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A4U Analytical Studies and Business Consultations N20

Mission Report, April-May 2018

Inputs for Industrial Dialogue under DCFTA, based on Analyses and Business Consultations N15 - N19

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1. The context

Under Component 3 of the project, this assignment focused on developing inputs for the Government of Ukraine for Industrial Dialogue under the DCFTA.

The main concept for this assignment is to contribute to informed policy making in the government through: better understanding of the wider issues and implications of DCFTA implementation and; consideration of the opinions and effects on wider stakeholders including Parliament as legislators, line ministries and executive agencies as implementers, business as those who have opportunities, as well as facing cost of compliance and, civil society as beneficiaries of greater integration with the EU.

To understand better the constraints faced by Ukrainian producers and reasons for their under- or weak performance in the EU market despite the DCFTA, business consultations took place with industry associations as well as representative businesses between February and April 2018. During the period under review, the A4U project carried out five **business consultation rounds** (workshops) in **Zaporizhia (26 Feb 2018), Dnipro (28 Feb 2018), Kharkiv (1 Mar 2018), Sumy (2 Mar 2018), L'viv (19 Apr 2018)** as well as **one in Kiev** at the Ukrainian Chamber of Commerce and Industry (UCCI; 6 Mar 2018). Further contacts were held with Government institutions (EPO, MEDT) and private business operators and associations in Kiev.

2. Assignment

The terms of reference about “A3.2.4 DCFTA analyses and policy papers & A3.3.7 Developing Inputs for Industrial Dialogue under DCFTA based on Analysis and Business Consultations” demand the following activities to be carried out:

- Support the Verkhovna Rada Committee on Industrial Policy and Entrepreneurship to identify key stakeholders in each of the eight sectors and develop a consultation plan based on priorities (essentially rank the sectors for investigation);
- Organise, under the auspices of the Committee, at least **5 round table discussions** with stakeholders and assist in the preparation of briefing paper detailing issues;
- Where appropriate **assist industry bodies** such as trade associations or chambers of commerce to research, compile and articulate problems and needs of the sector;
- Based on the **briefing paper**, research and investigate the highlighted issues both to **validate and gather supporting evidence** (could include inputs from industry, surveys, statistical analysis and other research as appropriate);
- **Following submission to the Government of Ukraine from the Committee**, of analytical papers on the constraints to trade under the DCFTA for each industrial

sector, **support Government in formulating a response** (either GOCEEI or MEDT) which could include written responses, meetings with the Committee and/or industry and should include a choice of solutions to the problems identified including policy options, remedies and industrial dialogue with the EU;

- Based on the Government response, the Committee (either jointly with Government or independently) to present and discuss the Government response/proposals with stakeholders to obtain validation/buy in;
- Establish **action plan** monitoring by Committee to track commitments and progress and provide reports to stakeholders (holding government to account on actions promised) and;
- For sectors not completed within life of the assignment, prepare and agree a future workplan on industrial dialogue under the DCFTA with the Verkhovna Rada Committee on Industrial Policy and Entrepreneurship.

During the assignment it became evident however, that the way through the Verkhovna Rada is too complicated and would not lead to the expected results of mobilising the GoU responses in useful time. Thus, the **ToR approach should be modified to involve directly the lead Ministry responsible for the economic development (MEDT)** instead (which would include also the Export Promotion Office EPO) and eventually, GOCEEI (Government Office for the Coordination of European and Euro-Atlantic Integration).

3. Delivery of the mandate

The expert carried out a first mission in December 2017 (6 WD). The expert held the second mission from 22 January to 8 March 2018 (34 WD). The third mission was held from 16 April to 18 May 2018 (23 WD).

The third mission encompassed participation in the Fellowship Day on 17 April. On April 19, the STE took the opportunity to be in L'viv for a business consultation at the local Chamber of Commerce and Industry (s. also Annex). 20 April was reserved for participating in the International Conference "Implementation of the Association Agreement EU-Ukraine: public and private law legal aspects" (20 April, L'viv), held at the Law Faculty of the University.

During the second part of the mission, the STE was completing research and drafting of the studies, coordinating also on the single elements of the studies with the associate fellow and with Mr. Mark Hellyer, A4U Activity Leader as well. The draft studies were completed by 18 May and submitted to Mr. Hellyer (incl. de-briefing), the latter offering backstopping on the industrial dialogue component. In June, the STE got the pertinent comments from Mark Hellyer and subsequently reworked all outputs accordingly, as well with the help of the associate fellow. The draft studies in the new, revised layout were submitted on 18 July 2018.

