
Foreign Economic Policy at a Crossroads

DAVID G. TARR AND NATALYA VOLCHKOVA

Russia is the largest economy outside the World Trade Organization (WTO) and—along with Azerbaijan, Belarus, Kazakhstan, Tajikistan, and Uzbekistan of the Commonwealth of Independent States (CIS)—is among the 29 countries that were attempting to accede to the WTO in April 2010.¹ The Working Party on the accession of the Russian Federation to the WTO, established in June 16, 1993, comprises about 60 countries and is the largest such Working Party in the history of the WTO. By the spring of 2007, Russia had successfully concluded bilateral agreements with all the Working Party members who sought such an agreement except Georgia.² The focus now is on the multilateral phase of the negotiations, where considerable progress has been made so that by mid-2008 only three issues remained to be resolved: (1) level of permitted trade-distorting subsidies in agriculture, (2) export taxes on Russian timber, and (3) rules on state trading enterprises. These issues, however, remain on the table.

During the years of the Vladimir Putin presidency, Russia actively sought membership in the WTO, which was seen as part of an open economy model of economic development. However, in recent years, in its efforts to diversify its economy away from energy and raw material dependence, Russia has employed several industrial policy and import-

David G. Tarr is a consultant and former lead economist with the World Bank and adjunct professor of international economics at the New Economic School, Moscow. Natalya Volchkova has been assistant professor of economics at the New Economic School since 2007.

1. As of June 2009, 153 countries were WTO members. Trade among them represented 97 percent of the world's trade turnover, including over 94 percent of foodstuffs.

2. Georgia had agreed to a bilateral agreement on Russian WTO accession but has withdrawn from that agreement.

substitution industrialization measures. We discuss why we believe that Russia's trade and foreign direct investment (FDI) policies for the future are at a critical crossroads. We begin by summarizing the estimates of what Russia will gain from WTO accession and why. Estimates place these gains at about \$53 billion per year in the medium term and \$177 billion per year in the long term, due largely to Russia's own commitments to reform in the business services sectors. In the next sections, we summarize the principal Russian reform commitments in the WTO and compare them with those of other acceding countries. We find that the demands on Russia are comparable to those on other transition countries. We then discuss prospects for the Russia-Belarus-Kazakhstan customs union and related WTO accession issues. In a separate section we explain why Russian WTO accession will result in the elimination of the Jackson-Vanik Amendment against Russia. In the last sections we discuss Russian policies to attract FDI and argue that uniform tariffs would yield substantial benefits for Russia, but preshipment inspection would yield marginal benefits at best. We conclude that Russian WTO accession is crucial for Russia. Due to pressure from the international community, WTO accession represents a unique historical opportunity for Russia to overcome the usual domestic political economy forces that have led to excessive protection. On the other hand, the economic gains to the international community from Russia's accession will likely be small. For Russia to successfully diversify its economy, it will have to reform its institutions to improve the business climate, especially for small and medium enterprises.

Gains from WTO Accession to Russia

The WTO accession process is an important tool that countries can use for economic development. WTO accession affects a wide range of policies and institutions, including tariff policy, customs administration, standards, rights of foreign investors (especially in services), agricultural policy, intellectual property, and possibly government procurement. It therefore represents a time for evaluating a country's regulations and an opportunity to implement important trade, FDI, and institutional changes. In many cases, Russia implemented changes prior to accession to adapt to post-WTO requirements; in other cases, commitments may be implemented only several years after accession due to a negotiated adjustment period. These cumulative changes will move the economy toward an open trade and investment model of economic development and away from an import-substitution industrialization economic model.

The World Bank has commissioned several studies on the consequences of WTO accession for the Russian Ministry of Economic Development and Trade. Jesper Jensen, Thomas Rutherford, and David Tarr estimated that in the medium term, Russia should annually gain about 3.3 percent of

Russian GDP (or about \$53 billion per year based on 2008 GDP at market exchange rates).³ In the long term, when the positive impact on the investment climate is incorporated, the gains should increase to about 11 percent of the value of Russian GDP per year (or about \$177 billion per year at market exchange rates).⁴

Rutherford and Tarr examined household and poverty impacts and found that virtually all households should gain from WTO accession.⁵ They found that skilled labor and urban households gain relatively more than average due to the increase in FDI in the skill-intensive business services sectors. Rich households gain less than the average household, since increased competition from foreign investment results in capital gaining less than labor. The poorest households are estimated to gain at about the level of the average household.

Given the vast geographic diversity of Russia, Rutherford and Tarr employed a ten-region model of Russia to estimate how impacts would vary across regions.⁶ They estimated that all regions should gain substantially, but those most successful at attracting FDI and creating a good investment climate would gain the most.⁷

In a study for the Russian Ministry of Communications, Jensen, Rutherford, and Tarr examined the impacts on Russia's telecommunications sector and found that skilled workers in the sector would gain substantially from FDI.⁸ Russian firms that become part of joint ventures with foreign investors would likely preserve or increase the value of their investments; but

3. Jesper Jensen, Thomas Rutherford, and David Tarr, "The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organization," *Review of Development Economics* 11, no. 3 (August 2007): 482–506.

4. Russia's GDP at market exchange rates is estimated at \$1.61 trillion by the World Bank, \$1.68 trillion by the IMF, and \$1.76 trillion by the CIA, making it either the eighth or ninth largest economy in the world. Based on purchasing power parity (PPP) exchange rates, Russia's GDP was \$2.3 trillion in 2008, making it the sixth largest economy in the world—larger than the United Kingdom or France. At PPP exchange rates, the estimated gains per year for WTO accession would rise to about \$76 billion per year in the medium term and \$253 billion per year in the long term.

5. Thomas Rutherford and David Tarr, "Poverty Effects of Russia's WTO Accession: Modeling Real Households and Endogenous Productivity Effects," *Journal of International Economics* 75, no. 1 (2008): 131–50.

6. Thomas Rutherford and David Tarr, "Regional Impacts of Russia's Accession to the WTO," *Review of International Economics* 18, no. 1 (2010): 30–46.

