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## **State Aid in Ukraine: Practice and challenges**

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## EXECUTIVE SUMMARY

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Because Ukraine must meet international commitments to the WTO and bilateral negotiations and faces economic restructuring challenges, state aid is becoming a priority area for policy formulation in this country. We have attempted to assess the level of tax exemptions in key economic sectors and quasi-fiscal activities in the energy sector.

Although the amount of state aid meted out was reduced in 2005, no institutional changes are evident. This makes the adopted decisions unsustainable and future policy-making in this area unpredictable. This kind of policy approach is costly to Ukraine because of the trade barriers it raises and the inefficiency and inconsistency of aid allocation that results in practice.

Distorted input prices due to improper regulation continue to provide “rents” for certain sectors in Ukraine. Given the risks of volatile commodity prices for industrial output and the need to follow through on a number of international commitments, Ukraine’s Government has to immediately introduce new institutions and procedures to develop state aid that is effectively allocated.

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## WHY A STATE AID POLICY?

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The urgency of an effective state aid policy is dictated by both external and internal forces.

First, Ukraine needs to conform to international commitments on state aid as it accedes World Trade Organization—most likely in 2007—and begins to negotiate a new Partnership and Co-operation Agreement (PCA) and perhaps a Free Trade Agreement with the EU in 2008. This is probably the key driving force, as favorable trading terms are critical to the Ukrainian economy.

Second, Ukraine's market liberalization and gas price shocks could mean increased demand from manufacturing industries for state rescue programs and assistance. Above all, a sound competition policy and state aid are a crucial part of what is considered a favorable business climate, for both local and foreign companies.

### New times for old industries

Lately, the situation on world commodity markets has been favorable for Ukrainian exporters, but price volatility remains a risk. Capital investments have been growing, but an expected short transition period to “market” gas prices for Ukraine means that significant financing is now needed to complete energy efficiency programs. Some of this will come from new loans and FDI. But, because a large portion of current and expected FDI inflows go to new industries and loans are affordable for only a handful of large companies, a gap will be left that state aid will have to cover.

In 2005–2006, Ukraine was granted market economy status by both the EU and the US. This acknowledged progress made in conducting market reforms but—perhaps more importantly—the dramatic political developments in the country over this period. It is widely recognized that Ukraine has yet to be a properly functioning market economy that is “able to withstand the competitive pressures of the *global* market without state subsidies.”

Though Ukraine has often scored well in developing its competition policy, a number of problems remain, such as, rationalizing state aid and ensuring its effectiveness. Enforcement of legislation is another area requiring improvement as well.

### WTO commitments

Ukraine has already signed all the key bilateral agreements with the WTO members (See **Ukraine and the WTO**). The most sensitive sectors, agriculture and steel, received much attention during Working Group meetings and in bilateral negotiations. Outstanding issues such as state aid in agriculture,<sup>1</sup> especially export subsidies for dairy products, and changes to a number of definitions and norms were recently resolved.

Farm sector talks were particularly difficult since this sector is one of the least competitive in Ukraine, yet it employs nearly 30% of the workforce. Ukraine has yet to decide which approach to state aid it will follow in agriculture: a liberal Australian and Canadian policy or the “old” EU and US policies of massive state support to the sector.

Unlike some sectors, the steel sector may reap significant short-term benefits from WTO accession, as most anti-dumping and anti-subsidizing probes against Ukraine have been initiated and imposed by WTO members against steel products.

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<sup>1</sup> Total direct state aid in agriculture in 2005 was estimated to be about US \$540mn.

## Ukraine and the WTO

Since Ukraine's application to WTO membership in 1993,<sup>2</sup> progress toward the final goal has been slow. In market access negotiations, the first offer on services was introduced in 1997 and on goods in 1999. The first bilateral protocols were signed in 2001, with Mexico, Uruguay and New Zealand. Since 2000, Ukraine has embarked on more earnest efforts toward accession, improving bilateral negotiations on market access with trade partners, and—most significantly—undertaking key domestic reforms. Its negotiators have even been criticized for what some Ukrainians see as unjustifiably large concessions made for the sake of quick membership. Ukraine signed nearly 10 protocols a year over 2003–2005, and as of August 2006, it still has to sign protocols with only three countries: Armenia, Chinese Taipei<sup>3</sup> and the Kyrgyz Republic.