The fourth and last mission must be planned for August/September (17 WD). The fourth mission will focus on establishing the Action plan for Government responses (including monitoring) and a **guideline for a standard approach towards business consultations** and replies. Business events will be held as mandated by the ToR. The timeframe will give MEDT some time consult the analytical studies once received from A4U.

MEDT should be involved actively in the preparation of those events to give them the opportunity to present GoU actions in favour of the five sectors analysed (and beyond). Indeed, Industrial Policy Department (IPD) is working on establishing an “Industrial Policy”. Furthermore, Industrial Department, on behalf of MEDT, took on board several constraints of the industrial sector to actively address them. The five A4U sector analyses and the suggestions therein feed well into this ongoing process.

4. Barriers to Trade of Underperforming Sectors and Products

a. Identification of sectors

To understand better the constraints faced by Ukrainian producers and reasons for their under- or weak performance in the EU market despite the DCFTA, business consultation took place with industry associations as well as representative businesses between February and April 2018. During the period under review, the A4U project carried out five business consultation rounds (workshops) in Zaporizhia (26 Feb 2018), Dnipro (28 Feb 2018), Kharkiv (1 Mar 2018), Sumy (2 Mar 2018), L’viv (19 Apr 2018) as well as one in Kiev at the Ukrainian Chamber of Commerce and Industry (UCCI; 6 Mar 2018). Further contacts were held with Government institutions (EPO, MEDT) and private business operators and associations in Kiev.

About 45 interested companies and institutions participated in the events. Relevant questionnaires were distributed to the companies. The 13 returned forms provided as well relevant information about constraints for business community in Ukraine.

Based on all data available and responses received, five sectors have been selected to be reported in detail:

- Pumps for liquids (HS 8413)
- Electric motors and generators (HS 8501)
- Taps, cocks, valves (HS 8481)
- Machinery, plant or laboratory heating equipment (HS 8419)
- Radar Apparatus (HS 8526)

b. Five Analytical Studies

Five analytical studies have been produced recapitulating the most urgent problems to be addressed. The analytical studies were submitted separately on 18 July 2018 and form integral part of this report.

Main constraints identified concern mostly Ukrainian, market internal problems, but not only. The rapid switch towards the EU, away from Russia, brought quite a lot of convergence issues, i.e. technical standards. A short recap of the issues flagged (or identified by the expert):

- **EU Technical standards:** Companies struggle understanding EU Technical standards, and consider them expensive and onerous to apply. There is no awareness that the EU applies often self-certification and no further laboratory testing is required. Ukraine's National Accreditation Agency (NAAU) is not yet Member of the European Committee for Standardisation (CEN), but at least a so-called "Companion Standardization Body (CSB)"¹.

An additional constraint is seen in industry standards, not only Government standards stipulated in EU legislation; eventually, such standards might require "digital" processing while companies in Ukraine do still "analogical" work. It is also true that companies might need to buy the standards before having found clients for their products, thus Ukrainian producers are reluctant to spend their last cash-flow on those standards.

- **Access to finance (cost, availability, conditions):** Ukrainian SMEs find it very hard to get access to finance, and if yes, it is too costly as interest rates are very high. Companies are financially strained after years of crisis and without adequate financing instruments, are not able to upgrade their products/production or explore new market opportunities.

For exporters, the implementation of the "The Law of Ukraine on ensuring the large-scale expansion of export of goods (works, services) of Ukrainian origin by insurance, guarantee and cheapening of export lending" to cover export risks would bring an urgently needed relief. Ukraine should also allow enterprises to hold foreign currency for longer periods of time to mitigate currency risks.

- **Marketing errors:** Companies were oriented towards the domestic market or towards the CIS, with limited export potential and not competitive products: For many years, companies focussed on their traditional markets and didn't invest into innovation, new technologies and new markets. Missing business knowledge and mistrust into the economic policy of the Government left business thunderstruck in front of the

¹<https://standards.cen.eu/dyn/www/f?p=CENWEB:60:::NO>

collapse of the Russian market. Companies also neglected to read the worldwide economic trends.

