SUPPORTING SMALL AND MEDIUM ENTERPRISES
IN THE CONTEXT OF THE
EUROPEAN UNION - UKRAINE
ASSOCIATION AGREEMENT

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All errors that remain are, of course, my own.

Amsterdam, 1 August 2015 - I, Wytse Sonnema, hereby declare that I have worked on this thesis, “Supporting Small and Medium Enterprises in the context of the European Union - Ukraine Association Agreement”, independently and that it is entirely my own work. It has not been taken from the work of others save to the extent that such work has been cited and acknowledged within the text of my work. All sources of information and references used in this thesis are listed at the end of the work.

Executive Summary

This thesis is concerned with policy proposals aimed supporting Dutch and Ukrainian small and medium enterprises (SMEs) dealing with the opportunities and threats that arise from the Association Agreement (AA) between the European Union (EU) and its Member States on the one hand, and Ukraine on the other hand. The AA is the contractual relationship encompassing the goals of political and economic integration of the signatories. The focus of this thesis is on proposals for Dutch policies which contribute to the successful implementation of the AA.

These proposals are grounded in a theoretical analysis of how the relationship between the EU and Ukraine developed over the past fifteen years. Looking through a liberalist lens, it becomes clear that the AA is the result of the EU's attempt to shape its neighbourhood through the promotion of the EU model of regional cooperation, trade liberalisation, and political conditionality and socialisation; in order to achieve its goals of physical security, economic prosperity, and value projection. For Ukraine, the welfare gains predicted by regional economic integration theory provide the rationale for negotiating, entering into, and now implementing the AA. Through a historical institutionalist approach it is demonstrated how the institutional legacy of the 2004 enlargement of the EU shaped the process and outcomes of political and economic integration between the EU and Ukraine.

From this theoretical framework the understanding arises that the Association Agreement, including the Deep and Comprehensive Free Trade Area (DCFTA), must be successfully implemented if the integration of the EU and Ukraine is to take place, and that the agreement is also the most suitable tool to achieve this integration. This is a daunting task even under optimal circumstances, in which the involved parties currently do not find themselves. Commitment of all whom it concerns is thus vital, both on the political level and in its practical form.

Policy aimed at supporting Ukrainian SMEs is a small, yet important, part of such a commitment. The underdeveloped private sector in Ukraine, and the poor business environment in which SMEs operate, have been one of the biggest constraints on economic prosperity of the country for years. Furthermore, SMEs will be directly and indirectly affected by the AA, whilst their capacity to deal with this is often relatively limited due to absent advantages of economies of scale.

For these reasons, SME policy is a political priority of the EU, backed by substantive direct (financial) and indirect (institution building) funding. The Ukrainian government subscribes to the importance of SME policy but has limited capacity to implement its stated policies. The Netherlands can and should play a role to support through technical assistance (TA). It has an interest to do so as a member of the EU, there is a bilateral relationship that deserves to be fostered, and there is a capacity to provide assistance. The areas in which Ukrainian SMEs face high adaptation costs to the AA and where the Dutch capacity to offer TA is the greatest are determined to be institution building concerning technical standards and sanitary and phytosanitary (SPS) measures. This results in proposals for policy involving TA by the Dutch Accreditation Council (RvA) and the Netherlands Food and Consumer Product Safety Authority (NVWA).

Incidentally, a sound business environment in that area would also offer opportunities for the Dutch private sector, including SMEs especially from the food/agro sector. Dutch efforts aimed

at positioning Dutch SMEs in the Ukrainian economy should focus only on those areas in which there is market failure, which can be (best) resolved by government intervention. There is sufficient expertise in the market to support SMEs who want to access the Ukrainian market - not in the last place because of the experiences of economic transformation in Central and Eastern Europe during the 1990s, and the fact that many civil servants of that age now work as consultants in the private sector. Still, economic diplomacy, understood here as organising trade missions headed by preferably a member of the Dutch cabinet, is of significant value and should thus be pursued. The most important barrier currently faced by Dutch businesses hoping to operate in Ukraine is insufficient access to credit. Export credit insurance, a product currently not offered sufficiently by the market, should be provided by the Dutch government.

It is argued here that in the Dutch government, starting with political commitment at the highest level, a stronger focus on economic development of Ukraine in general and SME development in particular will have a positive impact. Compartmentalised policy-making (following automatically from institutional design) in combination with limited availability of funds (also in relation to the other AA countries, Georgia and Moldova) might otherwise lead to inefficiencies.

The EU should more resolutely take up the role of coordinator of support. Providing demand-driven assistance is indeed the preferred approach, but the understandably limited Ukrainian capacity to formulate demands must be taken into account. The Member States engaged with Ukraine's faith, and Ukraine itself, would benefit from a clearer division of tasks.

Looking to the future beyond Ukraine, three general lessons learnt should be taken into account. First, the relationship between the EU and another country might touch upon the interests of a third party. A liberalist approach might go a long way, but the possibility that others act according to different rules remains. The behaviour of the Russian Federation towards the EU and Ukraine is an obvious example. Second, the economic benefits on the longer term will only materialise if the short term costs can be coped with. This may require substantive support, which must indeed be provided by those who pursued the integration in the first place. Lastly, institutional factors must be taken into account. The overly technocratic approach of the EU to the integration process is one of the significant downsides of an otherwise positive legacy of EU enlargement experience.

Contents

1 Introduction

On the pictures the world could see a wooden ship (the 'Galleon'), peacocks, a Rolls Royce collection, a Swiss Chalet-style palace - and Ukrainian civilians roaming the grounds. President Viktor Yanukovych, owner of the estate, was nowhere to be found on 22 February 2014 (Stebner, 2014). Ukraine was going through its second revolution in a decade. The protests that led to the toppling of the Yanukovych government had started three months earlier, when it became clear that the president would not sign the Association Agreement between Ukraine and the European Union and its Member States. This agreement, which aimed to politically and economically integrate the signatory parties, had been under negotiation for almost a decade. Until a week before signing was supposed to take place, it was the EU that was hesitant to move on with the process.

Fast forward one year. The Association Agreement has been signed, but Ukraine's troubles are not yet over. There is a an armed conflict in the Donbas region and the economy is faltering. A technocratic project of market access in exchange for political reforms, an affair between the EU and its neighbour, turned into a geopolitical conflict. Most of the attention in the media is paid to the problems in Eastern Ukraine, and the Russian involvement in the fighting. These are pressing issues. However, the idea that the country has to transform - both politically and economically - remains just as valid as when it was first raised. And in order to achieve that, implementation of the Association Agreement is a vital tool to be used.

This is the context in which this thesis is written. Implementation of the agreement would be a big job for any country, let alone one that would find itself in Ukraine's current state. But failure is not an appealing option. It would signify an immense opportunity missed, in various ways. Apart from the political and economic reforms that are long overdue, the possibility to integrate with the EU is all the more appealing for Ukraine because of the behaviour of the Russian Federation. Closely linked to this, the stakes for the EU have been raised. It can chose to demonstrate its willingness and capacity to help change its neighbours for the better, or it can showcase the exact opposite. Either way, a lot of eyes will be following what happens in the coming years - not in the last place those of almost 50 million Ukrainians.

The goal of this research is to contribute to successful implementation of the Association Agreement. The approach taken here is threefold. First, the mechanisms that are at the basis of EU-Ukraine relations are analysed. This theoretical framework will provide the fundament for the two questions central to this thesis. These questions are formulated as follows:

“What are the most feasible policy options for the Dutch government to support Ukrainian SMEs to adapt to the implementation of the Deep and Comprehensive Free Trade Area so that challenges may be overcome and opportunities will be exploited?”

“What are the most feasible policy options for the Dutch government to support Dutch SMEs *to adapt to the implementation of the Deep and Comprehensive Free Trade Area so that challenges may be overcome and opportunities will be exploited?”*

To answer these questions, several sub questions have been formulated. First, an overview of the most important aspects of SMEs is provided. Then, attention is paid to what the most important challenges and opportunities are that SMEs will face in the context of the DCFTA. This is followed by looking at the most important lessons learnt from previous policy aimed at dealing with comparable situations. The last two sub questions concern the current policies that are in place, and the recommendations for future policy.

The central questions cover only a small part of the efforts required for implementation of the agreement. Through a discussion on the choice for the specific components of these questions, the reason for formulating them like this will become clear.

The starting point is the implementation of the Deep and Comprehensive Free Trade Area (DCFTA). DCFTA refers to the title of the Association Agreement that is concerned with trade and trade-related matters. It is the most important section concerning economic integration. It is also the most detailed, spanning almost 150 pages of the 180 odd pages comprising the agreement, as well as most of the nearly 2000 pages of annexes. Implementation of these provisions will have a profound impact on the Ukrainian economy, which should lead to overall welfare gains. But for these welfare gains to actually materialise, the challenges that are posed must be overcome, and the opportunities must be exploited. If this does not happen, it will reflect on the public's perception of the agreement as a whole. Economic downturn as a consequence of dealing poorly with the implementation of the DCFTA can then risk the stability of the entire agreement. Disintegration would have profound effects that are best avoided, to put it mildly.

The challenges and opportunities will arise for many actors within Ukraine. The focus here is on the consequences for SMEs. This is because the poorly developed private sector is among the key reasons for the country's poor economic performance. An important part of the problem is that the private sector is unbalanced due to the small size of the SME sector (World Bank, 2014:27). That already justifies an effort to support the development of the sector in itself. To add to that, the DCFTA will have an impact on SMEs as well. The costs of reforms in the context of integration with the EU will not be borne just by the public sector - around half of them will fall on non-state actors (Delcour & Wolczuk, 2013:17). For SMEs, this can be the case for example when industrial production has to be brought in line with EU technical regulations adopted in the context of the DCFTA. SMEs do not have the advantage of economies of scale larger enterprises have - not just concerning production, but also with regard to bureaucratic red tape, access to finance, et cetera. The efforts required to deal with the challenges and opportunities are therefore relatively high. Thus, their importance to the economy of Ukraine, combined with the costs of adapting to the DCFTA, warrant special attention to support the SME sector.

So, why the focus on Dutch policy options? As will become clear in the theoretical framework, the Netherlands as an EU member has a political interest in EU-Ukraine integration. This interest became even more salient because of the MH17 incident. The downing of the airplane came at the cost of 298 lives, almost two thirds of which were Dutch. The economic interest of the Netherlands is low on an aggregate level, but the DCFTA has an impact on specific sectors nonetheless. Lastly, the practical reason for focussing on Dutch policy options is that the research for this thesis was conducted during an internship at the Europe desk of the Netherlands Ministry of Foreign Affairs.

The research presented here is based on both a literature review and expert interviews. The theoretical framework draws on a range of authors concerned with meta-level theories all the way to studies on the micro level. Furthermore, (statistical) resources from inter alia the World Bank, World Trade Organisation and OECD were used. Publications by the various institutes of EU, ranging from policy proposals to policy evaluations, as well as number of external en internal documents from the Dutch government (especially the Ministry of Foreign affairs) are also referred to. The interviews conducted include officials from a number of departments within the MFA as well as the embassy in Kiev, the Ministry of Economic Affairs, the RVO (the Netherlands Enterprise Agency), and various semi-public agencies. At the EU, officials from the European Commission and the European External Action Service were interviewed. From the private sector, a number of interest groups such as business (con)federations have been interviewed, as well as businesses themselves. Lastly, several seminars were attended. ranging from academic discussions on EU-Ukraine relations in general to expert workgroups on SME policy.

2 Theoretical Framework

The Association Agreement between Ukraine and the European Union has seen a turbulent history even before its implementation. In this chapter, a theoretical framework will be offered through which a better understanding of this history can be gained. This will provide not just an explanation for the various rationales that are at the base of the agreement, but it shall also provide the fundament upon which the answers central to this thesis will rest. In other words, through a discussion on the deeper goals, processes and outcomes surrounding the Association Agreement, better arguments with regard to policy advice can be given.

At the core of the Association Agreement, a political- as well as an economic rationale can be found. Both explain some part of the effort to integrate Ukraine and the European Union. It will be argued here that liberalism (as a theory of international relations) offers the most valuable conceptual lens to understand the political rationale of the agreement, whilst the theoretical prescriptions of regional integration illustrate the economic rationale best. Historical institutionalism is a useful framework to describe certain parts of the evolution of EU-Ukraine relations over the last decade-and-a-half on a more practical level.

This chapter is structured as follows. First, an overview of the contents of the Association Agreement is provided. This is purely introductory and takes a rather high level view - the document itself is over a 2000 pages long. Second, a brief review of the theories used here will be provided. The notion of liberalism and the EU as a liberal actor will be described, the basics of economic integration are explained, and the concept of historical institutionalism is put forth. Third, these insights will be applied to the relationship between the EU and Ukraine. The evolution of this relationship since the disintegration of the Soviet Union has at times been a gradual one, changing from year to year, but sometimes changed abruptly. For the sake of clarity three periods are grouped together. To begin, the period ranging from the 1990s up until 2004-2005, at which point a new chapter in the relation started. Then, the following five years, during which most of the contours of the contractual relationship where drawn. Lastly, the period up until 2015, which includes the finalization of negotiations on the agreement, as well as the watershed moment of the Ukrainian Revolution. Each of these periods is discussed using the threefold theoretical framework: liberal politics, integration economics and historical institutionalism.

2.1 Contents AA/DCFTA

The Association Agreement aims to establish political association and economic integration between the EU and Ukraine. It consists of a preamble, seven titles, 43 annexes and three protocols. It is signed not just by the EU and Ukraine, but also by the 28 Member States because the agreement covers issues where the EU does not have (sole) competence.

The preamble is of a non-binding, introductory character, but it does capture the essence of the most important issues surrounding the Agreement. Six goals of association are identified. First, the promotion of gradual rapprochement of the parties based on common values, as well as increased participation of Ukraine in EU policies, programmes and agencies. Second, the provision of an appropriate framework for political dialogue in all areas of mutual interest. Third, the promotion, preservation and strengthening of peace and stability in the regional and international dimensions, in line with several international charters. Fourth, the establishment of conditions for enhanced economic and trade relations, as well as supporting a Ukrainian transition to market economy. Fifth, enhancing cooperation in the field of Justice, Freedom and Security with the aim of reinforcing the rule of law and respect for human rights and fundamental freedoms. Sixth, establishing conditions for increasingly close cooperation in other areas of mutual interest.

Title IV of the agreement refers to the Deep and Comprehensive Free Trade Area (DCFTA). It consists of 15 chapters, 14 annexes and the three protocols that are associated with it. These cover *inter alia* market access, technical as well as sanitary- and phytosanitary standards, energy related commitments and dispute settlement mechanisms. Although it is considered to be an integral part of the Association Agreement, the title was signed later than the 'political' parts of the agreement, and its provisional entry into force has been postponed until 1 January 2016.

2.2 Theoretical Framework

2.2.1 A liberal actor in a realist world?

International relations theory consists of a wide range of approaches which look at different actors, goals, instruments and have varying assumptions and ideas about how the world works. Traditional theories such as realism, liberalism and Marxism are complemented or contradicted by others such as constructivism, institutionalism and post-modernism. It is not necessary to provide a complete overview of these theories here. Rather, the scope will be limited to an introduction of liberalism in relation to the EU, where necessary in contrast to other theories.

As a political theory, liberalism holds that international relations are determined by the *preferences* of states and other actors. Interactions occurs not just on the basis of politics of power and security, but also with economic and cultural aspects as drivers. This is in contrast to the (realist) view that international relations are the result of a zero-sum game between states based on power capabilities. The liberal mode of thinking allows for more possibilities of enduring relationships between states, because cooperation and interdependence can lead to absolute gains for those involved.

(Neo-)functionalism, which has its roots in liberalism, is one of the major theories used for explaining European integration. It holds that to facilitate economic interdependence a growing organizational capacity is needed, which will be accompanied by supranational rules replacing national regimes. This will spill over to other policy areas, going beyond mere integration of economic sectors. Regional integration is thus regarded as an inevitable process. Historical institutionalism is related to this approach, amongst other things because it takes into account the notion of path dependency as well as the importance of institutions. The concept of historical institutionalism will be described in more detail further below.

First, it is useful to take a step back and look at the way in which liberalism applies to the goals of the EU. When looking at the behaviour of the EU as a global actor, M.E. Smith (2011) argues that the EU tries to remake the world according to its own values. A 'grand strategy' can be determined through which the EU shapes itself, its neighbourhood and the planet. This concept refers to the coordination of goals and assets to achieve a core of interests, including physical security, economic prosperity, and value projection (M. E. Smith, 2011:145). Whilst the concept was originally applied to states, the behaviour of the EU as an actor means that it too can be considered to have a grand strategy. A focus on economic prosperity and value projection (trying to spread norms and ideational prescriptions) through soft power demonstrates a liberal approach to such a grand strategy. Whilst it could be argued that this is because there is little EU-level power with regards to physical security or hard power, the fact remains that the EU tends to act as a normative power.

Smith (2011:150) identifies the major components of this grand strategy. The following are relevant on a regional level, i.e. the neighbourhood. Physical security is thought to be enhanced through the promotion of the EU model of regional cooperation, which should lead to greater stability. Economic prosperity is accomplished especially through trade liberalisation. Value projection occurs through political conditionality on cooperation with the EU, with market access as a prime example of an incentive to shape the behaviour of its neighbours.

This type of behaviour fits well in the liberalist school of thought. The fact that the EU has been given the means to pursue such a strategy is a display of positive-sum cooperation in itself; because the Member States have pooled or transferred some of their sovereignty - not by coercion but by choice. Furthermore, the grand strategy is based on the same liberal values which are central to the EU, rather than on a notion of power capabilities. That this also applies to the relationship between the EU and Ukraine, with the Association Agreement as the current end result, will become clear in the sections further below. First, an introduction to theory of regional integration is offered, followed by a section on institutionalism.

2.2.2 The basics of economic integration

Economic integration refers to the elimination of economic frontiers between independent states, which results in the economies of these states in functioning as a single entity (Molle, 2006:4). Economic frontiers, or barriers, exist in many shapes and sizes. Tariffs, which are taxes on imports or exports, are well-known examples but a range of other impediments on trade exist. Non-tariff barriers (NTBs) include *inter alia* quotas, standards and administrative costs at the border. Economic integration can best be understood in a dynamic sense - not as a final state of being, but as a process whereby a gradual removal of barriers leads to increasingly merged economies.

There are two dimensions in which integration can take place: the integration of markets and the integration of policy. Market integration has three stages which can be seen as successive, but are encountered in practice also as combinations: a free trade area, whereby internal goods traffic has no impediments; a customs union, whereby a common external tariff is implemented; and a common market, which includes the two preceding categories and covers all markets (goods, services, labour and capital). The integration of policy can take three forms: an economic union, whereby coordination or unification of economic policy occurs; a monetary union, where a common currency circulates; and an economic and monetary union, which combines the preceding forms' characteristics.

The costs and benefits of economic integration depend on the stage of integration. The primary gain of free trade is a better allocation of resources. The idea is that countries will specialise in those areas of economic activity where they have comparative advantage, leading to higher overall efficiency. Enhanced competition and innovation will lead to increased economic growth. Costs are primarily encountered on the short term, when markets have to adapt to new circumstances. Equality of production structure and economic order are considered necessary for a free trade zone, and additional criteria are prescribed for further integration.