7. They estimate that as a percent of consumption in the medium term the three regions in their model that will gain the most are the Northwest (11.2 percent), St. Petersburg (10.6 percent), and the Far East (9.7 percent) while the Urals (6.2 percent) gains the least.

8. Jesper Jensen, Thomas Rutherford, and David Tarr, "Telecommunications Reform within Russia's Accession to the WTO," *Eastern European Economics* 44, no. 1 (January-February 2006): 25–58.

Russian capital owners in the telecom sector who remain wholly independent of multinational firms would likely see the value of their investments decline. Households dependent on capital income from such independent firms would likely lose from WTO accession. Rutherford and Tarr estimated a similar distribution of gains in other business services sectors.⁹

In summary, these studies indicate that Russia will reap substantial gains from WTO accession: The benefits are widespread and would reduce poverty, regions with a better investment climate would reap greater gains, and, crucially, most of the gains would be due to Russia's commitments to implement its own reforms. Reforms in the services sectors are the most important of Russia's own reforms that produce the gains.

However, these studies did not find that WTO accession would contribute positively to the diversification objective of the Russian government. The sectors they estimated would expand the most are nonferrous metals, ferrous metals, and chemicals, while light industry, food processing, and construction materials are likely to contract. These estimates suggest that less than 10 percent of the gains come from improved market access for Russian exporters. Russia has already negotiated most favored nation (MFN) status or better with all its significant trading partners. While Russian exporters will be accorded additional legal benefits in antidumping cases once Russia is a WTO member—and this is the source of the gains estimated in these studies—many economists are skeptical of the fairness of antidumping proceedings. This suggests that significant differences in determinations against Russian exporters in antidumping cases should not be expected, and improved market access therefore cannot be the source of substantial gains to Russia from WTO accession.¹⁰

Given that the benefits to Russia of WTO accession come from its own internal reforms, and since Russia could unilaterally implement these reforms, some infer that Russia will gain little from WTO accession. We take the opposite view, since the process of WTO accession is a unique historical opportunity to achieve reform.

The key reason that WTO accession is important is the political economy dimension. Since the benefits to industries that achieve protection are concentrated, industry groups typically lobby for protection. On the other

9. Rutherford and Tarr, "Poverty Effects of Russia's WTO Accession."

10. In addition, members of the WTO obtain rights in international trade. Members are granted permanent most favored nation status to the markets of other member states. So Russia will not have to be concerned about annual renewals of MFN status. Members can also use the WTO's dispute settlement procedures to protect their trade interests, such as in antidumping cases. Trade disputes among WTO members are resolved based on WTO legal agreements under which smaller countries have the potential to win disputes against large countries. All WTO agreements require unanimous consent of all the members, which helps provide a voice for the smaller member countries. On the other hand, nonmembers are affected by the new rules of this dominant organization in international trade with no voice in their formation.

hand, since the benefits to consumers are diverse and less concentrated, they typically do not lobby against protection but hope others with similar interests will lobby on their behalf. This “free rider problem” in political decision making results in an absence of representation of the views of the consumer and broader economic interests from political discussions of tariffs. Lobbying and political economy considerations often allow special interests to strongly influence policy so that reforms are slow. WTO accession, however, requires across-the-board reform in many sectors, and the pressure of a WTO negotiation engages policymakers at the highest levels of government. Experience has shown that high-level policymakers, who have the economywide interest in mind, often intervene to impose reform on slow-moving ministries. In the case of Russia, the process began to move when Putin made WTO accession a priority in his first term.

It is difficult to argue that Russia would have made reforms as widespread and as deep as it has without the external pressure of WTO accession. Reforms that are accomplished in the context of WTO accession would not normally be achieved so quickly. That is, WTO bindings and external pressure make it easier for a government to adopt a trade policy designed to promote growth and reduce poverty. Moreover, unlike unilateral reforms, once a country commits to a reform at the WTO, it is bound by an international commitment that is difficult to reverse in the future by a less reform-minded government. The process of negotiating bilateral market access with the countries in its WTO Working Party on accession has dramatically increased reform of Russia’s trade and foreign investment regimes, thereby helping the country move toward an open economy model of economic development.¹¹

Russia’s Commitments to Foreign Exporters and Investors

Nonagricultural Market Access

Russia agreed to reduce its bound MFN tariffs to about 8 percent on average. Shepotylo and Tarr show that for 2005, Russia’s MFN tariffs were about 12.1 percent on a simple average basis or 14 percent on a trade-weighted basis, taking into account the ad valorem equivalents of Russia’s specific tariffs.¹² Thus, a cut of average Russian tariffs to 8 percent implies a decline of about 50 percent on average.

11. For details, see US Trade Representative, Fact Sheets on the Russia-United States Bilateral Agreement on Russian WTO Accession, November 2006, www.ustr.gov.

12. Oleksandr Shepotylo and David Tarr, “Specific Tariffs, Tariff Simplification, and the Structure of Import Tariffs in Russia: 2001–2005,” *Eastern European Economics* 46, no. 5 (September–October 2008), 49–58.

Services

The business services sector has been the subject of some of the most intense negotiations associated with Russian accession. Russia has made numerous commitments in this area. It has agreed to increase the maximum share that foreign banks and insurance companies can attain from 15 to 50 percent and will phase out the prohibition of foreign participation in mandatory insurance lines. Russia reportedly agreed to terminate the Rostelecom monopoly on long-distance fixed-line telephone services as part of the Russia-EU bilateral agreement. (Multinational operators are already operating in the Russian mobile telephone market.) Russia will ensure national treatment and market access for a wide variety of professions, including lawyers, accountants, architects, engineers, marketing specialists, and health care professionals. Foreign-owned companies will be permitted to engage in wholesale and retail trade, franchising, and express courier services.¹³ The European Union has negotiated intensely for the rights of companies other than Gazprom to construct a gas pipeline, but no success in this area has been reported.

In the banking sector, Russia was willing to allow subsidiaries of international banks. Subsidiaries must be registered as Russian entities, and the capital requirements would be based on capital in the Russian entity. But opposition galvanized around branch banking. Branches do not have a separate legal status or capital apart from their foreign parent bank. In general, entry into a country's banking sector is easier when branches are permitted, and the US Treasury has been attempting to ensure branch banking is permitted in all countries admitted to the WTO. The Russian central bank maintained that it could not regulate or supervise branches adequately and that depositors would therefore be at risk.

