



Background Paper on FTA Impact on Trade in Transports services

Prepared in the framework of Trade Sustainability Impact Assessment (TSIA) study
carried out by international consortium of ECORYS and CASE Ukraine

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Summary

The paper presents an overview of transport services in Ukraine (road, rail, water and sea, other), studies present agreements between the EU and Ukraine penetrating into the sector, and assesses possible economic and environmental impacts the FTA can bring. This paper serves as a background for broader analysis that is been undertaken in the framework of [TSIA Study project](#).

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Sector overview and recent developments

The transportation sector accounts for 8.6% of total GDP - or 28.7% of all services - and is responsible for 14.4% of the total budget income. Despite recent strong development – freight traffic grew by 20.2% and passenger transport by 5.4% between 2000 and 2005 - passenger and freight transportation are only 54.7% and 45.6% of their pre-1990 levels respectively. Although increased transport activity in Ukraine is inevitable and necessary for economic growth, even under a scenario of vigorous trade expansion a significant traffic recovery seems unlikely in the short to medium term.

Due to Ukraine's geographic position, which means that it is an important transit country between Russia and the European Union, a major part of transportation services is provided to foreign companies. Thus in 2005, the share of transportation in total exports of Ukraine comprised 11.2%.

Institutional and market structures

Before 1990, Ukraine had a relatively efficient transportation system with widespread use of public transport. Today, there is an increasing push for greater individual mobility that creates a constantly increasing demand for road based transportation. Further impetus to improve the quality of services and modernise the transport infrastructure comes from Ukraine's huge transit transport potential. So far, however, progress towards modernisation has been quite limited and many long-term infrastructure projects failed to start as the government could not develop a coherent development strategy. Attempts to attract private capital for infrastructure projects were not successful because the country lacked an effective regulatory regime and long-term investment risks remain too high.

The transport sector suffers from a state monopoly: the entire national road network, railway system, ports and airports as well as many organisations involved in transport-related maintenance and construction are still state-owned units reporting to the Ministry of Transport. This strong state presence leads to frequent management changes and absence of long-term development programmes which results in poor reputation among transport equipment suppliers, i.e. Ukrainian rail carriages producers prefer Russian buyers to Ukrainian railway company. This fact coupled with limited investment capacity, limits technical innovations in transport and leads to a pace of reform in the sector that is too slow to take full advantage of the opportunities offered.

With the significant presence of the public sector in the provision of transport infrastructure and services, existing user charges, tariffs and fares are often insufficient or inappropriate to cover the cost of maintenance and renewal of the core assets required. Consequently, the asset base of the transport sector is eroding, and rehabilitation, maintenance and renewal backlogs are mounting. The situation is aggravated by the oversupply of outdated transport infrastructure. During the middle and the end of the twentieth century Ukraine's infrastructure was designed to handle much higher volumes of traffic than are currently using the infrastructure. As a result Ukraine faces a very high level of

maintenance compared to its traffic levels and subsequently technical innovation and technological upgrading needs are not being sufficiently addressed.

Current policy and sector issues

Although significant liberalisation will be part of Ukraine's WTO accession, important segments of the transport sector are not covered by the WTO and Ukraine's commitments under GATS. Among the main areas where WTO-related issues arise are:

- **Rail transport:** one of the main issues of conformity with WTO obligations in transport is the existence of differential tariffs applied domestically and those for the transportation of exports/imports on railway transport. The issue was raised many years ago and since then some of the tariffs had been already equalized (e.g. for the transportation of coal and ferrous metal scrap).

- **Port fees:** Ukraine used at differentiated rates (regular or reduced) for port fees according to the flag of the vessel. However in 2003, Ukraine committed itself to equalize port fees for foreign vessels. In December 2006 the limit for reductions was introduced; it constituted 18% to 50% depending on the type of cargo. Then, from 17th July 2007, four types of discounts for loading and unloading of cargo (bulked coal, coke, and ore) were abolished (bulked coal discounts were abolished in two ports)¹.

- **Transit procedures:** Ukraine has committed itself to consider transit of goods through the territory of Ukraine as a subject of simplified and express control procedures and, in the event of relevant agreements, custom controls may be performed jointly by neighbouring states. In April 2007 with an aim to facilitate procedures for transit cargo declaration and decrease the time needed for these procedures, a law was adopted enabling the possibility of railway cargo transit under cover of CIM/SMGS consignment notes. Ukraine currently takes part in the work on the convention on international customs transit procedures regulating carriage of goods by rail under cover of SMGS consignment notes.

The lack of development of transport infrastructure and services is seen as a serious impediment to the smooth operation of Ukraine's economy and an important 'non-tariff barrier' to the effective movement of goods and people and the integration of Ukraine with the EU and other international markets. Improving transport connections and services is seen as a major precondition for effective market integration, as well as a necessary component for Ukraine to exploit opportunities as a hub for transit transport. Accordingly, the transport sector – especially air and road transport – is seen as an area where multiple initiatives are required that go beyond free trade towards convergence on EU standards and enhanced investments in infrastructure.

