulgaria, and Romania.
Source: Magorzata Jakubiak and Anna Kolesnichenko, eds., "Prospects for EU–Ukraine Economic Relations," Center for Social and Economic Research, Report No. 66 (2006), p. 67.

of the single market had a positive effect on business: The elimination of customs documentation was reported to be the most beneficial (48 percent of respondents said it had a positive effect on business); followed by the abolition of border controls (42 percent); the harmonization of value-added tax procedures for sales within the EU (34 percent); and the harmonization of European product standards (33 percent).¹²

EU: Customs Effects

If the single market means common regulations, then the Common Commercial Policy, (CCP), means common defense of those regulations. The CCP establishes a single set of rules and regulations,

9. *Ibid.*, p. 6.

10. Magorzata Jakubiak and Anna Kolesnichenko, eds., "Prospects for EU–Ukraine Economic Relations," Center for Social and Economic Research, Report No. 66 (2006), p. 67.

11. The EU-15 are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

12. Jakubiak and Kolesnichenko, "Prospects for EU–Ukraine Economic Relations," p. 73.

a single tariff against non-EU countries, and a single set of administrative procedures. This produces further harmonization, further cost reduction, and a better overall business environment.

The impact of Ukrainian integration on Ukrainian–Russian relations is uncertain. On the one hand, Russia would prefer to maintain as much control over Ukraine as possible, and therefore disapproves of any Ukrainian overtures towards the West. On the other hand, Ukraine may gain a more favorable bargaining position vis-à-vis Russia if it allies itself more closely with the West. It will certainly be in the EU’s interest to provide Ukraine with political capital, since Ukraine is the primary route for Russian gas exports into Europe. Certainly Russia prefers economic integration, such as Ukraine joining the EU, over military integration, such as Ukraine joining NATO. Russian President Vladimir Putin said in 2004 that “Ukraine’s incorporation into the EU would be a more positive factor than NATO expansion.”¹³

Accession to the WTO

Like the Common Commercial Policy of the European Union, accession to the World Trade Organization (WTO) will bring protection from unfair and monopolistic competition, including protection against dumping and against unfair trade barriers such as those created by cartels. It will also bring the following economic gains specific to the WTO structure.

Most Favored Nation. First, Ukraine will gain for itself, and will have to grant others, Most Favored Nation status. This means Ukraine will abolish all kinds of quantitative restrictions with its trading partners, specifically with European Union members.

Customs. Second, import and export procedures will become easier as Ukraine complies with WTO agreements on customs valuation, rules of origin, and import licensing. Easier trade rules mean faster, and ultimately cheaper, transit.

Non-Tariff Barriers. Third, non-tariff barriers will be removed. These are burdensome technical

requirements, sanitary measures, unnecessary certifications, and more. The economic impact of non-tariff barriers is always hard to quantify, but these barriers undoubtedly increase the time and cost of trade and other business transactions.

National Treatment. Fourth, Ukraine will have to grant national treatment for commodities and services originating abroad. This means that any foreign product entering Ukrainian territory will be treated as though it were a Ukrainian product. This eliminates any possibility of imposing intra-state (within state) tariffs.

Quantifying Benefits. Comprehensive research of the effect of WTO accession—specifically the reduction of import tariffs, improved access of Ukrainian companies to external markets, and elimination of subsidies—indicates an increase in social welfare of 3 percent, and additional GDP growth of 1.9 percent per year.¹⁴ Table 2 shows a summary of empirical studies that predict the welfare gains to Ukraine and the EU from the economic liberalization of trade between the two. Accession to the WTO gives Ukraine a welfare gain of anywhere from 1.1 percent to 1.9 percent of GDP. Establishing a free trade agreement indicates a welfare gain of 4 percent to 7 percent.

Economic Benefits of Energy Independence

Geopolitical constraints prevent Ukraine from ever achieving absolute energy independence. However, economic and political integration into the Euro-Atlantic community promises greater political leverage in negotiations with major energy exporters, especially Russia. Three basic facts determine Ukraine’s desire for energy independence.

First, the Ukrainian economy is highly dependent on energy. Coal and ore mining, chemical refining, and electricity production constitute 60 percent of GDP.¹⁵ Ukraine consumes on average 73–75 billion cubic meters of gas a year.¹⁶ Ukrainian energy consumption is 2.3 times higher than that of countries with similar GDPs in the region.¹⁷

13. “Russia Welcomes Ukraine’s EU Membership: Ukraine’s Incorporation Into the European Union To Be a Positive Factor,” *Pravda*, December 16, 2004, www.cdi.org/russia/335-7.cfm (June 1, 2007).

