

ICPS newsletter[®]

State aid in Ukraine: Compliance with international standards = effectiveness

As a country likely to accede to the World Trade Organization (WTO) next year, Ukraine needs to comply with international standards for the provision of state aid. Expanded bilateral economic relations between Ukraine and the European Union also mean changes in the country's anti-monopoly policies. With widespread ineffectiveness and inefficiency, Ukraine's policies for providing state aid have needed a rethink for a long time. As part of the "Industrial restructuring in the NIS: Experience of and lessons from the new EU Member States" project (INDEUNIS), ICPS specialists have some recommendations for improvements

Common principles for trading partners

Anti-monopoly policy and especially state aid are important components of trade, as providing state aid to business has a substantial effect on conditions of trade. The provision of state aid by a country often leads to the launching of anti-dumping investigations against its traders. Common policy principles in this area can contribute to the rapid, effective resolution of disputes between trading partners.

The adoption of an agreement on a free trade area between Ukraine and the EU, which may happen after Ukraine accedes to the WTO, could prove both a model and an incentive for reforming state aid.

With formal commitments, the Ukrainian Government will be able to more successfully defend the interests of the entire country, leaning on lobbies in specific industrial sectors. Ultimately, the result of such reforms should also be greater effectiveness and efficiency in the delivery of state aid.

What the EU requires

The standard EU requirements to harmonize legislation on the provision on state aid have already been written into joint agreements between Ukraine and the EU, specifically in the Partnership and Cooperation Agreement. These include:

1. A legal definition of state aid that complies with the definition accepted in the EU.
2. Transparency in the delivery of state aid. To meet this requirement, a list of

institutions providing state aid must be drawn up, an independent supervisory body set up, and regular reports published on the types, volumes and recipients of state aid.

3. The principle of prohibiting state aid if it deteriorates trade conditions between Ukraine and the EU.

Ukraine still has to fulfill most of these requirements. The 2004 Bill "On state aid" was rejected because of some controversial provisions. Currently, there are plans to amend the Law "On protecting commercial competition," which only partly meets European requirements.

Change in policy without matching institutional change is unsustainable

The Government has not clearly identified the criteria for providing state aid. Moreover, it has not designated investment projects that might have a right to state aid or identified penalties for violating the conditions for getting state aid. As a result, state aid continues to be ineffective. For this reason, SEZs and TPDs became an example of how a good idea for regional development and attracting investment can go bad in the implementation. Support for car-making is an example of poorly selected priorities. In addition, although this sector was granted tax benefits worth billions of hryvnias, inconsistent government policy—preferential conditions were changed several times—obviously became an obstacle to investment.

According to ICPS calculations, over 2000–2005, tax benefits were worth

2–2.5% of GDP. The main recipients of these indirect subsidies were car-makers and fuel and energy companies. Serious volumes of indirect support are provided across the economy through subsidized energy. For example, in 2005, arrears for payments for electricity, gas and heating were about 3.7% of GDP, while hidden subsidies because of over-low gas prices were 0.5% of GDP. In H1'06, these hidden subsidies went up to 1.2% of GDP. This affects exporters, as one of the arguments the EU used to justify anti-dumping probes against Ukrainian pipe makers was domestic energy subsidies.

In 2005, the Government seriously cut benefits for a number of machine-building sectors and as well as benefits under special investment regimes. In addition to the expected State Budget deficit, this decision was conditioned by the lack of transparency and effectiveness in the delivery of this state aid. However, planned changes in the Draft 2007 State Budget and intentions to renew breaks for companies operating in SEZs and TPDs point to continuing unpredictability in state aid policy in Ukraine.

How to improve the provision of state aid

In 2005–2006, Ukraine obtained market economy status from both the EU and the US. These long-awaited decisions meant recognition of the country's progress in the economic sphere and the socio-political arena. In addition, Ukraine has already signed the majority of the necessary bilateral agreements to accede to the WTO. However, its Government still needs to make the maximum efforts to gain the status of a functioning market economy. Among others, this means rationalizing state aid and making it effective.

1. Revising priorities. This means reconsidering priorities by emphasizing the environmental, regional and R&D aspects of state aid to manufacturing. Thus, for example, the EU–25 spends 25% of its state aid on environmental projects and energy-saving, 12% is spent on R&D and another 12% is channeled to develop SMEs.

Regardless of the fact that Ukraine and the majority of the EU countries are at different stages of economic development, priorities in providing horizontal assistance are important for the country. Unless the country develops science, its economy will not be able to grow rapidly. The solution to the issue of energy-saving—and simultaneously to environmental problems—is a top priority for Ukraine, which has to restructure its energy-intensive industries.

2. Reforming the energy sector. The Government must gradually stop providing hidden subsidies through support to the energy sector, especially by reviving liberalization of the gas market and

increasing regulatory capacity. It makes sense to improve the collection of payments in the energy sector and to improve the efficiency of the social security system.

3. Strengthening institutions and providing legislative support. This should facilitate Ukraine's transition from the insider economy or *ruchne upravlinnia* (the practice of hands-on regulation and distribution of rents). Ensuring independent and transparent decision-making by regulatory and competition authorities requires legislative changes as well as proper enforcement. Predictable policies in the provision of state aid are extremely important for business.