- **DCFTA and PEM Convention Rules of origin:** While joining the PEM Convention on Rules of origin didn't change the rules of the game, the initial swap from the EU GSP to the DCFTA did however bring a significant restriction of rules of origin above all in the machinery sector. It must be said, that Rules of origin of the DCFTA had been negotiated before the EU GSP Rules got revised. It is now important that MEDT contributes in the Committee dealing with the PEM Convention revision, aiming at liberalising the current PEM ROOs.
- **Inefficiency of management and marketing skills, low productivity, low qualification of workforce, labour migration (brain drain):** Labour migration is felt by companies as impacting negatively the competitiveness of Ukraine. Companies fail to recruit qualified workforce, also due to the salary gap between neighbouring EU countries (i.e. Poland or Hungary). In addition, companies that would be willing to hire their own apprentices criticize the existing vocational education and training (VET) program and related handling of approvals by the Ministry of Education and Science (MES). It is also underpinned that technical and vocational education is not focused on the market needs. Eventually, VET in Ukraine is more focussed on technical schools instead of apprenticeship in companies.
- **Problems with the application of the current VAT scheme** and lengthy reimbursement procedures up to two years. Already financially strained companies run into great troubles because their money is unnecessarily held back in bureaucratic reimbursement procedures. Companies also complain that investment goods are taxed, with exception of foreign direct investment, creating an unfavourable market for local enterprises;
- **Access to the Public Procurement market in the EU:** Companies complain that despite having the chance to bid in EU public procurement, their chances are minimal as several preconditions like submitting revised accounting for 3 years according to "Generally agreed accounting principles" (GAAP). Ukrainian companies usually use other accounting principles, thus participating in EU PP would require them to redo the whole accounting system;
- **Lengthy customs/export procedures:** Companies find it very hard to provide extensive warranty and servicing in the EU as export procedures in Ukraine take too long (up to one week). Maintaining a stock of spare parts in the EU is too onerous because the export volume is still small. Customs also put severe constraints on returned, used parts to be returned and serviced in Ukraine;
- **Adequate export support institutions and instruments still missing:** Companies deeply deplore that Ukraine didn't yet implement an export guarantee scheme

despite the law was adopted several years ago. Thus, Ukrainian companies cannot operate on the same footing as their EU competition.

- **Electricity/energy deficiencies/weak infrastructure:** Through not transparent mechanisms an energy monopoly has been formed, thus access to energy for businesses is said to be difficult, and costly. In some parts of Ukraine, infrastructure constraints hinder further development (mainly, bad roads). Ukrainian Railways is (too) slowly expanding its rolling stock to accommodate larger shipments towards Europe (not enough container capacity);
- **Technologies used are out-dated** and lagging the European industry, especially modern equipment with integrated control technologies and meeting tough energy efficiency requirements. Years of crisis have strained adaptive capacities of many machinery producers (i.e. pumps, electric motors and generators, taps, cocks, valves, heating equipment) and blocked innovation. Without funding and industrial upgrading, the production of those goods remains outdated and not competitive on a long-run;
- **Mistrust in Government and Associations:** This leads into a sort of stalemate as many companies will not react anymore with Government solicitations, making it also hard for the Government to consult and adapt policies to the need of business community (which is one of the main wishes from the latter). In detail:
 - Low Trust in the Government or no trust, some companies refusing to cooperate in this study if result is shared with GoU (almost half of questionnaires are confidential);
 - Corruption allegations, including ProZorro; the latter might have brought some relief, but enterprises still see corruption during the signing of the contracts;
 - Oligarchic structures, making business operations hard for SMEs;
 - Wrong energy policy led to energy sector dominated by one Oligarch, raising energy prices and not offering alternatives for enterprises;
 - Some companies raised the bar, saying “Enough consultancy, now real help needed for enterprises”;
 - Government should focus on real business needs, on the other side, Government should not mingle into doing business of enterprises but give the necessary autonomy;
 - AA/DCFTA seen as negative and not bringing any advantage;

- Enterprises have low perception of utility of Chambers of Commerce or also their own associations, thus Chamber activities often are limited to sell services instead of influencing policy making;
- Low trust in their own associations makes it difficult for Government to consult private sector, as no strong partner is available; this makes also vulnerable and unpredictable and exposed to external influences (political, grey economy).

c. Possible Government interventions

The Government is involved in many of the flagged issues or at least aware of them, thus a good coordination among the different Ministries is primordial to achieve the desired results of solving most issues or at least flagging at the attention of the business community, that the GoU is working on it in a timely and correct manner.

Not all issues might be solved in future (they really go to the core of the Ukrainian governance since independence), but it is important that GoU standardises its replies and for instance high-level replies are coordinated among the Ministries involved.

Main lead should be at the Ministry of Economic Development and Trade (MEDT). The five analytical studies highlight the following possible government actions:

1. Support the machinery sector comply with EU technical regulations

- Explaining the system and requirements for compliance and what is already available in Ukraine, eventually empowering NAAU to further promote its functions and technical standards;
- Implement the Strategy for the Development of the Technical Regulation System (including an action plan);
- Developing systems/business support services for conformity assessment (especially self-certification procedures), i.e. through Innovation centres, Techno-parks and Incubation centres, Quality and Technology awards, Quality and Training Centre;
- Developing and facilitating intra-industrial dialogue to facilitate further consultation work of the Government but also to form a tissue of trustable industry associations representing the industry interests;
- Enhance and facilitate cooperation and knowledge sharing among the business community itself;

- Continue and intensify the High-level Industrial Dialogue with the EU, eventually adapting the working groups to key sectors with real economic potential; adapt “Roadmap of the Ukraine-EU Industrial Dialogue” accordingly.