Banking interests in Russia succeeded in getting Putin himself to say that branch banking was a deal breaker for Russian WTO accession. Based on its bilateral agreement with the United States, Russia succeeded in avoiding a commitment on branch banking, becoming the only acceding country that is not a least developed country to avoid such a commitment.¹⁴ Like many items in accession negotiations, succeeding in avoiding a commitment is a pyrrhic victory as Russia will lose the benefits from greater FDI. Nonetheless, multinational banks operating as subsidiaries have greater market access and national treatment rights under the bilateral US-Russia agreement and Russia should benefit from their greater involvement over time.

13. For details, see David G. Tarr, "Russian Accession to the WTO: An Assessment," *Eurasian Geography and Economics* 48, no. 3 (May–June 2007), 306–19.

14. Russia will have to reopen discussions on this issue upon consideration of membership in the OECD.

Agriculture

Agricultural issues have been among the most contentious in Russia's WTO accession negotiations. The key unresolved issue is agricultural subsidies. Russia, however, has made considerable commitments in market access as well as sanitary and phytosanitary negotiations. Disputes with the United States on beef, pork, and poultry exports were among the most significant. Under its bilateral market access agreement with the United States, Russia has made substantial concessions.

For poultry and pork products, instead of joint inspection of facilities, Russia agrees to allow the US Department of Agriculture Food Safety and Inspection Service to inspect and certify new facilities or facilities that need to remedy a deficiency. For beef, Russia and the United States agree to timely joint inspections of all facilities that will export to Russia. Once a joint inspection has been completed, the inspection process for poultry and pork exporters will apply. Russia made significant additional commitments to the United States to limit risks of trichinae in pork and of modern biotechnology products.

Are WTO Accession Demands on Russia Excessive?

Many observers have frequently alleged and come to believe that demands on Russia are either political or excessive by the standards of other countries that have acceded to the WTO. We believe, however, that the evidence contradicts this allegation. Aside from a couple of well-publicized cases where unusual demands were placed on Russia,¹⁵ the demands are typical of the WTO accession process in the past 12 years. The process of acceding to the WTO since 1998 is a difficult one in which all acceding countries have been asked to take on very significant commitments to foreign exporters and investors. Compared with the commitments of these countries, the commitments required of Russia do not appear excessive.

Goods

Russia has agreed to bind its tariffs on goods at an average level of 8 percent, after an adjustment period.¹⁶ This is slightly higher than that of most

15. One such example was the pressure on Russia to unify its domestic and export prices of natural gas. This demand, which occupied negotiators for considerable time and was eventually dropped by the European Union, would have imposed a very high cost on Russia. David Tarr and Peter Thomson, "The Merits of Dual Pricing of Russian Natural Gas," *World Economy* 27, no. 8 (August 2004): 1173–94.

16. US Trade Representative, Fact Sheets on the Russia-United States Bilateral Agreement on Russian WTO Accession.

countries that have acceded to the WTO since 1998.¹⁷ The average tariffs for other acceding countries are: Saudi Arabia, 10.5 percent; Former Yugoslav Republic of Macedonia, 6.2 percent; Armenia, 7.5 percent; Chinese Taipei, 4.8 percent; China, 9.1 percent; Moldova, 6.0 percent; Croatia, 5.5 percent; Oman, 11.6 percent; Albania, 6.6 percent; Georgia, 6.5 percent; Jordan, 15.2 percent; Estonia, 7.3 percent; Latvia, 9.4 percent; and the Kyrgyz Republic, 6.7 percent.¹⁸ Thus, by the standards of countries that have acceded to the WTO in the last eight years that are not least developed countries, Russia appears to have concluded market access negotiations with bound tariffs slightly higher than average, especially in comparison to the other transition countries, i.e., the Working Party has no excessive demands here.

Services

In the area of services, no simple measure like an average tariff is available. But an examination of commitments of the countries that have acceded to the WTO since 1998 shows that all of them have assumed a rather high and comprehensive level of commitments in terms of sectors included.¹⁹ More detailed qualitative analysis of banking and insurance²⁰ does not suggest an above average level of commitments in these important sectors. On the contrary, as mentioned earlier, Russia has been able to avoid committing to branches of banks, unlike almost all of the other acceding countries.

Agriculture

The level of agricultural support permitted has become a major point of controversy for Russia, which is attempting to negotiate a high permitted Aggregate Measure of Support (AMS). However, despite the increase in Russian agricultural subsidies in recent years, the *de minimis* level of subsidies under WTO rules should allow Russia to subsidize at its present levels or higher.

17. World Trade Organization, "Technical Note on the Accession Process," Note by the Secretariat, WT/ACC/10/Rev.3 (November 28, 2005), www.wto.org.

18. Two least developed nations acceded with relatively high bound tariffs: Cambodia, 17.7 percent; and Nepal, 23.7 percent. But the WTO accords preferential status to developing countries.

19. World Trade Organization, "Technical Note on the Accession Process," table 5.

20. Tarr, "Russian Accession to the WTO: An Assessment."

Green Box Subsidies—Unconstrained

The WTO allows without constraint an extensive list of subsidies in agriculture that are not considered trade distorting—the so-called Green Box subsidies.²¹ The worldwide trend is to move agricultural support away from trade-distorting subsidies toward Green Box measures. It is generally recognized that trade-distorting subsidies are a highly inefficient way of helping agricultural producers compared with Green Box measures. These measures, which focus on research and development and agricultural services to improve productivity, are more effective at creating a competitive agricultural sector in the long run.

