



# Should Ukraine become part of the EU's customs union?

## An assessment

**Ricardo Giucci, Veronika Movchan**

German Advisory Group in cooperation with the IER Kyiv

Berlin/Kyiv, March 2018

# Summary 1/2

---

**Current proposal:** Ukraine should become part of the EU customs union (despite not having a clear perspective for EU membership)

**Implication:** impact on trade with EU, but also on trade with third countries

## **Impact on trade with EU (ca. 41% of trade of Ukraine)**

- Positive impact due to cost elimination for border controls and for complying with rules of origin; but also due to removal of tariff rate quotas in agrofood
- However: this positive impact can to a large extent be achieved by customs reform and other measures

## **Impact on trade with third countries (ca. 59% of trade of Ukraine)**

- **Import-export-asymmetry:** Ukraine would have to open its market to EU preferential partners, without enjoying duty free access to these countries
- **End of free trade deals:** Ukraine would have to discontinue its existing free trade agreements, including with CIS partners such as BLR and, KAZ

➤ **Highly problematic features both in economic and political terms**

# Summary 2/2

## Overview of impact on trade with third countries

UKR \ EU	FTA partners	GSP partners	MFN partners
FTA partners	Group 1: EX ↓, IM constant	Group 3: EX ↓, IM ↓	Group 5: EX ↓, IM ↓
MFN partners	Group 2: EX constant, IM ↑	Group 4: EX constant, IM ↑	Group 6: EX constant, IM ↓

Source: BE calculations

➤ Clear negative impact on exports

**Conclusion:** qualitative analysis reveals problematic features of proposal; negative net impact on Ukraine's overall trade; not advisable

### Relevant experience so far

- The only non-EU member which belongs to the EU customs union is Turkey
- Reason: preparatory step for EU accession, which got stuck; historic accident
- There must be a reason, why other European countries don't use this instrument

### Policy recommendations

- Continuation of DCFTA implementation, which is quite challenging
- Further use of FTA instrument for promoting trade with other countries

# Structure

---

1. Starting point
2. Impact on trade with EU and investment from the EU
  - 2.1 Impact on trade with EU
  - 2.2 Impact on FDI from the EU
3. Impact on trade with third countries
4. Overall impact on Ukrainian trade
5. Political considerations in Ukraine
6. The EU perspective
7. Recommendations

Annexes

# 1. Starting point

---

## **Current proposal**

- Proposal by Ukraine at the Eastern Partnership Summit on Nov 2017 in Brussels: Ukraine should join the EU's customs union

## **Goals of this policy briefing**

- What would be the implications for Ukraine of a change in the trade regime with the EU?
- Are there better ways to pursue the goal of stronger integration with the EU?
- Does the measure make sense without a concrete perspective of EU membership?

## **Scope of measure: impact on economic relations with the EU and with third countries**

- At first sight: joining EU's customs union relates only to relations with EU
- However: this is not correct, joining a customs union has also major implications on trade with third countries

## 2.1 Impact on trade with the EU

---

- EU is the largest trade partner of Ukraine:
  - Exports of goods – USD 17.5 bn or 40.5% (2017, Ukrstat)
  - Imports of goods – USD 20.8 bn or 41.9% (2017, Ukrstat)
- Main trade-related factors affected by joining the EU's customs union:
  - i. Cost of customs clearance
  - ii. Cost of compliance with the rules of origin (ROO) requirements
  - iii. Full liberalization of trade in goods

## i. Cost of customs clearance

---

- Joining the EU's customs union would reduce/abolish the cost of custom clearance with the EU and thus have a positive impact on trade with the EU; this is clearly a positive feature
- However: there are other ways to significantly reduce the cost of customs clearance in general and in particular with the EU
- Concretely: by further reforming customs and continuing the implementation of the DCFTA
- **Key question:** how much room does Ukraine have to reduce this cost via reforms?
  - WB Doing Business 2018, “Trading across borders”: 119 out of 190 countries (see Annex 1)
  - Logistics Performance Index 2016: 80 out of 160 countries (see Annex 2)
  - OECD Trade Facilitation Indicators 2017: score 1.00 in range 0 to 2 (see Annex 3)