NOTA: This differs from the solution the MEDT is envisaging with the conclusion of an ACAA with the EU (**Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA)**). Concluding an ACAA will for sure help, but only partially, thus MEDT needs to be aware that their standard reply will involve more points to address the real constraints industries are facing.

2. Access to finance – favour direct investment

- Implement immediately the "Law of Ukraine on Providing for Large-Scale Export Expansion of Goods (Works, Services) Originating in Ukraine through Insurance, Guarantees and Cheapening of Export Credits"² adopted on 20 Dec 2016;
- (Continue) High-level dialogue with the EU, EBRD and other donors to secure cheaper credit facilities for banks in favour of SMEs willing to undergo industrial upgrading and restructuring;
- (Continue) fiscal reforms and stabilisation of Ukrainian currency; at the same time, provide financial relief to companies, i.e. through further implementation of VAT refund options to allow companies to self-finance their business operations;
- Create (productive, targeted) tax or other incentives for investment (tax relieves on investment capital, employment measures, industrial upgrading) to facilitate Ukrainian and not only foreign direct investment;
- “Grand-father” clause (i.e. tax amnesty) on offshore capital to allow Ukrainian investors to reinvest in the own country at global conditions³.

3. Modernisation of production/design

- Encourage Research & Development across industrial clusters (i.e. spending in EU amongst machinery sector is 5-6% according McKinsey) to allow industries to close the technological gap with European competitors;
- Create industrial investment fund that should act as a catalyst for investment activities and modernisation/upgrading.

² <http://zakon5.rada.gov.ua/laws/show/1792-19>

³ Tax amnesty is a common practice, i.e. adopted by Italy over the past years. See also:

<https://www.step.org/news/italy-reopens-tax-amnesty-domestic-well-offshore-assets>

It is well understood that the topic of “tax amnesty” is highly controversial in Ukraine. It looks however that considering the lack of other FDI, this is one of the best options to secure funding for companies. See also: <https://www.kyivpost.com/ukraine-politics/proposed-bills-grant-cheap-amnesty-corrupt-elite.html>

NOTA: Industrial Policy Department of MEDT is working on an industrial strategy, which also favours the introduction of **Support for business projects and innovations**. One point is however *“Introduction of mandatory offset agreements”*. Such agreements tend to make business contracts more expensive than necessary and are contra-productive (Offset agreements are often used in defence procurement).

4. Workers and skills development

- Evaluate achievements of actual VET system and establish measures of validation and alignment of education and training curricula with sector needs and requirements.
- Career opportunities could be studied in partnership with local industry starting in secondary school. Required competencies can be taught in vocational training systems if the equipment that is used is up-to-date by industry standard.
- Encourage the enterprises to implement programs improving labour productivity including insurance, recreation and introduction of competitive and transparent wages.

5. Rules of origin

- Ukraine should actively participate in the Paneuromed Convention Meetings, regularly held in Brussels by DG TAXUD;
- Focus should be to achieve at least as liberal rules of origin as the EU introduced in its GSP back in 2011;
- Networking with EFTA, which holds also a liberal stance to build up support;
- Continue opening other potential markets for Ukraine (i.e. FTA with Korea, Japan), also for attracting further investment into Ukraine and with the aim to introduce the concept of cross-cumulation EU-Japan-Ukraine for instance. The EU allows cross-cumulation in the EU GSP for instance, but also in the new Economic partnership agreements with African countries). PEM Convention should also be enhanced to allow for cross-cumulation option.

6. Export promotion

- Evaluate the achievements of existing export promotion tools as well as propose new tools to put on equal footing Ukrainian exporters vis-à-vis European competitors (Export risk guarantee can cover a multitude of trade risks);

- Set-up Ukrainian business hubs in key countries in Europe (i.e. the UK, Germany, France, Italy);
- Encourage intra-industrial dialogue and cooperation between, for example European Associations in the specific sectors, but also EU Members' associations and relevant Ukrainian institutions and key clusters;
- Continue High-level industrial dialogue with the EU, but also continue opening other potential markets (i.e. Korea, Japan), also for attracting further investment;
- Continue expanding the network of Free Trade Agreements to fully implement the Regional Convention on Rules of origin (Paneuromed Convention);