¹ These types of cargo form more than a half of loading-unloading works in two ports - Nikolaev and Kerch - where discounts ranged from 18 to 35 percent. It has been estimated that under the condition of unchanged amount of cargo shipped through these ports, the abolishing of these discounts will generate additional revenues of USD 800-900 million to each of the ports.

The EU-Ukraine Action Plan defined some priorities in reforming of Ukrainian transport sector, among them are:

- Elaborate and start implementing a national transport strategy, including transport infrastructure development and identify and commit sources of financing for this programme;
- Strengthen co-operation on regional and international issues through continuing consultations on the possible EU use of Ukraine's long haul air transport capacities;
- Take further steps for the integration of environmental considerations into transport sector;
- Implement selected measures and reforms in all transport sectors, among them:
 - Improve efficiency of freight transport services;
 - Obtain full member status in the European Joint Aviation Authorities;
 - Encourage the restructuring of the state-owned port sector.

The Partnership and Cooperation Agreement (PCA) provides for the following actions in relation to the transport sector:

- Abolishment of all obstacles which could have restrictive or discriminatory effects on the free supply of services in international maritime transport;
- Modernisation and development of railways, waterways, road, port, airport and air navigation including modernisation of management and, in particular, the modernisation of major routes of common interest and the trans-European links for the above modes;
- Promotion of joint research and development programmes;
- Preparation of the legislative and institutional framework for policy development and implementation including privatisation of the transport sector.

Specific initiatives and outstanding issues – that may eventually be incorporated in an FTA - in the transport field include:

- **Integration into Pan-European transport networks:** The EU-Ukraine action plan covers Ukraine's participation in the joint development of the Pan-European Corridors and Areas² as well as in the TRACECA programme³.

² Ukraine is a party to 3 pan-European Transport Corridors: Corridor III: Brussels-Aachen-Köln-Dresden-Wrocław-Katowice-Kraków-Lviv-Kyiv; Corridor V: Venice-Trieste/Koper-Ljubljana-Maribor-Budapest-Uzhhorod-Lviv-Kyiv; and Corridor IX: Branch B – Kaliningrad to Kyiv.

³ TRACECA (TRANsport Corridor Europe Caucasus Asia) is one of four Euro-Asian Land Transport Corridors, also called a 'New Silk Road'. It should result in creation of a railway line that will follow the ancient Silk Road from the Chinese port

- **Aviation sector reform:** EU-Ukraine has made progress in cooperation in the aviation sector with agreement on the formation of a single air space aimed at integration into the European Common Aviation Area by 2010. The Agreement between Ukraine and the European Union on Aviation (signed 01.12.05) removes nationality restrictions in the bilateral air services agreements between EU Member States and Ukraine and therefore allows any EU airline to operate flights between any EU Member State where it is established and Ukraine. The agreement acknowledges the existence of the single market for air transport between the EU and Ukraine and demonstrates that there is an external dimension of the single market for air transport.

In December 2006 Ukraine and the EU started negotiating an open sky policy. In May 2007 representatives of the Ukrainian State Air Administration conducted negotiations in Brussels following which Ukraine received an unofficial draft agreement for consideration. Opening up the market would be challenging for local carriers as they are less competitive than their European counterparts. Ukrainian airlines representatives complain about foreign superiority in operational management, modern fleet and access to cheap fuel. However open skies agreement would improve the situation for Ukrainian airlines in terms of time-slots in large European airports which are now complained about by airlines representatives for being inconvenient.

Infrastructure is a major challenge for all types of transport in Ukraine but is particularly a problem for foreign service providers in the sector of air transport. Boryspil airport (Kyiv) serves more than 60 percent of all air passengers in the country and is already overloaded and in need of new terminals. Seven others strategic airports, besides Boryspil, are in need to be upgraded to world standards. The government needs to attract long-term loans to renovate the runways and the terminals to serve European airlines.

- **Development of combined rail and road transport:** this segment is underdeveloped in Ukraine compared to the EU.

- **Elimination of border barriers (customs control reforms):** Ukrainian border controls are seen to be too long and complicated.

- **Restrictions on transportation of excisable goods:** at the present time some restrictions are set on the movement of excisable goods in transit, which need to be transported along specific routes and through designated points of entry at the customs border.

- **Visa procedures for transport service providers:** procedures for granting visas for personnel involved in cross-border transportation are said to be complicated and need to be improved.

- **Competition policy and privatisation:** Even if in principle Ukraine does not impose constraints on market access (or will remove constraints as part of ongoing reforms), the transport sector is characterised by state ownership and natural monopolies in transport infrastructure. Attracting investment into the transport sector will require, therefore, opening the transport infrastructure and services to (foreign) capital; for example, privatisation of port terminals and operations, granting concessions for airport, container terminal, or highway operations etc.