Amber Box Subsidies: De Minimis Level

Trade-distorting subsidies to production—the so-called Amber Box subsidies—are constrained, but the de minimis levels of support allow developing countries to provide state support to agriculture of up to 20 percent of the value of aggregate agricultural output. Amber Box subsidies are either product-specific or non-product-specific. For developing countries, if product-specific Amber Box subsidies are below 10 percent of the gross value of agricultural production in the specific sector, the level of support is considered de minimis. In addition, a developing country may provide further Amber Box support on a non-product-specific basis and have it be defined as de minimis provided it is not above 10 percent of the gross value of agricultural production. Countries can self-classify their support between product- and non-product-specific support, subject only to dispute settlement, which is rarely used in this area.²²

As part of their accession commitments, however, the countries of the former Soviet Union that have acceded to the WTO have had to accept developed-country de minimis limits (sometimes with an adjustment period). That is, Estonia, Latvia, Lithuania, Georgia, Armenia, Moldova, and the Kyrgyz Republic have all accepted 5 percent limits on product-specific agricultural subsidies and 5 percent limits on non-product-specific support. It is likely that Russia is being pressured to accept the same smaller developed-country de minimis limits on Amber Box subsidies. Regardless

21. Green Box subsidies include a wide range of publicly funded measures including research and development, pest control, general and specialist training, extension and advisory services, inspection services for health and sanitary reasons, marketing and promotion services, infrastructure services, including electricity, roads, and environmental expenditures, targeted support to low-income population through food stamps or subsidized prices, direct payments to producers to support income provided it has minimal trade-distorting features, crop insurance subsidies for natural disasters, adjustment assistance through producer retirement programs, and indirect income support not related to prices.

22. The de minimis levels of support for developed countries are one-half the allowed levels for developing countries. Post-accession, countries self-declare whether they are developed or developing.

of whether Russia declares itself a developed or developing country post-accession, if it agrees to the smaller level, its de minimis level of agricultural subsidies would be that for developed countries.

Aggregate Measure of Support (AMS) and the Russian Support Level

Incumbent members of the WTO, like the European Union, Canada, the United States, and Norway, have a base period for trade-distorting agricultural subsidies during which more substantial trade-distorting subsidies than the de minimis levels are permitted. The precedent among acceding countries, however, is that the three-year period prior to accession forms the base period for permitted trade-distorting subsidies, which are negotiated down from that base. Russia failed in the bilateral discussions to achieve its objective of defining 1992–94 as the base period for trade-distorting agricultural subsidies. It now hopes to be able to negotiate about \$9 billion in subsidies.

The total value of state support to Russian agriculture in 2008 was about 163 billion rubles (or about \$6.5 billion).²³ The Ministry of Finance data include all support to agriculture, including many items that would be considered Green Box (i.e., unconstrained) support. The total value of Russian agricultural output (including hunting and fishing) in 2008 was 1,776 billion rubles.²⁴ Subsidies of 163 billion rubles are about 9 percent of the value of agricultural output. The \$9 billion in Amber Box subsidies sought by Russia is about 12 to 13 percent of the aggregate value of Russian agricultural output.

If Russia were constrained by developed-country de minimis levels post accession, it would still be permitted the \$9 billion in agricultural support, provided about \$2 billion of that support is through Green Box subsidies. According to press reports, at least \$2 billion of existing support is likely to be classified as Green Box support.

In summary, the de minimis levels of agricultural support in Russia appear to allow Russia to subsidize agriculture at its present level of support or considerably more to the extent it uses Green Box subsidies (which are more effective at helping farmers). Thus, unless Russia seeks to use Amber Box subsidies to a significantly larger extent than at present, we do not understand why this is a crucial issue for Russia.

23. Ministry of Finance of the Russian Federation, *Budget for the Years 2008–2010*, www1.minfin.ru.

24. See Federal State Statistical Service of Russia, *Nominal Value of GDP Produced*, www.gks.ru.

Remaining Issues in WTO Accession

Often the most difficult issues remain at the end of accession negotiations. Although Russia has resolved some of the most contentious ones (such as gas pricing and branch banking, where Russia achieved its objectives in the negotiations), several thorny issues remain.

Conflict with Georgia

The conflict between Russia and Georgia regarding Abkhazia and South Ossetia has spilled over to the WTO negotiations. Georgia signed its bilateral agreement on Russian WTO accession in 2004, then withdrew its support. Moreover, Georgia has objected to the agenda of the multilateral meetings and blocked any formal meetings of the Working Party on Russia's WTO accession. The Working Party has therefore been meeting on an "informal basis." Agreement on Russia's intellectual property regime was accomplished in this manner.

Article XII of the WTO Articles on Accession states that "Decisions on accession shall be taken by the Ministerial Conference. The Ministerial Conference shall approve the agreement on the terms of accession by a two-thirds majority of the Members of the WTO." Russia has apparently investigated whether it can bypass Georgia based on this two-thirds majority rule. As a practical matter, this rule is an illusion and all accession decisions are taken by unanimous consensus as are all other decisions of the WTO (except dispute settlement). The Working Party would have to write a final report on Russia's WTO accession, without which the matter will never come to a vote before the WTO ministerial meeting. Just as Georgia has been able to block the Working Party from meeting, it will be able to block the report from going to the ministerial. So again, consensus is required and Georgia has a blocking vote. Thus for Russia to accede to the WTO, Georgia will have to agree.

Agriculture

As discussed earlier, Russia is having difficulty achieving its objective of about \$9 billion in permitted trade-distorting subsidies. Other countries like Kazakhstan and Azerbaijan would like similar departures from the WTO precedent. If the Working Party allows Russia a larger trade-distorting subsidy than suggested by precedent, it will find it more difficult to negotiate previous limits with subsequent applicants for WTO membership. Australia and New Zealand are likely to resist a change in precedent that would allow an increase in trade-distorting subsidies.