**Conclusion:** vast room for lowering cost of customs clearance via reform according to all relevant indices

## ii. Cost of compliance with the rules of origin

---

- Today: use of DCFTA requires the compliance with rules of origin (ROO); DCFTA does not eliminate these costs
- But: joining the EU's customs union would eliminate such cost; positive feature
- Quantification of cost: based on international studies, the costs of ROO compliance could be 2-6% of the export value; costs tend to be higher for producers using imported intermediate materials
- However: cost of ROO compliance can be significantly reduced by other means
- Concretely: membership in Pan-Euro-Mediterranean Convention on the rules of origin, envisaged in the DCFTA, allows diagonal accumulation among member countries and thus reduces the ROO compliance costs

**Conclusion:** the cost of compliance with rules of origin can also be reduced significantly, without joining the EU's customs union



### iii. Full liberalization of trade in goods

---

- EU-Ukraine DCFTA contains exemptions from a free trade regime for selected products:
  - EU: tariff rate quotas and entry price regulations
  - Ukraine: tariff rates quotas and non-zero final import duties
- Establishing the EU's customs union that covers agricultural products will remove these restrictions; positive feature
- But: these restrictions could be removed within the DCFTA (Art. 29 of the Agreement)

**Conclusion:** the market access could be improved significantly without joining the EU's customs union

## 2.2 Impact on FDI from the EU

---

- Joining the EU's customs union would reduce/abolish the cost of customs clearance and the cost of ROO; positive feature
- For which kind of foreign investors is this relevant? Mainly for those interested in producing in Ukraine, but selling elsewhere (incl. EU); industrial investors
- However: main impediment for FDI in Ukraine is not the trade regime with the EU, but the difficult business climate, despite recent reforms; this view is widely supported by interviews with foreign investors
- Thus: structural reforms and a better business climate would most likely have a much stronger effect on FDI from the EU

**Conclusion:** change in trade regime would have a positive impact on FDI from the EU, but the improvement of the business climate would have a much stronger effect on FDI. Thus, the advantages of joining the EU's customs union regarding investment can to a large extent be achieved via structural reforms

### 3. Implications on trade with third countries

Participation of Ukraine in EU's customs union does not only impact trade with EU members, but also with third countries → six groups of countries

Group	Description	Examples	EX share, 2017, %	IM share, 2017, %
<b>Group 1</b>	Countries that have FTAs with both the EU and Ukraine	Moldova, Georgia, EFTA , Canada	4%	5%
<b>Group 2</b>	Countries that have FTAs with the EU, while Ukraine applies MFN	South Korea, Egypt, Israel, Chile, Mexico, Turkey	17%	5%
<b>Group 3</b>	Countries to which the EU provides unilateral preferences and that have Ukraine's FTA	Kyrgyzstan, Tajikistan, Armenia	1%	0%
<b>Group 4</b>	Countries to which the EU provides unilateral preferences, while Ukraine applies MFN duties	Botswana, India, Indonesia, Kenya, Afghanistan	12%	4%
<b>Group 5</b>	Countries to which the EU applies MFN, while Ukraine has FTA	Belarus, Kazakhstan	4%	8%
<b>Group 6</b>	Countries to which both the EU and Ukraine applies MFN	USA, Japan, China, Russia (now)	22%	36%
<b>TOTAL</b>			<b>60%</b>	<b>58%</b>

Source: BE calculations

→ Analysis has to take into account the impact on trade with third countries

# Trade with countries that have FTAs with both EU and Ukraine (Group 1)

---

- If Ukraine were to join the EU customs union, it would have to discontinue its existing FTA's
  - EFTA, Montenegro, Macedonia, Canada, Moldova, Georgia
- At the same time: EU's FTAs with third countries would not apply to Ukraine, because of not being a EU member
- Thus: immediate negative impact on exports
- But: Ukraine will keep its market open for goods from these countries thanks to the EU's FTAs
- Thus: no impact on imports
- Re-negotiation of FTA is possible, but will require time and resources
- Short-term: asymmetry and thus negative impact
- Long-term: depends on the success of Ukraine in renegotiations

