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The European Neighborhood Policy and the Ukraine: Incentives for Economic and Political Reform

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1. Introduction and Literature Review

On September 30, 2007, Ukraine's pro-Western parties won a parliamentary majority. The election's results confirmed the pro-Western consensus of the Orange Revolution—the November 2004 election in which Viktor Yushchenko took power after hundreds of thousands of Ukrainians protested pro-Russian Viktor Yanukovych's electoral victory. Western states have repeatedly looked on Ukraine's elections as an opportunity for it to prove its commitment to democracy. Though the Orange Revolution instated a Western-leaning president, allegations of vote-rigging that prompted the "Revolution" made the democratic system seem unreliable. The September elections will surely affect the way foreign powers look upon Ukraine, while the country's attitudes toward East and West continue to be established. Whether Ukraine will ultimately find a stable position in Western institutions (such as NATO, the WTO, or the European Union) is unclear as of yet.

As a primarily economic actor with limited political or military power, the EU has relied on enlargement as its chief foreign policy tool, widening its economic scope by offering membership to less politically and economically stable neighbors. Offering the "carrot" of member state status and the associated benefits of market access, monetary union membership, a common external border, and some political solidarity, the EU has successfully spread its 80,000 pages of common laws (*acquis communautaire*) and induced political and economic reforms in each of its acceding member states. Indeed, accession arrangements undoubtedly provided motivation for the EU's newest Central and Eastern European members' rapid transitions from Soviet to market economies. Even without formal accession, the prospect of EU membership has induced reforms in some surrounding states, such as Turkey. Offered the incentive of accession to the EU, Turkey instituted various political reforms, including the abolition of capital punishment and improvement in rights for its Kurdish population.

Under the stipulations of EU treaties, enlargement cannot proceed further until the EU adopts a constitution, which has proven a slow and contentious process since the constitution was rejected by French and Dutch voters in 2005. Additionally, citizens and politicians have lost energy to pursue enlargement and are grappling with the need to deepen ties among current member states. Due to this sense of "enlargement fatigue," it is unlikely that enlargement will proceed further in the near future. Since the 2004 EU enlargement (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia) and 2007 enlargement (Bulgaria and Romania), the EU's foreign policy has focused on offering a different set of incentives to its neighbors that does not include full EU membership. Figure 1 shows a map of the EU as of 2007.

Figure 1: Map of the European Union, 2007: EU member states are shown in yellow. States that already have open accession agreements with the EU and are in the process of achieving membership are shown in dark blue. Here we see that Ukraine is poised on the EU's eastern border and shares a long border with Russia.
(Source: www.europa.eu)

The EU in 2004 instituted the European Neighborhood Policy (ENP), a system of privileged relationships with its 16 immediate neighbors, based on a "mutual commitment to common values (democracy and human rights, rule of law, good governance, market economy principles and sustainable development)" (Commission, 2007c, ¶ 3). These "neighbor states" include some that do not fall under the geographic definition of "Europe," such as the Palestinian Authority, which will never have the prospect of EU membership, and some states such as

Ukraine that could potentially be offered EU membership someday. Under the ENP, the EU and each neighbor country create a bilateral ENP Action Plan, which establishes political and economic reform priorities for the neighbors.

The ENP is merely a variation of the enlargement foreign policy tool; rather than full membership, the ENP offers deeper economic ties without institutional participation. That is, the ENP does not offer membership in the EU's decision-making bodies. Successful implementation of the Action Plan will result in negotiation of an Agreement on Conformity Assessment and Acceptance of Industrial Products in key sectors (Burakovsky, et. al., 2006). Kelley (2006) argues that drafts of the Action Plans were based directly on the Association Agreements for the 2004 enlargement; both schemes have similar requirements for economic and political liberalization and offer the incentive of integration with the EU. The ENP offers neighbor states "the prospect of a stake in the EU's Internal Market and further integration and liberalization to promote the free movement of persons, goods, services and capital" (Commission, 2003, p. 4). Thus, the ENP Action Plans go beyond what has been offered through bilateral Partnership and Cooperation Agreements, which laid the framework for future political and economic cooperation between the EU and bilateral partners. By promising free movement of persons, goods, services, and capital, the EU is essentially offering everything except institutional membership to the neighborhood states and precluding their participation in the European Monetary Union (common currency area) (Haukkala, 2007).

Ukraine, one of the states with which the EU has an ENP Action plan, has repeatedly expressed an interest in EU membership but has been denied the possibility of opening an Association Agreement, the first step toward membership negotiations (Molchanov, 2004). At the very least, Ukraine repeatedly indicates its supposed interest in Europeanization. In 1998, the president issued a Decree on Strategy for Ukraine's Integration into the EU, tasking the government with meeting membership preconditions by 2007, and in 2003, the President formed a National Council for Approximation of the Legislation of Ukraine to that of the European Union (Molchanov, 2004). Oleksandr Chalyy, a senior aide to President Viktor Yushchenko, stressed Ukraine's European orientation in September 2007: "Anchoring our political future to a united Europe is our top strategic priority….The key point of such policy must be to meet the Copenhagen criteria [EU entry rules] –unilaterally, if necessary—within a 10-year timescale," (Runner, 2007, ¶ 10). Therefore, exclusion from the accession process as a member of the EU's "neighborhood" is disappointing to Ukraine. Ukraine's ambassador to the EU said in 2007 that the ENP without a membership perspective "cannot be accepted as an adequate basis for EU-Ukrainian relations," (Vucheva, ¶ 6).

This paper examines the ENP Action Plan for Ukraine and studies whether the ENP provides strong enough incentives to induce the social and democratic reforms desired by the EU and demanded by the ENP Action Plans. We examine the incentives schemes at work in the Action Plans and assess the impact of the ENP on trade as well as economic and political reforms in Ukraine. We analyze Ukraine's incentives for pursuing its Action Plan and its success in doing so to date in order to assess the ENP as in institution that could bring about democratic reform there. Institution of the ENP has not significantly affected Ukraine's economic and political development due to insufficient incentives inherent in the Action Plan and due to the riskiness of pursuing the Action Plan.

2. Theoretical Framework

New Institutional Economics (NIE) provides a framework through which we can understand the ENP as an institution and its effectiveness in motivating action for Ukraine. NIE can be used to assess various components of an institution, such as its incentives regime, information asymmetries, the motives of actors, monitoring mechanisms, and conditionality.

One branch of NIE, principal-agent theory, examines the motives of an economically powerful actor (the “principal”) and a less powerful actor (the “agent”) to reveal an optimal contractual arrangement between the two. Agents operate under an “incentive constraint,” meaning they must have sufficient motivation to undertake the action specified in the contract, according to their own preferences. An agent’s opportunity cost (or “reservation utility”) in pursuing the course of action must also be considered. An optimal contract will yield the highest possible return to the principal while meeting the agent’s reservation utility and incentive constraint (Ray, 1998). An optimal Action Plan, therefore, will lead Ukraine to become a member of the EU common market while providing sufficient incentive for the Ukraine to carry out the Action Plan and ally with Europe.

Lessons from foreign aid programs can be applied to the ENP to demonstrate some of its potential weaknesses. Paul (2006) examined the nature of foreign aid relationships and the incentive problems involved. Aid contracts are subject to information asymmetries, as the motives of both donor and recipient are unclear and likely diverge. An analysis of the motives of the EU and Ukraine is needed before we can determine whether the ENP adequately aligns the two actors’ motives. Strategic behavior may arise as recipients might not use aid for its intended purpose, and adverse selection may occur if recipients conceal information about their motives or capacity for change. Ray (1998) identifies “hidden action” as a specific type of informational problem in which one party in a transaction may not have any incentive to follow through with the actions stipulated under the contract because the action is not publicly observable. For instance, Ukraine may attain closer integration with the EU without undertaking the necessary reforms if integration does not appear to be clearly contingent on its adoption of the Action Plan.

To mediate these potential problems, a monitoring mechanism is important to ensure that a contractual agreement is fulfilled. Conditionality can help alleviate moral hazard by requiring evidence of improvement in order to receive additional benefits; that is, rewards should not be guaranteed but should be contingent on the level of effort put forth. Institutional failure in developing countries is widely cited as a hindrance to development aid's effectiveness; corruption and poor infrastructure, for instance, can keep aid from reaching its targeted recipients. In fact, Herath (2005) asserts that institutions are so important as to be the "primary reasons for differences in economic performance" (p. 879). Thorbecke (2000) thus recommends process conditionality and political monitoring to ensure aid effectiveness. Conditionality also allows donor countries to achieve political motives; they provide aid in an attempt to reach foreign policy goals, while seeking political support from recipients (Paul, 2006). We will assess the extent to which conditionality operates within the ENP as a way to uncover whether the ENP will successfully motivate political and economic reform in Ukraine.

3. Data and Analysis

In principal-agent theory, an economically powerful actor such as the EU (the "principal") creates contracts with "agents" (like Ukraine) to best serve its own interests and reduce the agent's moral hazard (Ray, 1998). The EU controls access to its market and so can dictate the terms of the Action Plans, providing incentives schemes and conditional agreements. The EU is also politically stronger than the neighbor states (Raik, 2006). This justifies our categorization of the EU as the "principal" in the principal-agent framework analysis of the ENP. Here, we use principal-agent theory to analyze the effectiveness of the ENP.

3.1 The Actors and their Motives.

3.1a The European Union

The EU's 27 member states form a common market. With a GDP of nearly 16 trillion dollars, it is the world's largest economy (IMF, 2007). The ENP is a policy of Westernization on European terms, with the goal of fostering stable, pro-European regimes in the EU's neighborhood. Part of the EU's motivation for providing aid and encouraging reform in its "neighborhood" is to create political and economic stability at its borders. The EU seeks to create allies in its sphere of influence without enlarging, increasing cooperation at its borders without going through the difficult process of extending EU membership. In neo-realistic thinking, cooperative institutions such as the ENP contribute to donor security by promoting democracy, human rights, and low military spending (Zanger, 2000); institutions of regional cooperation have replaced accession agreements as the EU's means of fostering stability in its neighborhood. Specifically, by drawing countries into its sphere of influence, the EU can gain support for foreign policy objectives such as crisis management operations (Tassinari, 2007). Thus, the EU seeks to promote shared values, and economic integration is clearly contingent on adoption of these "shared values," or the EU's values. Kelley (2006) cites a European Commission official stating: "The countries that push more shared values will get priority in financial support, greater and speedier access to the internal market" (¶ 16).

Minimizing Russian influence in Eastern Europe is also an important strategic goal for the EU, because Russian influence may foster economic instability and authoritarianism rather than liberal reform. Specific security threats that the EU sees in Russia are nuclear weapons, access to Caspian Sea oil and gas, and terrorism (Legvold, 2004). Russia cut off gas supplies to Ukraine in January 2006 and again threatened to do so in October 2007, amid speculation that these actions could have been connected to the Orange Revolution and Ukraine's elections. Many European countries were affected by the gas cut-off; reducing reliance on Russia for oil is thus important for strategic reasons. Russian influence is an important consideration for the EU in offering integration with Ukraine, which has strong historical, cultural, and ethic ties to Russia and shares a long border with Russia. Strengthening Ukraine creates a buffer against Russian influence and aggression, whereas making Ukraine a member of the EU would extend the EU's growing border with Russia.

The EU also has economic motives for integrating with its neighbors. Stronger neighbors are better trading partners and require less aid. By contributing to the economic strength of its neighbors, the EU reduces the likelihood that its neighbors will experience an economic crisis that affects the EU or requires the EU to intervene. With the 2004 EU enlargement, Ukraine's economic security became more relevant to the EU because Ukraine is now at the EU's eastern border (Legvold, 2004).