Export Taxes on Timber—Dispute with the European Union

In early 2007, the Russian government announced an increase in the export tax on timber, to be phased in over 18 months. Export taxes on softwood or poplar timber, which in early 2007 were the greater of either 6.5 percent or 4 euros per cubic meter, were progressively raised, reaching the maximum of 25 percent or 15 euros per cubic meter as of April 1, 2008. The plan was to increase the export taxes further in January 2009 to the maximum of 80 percent or 50 euros per cubic meter.²⁵ To date, however, the Russian government has postponed implementation of the 80 percent export tax. The increase in the export tax is part of the government's effort to diversify its industry and is intended to dramatically reduce log exports, provide cheaper inputs to wood processors, and attract FDI to its wood-processing sector. Finland, which is the most heavily affected by the export tax measure, has strenuously opposed it; so has Sweden. As bilateral talks with Russia failed, these two countries succeeded in getting the European Union to negotiate the matter as part of Russia's WTO accession negotiations, but the issue remains unresolved.²⁶

Regarding Russia's national interest in the matter, increasing value added is not a goal to be pursued at any cost. If value added were the only criterion, bananas could be grown at exorbitant cost in greenhouse conditions in northern Siberia. Rather, production according to comparative advantage is the appropriate criterion. But Finland's strong concerns suggest that Russia has some monopoly power in its trade with Finland, and given the competitive nature of the logging industry, an export tax would be needed to exploit it.

By extending the model of Tarr and Thomson,²⁷ Khramov, Korableva, and Kovaleva²⁸ show that Russia does have an optimal export tax to exploit its monopoly power on timber exports. However, they estimate that the export tax is about 11.5 percent. Thus, the actual export tax applied since April 2008 is more than twice the optimum level and dramatically less than the approximately 80 percent proposed for the future. When the costs to the logging industry are taken into account, the timber export tax imposes a lot more costs on the Russian economy (and the logging sector in particular) than benefits.

25. In 2005, Russia introduced a 6.5 percent export tax on logs. As of July 1, 2007, export taxes were raised to the maximum of 20 percent or 10 euros per cubic meter.

26. International Centre for Trade and Sustainable Development, "Russia and Finland at Loggerheads Over Timber Taxation" (Geneva), <http://ictsd.net>.

27. Tarr and Thomson, "The Merits of Dual Pricing of Russian Natural Gas."

28. Vadim Khramov, Larisa Korableva, and Anna Kovaleva, "Export Taxes on Russian Timber Case of Finland and Sweden" (photocopy, New Economic School, May 2008).

Rules on State Trading Enterprises

Russia is willing to accept the usual restraints on state trading enterprises for WTO members. It objects, however, to US demands for more stringent restraints on such enterprises.

Acceding as a Customs Union: What Does It Mean for Russia's Trade Policy?

Customs Union and WTO Accession

In June 2009, Prime Minister Putin announced that Russia would abandon its effort to join the WTO as a single country and seek membership as part of a three-country customs union with Kazakhstan and Belarus. However, President Dmitri Medvedev and some officials from his office promptly indicated that single country accession was still preferred.²⁹ Considerable confusion prevailed in the Russian government until October 15, 2009, when Maxim Medvedkov, the lead Russian negotiator on WTO accession, announced that the three countries would seek to accede to the WTO as single countries rather than as a customs union.

Although Russia, Belarus, and Kazakhstan have returned to independent accession negotiations, Medvedkov announced that they hoped to accede to the WTO on the basis of a common external tariff that was implemented on January 1, 2010.³⁰ The return to the negotiating table as independent countries apparently reflects the enormous complexity that negotiating as a common customs entity entails. If the three countries were to jointly apply to the WTO for accession as a customs union, a new WTO working party on the accession of the customs union would have to be formed. This new working party would have to be convinced that the conditions of agreement would be applied throughout the three countries. These commitments include but are not limited to commitments on bound tariffs; rights of foreign investors in services (a rather complicated area of negotiation); Technical Barriers to Trade (TBTs); Sanitary and Phyto-Sanitary Measures (SPS); Trade Related Investment Measures (TRIMs); agricultural trade-distorting subsidies; and intellectual property commitments. All this is sufficiently difficult as no customs union has acceded to the WTO, only individual countries.

The biggest problem with the October 2009 announcement is the

29. "Russian President: WTO Membership via Customs Union with Kazakhstan, Belarus, 'Problematic,'" *Breaking News* 24/7, July 10, 2009, <http://blog.taragana.com>.

30. Frances Williams, "Russia Scraps WTO Customs Union Bid," *Financial Times*, October 15, 2009, www.ft.com.

statement, repeated by Belarusian representatives,³¹ that the three countries would accede to the WTO simultaneously. Since Belarus is far behind Russia in its WTO accession negotiations, simultaneous accession would mean that Russia would have to wait, potentially many years, until Belarus is ready to join the WTO.

Medvedkov announced that the common external tariff would not violate any bound tariff agreement at the WTO. However, the chief negotiator for Kazakhstan, Zhanar Aitzhonova, implicitly acknowledged that the customs union tariff will violate commitments Kazakhstan has made in its bilateral market access agreements on its WTO accession.

Prospects for the Customs Union

As with earlier agreements on the Eurasian Economic Community (EurAsEc), questions remain whether the common external tariff will be implemented outside Russia. As Michalopoulos and Tarr explain in detail, EurAsEc adopted the Russian tariff, which protected Russian industry and made the other countries pay higher prices for Russian goods compared with cheaper third-country imports.³² Thus, the common external tariff was reportedly implemented on only 50 to 60 percent of the tariff lines outside Russia. In the current three-country customs union, a formal supranational tariff-setting authority should begin operating in January 2010, but the common external tariff has already been established. As in EurAsEc, the tariff structure is likely heavily biased in favor of protecting Russian producers. Thus, there is reason to believe that over time, Russia's trade partners will avoid implementing the common external tariff.

While negotiation of a common external tariff is notoriously difficult in a customs union, members of the customs union could potentially provide substantial trade benefits to each other in other areas. Two such areas include improving trade facilitation and reducing nontariff barriers.

The Jackson-Vanik Amendment

The Jackson-Vanik Amendment of the United States requires an annual review of emigration policies in countries such as Russia and other former

31. See "Response by Press Secretary Andrei Popov to a media question over a situation in the accession of Belarus to the WTO," NewsBY.org, October 19, 2009, www.newsby.org.

32. Constantine Michalopoulos and David Tarr, "The Economics of Customs Unions in the Commonwealth of Independent States," *Post-Soviet Geography and Economics* 38, no. 3 (1997): 125-43; and "The Economics of Customs Unions in the Commonwealth of Independent States," World Bank Policy Research Working Paper no. 1786 (Washington: World Bank, 1997), <http://econ.worldbank.org>.

communist countries in order for the United States to grant them MFN status. This is a significant irritant to Russia, but the United States is currently under no commercial pressure to remove it. Once Russia becomes a WTO member, however, there will be commercial pressure on the United States from its own exporters and investors, at which point the United States will almost certainly terminate the amendment's application to Russia.