**Conclusion:** asymmetry in the short term; negative feature

# Trade with EU's preferential partners that have no FTA with Ukraine (Groups 2 and 4)

---

- Ukraine would have to open up its market for goods from EU's preferential partners (the degree of opening would depend on the preferences provided by the EU) → increase in imports
- But: no automatic reciprocal access to the markets of these countries → no change in exports
- This would later on also apply for future FTA's from the EU, e.g. with China, Mercosur, Japan or USA
- In short: "Obligations, but no rights"
- Possible: conclusion of FTAs between Ukraine and EU FTA partners
- However: Ukraine would be in a very weak position, since it is obliged to open its market anyway; thus, poor results to be expected from negotiation

**Conclusion:** strong asymmetry; imports would increase, while export would not change; highly problematic feature

# Trade with Ukraine's FTA partners that have no FTAs with the EU (Groups 3 and 5)

---

- Ukraine would have to discontinue existing FTA's with CIS countries:
  - Armenia, Belarus, Kazakhstan, Central Asian countries, Azerbaijan
- Re-negotiation is not possible unless the EU concludes a FTA with the country
- Impact on exports: decrease due to discontinuation of duty free regime
- Impact on imports: decrease, the impact will depend on the existence of EU unilateral preferences for these countries:
  - Low impact for countries eligible to GSP/GSP+ (e.g. Armenia)
  - High impact for countries with no EU preferences (e.g. Kazakhstan)
- Thus: less trade with traditional partners in the CIS
- Also: Ukraine will not be able to negotiate FTAs with countries that don't have or negotiate FTAs with the EU

**Conclusion:** discontinuation of free trade; negative impact

# Trade with countries that have MFN with both EU and Ukraine (Group 6)

---

- Increase in import weighted MFN average tariff (2017) from 2.5% to 3.1% due to joining the EU's customs union → decrease in imports
- Change in import weighted MFN average tariff (2017) for the largest partners:
  - Russia: from 1.9% to 2.5%
  - China: from 3.0% to 3.4%
  - USA: from 2.4% to 2.7%
  - Japan: from 6.2% to 6.6%
- Thus: increase in average import tariffs and less imports from MFN partners → negative impact on internal production
- At the same time: Ukraine faces no change in access to markets of these countries
- Thus: no impact on exports

**Conclusion:** less trade with important partners

## 4. Overall impact on Ukrainian trade

### Overview of impact on trade with third countries

UKR \ EU	FTA partners	GSP partners	MFN partners
FTA partners	Group 1: EX ↓, IM constant	Group 3: EX ↓, IM ↓	Group 5: EX ↓, IM ↓
MFN partners	Group 2: EX constant, IM ↑	Group 4: EX constant, IM ↑	Group 6: EX constant, IM ↓

Source: BE calculations

**Here:** no quantification of net impact using a model

**However:** qualitative results are quite clear

- Trade with EU: positive impact
- Trade with third countries: negative impact

**Ukraine trade structure:** EU ca. 41%, third countries 59%

→ Qualitative results suggest a clear worsening of the situation for Ukraine in case of joining the EU customs union

→ **Participation in EU customs union without a clear perspective for EU membership doesn't seem to be a good idea**



## 5. Political considerations in Ukraine

---

- Joining of EU CU seen by some politicians as a symbol of EU approximation
- However: soon after a hypothetical joining of EU CU, resistance from business and political parties will certainly pop up
- This would lead to critical voices claiming:
  - “Duty free access to our market, but no duty free access to many markets; this is unfair and needs to be renegotiated”
  - “Deal is bad for Ukraine and needs to be changed or cancelled”
  - “The EU forced Ukraine to discontinue free trade with CIS partners; asymmetry of the deal shows the arrogance of the EU”