- **Uncompetitive situation of transport service suppliers:** enterprises in the Ukrainian transport sector are seen to be highly uncompetitive. This is attributed partly to the absence and lack of correspondence to international supply standards; for example, vehicles do not meet international environmental standards. While, the stock of soviet-era trucks with large loading capacities do not correspond to modern logistics requirements. This lack of competitiveness raises obvious concerns from domestic service providers over the impact of rapid liberalisation on their market position.

- **Training programmes:** provision of training programmes in economics, legislation and technical matters for transport operators and senior civil servants with an aim of promoting operating standards.

- **Harmonisation of transport statistics:** Ukraine's transport statistics are thought to be subject to considerable distortion by transport operators.

- **Information exchange:** covering information on transportation policies, interconnection and interoperability of multimodal transport networks and other issues of mutual interest.

FTA impacts

As described above, the transport sector is characterised by oversupply of outdated transport infrastructure, inefficient service provision – often through state monopoly service providers – and, as a consequence insufficient investment, for example in maintenance and technological development. Major structural reform within the transport sector is required and the FTA can be seen as providing a catalyst for this necessary development. Opening up Ukraine's transport sector to increased international competition – which may involve private sector participation in provision of services currently in government hands - will necessitate considerable efforts to improve efficiency and productivity. However, the negative consequences this may have for the transport sector itself need to

be weighed against the positive contribution that efficient and cost-effective transport services will provide to enhancing other sectors of the Ukrainian economy.

Although WTO Membership implies cancellation of the limitations on the share of foreign capital in the authorized fund of enterprises which supply transport services, Ukraine undertook no obligations in terms of commercial presence in any of the following sectors: passenger transportation and freight transportation by internal waterways, by rail transport and road transport, as well as air transport computer reservation system (CRS). No obligations were taken in terms of cross-border supply of the services in rail and road passenger and freight transportation as well as air transport CRS. This fact gives reason to expect minor reduction in tariff equivalent barrier in the result of WTO accession.

Economic impacts

Development of transportations services has three kinds of impacts. First, the direct impact of transport is evident in industry employment and the development and manufacturing of vehicles, ships, aircrafts, and engines, the movement of passengers and freight, and the direct employment and materials necessary to support the transport network. This includes transport employees, traffic control systems, airports and on ground services that are essential to the movement of aircraft, e.g., fueling systems. Second, the indirect impact of transport development can be seen in the development of hotel and tourism industries and the producers and suppliers of the goods and services to the transport companies, i.e. airlines, and related industries, i.e. accounting and legal firms, food and beverage suppliers, etc. Third, induced impacts are driven by, among other things, the “spend” of the people that provide support to the industry.

In the result of the FTA tariff equivalent barrier is expected to decrease two fold in comparison with the WTO membership situation or become zero in case of extended FTA. In the result the total market of transport services will increase substantially through the liberalisation of trade in goods. It will open opportunities for further growth in the already strong transport sector. European firms exporting transport services will gain easier access to Ukrainian markets where they currently face significant non-tariff barriers. However due to insufficient competitiveness of the national transport service providers, Ukrainian operators may suffer decrease in production output and employment especially in short run.

Ukrainian companies supplying transport services to consumers on the Ukrainian market will face greater competition from EU firms. This greater competition will come from the removal of non-tariff barriers. However, what will be loss for Ukrainian transport companies will be a gain for Ukrainian consumers, who will enjoy lower prices as a consequence. Moreover transport services tend to have high elasticities of demand, so as a country gets richer, the proportion of services in total output tends to rise

Effects of the FTA will be different depending on transportation sector. No changes are expected in pipeline transportation, as the volume of services provided by pipelines depends on other variables (mostly oil and gas demand) and foreign companies are not expected to be allowed to enter the market.

At the same time air transportation may suffer the greatest losses in terms of production as national carriers cannot compete on equal terms with European airlines. They will also experience significant employment losses inevitable in order to maintain competitiveness. High skilled employment will decrease among administrative staff partially due to possible computer reservation system introduction. Demand for labour will also fall in transit trucks transport and sea transport sectors where the share of low skilled employment is rather high.

Environmental impacts

Increased trade under the future FTA – particularly large volumes of agricultural and mineral trade – would significantly increase both domestic and in particular international transport between Ukraine and the EU. Increased air pollution from transport significantly effects air quality and thus human health. International shipping causes a wide variety of pollution, including carbon dioxide (CO₂), methane (CH₄) and nitrous oxide (N₂O), etc. Air transport which is expected to experience the most positive effect from the FTA causes far more pollution while carrying less passenger traffic; it emits gases and particles directly into the upper troposphere and lower stratosphere where they have an impact on atmospheric composition.

The most significant environmental issue represented by pipelines leakages (both oil and gas) is not expected to be affected as the future FTA is not anticipated to have influence on pipelines development.