Two of the more recently signed important bilateral protocols were with Australia and the US. During negotiations with the US, two issues proved major hurdles: intellectual property rights and poultry imports. Eventually, Ukraine adopted and implemented a law on the protection of intellectual property rights in 2005. A solution was found to the second issue that both sides declared mutually beneficial. The US has also expressed satisfaction with Ukraine's comprehensive tariff offer, and has not countered with any serious technical reservations regarding access to Ukrainian goods and services.

Negotiations with Australia were also complicated by two issues: access to the Ukrainian sugar market and state aid in the farm sector. Finally, the two sides agreed on a Ukrainian proposition for a sugar import quota that was twice as low as what the Australians had wanted.

While Ukraine lately adopted a number of important changes in its legislation, more remains to be done. In 2005, the Tariff Code has almost been put in accordance with obligations Ukraine took during negotiations. Regulations for customs procedures, external trade and standardization have also been harmonized with the WTO rules. 16 draft laws have not passed the Verkhovna Rada yet, which remains the main obstacle to final WTO membership. These bills are aimed at changing such aspects as regulations for Ukrainian exports, access to the internal market by foreign companies, state support for the farm sector, and the enforcement of intellectual property rights.

Problems with legislative changes arose mainly because of the low level of information about the impact of WTO membership on Ukraine among deputies and because of vested interests. At this time, expectations are that formal accession will take place no later than in 2007.

## EU requirements

After the failure of the Doha round of talks in the World Trade Organization, the focus in trade negotiations will shift toward regional and bilateral agreements. In the case of Ukraine, this means integrating with the Russian and EU markets.

While the level of state subsidies has proved to be of concern to all parties, West and East alike, EU requirements are better articulated, encompass more areas of concern, and are ultimately stricter. The 1998 PCA between the EU and Ukraine refers to WTO principles on state aid and prohibits aid when it distorts competition and affects trade between the two parties. With regard to state aid, the EU specifically requires:

- 1) an existing legislative framework regarding antitrust and state aid;
- 2) adequate administrative capacity, that is, a well-functioning competition authority;
- 3) a credible record of enforcement of the rules in all areas of competition policy<sup>4</sup>.

A 2003 joint report on PCA implementation noted that neither a state aid oversight system nor a coherent legal framework and monitoring mechanism were in place in Ukraine. Since that time, policy

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<sup>2</sup> That year, 35 countries joined the Working Party, established to negotiate the terms of Ukraine's accession. With WTO enlargement, other states joined the Working Party, among them Armenia, China and Georgia. As of today, 42 WTO member states have requested trade negotiations with Ukraine.

<sup>3</sup> Separate customs territory of Taiwan, Penghu, Kinmen and Matsu.

<sup>4</sup> PCA between the EU and Ukraine, 1998.

developments have not improved institutional capacity to administer state aid. A draft law on State Aid was eventually not passed in 2004. A key issue that the legislators now hope to resolve is the way to distribute a number of functional responsibilities between the Anti-Monopoly Committee and the Economy Ministry.

The EU–Ukraine Action Plan signed in 2005 has reinforced existing EU requirements of Ukraine. Finally, a possible Free Trade Agreement between the EU and Ukraine, which will be feasible after Ukraine accedes to the WTO, should offer another, perhaps more binding and therefore more effective, way to bring about changes in the country’s competition policy.<sup>5</sup>

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<sup>5</sup> The EU focuses on requiring countries to approximate their domestic legislation with that of the EU. See Szepesi, S., 2004, “Comparing EU Free Trade Agreements: Competition policy and state aid.” (ECDPM InBrief 6E), Maastricht: ECDPM. For more on EU-Ukraine FTA prospects see Emerson et al (2006).