When looking at the effects of free trade in a customs union, it is useful to consider a distinction in trade creation, diversion and expansion. Trade creation means an increase in trade between the member countries, implying that demand shifts towards the more efficient producer. Trade expansion refers to an increase in demand (and thus trade between the members and the rest of the world) because of lower market prices due to a removal of tariffs between the members. Both these tendencies increase efficiency, whilst trade diversion does the opposite. Trade diversion occurs when members trade between themselves rather than with the rest of the world. This is an issue when prices on the world market are lower than those within the customs union, but are distorted into higher prices due to the common external tariff. If trade expansion and creation offset trade diversion, the customs union contributes to overall efficiency, yet it might still hurt producers or consumers in specific countries.

The notion that entering into a customs union hurts those who remain outside was already discussed in 1950 (Viner). According to Olofsdotter and Torstensson (1998:303) it has been demonstrated that "regional integration unambiguously benefits the member countries and hurts the outside country". This is especially visible when a country acceding a customs union has to raise its tariffs towards third countries. However, since the costs of trade between members go down in relation to trade with those outside the union, trade diversion can also occur in the case of an FTA. On the longer run, the picture might be different because increased economic welfare within a union can lead to trade expansion with countries on the outside.

This is underwritten by the example of trade shifts after the 2004 enlargement (Papazoglou, Pentecost, & Marques, 2006:1088) , whereby a decrease of North American (-2.52 percent) and Far East (-2.87 percent) exports to the accession countries was observed. The authors do note that this might be only temporal, because higher welfare might lead to more trade later on. Another study shows that for a range of regional free trade schemes the EU and its predecessors engaged in, the results accounted for decrease in trade by average of 0.1 percent of the non-partner countries' GDP (Kandogan, 2009:16). It is important to take these arguments into account when engaging in a free trade scheme, even if the effects are quite small. For a third country, there are roughly three courses of action that can be taken in response to possible harmful effects. Pursue economic integration yourself (the domino-effect); renegotiate tariffs through a multilateral organisation (the WTO), or retribute (which might lead to a trade war). The last option of course will lead to welfare losses, rather than welfare gains.

2.2.3 'Institutions matter'

New institutionalism, the theoretical approach under which historical institutionalism falls, consists of a range of theoretical ideas and hypotheses concerned with the relations between political agency, performance and change on the one hand, and institutional characteristics on the other (March & Olsen, 2005:4). Six core features can be identified (Lowndes, 2010). Firstly, rather than the traditional focus on organisations as institutions, the importance of rules which prescribe ways of doing things is recognised. Secondly, those rules are not only the formal rules, but also the unwritten conventions, arrangements and mechanisms. Thirdly, although institutions are concerned with stability, they do possess a dynamic nature. Institutions are not 'things', they are processes; change and development of those processes is possible and relevant. Fourthly, the realisation that institutions embody and shape societal values is of importance - although the way this happens and to what extent is controversial. Fifthly, new institutionalism has a differentiated conception of institutions, so rather than comparing an entire system of government, one would look at a specific component, realising that institutions do not necessarily "fit together to form a whole" (Lowndes, 2010:69). Finally, it should be noted that according to new institutionalist theory institutions are embedded in a particular context - they are not entities separate from space and time.

The most important difference between the three main variants of new institutionalism lies in the assumptions regarding human behaviour. The theoretical assumption of rational choice institutionalism can be labelled the 'calculus approach' (Hay, 2006:3). The idea is that actors are instrumentally rational, so their behaviour is a function of rules and incentives. At the base of their behaviour lies the strive for utility maximization, acting strategically and with a fixed set of preferences or tastes, existing exogenously to the institutional analysis. Opposite to this is the 'cultural approach', as the theoretical assumption of normative institutionalism is called. Within this approach, actors are considered to follow norms and conventions: the choice of a course of action is, to a certain degree, dependant on the interpretation of the situation. Individuals are seen as satisfiers, who act according to their worldview. Within historical institutionalism, both these approaches are combined: humans are both norm abiding followers and self-interested rational actors (Steinmo, 2008:126).

So, according to historical institutionalism, behaviour depends on the individual, the context, and the rules. This sounds both obvious and far too wide - which is it is essential to take into account what the historical record holds. Instead of looking at history as a chain of independent events, historical institutionalism is concerned with tracing the path which led up to a certain situation. There are three important reasons to do so (Steinmo, 2008:127). First, the historical context has a direct influence on the decisions or events that can occur, because institutions are the result of history. Second, actors can and do learn from previous experiences - they try to replicate successes and avoid making the same mistakes. Last, expectations are also shaped by the past. This means that actors will expect that, for example, a positive outcome in the past can be replicated.

New institutionalism in general (and to a degree historical institutionalism as well) is 'better' at explaining institutional continuity than change (Steinmo, 2008:129). This is also because of the nature of institutions: they are often embedded in other institutions, due to actors' learning and expectations they are hard to change, and preferences can be shaped by institutions. Yet if ideas about what is right, or what should be done, do not line up any more, change can still be induced. Furthermore, the notion of a 'punctuated equilibrium' should not be discarded entirely: exogenous shocks can radically alter institutions.

This basic discussion of new- and historical institutionalism concludes the introduction of the theoretical framework. With these tools at hand, the evolution of relations between the EU and Ukraine will be analysed in the following sections.

2.3 EU - Ukraine relations

The discussion of the relation between the EU and Ukraine is structured as follows. As noted before, three periods are identified and analysed separately: pre-2005, the five years that followed, and the last five years. It will become clear that this is a somewhat artificial distinction, yet a useful one for the sake of clarity. After a brief introduction of the most important developments during each period, a discussion using the rationales that were introduced above is offered. The relation between political and economic goals, and the way in which the outcomes of those goals are shaped by institutions, forms the conclusion of each section.

2.3.1 Post-communist times and an absent transformation

Ukraine has been an independent country since 1991, when the Soviet Union was officially dissolved. The years that followed have been characterised by troublesome or failed reforms. Writing in 2000, an expert on economic transition and former advisor to Ukraine wrote that:

"To sum up, Ukraine suffers from a weak state, the absence of a sense of direction, and a weak civil society, while it is dominated by an omnipotent ruling elite that is more interested in its own rent seeking than in the public's welfare." (Åslund & De Menil, 2000:25)

In 2004, then prime-minister Viktor Yanukovych was declared winner of the presidential elections. The public outcry against this rigged election led to the Orange Revolution, bringing the more western minded Viktor Yushchenko and Yulia Tymoshenko[1] to power.

It falls outside the scope of this thesis to further go in to detail about this period here. Whenever relevant, legacies from that era will be described and analysed - the realities were of course far more complex than described here.

The relationship between Ukraine and the European Community during this time did already include formal agreements. After the disintegration of the Soviet Union, the 1989 Trade and Cooperation Agreement between the EC and the USSR became outdated. This led to the conclusion of a Partnership and Co-operation Agreement (PCA) between the EC and Ukraine in 1994, which entered into force in 1998. This Agreement was a framework before all else, of

[1] Although at times used as the poster childs for Ukraine's efforts to liberalise and democratise, the reality is more complex. It is not necessary to offer full biographies here, rather, it should be taken into account that Yushchenko was first appointed pirme minister by President Leonid Kuchma and that Tymoshenko was amongst the richest people in Ukraine due to her succes in the energy business.

which the main objective was to structure political dialogue for the development of closer political, trade and economic relations. It was considered to be a dynamic instrument because the means provided in the agreement still had to be developed upon its entry into force. The Agreement was neither far-reaching nor used to its full potential (Hillion, 1998:419).

This very brief introduction provides the context from which efforts for a renewed relationship stem. In the following section, the political rationale for the policies regarding such a relationship are discussed.

2.3.1.1 A ring of friends: political arguments for the ENP

The European Union's 'big bang' enlargement of 2004 caused an increase in interest in the countries to the East of the newly redrawn EU border. The European Neighbourhood Policy that was formulated to shape this interest had at its core the concept of a 'ring of friends'[2]. These friends, through sharing the EU's fundamental values and objectives, would then be drawn into an increasingly close relationship. A relationship that would be beneficial to all involved because it leads to greater stability, security and well-being. The ENP would not take the place of existing agreements that had already been concluded with some of these friends, but instead develop them further on the basis of action plans. Within these action plans, the more specific goals were then identified and prioritised.

The idea of creating a friendly neighbourhood was not first voiced in the ENP. It was, in fact, already a central part of the 2003 European Security Strategy. One of the three strategic objectives for the EU encompassed in that document was the promotion of a "ring of well governed countries to the East of the European Union and on the borders of the Mediterranean"(European Council, 2003). Furthermore, it was included in the European constitutional treaty, of which drafts were already circulating before the ENP strategy paper was published. In this treaty, which never entered into force, a new provision was found on relationships with Union neighbours. These relationships would be "aiming to establish an area of prosperity and good neighbourliness founded on the values of the Union" (European Convention, 2003).

It can thus be argued that the EU had three political reasons to establish an ENP with the goal of creating a ring of friends. The first reason is quite pragmatic: because of the 2004 enlargement, the Union had a number of new neighbours. It was therefore an appropriate time to create a framework policy so that the new borders of the EU would not lead to new dividing lines - economic or others. The second reason is that a ring of friends means that the EU finds itself in a safer neighbourhood (K. E. Smith, 2005). Interestingly, this argument of security can be illustrated by the exact lack of it which the EU now faces through instability in its neighbourhood: threats of terrorism to the South, and geopolitical tensions to the East. The third reason can be called 'value projection': the disposition the EU has to spread the values upon which it is founded (M. E. Smith, 2011). Notwithstanding the fact that these values might be applied inconsistently or selectively, this normative power does appear to play an important role in EU foreign policy (Wood, 2009). Liberalism resonates through this behaviour, because it is based on a strategy of cooperation and interdependence to promote liberal goals.

[2] The 16 countries taking part in the ENP are: Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Libya, Moldova, Morocco, Palestine, Syria, Tunisia and Ukraine.

The ENP had to deal with a certain elephant in the room from the very beginning. This elephant, which was actually discussed rather than ignored, was the perspective on membership. The EU was fairly clear in what was on offer, namely "all but the institutions"(Prodi, 2002) - meaning no membership. At the same time, some of the neighbours were not hiding their aspirations - Ukraine being vocal about its wish to join the Union. From the onset, the question was whether it was possible to get the neighbours to reform according to the EU's wishes, without the transformative appeal of being granted membership. Conditionality, the principle of quid pro quo regarding economic access and political reform, only works when incentives are on offer. However, the biggest incentive of them all was not: membership was not on the table. The EU was optimistic, as the President of the European Commission said: "the goal of accession is certainly the most powerful stimulus for reform we can think of. But why should a less ambitious goal not have the same effect?" (Prodi, 2002). The next best thing was a contractual relationship on deepening trade and economic relations.

The following section is devoted to the economic interests which led to Ukraine's interest in enhanced relations with the EU, and thus their participation in the ENP.

2.3.1.2 Access to the single market

Regional integration facilitates increased trade which leads to higher efficiency which brings about more welfare. That is, in a nutshell, the theoretical core of economic arguments for integration. The liberalization of trade between the EU and the neighbourhood countries was one of the possible goals encompassed in the ENP. Access to the EU internal market was the most far-reaching aspect of the policy, in other words: the highest goal that could be reached by countries in the absence of a membership prospect. This does not mean access could be achieved by each country: in theory, economic access was tied to the will to reform, especially with regards to values - as discussed in the previous section. The first years of the new millennium saw unprecedented growth and stability in Ukraine. In a 2004 World Bank report, it is argued that the favourable economic conditions offer an opportunity to pursue policies that will ensure long-term growth. These economic conditions include a GDP that is 30 percent higher in 2003 than in 1997, industrial output growth of 56 percent in the same period, and inflation which has been under control since mid-2000 (Litwack & Wetzel, 2004:vi). GDP in 2003 was about $50.1 billion in Ukraine, compared to the €9,953.3 billion ($8,798.7 billion) of the EU-28 and $430.3 billion in Russia (World Bank, 2015b).

However, it were mostly external factors that were responsible for this turnaround: higher prices of Ukrainian export goods on the world market, depreciation of the Ukrainian currency and tighter external financial constraints on the country. The investment climate in the country was still characterised by weak market institutions, regulatory instability and unfair competition. Furthermore, large financial-industrial groups (FIGs) with significant political power created an 'insider economy' which weakened the link between economic gains and welfare benefits for the general public (Litwack & Wetzel, 2004:ix).

With regards to trade, the period of 1996-2004 was characterised by growth as well, albeit in varying directions. During this period, export towards Europe (including countries not in the EU) doubled to $11.6 billion, whilst export to Russia grew barely more than 5 percent to $5.9 billion. Exports to the rest of the world increased almost fivefold to $15.2 billion, adding up to a total of $32.7 billion of Ukrainian exports. Manufactured goods/metals and machines comprised the biggest part of exports, followed by fuel (to the EU-25), food and crude materials (Emerson, 2006).

Imports increased with almost 65 percent to $29.0 billion, with 42.8 percent coming from Russia in 2004 against 50.1 percent in 1996. Imports from Europe grew the most in both relative and absolute terms: from 24.8 percent to 32.9 percent (or $9.6 billion) in 2004. The rest of the world remained virtually stable in relative terms at 25.2 percent. Fuel is the largest element of imports and originates almost entirely in Russia, whilst imports from Europe are mostly machines, manufactured goods/metals and chemicals (Emerson, 2006).

Dodini and Fantini (2006) discuss the implications for economic growth and stability of the European Neighbourhood Policy. Apart from the advantages of trade and factor movement, they identify two more channels through which the ENP can expect to have an impact. Because of the structural reforms that should follow from implementation of the ENP, the regulatory framework of the participating countries will improve. Furthermore, the ENP should provide a 'macro policy anchor'. This refers to the idea that better monetary and fiscal policies will be adhered to due to the economic integration.

Dodini and Fantini (2006) argue that the ENP does not pose serious risks for economic and financial stability, mostly because implementation will be gradual. Still, some risks are identified, with the note that they need not materialise as long as certain measures are taken. Greater dependence on the EU market for exports can make the ENP countries more vulnerable to economic downturn in the EU, a tendency that is even more pronounced when there is supply-side specialisation in the latter. Another issue that must be taken into account is the risk of over-regulation. The legislation of the internal market can be very detailed and extensive and is not designed with the less developed ENP countries in mind. This can lead to higher compliance costs for the neighbour's private sector, and higher administrative costs for their governments.

Overall, the potential benefits of economic integration within the ENP are considered higher than the associated costs, as long as the pace of convergence to the EU and the internal processes of economic reform are matched (Dodini & Fantini, 2006:530). From this general prediction, the attention will now shift to the study on prospects of deep free trade between the EU and Ukraine.

Emerson et al. (2006) discuss various options for economic integration between the EU and Ukraine in a study commissioned by DG Trade. It is an updated and extended version of a similar study undertaken six years earlier, warranted not only by the passing of time, but also a change in context. Ukraine had seen an economic recovery after a deep recession in the 1990s and was negotiating its WTO accession. The study considers not just the impact and cost/benefits, but also the feasibility of possible forms of integration. The conclusion is that a so called FTA+ is the preferable option. It should be noted that this is can be seen as a compromise between the economic argument for (more) complete integration, and the political and practical arguments against such a move. Before describing the considerations regarding the FTA+ in more detail, an overview of the other possible types of agreement is in order.

A simple free trade agreement would go just beyond the extensive WTO package that was already under negotiation. Eliminating all tariffs, liberalising more services and capital, as well as some visa-liberalisation would be an option with high feasibility. At the same time, the benefits would not be substantially higher than what was foreseen under the WTO agreement anyway, whilst some risks are involved by liberalisation without demands for reforms in the domestic business climate.

A customs union would add to this agreement the alignment of external tariffs with the EU, as well as participation in other trade-policy measures. Apart from the higher technical and administrative burden, this would incur significant costs on Ukraine- both politically and economically. This is due to trade diversion with regards to Russia. Because Ukraine would have to give up its free trade agreement with Russia and impose the EU tariff, the consequences would be substantial. Of course, this could be mitigated if Russia would itself engage in a similar agreement with the EU, or in the very least show interest in the FTA that was on offer. Such a lock in, or domino effect, follows somewhat logically from a theoretical point of view. The real world turned out to behave differently.

Complete market integration, similar in form to the European Economic Area (EEA) would be problematic for Ukraine as well. The benefits for the country would be higher than in the FTA+ scenario, but the implementation capacity of both government and business in Ukraine was doubtful, as was political feasibility. This was mainly due to the loss of sovereignty it would mean for Ukraine due to the obligations of the EEA.

The study presents the FTA+ as the preferable option: "deep free trade is complex and demanding in terms of feasibility, but offers the prospect of large economic advantages of strategic value" (Emerson, 2006:130). Such an agreement would comprise, broadly speaking, the following: extending the zero tariff principle to goods, services, capital, and (on the longer run) labour; substantial elimination of NTBs for goods through harmonisation or mutual recognition; convergence with EU regulatory rules for trade in services; commitment to better competition policy, corporate governance and selective environmental standards; and the adoption of accompanying policies, including technical assistance and infrastructure investment (Emerson, 2006:4). As will be discussed further below, this is to a large extent in line with the actual DCFTA that is now in place.

The economic advantages predicted by the study for deep free trade through a computable general equilibrium (CGE) model range from 4-7% welfare gains for Ukraine in a static simulation, which would be twice to thrice as large if dynamic effects are taken into account. Furthermore, this model does not take into account the effects of institutional change and approximation on the medium and long term. Estimates of the impact of improved institutional quality are very large: 20 to 30% (Emerson, 2006:72).

However, the benefits associated with such an agreement might not be easily reached - several remarks regarding feasibility are to be considered. The demands an FTA+ would place on the administrative system are not to be neglected, and "heavy investment in institution- and capacity-building would be needed" (Emerson, 2006). Furthermore, convergence to the EU would require a transformation of the Ukrainian economy. Technical standards for industrial products were not in line with those of the EU for large parts of production, and "recognition of standards for processed foods is going to be a long and costly process"(Emerson, 2006:87). It is important to note there that such costs are not just borne by the government, but also by businesses - around half the costs of legal harmonisation might be incurred by non-state actors (Delcour & Wolczuk, 2013:17). These issues are further complicated by the interests of FIGs, i.e. the oligarchs. The business community, and by extension the parliament, might not be too forthcoming with regards to measures unfavourable to them.

These conditions notwithstanding, the EU and Ukraine did decide to pursue the option of a FTA+. Before going into the details, the following section will analyse the mechanisms through which the EU approached relations with its neighbours.

2.3.1.3 Institutional legacies

Two approaches can be taken for the discussion of these mechanisms. On the one hand, it is interesting to note the practical methods and financing instruments that are used to reach the objectives. On the other hand, it is necessary to understand the underlying mechanisms. The former will be dealt with briefly; the latter is of course more important from the theoretical point of view.

As mentioned before, the Action Plans that were drawn up for each of the ENP countries were the primary tool to achieve the objectives. The first of these documents for Ukraine listed 70 priorities for action, of which 14 were to be given special attention (European Commission, 2005). Interestingly, it is mostly a to-do list for Ukraine, with only vague reference to benefits it will yield – let alone that those benefits are directly connected to fulfilment of the objectives (K. E. Smith, 2005). The activities that supported the ENP were funded from the European Neighbourhood and Partnership Instrument (ENPI), which was the 2007-2013 successor to the financing instruments already in place (TACIS in the East, MEDA to the South). The budget allocated for that period was €11.2 billion.