In some ways, it is not accurate to speak of the EU as a singular actor with one set of motives. As an organization of 27 member states, the EU makes many of its decisions through intergovernmental processes. The differing motives of the member states make it difficult for the EU to act with one common voice, particularly in the realm of foreign politics. The EU's newer members are more in favor of enlargement, with Poland particularly interested in making Ukraine a member of the EU, whereas older members of the EU are not as receptive to enlargement. This contentiousness impacts Ukraine's integration prospects; some states may be resistant to the idea of allowing Ukraine to enter the common market and may block the decision in the end, despite the ENP's promise of access to the common market. Political resistance within the EU also makes enlargement unlikely.

Instead of applying economic pressure, such as tariffs or embargos, the EU attempts to promote its foreign policy agenda through soft power, offering economic integration without union membership (Kravchenko, 2007). Enlargement has been the EU's main tool for this purpose; however, the ENP could meet these objective without creating internal political resistance and straining the EU's already cumbersome institutions.

3.1b Ukraine

Since the 2004 EU enlargement, the EU has been Ukraine's largest trading partner, accounting for about 32% of Ukraine's total trade in 2005. Ukraine's total trade with the EU amounts to about 1.1% of total EU trade. Iron and steel, mineral products, and chemicals make up 64% of Ukrainian exports to the EU, and Ukrainian imports of machinery, equipment, and chemicals make up 66% of Ukrainian imports from the EU. Trade in services between the two actors is limited. The EU imposes quotas on some Ukrainian steel exports, which will be abolished if Ukraine joins the WTO.

Ukraine also has a highly inefficient economy, owing to its previous central control that concentrated resources in heavy industry (Goncharuk, 2006). Goncharuk (2006) found that between 1992 and 2004, economic efficiency in Ukraine actually declined by 8.5 percent, and the economy experienced inefficient utilization of investment and innovation. This points to the need for Ukraine to reform its economy; it must improve its technological capabilities and energy efficiency, demonopolize, increase competition, and reduce state involvement in the economy (Goncharuk, 2006). A study of Ukraine's economy by the World Bank (2005) found that Ukraine's exports to the EU were constrained more by the domestic business environment than by EU trade policies.

Ukraine’s investment climate would become more favorable through enforcement of legislation and further reforms, resulting in increases in FDI and a reduction in capital flight (EU Commission, 2007a). Ukraine’s economy suffers from an inconsistent regulatory environment, corruption, low security of property rights, lax enforcement of contracts, and little protection for minority shareholders, all of which discourage foreign direct investment and stifle growth (Burakovsky, et. al., 2006).

Ukraine’s historical, economic, and cultural ties are important to understanding its economic and security priorities. Ukraine is economically dependent on Russia, though the EU is now Ukraine’s largest trading partner. Ukraine is a major exporter of food and industrial products to Russia. Its key imports from Russia are oil and gas, paper, and industrial components, and about 80% of Ukrainian businesses depend on these imports from Russia. This dependence makes Ukraine’s economy vulnerable, and diversification is necessary. Ukraine’s strategy is to distance itself from Russia, which it hopes will bring Western financial assistance and improve Ukraine’s strategic importance to the West. To accomplish this, Ukraine has redirected trade away from Russia and has declared Europeanization as a goal. However, Russian capital continues to enter Ukraine, sustaining previous power relationships (Wilson, 2004).

Legvold (2004) describes how security threats faced by Ukraine are linked to economic issues. Though the threat of a Russian invasion has diminished, Ukrainian leadership still must plan for the possibility. It is more likely that Russia would use its military as leverage in diplomatic negotiations, so it is important for Ukraine, a much smaller state with a smaller military, to build alliances. Civil strife and regional conflict are also realistic threats. Economic resources are needed to sustain defense, and the Soviet-era military must be restructured, requiring budgetary outlays. Finally, Legvold argues that economic reform leads to growth, creating socio-economic stability. For these reasons, Ukraine's incorporation into the global economy and alliance with Europe is strategically important.

As Ukraine's political leadership has changed, its commitment to Europeanization has fluctuated, making its motives and capacity unclear. Yushchenko's two predecessors, Leonid Kravchuk and Leonid Kuchma, "pursued a foreign policy that was confusing, contradictory and ideologically empty. It was not driven by 'national' or public interest but simply by the objectives and personal interests of Kuchma and his oligarch allies," (Kuzio, 2006, p. 40). In August 2005, the political crisis that followed the Orange Revolution finally came to an end, as President Yushchenko appointed rival Yanukovych prime minister. Pro-Europe Yushchenko retained control over foreign and defense policies, and on August 3, 2006, key government leaders, including Yanukovych, agreed to common approaches on major foreign policy issues in the Universal Declaration of National Unity. Theoretically, this agreement committed Yanukovych to the pro-EU foreign policy. However, the level of commitment of Yanukovych and his Party of Regions' to a pro-Western foreign policy is unclear. In fact, Kuzio (2006) argues that Yanukovych's return as prime minister partially closed the door to Ukraine's NATO membership. Wolczuk (2006) argues that the uncertainty of Ukraine's political system, especially between the 2004 and 2006 elections, led to slow reform and slow implementation of the Action Plan. Moreover, in the 2006 parliamentary elections, Yanukovych's Party of the Regions earned the majority of votes, making it "difficult to formulate foreign policy priorities…and to pursue coherent domestic policies to realize these priorities," (Wolczuk, 2006, p. 14). According to the chairman of the Ukrainian parliament's Committee on National Security and Defense, Anatoliy Kinakh (2007), new constitutional provisions implemented in

2006 redistributed power within the government without laws to address the technicalities of the power redistribution. Thus the balance of power within the Ukrainian government is tenuous, limiting the government's capacity for sustained commitment to reform. Wolczuk (2006) argues that the various parliamentary parties all agree with the goal of European integration but do not equally see it as a priority, and changing coalition dynamics and constitutional changes make policymaking precarious, impeding implementation of the Action Plan. Continued political reform is thus a necessity for Ukraine.

Ex-communist elites continue to have a great deal of power in Ukraine and are woven into the political structure through co-optation, making economic gains through their connections to power (Wolczuk, 2004). Wolczuk (2006) argues that all parties in the Ukrainian parliament are "'infiltrated' by business elites," and business elites are interested in integration with the EU only as it benefits their interests. Industrial output is also dominated by financial industrial groups with connections to government. This "insider economy" is associated with an anti-competitive economy, which is "heavily dependent on a few low-value added sectors, with poor productivity and high sensitivity to small movements in prices and exchange rates and to external shocks," (Burakovsky, et. al., 2006, 3). Ukraine's economy can experience severe downturns due to shocks in the energy supply, for instance.

The problem of hidden action may also be relevant. For instance, while Ukrainian leadership may publicly commit to democratization and liberalization, corruption may lead to the fixing of elections or insider privatization, and other political actors may be unwilling to carry out the steps needed for Europeanization. Different actors within the Ukraine have different motives; there is a national interest in pursuing Europeanization, but undemocratic elites and oligarchs desire developmental and financial assistance but not EU laws and regulations

(Molchanov, 2004). Ukrainian elites who desire capitalist development are motivated by the incentives of economic development and ties with a strong trading partner (Molchanov, 2004); however, their desire for Europeanization has not been matched by reforms (Wolczuk, 2004). Ukrainians also hope that associate membership of the EU would guarantee increased financial aid (Molchanov, 2004). Thus, whereas some leaders have declared Europeanization a priority, there is neither a strong opposition nor support for Europeanization from society, and the volatility of elite actors' preferences result in a somewhat weak commitment to this goal (Wolczuk, 2004). The elites' rent-seeking behavior and resistance to sustained reforms also weaken the state's ability to pursue reforms. As Wolczuk (2004, 11) says: "That pro-European declarations have not been accompanied by domestic policy changes can be attributed to the high costs of compliance with the EU's 'normative targets' for the Ukrainian 'parties of power.'"

Overall, the advantages of Europeanization are economic stability through economic reform and integration with one of the world's strongest economies, the potential for political protection by the EU and member states against Russia or others, and prestige. Pro-Western Ukrainians see EU membership as a confirmation of their European self-identification and an acknowledgment of Ukraine's transition to a market economy. A European affiliation could also be a powerful signal to investors or a sign of power to other international actors; EU membership would be the best indicator of strength, and unrestricted capital mobility through membership in the EU common market would make it easy for European investors to invest in Ukraine.

Principal-agent theory analyzes the ways in which agents' aversion to risk affects their behavior. For Ukraine, adopting political and economic reforms is risky—political leaders risk alienating elites with a vested interest in the current system, internal opposition to difficult economic reforms that have no clear or immediate payoff, and the possibility that reforms will not produce the desired effect and could create a political or economic crisis. In integrating with the West, Ukraine also risks alienating its sizable population of ethnic Russians.

Finally, implementing reforms is highly costly for Ukraine because of its lack of legislative and administrative capacity, as well as interests of elites that prevent against reform (Wolczuk, 2004).

3.2 The ENP as an Institution, through the Principal-Agent Framework

Because of the capriciousness of Ukraine's commitment to EU integration, Wolczuk (2006) argues that pressure, monitoring, and assistance must come from the EU in order for Ukraine to keep up its momentum on reform. Exacerbating this problem, Kubicek (2007) argues that the ENP lacks a clear enforcement mechanism. Principal-agent theory says that agents must be paid more for good outcomes but be penalized with reduced pay for bad outcomes (Ray, 1998). Yet the ENP offers only a carrot and no stick to punish; it is unlikely that if reforms fail, the EU will cut aid or economic ties with the neighborhood states entirely or punish them with sanctions.

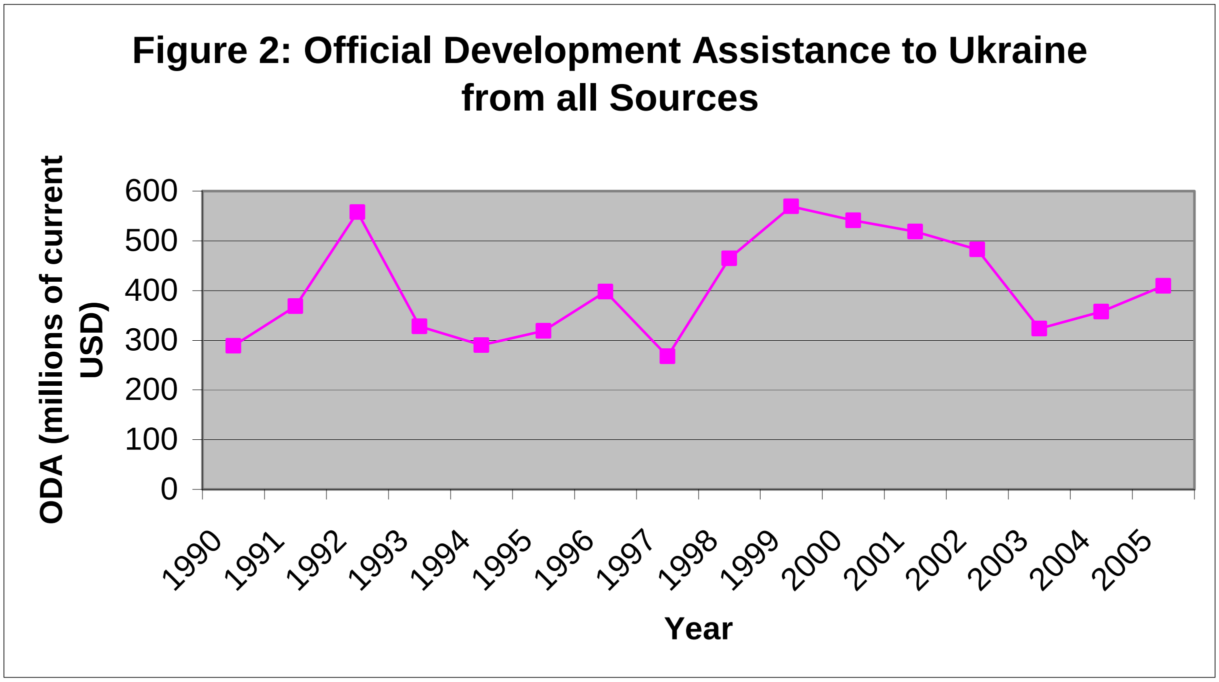
To ensure that Ukraine is undertaking reforms, the ENP incorporates conditionality, as the incentives of aid and deepening ties to the EU are conditioned on social and economic outcomes (Paul, 2006). Conditionality in the ENP refers to the incentives scheme, which can be revoked, modified, or re-asserted according to how well the EU perceives its neighbors to be implementing the Action Plans and adopting the *acquis communautaire*. According to the EU Commission, "This is a dynamic process—when monitoring demonstrates significant progress in attaining the agreed objectives, the EU incentives on offer can be reviewed, or the Action Plans adapted, or further proposals made as regards future relations," (Commission, 2007b, ¶ 5). Repeated assertions by EU officials that the EU will only consider Ukrainian accession once

Ukraine has achieved democratic stability highlight this notion of conditionality. The conditionality of the ENP Action Plans exists for two reasons. Political reforms are necessary both to make the EU's aid and economic engagement package effective (in that aid will be more useful to a politically stable country) and to meet the EU's foreign policy objective of promoting liberalism and stability abroad.