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# STATE AID PRACTICE IN UKRAINE

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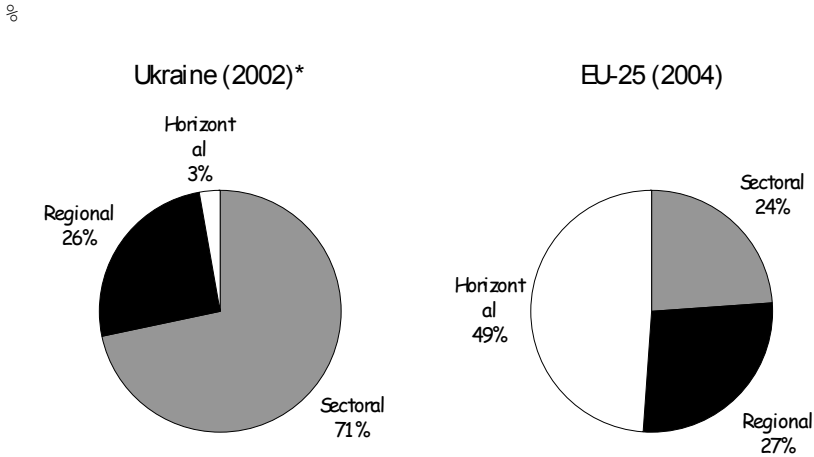
## Previous findings

The absence of specific definitions and the variety of ministries that distribute state funds and monitor aid policy implementation make it challenging to properly estimate actual aid volumes. This is one of the reasons why there are not many assessments of state aid in Ukraine.

A major study to quantify state aid within the context of Ukraine’s international obligations (CASE, 2004) attempted also to classify this aid by categories (See **Chart 1**). The authors show both the structure and the GDP share of aid to vary significantly from similar indicators in EU countries. Sectoral aid in Ukraine is the most important type of aid, while horizontal aid is virtually non-existent. While regional aid comprised about 26% of aid in Ukraine, it should be kept in mind that privileges given within the SEZs are often not quite regional aid as it is understood and practiced in the EU. It was also estimated that the GDP share of industry-related state aid is as much 2%, compared to an EU norm of about 0.4%.

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**Figure 1. State aid structure**



Sources: CASE Ukraine, Eurostat

\*Industry related subsidies

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## Tax Exemptions: Pros and cons

Tax exemptions are a very popular instrument of state aid in Ukraine, one explanation being the widespread perception that grants are stolen or frittered away and are associated with corruption. The dynamics and volumes of indirect subsidies are thus a good sample of state aid allocation in the country. We have selected those sectors of the economy (see **Table 1**) for which the presence of state aid may have trade restriction implications. Of a wide range of tax breaks considered, the main ones are income tax, VAT and land tax.

**Table 1. Tax exemptions in selected sectors of Ukraine's economy**

'000 UAH

	2000	2001	2002	2003	2004	2005
Children's food	32,422	32,825		38,430	25,736	32,766
Publishing	314,085	396,482	487,608	558,891	279,341	433,757
Steel manufacturing	2,145,259	1,028,577	491,863			
Car making	166,356	167,819	296,486	1,185,767	1,896,701	695,426
Aircraft building		27,692	53,776	45,642	21,912	19,038
Shipbuilding	17,568	34,963	43,413	32,532	42,107	14,400
Aerospace	26,029	45,728	36,184	60,141	94,345	5,472
Armored machines		22,400	28,033	23,073	17,982	16,970
SEZ and TPD (free economic zones)	92,633	220,872	356,903	414,752	567,937	6,719
Technoparks		19,456	44,060	36,051	144,074	11,056
Fuel and energy	232,349	232,850	522,106	4,762,543	4,194,654	5,747,559
Exploration	2,979	4,619	28,712	74,749	95,012	78,848
Agriculture	359,570	592,336	573,097	577,031	255,998	1,176
Pharmaceuticals		2,502,943	3,112,505	3,215,646	1,162,779	1,454,239
<b>Total:</b>	<b>3,389,250</b>	<b>5,329,562</b>	<b>6,074,744</b>	<b>11,025,249</b>	<b>8,798,578</b>	<b>8,517,426</b>
<b>As share of GDP</b>	<b>2.0%</b>	<b>2.6%</b>	<b>2.7%</b>	<b>4.1%</b>	<b>2.5%</b>	<b>2.0%</b>