Looking at the broader picture, it becomes clear that the EU strategy with regards to the ENP had strong roots in the preceding enlargement experience (Kelley, 2006:31). Through learning and adaptation, the Commission transferred methods used during the enlargement process to the ENP. This is most pronounced in the use of conditionality and socialisation.

Conditionality can be designed as a strict *quid pro quo*, by creating a matrix of rewards for certain reforms. However, this can lead to a range of problems due to its inflexibility – not in the last place because it does not exactly fit well with the concept of joint ownership that is part of the 'partnership' between the EU and its neighbours. Therefore, a more ambiguous approach was taken, whereby the overall level of shared values would influence the degree to which ambitions are shared. As a Commission official said: “The countries that push more shared values will get priority in financial support, greater and speedier access to the internal market” (Kelley, 2006). A vital element for the mechanism of conditionality to work is that the incentives must in fact be appealing. With a membership perspective kept outside of (or beyond) the ENP, the question of whether the carrot was big enough was raised early on.

Socialisation occurs when behaviour is changed due to persuasion and reputational pressure. This means that the focus lies not only on benchmarks and targets, but rather on the process of negotiating and interacting. Socialisation can be found in various elements of the ENP. The extensive language on values combined with notions of 'partners', 'dialogue' and 'joint ownership' are an effort to making sure that EU norms are appropriated without explicitly forcing them upon the countries in question. Interaction with domestic partners, including political opposition, civil society and other reform-minded parties is a tool to achieve this.

Progress reports, annually published for each country, can be used for naming and shaming (Johnston, 2001:11).

Could the goals of the ENP be achieved without problems, using the tools of conditionality and socialisation? Already in the first analyses, some headaches were predicted. Smith (2005) points out that assessing the progress made by the neighbours can be problematic because of three reasons. Firstly, it is sometimes not clear who should be carrying out an action: the EU or the neighbour? Secondly, it is not always clear how progress will be judged. Thirdly, whilst the Action Plans span a timeframe of three years, it is not clear when particular objectives are due. Whether or not these issues become problematic depends. On the one hand, the vagueness allows for flexibility which might be beneficial to both the process and the end result. On the other hand, it might lead to frustration or damaged credibility.

Taking a step back, Kelley (2006) discussed whether optimism regarding the ENP was in order. She argues that the effort to emulate the success of the enlargement had potential. Whilst the ENP was clearly meant to be something else from the onset, the experiences gained by the EU during the enlargement process were indeed valuable lessons for interaction with the neighbours. Nonetheless, there were two reasons to temper the enthusiasm. First, the ENP countries were at a significantly lower level with regards to 'EU values' than the new Member States in the early 90s. Most ENP countries had extensive human rights abuses, no democracy, and were poor. A second obstacle is the historic relationship of the EU with the neighbours. Because of the ineffective promotion of human rights and democracy by the EU in these countries, the EU might be lacking a credibility problem. This is however more pronounced with the southern than with the eastern neighbours.

The efforts of the ENP were, of course, not aimed at an Ukrainian tabula rasa. Rather, it was a country where institutional power asymmetries allowed a group surrounding the president to be dominant in both politics and the economy. The tendency of this group to mould reforms in a fashion mostly (or only) favourable to themselves led to the situation where "[t]he experience of such self-serving 'reforms' and 'state-building' has […] deepened society's disillusionment with politics in general and reforms in particular, leaving the Ukrainian society politically disfranchised"(Wolczuk, 2004:4).

The importance of institutions and their history can clearly be seen above. First, because knowledge, experience and methods where transferred from institutions concerned with enlargement to the ENP. Second, because the expectations where sometimes aligned with previous experiences - both from the side of the EU and Ukraine. And third, because from the early stages on, a focus on institutions was part of the strategy - whether it was a focus on a rules-based relationship or the recognition of the need for institutional reform.

2.3.2 A changing Neighbourhood

Ukraine went through several significant developments in the five years that followed. A very brief overview of the most important issues will be presented first, as well as a synopsis of the relationship between the EU and Ukraine. Then, attention will be paid to the political rationale, followed by the economic arguments, and a concluding institutional synthesis.

The 'Orange government', in place from 2005-2010, was marked by infighting between President Viktor Yushchenko and his two-time Prime Minister Yulia Timoshenko. In 2006, their rival Viktor Yanukovych held the post of Prime Minister. Outwardly, the government was more or less consistently pro-European. Relations with Russia saw two major disputes over gas, with interrupted supply affecting third countries in 2006 and 2009. A financial crisis hit Ukraine in 2008-09, with a 15 percent drop in GDP during the latter year. The period was concluded by Yushchenko losing the presidential elections in 2010 to Yanukovych (who took 48 percent of the votes) .

The relationship with the EU evolved as well. In March 2007, negotiations on a 'New Enhanced Agreement' were opened between Brussels and Kiev. These negotiations were in recognition of the democratic and economic reforms underway in Ukraine, including constitutional reform following the 2004 Orange Revolution. Early on, it was noted that the agreement was to go beyond mere partnership and cooperation, instead aiming for political association and economic integration (European Commission, 2007). The first report further states that the negotiations proceeded well in the first four rounds due to a positive spirit of constructive engagement. This language is repeated in each of the yearly updates up until the final 2010 report. After Ukraine's accession to the WTO was approved in January 2008, negotiations on a DCFTA with the EU were opened in the following month. By 2010, a joint understanding and provisional agreement was achieved for large parts of the Agreement, with completion of the negotiations as a key short term objective (European Commission, 2010a).

From then on, the so-called EU-Ukraine Association Agenda (AAg) was the primary tool to prepare for, and facilitate the entry into force of, the Association Agreement. This 'living document' contained priorities for action and was updated along the way. The 2010 list contained 78 priorities covering a range of issues, from political dialogue to statistics (European Commission, 2010b).

2.3.2.1 A ring of friends on fire

The ENP was flexible in the sense that the action plans, and later the Association Agendas, were updated on at least a yearly basis. On the other hand, the framework of the policy was not essentially changed. But the world surrounding the EU did. Starting in 2010, many countries in the Southern neighbourhood went through the 'Arab Spring'. In this light, thought was given to ENP: did the EU react properly in that region, and did it have the tools to do so? Whilst the Southern neighbourhood is not directly relevant here, the discussion regarding the ENP did matter for Ukraine as well.

The goals the EU had towards its neighbours were, in essence, the same as they were in 2004. The 2007 Lisbon Treaty had introduced the provision earlier seen in the Constitutional draft, stating that a 'special relationship shall be developed'[3]. This was not something new, since the ENP already aimed exactly at fulfilling that article. However, there was something else that was

[3]Article 8 TEU:
1.The Union shall develop a special relationship with neighbouring countries, aiming to establish an area of prosperity and good neighbourliness, founded on the values of the Union and characterised by close and peaceful relations based on cooperation.
2. For the purposes of paragraph 1, the Union may conclude specific agreements with the countries concerned. These agreements may contain reciprocal rights and obligations as well as the possibility of undertaking activities jointly. Their implementation shall be the subject of periodic consultation.

new: the Eastern Partnership (EaP), launched in 2009. This multilateral forum aimed at bringing six Eastern countries closer to the EU: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Three objectives were formulated: accelerating political association, furthering economic integration between the EU and its Eastern neighbours, and providing for citizen's mobility. Once again, stress was placed on values: "it is about developing democracy, promoting human rights, the rule of law and good governance, and securing fundamental rights and freedoms in the Eastern European partner countries" (Website European External Action Service). The goals encompassed within the Eastern Partnership can thus be considered to be a reiteration of those of the ENP - the difference is more in the process than in the envisioned end result.

So how did the method to achieve those goals change? The biggest difference between the European Neighbourhood Policy and the Eastern Partnership is that the former is a bilateral instrument, whilst the latter takes a more multilateral approach. This is not to say that the EaP does not have a bilateral dimension, in fact, the perspective on Association Agreements and support for reforms was placed within this new instrument as well. The multilateral dimension was displayed through the creation of four platforms, which would meet regularly to foster exchanges on best practices regarding issues of mutual interest. These platforms were formed around the subjects of democracy, good governance and stability; economic integration and convergence with EU policies; energy security and transport; and contacts between people. They would serve as forums not just for governments but also international organisations, civil society and the private sector.

But is the EaP really something new? Korosteleva argues that "the EaP appears timely and seemingly more versatile than the ENP, and it aims to amplify the latter's effectiveness in the region" (2011:244). Appearances matter, but actual content should not be ignored. The fact that are large share of funding of the EaP is diverted from the ENP is already telling, but also on a conceptual level there is more continuity than change. This is especially the case with the notion of 'partnership' as central to the instrument (Korosteleva, 2011). That this is not necessarily a good thing will become obvious in the discussion further below on the troubles faced by the ENP during the first five years.

On a more conceptual level there were several tensions enclosed in the ENP (Bechev & Nicolaïdis, 2010:479), which also had their effect on Ukraine. The fundamental asymmetry between the EU and the surrounding countries thus leads to tendencies of hegemony rather than partnership. It reflects the centrality of the EU, whereby the neighbour is managed rather than perceived as an actual partner. Whilst this reflects the realities of political and economic power, the gap between the narrative and the experience of the neighbour can lead to frustrations. Ukrainian officials explicitly voiced their dissatisfaction, arguing that "the EU does not want to see Ukraine as an equal partner" (Korosteleva, 2011).

Concluding, it can be argued that both the goals and methods pursued by the EU remained liberal. Although the goals did not essentially change, some issues concerning the methods came to the fore here. On the one hand, the promotion of regional integration through the EaP is a clear example of the trend mentioned by Smith (2011) in his discussion on a liberal grand strategy. On the other hand, better scrutiny reveals that politics of power remain enclosed in the ENP and EaP. Furthermore, some limits of EU influence were already identified.

These limits followed also from the domestic situation in Ukraine. As indicated above, the period in which Yushchenko was president was far from politically stable. Already in 2005, Tymoshenko was fired as prime minister, and although she was reinstated in 2007, their infighting never stopped. Furthermore, Yanukovych' position as prime minister in 2006-2007 led to a two-tier foreign policy, with the leadership being divided between being more western- or more Russian-minded. This lead to limited implementation of the ENP, not in the last place due to a lack of coordination in Ukraine (Wolczuk, 2009).

In the following section, the economic arguments which surfaced during this period are discussed.

2.3.2.2 "I have problems to participate in the zero-sum game, as I am a believer in win-win games" (Füle, 2013)

The economic advantages of regional integration remained valid during the 2005-2010 period. However, a new option of integration materialised for Ukraine: a customs union with Russia, Belarus and Kazakhstan. Below, a brief overview of the most important developments regarding the state of Ukrainian economy and trade is presented. This is followed by a discussion on the merits of this new scheme compared to the agreement that was under negotiation with the EU.

It appeared that Ukraine's economy would continue to grow in the second half of the new millennium - 2006 and 2007 saw GDP growth over 7 percent (World Bank, 2015b). But, as was mentioned before, this was by and large due to extremely favourable external conditions. Ukraine was therefore hit hard by the worldwide economic downfall starting in 2008.

A 2010 (World Bank) report mentions two of those external conditions. First, Ukraine's terms of trade allowed real income growth beyond productivity growth, because prices of steel, chemicals and agricultural products went through a sustained boom up until the crisis. FDI inflows and bank lending were huge, justified by the expected income convergence that was seen previously in other Eastern European countries. At the same time, reforms were not far-reaching enough. Domestic competition was lacking, financial regulation was not developed, and political infighting led to short-term visions.

So, when the world economy tanked, the consequences were felt. In 2009, a 45 percent decline in exports was accompanied by a 15 percent drop in GDP. The poverty headcount rose to 16 percent in that year, the same level as 2006. Furthermore, a dispute with Russia over gas debts resulted in interrupted supplies in 2009, similar to the 2006 interruption. Then, in 2010, former prime-minister Viktor Yanukovych won the presidential election. When that happened, a new type and direction of economic integration was already on the table.

Within the scheme of the Eurasian Economic Community, which comprises Armenia, Belarus, Kazakhstan, and Russia, a customs union was introduced between the latter three in 2010. Substantial pressure was put on Ukraine by the Russian Federation to join this scheme in favour of pursuing an agreement with the EU. Whilst the DCFTA that was being negotiated with Ukraine did not preclude the country from having free trade with third countries, it was incompatible with a customs union. It is not possible to remove barriers between the EU and Ukraine, and at the same time commit to an external tariff with another entity. A choice was thus to be made. A 2011 quantitative study (Movchan & Giucci) assessed three scenarios: a simple

FTA with the EU, a DCFTA with the EU, and a customs union with Russia, Belarus and Kazakhstan (CU RBK).

The CU RBK was focussed on trade in goods primarily when it was introduced, although further harmonisation and integration was envisaged (Movchan & Giucci, 2011:8). Apart from the economic consequences, three benefits for Ukraine are identified: cheaper energy as a consequence of price discounts, elimination of customs control, and stronger bargaining power (2011:10). Political credit with Russia could be added to this. At the same time, several costs would also be imposed: a loss of independence in trade policy, a slower pace of modernisation, and the burden of renegotiations with the WTO.

The economic impact in quantitative terms is significant for either option, whether it is a DCFTA with the EU or CU with Russia, Belarus and Kazakhstan. For the latter scheme, it would have a negative impact for Ukraine. A reduction of welfare of 0.5% on the medium term, up to a reduction of 3.7% on the long term is calculated if Ukraine were to join the customs union. On the other hand, a DCFTA with the EU would boost welfare by 4.3% in Ukraine in the medium term, a number in line with the 2006 predictions of Emerson et al. Furthermore, an 11.8% gain in welfare is predicted in the long term.

The choice therefore seems fairly obvious from an economic point of view. However, it must be taken into account that the model from which these predictions follow is based on certain assumptions. The DCFTA scenario expects not just the mutual elimination of import tariffs, but also a 2.5% reduction of 'border dead-weight costs'. The latter is the consequence of approximation of the regulatory framework in Ukraine, and the improvement of customs and other procedures. As was noted before, this is not something that will happen out of the blue. In the following section, attention will therefore be paid to early evidence of reforms in selected sectors, demonstrating how the political will combined with the economic interest of various actors might induce change.

2.3.2.3 Evidence of institutional reform

According to an analysis by Langbein and Wolczuk (2012), the EU is not completely ineffective in causing reforms Ukraine. They show evidence of domestic impact in rule selection, adoption and application. Rule selection, meaning the official commitment to adopt and implement EU rules, is most often seen. Adoption and application, which involves more actors and higher costs, are often still hampered. If domestic state and non-state actors lack the incentive to reform, or actually demonstrate strong resistance, implementation of bilateral documents occurs selectively or not at all (Langbein & Wolczuk, 2012).

Langbein and Wolczuk (2012:877) identify three mechanisms which promote the enactment of selected EU rules in Ukraine. First, conditionality in trade related policy fields must clearly describe how market access is tied to convergence with EU rules. Second, technical and financial support to empower and diversity domestic state and non-state actors has an impact. Third, membership of local regulators in trans-governmental networks through which lessons are learnt has positive results. These mechanisms show that both conditionality and socialisation can be effective, but that support also goes a long way. Furthermore, it should be noted that this works in *selected* policy areas, and is not a uniform recipe for success.

Grant (2011) focuses on the failure of the EU to achieve its goals completely, and argues that the incentives need to be raised in the form of 'money, markets and people'. Money ought to be delivered not just through programme funding, but also by increased activity of lenders: the EBRD, or perhaps through the creation of a new EIB branch. Market access, which was already on the table for Ukraine, should come with less demands. Grant proposes access on a sectoral basis, so that domestic reforms can take place more gradually. 'People' refers to the easing of travel restrictions, for example through visa liberalisation. These recommendations have not entirely been adhered to. Visa liberalisation is highly sought after, but still not achieved by Ukraine. Whilst the time scheme for implementation of the DCFTA is not completely uniform for all sectors, it is not possible either to speak of variable access. There are fixed schedules for implementation for specific sectors which must be adhered to. EU funding for Ukraine is increased, but perhaps more because of immediate geopolitical necessity than by design.

The first period after the conception of the ENP and enhanced relations between the EU and Ukraine can thus be characterised by several issues. First, whilst the political arguments for closer integration were heard both in Brussels and Kiev, the Ukrainian government was marked infighting and conflict since the Orange Revolution. Second, the sustained period of economic growth came to an end - in Ukraine and the rest of the world. Third, some reforms did take place in Ukraine, but these were not enough. Furthermore, the EU had some hand in them, but its influence remained limited.

2.3.3 Yanukovych, Euromaidan, and beyond

This section will cover some of the developments in Ukraine during the last few years. Many of those developments, the underlying causes, and the impact they had are too complex and far-reaching to discuss here. The scope of the following analysis will therefore be limited to what is immediately relevant to the Association Agreement and the DCFTA, without pretending to present a complete picture of what happened in Ukraine since 2010.

The 2010 presidential elections were considered to be fairly won by Yanukovych. The new president appeared more Russian-minded than his predecessor, promptly renewing the lease of Sevastopol to the Russian navy in exchange for a gas discount. However, negotiations on the Association Agreement were continued, as Ukraine decided to remain outside of the Russian customs union scheme. Yanukovych' attitude to the EU and the Russian Federation can be considered a balancing act. In a way, this can be regarded as the continuation of the multi-vector policy of Leonid Kuchma, Ukraine's president from 1994 until 2004. Kuchma attempted to use the differences between the East and the West to his advantage, which ultimately failed (Korduban, 2010). Yanukovych attempts to this type of foreign policy were even more constrained due to the contractual nature of both the AA and customs union, and ultimately failed as well. Looking at his domestic policies, the two issues that were most problematic for the EU were reverting a 2004 constitutional reform, so that his presidential powers would increase; as well as jailing political opponent Tymoshenko.

Grant (2011) argues that the ENP has failed and identifies three problems with regards to Ukraine. First, there is the behaviour of the then recently elected president Yanukovych, especially his efforts to curb media freedom and political opposition (interestingly, rapprochement towards Russia is not really considered an issue by Grant). Second, the fusion of politics and business in the country: the oligarchs' practices are not necessarily compatible with the Association Agreement, and they will therefore present an obstacle. Third, the EU demands too much: the reforms laid down in the agreement are so sweeping that it is very questionable whether Ukraine could adhere to them even if they unequivocally wanted to. The EU's inability to deal with these problems demonstrates the limited extent to which it can shape its neighbours.

Still, the Association Agreement was initialled in March 2012 by senior officials of Ukraine and the European Union. However, signing of the document was delayed due to concerns over the deterioration of democracy and the rule of law that was witnessed under Yanukovych' presidency. As far as Brussels was concerned, the ball was with Kiev: "It is up to Ukraine to demonstrate political will by taking clear and concrete steps to reverse the negative trends we have seen since 2010", according to Barroso and Ashton in a July 2012 interview (Razumkov Centre).

In December 2012, the EU Foreign Affairs Council concluded that signing could take place during the Eastern Partnership summit in Vilnius in November 2013 (Council of the European Union, 2012). However, this would only be possible if the Ukrainian authorities demonstrated action and progress with regards to electoral, judiciary and constitutional reforms. Important issues were, respectively, the recent parliamentary elections, the politically motivated imprisonment of former members of the Government, and the reforms needed for the DCFTA. Not all of these conditions were met with the same enthusiasm.