14. Jakubiak and Kolesnichenko, “Prospects for EU–Ukraine Economic Relations,” p. 73.

Table 2

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Welfare Gains from Liberalization of EU–Ukraine Trade

Study	Gains for the EU (percentage change of national income)	Gains for Ukraine (or former Soviet Union) (percentage change of national income)	Notes
WTO Accession			
Ukraine* (Eremenko and Lisenkova, 2004)	n/a	Welfare gain of 1.1 percent of GDP from bringing the steel production to WTO rules—elimination of subsidies and opening for external markets	
Ukraine (Pavel et al., 2004)	n/a	Welfare gain of 1.9 percent of GDP (consumption up 3 percent)	Full WTO membership: tariff reductions (including agricultural goods), better market access for Ukrainian products, removal of distorting domestic subsidies
EU–Ukraine Free Trade Agreements			
Ukraine (CEPS, 2006)	Negligible	Negligible	Typical EU FTA
Ukraine (CEPS, 2006)	Negligible	4–7 percent welfare gain through lowering of non-tariff barriers to trade	“Deep” EU–Ukraine FTA
Former Soviet Union (Vinhas de Souza, 2004)	Welfare improving and negligible increase in production	Welfare improving and 0.2 percent increase in production	

*Slightly different approach; partial equilibrium analysis.

Notes: Table contains references to static welfare gains.

Source: Magorzata Jakubiak and Anna Kolesnichenko, eds., “Prospects for EU–Ukraine Economic Relations,” Center for Social and Economic Research, Report No. 66 (2006), p. 67.

Further, Russia is pursuing a strategy to diversify its supply routes to Europe. Its Blue Stream gas pipeline will circumvent Ukraine. So will its Nord Stream gas pipeline to Germany, which will also bypass the Czech Republic, Belarus, Slovakia, and Poland.

Second, energy costs are rising. As of January 1, 2007, the average price for gas in Ukraine increased 70 percent. With transportation fees and shipping fees, the average price for enterprises and businesses is \$160 per 1000 cubic meters.¹⁸ Energy costs

will continue to rise as Russia consolidates its monopoly on oil and gas and exercises its monopoly power to raise prices.

Third, Ukraine’s energy supply is heavily concentrated. Therefore, Ukraine needs to diversify its energy supply. Integration into the Euro-Atlantic community will provide Ukraine with the political muscle to improve its economic situation. It will be better situated to negotiate with Russia—as a European country, not a former Soviet puppet.¹⁹

15. “Ukraine’s Economic Rise,” Carnegie Endowment for International Peace, January 31, 2007, www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=968&prog=zru (May 31, 2007).

16. *Ibid.*

17. *Ibid.*

18. *Ibid.*

19. *Ibid.*

A good example of possible Ukrainian energy diversification is the Georgia–Ukraine–European Union gas pipeline project through the Black Sea.²⁰ The GUEU project would use the Ukrainian transit network’s spare capacity to deliver Caspian gas to Ukraine, Poland, and beyond.

Domestic Reform

Ukrainian integration into the Atlantic and European community must start at home. Regardless of whether Ukraine ultimately joins the EU or the WTO, it will benefit from those extensive domestic reforms, as Turkey has done on its path to European integration.

During the period between 1998 and 2004, the EU granted Ukraine €838 million of technical assistance. Of that, approximately €500 million was directed for the development of civil society, economic reforms, regional development, education, and other priority areas.²¹ Monetary assistance is one way Ukraine gains from economic and political reforms. The outcomes of the actual reforms present other, more important, gains.

Turkey is a perfect model for the benefits of the political reforms required to join the European Union. Thus far, Turkey has adopted a new, better criminal code, allowed for greater freedom of speech, and increased the rights of its Kurdish minority.²² Further,

Turkey’s economic benefits from recent market reforms include “a GDP growth rate exceeding 8 percent and low inflation.”²³

Conclusion

In summary, on whatever other issues the Ukrainian people find themselves divided, they must stand united on the issue of integration into the Euro-Atlantic community. The economic benefits of such integration are obvious: The closer Ukraine moves towards the West, the better off its citizens will be. Even the road towards integration—political and economic reforms—strengthens the country and its welfare.

For a long time now, Ukraine has wavered between a Western and an Eastern orientation. But Ukraine’s true home lies in the West, in Europe. And Ukraine must come home.

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20. Vladimir Socor, “Trans-Black Sea Pipeline Can Bring Caspian Gas to Europe,” *Eurasia Daily Monitor*, December 7, 2006, www.jamestown.org/edm/article.php?article_id=2371712 (June 1, 2007).

21. See Jakubiak and Kolesnichenko, “Prospects for EU–Ukraine Economic Relations.”

22. Esther Pan, “Turkey’s EU Bid,” Council on Foreign Relations, September 30, 2005, at www.cfr.org/publication/8939/turkeys_eu_bid.html#6 (June 1, 2007).

23. “Connecting Regions—Creating New Opportunities,” World Economic Forum in Turkey, November 2006, at www.weforum.org/pdf/Turkey/Programme.pdf (September 25, 2007).