Source: Ministry of Finance, calculations by ICPS

Over 2000–2005 indirect subsidies stood at a stable 2–2.5% of GDP, growing with the economy. The largest beneficiaries of state aid are the auto, fuel and energy, and pharmaceutical industries. It should be emphasized, however, that the amount of indirect aid in pharmaceuticals and fuel and energy may be overestimated because a certain share of the benefits received in these spheres are passed on to the consumer. Given a very general description of tax exemptions, it is difficult at times to determine the final beneficiaries of the aid. The seemingly small volume of indirect subsidies in agriculture, on the other hand, is deceptive because the sector enjoys other types of aid as well.

A major change in state aid practice took place in 2005 when most of the tax breaks for machine building (e.g., auto industry, shipbuilding) and free economic zones were lifted. A key reason for this decision was the prospect of running a significant budget deficit that year, but also the determination of the new Government to improve Ukraine's WTO accession prospects.

At the same time, this also meant violating contractual obligations from the state toward affected businesses, both local and foreign. The new Government's decision in 2006 to reestablish SEZs illustrates that simply reducing state aid is not sustainable without rethinking policy and building institutional capacity.

## Indirect Aid: Focus on energy input prices

Indirect aid assumes many faces in the Ukrainian economy, among which are state-backed loans, deferred tax liabilities, and mispricing inputs. It is the opaqueness of indirect aid rather than its significance that raises questions among Ukraine's trading partners.

Of the listed indirect ways of rendering state support, distorted energy input prices have by far the greatest impact on commercial activity. This practice traces its origins back to the USSR, when electricity, fuel and transportation prices were manipulated to benefit energy- and capital-intensive industries and consumers.

To calculate indirect state aid through the energy sector, we replicated an IMF estimation of so-called quasi-fiscal operations (QFO)<sup>6</sup> in the Ukrainian energy sector for 2005 and H1'06. We followed the EBRD approach and considered major instances of QFO: 1) mispricing, 2) poor enforcement of payment collection and payables, and arrears. The resulting estimates are quite crude due to data limitations and obviously do not account for explicit subsidies, which are significant in a sector like the coal industry. The major focus was on the gas sector because of its greater importance for the overall economy, including the power sector itself, but also because of its implications for Ukrainian-Russian supply price renegotiations.

**Payment arrears and collection ratios.** The shrinking share of payment arrears in GDP over the last few years is explained by high economic growth rates. Most of the arrears formed in 1990's have not been restructured and, as cash collection trends have significantly improved, arrears have not been growing much anymore. The deterioration in the cash collection ratio in the first half of 2006 from nearly 100% in 2005 to an average of 90% is largely explained by an increase in residential gas and electricity rates—these went up 25% in March 2006. The poor collection ratio is likely to remain as further increases in residential utilities kick in in July and again in the future.

**Table 2. Quasi-fiscal operations in Ukraine's energy sector**

	2002	2005	H1'06
Payment arrears, % of GDP			
Gas	2.4	1.1	1.1
Electricity	4.2	2.5	2.2
Central heating	0.4	0.2	0.2
Cash collection ratio, %			
Gas	88.3	98.5	88.7
Electricity	87.2	99.3	96.8
Sources: Ministry of Fuel and Energy, National Electricity Regulatory Commission, Ministry of Economy; estimates by ICPS			

**Debt and tax arrears.** It is challenging to evaluate debt and tax arrears in the energy sector, as information is both controversial and fragmented. A very good benchmark of the general trend is the gas sector and, in particular, the debts of the national giant, Naftogaz Ukrainy. The company's long-term liabilities doubled in 2005, to US \$1.54bn, which is about 2% of Ukraine's GDP, while tax arrears totaled US \$1bn. In 2006, the company went on to take additional loans to pay for imported gas. The gas price shock was absorbed by Naftogaz in the first place, since domestic prices have not fully and immediately reflected new import prices. In 2005, Naftogaz Ukrainy's losses reached some US \$350mn, after the company had reported a profit of about US \$1.5bn just the year before.