By October 2013, especially the continued imprisonment of opposition leader Julia Tymoshenko had become a symbolic, but very real, stumbling block. The proposed terms of her release, whereby she would be allowed to seek medical treatment abroad but would then have to return to sit out the remainder of her sentence, were not deemed to be sufficient by EU Members (Die Welt, 2013). As late as November 10., Ukrainian Foreign Minister Azarov argued that the government was taking all the necessary steps to sign the agreement during the Vilnius summit that would take place on 28-29 November (Interfax Ukraine, 2013).

But in the week before the summit it became clear the Yanukovych, rather than the EU, would withhold his signature. Under pressure from Russia, which had been mounting since the summer, preparations were first delayed in Parliament under the guise of economic complexities which had to be resolved (Buckley & Olearchyk, 2013). Then, in Vilnius, the President refused to sign, whilst protestors had taken to the streets in Kiev.

The events that followed are too complex to reduce to a few paragraphs here, so our focus will remain on the fate of the association agreement. After the ousting of Yanukovych in February 2014, Arseniy Yatseniuk became prime minister and in that capacity signed the political provisions of the Association Agreement in March 2014. Signing of the economic provisions, encompassed in the DCFTA, would take place after the election of a new president in May 2014.

The winner of this election, Petro Poroshenko, thus signed the entire agreement on 27 June 2014 and provisional entry into force was scheduled for 1 November 2014. Provisional, because ratification, and thus actual entry into force of the agreement, can take several months up to several years because of the legislative procedures in the EU Member States. But even before ratification by the EU and Ukrainian parliaments on September 12., Russian pressure lead to the delay of provisional entry into force of the economic parts until 2016. However, the EU decided to apply autonomous trade preferences, meaning in effect that the EU unilaterally opens its market to Ukraine.

Ukraine has seen turbulent times since November 2013. When looking at the capability of the European Union to induce change and political reform, an obvious argument would be: look at the Euromaidan. Did the people of Ukraine not voice their preference for European values loud and clear? Did they not manage to elect leaders who adhere to that wish? The question of course is whether the reforms will take place. It is too soon to draw definitive conclusions here. First of all because it is not that long ago since Yanukovych was ousted. It takes time to draft and implement reforms, and Poroshenko has only been elected into office since May 2014. Furthermore, Ukraine is still not exactly stable. The conflict in the East is ongoing and the economic and financial health of the country is suffering. Unfortunately, there is no guarantee that reforms will be lasting. Nonetheless, the following section will try to provide an overview of the political integration of Ukraine and the EU. Signing of the Association Agreement in the summer of 2014 can be considered a seal on this integration, but it is at least as important to look at what has been done in Ukraine - a bilateral commitment is one thing, adhering to it is something else. This will be followed by a discussion on the economic troubles that must be faced by Ukraine. Then, concluding remarks on this period are offered, followed by some reflection of the evolving relationship between the EU and Ukraine.

2.3.3.1 Political reforms after the revolution

The first step of reform was taken by the Verkhovna Rada, the Ukrainian parliament. On 21 February 2014, at the height of the Ukrainian revolution, a compromise was signed between Yanukovych and the opposition. Part of this compromise was the restoration of the 2004 Constitution, which had been curtailed by Yanukovych when he came into power in 2010. He disappeared the very same day, and was relieved of his position by parliament on the 22nd of February. By restoring the 2004 Constitution, some power flowed away from the office of the president, yet further improvements were necessary. Reform has since been slow.

After initial enthusiasm on constitutional reform in the spring of 2014, the issue dropped from the list of priorities (Democracy Reporting International, 2014). A draft for constitutional reform, submitted by Poroshenko, was met with mixed feelings by the Venice Commission, an advisory body in the Council of Europe (European Commission For Democracy Through Law, 2014). Especially the lack of consultation with both civil society and parliament was denounced. The initiative then largely disappeared from the agenda. There were other relevant reforms: a law on the prosecutor's office, a law on lustration and a new public procurement law. Whilst the first was considered a step in the right direction, yet in need of additional improvements, the Venice Commission was more critical of the lustration effort. Whilst anti-corruption laws are very necessary, questions over the fairness and independence of the measures were raised.

On 3 March 2015, President Poroshenko announced the establishment of a commission for constitutional reform. It is a clear attempt to meet demands for a more inclusive process, since the commission will consist of representatives from not just the government, but also from political parties, civil society, academia and international organisations. At the same time, several pitfalls remain on the way to reform. An important tension exists between the wish to move quickly on one hand, and the want for due process on the other. Speediness, or ´the executive overdrive´, can be at odds with inclusion and transparency (Democracy Reporting International, 2015). There are several risks following this tension, such declining support from reform-minded for the President and a mismanagement of expectations. This is only exacerbated by the conflict: it is harder to offer a convincing narrative aimed at reform when the military effort is also in need of scarce resources.

As far as the European Union is concerned, constitutional review remains a priority. In the progress report on ENP implementation in Ukraine, it is the first on a list of the 19 most important focus areas for this year (European Commission, 2015b). Apart from financial support to the country, the EU also offers technical assistance on drafting new legislation.

2.3.3.2 Economic troubles

Whether or not the predicted benefits of the EU - Ukraine DCFTA will come to fruition is not yet clear, but previous reasoning on the subject remains valid. Only after the agreement has been implemented, and the necessary transformations have taken place, the impact can be considered. Of course the effects will remain a point of discussion even then, since the question of what can be attributed to the agreement and what to other factors will not have an absolute answer. This section will discuss some of the most recent economic developments and their causes.

In 2014, the year that Yanukovych was ousted as president, Ukraine experienced a deepening economic recession. Large accumulated fiscal and external imbalances, combined with the conflict that erupted in Eastern Ukraine, led to a 6.8 percent decline of GDP. Except for the agricultural sector, almost the entire economy was hit. Furthermore, devaluation and increasing gas and utility prices contributed to high inflation - from 25.9 percent year-on-year in December, up to 60 percent y/y in April 2015 (World Bank, 2015c).

Even though the government aimed at fiscal consolidation, deficits turned out to be unavoidable and public debt grew rapidly - from 40.6 percent in 2013 to 70.3 percent of GDP in 2014. Apart from devaluation, financing of Naftogaz and recapitalization of state owned banks as well as the Deposit Guarantee Fund were responsible. In March 2015, the IMF decided to intervene with a $17.5 billion loan programme (World Bank, 2015c).

World Bank forecasts are somewhat optimistic for the future, but stress the risks. Writing in April 2015, a growth of 2 percent in 2016 and a growth of 3 percent in 2017 is expected. However, this is subject to a lot of 'ifs': the situation in the East has to stabilise and decisive reforms in the banking and energy sector are necessary (World Bank, 2015c).

Concluding this economic overview, it is obvious that the Ukrainian economy is not doing too well at the moment. There are various reasons: insufficient reforms in many sectors during the last 25 years, regulatory failure and institutional deficiencies, as well as the conflict in Eastern Ukraine. Looking forward, the importance of reforms is obvious. Below, a discussion is offered on the latest academic evidence regarding regulatory change - stemming from before the revolution. Then, the theoretical framework will be concluded.

2.3.3.3 Drivers of change

This section will deal with two studies concerning regulatory change related to economic issues in Ukraine. It discusses recent demonstrations of the EU's capacity (and limitations) to induce change in Ukraine. Two themes can be discerned: the importance of including non-state actors in policy aimed at reforming Ukraine, and the fact that even under Yanukovych changes were accomplished. First, an analysis of the effects of the EU Cross Border Cooperation (CBC) programme is offered, second, the role international financial institutions play is discussed.

The EU Cross Border Cooperation programme is a tool used for internal integration, which is also applied in the European neighbourhood. The mechanism is part of the ENP and aims to promote economic and social development in border areas; addressing common challenges regarding environment, public health, safety and security; and putting in place better conditions for persons, goods and capital mobility. It is a partnership between bordering EU and neighbourhood countries, with management entrusted to a national or local authority.

Turkina and Postnikov (2014) argue that the networks that stem from this policy have an impact on economic integration. The authors conducted a double survey of approximation of EU law, focussed at both regional authorities exposed to CBC, as well as an analysis of enterprise-related regulations in Ukraine, Russia and Moldova. The conclusion reached is that "the learning processes occurring in cross-border inter-firm networks can instigate policy change at the local level" (2014:1121). This happens because firms, who reach a new understanding of efficient and legitimate ways of doing business, lobby policy makers. There are, of course, limits to these policy spillovers. The institutional distance between the participating neighbours' authorities and the EU state cannot be too wide, whilst certain levels of network density are necessary. Nonetheless, positive effects on regulatory approximation are proven as a consequence of the CBC programme (Turkina & Postnikov, 2014:1137). At the same time, the authors recommend that further research into the specific results is necessary.

Langbein (2014) offers an analysis of regulatory outcomes in four sectors of the Ukrainian economy. Her argument leads to the conclusion that the EU has a limited impact on reform, whilst the role international financial institutions (IFIs) and donor countries played was much more pronounced. The case study is especially valuable because it takes into account both EU conditionality and capacity-building as variables, and demonstrates that those alone might not be sufficient. The most important lessons from the article will now be discussed, after which a conclusion of the economic focus of the theoretical framework will be drawn.

As discussed before, two important mechanisms through which the EU tries to influence its neighbours are conditionality and socialisation. Langbein (2014) uses two variables closely related to this in her research, namely conditionality and capacity building. If either of these dimensions is observed, medium convergence with EU rules is expected; if both are applied there is a theoretical expectation of strong convergence. Looking at shareholder rights, technical regulations, telecommunications, and food safety, the role IFIs and donors play comes into sight. Even when the EU applies both conditionality and capacity-building, as was the case for technical regulations, only medium convergence is observed. Langbein identifies another important aspect: whether domestic non-state actors are engaged or not. IFIs and donors have targeted those non-state actors, as opposed to the EU's focus on state actors. So, when the domestic forces join in pressuring the regulators, stronger convergence occurs - as was the case for shareholder rights. In other words, to access the funds they want, market players must first bring regulatory affairs up to par - which they successfully did.

This leads to several conclusions. First, the EU's inability to foster strong regulatory convergence is worrying. But there is hope: this study was limited to only four cases so this inability might not be universal. At the same time it offered clear advise: focus on non-state actors as well. Second, the role IFI's play is valuable, but their focus on a limited number of sectors means that their involvement is no universal solution up until now. Third, if regulatory convergence remains limited, a new dividing line between east and west will form, whereby even the laggards of EU integration (Romania and Bulgaria) are much better off than Ukraine. In order to overcome these issues, the EU must use the underlying mechanism of activating domestic non-state actors. By aiming policies only at public authorities, the EU is an inefficient transformative power in many cases. Coordination with bilateral donors and IFIs can only enhance the positive results that are visible when non-state actors are engaged.

2.4 Conclusion

Time will tell whether the current reforms will be successful and the necessary further reforms will take place. A conclusion on the theoretical framework can however be reached. From the conception of the ENP on, doubts were raised over whether the incentive to integrate politically to the EU was high enough. Membership perspective was considered to be of high importance to truly induce reform - and it was not on the table.

But the association process did take off, and the negotiations resulted in an agreement that was wider and deeper than any relation the EU had with a third country up until that time. The biggest hurdle for the agreement, Yanukovych, came into office when negotiations were well underway. Nonetheless they were finished in 2012, two years into his term. Then, his refusal to sign led Ukraine to a fundamental political (and otherwise) shift towards the EU, albeit it at a high cost of human life. There are reforms underway, which are influenced by, if not in line with, the EU's wishes. It can therefore be concluded that the EU has had a profound impact in its attempt to shape the 'European neighbourhood'.

The preceding sections also provided an overview of the economic rationale of integration, the predictions for Ukrainian integration with the EU internal market, the alternative offered by Russia, as well as a preliminary report on regulatory convergence with regards to the Ukrainian economy. Several conclusions can be drawn.

First, the benefits of deep and comprehensive economic integration outweigh the costs for Ukraine. In line with the general understanding that breaking down barriers to trade is beneficial to all parties involved, the impact on Ukraine is predicted to be quite positive. Based on several economic models, the expected gains are between 4% and 11% over the medium- and long term.

Second, there are risks associated with such an agreement. The Ukrainian economy will not necessarily reform without external help, both financial and technical. And even is this help is offered by the EU, it might not be enough to achieve sufficient regulatory change. Activation and involvement of domestic non-state actors is vital. Still, the process of transformation might be painful for sectors of the Ukrainian economy and society.

The importance of taking into account institutions resonated throughout the arguments presented in this theoretical framework. The role the EU took on towards its neighbourhood and Ukraine, concerning both the goals and the methods, has clear links to its own institutional identity and previous ways of doing things. The lack of institutional reform in Ukraine, both formal and informal, has been an important cause for the (economic) problems the country now faces.

Looking forward, it is therefore important to improve these institutions. The following chapter will be devoted to a small part of that task.

3 Transition Ukrainian SME

3.1 Introduction

Ukraine has signed the Association Agreement (AA) with the EU. Not just the political provisions, but also title IV: the Deep and Comprehensive Free Trade Area (DCFTA). (Provisional) entry into force of the latter part has been set at 1 January 2016. We assume here that this will indeed happen, and that implementation of the AA including the DCFTA must indeed occur. This is an enormous task, both because of the far-reaching nature of the agreement and the current state of the Ukrainian society, economy and government. This chapter will discuss a small part of the reforms that are necessary in light of this implementation, focusing on Small and Medium Enterprises (SMEs). As explained above, a focus on SMEs is justified because they are important to the economy on the one hand, and will have to face relatively high reform costs on the other hand.

The question that is central to this chapter is as follows:

"What are the most feasible policy options for the Dutch government to support Ukrainian SMEs to adapt to the implementation of the DCFTA so that challenges may be overcome and opportunities will be exploited?"

A few remarks are in order before the structure of this chapter is presented. First, the term 'feasible' deserves some clarification. Feasible refers to the question of whether it is possible to do something. In this case, it therefore relates to the capacity of the Dutch government do support Ukrainian SMEs. This thesis does not include full feasibility studies; rather, it will identify policy options and present the basic rationale for considering them feasible. Furthermore, it will not list all feasible policy options; rather, the most feasible options according to the research done here are presented. Second, that something is feasible does not necessarily mean that it must be done. Still, arguments will be provided here as to why it is important and even necessary to support Ukrainian SMEs. Of course, the Dutch government operates with scarce resources so it will in the end be a political choice of priorities.

In order to formulate an answer to the question central to this chapter, several issues will be covered. These will be contained in four parts. First, various aspects of Ukrainian SMEs in the context of the DCFTA are presented. This includes an overview of the key indicators of Ukrainian trade, but also an analysis of the opportunities and challenges the upcoming integration with the EU poses, and the reforms that are necessary to deal with them. Second, the most important lessons from previous reforms are presented. The EU and its Member States have a track-record in reforming post-communist countries in Central and Eastern European (CEECs), therefore some experiences and practices might bring valuable insights to the current situation. This will include a section on private sector development in future member states by the Netherlands before the 2004 enlargement. Third, the current policies aimed at SMEs in Ukraine are discussed, looking at Ukrainian, EU and Dutch efforts. Fourth, policy proposals are presented.

3.2 Ukrainian SME

The following sections present the most important issues concerning Ukrainian SMEs. The discussion consists of four parts. First, an overview of the key indicators is offered. This includes research into ten dimensions used by the Small Business Act for Europe, a set of EU measures aimed at creating a level playing field for SMEs. Second, Ukrainian trade figures are analysed in the context of the DCFTA. An introduction to the biggest trade partners and the types of imports and exports is presented. Third, the opportunities and challenges that the DCFTA poses to Ukrainian SMEs are discussed. Fourth, a review and some general recommendations concerning the necessary reforms are offered.

3.2.1 Overview

The latest study into the state of the Ukrainian SME sector stems from 2012 (OECD, European Union, ETF, & EBRD). It was commissioned within the framework of the Eastern Partnership (EaP) and tests SME policy against the dimensions of the Small Business Act for Europe. But before discussing the regulatory climate in which Ukrainian SMEs operate, some basic figures as provided here.

The Ukrainian definition of SMEs includes all enterprises with less than 250 employees and a yearly turnover lower than €50 million. This is almost the same as what the EU understands to be an SME (an extra criteria is used in the EU: <€43 million on the balance sheet). However, this is a new definition, whilst the statistics used in the 2012 study consider enterprises to be large if their turnover is higher than about €9,1 million (UAH100 million). 99.5 percent of the legal business entities in Ukraine were SMEs, the employment and turnover rates are lower (OECD et al., 2012). In 2010, 58.1 percent of employment was accounted for by the SME sector, generating 51.2 percent of Ukrainian turnover (there is no information on added value, but the EaP countries' average is 30 percent added value). Compared to the OECD countries, where SMEs account for 60-70 percent of employment and 55 percent value added, Ukrainian SME does not yet play the important role it does in more developed economies. It should be noted that according to estimations about 22% of the population was employed informally, whilst individual entrepreneurs are also excluded from Ukrainian statistics – so in reality the difference might be smaller. With regards to information on Ukrainian SMEs, several issues must be taken into account. Statistical data revealing in which sectors SMEs are most active is scarce. But, according to the available information, SMEs (versus large companies) are especially abundant in real estate, rent, engineering, provision of business services, construction and hotels and restaurants. Medium-sized firms (>50 employees or >UAH70 million turnover) are well represented in agriculture, hunting and forestry and industry.

A Berlin Economics (2014) study further discusses some of the problems with statistical data on SMEs. Whilst the definition of SMEs seems to be rather straightforward, the sector actually encompasses vastly different categories, of which five are identified here. First, there is a group of pseudo self-employed. These people have the legal status of self-employed but are not entrepreneurs; rather, it is for tax or fraudulent purposes (not necessarily by choice). Second, there are subsistence businesses. These are self-employed and micro enterprises, e.g. street stalls, which are only concerned with providing enough income for those involved to survive.

Freelancers, with non-scalable businesses (such as journalists or designers) comprise the third category. Then, there are two categories which actually are (scalable) companies as you would expect them in the SME sector. They can be either 'stuck in the middle', unable to grow because of barriers or a lack of ambition; and innovative growing companies, which do manage to scale up. It is estimated that the latter two categories make up only about 5 percent of the registered SME entities. It is this 5 percent at which traditional SME policy is aimed, because these businesses add value to the economy and have growth potential. The other categories mostly do not, and some businesses might even exist only by the grace of faulty tax systems and corruption, or insufficient employment and pension benefits.

The SME Policy Index (OECD et al., 2012) assesses national SME framework using 92 indicators which measure twelve dimensions. The results are presented in **Fout! Verwijzingsbron niet gevonden.**. Each dimension can receive a maximum score of 5, which represents the strongest policy reforms according to best practices. It is clear that Ukraine does not score particularly high. Compared to the other EaP countries, the scores are often but not always amongst the lowest. For example, internationalisation of SMEs is a full point below Georgia, at a level similar to Belarus (which is not entering into a DCFTA). Whilst reforms were already underway in 2012, the report concludes that the overall business environment continues to inhibit private sector growth and SME operations.