4. Supporting dialog. Any policy changes will face resistance from powerful interest groups, as was demonstrated by the difficulty with adopting WTO legislation in the Verkhovna Rada. The Government should have a dialog with stakeholders by quantifying and justifying the costs and benefits of a given decision. ■

The present document is one output from an international research project financed by the EU's 6th Framework Programme. This project is being implemented by ICPS in cooperation with research institutes from other countries. For additional information contact Ildar Gazizullin by telephone at (380-44) 484-4403 or via e-mail at igazizullin@icps.kiev.ua.

The ICPS position on integration with NATO

Premier Viktor Yanukovich's 14 September announcement in Brussels that Ukraine would postpone joining the Membership Action Plan (MAP) indefinitely demonstrated that Ukraine currently does not have a coordinated and consistent policy of integration with NATO. The country's foreign policy remains hostage to the struggle for power. Meanwhile, not only Ukrainian society but also politicians themselves understand little about the purpose of integrating Ukraine with NATO and the Membership Action Plan

The Premier's statement did little to illuminate the Government's short-term or long-term plans with regard to relations with NATO. It is not clear what Ukraine's refusal to join the MAP will mean for the reform of the country's Armed Forces and its security sector. How will Ukraine's ambiguous position affect its relations with partners both West and East?

Moreover, the Premier's announcement gave no answer to the question, What is the Government's position in terms of ensuring Ukraine's national security? Has it weighed the costs and benefits of joining the MAP? If Ukraine does not join the MAP, what form will its cooperation with NATO now take? If Ukraine does not want to become a member, what alternative to NATO does the Government see?

By not providing a clear, unambiguous and well-grounded answer to these questions, the Government is intentionally reducing discussion around NATO to black-and-white clichés and deliberately ignoring the fact that the issue of Ukraine's national security has now moved from the political arena to the level of state policy.

The Premier explained his decision to "take a break" as necessary in order to increase the level of popular support for Ukraine's membership in NATO. But the Draft 2007

State Budget actually cuts state funding for a public awareness campaign on integration with NATO to UAH 3mn, from UAH 5.3mn in the 2006 Budget. By comparison, in Slovenia, whose GDP is one third of Ukraine's, a similar campaign in 2001 cost the country US \$7.5mn.

In addition to formally not joining the MAP, the Premier's decision has disrupted the entire logic of the process of cooperation that Ukraine has undertaken with NATO. Moreover, the MAP itself is mostly needed by Ukraine, because it is an internal country plan for carrying out political, economic and social reforms, for internal security, for strengthening democratic institutions, for human rights, for the court system, and for reforming the army and internal security agencies—and it does not obligate the country to join NATO after its completion.

Considering the importance of integration with NATO for Ukraine's national security, the serious concern is being expressed by think-tanks and community organizations over the situation since the Premier's bombshell in Brussels, and the conflict over political integration with NATO among Ukraine's political leadership and Ukrainian society, the International Centre for Policy Studies is calling on government bodies and civil society organizations to begin a

broad-based public dialog on Ukraine's integration with NATO and the benefits of carrying out the Membership Action Plan.

ICPS supports calls by leading think-tanks and community organizations to hold a special session of the National Security Council dedicated to this issue. We believe that this kind of meeting also needs to be done in the presence of television cameras with the participation of top analysts from both state and non-government organizations, with this kind of agenda:

1. The meaning and purpose of Ukraine's relationship with the North Atlantic Alliance as it is set up in the Membership Action Plan.
2. The Verkhovna Rada–Government coalition's vision of the meaning and plan of action in terms of carrying out the Manifesto of National Unity and Ukrainian legislation on national security and relations with the North Atlantic Alliance.
3. A review of the Draft State Budget of Ukraine with regard to the items on plans to increase public awareness about NATO activities and Ukraine's integration with the Alliance.

ICPS is of the opinion that an open meeting of the NSC should not become a platform for any particular political force to force its own solutions on this issue "down everybody's throats." Instead, the NSC should launch a public debate about Ukraine's relationship with NATO and the Government's policies in this area at the highest possible level. ■

For additional information contact Viktor Chumak by telephone at (380-44) 484-4400 or via e-mail at vchumak@icps.kiev.ua.

icps newsletter is a weekly publication of the International Centre for Policy Studies, delivered by electronic mail. To be included in the distribution list, mail your request to: marketing@icps.kiev.ua.

icps newsletter editor: Olga Lvova (olvova@icps.kiev.ua)
Phone: (380-44) 484-4400. Fax: (380-44) 484-4402
English text editor: L.A. Wolanskyj
Articles may be reprinted with ICPS consent.

The International Centre for Policy Studies is an independent research organization whose mandate is to promote the introduction of public policy concepts and practices in Ukraine. This is achieved by increasing the know-how of key government officials for policy choices, formulation and debate, and the awareness of the public-at-large of the benefits of policy.
Address: vul. Pymonenka 13A, Kyiv, Ukraine 04050
Web-site: <http://www.icps.com.ua/eng/>