**Gas mispricing.** Gas mispricing as one way of passing a subsidy to the Ukrainian economy has two dimensions. First, until 2006 the price of imported natural gas from Russia was cheaper than the price the Central Europe, given transportation costs.<sup>7</sup> The EU has long been encouraging Russia to liberalize regional energy prices to create a level playing field for competition. It is much more difficult to accuse Ukraine of accepting low price of Russian gas, unless, for instance, it can be shown that Ukraine forwent additional Budget revenues by setting low transit fees in return. The second and more important dimension of the problem of indirect state aid is the situation with gas pricing for domestic consumers.

<sup>6</sup> The authors define quasi-fiscal activities "as operations carried out by public enterprises that have a direct impact on the financial position of the enterprises and would not prevail in competitive markets without government intervention." See IMF, 2003.

<sup>7</sup> It is yet not clear whether Moscow had a geopolitical objective in holding prices down or whether Kyiv took advantage of its strategic position in carrying Russian gas. In many respects, the resulting price scheme seems to be a lose-lose deal for both countries, as it fails to end the rent-seeking activities strongly rooted in the sector on both sides of the border.

**Table 3. Gas mispricing in Ukraine**

	2005		H1'06	
	Volume, bcm	Price/Cost, USD per tcm	Volume, bcm (est.)	Price/Cost, USD per tcm
Domestically produced gas	20.4	18.5	20.5	18.5
Russian (transit gas)	21.9	50	59.2	95
Turkmen gas	37.3	77.7		
Weighted average	79.6	55	79.7	75.3
Total supply price, local delivery fee incl.		64		88.3
	VAT incl.	w/o, VAT	VAT incl.	w/o, VAT
Average gas price	70	59	97	81
Effective price	68.95	58.1	86	72
Mispricing, USD per tcm	5	-6	-2	-16
Domestic consumption, bcm		68.7		68.9
Total mispricing, mn USD		-404.3		-1,135.2
Total mispricing, % GDP		0.5		1.2

Source: Derzhkomstat, NERC, Ministry of Economy; calculations by ICPS

The quasi-fiscal nature of gas pricing can be seen in the way that internal prices for various consumers match the import or supply price. The first instance of mispricing (see **Table 3**) is the domestically-produced gas price, which is set much below the price of imported gas. The resulting supply price of US \$64 in 2005 already reflects an implicit subsidy to the economy.

The price of gas on the domestic market has been calculated as a weighted average price of three major types of consumers: industrial (52%), residential (27%) and other (21%).<sup>8</sup> The average price is then discounted by the collection ratio in the sector to receive an effective price. The difference between the supply price and the effective price is the mispricing that takes place because of state policy in the sector.