The WTO requires that permanent MFN status be granted unconditionally to all members, but the provisions of Jackson-Vanik are inconsistent with this requirement. Once Russia becomes a WTO member, the United States has two options: (1) eliminate Jackson-Vanik or (2) invoke the "nonapplication principle" of the WTO. If a WTO member cannot comply with a WTO requirement toward a newly acceding country, it can opt out of its WTO commitments with respect to that country by invoking the nonapplication principle. If the United States were to invoke the nonapplication principle against Russia, it would mean that the United States would refuse to honor its WTO obligations toward Russia. But nonapplication is reciprocal. So the United States would not have any assurance that US exporters to or investors in Russia would be treated according to Russia's WTO commitments.

In practice, the United States has dropped Jackson-Vanik from all countries that have acceded to the WTO with one exception (Moldova). In the cases of Albania, Bulgaria, Cambodia, Estonia, Latvia, and Lithuania, Jackson-Vanik was repealed prior to accession. In the cases of Mongolia, Armenia, Georgia, and the Kyrgyz Republic it was repealed within a year or two after accession, so the nonapplication principle was invoked for a period of time. (In the case of Georgia, nonapplication was never invoked since Jackson-Vanik was removed soon after accession.)

Former US Trade Representative Rob Portman testified before Congress in 2006 that the United States will have to lift Jackson-Vanik against Russia, Ukraine, and Kazakhstan in order for US exporters and investors to gain the advantages of these countries' WTO commitments. The same year, Jackson-Vanik was dropped against Ukraine.

Foreign Direct Investment

In the first ten years of transition, FDI inflows to Russia were very low compared with Eastern European countries and the other so-called BRICs (Brazil, India, and China). This trend was reversed, however, around 2002–03. As fuel prices rose, FDI flows into Russia increased tenfold over time, and Russia became one of the top FDI recipients in the world (table 10.1). By 2006, FDI inflows to Russia surpassed even those to China in per capita terms. Russian outward FDI also has some unusual features: Outflows are more significant than in other emerging-market economies and started very early in the postcommunist transition.

Table 10.1 Foreign direct investment (FDI) inflows to Russia, 2000–2008

Year	Net FDI inflows (current billions of dollars)	FDI	
		Percent of GDP	Percent of gross capital formation
2000	2.7	1.0	5.5
2001	2.7	0.9	4.1
2002	3.4	1.0	5.0
2003	7.9	1.8	8.7
2004	15.4	2.6	12.4
2005	12.8	1.6	8.4
2006	29.7	2.9	14.2
2007	55.1	4.2	17.1
2008	72.8	4.5	18.1

Sources: World Bank, *World Development Indicators*, 2009; Central Bank of Russia.

Nevertheless, starting from such a low base, the stock of FDI in Russia remains substantially less than in some important comparator countries. The accumulated stock of FDI as a share of GDP was 9.5 percent in 2006. This compares with 26 percent in China and 20 percent in Brazil and is only slightly more than in India (7.5 percent).

The sectoral composition of inward FDI is dominated by mining and quarrying (49 percent in 2007) followed by manufacturing (17 percent) and real estate and business services (11 percent). Increased FDI in the last decade was predominantly channeled into oil and gas extraction, further improving this sector's already dominant position in FDI stock. Geographically, FDI flows are very concentrated: Moscow city got 38 percent in 2006, the Sakhalin region 15 percent, and the Moscow region 10 percent.

The two major source countries for FDI are Cyprus (around 35 percent in 2006) and the Netherlands (about the same). The latter enjoys a special position in managing cross-border transactions in the fuel and gas sectors, while the former is home to capital-rich Russian nationals, who have made substantial investments in Russia.³³ The next most important source country for FDI is Germany, which provided 4.4 percent of the inflow to Russia in 2006. China has also now emerged as a major FDI partner. FDI inflow in the first half of 2009 was cut in half compared with that in 2008 due mainly to the global financial crisis.

The significant increase in FDI inflows to Russia in the past seven years can be explained to some degree by its macroeconomic stability,

33. Organization for Economic Cooperation and Development (OECD), "Russian Federation: Strengthening the Policy Framework for Investment," *OECD Investment Policy Reviews* (Paris, 2008), 16.

sound fiscal policy, efficient external debt management, and accumulation of foreign reserves. Infrastructure projects initiated by the state may also have indirectly attracted FDI flows. But the major factor behind the increase in FDI was the increase in the price of oil, which made investments in the Russian oil and gas sectors more profitable.

While the large and expanding Russian domestic market can be attractive for foreign investors, several very clear risks are associated with the Russian economy. The first is the high share of output and exports in the energy sectors. Such heavy dependence on a small number of commodities with volatile prices makes the whole economy relatively volatile. Investors may need to be compensated for this volatility with higher returns, which could reduce FDI inflows. To fight the potential risks of macroeconomic instability associated with volatile oil prices, the government launched the Stabilization Fund of the Russian Federation in 2001.

On the other hand, in the past decade, increased government control over the economy and slow regulatory and administrative reforms have impeded FDI. Government control of the economy increased with Putin's first administration. He became progressively more open in establishing a dominant role for the Russian state in key sectors, including scrutiny of foreign investors in these sectors. The key piece of legislation on this was the Law on Foreign Investment in Strategic Sectors, approved in May 2008. It defines the conditions under which foreign investment can operate in 42 strategic sectors. A foreign investor requires prior authorization to be able to control any business entity in these industries. Most of the industries on the strategic list can be aggregated in broad categories such as military and defense industries, nuclear and radioactive hazardous materials, space and aviation-related sectors, subsoil exploration and exploitation, and fisheries. The list also includes industries covered by the Law on Natural Monopolies, large-scale communications companies, TV and radio broadcasting, and printing services.