7. Government Dialogue with Industry

- Evaluate effectiveness of current Government dialogue activities, i.e. of business events organised by EPO (MEDT);
- Evaluate Government actions in all areas of internal market intervention raised by enterprises:
 - Fighting corruption;
 - Technical standards;
 - Public procurement (ProZorro);
 - Access to finance (cost, availability, conditions) (i.e. IMF conditions are felt as destructive for Ukraine economy);
 - Access to electricity and pricing of energy;
 - Labour law and labour workforce, massive migration of educated workforce, education system and TVET;
 - VAT related issues (refund difficulties and delays, VAT on investment);
- Enhance intra-governmental coordination and enhance a common Government language towards industrial dialogue and communication (i.e. "answer toolkit" or "text modules") with private sector about common issues raised, i.e. corruption allegations, VAT refund problems, financial market and credit situation, IMF conditions, infrastructure, energy market and supply, land reform, DCFTA rules of origin, and many other issues at stake.

5. Output monitoring

The project ToR requests the following contribution to the GoU:

- ✓ 5 business consultation events in five priority sectors to identify constraints limiting exports under the DCFTA;
- ✓ 5 Analytical studies providing evidenced based constraints as well as suggestions for addressing those constraints;

- ✓ Guideline for government responses to industrial development submissions (mostly integrated into the analytical studies);
- Follow up consultation events with solutions/responses from government;
- Guideline and methodology for the Verkhovna Rada Committee on Industrial Policy and Entrepreneurship to monitor progress.

6. Annexes

a. A4U Analytical Studies and Business Consultations

The five analytical studies have been submitted separately and form integral part of this report.

b. Annex – Updated workplan (status July 2018)

MONTHLY WORK PLAN		
	ACTIVITIES	OUTPUTS
January 2018	Second mission: <ul style="list-style-type: none"> Background research on Industry in Ukraine; First meetings in Kiev; Identify key stakeholders in specific industrial sectors; 	
February 2018	<ul style="list-style-type: none"> Developed a consultation plan; Prepared briefing papers detailing issues at stake; Organised 5 round table discussions and Held 4 round table discussions in in other towns. 	Early February: Consultation plan with stakeholder list Mid-February: Briefing papers, draft questions and presentations for the events in Ukrainian and English established Second half February: Events/consultations held
March 2018	<ul style="list-style-type: none"> March 6: Consultation in Kiev Follow-up on materials and questionnaires of participants in the events Mission break 	Consultation in Kiev
April 2018	Third mission: <ul style="list-style-type: none"> Fellowship Day on 17 April One business event in L'viv (19 April) Participation in the Faculty of international relations at the University in L'viv on April 20 Investigate and research highlighted issues, validate and 	Five analytical studies ready to be submitted

	gather supporting data from available sources (industries, surveys, statistics, etc.)	
May 2018	<ul style="list-style-type: none"> • drafting 5 analytical studies about the sectors concerned; • Assist the MEDT in coordinating in the Government and in formulating written responses to industries, formulating solutions to problems highlighted, including policy options, remedies and future industrial dialogue, e.g. with the EU; 	Submitted the five draft analytical studies to Mark Hellyer (backstopping) for comments.
June 2018	<ul style="list-style-type: none"> • Comments received from Mark Hellyer • Updating of the five analytical studies to meet the new layout 	Highlighted analysis of the problems and possible solutions in the five analytical studies to MEDT rather than separate submissions (as suggest by Mark Hellyer)
July 2018		Submission of the five analytical studies to A4U and MEDT
August 2018	<p>Fourth mission:</p> <ul style="list-style-type: none"> • Assist MEDT to present the responses and discussion in at least 3 follow-up consultations with private sector and UA Government; • Assist EPO, MEDT and A4U to establish an action plan and monitoring tool to track commitments and progress of Government actions in relation to the problems and solutions identified; • Assist the MEDT in establishing a future work plan on industrial dialogue under the auspices of the DCFTA, with the industries concerned and the Verkhovna Rada Committee on Industrial Policy and Entrepreneurship. 	<p>To meet with the presence of MEDT/EPO:</p> <ul style="list-style-type: none"> - State Fiscal Services (different departments, i.e. about VAT, customs procedures at the border) - Ministry of Finance (about currency, fiscal reforms, taxation, incentives for investors and industrial upgrading) - Ministry of Education and Science (VET system) - MEDT Departments themselves - EPO itself <p>3 business events held, eventually in Kiev, Sumy and Dnipro.</p> <p>Draft Action Plan /future work plan with monitoring tool (Excel recapitulation, regular updates and meetings, among other options)</p>

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