If conditionality does not exist in practice, the incentive for fulfillment of the Action Plan is decreased. Hughes, et. al. (2004) describe how conditionality worked during the EU's Eastern enlargement of 2004, in which the EU imposed similar requirements on the Central and Eastern European countries to those imposed on Ukraine through the ENP. They describe conditionality as an inconsistent, fluid process. Various perspectives on EU conditionality exist; some argue that EU conditionality is costly to acceding countries because the specific requirements that acceding countries must fulfill change according to the political whims of the EU, while others argue that conditionality is essential as an EU admission requirement. In some areas, the *acquis communautaire* is "thick" with detail, while in others the *acquis* is "thin," allowing the Commission less leverage and weakening conditionality (Hughes, et. al., 2004). Because the Action Plan does not give detailed requirements as to what Ukraine must achieve and because a membership perspective is not clear, conditionality imposes costs for Ukraine. The same was true of the accession requirements for the Central and Eastern European countries, which were ambivalent (Hughes, et. al., 2004). Due to these weaknesses, Hughes, et. al. found little evidence of direct causal link between EU conditionality and compliance by the Central and Eastern European countries. Furthermore, Zanger (2000) found no strong evidence of good governance having an effect on European aid allocation from 1980 to 1995. The EU has built increasingly close relationships with Ukraine over time, beginning with the Agreement on Trade in Textile

Products in 1993 and looking toward a new Enhanced Agreement in 2008, despite Ukraine's slow progress toward democracy. That the EU would stop cooperating with Ukraine in response to Ukraine's failure to fully implement the ENP seems unlikely, and at least some cooperation between the EU and Ukraine seems bound to exist. Thus, elements of conditionality within the ENP seem weak, making it unlikely to be effective.

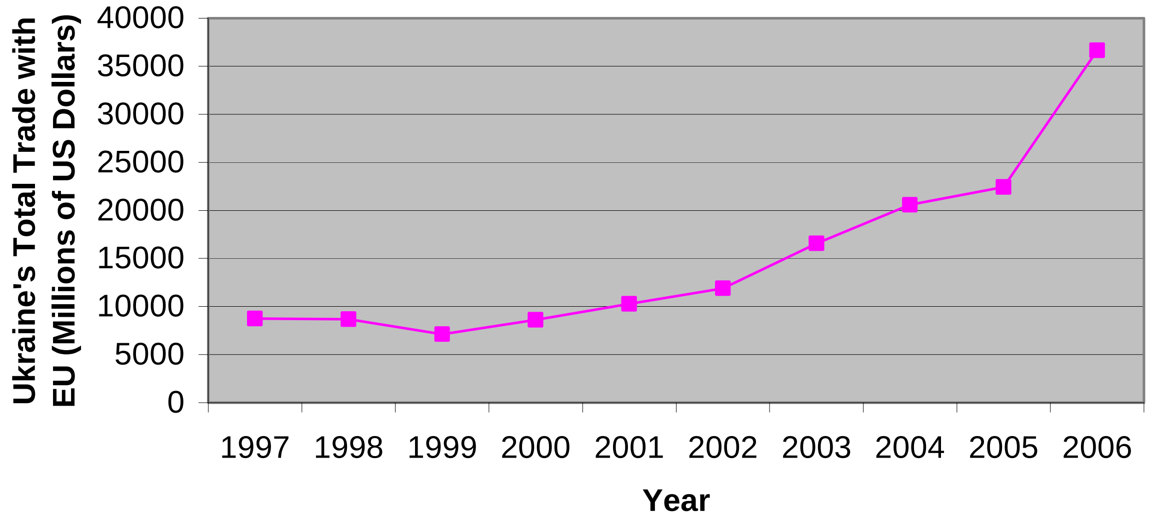
An analysis of official development assistance to Ukraine from the EU provides evidence of how conditionality works in the ENP. Figure 2 shows official development assistance to the Ukraine from all sources. This figure shows that aid from all sources has been erratic and has not increased dramatically since the ENP was instituted. One would expect that the implementation of the ENP would increase flows of aid to Ukraine; however, as ENP builds upon existing EU assistance agreements (such as TACIS) rather than introducing new forms of aid, aid is not given as a conditional reward. According to Raik (2006), the EU offers limited financial assistance to the neighbors, and little of this goes toward democracy and civil society. In fact, the US gave more aid to Ukraine than the EU did from 1998-2004. This lack of financial assistance limits the EU's ability to promote democracy and weakens conditionality.



(Source: Development Data Group, the World Bank)

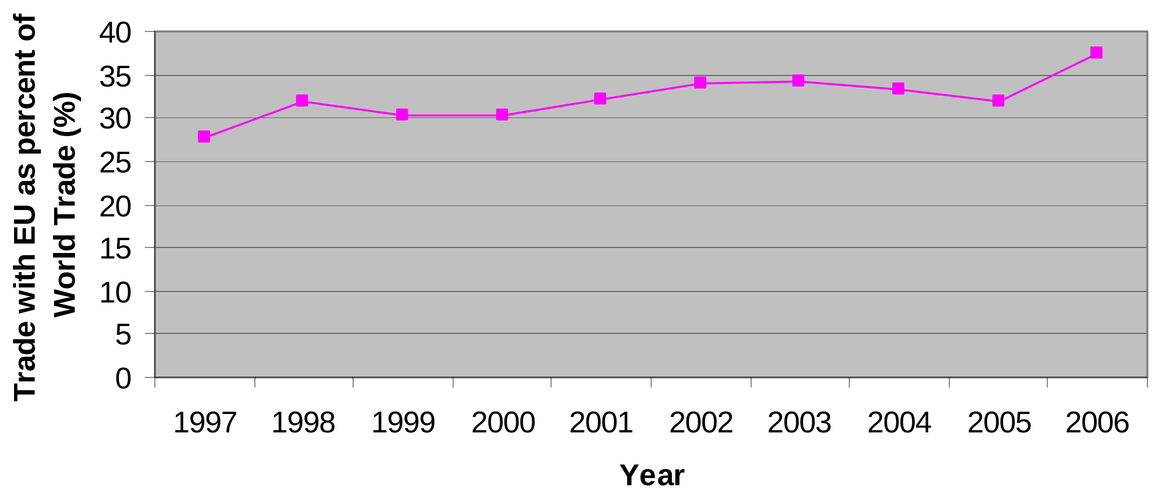
Total trade with the EU (Figure 3) has increased, but this is somewhat a reflection of Ukraine's increased external trade in general. Figure 4 shows that trade with the EU as a percent of world trade has increased slowly and steadily over the last ten years, without an increase since the adoption of the ENP. While the ENP does not bring market access at once, liberal reforms would promote trade between the two. It may be too early to see the impact of the ENP on trade. Adoption of reforms over time may result in improvements in trade relations, if conditionality actually holds.

Figure 3: Ukraine's Total Trade with EU



(Source: EuroStat)

Figure 4: The EU's Share of Ukraine's Total World Trade



(Source: EuroStat)

Additionally, the lack of a clear EU membership perspective for Ukraine weakens the element of conditionality. These Action Plans will only be effective in instituting the desired economic, political, and social reforms if the neighbor countries are willing to adopt the EU's reform program without prospect of full integration into the EU—that is, if the incentives are sufficiently strong. As they are not EU members, the neighbor states are asked under the ENP to adopt policies that they have no voice in establishing (Kelley, 2006). Haukkala (2007) argues that despite the EU's asymmetric power over states in its neighborhood, "the key component of the Union's active leverage, political conditionality, has been weak and inefficient," (p. 12). Because the EU is "trying to apply its normative hegemony in Europe along the lines of the accession process without the legitimizing effect of enlargement…it is unlikely that the economic side of ENP can be robust enough to act as a sufficient incentive for the neighbours," (Haukkala, 2007, p. 14). Palánkai (2004) argues that conditionality was effective in the enlargement process because EU membership was a strong reward, but "for other non-acceding countries it is quite problematic," (348).

Monitoring mechanisms—a joint assessment and a unilateral EU report—mirror those used in the enlargement process. The EU's report may have particular significance, as international financial institutions will likely use the reports to assess the neighbor countries' financial climate, and the report may affect funding from those financial institutions. The reports can also be used to praise or shame countries, and ENP countries will thus have an incentive to compete for praise (Kelley, 2006).

3.3 Alternatives to ENP: Ukraine's Reservation Utility

Adoption of the Action Plan and pursuing membership in the EU are certainly not Ukraine's only options for managing its economy. Its options are varied: it could close itself off from trade entirely (autarky), integrate with Russia and other Central Asian neighbors, or pursue membership in the WTO, among other things. In addition to a discussion of potential integration with Eastern European neighbors, we will assess four possible levels of Western integration that Ukraine could pursue: low-level integration with the European Union, WTO membership, entrance to the EU common market, and EU membership. Because WTO membership is the next best alternative to EU common market access, pursuing WTO membership represents Ukraine's reservation utility for completing the requirements of the Action Plan. Each of these levels would be achieved in sequence, but Ukraine might not advance to higher levels if it does not put forth sufficient effort.

3.3a Integration with Russia, Belarus, and Kazakhstan

Since the collapse of the USSR, Ukraine has maintained close ties with Russia, owing to the countries' strong historical, cultural, and economic ties. According to Wolczuk (2004), competition between Europeanization and Russification has not led to a clear analysis of which path to pursue. Though the "European choice" has been proclaimed, eastern integration continues to remain an option, pulling away from Ukraine's commitment to Europeanization and contributing to the volatility of Ukraine's reform process. Seeking to preserve its sphere of influence, Russia has sought to continue its economic and political ties with Ukraine. Ukrainian leadership is receptive to cooperation with Russia as it benefits its economy (particularly due to its dependence on Russian energy) but has not sought political integration. While Ukraine's political leadership has resisted re-integration with Russia, elite interests often draw Ukraine closer to Russia (Wolczuk, 2004).