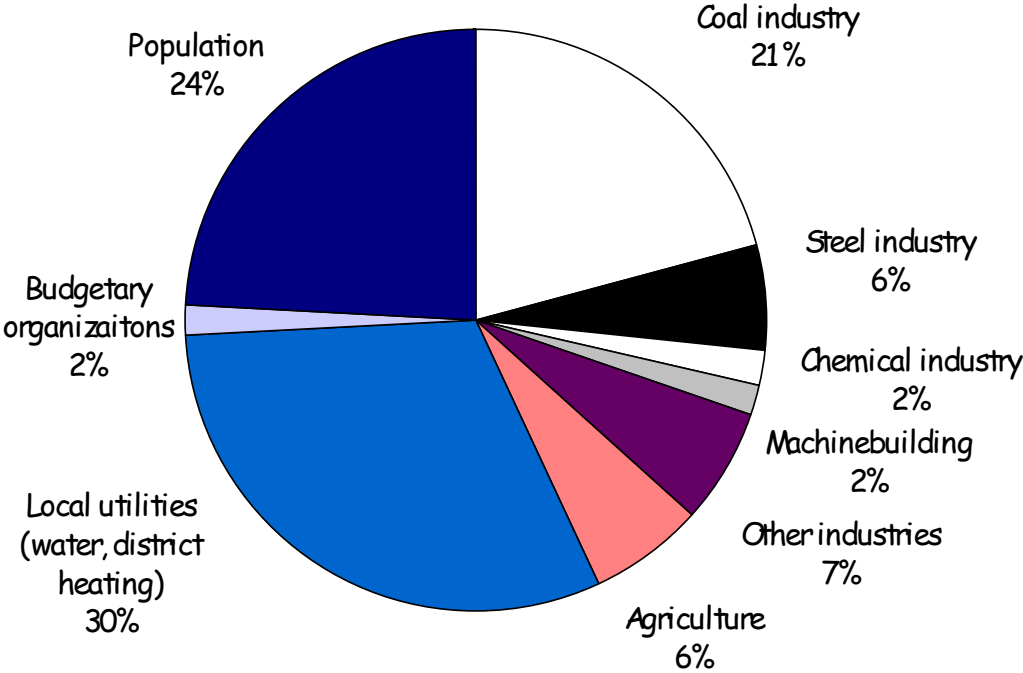
The total amount of indirect aid was quite large, both in 2005 and H1'06, at 0.5% and 1.2% of GDP. Even if the VAT imposed on the gas is included in calculations, results for the H1'06 still show mispricing. Whether the gap will increase or not depends on the Government's ability to bring domestic gas prices to a reasonable level by early 2008, as promised.

The fact that the lion's share of the benefit from mispricing is passed along to residential consumers at the expense of the energy sector and other sectors of the economy does not mean that industrial consumers gain no benefit through energy prices. Indeed, it has been long recognized that social priorities are at the heart of energy policy in Ukraine and that industrial energy prices were traditionally set as to cross-subsidize residential users.

The latter group is also responsible for a significant share of energy payment arrears (see **Fig. 2**). The fact is that the scale of rent redistribution is at a simply intolerable level for a market economy. What's more important, allegations of energy subsidies are still an issue in disputes between Ukraine and its trading partners.

<sup>8</sup> Includes centralized heating and public institutions. This makes the estimate conservative, since the latter enjoy discounted gas prices.

**Figure 2. Electricity payment arrears in Ukraine in 2004, %**



Source: UkrEnergo

**Sensitive Sectors: Steel-making**

State aid in the steel industry is currently largely indirect. A large-scale state aid program developed for the sector in 2001–2002 was intended to assist companies facing low world prices for steel. It was stopped in 2003 and tax breaks were lifted (see **Table 1**).<sup>9</sup> Currently, the state effectively supports the sector through export duties on scrap and subsidized coal prices.<sup>10</sup> It is expected that the export duty will be gradually withdrawn as Ukraine joins the WTO. The Government has yet to find a solution to the possible abuse of transfer pricing among private companies that own both coal and steel enterprises.

The future of the steel sector will depend upon its ability to replace or modernize outdated facilities in the face of higher energy prices. Input-output table assessments indicate that, with EU energy prices in Ukraine, value-added in the steel sector would be negative. However, unlike the steel sector in most of the EU-15 and NMS, Ukraine’s steel companies have a number of advantages that mean there is actually little need for state intervention. These advantages include domestically available natural resources and private ownership. Both local and strategic foreign investors have recently increased capital investments in the sector (see **Table 4**).

**Table 4. Investments in Ukraine’s steel sector**

	2001	2002	2003	2004	2005	Q1’06
Capital investments, bn UAH	1,422	1,366	2,032	3,282	5,575	1,029
Investments, USD/t	8	8	10	16	28	22

Sources: Derzhkomstat, International Iron and Steel Institute, calculations by ICPS

<sup>9</sup> For more on state aid in Ukraine’s steel sector, see the World Bank Steel Sector Study.

<sup>10</sup> In 2005, coal subsidies amounted to 0.7% of GDP and could reach 0.9% in 2006.

