

Blue Ribbon Analytical and Advisory Centre

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FREE-TRADE AREAS VERSUS CUSTOMS UNION?

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Summary

- I. Ukraine's accession to the Customs Union with Russia, Belarus and Kazakhstan with no serious complication is possible subject to the following conditions being met:
 1. accession of Russia, Belarus and Kazakhstan to the WTO;
 2. adoption by Russia, Belarus and Kazakhstan of trade barriers to third countries at a level not higher than applied by Ukraine when joining the WTO;
 3. joining of Russia, Belarus and Kazakhstan, already as WTO members, to Ukraine's negotiations on a free-trade area (FTA) with the EU. If Ukraine has already had a FTA with the EU at that moment, the FTA will be established on terms agreed between the five countries.

- II. If Ukraine acceded to the Customs Union with Russia, Belarus and Kazakhstan without the above-stated conditions, it would mean the following to Ukraine:
 1. revision of Ukraine's existing agreement with the WTO and commencement of negotiations with the WTO on new terms;
 2. breakdown of negotiations with the EU on a free-trade area and their postponement until Russia, Belarus and Kazakhstan join WTO.

1. If understood traditionally, **a free-trade area** means a group of countries that have eliminated among them tariffs for all or most commodities and nontariff measures affecting trade among themselves. **Free trade areas** do not have a common external tariff. Participating countries in an area may continue to apply their own tariffs on external goods from third countries.

According to *Article XXIV GATT*, customs unions and free-trade areas must eliminate the duties and other restrictive regulations of commerce "on substantially all the trade" between the parties to meet a free-trade criterion. Traditionally, free-trade agreements set a free-trade regime no less than for 90% trade with preferential partner countries. Ukraine already has bilateral free-trade agreements with the Russian Federation, Belarus and Kazakhstan that have founded a Customs Union recently. Ukraine has no free-trade agreement with the European Union so far. Negotiations began in February 2008. During the negotiations for preparation of a free-trade area agreement between Ukraine and the EU, both parties provide for liberalization of no less than 95% trade.

A future free-trade area between Ukraine and the EU does not require revision of Ukraine's existing free-trade agreements with other countries. Ukraine may have free-trade areas with the Russian Federation and the European Union at the same time. Besides, it may establish new free-trade areas in the future, e.g. with Israel or Canada. The EU has free-trade agreements with 24 countries and customs unions with three countries (Andorra, Turkey, and San Marino). There are also a common market and a common customs policy within the European Union, the policy providing for a common customs tariff in relation to third countries.

2. **A customs union** is a higher level of integration because, in addition to free trade among the union member countries, it establishes a common external tariff for third countries. Customs union members agree to eliminate all the tariffs and sometimes broader trade impediments between them. At the same time, they replace their individual tariffs with common (uniform) import tariff applied by the customs union members against non-members. Under WTO rules, establishing new one or joining existing custom union may not be used to increase the level of market protection overall.

3. Consistency of free-trade arrangements with the WTO rules. According to *Article XXIV GATT*, WTO members may have a preferential trade regime, particularly for parties to free-trade area or customs union agreements in the meaning of *Article XXIV GATT* and *the Understanding on the Interpretation of Article XXIV GATT, 1994*. Since 1947 till now, about 100 regional trade arrangements have been notified to the GATT/WTO under *Article XXIV* which provides the legal exemption from the need to extend *most-favoured-nation treatment (MFN)*.

Ukraine is already a member of the World Trade Organization whereas the Russian Federation, Kazakhstan and Belarus are in the process of WTO accession negotiations. Each country formulates its own commitments and provides its own concessions during the WTO negotiations.

Subject to WTO membership of all these countries, a customs union among them may be established given the following conditions: a common external tariff for third countries must not be higher than a bound tariff of that one of the four member countries that has agreed it upon at the lowest level when joining the WTO. At this point, Ukraine is a WTO member among the four countries in question, which means that two scenarios are possible if Ukraine joins the Customs Union:

- 1) either Russia, Kazakhstan and Belarus as the Customs Union members must adopt as common customs tariff such tariff level that will not exceed the bound Ukrainian tariff level agreed upon when Ukraine joined the WTO, and must conduct further negotiations in the WTO, based on tariffs that won't exceed the Ukrainian ones;
- 2) or, if they don't agree, Ukraine will have to withdraw the tariff concessions previously agreed upon within the WTO framework, that being a very unlikely step for Ukraine.

This way, compliance with *Article XXIV:5 GATT* will be ensured, namely: the duties and other regulations of commerce imposed at the institution of a customs union in respect of trade with not parties to such union shall not on the whole be *higher or more restrictive* than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union. If a contracting party, being a WTO member, that joins a customs union or becomes a party to an interim agreement leading to a formation of a customs union, proposes to increase bound import duty rates, it must act pursuant to provisions of *Article XXVIII GATT* concerning modifications of schedules of member country commitments. If a contracting party withdraws tariff concessions at negotiations, previously agreed upon within the WTO framework, the question arises as to securing compensation to the countries whose trade could have suffered losses due to increase of customs rates. Ukraine will have to ensure compliance with this regulation.

4. Concerning a future free-trade area agreement with the EU

Ukraine's accession to the Customs Union with Russia, Belarus and Kazakhstan would mean to Ukraine an end of negotiations on the establishment of a free-trade area with the EU. In that case the EU can establish a free-trade area only with the Customs Union, but not with an individual member state of the Union. However, it is also impossible because the EU requires WTO membership from any free-trade area participant.

At the same time, establishment of a free-trade area between Ukraine and the EU will not hinder Ukraine's trade relationships with members of the Customs Union consisting of Russia, Belarus and Kazakhstan.

The EU's policy provides for establishment of free-trade areas with many countries of the world, hence it can be foreseen that accession of the three countries (Russia, Belarus and Kazakhstan) to the WTO in the future would open a way to negotiations on establishment of free-trade areas between them and the European Union.

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