Prior to the Orange Revolution, in September 2003, Ukraine signed an agreement with Russia, Belarus, and Kazakhstan to form a Single Economic Space. They agreed to create a common economic area and introduce a single currency within five to seven years (Chaplygin, 2006). The SES runs contrary to the goal of European integration, and a country cannot be in two customs unions (the SES and EU) at once, so today's Ukrainian government is therefore not prioritizing the Single Economic Space, though Prime Minister Yanukovych is supportive of the

SES and says it will help resolve Ukraine's gas crisis (United Nations Economic Commission for Europe). Ukrainian Deputy Prime Minister for European Integration Oleh Rybachuk said that he was "not aware of a single argument that would support the fact that accession to the SES is advantageous to Ukraine. If SES documents run counter to European integration, we will not implement them, since they do not correspond to our chief course," (Day Weekly Digest, 2005). Trade flows reflect these priorities. In the past decade, Ukraine's trade flows have moved away from Russia toward other partners, including the EU. Ukraine wants integration with Russia to occur gradually, while Russia seeks rapid integration; this difference in goals "hampers the realization of the project," (Shportyuk and Movchan, 2007). Yet, Ukraine still desires to remove trade barriers with Russia, according to Rybachuk. Integration with former members of the Commonwealth of Independent States is an alternative that Yushchenko's government seems to be foregoing in favor of Westernization. It can be seen as the reservation utility of integration with Europe.

Chaplygin, et. al. (2006) analyze the economic implications of a common currency for these four countries and find that the economic burden would largely be borne by Belarus, Kazakhstan, and Ukraine, so creating the currency union would require significant political will on their part. According to Chaplygin, this would have been particularly costly for Ukraine: "It would appear that Ukraine could not adopt the rouble without considerable cost to its economic performance," (63). Shportyuk and Movchan (2007) calculate that deep integration within the SES would reduce Ukraine's GDP by 0.6% and decrease welfare by 0.7%. The SES is clearly not an economically viable path for Ukraine. "The overview of the macroeconomic consequences of Ukraine's trade regime changes confirms the accuracy of the declared strategy for deeper integration with the EU as the most beneficial option for the economic development and welfare," (Shportyuk and Movchan, 2007, 16).

Furthermore, economic relations between Ukraine and Russia are volatile. According to Shportyuk and Movchan (2007), some call their relationship a trade war, characterized by frequent use of commercial defense measures and other non-tariff barriers. These problems make deep integration with Russia less attractive to Ukraine. However, the business interests of elites in power may lead to closer economic integration with Russia (Wolczuk, 2006). Closer integration with Russia would likely occur only on economic lines and not politically, and economic integration with Russia would come second to European integration.

3.3b Western Integration

Instead of pursuing integration in Central Asia, Ukraine under Yushchenko's leadership is pursuing Westernization. What form this Westernization takes will depend on political will in Ukraine as well as how Western institutions reward Ukraine's efforts. In our analysis, we assume that there are four levels of effort Ukraine could exert, as well as four corresponding rewards from Western institutions: a low level of effort (which we will call E_i) will be rewarded by low-level cooperation with the European Union (W_i); a high level of effort (E_j) will result in WTO membership (W_j); a higher level of effort as demonstrated by fulfillment of the Action Plan (E_k) will result in common market membership (W_k), and the highest level of effort (E_l) could result in European Union membership (W_l). In our analysis, $E_i < E_j$ and $W_i < W_j$ for $i<j$. We analyze each of these levels of effort and reward, including the costs and benefits for Ukraine as well as the risks to the EU in offering these rewards or "wages." These levels are summarized in the payoff matrix (Table 1).

3.3c Low-level Cooperation with the European Union

The EU and Ukraine have worked together cooperatively for over a decade. The Partnership and Cooperation Agreement, signed in 1994, will expire in 2008. Currently, the EU and Ukraine are negotiating an Enhanced Agreement to take its place. The strength of the agreement will depend on the parties' political will; low effort by Ukraine will be met by a low level of commitment and prospects of minimal cooperation with the EU. In order to maintain a working relationship with the EU, Ukraine need not undertake drastic reforms. Even if Ukraine does not pursue reforms, its presence as a global trade actor and its shared border with the EU necessitate that the two actors will interact at some minimal level. Unless Ukraine should cut itself off from global trade or align itself with Russia in some Cold War II scenario, Ukraine and the EU will likely cooperate, at least at a low level. Ukraine's cooperative efforts will be thus rewarded by cooperative efforts from the EU. Thus, a benefit of this type of relationship is that it is low-cost for Ukraine. Ukraine could continue to receive aid from the EU and its member states and continue to collaborate with the EU on political and economic goals at its will. For example, in 1993, Ukraine and the European Communities signed an Agreement on Trade in Textile Products. Ukraine might also benefit from European technical assistance, and Ukraine would likely receive humanitarian and development aid; Ukraine certainly received aid from the EU and member states before the Orange Revolution when its Western orientation was established, suggesting that pro-European reforms are not required for aid. This cooperation *could* occur even if Ukraine joins a free trade area with Central Asian states.

From the perspective of the EU, this relationship is not desirable because it keeps Ukraine at a distance and allows the possibility that Ukraine pursue closer ties with Russia. The EU's goal is to see Ukraine democratize, but cooperative agreements are loose and do not provide a strong framework or incentives for political and economic reform. Such a relationship could potentially entail losses for the EU; while Ukraine could expend minimal effort and gain some benefits, the EU would make an investment through financial aid, technical assistance, and diplomatic consultations which would have almost no payoff in creating a stronger, more stable Ukraine.

3.3d World Trade Organization Membership

World Trade Organization membership would benefit Ukraine's economy greatly and is a goal that Ukrainian leadership declares the country to be working toward. As a member of the WTO, Ukraine would have Most Favored Nation status, abolishing quantitative restrictions with its trading partners, including the EU. According to Ukrainian state secretary of the Ministry of Economy and European Integration Andriy Honcharuk (2004), this would have several key effects on Ukraine's economy. Through a reduction in tariffs, Ukraine would have more liberalized access to world markets, trading with the WTO's 151 members, and consumers would benefit from price reductions. According to Honcharuk, currently up to $2 billion in markets are closed to Ukrainian products, and these markets would be opened with WTO accession. Increased exports would also increase Ukraine's stock of foreign currency. The WTO also has agreements on import and export procedures, and compliance with these rules would facilitate transit of goods. WTO membership would eliminate non-tariff barriers, such as technical requirements and certification standards. In trade disputes, WTO membership would improve Ukraine's ability to defend its interests and protect producers through the dispute settlement mechanism (Kinakh, 2007). According to Honcharuk (2004), up to $750 million worth of Ukrainian exports are at risk of investigation or antidumping restrictive measures; an improved ability to negotiate through the WTO could thus have a sizable economic impact. In particular, ferrous metals are subject to antidumping and special inquiries, but removal of these barriers would lead to an increase in exports. Honcharuk estimates that Ukraine's 2001 ferrous metal exports of $463.8 million could have been $553.8 million if ferrous metals were not subject to quotas, and $643.8 million if Ukraine was a member of the WTO. Ferrous metals and light industry will benefit from elimination of EU quotas as well (Eremenko, et. al, 2004). Finally, as a member of the WTO, Ukraine could have a voice in WTO negotiations, asserting its own economic interests. Ukraine would also be able to participate in negotiations on EU agricultural subsidies (World Bank, 2005).

Pavel, et. al. (2004) analyze the impact of WTO accession on Ukraine's economy. They find that WTO membership would increase Ukraine's consumer welfare by 3.0% and GDP by 1.9%. Aggregate exports would increase by 128.5 billion UAH (Ukranian grivna) and aggregate imports would increase by 125.2 billion UAH. Total exports would increase by 13.5% and total imports by 13.1%. According to Burakovsky (2004), Ukraine's metallurgical, textile, and clothing industries will export more to the EU. An additional important benefit is that the reforms mandated by the WTO would create a stable legislative environment, encouraging investment as well as securing Ukraine's market economy by dismantling the existing bureaucracy. Benefits would accrue through tariff reduction, greater market access, and adjustments to domestic taxation.

Just as adopting the EU *acquis* would help liberalize Ukraine's economy and improve its competitiveness, adopting the WTO accession standards could help develop Ukraine's economy, resulting in a decrease in transactions costs. Adoption of WTO standards would create greater stability and predictability in the country, as well as guaranteeing channels of exports between Ukraine and all other WTO member states (EU Commission, 2007a).

An additional benefit of WTO accession to Ukraine is that it is seen as a step toward EU membership. Rather than fulfilling the Action Plan, which has no guarantee of an EU membership perspective in the future nor even a concrete promise of market access, WTO membership is more tangible. If neither WTO membership nor implementation of the Action Plan will lead to an EU accession agreement, it may make more sense for Ukraine to pursue WTO membership instead of the ENP. Thus, pursuit of WTO membership is an objective that risk-averse Ukraine might pursue instead of fulfillment of the Action Plan or EU membership. WTO membership would not likely alienate Russia (which has also pursued WTO membership) nor Ukraine's Russian population.

For Ukraine, costs of pursuing membership in the WTO are high, particularly because Ukraine's economy was inherited from the USSR and is incompatible with the economies of Western states that designed the WTO (Schuler, 2004). Ukraine must adopt difficult economic reforms in order to be considered for membership. Compliance with WTO rules will require the introduction of legislation and rules, such as changing regulatory policy in trade, and this is a slow and difficult process (Burakovsky, 2004). Ukraine will need to liberalize access to its market by foreign companies and to develop institutional capacities to make sure Ukraine abides by the WTO's principles of transparency, rule of law, effective enforcement of contractual discipline, and an independent judiciary system. For instance, Ukraine must create institutions to maintain its transparency, reporting all trade policies to the WTO so that information on Ukraine's policies can be disseminated to all member states. These changes will impose diplomatic costs on Ukraine, which must raise the professional qualifications of its negotiators, maintain a staff to deal with the adjustment to these new institutions, engage in bilateral and multilateral negotiations, and negotiate with interested parties domestically (Burakovsky, 2004;

Deutsch, 2004). Still, the cost is less than pursuit of EU membership or fulfillment of the ENP, as political reforms are not required and WTO regulations are less extensive than the *acquis*. Pursuit of WTO membership is risky in that economic reforms might fail or meet resistance from those elites whose power would be threatened by free trade. Lower import tariffs will increase competition from imports of textiles, metallurgy products, and electric machines (Honcharuk, 2004). In the long run, the economy will benefit from this increased competition, but there will be short run costs as producers will need to increase their competitiveness and adapt to new regulations. Assisting workers with the transition to the new economy, such as by providing training courses, will also impose costs on Ukraine (Burakovsky, 2004).

Schuler (2004) describes many of the capacity-building projects that Ukraine would need to complete in order to become a member of the WTO. In the realm of international property rights, Ukraine would need to rewrite its laws in order to ensure compliance as well as build well-functioning capital markets and create contract enforcement capabilities in order to attract investors. Ukraine also needs to alter its industrial product standards, and over 2,500 regulations need to be harmonized with WTO rules; it must create a certification system for high-technology goods and harmonize its laws with international standards. These changes would require administrative reorganization, capacity building, and public education. Schuler estimates that Ukraine would need to spend at least $40 million over four to five years to complete these reforms, and it would cost over $100 million for building metrology facilities which provide measurement information. Finally, food, plant, and animal safety regulations would cost an estimated $40 million to harmonize and to establish transparency procedures.