**Thus:** business lobby and political pressure will try to cancel any deal

**Conclusion:** deal might not last for long; unsustainable deal

## 6. The perspective of the EU

---

### **Possible argumentation by EU Commission (not official view)**

- Ukraine has lots of homework to do in the context of DCFTA
- Implementation started well, but currently major challenges to DCFTA
- Example: protectionist “buy Ukrainian, pay Ukrainians” draft law
- Thus: “Let’s wait for the DCFTA implementation and look further afterwards”

**Also:** EU Commission would be concerned about the reputational implications

- Deal is clearly not in the interest of Ukraine; especially: asymmetry
- So the question will be: “Why did the EU sign this deal?”
- Or even: “Why did the EU force Ukraine to sign such a deal?”

**Conclusion:** for different reasons, the EU Commission is likely not to be interested in such a deal

## 7. Recommendations

---

- Goal of intensifying economic ties with the EU makes a lot of sense
- However: joining the EU's customs union without an EU membership perspective seems as not the right instrument to achieve this goal
- Why not? Because there are ways to achieve similar positive results, without the highly problematic negative “side effects”
- Concretely: a continuation of the reform of the Customs Service, the implementation of Pan-Euro-Med Convention and of the implementation of measures to improve the business climate would lead to a clear intensification of trade and investment with the EU; at the same time, it would have no negative impact on trade with third countries
- Thus: policy focus should be on reforms, not on trade regime; the problem in Ukraine is not the trade regime with the EU (which is actually pretty good!), but customs and business climate

**Recommendation:** economic policy should continue focusing on structural reforms. Changes in the trade regime are no substitute for economic reforms



German  
Advisory Group  
Ukraine

## Contact

Berlin  
Economics

### Dr Ricardo Giucci

[giucci@berlin-economics.com](mailto:giucci@berlin-economics.com)

### Veronika Movchan

[movchan@ier.kiev.ua](mailto:movchan@ier.kiev.ua)

German Advisory Group

c/o BE Berlin Economics GmbH

Schillerstr. 59, D-10627 Berlin

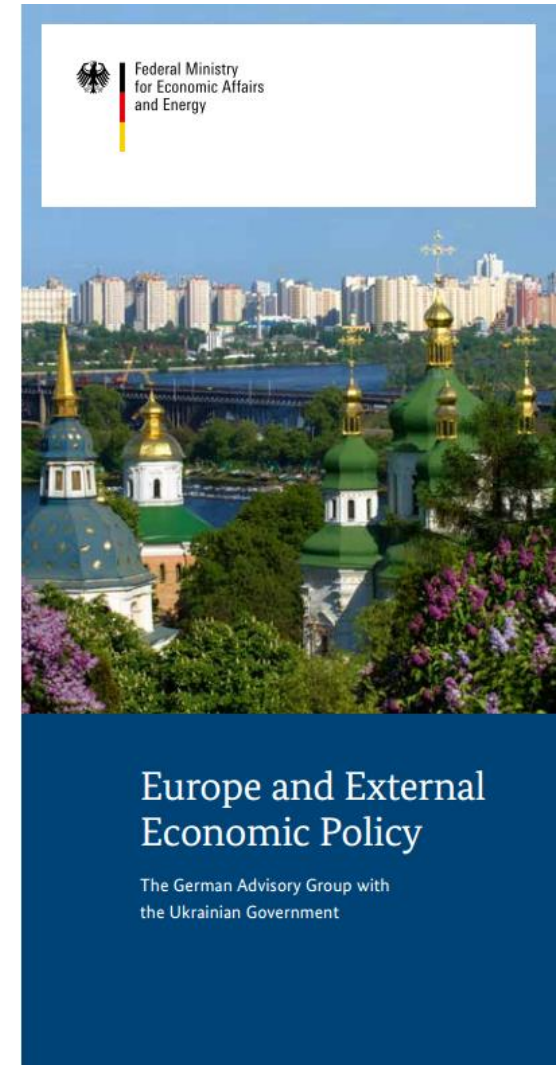
Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9