The first obvious critique of this law is the extension of strategic status to sectors that are not deemed strategic in many economies. Some services sectors such as TV and radio broadcasting and printing are on the list so the state can control the major media outlets in Russia. Inclusion of industries covered by the Law on Natural Monopolies is aimed at widening state control over the Russian economy.³⁴

While the procedures required for prior clearance of foreign investments are meticulously specified in the law, the time it takes an official to approve or declare the transaction a security threat is quite long and varies from case to case: from four to seven months. In this respect the law differs from the practice of similar legislation in many OECD countries.³⁵

Overall, some experts point out the positive role this law might play

34. These industries include pipeline delivery of oil, petroleum products or natural gas, power-station operations, railway transportation, ports, and airports.

35. OECD, "Russian Federation: Strengthening the Policy Framework for Investment," 27.

in attracting FDI into the economy because the conditions the investor must take into account while planning business transactions are explicitly defined.³⁶ Nevertheless, by limiting foreign control in too many sectors and allowing officials too much time to reach decisions, the law can discourage a substantial amount of potential FDI inflows. It remains to be seen if foreign investors will see these determinations as *ad hoc*.

Another potential negative effect of the law could derive from the excessive controls on subsoil exploration and exploitation. It limits the degree of risk sharing related to subsoil exploration. Given volatile oil and gas prices, risks involved in the very substantial investments in the energy field are often shared. As foreign shares of these investments will be limited, greater risks will be borne by the Russian economy.

The Russian government has also substantially expanded its role through state strategic corporations in energy, aircraft, shipbuilding, car manufacturing, forestry, and banking. State enterprises absorbed many incumbent firms in these sectors and now are often the dominant firm in the sector; these enterprises may have access to budgetary support.³⁷

In many of these markets, private firms may find it difficult to compete with state enterprises that are subsidized, leading to less competition in many domestic markets, an inevitable decline in efficiency, higher prices, and lower quality of domestic production.

Over the past two years, the government has changed its public stance, arguing for modernization of the economy via FDI. However, the increase in state control of productive assets, limitations on FDI in several questionable areas, and increased use of import-substitution industrialization all work against achievement of this objective. These tendencies emphasize internal conflicts in the current government regarding its economic policy in general and FDI in particular.

To increase Russia's attractiveness as a destination for FDI, the government should work in several important directions. First, it needs to improve domestic institutions to make Russia a better place for doing business. Russia's rankings in the Doing Business Survey and Enterprise Surveys are below the mean in almost all respects and have worsened in recent years.³⁸ In 2009, 50 percent of the surveyed firms in Russia mentioned corruption as a major constraint. Enormous efforts, involving legislation and court reform, should be made to curb corruption (see chapter 4).

Second, important steps should be taken toward making Russia a bet-

36. Toby T. Gati, "Russia's New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy" (Akin Gump Strauss Hauer & Feld, October 1, 2008), 22. www.usrbc.org.

37. *Ibid.*, 17, for a similar view.

38. World Bank, *Doing Business 2010*, www.doingbusiness.org; and *Enterprise Surveys 2009*, www.enterprisesurveys.org.

ter location for some part of the production process. Trade flows in the 21st century are highly linked with FDI flows. Much of FDI is “vertical” investment designed to achieve international production sharing in a vertical production chain. But to make Russia an attractive country for investment in the production of components in a production chain, Russia will have to significantly improve its business climate, including transparency of its laws, and improve trade facilitation at its national borders. Russia currently falls behind its major competitors for FDI on the Logistic Performance Index, ranked only 99th out of 150 countries.³⁹ The situation with customs is especially dreadful, with Russia ranking only 137th out of 150. Customs reform was not on the list of priorities for modernizing the Russian economy that President Medvedev highlighted in his annual address to the Federal Assembly on November 12, 2009.

Improving Customs: Uniform Tariffs or Preshipment Inspection?

Given the problems in Russia’s customs performance, some experts have recommended uniform tariffs and preshipment inspection services. In our view, there is enormous merit in uniform tariffs, but preshipment inspection services are likely to produce only marginal benefits at best.

One of us has analyzed the advantages and disadvantages of a uniform tariff for Russia,⁴⁰ finding that the arguments against a uniform tariff are not persuasive.⁴¹ That is, there is little merit in the argument for diverse tariffs for strategic trade policy, for optimum revenue, for exploitation of optimal power on imports, for negotiation leverage at the WTO, or for balance of payments purposes. A uniform tariff reduces the incentive to smuggle or to misclassify goods at customs by eliminating tariff peaks. But by far the biggest advantage of a uniform tariff is the political economy incentive. As the experience of Chile has shown, since the uniform tariff eliminates gains to individual sectors, it removes the incentive for industrialists to lobby for higher tariffs. So the country gets a more liberal tariff regime.

Even if under a uniform tariff there is no incentive to misclassify goods, an incentive to falsify the valuation of goods remains, which provides opportunities to customs officials to extract bribes. Preshipment inspection

39. World Bank, Logistics Performance Index, <http://info.worldbank.org>.

40. David Tarr, “Design of Tariff Policy for Russia,” in *Russian Trade Policy Reform for WTO Accession*, ed. H. G. Broadman (Washington: World Bank, 1999). These ideas were developed further in David Tarr, “On the Design of Tariff Policy: Arguments for and Against Uniform Tariffs,” *Development, Trade and the WTO: A Handbook*, eds. B. Hoekman, A. Mattoo, and P. English (Washington: World Bank, 2002).

41. Tarr, “Design of Tariff Policy for Russia” and “On the Design of Tariff Policy.”

(PSI) is designed to deal with that problem (among others). PSI delegates valuation and some other functions to a foreign private firm for a fee (about 1 percent of the value of the imports). However, customs revenue from PSI is not impressive, and importers often complain that they have to incur extra expenses to undergo a PSI and are again put through customs inspections. This raises the costs of delivering the goods and further erodes any benefits to the home country. Crucially, PSI does nothing for building the capacity of the home country to effectively implement a customs regime (including customs valuation), which is the real long-run goal.

Is Russia's Accession to the WTO Crucial to the International Community or to Russia?