The EU would not be required to assist Ukraine in its pursuit of WTO membership, though it likely will support Ukraine in this goal through financial aid and other support. The

EU would benefit from Ukrainian accession to the WTO because it would be able to trade with Ukraine on a most-favored nation basis. Additionally, WTO membership would bring economic stability to Ukraine, potentially preventing economic crises that the EU would need to intervene in. Ukrainian economic development through WTO membership would also reduce the need for EU aid and assistance. Economic gains for the EU would likely be close to its gains from EU accession. However, the EU would make fewer political gains. WTO membership would not ally Ukraine with the EU nor preclude Ukrainian political allegiance with Russia. The risk for the EU is that Ukraine might still ally with Russia.

3.3e Common Market Membership

The ENP offers the prospect of EU common market membership. Because it would require a sustained commitment to political and economic reforms through the framework specified in the Action Plan, it is highly costly for Ukraine in terms of effort. It is also risky for Ukraine to pursue because whether Ukraine could actually become a member of the common market is not entirely clear, given that this may encounter resistance from the EU, and what will constitute full implementation of the Action Plan is not well-defined. The ENP's design also gives asymmetric power to the EU because the EU writes the *acquis* that Ukraine must adopt. According to Raik (2006), the asymmetric interdependence that is entailed in the ENP restricts Ukraine's self-determination and could foster resentment toward the EU. While states that adopt the *acquis* as part of the accession progress will someday become part of the EU's decision-making process and thus will not always face a power asymmetry, as a state without a membership perspective, Ukraine does not have a prospect of lessening this power asymmetry. Pursuing the ENP could therefore have political costs or could be seen as an impediment to Ukrainian sovereignty.

Through its incentives scheme, the ENP provides a lengthy list of incentives for neighbor states (the "agents," following the principal-agent theory model) to pursue the Action Plans. This "incentive constraint" offered in the Action Plans includes: economic integration and a stake in the EU's Internal Market; increased political cooperation; reduction of barriers to trade; increased financial support; participation in programs promoting cultural, educational, environmental, technical and scientific linkages; support in meeting EU standards, and deepening economic relations. A European Neighborhood Instrument coordinates technical assistance and promotes trade infrastructures, financing reforms (Milcher & Slay, 2005). The EU also provides billions of dollars in aid to the neighborhood countries, through various pre-existing programs (such as TACIS) that provide some of the framework for the ENP (Commission, 2007c).

Trusting that the Action Plan will bring the benefits of the EU common market as promised is risky as well. For one thing, it is uncertain exactly how much integration the neighbors can expect to gain in pursuit of the ENP. Haukkala argues that vested interests within the EU would oppose opening the EU internal market to those states' most crucial exports, such as steel and agricultural products from Ukraine. Akgül Açikmeşe (2005) also argues that some of the ENP's promises are unrealistic, such as free movement of people, which EU member states will oppose. Indeed, people and services still cannot flow freely between the EU and its newest member states. That Ukraine shares a border with Russia makes its integration with the EU particularly contentious (Miller, 2002). Some might oppose free movement of people between the EU and Ukraine because Russians could easily enter the EU through Ukraine, potentially leading to a surge in illegal Russian immigration in the EU. The spectre of competition from migrant Ukrainians for European jobs might also foster opposition. Akgül

Açikmeşe (2005) also questioned whether the EU will continue to allocate sufficient funds to the ENP to make its fulfillment realistic. Schneider (2007) found that opposition by EU member states to distributive outcomes of enlargement have led to the EU restricting membership benefits for EU member states; therefore, the risk that Ukraine will not receive all the promised benefits of membership is certainly plausible. Despite the EU's continued stance that Ukraine must demonstrate a commitment to democratization and action before it will consider Ukrainian membership, the EU has not explicitly stated what exactly will be considered "sufficient action" (Kuzio, 2006). As fulfillment of the ENP is not explicitly stated as a point on the path to EU membership, from Ukraine's pro-membership perspective, there is no reason to fulfill the Action Plan's requirements. As Wolczuk (2006) says, "the lack of a clear-cut project makes *Evrointegratsia* a project too abstract to 'focus the minds' of many politicians in Ukraine," (p. 8).

These risks make adoption of the Action Plan a gamble—the precise payoff is unclear. Because Ukraine is a risk-averse actor, the uncertainty inherent in the Action Plan adds an additional cost to implementation of the Action Plan, reducing Ukraine's incentives to reform. This risk aversion may explain some of the volatility in Ukraine's attitude toward Europeanization; perhaps Ukraine is not willing to devote itself fully to EU membership because of the risk entailed in doing so. Still, Ukraine sees the ENP as a step toward attaining a new agreement with a clear EU membership perspective.

For the EU, offering common market membership is less risky than offering an EU membership perspective. The EU can avoid the costs that enlargement entails while gaining a close relationship with the Ukraine that will solidify Ukraine's Western orientation. Because Ukraine would not become a member of EU institutions, there are no risks to the EU's institutions. The EU holds asymmetric power; it already has the *acquis* written, and the *acquis* benefit its own interests. The EU merely needs to ensure that Ukraine adopt political and economic reforms and so endures some costs through financial aid, technical support, and diplomatic work.

Offering Ukrainian access to the EU common market, however, is a high risk for the EU. Ukraine shares a long border with Russia, and if it becomes a member of the EU common market, it will have free movement of people. Thus, Russians could illegally access the EU through Ukraine; just as Europeans feared that enlargement to Central and Eastern European countries would result in a surge of cheap labor from the new member states, Ukrainian common market membership could arouse a fear of cheap Ukranian labor or illegal Russian labor. The EU also risks competition from some Ukrainian sectors, such as steel, that might damage its own industries. Potentially, the EU could impose protectionist restrictions to avert these risks, making political resistance from EU members an additional risk that Ukraine faces.

One way to assess the potential impact of Ukrainian access to the EU common market is to analyze other states that have access to the EU common market but are not EU members. Through the European Economic Area, Iceland, Lichtenstein, and Norway have access to the common market, including free movement of goods, services, persons, and capital. However, a shortcoming of the EEA is that agriculture and fishing products have restricted movement (Pointner, 2005). Sweden, Finland, and Austria were members of the EEA before joining the EU, suggesting that common market membership could be a precursor to EU membership. Membership in the common market and the EEA increased Finland's growth by 0.7 %, Austria's growth by 0.4 %, and Sweden's growth by 0.3 % (Breuss, 2005 as cited in Pointner, 2005). The EEA member states benefit from access to the EU common market, and as wealthy nations, they avoid having to contribute to EU funds as they would as EU members (Hindley and Howe, 2001). Ukraine, a poorer nation, would likely be a net recipient of EU funds as a member; common market membership would be less advantageous for Ukraine in this respect. Membership in the common market does not allow EEA states to contribute to the EU's decision-making process so they cannot promote their economic interests through EU decisions, though they are affected by EU decisions and must adopt some of the EU's rules. Still, EEA members are consulted on future EU single-market directives, though they do not have a formal vote. Therefore, while they are granted some voice, their exclusion from EU institutions gives them less power over their economy. According to Hindley and Howe (2001), the list of single-market harmonization measures that EEA states had to implement is hundreds of pages long, while the actual measures are thousands of pages. This suggests that becoming a member of the common market is a laborious, costly process. Finally, EEA member states are precluded from deeper integration, such as joining the monetary union and political integration.

Another possibility would be for Ukraine to sign a Free Trade Agreement with the EU and thereby gain most of the advantages of common market membership, though benefits would be limited to the specific sectors covered by the agreement. Switzerland, for instance, has had a FTA with the EU since 1972. Still, Van Nieuwkoop and Müller (2001) found that Switzerland would benefit from becoming a member of the EU; a FTA does not confer all the economic benefits that EU membership does on member states. Additional benefits accrue through the small increase in access to the EU market and monetary union membership. EU membership would have negative economic impacts on Switzerland due to an increase in taxes and transfers to the EU (Van Nieuwkoop and Müller, 2001). Ukraine might benefit from EU membership in these areas where Switzerland would lose. EU Free Trade Agreements frequently exclude agriculture and some heavy industry, sectors which would be important for Ukraine to liberalize.

Thus, a Free Trade Agreement with the EU would be of limited value to Ukraine, though would lead to increased trade and would stimulate investment and Ukraine's economic modernization (Burakovsky, et. al., 2006). Thus, it seems that an FTA would be less advantageous to Ukraine than EU membership. Shportyuk and Movchan (2007) calculated the benefits of Ukraine establishing an FTA with the EU after acceding to the WTO. They found that the FTA would increase real GDP by 3.1% and welfare by 8.1%.

Benefits of the common market include a common external tariff, elimination of border costs and delays, and reduced costs of complying with national standards, as these standards are subsumed by common market standards (Cohen, 2007). Joining the EU common market would have positive trade effects, as final product costs would be reduced by five to ten percent (Cohen, 2007). Due to increased competition within the common market, Ukrainian businesses would adapt and become more efficient, and increased specialization through the international division of labor would result in more growth (Pointner, 2005). Adopting the Action Plan reforms would also create a more favorable investment climate, attracting investment and reducing capital flight, while reducing negative consequences that could result from simply eliminating trade barriers between the EU and Ukraine (EU Commission, 2007a). Common market membership, defined by a new treaty between the EU and Ukraine, would reduce the risk of investing in Ukraine, encouraging investment, and the Action Plan's reforms will improve Ukraine's business climate (Burakovsky, et. al., 2006). Pointner (2005) found that EEA members experienced lower inflation due to the elimination of customs costs and increased competitiveness that prevented monopolistic and oligopolistic behavior. Inflation decreased especially in industrial goods, where competition is greater compared to the services sector. These benefits would likely accrue to Ukraine as a member of the common market as well.

Because all EU common market members abide by the same regulatory standards, manufacturing would be less burdened by regulations, and consumers would benefit from product standardization (Cohen, 2007). Adopting the *acquis* is important for this purpose. In a study of how institutions impact bilateral trade, De Groot, et. al. (2004, as cited in Lejour and Mooij, 2005) showed that a regulatory framework such as that of the EU could increase bilateral trade between 12 and 18 percent, while better quality institutions and a reduction in corruption could increase trade by 17 to 27 percent. Adoption of the *acquis* could therefore have a tremendous impact on EU-Ukraine trade. Cohen's (2007) analysis of literature on common market membership shows that other Eastern European countries experienced welfare gains between 3.4 and 18.8 percent of GDP.

Free movement of persons would likely result in emigration from Ukraine to the EU, imposing costs for both actors. De Mooij and Tang (2003) estimated that for Central and Eastern European Countries (not including Ukraine), EU accession would result in a net migration of 3 percent of the population. In the long run, this migration could be expected to contribute to increased international specialization, though it would impose short run costs.

3.3f European Union Membership

Although the EU has thus far been unwilling to offer Ukraine a membership perspective, in our analysis we presume that Ukraine could become a member of the European Union with a very high amount of effort.

The benefits of EU membership are difficult to quantify, though researchers attempt to estimate the benefits of growth by assessing proxies for integration, such as trade, foreign direct investment, and research and development expenditure. According to Katan and Yigit (2007), accession to the EU raises living standards by increasing political, economic, and institutional cooperation and knowledge sharing. In their study of the benefits of EU accession, Katan and Yigit (2007) found that integration into the EU resulted in capital accumulation and technology transfer, increasing the country's growth. Some of these benefits would certainly accrue to Ukraine as a member of the common market, though institutional membership would bring greater cooperation, potentially resulting in further improved growth. In a study of the Central and Eastern European member states, De Mooij and Tang (2003) estimated that EU accession would result in long term GDP increases from 1.5 to 7.8 percent. Although Ukraine was not included in these estimates, it shares similarities with these countries in its level of welfare and in the economic and bureaucratic structures inherited from the USSR. Though estimates of the effect of EU membership on Ukraine's GDP were not available, De Mooij and Tang's results suggest that the impact would be significant.