E-mail: [info@beratergruppe-ukraine.de](mailto:info@beratergruppe-ukraine.de)

[www.beratergruppe-ukraine.de](http://www.beratergruppe-ukraine.de)

Twitter: @BerlinEconomics



# Annex 1: WB Doing Business 2018 – Trading Across Borders

- Ukraine: position 119 out of 190 countries
- WB Doing Business ranks Ukraine low in the category “Trading across borders”. This would imply a large room for lowering the cost of customs clearance by implementing reforms

Indicator	Ukraine (#119)	Serbia (#23)	France (#1)	Europe & Central Asia	OECD high income
<b>Exports</b>					
Time to export: Border compliance (hours)	26	4	0	28	13
Cost to export: Border compliance (USD)	75	47	0	191	150
Time to export: Documentary compliance (hours)	96	2	1	28	2
Cost to export: Documentary compliance (USD)	292	35	0	114	35
<b>Imports</b>					
Time to import: Border compliance (hours)	72	4	0	26	9
Cost to import: Border compliance (USD)	100	52	0	185	112
Time to import: Documentary compliance (hours)	168	3	1	27	4
Cost to import: Documentary compliance (USD)	212	35	0	95	26

Source: WB Doing Business 2018

## Annex 2: Logistics Performance Index 2016

- The logistics performance index (LPI) is the weighted average of the country scores on six key dimensions including efficiency of the border clearance process, quality of infrastructure and logistics services, competitiveness of shipments pricing, consignment traceability and timely delivery
- Score between 1 (worst) and 5 (best)
- Ukraine is ranked 80 out of 160 countries
- Rather poor ranking suggests a vast room for lowering the cost of customs clearance with reforms

	LPI		Customs		Infrastructure		International shipments		Logistics competence		Tracking & tracing		Timeliness	
	rank	score	rank	score	rank	score	rank	score	rank	score	rank	score	rank	score
<b>Ukraine</b>	80	2.74	116	2.30	84	2.49	95	2.59	95	2.55	61	2.96	54	3.51
<b>Germany</b>	1	4.23	2	4.12	1	4.44	8	3.86	1	4.28	3	4.27	2	4.45
<b>Serbia</b>	76	2.76	87	2.50	85	2.49	90	2.63	69	2.79	66	2.92	79	3.23

Source: WB Logistics Performance Index 2016

## Annex 3: OECD Trade Facilitation Indicators 2017

- OECD Trade Facilitation Indicators reflect the measures negotiated within the WTO Trade Facilitation Agreement and assess the regulatory framework and the state of implementation of the specific trade facilitation measures in a country
- Ukraine is scored 1.00 within a range between 0 (worst) and 2 (best)
- The current score suggests vast room for lowering the cost of customs clearance with reforms in the most of areas

	Ukraine	Netherlands	Serbia
Information availability	1.05	1.95	1.20
Involvement of the trade community	1.57	1.88	1.00
Advance rulings	1.00	1.82	1.71
Appeal procedures	1.44	1.50	1.44
Fees and charges	1.54	1.92	1.46
Formalities - documents	0.89	2.00	1.33
Formalities - automation	0.54	2.00	1.00
Formalities - procedures	0.62	1.94	1.46
Internal border agency co-operation	0.45	1.50	0.46
External border agency co-operation	0.64	1.90	0.91
Governance and impartiality	1.22	2.00	1.67

Source: OECD Trade facilitation indicators

## Annex 4: The case of Turkey as relevant experience

---

**Today:** Turkey is the only non-EU member participating in the EU customs union (besides very small countries such as Andorra, San Marino and Isle of Man)

### How come?

- Before: strong commitment from both sides for Turkey joining the EU
- Transitory measure: participation in the EU customs union
- However: negotiations on EU membership got stuck and transitory measure became permanent

**Thus:** historic accident with unfavourable conditions for Turkey

- Other European countries (Balkan, etc.) not interested to repeat this accident
- **Our view:** no need for Ukraine to repeat this historic accident