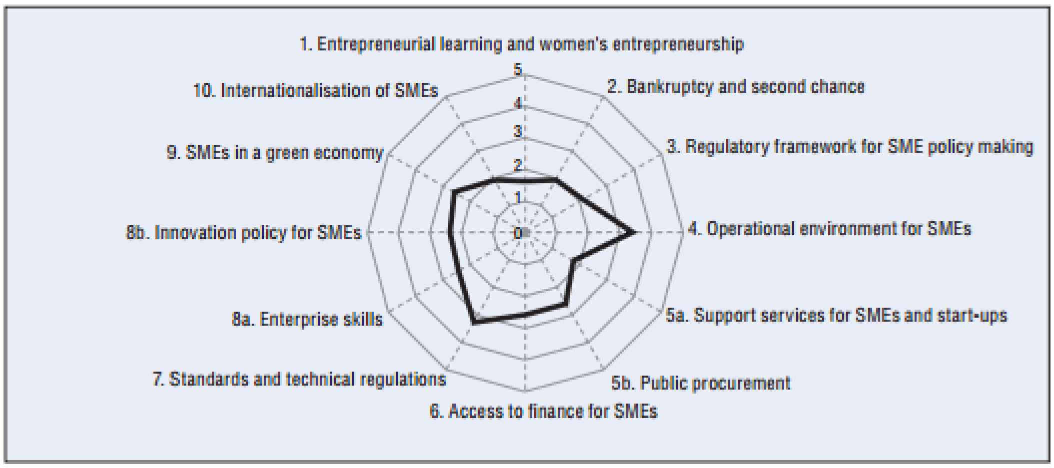

Figure 1 (OECD et al., 2012)

According to a 2014 IFC/World Bank report, "the stunted growth of the private sector goes a long way in explaining Ukraine's poor growth performance" (World Bank, 2014). This is reflected by three issues. The domination of old industries such as steel, machine-building, and chemicals with low productivity indicate a stagnant structure of the economy and exports. There is a lacking inflow of high value-added FDI, especially with regard to manufacturing focused on exports. Last, SMEs do not drive the development of the Ukrainian economy through entrepreneurship, innovation, and productivity.

Several conclusions can be drawn. First, because the Ukrainian SME sector employs more than half of the workforce, and is responsible for about half the turnover; its economic relevance is therefore high. Second, there are some issues regarding the availability and content of statistical data that should be taken into account when looking at 'the numbers'. Third, SME policy was already being reformed in 2012, but could be considered not up to par. Fourth, poor performance of the private sector restricts growth of the Ukrainian economy. The Association Agreement and DCFTA include provisions aimed at these issues, which will be reviewed further down below. But attention will first be paid to the key indicators of Ukrainian trade.

3.2.2 Trading Ukraine

This section consists of three parts. First, some general remarks and figures regarding Ukrainian trade are presented. Second, a specification of the types of imports and exports Ukraine is most involved in is provided. Last, a discussion on SMEs involved in trade is offered.

Ukraine has been a member of the WTO since 2008. The latest country profile provided by that organisation is from September 2014 and uses data up to and including 2013. Of course, this was before the revolution and Russian invasion, so it is unfortunate that more recent figures are not yet available. The EU does provide some figures for 2014, but these are only concerned with EU-Ukraine trade. It is therefore not yet clear what the impact of lower EU tariffs and the conflict in eastern Ukraine will be.

For the 2011-2013 period the trade to GDP ratio of Ukraine was 108.9, on a GDP of $177,431 million in 2013 (WTO, 2015). Compared to 2005, exports were 19 percent lower in 2013, whilst imports were 22 percent higher. A high-level breakdown of merchandise exports and imports by main commodity group, as well as the most important trading partners can be found in Figure 2-5 (WTO, 2015 [2013 data]).

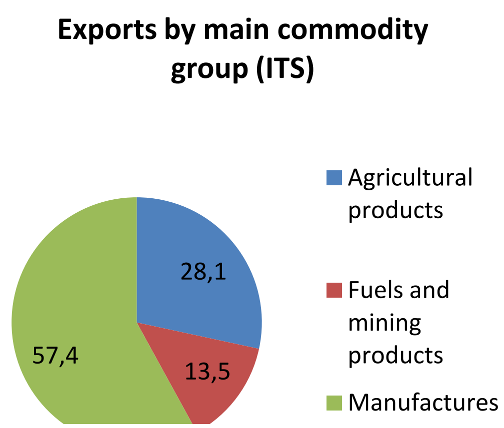

Figure 4 (WTO, 2015)

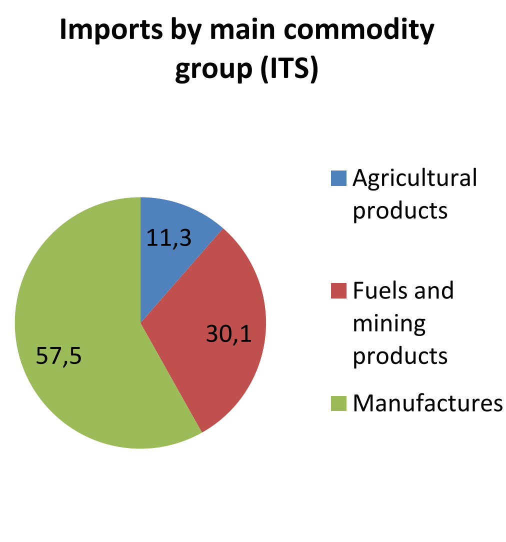

Figure 5 (WTO, 2015)

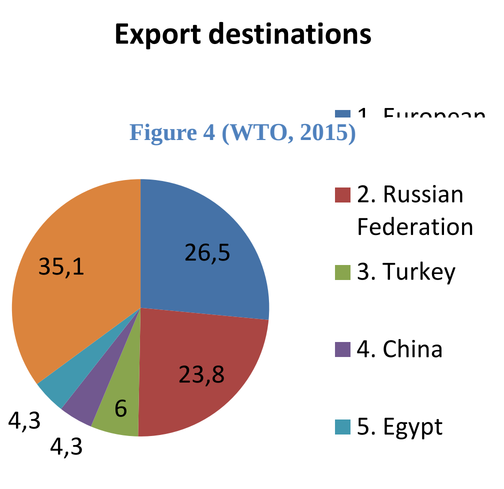

Figure 3 (WTO, 2015)

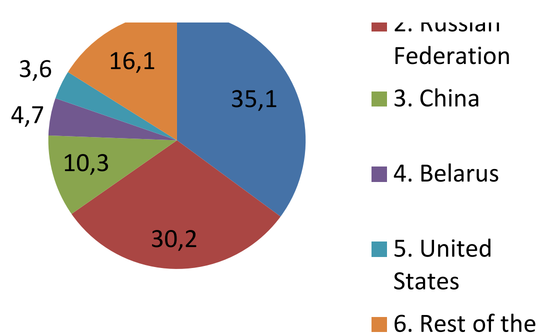

Figure 2 (WTO, 2015)

There are some unknowns regarding trade with Russia, apart from the lack of recent data. There might be trade diversion due to reduced barriers between the EU and Ukraine. But the conflict also has its impact, so it will be hard to allocate changes in trade flows to one cause or the other. To control for the conflict variable, the preferred method would be to make a comparison with similar countries. Moldova and Georgia have also signed the DCFTA, but unfortunately these countries also have a conflictual relationship with the Russian Federation. Concluding, it can be argued that it is hard to predict the impact of the DCFTA and the conflict on trade Russian Federation. A Forbes article referring to the Ukrainian statistics service says Russia is still Ukraine's largest trading partner, but does not group trade with the EU-28 together nor does it cover the entire year (Adomanis, 2015). Still, it is not unlikely that trade diversion will occur. Therefore, a closer look at trade flows to and from Ukraine is warranted.

The two most common trade classifications are the Standard International Trade Classification (SITC) and the Harmonized System (HS). Most international trade, including for tariff purposes, is classified according to the latter. Since this is also the case for the EU (and the Association Agreement) the HS is used here as well. Figure 7-8 display trade flows between Ukraine and Russia. First, some remarks can be made regarding the types of exports. Broadly speaking, Ukraine exports mostly products based on 'heavy industry' to Russia, such as railway freight cars, iron bars, and aluminium oxide. According to the 2012 SBA Country Profile (OECD et al., 2012), about 11.7 percent of industry is comprised of SMEs, so they might be directly hit by potential trade diversion away from Russia. For Ukrainian companies, trade diversion would of course amplify the need to reform in order to conform to EU standards if this is not already the case. For Russia, the theory behind trade diversion tells us that the lowering of barriers between the EU and Ukraine can mean that it misses out on trade, or has to pay a higher price for its imports from Ukraine. This could of course be mitigated by lowering trade barriers with Ukraine, as explained in the theoretical framework above. Imports from Russia to Ukraine consist for an important part of energy resources: gas, petroleum oils, and coal are all mineral products. Heavy industry once again is important, as demonstrated by the rest of figure 7**.**

Exports to the European market have been volatile over the past decade. After growing up to the crisis in 2008, a 45 percent drop was seen in 2009. The following year, exports to the EU grew again with 45 percent in 2010 and 31 percent in 2011. The three years that followed were a bit more stable, with declines between 5 and 1 percent per year. Some caution should therefore be taken when looking at a single year. In 2014, exports to the EU totalled €13.8 billion, as shown in Figure 8. When comparing these numbers to exports to the Russian federation, the importance of metals for trade is clear. Some of the exports to the EU in that category are already free of tariffs, e.g. most iron and non-alloy steel, whilst some primary materials are taxed at 5 percent but will have a 0 percent tariff in the future. The latter category might therefore be an example of possible trade diversion, but this should be regarded more as an illustration than a prediction. Looking at imports from the EU-28 to Ukraine, the variation in types of trade is clear. Making the comparison to imports from Russia, it is clear that apart from energy resources there is an overlap concerning machines, chemicals, and metals. However, these are rather broad categories. It is not clear whether the origins of imports of these goods are readily substitutable for each other.

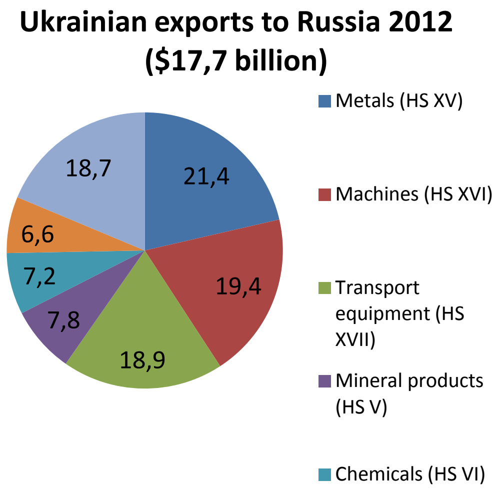

Figure 8 (Observatory of Economic Complexity, 2015b)

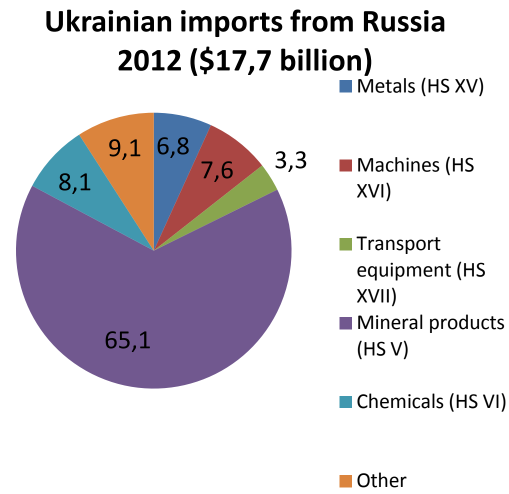

Figure 7 (Observatory of Economic Complexity, 2015b)

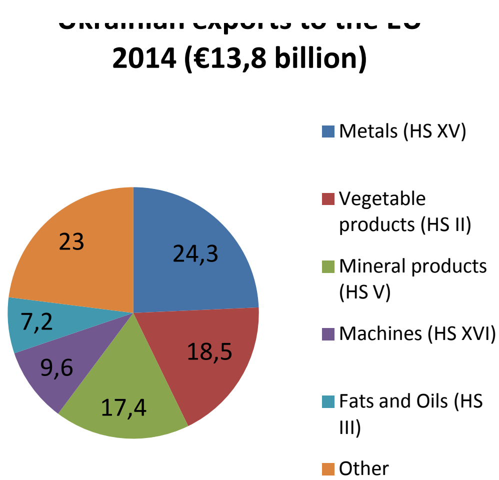

Figure 9 (European Commission, 2015a)

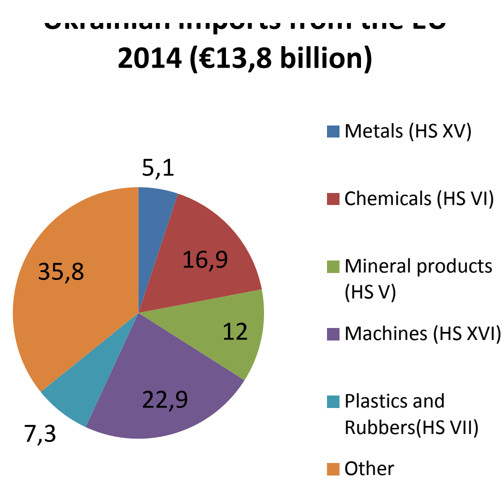

Figure 6 (European Commission, 2015a)

As noted earlier, the Russian Federation has put forward serious concerns regarding the effects the DCFTA will have. The economic arguments fall into three categories. First, there is the fear for trade diversion. It should be noted that energy resources, which comprise a big part of Russian exports, are largely unaffected by the DCFTA. Therefore, the share of trade affected by the agreement is not as big as one would think at first sight. Since the DCFTA is conform WTO rules – of which the EU, Ukraine, and Russia are all partners, that forum would be a good place to address this issue. Such an approach would demonstrate also that the Russian Federation takes its obligation as a member serious. The second Russian complaint is that changing standards in Ukraine will create barriers to trade towards Russia. Currently, Ukrainian technical and SPS standards are based on the former Soviet system, GOST. The DCFTA stipulates that Ukraine will progressively introduce standards based on EU regulation. However, adoption of EU standards does not forbid Ukrainian industry to produce for the Russian market according to Russian Standards (Dreyer & Popescu, 2014). Nor does it preclude Russian exporters to Ukraine from producing according to new standards in the latter. But, in practice, changing standards in Ukraine would indeed pose barriers to trade with Russia. The third concern voiced by Russia is that the agreement between Ukraine and the EU will lead to trade deflection. This would mean that the Russian market is exposed to EU producers using Ukraine as an intermediary to avoid EU-Russian tariffs. To avoid this, rule-of-origin provisions are in place. Of course, these are only as strong as their enforcement. This has been demonstrated by Belarus, which is said to play an important role as a re-exporter avoiding the Russian ban on EU food trade (The Associated Press, 2014).

So what followed from these concerns? After provisional entry into force was delayed until 2016 under Russian pressure in the summer of 2014, Putin pushed for systemic adjustments in the Association Agreement (Gotev, 2014). According to inter alia researchers from the Centre for European Policy Studies and the EU Institute for Security Studies, Russian complaints are "basically a non-story" (Emerson, 2014) whereby "the figures do not substantiate the claim[s]" (Dreyer & Popescu, 2014). They argue that, whilst the arguments as presented above are sound, the real effects will be minimal, can be mitigated, or even fall in line with Putin's once declared wish for a free trade zone from Lisbon to Vladivostok. Either way, the EU did engage with Russia and Ukraine to deal with the objections. Trilateral talks on the expert level were started after postponement of the provisional entry into force in September 2014, and were followed by a ministerial meeting in April. There, the parties agreed "to intensify their efforts and task their experts to achieve practical solutions to the concerns raised by Russia"(European Commission, 2015c). Interestingly, Ukrainian Foreign Minister Pavlo Klimkin said that Russia does not any longer demand amendments to the agreement (Interfax Ukraine, 2015). This would mean that it is now accepted by Russia that the DCFTA has enough built-in flexibilities and will not be renegotiated.

How much of an impact the DCFTA has on Ukraine-Russia trade would have been hard to determine even under normal circumstances. But, even whilst Russian concerns might be legitimate, the context should be remembered. The country's economy is under pressure due to low oil prices, sanctions because of the illegal annexation of the Crimea, as well structural problems (Economist Intelligence Unit, 2015)**.** Furthermore, Russia is pursuing its own customs union, which can be expected to have an impact on trade flows as well. Russia's focus on the DCFTA whilst their troops are said to be fighting in the Donbas might not be the most pragmatic way to deal with pressures on Ukraine-Russian trade.

There are no comprehensive statistics on the share SMEs have in Ukrainian exports. However, growing that share is a policy objective of the EU within the Eastern Partnership. Internationalisation of SMES is considered to have various advantages (OECD et al., 2012:174). The most obvious advantage is that access to a larger market allows SMEs to grow and achieve economies of scale that would not be attainable otherwise. Furthermore, exposure to international competition will lead to higher productivity. This is also due to gaining insights into best practices and the possibility to expand business networks. Therefore, lowering barriers to internationalisation of SMEs is important. The DCFTA will remove many barriers, but this does not mean that SMEs will automatically reap the benefits of possible internationalisation.

3.2.3 Most impacted by DCFTA: opportunities/challenges

In this section a discussion will be provided on the consequences the Association Agreement, and especially the DCFTA, has for SMEs. The agreement is based on various rationales, which were discussed extensively in the theoretical framework above. It was demonstrated how political considerations and economic expectations resulted in the agreement as it has been signed. Regional integration theory prescribes that breaking down barriers to trade will increase welfare, the studies on EU-Ukraine free trade predicted that this would indeed happen in this specific case. But to achieve this, the economy will have to adapt to the new circumstances. The main opportunities and challenges these new circumstances pose are presented here. First, the benefits for business are considered. Second, the areas of the AA/DCFTA which have a direct effect on business are explored. Last, those adjustments with relatively high costs, for example because they require significant investments, are analysed.

The most important benefits of the AA and DCFTA for Ukrainian businesses can be divided into two categories. First, and most closely related to the DCFTA title, there will be market integration with the EU. Second, also flowing from the other parts of the agreement, there will be a better business climate. Market integration, or the lowering of barriers to trade, allows better access to the EU market. On the one hand, this offers enormous opportunities regarding sales. The EU has more than 500 million consumers and is the largest market in the world by GDP (World Bank, 2015b). Furthermore, lowering barriers allows Ukrainian producers to lower the costs of their imports. But implementation of the Association Agreement also means that the business climate will improve. On the World Bank index on 'ease of doing business', Ukraine takes the 96th place (the ranking consists of 189 countries) – the lowest of the EaP countries and near the bottom of the entire Europe & Central Asia region (World Bank, 2015a). This should improve because of provisions on co-operation in macro-economic aspects, taxation, industrial and enterprise policy, mining, the steel and energy sector, financial services, company law, corporate governance, accounting, and auditing (European Commission, 2009).

The most important areas of the AA/DCFTA which have a direct impact on businesses are mentioned in [redacted]. Those which are expected to cause relatively low adjustment costs are listed and briefly discussed first. The provisions which demand relatively high investments are then further analysed. Note that the areas of the AA/DCFTA which have relatively low adjustments costs might indeed still require investments, so business might still have problems adapting to the new circumstances. The division between low and high is made so that it is clear which areas of the agreement will cause the most serious or urgent problems of adaptation.