Membership in the EU confers many benefits beyond what is offered in common market membership alone. Benefits include agricultural subsidies through the Common Agricultural Policy and other transfers from the EU budget (Grether and Müller, 2001), as Ukraine would be a net recipient of the EU budget. During the accession process and until its economy became significantly strong, Ukraine would receive Structural Adjustment Funds from the EU; as a low-income member state, Ukraine would be a net recipient of internal Cohesion Funds. Cohesion Funds are provided to member states whose GDP is below 90% of the EU average; for 2004-2006, € 15.9 billion was allocated, with € 8.49 billion going to new member states (EU Commission, 2006). Kutan and Yigit (2007) found that Structural Adjustment and Cohesion Funds are extremely important in furthering economic growth and raising productivity for countries acceding to the EU. These funds allow for long run growth and convergence, offsetting initial distortions in prices of productive factors that occurs during accession and that would occur through common market membership alone. EU membership would also increase Ukraine's access to credit, investment, and technology, which would help increase Ukraine's economic growth (Wolczuk, 2004). Ukraine would also benefit by becoming a member of EU institutions; it would be able to help set policies rather than simply having to implement those that would be required of it as a member of the common market. These benefits that accrue through EU membership would enable Ukraine to take full advantage of common market membership, whereas market access alone brings fewer benefits because Ukraine has a weak economy currently (Wolczuk, 2004).

Economic gains to the EU from offering EU membership would be realized through common market membership. EU member states that are net contributors would lose from subsidies and other transfers made to Ukraine.

More difficult to quantify is the benefit in terms of reputation that would accrue to the Ukraine as a member of the EU. Palánkai (2004) found that association agreements (cooperative agreements with the EU) improved countries' reputation in international organizations and among investors. Thus while Ukraine surely gains a benefit in reputation by association with the EU through the ENP, this benefit would surely magnify if Ukraine were an EU member.

It is unclear how much effort Ukraine would have to put in, beyond the effort required to fulfill the Action Plan, in order to become an EU member. If the EU was more eager to enlarge, fulfillment of the Action Plan might result in EU membership, given the similarities between the Action Plans and earlier accession agreements. Therefore at this point, Ukraine's required effort in order to achieve EU membership is unclear, though it is greater to or equal than E_3. The risk to Ukraine in putting forth this effort is that a membership perspective might never materialize. Ukrainian membership in the EU could also damage its relations with Russia.

Ukrainian membership in the EU would entail the risks of common market membership as well as additional risks to the EU. The chief risk is that enlargement would strain the EU by draining the political will of member states, fostering anti-Europeanization among EU citizens, further slowing and complicating the EU institutions, and jeopardizing deeper integration within the EU. At a time when many Europeans are pessimistic about the EU, and given the EU's stalemate over the constitution issue, deepening seems more important to the EU than widening. Some EU member states face more financial risk than others due to enlargement, as those states which are net contributors to the EU budget may be burdened by Ukraine, and other states may receive a smaller portion of the EU budget if it must be shared with Ukraine. For instance, in analyzing the costs of the EU's 2004 Eastern enlargement, Hughes, et. al. (2004) argue that Spain and Portugal would lose in terms of diverted Structural Adjustment and Cohesion Funds, while they would benefit little from increased trade due to their geographic distance from the new member states. European enlargement has also been interpreted by Russia as a threat, and enlarging to Ukraine would undoubtedly be deemed threatening by Putin's regime. In enlarging, the EU therefore risks aggravating Russia. However, the EU can shift risks to Ukraine by practicing "discriminatory membership," offering only restricted membership benefits; for instance, during the 2004 Eastern enlargement, the EU agreed to only offer full agricultural subsidies to the acceding member states after ten years (Schneider, 2007). Finally, EU membership is far more permanent than common market membership, so offering an irreversible membership perspective is risky for the EU.

For the EU, Ukrainian membership would allow the EU to play a stronger role in Ukraine. Ukraine is important for the EU's energy security; thus, political influence in Ukraine would strengthen the EU's security. Since almost 90% of EU natural gas imports from Russia pass through Ukraine, Ukrainian membership in the EU would give the EU direct access to the pipelines, reducing risk. Ukrainian membership in the EU would give the EU more strategic control over the Black Sea area and would pre-empt Russian political control of Ukraine. EU membership would also give the EU access to Ukrainian land, for agricultural or solar energy projects that might benefit all member states (European Policy Centre, 2007).

Table 1: Payoff matrix for various types of Westernization

Low-level Cooperation ▪ Examples: sector-specific trade agreements, technical assistance projects, consultative or "collaborative" partnership agreements	
Costs for Ukraine ▪ Low cost: weak (if any) commitment to political and economic reform, and pro-European reforms are not required for aid	Costs for EU ▪ Likely exceed benefits ▪ Expenditure on financial aid, technical assistance, diplomatic consultations
Benefits for Ukraine ▪ Humanitarian and development aid from EU and member states ▪ Collaboration on specific projects as desired: development, democracy, cultural exchanges, etc. ▪ Technical assistance to pursue these projects	Benefits for EU ▪ Collaboration on goals as desired could produce sector-specific trade benefits
Risks for Ukraine ▪ Might come short of having strong impact on economy, so effort could be wasted ▪ Might not lead to EU membership perspective	Risks for EU ▪ Agreements on paper might not lead to tangible reforms because dependent on Ukrainian political will ▪ Ukraine might develop closer ties with Russia ▪ Ukraine will not become stronger or more stable
WTO Membership	
Costs for Ukraine ▪ Adoption of difficult economic reforms (but not political reforms): opening trade, removing protectionism ▪ Introduction of legislation and rules ▪ Development of institutional capabilities	Costs for EU ▪ Financial assistance for Ukraine in pursuit of this goal through aid and assistance

▪ Raise skills of negotiators ▪ Maintain staff to deal with adjustment to new institutions ▪ Bilateral and multilateral negotiations ▪ Negotiation with interested parties domestically ▪ Short run costs for producers who adapt to new regulations and competition ▪ Helping workers adjust to transition ▪ Over $40 million required to change industrial product standards (Schuler) ▪ Over $100 million for building metrology facilities (Schuler) ▪ $40 million to harmonize food, plant, animal safety regulations (Schuler)	
Benefits for Ukraine ▪ Most Favored Nation status ▪ Abolition of quantitative restrictions with trade partners ▪ Price reductions for consumers ▪ Opening of $2 billion worth of markets for Ukrainian products (Honcharuk) ▪ Facilitation of transit of goods ▪ Improved ability to defend interests and protect producers through dispute settlement mechanism ▪ Consumer welfare increase of 3.0% (Pavel) ▪ GDP increase of 1.9% (Pavel) ▪ Increased exports by 128.5 billion UAH (especially ferrous metals, light industry, textiles, clothing) and imports by 125.2 billion UAH (Pavel) ▪ Increase in stock of foreign currency ▪ Tariff reduction, elimination of non-tariff barriers, more liberalized access to world markets ▪ Improvements in competitiveness ▪ Investment encouraged by more stable legislative environment ▪ Lower transaction costs due to reforms ▪ Possible step toward EU membership ▪ Participation in WTO negotiations, including on EU agricultural subsidies	Benefits for EU ▪ Able to trade with Ukraine on most-favored nation basis ▪ Ukrainian economic stability ▪ Reduced reliance on EU aid
Risks for Ukraine ▪ Reforms might fail or meet resistance	Risks for EU ▪ Ukraine could still ally with Russia

▪ Domestic political risk: resistance from protected industries and elites (especially in textiles, metallurgy products, and electric machines)	
EU Common Market Membership ▪ Fulfillment of the ENP Action Plan	
Costs for Ukraine ▪ Highly costly: sustained commitment to political and economic reforms as enumerated in Action Plan ▪ Adoption of EU rules without a voice in establishing them due to asymmetric power relationship ▪ Implementing 80,000 pages of *acquis* ▪ Emigration from Ukraine to EU ▪ Distortions in prices of productive factors	Costs for EU ▪ Costs of ensuring Ukrainian reform: financial aid, technical support, diplomacy ▪ Immigration from Ukraine to EU
Benefits for Ukraine ▪ Economic growth ▪ Increased trade ▪ Free movement of goods, services, persons, and capital through EU ▪ Increased political cooperation ▪ Reduction of non-tariff barriers ▪ Increased financial support ▪ Participation in cultural, educational, environmental, technical, scientific programs ▪ Deeper economic relations with EU ▪ New product markets, access to cheaper products, immigration, FDI ▪ European Neighborhood Instrument provides financial support ▪ Sector-specific benefits ▪ Stimulus to investment and economic modernization ▪ Common external tariff ▪ Elimination of border costs and delays ▪ Reduced costs of complying with national standards ▪ Final product costs decline by 5-10% (Cohen) ▪ Increased competition would improve business efficiency ▪ Increased specialization	Benefits for EU ▪ Free movement of goods, services, persons, and capital through EU ▪ Access to Ukrainian markets ▪ Investment opportunities in Ukraine ▪ Reduction of non-tariff barriers ▪ Solidify Ukraine's Western orientation ▪ Opportunity to influence Ukraine's political and economic system through *acquis*

▪ Improved business climate ▪ Lower inflation ▪ Reduced corruption	
Risks for Ukraine ▪ Political resistance from EU member states ▪ All benefits might not materialize (especially immigration, products such as agriculture and steel) ▪ Not entirely clear how EU will decide when Action Plan is "completed" ▪ Political resistance within Ukraine due to lack of self-determination ▪ Could foster resentment toward EU	Risks for EU ▪ Influx of Russian and Ukrainian immigrants ▪ Competition from Ukrainian industry, agriculture, and labor
EU Membership	
Costs for Ukraine ▪ Costs of Ukrainian common market membership ▪ Additional costs could occur, depending on what criteria EU sets for membership	Costs for EU ▪ Costs of Ukrainian common market membership ▪ Transfers to Ukraine (especially costly for wealthier member states): structural adjustment funds, cohesion funds, agricultural subsidies (CAP)
Benefits for Ukraine ▪ Increased political, economic, and institutional cooperation and knowledge sharing with EU members ▪ Capital accumulation and technology transfer ▪ Long term growth ▪ Net beneficiary of EU budget: Structural Adjustment Funds, Cohesion Funds, agricultural subsidies (CAP) ▪ Funding will promote more long-term growth than possible through market access alone, offsetting distortions in prices of productive factors ▪ Economic growth, convergence with EU member states ▪ Improved access to credits, investments, technologies ▪ Some ability to influence EU policies so as to be more favorable to Ukrainian economic interests ▪ Improved reputation in international	Benefits for EU ▪ Benefits of Ukrainian membership in common market ▪ Solidify Ukraine's Western orientation ▪ Opportunity for political influence ▪ Strategic control over Black Sea area ▪ Pre-empt Russian political control of Ukraine ▪ Access to Ukrainian land