Small Economic Gains to the International Community

We are skeptical that Russian WTO accession will convey significant benefits to the international trading community. Multiregional trade models have shown that it is own-country liberalization that is important: Countries that make substantial commitments in multilateral negotiations gain more, and those that don't make commitments gain very little from the liberalization in the rest of the world. Numerous assessments of the Uruguay Round have found this result.⁴² Harrison, Rutherford, and Tarr also found this result in multiregional trade models of regional arrangements.⁴³ Rutherford, Tarr, and Shepotylo showed that Russia has dramatically more to gain from its own liberalization in WTO accession than from liberalization in the rest of the world such as through a very successful Doha Development Agenda.⁴⁴ Adapting the well-known computer acronym, Alan Winters has summarized these results with the acronym "WYDIWYG—what you do is what you get." The bottom line is, notwithstanding the growing importance of Russia in world markets and the fact that some Western firms will find profits selling or investing in Russia, it is difficult to argue

42. Glenn Harrison, Thomas Rutherford, and David Tarr, "Quantifying the Uruguay Round," *Economic Journal* 107, no. 444 (1997): 1405–30; and Will Martin and L. Alan Winters, eds., *The Uruguay Round and the Developing Countries* (Cambridge University Press, 1996).

43. Glenn Harrison, Thomas Rutherford, and David Tarr, "Trade Policy Options for Chile: The Importance of Market Access," *World Bank Economic Review* 16, no. 1 (2002); Harrison, Rutherford, and Tarr, "Trade Policy and Poverty Reduction in Brazil," *World Bank Economic Review* 18 (2004): 289–317.

44. Thomas Rutherford, David Tarr, and Oleksandr Shepotylo, "The Impact on Russia of WTO Accession and The Doha Agenda: The Importance of Liberalization of Barriers against Foreign Direct Investment in Services for Growth and Poverty Reduction," in *Putting Development Back into the Doha Agenda: Poverty Impacts of a WTO Agreement*, eds. Thomas Hertel and L. Alan Winters (New York: Palgrave MacMillan and World Bank, 2005).

that the United States or the rest of the world will significantly gain economically from Russia's accession.

We believe that the United States and the rest of the world would like to see Russia as a cooperative partner in dealing with international problems. And they would like to see Russia in the WTO, trading by the same rules, as part of that process. But this is more a geopolitical argument than an economic one.

Unique Historical Opportunity for Reform in Russia

We have shown estimates that suggest Russia will reap large gains from WTO accession and that the largest gains from WTO accession will derive from its own liberalization commitments. Some will argue that if virtually all the gains come from own liberalization, why bother going through the long, painful, contentious process of WTO accession when the country can independently liberalize and achieve virtually all the benefits of accession? We argue that WTO accession is a unique historical opportunity to dramatically move the country toward an open economy model of economic development. In a business as usual scenario, forces that want protection in their sectors are concentrated and will lobby to defeat liberalization, while those who gain from liberalization are diverse and due to a free-rider problem often do not lobby. Uneven lobbying therefore often leads to excessive protection.

WTO accession involves foreign business interests and foreign governments in the negotiations on the level of protection at home. WTO accession compels policymakers at the highest levels of government to engage in the process, and they often impose liberalization on slow-moving ministries and sectors. Moreover, commitments at the WTO "lock in" reform in a manner that is not easily reversed by future governments who may be less reform-minded.

Import-Substitution Industrialization or Open Economy Development with Institutional Reform?

Throughout the first decade of the 21st century, Russia has had large trade surpluses, which have exceeded \$100 billion annually since 2005, giving Russia the largest trade surplus in the world in some of those years. Despite these large trade surpluses, which amounted to between 9 and 14 percent of Russian GDP since 2005 (table 10.2), Russia has become increasingly concerned about the mineral (mainly energy) dependence of its production structure and exports, as mineral exports alone constituted 65 percent of exports in 2007. In response, Russia has increasingly employed import-substitution industrialization and industrial policy for diversification of its economy or for political purposes. These measures include very high export taxes on timber to develop the wood-processing industry; in-

Table 10.2 Russia's trade balance, 2000–2008 (billions of current US dollars)

Year	Exports	Imports	Trade balance	
			Billions of current US dollars	Percent share of GDP
2000	114.6	61.1	53.5	20.6
2001	112.7	73.0	39.7	12.9
2002	120.9	84.5	36.4	10.5
2003	152.1	103.2	48.9	11.3
2004	203.8	130.7	73.1	12.4
2005	268.8	164.2	104.6	13.7
2006	334.6	209.0	125.6	12.7
2007	393.8	282.5	111.3	8.6
2008	522.9	368.2	154.7	9.6

Sources: Rosstat; World Bank, *World Development Indicators*, 2009.

creased import tariffs on food processing, light industry, and automotive sectors; sanitary and phytosanitary measures for protection against meat imports from the United States and as a political tool against Georgia, Moldova (briefly), and allegedly Belarus in June 2009; increased agricultural production subsidies; restrictions on foreign investment in the Russian economy through the introduction in 2008 of the Law on Foreign Investment in Strategic Sectors; and creation of a grain marketing board with unclear objectives. Many of these actions would be constrained by WTO rules or commitments. Thus, Russian leaders may wish to more actively use industrial policy and import-substitution industrialization and could see the WTO rules as counterproductive to Russia's development.⁴⁵

Diversification of the Russian economy is a worthy goal. However, as emphasized in chapter 1, institutional reform to improve the business climate is necessary. Russia rates badly on measures of institutional development. As noted earlier, it ranks 120th out of 183 countries on the Doing Business ranking; 99th out of 150 on the Logistics Performance Index; and 147th out of 180th on Transparency International's Corruption Perceptions Index. Small and medium enterprises depend crucially on the institutional environment for doing business. The incredible improvement of Georgia in the past eight years (now ranked 11th in the world on ease of doing business) has shown that rapid progress in institutional performance is possible when a concerted effort is made starting from the highest levels of government.

45. Anders Åslund, "Russia's Policy on Accession to the World Trade Organization," *Eurasian Economics and Geography* 48, no. 3 (May–June 2007), elaborated on the stiffening of political will in Russia on WTO accession.