Market access, understood in a limited fashion as the removal of tariffs and quotas, has a relatively low impact in terms of investments – it offers especially opportunities. Other areas of the agreement which are expected to require relatively low investments are those regarding money laundering, customs and intellectual property rights, public procurement, the use of geographical indications (GIs, e.g. 'Champagne'), provisions on genetically modified organisms (GMOs), company law, accounting and auditing, and employment/health and safety. Not all of these areas affect every sector of the Ukrainian economy. For example, GMO provisions are only relevant to the agricultural sector. On the other hand, provisions on money laundering, crime and corruption will affect all [redacted].

[redacted] identifies five areas which require businesses to invest significantly, and therefore bring about relatively high costs of adjustment. These concern technical regulations, sanitary and phytosanitary (SPS) measures, road transport, energy efficiency and environmental protection. Approximation of technical regulations, standards, and conformity assessment will affect sectors involved in manufacturing. Businesses might have to transform their production methods to conform to EU standards, acquire the right certificates to prove that they do, et cetera. Related to this, but with an impact on the agricultural sector and food processing industries, is the approximation of SPS measures. Road transport regulations will change the requirements regarding road and vehicle safety, and has a potential impact on the sectors involved in transport, wholesale/retail, and manufacturers (particularly of dangerous goods). Energy efficiency measures will apply to, for example, product standards and labelling, as well as building requirements. Apart from manufacturers this will affect, *inter alia,* construction and real estate sectors. Environmental protection will result in new controls of industrial pollutions and hazards, affecting for example transport, agriculture, and manufacturing (especially chemicals) [redacted]

The issues described above focus on the impact the DCFTA will have on SMEs in terms of adjustments needed. This, of course, does not paint the entire picture. The DCFTA will have a much broader impact - on larger companies, on the government, on society in general. Economic integration will lead to increased competitive pressures on Ukrainian enterprises. On the longer run, this should lead to increased efficiency and greater welfare. However, the necessary transformation can also cause problems on the short run, for example when large (former state-) enterprises are unable to deal with changing market conditions. Whilst the agreement's sustainable impact assessment predicts welfare gains also on the short-term, it is noted that not everybody wins (Ecorys, 2007:20). This, of course, can reflect on the public support for the agreement (and probably the current government). The assessment offers examples of problematic issues. Restructuring of the coal industry, which could be an outcome of implementation of the DCFTA, would have a negative impact on poverty levels in those areas where this industry is concentrated (Ecorys, 2007:26). Incidentally, the Donbas is exactly the region where the majority of coalmining takes place. This context should be kept in mind, even though it falls outside of the scope of this thesis.

3.2.4 Transformation: to do

The previous section provided an overview of how Ukrainian businesses are directly affected by implementation of the DCFTA. The impacts described are the result of Ukrainian laws changing according to the requirements of the agreement. At the same time, reforms are needed to support SMEs operating in this new environment. Simply adopting legislation is not enough – policies must come to fruition on a practical level. This holds for several dimension.

On the most general level, Ukrainian rule of law must be improved. The World Justice Project index has Ukraine on the 70th position of the 102 countries that are ranked by rule of law. The corruption indicator scores even worse, with the 84th position. As discussed above, these problems are understood, and combating them is on the Association Agenda. Listed as short-term priorities are, inter alia, constitutional reform, preventing and combating corruption, judicial reform, public administration reform, and public procurement reform. An approach of both deregulation and reregulation is followed. One of the reasons deregulation is necessary is to reduce the regulatory burden for the private sector. This is related to corruption as well: in 2008, less than 30 percent of businesses had no issues with getting licences and permits, and 20 percent report that unofficial payments were demanded (Transparency International, 2011:183). Reregulation comes naturally with adoption of (parts of) the EU *acquis*. This is not just a matter of changing existing regulations, but also of regulating issues which previously were not really covered by Ukrainian law. An example would be the establishment of a National Anti-Corruption Bureau.

Focussed more specifically on reforms that improve the business environment, a distinction can be made between the private sector in general, SMEs, and SMEs in the context of the DCFTA. The three reports discussed below each deal with one of those dimensions. Extensive lists of recommendations are provided, dealing with both deregulation and reregulation. Of course, implementation of such recommendations does rely on improvement of the rule of law in general.

The 2014 World Bank report mentioned earlier argues that robust implementation of policy aimed at private sector development is the key to breaking the low equilibrium in which the Ukrainian market finds itself. Three broad constraints are identified, and for each both short and medium-term policy recommendations are offered. Perhaps optimistically, and with quite some self-confidence, the report states that if these recommendations are effectively implemented the impact on GDP will be 'substantial'. An overview of these recommendations will now be provided.

Ukraine's regulatory framework still suffers from excessive red tape, uneven implementation and systemic corruption. Three types of recommendations on the short term are given. First, obsolete or overburdening legislation for businesses must be cut. Second, businesses must be given various sorts of leeway concerning self-certification, exemption of international/EU induced legislation if they do not operate for markets outside of Ukraine, and risk based inspections system. Third, reforms must focus on issues measured by the Doing Business ranking and public access to documents related to business legislation must be safeguarded. On the medium term, several priorities are identified. The business climate must be improved by inter alia regulatory impact assessments and improved consultations during the legislative process. There must be an SME strategy in line with international best practice, including e-government and ICT solutions facilitating businesses. Furthermore, technical and SPS standards must be harmonised with the EU and the institutional system dealing with regulations should be reformed (World Bank, 2014).

Lacking access to finance, the second impediment to private sector development, can be improved by several short- and medium-term measures. Some short-term recommendations have already been followed, e.g. free floating the Hryvnia exchange rate (Eder & Krasnolutska, 2015) and removing the interest caps for IFI lending (Pokonay & Aslanian, 2015). Medium-term reforms should mainly be focussed on reforms which improve transparency, protection on investors rights, and confidence of the financial system.

The third main constraint identified by the report is that the level of competition is not up to par. The two main reasons are the barriers to market entry and the weaknesses in competition policy. On the short term, state aid legislation must be brought in line the EU requirements, and abuse of dominance battled. The Anti-Monopoly Committee (AMC) must be strengthened through increased investigative powers on the short term; and adequate resources, political independence, and a focus on its core activities on the medium term.

The report thus offers practical priorities for reform on the short- and medium term. It is noted that the Ukrainian government is aware of the challenges and that some progress has already been made. Furthermore, it is argued that the Association Agreement could be an important anchor for the policy process. The following section will discuss the recommendations offered through the Eastern Partnership framework, focusing not on the entire private sector but rather on SME policy.

The 2012 SME policy index, which measured policy performance in the EaP countries along the ten dimensions discussed in a previous section, offers several recommendations. A range of issues is covered under five SME policy areas: strengthening institutions and mechanisms for SME policy making; establishing a conducive operational environment; facilitating SME access to finance and developing the legal and business environment; promoting a culture of entrepreneurship and skills development; and enhancing SME competitiveness. Although at times rather abstract, four priorities are identified.

First, a viable long-term SME development strategy must be adopted. This should go beyond declarations. Resources must be allocated, and implementation must be done by a specialised body. Furthermore, monitoring and evaluation on the basis of measurable indicators of clear objectives should ensure effectiveness. Furthermore, the strategy should include the creation of a legal environment that enables small business development.

Second, public-private consultations must become more effective through strengthening representativeness of SMEs (and the private sector in general) in regulatory decisions. For example, the Council of Entrepreneurs under the Cabinet of Ministers would need to be regulated and strengthened so that consultations take place on a regular basis, whereby recommendations and alternative proposals are actually taken into consideration.

Third, entrepreneurial skills must be developed further. Competence in entrepreneurship deserves attention in education and training. The report advises that this can be achieved through reforms are of educational curricula, improved and innovative teacher training and new forms of cooperation between government and business.

Fourth, the innovation policy framework should be improved. Bottom-up initiatives must be encouraged, and scientific outcomes should be linked to practical applications in the market. In order to achieve this it is once again vital that there is not just a strategy but that it is also implemented - so funding is necessary.

According to the 2012 report, Ukraine has shown some progress regarding deregulation and simplification of administrative procedures. At the same time, the business environment continues to deteriorate because of a lack of strategy, policy tools and resources. The following section will discuss more recent recommendations, aimed specifically at supporting SMEs in dealing with the implementation of the AA/DCFTA.

[redacted] identified not only how the agreement had direct effect on businesses, as discussed further above. It also included a survey conducted amongst SMEs, business support organisations (BSOs) and financial institutions, and government ministries, departments and agencies in the three AA/DCFTA countries (Georgia, Moldova, and Ukraine). Formulated [redacted] were recommendations for policy on four subjects: awareness, know how, investment finance, and certification and approval.

Awareness of the AA/DCFTA amongst SMEs was relatively high in Ukraine compared to Georgia and Moldova. Two indicators were both between 70 and 80 percent: how many business had heard of the DCFTA, and whether they thought it would have a moderate or high impact. Under BSOs there is limited awareness, whilst their capacities are limited too. Financial institutions are having difficulties to find clients with bankable projects. One of the reasons is that collateral can be hard to secure since the cadastral institutions are not up to par (Razumkov Centre, 2011). At the same time, it should be noted that Ukraine is faced with a paralysed banking sector which is in de-capitalisation. Governments are focussed on compliance with AA/DCFTA provisions, but enforcement of legislation is limited to non-existent. All in all, the study recommends on the one hand a national business awareness campaign, to properly inform SMEs of the impact the AA/DCFTA will have. On the other hand, an outreach programme aimed at BSOs, financial institutions and governments should inform those actors issues surrounding the implementation of the agreement.

With regards to know how, two types of recommendations are offered. On the one hand, business data and statistics must be available for planning and strategy concerning the AA/DCFTA. On the other hand, the establishment of a 'National AA/DCFTA Centre' is proposed. This would be a creator and keeper of relevant information for businesses with regards to the agreement. Such a central point would also allow for higher awareness, because information would become more easily accessible.

The problems with access to finance for businesses are exacerbated by the economic and financial problems Ukraine faces. Therefore, recommendations on a lower level can still be offered, but is should of course be remembered that there are some limits because of the current state of the system. [redacted] argues that credit lines should be offered to allow for investments due to the DCFTA. This includes adjustments to comply with technical and SPS measures; investments in approved technologies for transport, energy efficiency, and environmental protection; and financing of equipment for testing.

With regards to certification and approvals, [redacted] recommends that access to certification bodies should be facilitated and that certification costs should be financed. The issue is that even if businesses comply with the requirements of the EU, they still need to prove it. This can be costly, especially for smaller companies. Before 2011, the standardization and certification body in Ukraine was responsible for a such a range of tasks that there was a considerable conflict of interest built in. For example, it had both commercial certification functions and state supervisory powers, combined with the fact that it appointed other certification bodies. As a consequence of the historical legacy of this situation, non-Ukrainian certifying bodies are often still a more reliable yet also more expensive option.

It is no surprise that Ukraine needs to reform its SME policy. The discussion above indicates that a range of issues needs to be addressed on various levels. In the following section, an attempt will be made to identify previous experiences in dealing with such reforms in countries who found themselves in a comparable situation. This will be followed by an overview of the current practices in Ukraine, after which this chapter will be concluded by some policy options best on lessons learnt in the past.

3.3 Lessons learnt during the CEE pre-accession period

The EU played a significant role in the transition of post-Soviet countries in Central and Eastern Europe. On the basis of conditionality and socialisation, it stimulated countries to reform not just their economy but also their political sphere and broader society. This mechanism has been especially strong in those states with a membership perspective. As outlined in the theoretical framework above, attempts to recreate this logic towards the EU neighbours has had some success. In this section, past experiences with EU and Dutch assistance concerning SMEs and SME policy are explored. The focus will be on projects aimed at the 2004 accession countries.

The evaluations of the efforts during that period might hold some valuable lessons to take into account when discussing SME development in Ukraine. SMEs in Ukraine face the same problems as the ones in CEECs during the 1990s. For example, in Poland 60 percent of manufacturing enterprises faced financial constraints (e.g. access to finance), 56 percent experienced barriers in government policies, and 30 percent faced production related constraints such as the need to modernise equipment. Nonetheless, it should be taken into account that there are many differences between the 2004 accession countries and Ukraine (and also between the 2004 accession countries themselves). Still, some of the lessons learnt might be transposed to the current situation, as will become clear in the following paragraphs. But before moving on to the lessons learnt, some remarks concerning SME development as a government endeavour are in order.

Smallbone and Welter argue that there is a range of ways in which governments in transition countries can influence SME development. Although Ukraine has moved beyond a Soviet economy, it has not necessarily completed this transition, so their arguments might be valid in this case as well. First, governments exert influence on the macro-economic environment – which in turn influences SMEs. SME managers look at stability and indicators such as aggregate demand or interest rates when taking decisions. Second, legislation concerning firms is a factor, since it has a differential impact with regard to firm size. For example, SMEs can face relatively higher costs of compliance due to their smaller internal resources. Third, states can shape or support economic institutions such as business support centres and banks. Fourth, SME development can occur through direct programmes and support policies. Lastly, the authors argue that states play a role by the promotion of values of entrepreneurship and enterprise in society. EU and Dutch SME policy in third countries is mostly focussed on legislation, economic institutions, and direct assistance.

3.3.1 EU evaluation

The EU pre-accession strategy is, broadly speaking, based on seven dimensions. There are bilateral agreements; the accession partnerships and the national programmes for the adoption of the acquis; participation in Community programmes, agencies and committees; political dialogue; the evaluation of the Commission ("monitoring"); pre-accession assistance; and co financing by international financial institutions (IFI). Pre-accession assistance for the 2004 enlargement occurred through a range of instruments, such as PHARE, SAPARD and ISPA. The latter two were focussed on rural and agricultural development; and infrastructural development for the environment and transport, respectively. PHARE was the catchall for other assistance, amounting to about €1.5 billion per year in the last programming period (2000-2006). SME support from the EU was mostly financed through PHARE. The programmes fall into two categories: direct financial support for SMEs, and technical assistance for institution building.

Concerning the first category, direct financial support for SMEs through Phare amounted to €163 million for the period 1990-1998. Considering this covers ten countries and nine years it can be argued that the scale is fairly limited. Still, a further division can be made since there were five schemes within the financial support category: loans, micro-credits, grants, credit guarantees and equity funds. All programmes performed poorly except for equity, which was rated between ‘acceptable’ and ‘rather good’ (Phare, 2000). Problems were, inter alia, that loan schemes showed low additionality to the market, that micro-credits and grants had high public costs, and that there was lacking trust for credit guarantee schemes. Equity funds scored well because of satisfactory disbursement rates, additionality to the market (especially for smaller amounts), and catalysing characteristics. Generally speaking, SME development was constrained by underdeveloped banking sectors, high costs due to low volumes, and a lacking recognition by banks of SMEs as a long term investment option.

Several recommendations are provided to improve the economic impact of direct financial support to SMEs. First, funding should have clearer strategic objectives, accompanied by details on its composition, ownership and management. Second, a national ‘champion’ actor can be appointed which owns the fund, but also monitors and ensures that loan criteria are regularly adjusted. Third, loan applications should be assessed with regard to the additionality, displacement, and employment impact. Failure to do so can be harmful to the market. Fourth, co-financing in a risk-sharing basis can increase the value of the fund. Lastly, a greater involvement of business support networks is necessary. They should engage in marketing, economic appraisal and performance monitoring of firms.

This role for business support networks can of course only be taken on if the networks in fact exist. This brings us to the second category of Phare SME support, which aimed at technical assistance for institution building. The budget was €158 million for the period 1990-1998. Programmes were concerned with i) policy work within governments, ii) national SME agencies, and iii) Business Support Centres (BSCs). All schemes were evaluated as poor, with BSCs scoring the highest (almost halfway to ‘acceptable’) (Phare, 2000). The low importance attached to SMEs by the national governments meant that limited attention was paid to reforms in fiscal, legal and regulatory frameworks. National SME Agencies did build up capacity for developing and implementing SME strategies and acted as a bridge between policy and operational issues. However, because they were placed outside the government, they were overly reliant on Phare funding and were unable to influence national governments sufficiently. Business Support Centres had initial success, as they provided SMEs with access to information, training and advice, and sometimes finance. This diminished after national and local governments did not take up funding when Phare support ran out, and the BSCs were forced to evolve into consultancies.

Again, several recommendations are offered. The obvious advice concerning policy work is that more attention must be paid to reforming the fiscal, legal, and regulatory frameworks. National governments must be convinced of the necessity of an SME strategy, and should ensure that appropriate funding is available. The National SME Agencies avoided many problems by being outside of the government, but insufficient and unclear funding sources limited their capacities. If the latter is resolved, the agencies can make use of economies of scale which cannot be achieved at the local or regional level. With regard to the Business Support Centres, it became clear that their model of public-private partnerships was unsustainable. Therefore, they should either be integrated within the public sector, or left to the market entirely. The latter option will of course often limit their services to paying customers, excluding smaller enterprises. It is thus recommended that they receive sufficient support to act as a public entity which facilitates local business development.

A few concluding remarks are in order with regard to the Phare evaluation. First, whilst the SME programmes performed poorly, they necessity of SME development must be acknowledged. Second, the evaluation identified better performing programmes and offered recommendations. These lessons learnt should be remembered when taking on SME development in Ukraine. Third, it is vital that the government understands the importance of not just formulating, but also implementing, an SME strategy – including appropriate funding. Fourth, the perverse incentives of external funding should be taken into account. Many programmes from the pre-accession era were not sustainable because governments never contributed, nor did they intend to do so.

3.3.2 NL evaluation

Dutch policy during the pre-accession period has also been evaluated (Netherlands Ministry of Foreign Affairs, 2005). There was no specific focus on SME development in the context of the 2004 enlargement. Rather, the Netherlands busied itself with four aspects: the more diplomatic policies concerning i) EU enlargement and ii) bilateral relations concerning accession, and the more aid-related policies concerning iii) accession assistance and iv) sectoral cooperation. The most important issues concerning the latter two, including the lessons learnt, will be outlined below. This will be followed by a brief discussion on Dutch policy concerning private sector development in general.

The evaluation of Dutch policy towards the 2004 enlargement of the EU does not look at just specific programmes or outcomes. The underlying processes and policy mechanisms were reviewed as well. According to the main conclusions there was little cohesion between policies; poor coordination within the varying parts of the Dutch government; and an inability to determine the effectivity and efficiency of policy due to a lacking orientation on results, and fragmented implementation of policy. However, activities supporting pre-accession did have positive effects, even though those effects were usually not visible on the sectoral- or country-level. Regarding the agricultural sector, where policy was coherent, it was demonstrated that sufficient resources and capacity do lead to good results which are also visible on the sectoral level.

The recommendations that follow logically from these findings fall into two categories. First, coordination should be improved. This is necessary for several dimensions: between policies, intra-government (and even within ministries), as well as inter-government. It is advised that the Foreign Affairs Ministry takes the lead. Second, policy must become more result-oriented. The focus should not be on how various instruments can be used. Rather, the focus must be on what should be achieved. Therefore goals and priorities must be defined clearly first, which *then* can be pursued.