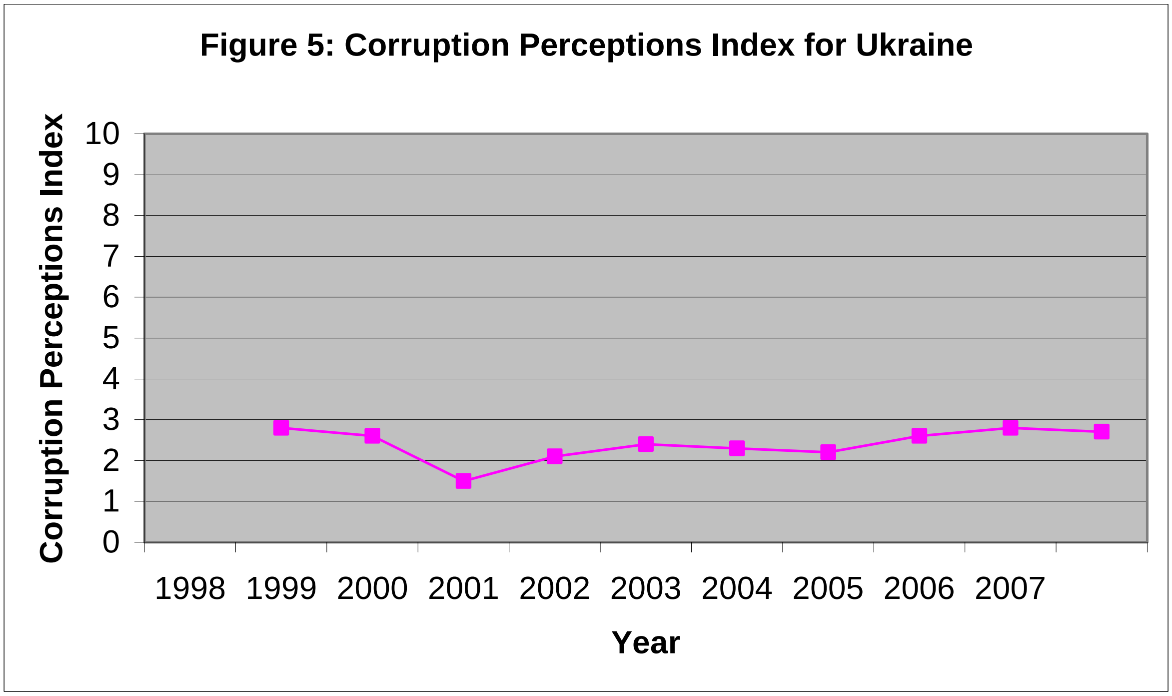
organizations and among investors	
Risks for Ukraine ▪ Membership perspective may never materialize ▪ Might aggravate Russia	Risks for EU ▪ Straining EU and member states (Eurosclerosis) ▪ Might aggravate Russia ▪ Ukraine borders Russia: influx of illegal immigrants possible ▪ Competition from Ukrainian sectors ▪ Membership is irreversible

3.4 Assessment of ENP's Results in the Ukraine

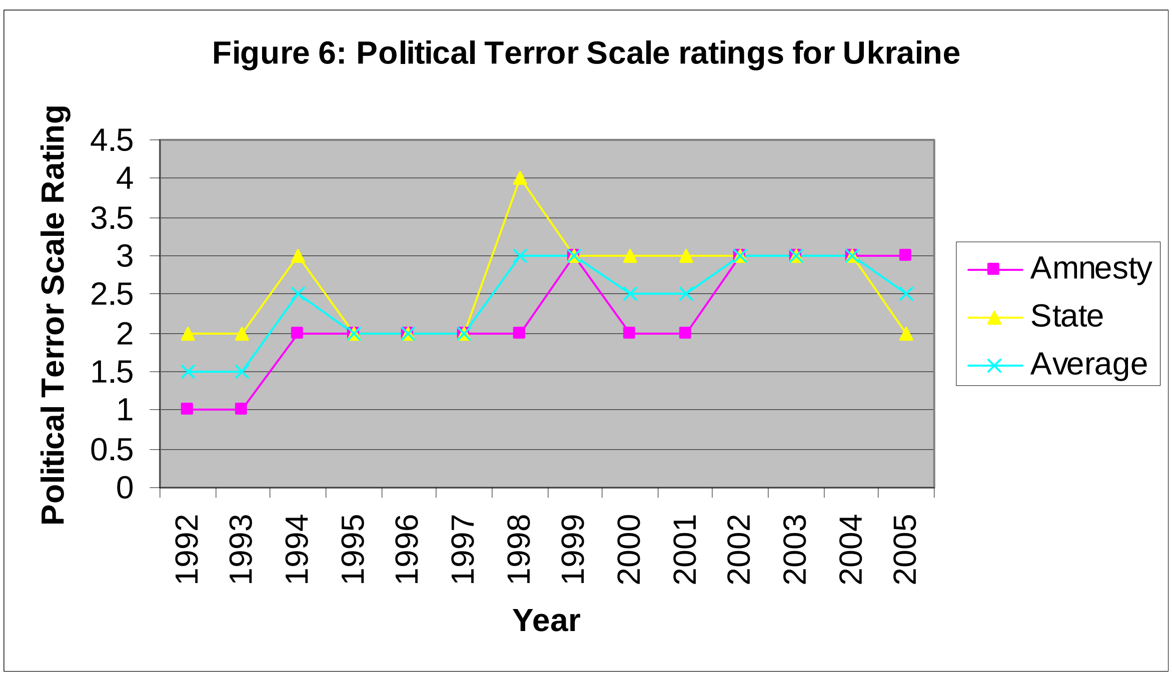
Given the weaknesses of the ENP and the availability of alternatives for Ukraine, how effective has the ENP been in effecting political and economic change in Ukraine? Despite Ukraine's strongly professed desire for EU membership, it is lagging behind in implementing necessary reforms. Since the Orange Revolution and the adoption of the ENP, Ukraine's economic growth has slowed dramatically, and public confidence in democratic reform has declined. Yanukovych's election in 2004 prompted the addition of a ten-point "Road Map" to its Action Plan, but this changed little and was not seen as an opening of the EU's doors to the possibility of Ukrainian membership in the EU (Kuzio, 2006). Indeed, in November 2006, the EU issued a report denying Ukrainian accession, saying Ukraine had not made significant economic and judicial reforms (Kubicek, 2007). Furthermore, the EU has focused on human rights and freedom of the media as areas needing reform (Molchanov, 2004). In advance of the September 30, 2007 elections, EU and Ukrainian leaders agreed in a joint statement that "free and fair early parliamentary elections…and the formation of an effective and stable government" would be steps toward deeper integration with the EU (Runner, 2007, ¶ 1).

Figures 5, 6, and 7 show measurements of Ukraine's political climate. The Corruption Perceptions Index (Figure 5) rates countries from zero to ten, with a score of ten indicating no corruption. Ukraine's corruption index has not changed significantly between 1998 and 2007, suggesting that political reforms to reduce corruption are not taking place. The Political Terror Scale (Figure 6) uses reports from Amnesty International ("Amnesty") and the U.S. Department of State ("State") to assess "political terror," with a score of five indicating high terror and a score of one indicating low terror. This shows a slight *increase* in political terror in Ukraine since 1992, but overall, the level of political terror has stayed mostly between two and three. Again, this suggests that political reforms that promote democratization and human rights are not taking place in Ukraine. The Freedom in the World indicators (Figure 7) show scores for both political rights and civil liberties. Freedom House rates countries in these two areas, with a score of 1 representing the highest degree of freedom and a score of 7 indicating the lowest degree of freedom. These ratings have improved over time, with improvements in civil liberties since 2004 and in political rights since 2005. In all years prior to 2005, Ukraine was rated as "Partly Free" but was rated "Free" in 2005 and 2006. Contrary to the Political Terror Scale and Corruption Perceptions Index, on these measures, Ukraine's political climate is improving somewhat.

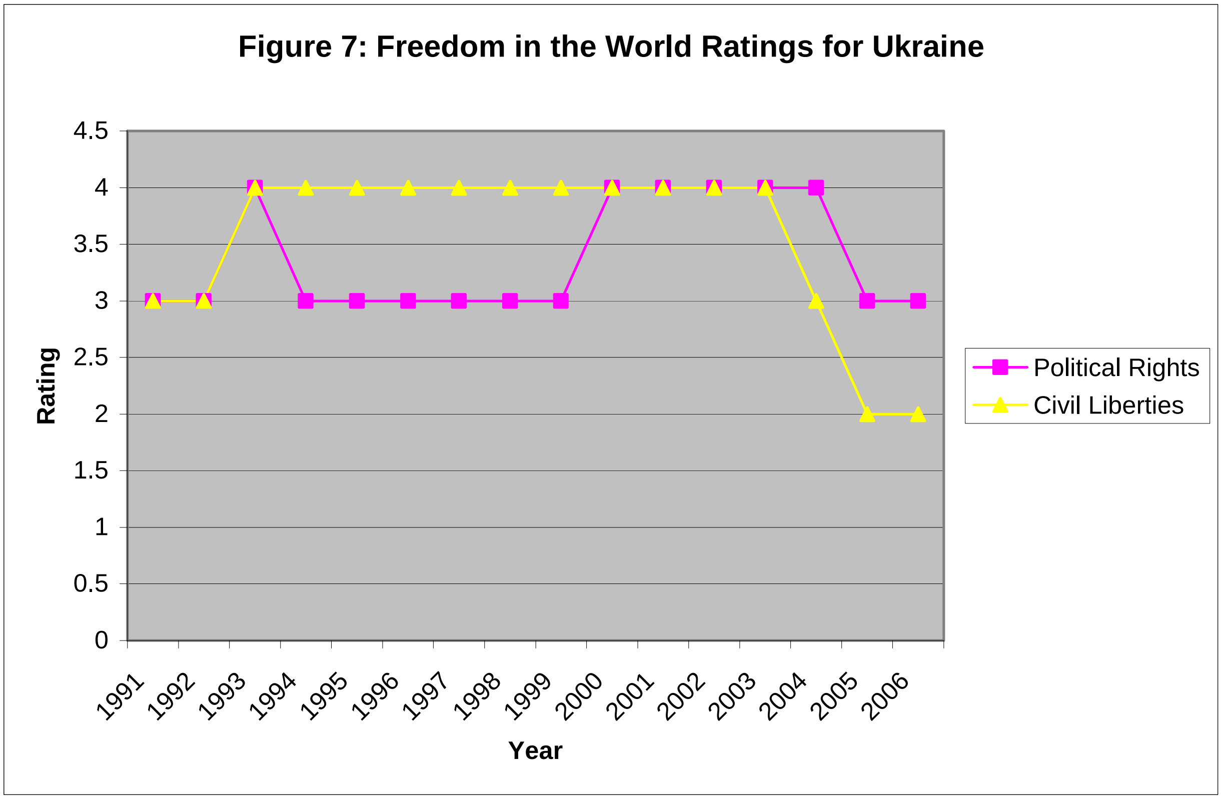
These contradictions could reflect the rating agencies' differing methodologies or could indicate that Ukraine's political reforms are occurring in particular ways; the entire political regime as a whole is changing very slowly, though specific areas such as political freedoms are improving. Still, according to Freedom House, Ukraine is not close to achieving judicial standards set by the EU (Freedom House). One must interpret these results with caution, as the ENP was only adopted in 2004; perhaps with more time, political reform will take place. Whether future reforms will be stimulated by the ENP cannot be determined easily; however, it is clear from these initial findings that adoption of the ENP has not had any dramatic, immediate effect on Ukraine's political climate, and that Ukraine's political climate has been relatively stagnant since the early 1990s, despite cooperative agreements with the EU.