## The NMS experience and Ukraine

The relevance of reforming state aid in the NMS stems from Ukraine's objective of increasing trade with the EU. This is especially true when it comes to establishing institutions to administer state aid according to EU standards. However, when determining policy implications, there are a number of issues that have to be considered:

- Most of manufacturing enterprises in Ukraine are already privatized as opposed to predominantly state-owned companies, especially steel-makers, in accession countries that were given state aid.
- Industry is much more important to Ukraine's economy—as a share of GDP, employment, and so on—than it was in case of the NMS. Thus, when it is given, state aid is also expected to be more significant, all other factors being equal. Due to the challenges of restructuring, state aid as a share of GDP in most NMS is higher than in the EU (see **Table 5**).

**Table 5. State aid in the EU, % GDP**

		2000	2001	2002	2003	2004
EU-15	State aid	0.6	0.6	0.7	0.6	0.6
	Not including agriculture	0.4	0.4	0.5	0.4	0.4
NMS	State aid	1.2	1.0	1.2	2.1	1.1
	Not including agriculture	1.2	1.0	1.2	2.1	0.7

Source: Eurostat

- Steel, chemicals and machine-building, the sectors that need to undergo significant restructuring in Ukraine, export most their output, in contrast to the NMS, which also focused mostly on EU markets. This raises negative implications for trade when state aid is provided.
- Ukraine is not a candidate country for EU membership and exemptions from European/international competition policy standards are less likely to be offered in its favor.
- There is a high risk of ineffective spending of state aid, if allowed, as the court system is weak, government officials still tend to be corruptible, and no state aid monitoring institution is in place.

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## POLICY IMPLICATIONS

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The weak institutional administration of state aid that can be seen in the absence of aid eligibility criteria—and penalties for violating the terms and conditions for receiving it—are the key aid policy problems that have to be addressed in Ukraine. Otherwise, aid practice will inevitably be inefficient and ineffective, as was the case with many projects that got their tax exemptions canceled in 2005. A most blatant example of abuse of state aid was the companies that imported meat to Ukraine through SEZs.

A new state aid policy inevitably means choosing an approach that will affect a wide range of policies, sectors and interest groups while coping with the coming challenges of economic restructuring:

- **Repackaging state aid.** This means reconsidering priorities by emphasizing the environmental, regional and R&D aspects of state aid in manufacturing. All three priorities are quite relevant for Ukraine and financing horizontal objectives is also a good strategy to avoid trade sanctions for providing aid.
- **Reforming the energy sector.** The Government has to proceed with reform in the gas sector, which lags far behind the power sector. Liberalizing oil and gas is challenging, but better regulation and new market rules are crucial to improve the financial standing of sector companies. Payment discipline must improve: the fact that the biggest deadbeats tend to be state-owned and public institutions is a signal that the state is reluctant to reform the energy sector.<sup>11</sup> Gradual price liberalization would also require reforming the social security system.
- **Strengthening institutions.** This should facilitate Ukraine's transition from an insider economy with a practice of *ruchne upravlinnia* (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. The latter may offer new ways for Ukraine and the EU to cooperate in competition policy to rule out any possible disputes that the state aid practices of either side might cause, from the very start. A Free Trade Agreement could offer another opportunity to enshrine reforms and achieve asymmetric concessions from the EU.
- **Ensuring predictability.** When developing and implementing new policy in this sphere, Ukraine should follow the example of many accession countries that have preserved most of their aid schemes to fulfill their state's contractual commitments. This, of course, does not mean that Ukraine should abuse state aid given to attract FDI. A certain degree of foresight is needed when negotiating transition periods and conditions under which the government can provide incentives to business.
- **Developing evidence-based policies.** Any policy changes will face resistance from powerful interest groups. This was amply demonstrated by the difficulty in getting WTO legislation passed in the Verkhovna Rada. The Government should start a dialog with stakeholders that includes quantifying and justifying the costs and benefits of a given decision.

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<sup>11</sup> See Voll et al (2006).

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