Private sector development is a core element of Dutch development policy outside the pre-accession context. It is aimed at every type of DAC country[4], and has positive impacts on the activity-level. Therefore, lessons learnt might be applicable to Ukraine as well. An evaluation of over 15 instruments, covering €3,3 billion for the period 2005-2012, offers some of those lessons (Netherlands Ministry of Foreign Affairs, 2014). First, the question that must always be asked is whether support is additional to the market. Second, better alignment of instruments, for example through a bigger role for (the embassy in) the recipient country, will lead to better results. Third, there should be more focus on the goals and results of policies, rather than just on the execution of projects.

It is clear that policies aimed at private sector- and SME development do not always live up to the expectations. In order to overcome obstacles to success, it is important that the lessons learnt are indeed taken into account when formulating and implementing new policies. In the following section, attention will be paid to the current policies aimed at SME development in the context of the DCFTA.

3.4 Current policies concerning Ukrainian SME

The importance of SME development in Ukraine in the context of the DCFTA is recognised by Ukraine itself, the EU, and to some degree the Netherlands. Various agendas, policies, and programmes are in place to support businesses to exploit the opportunities, and also face the challenges, which come with the implementation of the DCFTA. These efforts will be discussed here. It is not the intention to offer a full review of the current activities, rather, the goal is to present a broad overview of the current state of affairs concerning SME development in the context of the DCFTA in Ukraine.

The ‘Strategy for Sustainable Development Ukraine 2020’ outlines the main policies and priorities that Ukraine will pursue in the coming years. This January 2015 presidential decree consists of four vectors that will be followed, one being a ‘vector of development’ - under which business is mentioned. One of the ten ‘top priorities’ is deregulation and business development, which also includes references to issues identified above (e.g. technical standards). Furthermore, one of 25 indicators for the success of the strategy is the ‘Doing Business’ rank – which is closely related to the position of SMEs.

Whilst a total of 62 priorities and programmes are proclaimed in the document, it appears that deregulation is something the government has indeed been engaged in. However, deregulation is not the same as SME development. Activities in this area have been limited up until now - previous programmes were mostly paper tigers due to a lack of funding. At the moment, a new SME support programme is under development by the Ukrainian Ministry of Economic Development and Trade (MEDT). This should be in line with the EU principles found in the Small Business Act, but it is not yet clear whether funding will be appropriate. So, whilst efforts are being made, true SME policy is still fairly limited at the moment.

[4] The DAC list contains countries that are eligible for official development assistance (ODA), categorised according to gross national income (Least developed, Other low-income, Lower middle-income, and Upper middle income – e.g. Afghanistan, Kenya, Ukraine and Albania respectively)

The Association Agenda, as endorsed by the EU and Ukraine in March 2015, also contains some relevant provisions. Reducing the regulatory burden for businesses, in particular SMEs, is one of the short-term priorities for action. Concerning action on trade and trade related matters there is mentioning of technical regulations on industrial products, standards and conformity assessment procedures; and sanitary and phytosanitary measures. So, there are more than enough declarations to build concrete action on.

The EU itself has a number of actions in place which are (partly) relevant for SMEs in Ukraine. Some are not yet operational, but will come ‘online’ in the next few years. In April 2015, a €110 million package was announced that is aimed specifically at SMEs. EU SURE (i.e. Support to Ukraine to Re-launch the Economy) budgets 95 million for technical assistance at the national level (SME deregulation and development strategies) and the regional level (setting up Business Support Centres). The Technical Cooperation Facility budgets 15 million for through twinning grants. The objectives are aimed at reforms which aid the implementation of the DCFTA.

Furthermore, Ukrainian SMEs are supported through multi-country instruments in which the EU participates. The so-called DCFTA Facility entails about €200 million of grants that will be dispersed amongst SMEs in Georgia, Moldova, and Ukraine. The instrument, which is implemented and co-funded by the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), is part of the SME Flagship Initiative. This EaP programme also includes institution building and advisory services.

Other donors with instruments (partly) aimed at SMEs are inter alia the International Finance Corporation, the World Bank, USAID, and development banks from Germany, Sweden, and Switzerland. The Netherlands is also engaged in bilateral support. Dutch support amounts to about €15 million total for the last few years, aimed at various issues ranging from rule of law to societal transformation. Some funding is very specifically related to the implementation of the DCFTA, such as a €100.000 grant for technical assistance aimed at improving the capacity of Business Support Centres regarding knowledge about the agreement.

From the expert interviews conducted with civil servants from the EU and the Dutch government, the following conclusions can be reached on SME development efforts. Concerning Ukraine, the consensus seems to be that there is no lack of ambition whilst the conditions understandably have a negative impact on the pace of the transformation. There is a political understanding of the need to reform, which also translates into concrete action. But of course, even with the best intentions, there are barriers which are not easily overcome. Such barriers include financial interest groups (e.g. in relation to the flailing banking sector), limited government capacity (e.g. poorly staffed ministries), and the economic crisis. The situation in Eastern Ukraine does not help matters, as the conflict has an impact on the political and economic health of the country. SME development must be seen in this light. There are ambitions, but on practical terms there are somewhat limited results until now. Furthermore, there is primarily a focus on deregulation - which is a very important issue for SMEs, but it is not the entire picture.

On the EU level there is no lack of ambition either. SME development is a priority which is accompanied by concrete action - both on the institutional development side, and directly through financing instruments. The impression is left that the mechanisms of socialisation and conditionality are used in an appropriate manner by the Commission. What does seem to be an issue for the EU is finding the right balance between 'ownership' and assistance[5]. In practical terms, this refers to finding out what the best approach is when there is not enough capacity on the Ukrainian side to demand assistance. Demand-driven assistance is essential to a relationship of which Ukraine is a co-owner, which is important to the EU. At the same time, it seems that sometimes it would not be unreasonable to support Ukraine in formulating their demands. By extension, the EU does not play the coordinating role for bilateral support for which it is so well positioned. The argument that Ukraine should demand and coordinate is valid from an ownership perspective, both not necessarily practical from a capacity perspective. The EU should then step in.

Concerning the Netherlands, a more detailed picture can be painted. On a general level, there is an understanding of the issues faced by Ukraine and Dutch commitment to deal with them. Ukraine has been a salient topic, not in the last place due to the MH17 disaster. Policy over the last few years was focused mostly on the areas of societal transformation and human rights, but with the political will now demonstrated by the Ukrainian government this has been extended to supporting governance, economy, and rule of law. A range of programmes is up and running, and future projects are under consideration.

Turning to private sector development and SME support specifically, several observations can be made. On the lowest level actors are open to, and at times enthusiastic about, offering technical experience to Ukraine. Even though previous activities are not always regarded as successes, the new political climate in Ukraine leads implementers to believe future action might be useful. This appears to be the case with both the Netherlands Enterprise Agency (Rijksdienst voor Ondernemend Nederland, RVO) as well as agencies executing the actual technical assistance.

Regarding the policy level's engagement with economic transformation in Ukraine, some of the 'lessons learnt' (as described above) have, in fact, not been learnt. For example, coordination requires a lot of effort. This is not necessarily because of a lack of willingness or expertise, but more a logical consequence of institutional design. Within the Ministry of Foreign Affairs, Ukrainian economic reform is a topic for three directorates-general: DG European Cooperation, DG International Cooperation, and DG Foreign Economic Relations. Within each DG, there are also various departments concerned with the issue. Furthermore, the Ministry of Economic Affairs is involved, as is the RVO. The embassy in Kiev, whilst perhaps less involved in policy making and more in policy implementation, plays an important role as well. Naturally, supporting Ukrainian economic reforms has varying priorities at the various desks involved. At the same time, policy aimed at such reforms has different frames of reference depending on the department. Such a frame could be based on the available instruments for development cooperation, or the Dutch top sector policy, or the bilateral relation from a political perspective, to name a few.

Any inefficiencies in policy-making that might follow from these issues would be pitiful. On the one hand because the Netherlands has a clear interest in successful integration of Ukraine and the EU. On the other hand because the extensive experience with the necessary transformation in other countries means that it is, in fact, possible to contribute to such a successful integration. Greater saliency of supporting Ukrainian economic reform on the political level would be helpful. For example, it is characteristic that Ukraine is not on the Dutch list of 68 development

[5] Author's own conclusion following conversations with EU and Netherlands MFA officials.

partners (i.e. ODA recipients), in contrast to for example Moldova and Georgia. This is not to say that there should be a sole focus on economic issues - other areas (as mentioned above) are important as well. It should, however, be realised that a failure to implement the DCFTA successfully will probably have consequences on Ukrainian public opinion of the EU. This in turn might lead to instabilities of the type exactly opposing EU/Dutch interests.

Once again, the discussion above is not meant to offer a full evaluation: not of the policies and instruments, nor the underlying processes. It does, however, sketch out the environment in which any new policy proposal will exist.

3.5 Possibilities for Policy

This section is devoted to identifying the most feasible policy options the Dutch government might pursue to support Ukrainian SMEs in the context of the DCFTA, thus answering the question central to this chapter. To determine what the most feasible policy options are, it must be decided what the goal is. Attention will first be paid to that. Then, two specific possibilities for policy are identified, which are in line with the formulated goal(s). This section will be concluded by a reiteration of the most important issues which contribute to the success or failure of policy supporting Ukrainian SMEs.

Recapitulating, we can identify goals at various levels, which should be pursued by the Netherlands. Speaking in the most general of terms, the economic and political integration of Ukraine and the EU is the main goal. The Association Agreement, including the DCFTA, is the primary tool through which this can be achieved. Allowing SMEs to exploit the opportunities and overcome the obstacles associated with the agreement is an important element of economic integration. This encompasses more than just lowering the barriers to trade on paper. To allow SMEs to participate in the EU market in the way the DCFTA envisions, reforms are necessary. Successfully implementing those reforms is thus a crucial goal. This means that supporting Ukrainian SMEs to do so is an appropriate course of action in order to achieve economic integration.

Having established the goal, the second question is how that goal might be reached. There is a broad spectrum of assistance required if Ukrainian SME is to adapt successfully to the DCFTA. There are also many types of donors who are willing to provide that assistance. Which area should the Netherlands focus on? Sticking to the division of assistance into direct financial support on the one hand, and technical assistance on the other; there are the following opportunities for Dutch action.

In order to determine what kind of technical assistance would be feasible, it is wise to look not just at what is needed. It is also important to identify areas of expertise in which the donor has a good track record. Furthermore, it would be an added bonus for the donor if assistance not only improves conditions in the recipient country, but also benefits the relationship between the two. Whether the bilateral relationship improves was also evaluated for the 2004 enlargement. It turned out that it was not measurable (Netherlands Ministry of Foreign Affairs, 2005). That does not preclude the possibility of positive effects now, nor would the absence of measurable benefits from an improved bilateral relationship be an excuse to not act. Either way, the positive relationship between Ukraine and the Netherlands seems to be enjoyed by both sides[6].

The research for this thesis has identified two areas in which there is both a Ukrainian need for support to reform, as well as a Dutch capacity to provide technical assistance. Furthermore, both these areas are highly relevant for the Dutch private sector. As explained above, the costs of adaptation faced by SMEs are high for, inter alia, technical standards and SPS measures. The Netherlands has experience in building the relevant institutions, in line with the EU norms. The primary institutions dealing with issues surrounding technical are accreditation bodies and food safety authorities.

The Dutch Accreditation Council (Raad van Accreditatie, or RvA) is tasked with accrediting conformity-assessment bodies. These include laboratories, inspection bodies, certification bodies, and verification bodies – organisations which ensure that trust in the quality of products and services is justified. The RvA has extensive experience with technical assistance in Central and Eastern Europe. It has also conducted a project with its Ukrainian counterpart, the National Accreditation Authority of Ukraine (NAAU). This was under the Yanukovych government, and the impact of RvA assistance to the NAAU was limited due to issues associated with that era. At the NAAU this included nepotism and disinterest at the higher levels, a lack of capacity at the lower levels, and a general absence of interest in SME development. Because similar projects in, for example, neighbouring Moldova were successful, the RvA appears to have faith in future projects.

For SMEs, a properly functioning accreditation body is vital because that body has a direct impact on the value of certifications held by enterprises. SMEs who want to access the EU market will bring their production standards in line with EU requirements. Whether this concerns technical standards or SPS measures, SMEs will also need the trusted certification to prove that they are indeed producing conform those requirements. The conformity-assessment bodies who provide such certification in turn need to work according to the right standards. At the moment, the existence of such bodies in Ukraine is fairly limited. This means that SMEs have trouble getting proper certifications. They can, of course, turn to foreign companies, but this is accompanied by higher costs. This is especially problematic for smaller companies. A well-functioning system within Ukraine is thus needed.

The Netherlands Food and Consumer Product Safety Authority (Nederlandse Voedsel- en Warenautoriteit, or NVWA) is tasked with monitoring food and consumer products to safeguard public health, and animal health and welfare. This is done through supervision, risk assessment, and risk communication. The NVWA also has extensive experience with international cooperation. This includes two projects with the predecessors of the Ukrainian State Service on Safety of Foodstuffs and Consumer Protection, which was created in the summer of 2014. Similar issues as those described above concerning the RvA were encountered, yet possibility of successful projects is not doubted by the NVWA.

For SMEs who are active in the agro/food sector, the possibilities for export to the EU are huge. Furthermore, the strained relationship with Russia means that for those already exporting it might be wise to focus on the EU market. Either way, adherence to SPS measures is essential. In

[6] Author's understanding based on conversations with Netherlands MFA officials.

order to facilitate this, a proper regulatory framework is needed in which the private sector can operate. The newly formed Ukrainian institution needs to operate at a level that allows European markets to trust in the safety of Ukrainian exports. Technical assistance from the NVWA could contribute to that.

The Dutch private sector benefits from improved conditions concerning both topics. On the one hand, the bulk of Dutch exports to Ukraine consists of machines. With Ukrainian SMEs adjusting to EU standards, there will be many opportunities for Dutch producers to participate in those reforms. On the other hand, imports from Ukraine to the Netherlands are for a large part made up by grains and oils. The DCFTA might offer opportunities for the Netherlands to increase its imports for the food processing sector.

Apart from technical assistance, financial assistance to support Ukrainian SMEs can be considered. It is not advisable for the Dutch government to pursue policies of direct financial assistance to SMEs on its own. The reason for this is that other institutions are better positioned to do so. The EIB and EBRD are involved in the EU's funding schemes, both have a presence on the ground in Ukraine. As became clear from the evaluation of EU direct financial assistance during the pre-accession period of the 2004 enlargement, the relatively high costs of funding schemes are in direct relation to their limited scale. If the Netherlands would want to pursue direct financial assistance to SMEs by itself, the budget would be limited (in real terms, and compared to EU and associated funding), leading to relatively high overhead costs that are unnecessary because the infrastructure already exists.

3.6 Conclusion

Having proposed two policies of technical assistance, it is useful to take a step back. These policies are worthwhile to pursue. On the one hand because the 'targets' are in need of assistance, and an improvement of those institutions will benefit SMEs in Ukraine - and indirectly in the Netherlands as well. On the other hand because the Netherlands has expertise in this area and is a very suitable actor to deliver this assistance. But some recommendations on the processes that result in actual action can be made as well.

As far as the Netherlands is concerned, the advice that followed from the evaluation of past experiences is still valid: coordination is key. Whilst Ukraine, economic development, and SME policy are on the agenda of a range of very capable officials within the Dutch government, the institutional design and budgetary priorities are a natural constraint. It is advisable that, first and foremost at the political level, the importance of the issues described here is recognised and supported by appropriate funding. This would in turn allow a more focussed approach of all relevant actors on the policy level. A taskforce, not just in name but also in practice, with dedicated resources, could increase the possibilities of effective support to economic development of Ukraine.

Added to this, the EU is not making use of its full capabilities as a coordinator. As pointed out earlier, the importance of Ukrainian ownership of its own development makes sense. Still, a more leading role of the EU in the coordination of its Member States would increase efficiency. Whilst there are various working groups in Kiev, the overall process is not streamlined. A type of division of tasks by the Member States which is facilitated and lead by the EU would increase efficiency.

4 Positioning NL SME

Having discussed the political and economic importance of SME development in Ukraine, this chapter will be devoted to Dutch SMEs. Whilst the impact of the implementation of the DCFTA will likely not be as profound for Dutch businesses as it will be for their Ukrainian counterparts, the agreement might have an impact nonetheless. Therefore, an answer to the second question central to this thesis will be formulated here. That question is:

"What are the most feasible policy options for the Dutch government to support Dutch SMEs to adapt to the implementation of the DCFTA so that obstacles may be reduced and opportunities will be exploited?"

The build-up of this chapter will be as follows. First, an introduction to the relationship between Dutch SMEs and Ukraine will be offered. Second, some of the lessons learnt during previous efforts of the Dutch government to 'position' Dutch SMEs in CEE countries will be presented. Third, an overview of the current instruments aimed at stimulating SME activity in and with Ukraine is provided. Last, an answer to the question posed above is formulated.

4.1 Dutch SMEs in relation to Ukraine

In order to provide some background information, this section will start with some basic figures on SMEs in the Netherlands. This will be followed by a presentation of figures on trade between the Netherlands and Ukraine. Then, a discussion if offered on some of the organisations focused on supporting Dutch SMEs that are active in, or trade with, Ukraine.

Using the EU definition of SMEs (i.e. <250 employees, <50 million annual turnover, <43 million annual balance sheet total), the 2013 figures indicate the importance of SMEs to the Dutch economy. The very high proportion of the total number of registered enterprises, 99.8 percent, is responsible for 63.7 percent of employment. This is accompanied by a turnover of €189 billion, or 61.6 percent. These figures are close to the EU averages of 99.8 percent, 66.9 percent, and

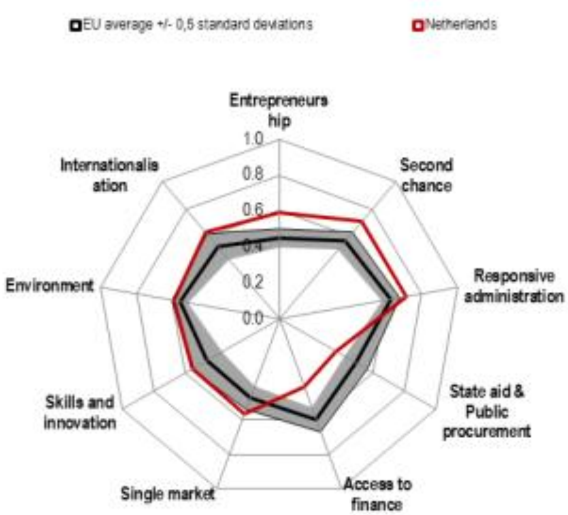

Figure 10 (European Commission, 2014)

58.1 percent respectively.

Figure 10 displays the SBA policy index scores of the Netherlands, offering insights similar (but not the same) to those found in Figure 1 (OECD et al., 2012) concerning Ukraine. The main conclusion to take away is that the Netherlands scores quite well concerning SMEs, except for access to finance and state aid. Issues faced by SMEs are also related to the remnants of the economic downturn since the financial crisis in 2007/2008. Aggregate demand is still low due to high private indebtedness and a distressed housing market, which hinders the recovery of SMEs. This is relevant because it exacerbates the lacking access to finance that SMEs face.