(Source: Transparency International)

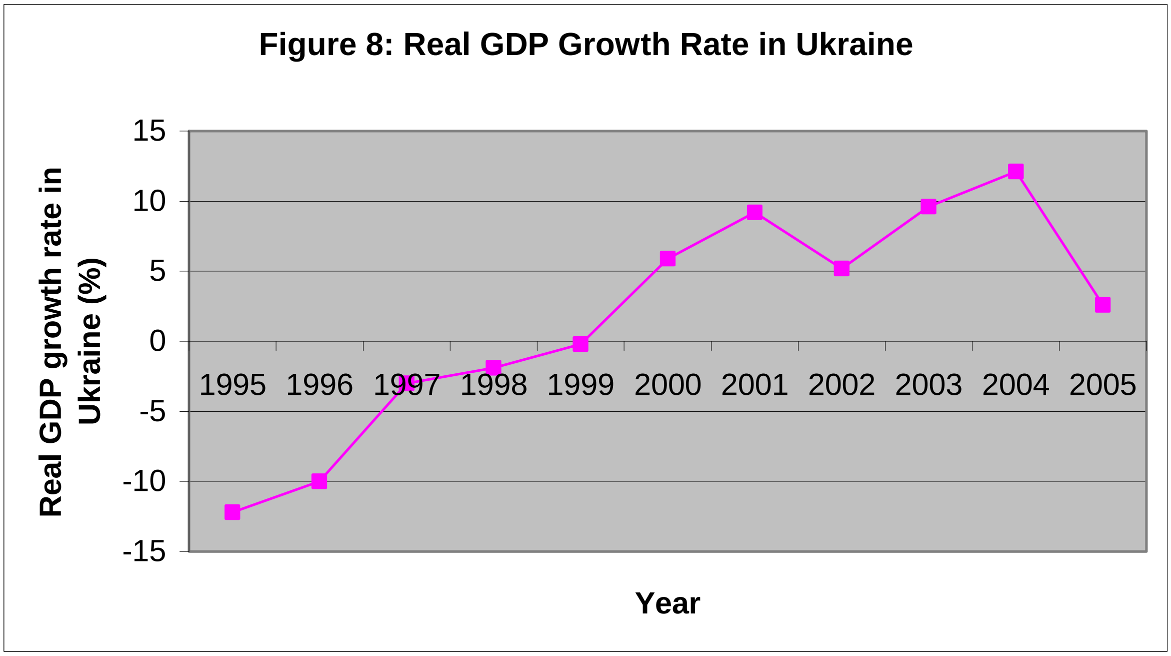


(Source: Political Terror Scale)

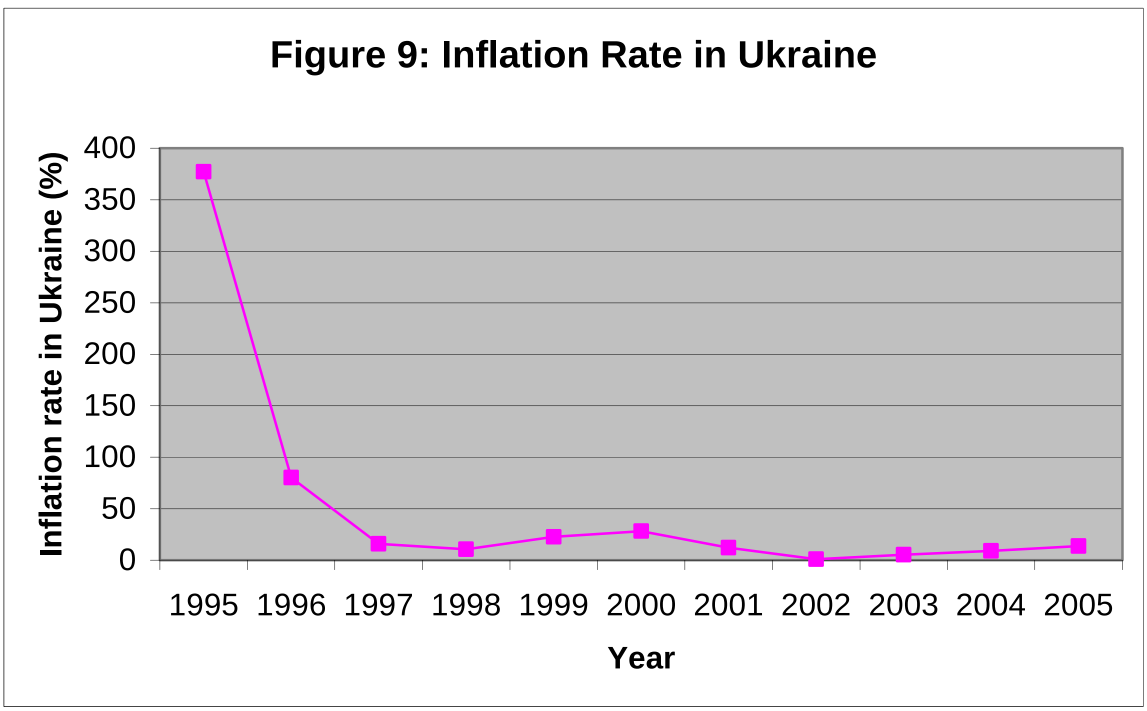


(Source: Freedom House)

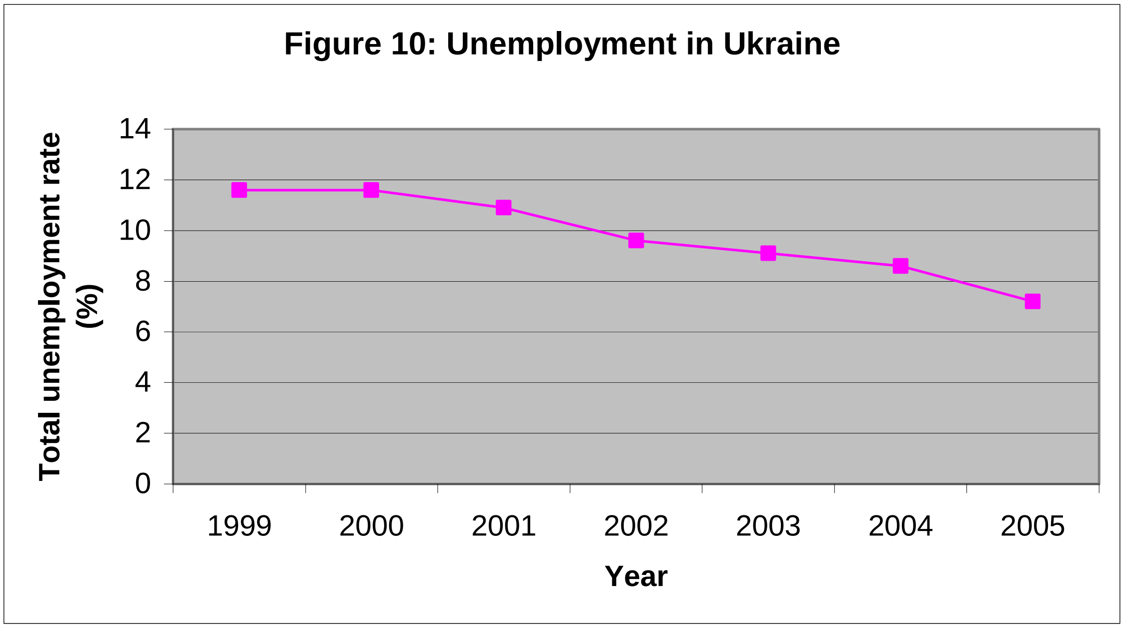
Measures of Ukraine's economic performance seem to show that it is improving overall, with real GDP growth (Figure 8) on an upward trend, the inflation rate (Figure 9) stabilizing, and unemployment (Figure 10) declining. These data are only available through 2005, so again, one cannot disambiguate the effect of the ENP from other causes of economic improvement. However, these figures demonstrate that Ukraine's economy was experiencing economic improvement prior to the adoption of the ENP Action Plan in 2004. It is somewhat surprising that Ukraine's economy has improved while its political climate has not improved; EU rhetoric suggests that both must improve as the Action Plan is implemented and that reforms in both areas are required before the EU will consider a Ukrainian accession.



(Source: EuroStat)



(Source: EuroStat)



(Source: EuroStat)

Wolczuk (2004) argues that Ukraine seeks integration with the EU but has been unwilling to actually undergo Europeanization by implementing reforms. Despite Ukraine's economic growth, Wolczuk points to incomplete economic reforms and questions Ukraine's commitment to liberalization. She cites barriers to market entry and exit, as well as weak property rights, laws, and contractual obligations, as evidence of the weak commitment to economic liberalization in Ukraine.

4. Conclusion

Clearly, Ukraine strongly desires to become a member of the EU, whereas the EU desires for Ukraine to become a member of the EU common market only. For the EU, the benefits of Ukraine joining the common market and joining the EU are almost identical, whereas extending membership to the EU entails additional costs. For this reason, the EU has offered common market membership through the ENP but ignored Ukraine's requests for a membership perspective.

The greatest possible gains for the Ukraine would likely come about through WTO membership. Beyond WTO membership, the incremental benefit of joining the EU common market or the EU itself are far smaller. Péridy (2005) used a theoretical trade model to estimate the export potential of the neighbor states to the EU. Péridy's study of trade prospects for the ENP demonstrated that the neighborhood states have great export potential; however, this export potential changes little whether or not implementation of the *acquis* is assumed. Adoption of the *acquis* does not add much to Ukraine's export potential over the export potential gained simply through access to the EU's restricted market. Without implementing the Action Plans, neighbor states can achieve their export potential through trade liberalization, such as WTO membership or implementing an FTA with the EU. For the neighbor countries, the difficulty of implementing the *acquis* (including both the budgetary costs of overhauling political and economic laws as well as the costs of political resistance) may be too great when there is little additional value to implementing the *acquis* compared to achieving market access on other terms. Although the EU's reasons for requiring adoption of the *acquis* are clear, doing so imposes a cost on neighbor states that is so great that it may make the ENP not worthwhile for states that could achieve market access through other means.

Qualitative and quantitative analysis suggest that the European Neighborhood Policy is not an effective foreign policy tool for dealing with Ukraine. Political reforms are occurring very slowly—if at all—in Ukraine, despite the impetus for change from the ENP Action Plan. Ukraine is an increasingly global economic actor and is experiencing an improvement in economic performance, but this does not appear to be attributable to its adoption of the Action Plan. Scholars doubt whether prospects of a free trade area or membership in the common market will provide sufficient incentive to introduce necessary reforms or to gain commitment of both leaders and elites to liberalization (Wolczuk, 2004). Haukkala (2007) summarizes the weaknesses of the ENP:

> "By demanding reforms right now and offering only vague and amorphous incentives somewhere down the line, the ENP puts the veritable cart before its neighbours' horses with no tangible carrot in sight. The material benefits are not strong enough to entice the elites in the new Eastern neighbours to change the current system that is skewed in their favour. But even if the ENP was made financially robust enough to act as an economic carrot, it does not answer their calls for belonging in full. A case in point is Ukraine, which has to no avail repeatedly voiced her hopes of becoming a full EU member as soon as possible," (17).

Whereas EU membership might be sufficiently beneficial enough to motivate Ukraine to undertake the reforms specified in the Action Plan, the actual benefits of fulfilling the Action Plan are below what Ukraine desires.

Various changes to the ENP could make it a more effective institution for motivating reform in Ukraine. Currently, the Action Plans are extremely vague; setting more concrete guidelines for policy change and incorporating these guidelines with Ukraine's own reform priorities could make change more realistic (Raik, 2006). The institution's conditionality could also be improved by making the link between democratization and assistance clear. Raik (2006) suggests that additional "carrots" such as visa facilitation could be offered as incentive for democratic reform. A clear membership perspective would also legitimize the EU's role in Ukrainian policymaking and provide elites with a strong tool for implementing necessary reforms (Wolczuk, 2006; Wolczuk, 2004). The EU's role clearly must be to provide pressure as well as incentives to Ukraine to adapt, as well as a robust monitoring mechanism.

The ENP may prove effective in other neighborhood states; because Ukraine has expressed such a strong interest in EU membership, a policy without a membership perspective may lack sufficient incentives for the Ukraine to reform, though other countries might find sufficient motivation to adopt the Action Plan.

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