The biggest categories of goods that are traded between the Netherlands and Ukraine are displayed in Figure 11 (Observatory of Economic Complexity, 2015a) 12. Whilst definitively not negligible, Ukraine is not a huge trading partner of the Netherlands – in 2011 it accounted for about 0.3 percent of exports, ranking 43st on the list of export destinations. Furthermore, it is not exactly clear which percentage of trade is done by SMEs. However, there is an economic interest in the country nonetheless. Unfortunately, no official figures that are more recent are avaliable

Figure 11 (Observatory of Economic Complexity, 2015a)

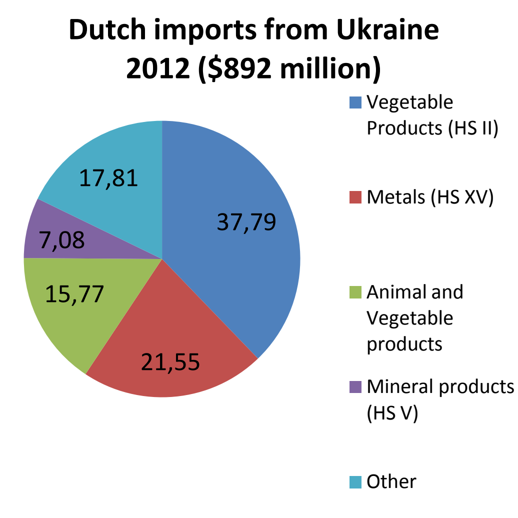

Figure 12 (Observatory of Economic Complexity, 2015a)

(in English). However, according to the Ukraine Ministry of Foreign Affairs (2015), Ukrainian exports to the Netherlands tripled in the January-September 2014 period, whilst imports from the Netherlands decreased by 41.5 percent. Bilateral trade in services increased with 39.5 percent in the same period. In 2012, the most promising areas for Dutch SMEs were agro-food and the chemical sector. On the longer term, services might become more important as well – for example in the IT sector (FMO, 2012).

Because Ukraine will be adapting to the EU acquis, and not the other way around, Dutch SMEs will not be facing regulatory changes in the Netherlands as a consequence of the DCFTA. The consequences of the agreement for Dutch enterprises will thus mostly be found in the lowering of barriers to trade. On an aggregate level, these consequences will be low, as indicated earlier [redacted]. However, individual enterprises or even sectors might feel the effects of implementation.

Whilst the lower efficiency and overall state of the Ukrainian economy would lead to the expectation that Dutch SMEs have little to fear from the lowering of barriers, is does not mean that there are no challenges at all. An interesting example is the poultry sector. Access of Ukrainian companies to the EU market led to protest in the Dutch poultry sector, and even questions in the Dutch parliament in October 2014. One of the critiques was that competition was distorted due to lower animal welfare standards in Ukraine. Be that as it may, the producers did conform to the standards set by the EU – which is why access was granted. Interestingly, investments there have been made by both Dutch banks and through public funds, whereby Dutch companies have built up production capacity for Ukraine to export to the EU (Both ENDS, 2012). There are (almost) always winners and losers.

If Dutch SMEs are to take advantage of the DCFTA, internationalisation is of key importance for those not already active in Ukraine. There are both internal and external barriers to internationalisation (EIM Business & Policy Research, 2010). Internal barriers include the high cost of their own product or service (in comparison to the price level of the target economy), and the high costs associated with internationalisation. External barriers include lack of capital, lack of adequate information, and lack of adequate public support and the costs of or difficulties with paperwork associated with transport. Before further discussing the possibilities the public sector might have to mitigate these barriers, it is worthwhile to look at the support that exists from the private sector.

The Netherlands has a broad spectrum of interest groups representing businesses, which often also have international desks. On the highest level, there is the Confederation of Netherlands Industry and Employers (VNO-NCW). SMEs have their own organisation, called MKB Nederland. Sectoral interest groups with an interest in Ukraine include the Federation of Agriculture and Horticulture (LTO), Netherlands Oils and Fats Industry (MVO), the Netherlands Potato Association (NAO), the Royal Dutch Grain and Feed Trade Association, FME Association (technology), and so forth. To varying degrees, these organisations support their member's interest towards-, and provide information concerning Ukraine. Furthermore, there is a wide range of consultants available for SMEs who are interested in internationalisation. These include specialists on Ukraine specifically as well. The interviews conducted with several of these organisations, associations, and federations gave the impression that the market was fairly capable of supporting SMEs who want to position themselves on the Ukrainian market. As someone who had worked on both the public and the private side of internationalisation support for SMEs said: "During the 1990s, Central and Eastern Europe was something new. Now we know how it works, how to do it."

4.2 Lessons learnt

During the pre-accession period of the 2004 enlargement, the Netherlands was active in supporting CEE countries in their efforts. Whilst the Ministry of Foreign Affairs was mostly focussed on societal transformation, the Ministry of Economic Affairs was responsible for economic transformation. The latter had a clear aim of positioning Dutch business in the region. However, the evaluations of policy aimed at economic transformation through positioning Dutch business focussed on the effects it had on economic transformation, not on the merits for Dutch business. That does not offer a direct answer to question posed in this chapter. For example, the instrument called IBTA (Investment Promotion and Technical Assistance) contributed positively to sustainable transition and the promotion of Dutch investment in Central and Eastern Europe

(Ybema, 2000). But this says little about the welfare effects in the Netherlands, or on specific Dutch business sectors. This makes it difficult to draw hard conclusions.

Still, there is indirect evidence of positive effects, for example in the agricultural sector. Policy aimed at the agricultural sector in accession countries distinguished itself through its coherence. This meant that the results were visible on the sectoral level. What is interesting, is that the evaluation (Netherlands Ministry of Foreign Affairs, 2005) reports that this was caused for an important part by the economic motives underlying the policy. The use of the line ministry´s receptiveness, resources, and capacity by the Dutch agro industry indicates their interest in the policy´s success.

There is a 2008 evaluation on the financial instruments aimed at foreign policy in the Ministry of Economic Affairs' portfolio (Van den Berg, de Nooij, Garretsen, & de Groot). It does not say much about the effects for SMEs exclusively, nor does it focus specifically on countries in a comparable situation as Ukraine find itself now. Still, the findings might offer an indication of which instruments might offer the best value in the current situation. Looking at the Net Present Value per year, which compares the amount invested now to the future receipts from the investment, five instruments are evaluated. The evaluation offer insights to the costs associated with the instruments for both the government as well as business, and the societal welfare benefits (or losses) that follow. Three of these instruments offer a positive NPV. Whilst NPV should not be only indicator of whether a policy should be pursued, the report does offer indications of the use for business compared to the welfare results.

The Programme Starters on Foreign Markets (PSB) offers support that includes advice and guidance in the preparation and implementation of an internationalization plan, and a contribution towards the costs of certain activities mentioned in the plan. The programme does not exist anymore, but there is a successor called Starters International Business. With similar goals and methods, the instrument provides 600 vouchers worth €2,400 in 2015. PSB had a positive NPV of €5.4 million at government costs of €2.7 million, whilst the net productivity gains for business were €10.5 million**.** The Fund Emerging Markets (FOM) provides medium- and long-term loans to companies or joint ventures in emerging markets that are majority owned or controlled by Dutch enterprises. The instrument still exists, finances with a minimum of €500,000 and a maximum of €10,000,000**.** Its NPV in the evaluation is €8.4 million, whereby both the government and business have net gains. For the government, the outcome is positive mostly because of the increased revenues from taxation. Economic diplomacy, here considered to be a trade mission headed by a member of cabinet, contributes the most to Dutch prosperity. The NPV per year is €109 million, which includes gains of €33 million for the government due to increased tax revenues.

The two other instruments, called Programme Economic Cooperation Projects (PESP) and Programme Cooperation Emerging Markets (PSOM) both had a negative NPV. As mentioned above, the NPV should not be the only criterion when evaluating an instrument. However, for the purpose of positioning Dutch SMEs both indeed appear to be less suitable. PESP because it also had negative impact on business (on the aggregate level, otherwise individual businesses would probably not take part). PSOM because the government costs are not compensated enough by business.

Concluding, it is clear that there the lessons learnt during the pre-accession period are not easily discernible as they were in the previous chapter. Most of the evidence is only indirectly related to the positioning of SMEs. Still, it the importance of a coherent approach can be reiterated.

4.3 Current efforts

Just like Ukrainian SMEs have an interest in a good business environment in Ukraine, Dutch SMEs profit from things like a well functioning bureaucracy, proper rule of law, and the general economic wellbeing of the country. In that sense, the measures discussed in the previous chapter are supporting Dutch enterprises as well. However, there is also policy aimed specifically at Dutch SMEs. The Dutch government currently offers three instruments for enterprises who want support in relation to Ukraine. There are other instruments available for a range of other countries, with varying aims, budgets, and methods. Because Ukraine is not on the list of 68 ODA recipients on which Dutch development policy (and funding) is aimed, the Dutch Good Growth Fund is not available. This is flagship fund is aimed at Dutch SMEs who want to export to, or invest in, developing countries and emerging markets.

The instruments that are currently available are called FIB (Finance for International Business), PIB (Partners in Business) and DHK (demonstration projects, feasibility studies, and knowledge acquisition). The total budgets of these instruments, which are not solely aimed at Ukraine, are €5.8 (22 countries) million, €6.3 million (62 countries), and €4 million (22 countries) respectively. An introduction to the most important characteristics of these instruments will be provided below, but it should be remembered that their size in combination with the number of countries means there is a limited availability.

FIB offers, as the name might give away, financial support for businesses who want to invest in their activities abroad. The government co-finances 35% of a loan with a maximum of €875,000, the rest must be provided by a professional party. Investments that are considered must concern company assets, start-up or expansion of production facilities, and sales offices and/or working capital. It is a five-year loan with interest and an 'equity kicker', a profit-dependent remuneration. There are currently no FIB projects active in Ukraine.

PIB is aims to bring clusters of companies together in their efforts to go abroad. It is a rather flexible instrument. It consists of three modules with a total maximum budget of 250,000 euro, which is dependent on matching by the cluster. The modules are promotion and matchmaking, knowledge exchange and networks, and economic diplomacy. In March 2015, a covenant for the consortium FoodTechLink was signed by a group of companies active in the food industry and the RVO. The goal is to collectively approach the Ukrainian market, to increase the exports of Dutch machines. The project will also include a (small) budget for government-to-government (G2G) support.

DHK is an instrument that actually consists of three instruments. Demonstration projects can be subsidised so that businesses can showcase their technology in a target country, in order to convince potential clients of their worth. Feasibility studies can be made into either the technical or the commercial feasibility abroad. Knowledge acquisition allows businesses to contract external parties to consult them on for example judicial or fiscal aspects of the target country, or to help them find a business partner. There are currently no DHK projects active in Ukraine.

Lastly, there have been trade missions organised to Ukraine. In April 2015, a trade mission was organised under the guidance of the Dutch embassy in Kiev. 20 Dutch companies visited Lutsk and Lviv, in western Ukraine, for a program of matchmaking and networking. Whilst there is no official evaluation, the embassy considered to mission a success due to the positive feedback from the participants. The importance of economic diplomacy was also underwritten by the 2008 evaluation of the Ministry of Economic Affairs´ financial foreign policy instruments (Van den Berg et al., 2008).

The paragraphs above are devoted to the types of support the Dutch government can offer to SMEs so that they can exploit the opportunities the DCFTA offers. At the same time, increased access to the European market by Ukraine might put pressure on specific Dutch sectors or companies. This is in line with the basic rationale of economic integration. At this point, there are no indications that these pressures would be so large for the Dutch economy that it would be a threat. It goes beyond the scope of this research to make a detailed analysis of the specific sectors, or timelines, where Ukraine's (future) competitiveness would have a specific impact.

Having identified the most important efforts to support Dutch SMEs in accessing the Ukrainian market, recommendations can now be made.

4.4 Policy proposals

The recommendations made here are based on several things. As a background, the evaluation of Dutch pre-accession policy and the societal NPV study are important. This is supplemented by the author's own conclusions following interviews with the private sector and public officials. Whilst there is a political aspect connected to positioning Dutch SMEs in Ukraine, such an effort is mostly about economic interests. Combined with the belief that it usually preferable to leave as much as possible to the market, the following two directions for policy are to be considered.

SIB, or Starters in International Business, should be made available for Ukraine. Apart from its positive NPV, the instrument has several interesting characteristics. Due to the small size of the grant on offer (a €2,400 voucher), it is especially interesting for SMEs. Furthermore, the requirement that an enterprise must have little or no experience with going abroad is useful. This adds an incentive to internationalise, hopefully bringing this step forward. Lastly, possibility to use external consultants means that knowledge in the markets can be accessed. At the same time, the small size of the grant ensures that consultants do not have the incentive to create huge, subsidised projects which mostly serve the consultant, and not necessarily other actors (which, according to such a consultant interviewed for this thesis, did happen from time to time in CEE before the 2004 enlargement). The list of approved consultants is useful quality control.

The second recommendation has explicitly been requested during the interviews with actors from the private sector. Export credit insurance (or Export KredietVerzekering, EKV) is an instrument that provides coverage against payment risks arising from export transactions entered into by Dutch enterprises with debtors in emerging markets. Depending on the target market, the minimum compensation to be insured is €5 million (weak emerging markets), €50 million (stronger emerging markets), or €100 million (rich EU countries). The export transaction can be construction abroad or the export of capital goods.

Export credit insurance is also offered by the market. The EKV instrument is supposed to be additional to export credit insurance by offered by the market.. It is provided by a division of

Atradius, which is one of the largest credit insurers in the world, on behalf of the Dutch state - which also picks up the tab. Two ministries are involved in the approval of Atradius' proposals: the Ministry of Finance and the Ministry of Foreign Affairs. It is a balancing act between the economic feasibility and the political interests. This already starts at Atradius. On the one hand, it has an interest in getting projects approved: it's where the company gets its business. On the other hand, it must not risk its credibility as a skilled insurer. Then, there are the different interests from the two Ministries. Foreign Affairs might be more interested in the political gains that might be had, whilst the Ministry of Finance will be focusing on the financials risks.

For Ukraine, it has been decided that this instrument will be closed for the year 2015. This is a pity for several reasons. That SMEs have trouble gaining access to finance is a problem not unique to Ukraine, it is an oft-faced issue throughout the EU as well. However, this problem is exacerbated by the current situation in Ukraine. The banking system is by and large in crisis, whilst at the same time there need to be al lot of investments made to adapt to the EU market requirements. In practice, this can mean that two healthy companies with an ambition to go into business, where it would make sense from an economic point of view, fail to do so. For example, a milk producer in Ukraine wants to invest in their production assets in order to satisfy the conditions set for exporting to the EU. A Dutch company, specialised in the necessary machines, is the most suitable party. However, the Ukrainian banks will not offer a bank guarantee because the financial system is in crisis. Dutch banks refuse to offer an export credit insurance due to the overall lack of stability in Ukraine, instead recommending to wait for two years. Whilst this might make sense from their perspective, it does not for both the Ukrainian and the Dutch company. The investment needs to be made now, since implementation of the DCFTA is at the doorstep. Since other countries, such as Germany, do offer ECI for Ukraine, an opportunity might be missed by Dutch business. This is of course counter the goal of positioning Dutch SMEs. Whilst the risks must always be evaluated on a case by case basis, there is a clear rationale against closing the instrument completely with regard to Ukraine.

4.5 Conclusion

In the end, it comes down to the fact that most gains can be made if political commitment to Ukraine's economic reform is made. There is a range of financial instruments already available, but their budget is limited. If the DGGF includes Ukraine as a target country, this would be both a political signal and an economic opportunity. Ukraine finds itself in the same category on the DAC list as Georgia and Moldova, and has concluded extremely similar Association Agreements. Ukraine has a much larger market than the latter two, and growth opportunities in sectors of interest to Dutch exporters. Yet Moldova and Georgia are on the list, whilst Ukraine is not. This should be resolved.

As far as what the most feasible instruments are, an indication has been made above. Apart opening SIB and EKV for Ukraine, the instruments currently used appear to be valuable. Especially trade missions are interesting. Not only do they give a political signal, their economic value is high (Van den Berg et al., 2008). Organising such a mission, headed preferable by (a) member(s) of cabinet, should be a priority.

5 Conclusion

For policies supporting Ukrainian and Dutch SMEs, advice has been offered above. A common denominator is that whilst many policy officers and implementers are aware of the need of action is this area, it is not yet a political priority. This is a shame and a danger, because since the first steps have been taken, the EU and its Member States should follow through. As noted before, the reforms that are needed in Ukraine are vast, and would have been a challenge even under perfect circumstances. The current state of affairs means that all hands must be on deck - in Ukraine, but also in the EU. If there is no sufficient support to those actions in Ukraine that are in line with the Association Agreement and its underlying rationales, they entire effort might fail. That is unappealing for all involved.

In Ukraine and at the EU level, the importance of SME development is understood and underwritten. Even if the actual implementation is not yet taking place in a desirable manner, the underlying processes are not effective and a range of pitfalls still exists: there is a political will. It is worrying that this is not the case in the Netherlands. On the policy level and with implementers, the importance of economic development and support for SME policies is recognised. At the political level, this is still far too limited. Even though steps in the right direction are taken, the efforts that are required can only take place of a political commitment is made.

Having said that, various other lessons can be learned from the process of EU-Ukraine integration. These are slightly less relevant for the current situation in Ukraine and the direction it might take, but all the more important for the EU when considering its relations with neighbours in the future. These lessons are closely interrelated.

On a theoretical level, two remarks are in order. That the EU's behaviour falls within the liberalist frame by and large, does not mean that the rest of the world agrees. The Russian Federation has been offered a place in the European Neighbourhood Policy, just like all the other neighbours. When the Kremlin communicated that it had no interest therein, a different framework was created. However, it turned out that it did retain an interest in what happened within the ENP. Whilst the Russian Federation did not voice its concerns regarding Association Agreement in the earlier stages, its position changed when the agreement as initialled and signing was the only task left. The consequences were, and still are, felt. As for the economic rationale underlying the current agreement, it remains to be seen whether the expectations for welfare gains were not too optimistic. Especially the impact that economic issues on the short term might have on the long-term feasibility might be significant. As we currently find ourselves in the midst of the situation, it is hard to form a judgement now. However, it is not unthinkable that ongoing economic failures will have their effects on public opinion of the project. Considering the political instability that has been lurking around the corner for the last decade-and-a-half, the consequences could be vast. It is too soon to say whether the EU was too naïve as far as politics are concerned, and Ukraine was too naïve as far as its economic gains go. But still, reading back in the policy documents of the last decade, it appears that an overly optimistic picture has been painted at times.

On a slightly more practical level, the effects of institutions have been positive to a large degree: the concepts of conditionality and socialisation have been more successful than predicted by many. Apart from the need for proper support, which lies at the core of the recommendations made in this thesis, two further remarks are in order. Whilst it is important to recognise that the conflict in the Donbas region must be sought primarily east of Ukraine, the EU could and should have foreseen that the Russian Federation would not be as complacent as was first thought and expected. Even though the EU has had a political rationale, the approach taken was in essence very technocratic. The legacy of the institutions of the enlargement process meant that whilst the transformative capacity of the EU was used, the possibility that third parties had their own ideas was not sufficiently taken into account. As a consequence, the issues pointed out in the previous paragraph could develop in the manner they did. The European Commission, whilst far from completely apolitical, appears to have underestimated the importance of (geo-)politics. Had these been taken into account earlier, a the integration of the EU and Ukraine *might* have been a calmer process than it is now.

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