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# Global Economic Integration: Prospects for WTO Accession and Continued Russian Reforms

Soon after the breakup of the Soviet Union, the Russian government recognized that, to transition successfully from a centrally planned economy to one based on market institutions, the country's economy would need to integrate with the global economy. This realization led almost immediately to initiatives to liberalize Russia's foreign-trade regime. The government lowered tariffs significantly, reduced quotas, diminished import trade subsidies, and formally applied in June 1993 to become a member of the General Agreement on Tariffs and Trade (GATT)—the predecessor of today's World Trade Organization (WTO).

Since 1993, Russia has continued to liberalize its trade regime and to pursue membership in the WTO, which has nearly 150 members that account for more than 97 percent of world trade at present. Russia has the largest economy of the more than 30 countries currently negotiating membership.[1] Today, Russian officials—most visibly President Vladimir Putin himself—repeatedly and increasingly emphasize Russia's desire, if not commitment, to accede to the WTO as a critical policy objective for the country's integration into the world economy. The world's major trading powers, including the Group of Seven (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), also have come to realize the importance of Russia's WTO accession.

At the same time, Russia still faces enormous challenges in the structural reform of its domestic economy. After the slow and uneven growth of the

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1990s and, ultimately, the 1998 crisis, Russia's economy has been growing steadily: during the five years since the 1998 financial meltdown, the economy grew by a cumulative 28.2 percent (as of the fall of 2003). Yet, is this newfound growth, initiated largely by increased world oil prices and the devaluation of the ruble, which has given domestic production a competitive edge over imports (what economists refer to as import-substitution effects), sustainable?

**Key remaining challenges may make WTO accession unachievable until 2006.**

Although privatization initiatives have successfully changed the ownership of many Russian firms, they have not led to a major and much-needed restructuring of most incumbent enterprises. The mode of privatization most commonly used has relied on worker/management buyouts. The subsequent insider-controlled firms faced weak incentives to restructure, especially against the backdrop of a policy framework that, up until relatively recently, widely permitted subsidies, tax forbearance, and payment arrears (also called soft-budget constraints), further reducing pressure to restructure. The growth of new private-sector businesses in Russia, especially small- and medium-sized enterprises, has been strikingly low, particularly when compared to other transitional countries in central and eastern Europe. Moreover, the vast majority of new businesses that have taken root are located in the largest, wealthiest cities, such as Moscow and St. Petersburg, exacerbating the already skewed pattern of Russian regional geographic development.

Structural policies that engender incentives for efficiency and predictability in businesses' transactions are crucial for sustained enterprise development in Russia, as in other transition economies. In developed market economies, a set of basic market institutions that work to facilitate and reduce firms' transaction costs, whether through new investments or the restructuring of existing operations, shape these incentives. These market institutions include vigorously enforced competition policy to check market power exercised by dominant incumbent firms and to facilitate the entry of new enterprises; a regulatory regime that ensures that products and services are provided to consumers through a decisionmaking process that protects the public interest through transparent, accountable, rules-based, and independent governance; an efficient system for the intermediation of savings into investment capital and the provision of finance to businesses on commercial terms; and an effective system to protect property rights and to foster the settlement of commercial disputes.

To be sure, the government has implemented many important structural reforms in recent years to help create these market institutions and to dis-

mantle the remnants of the earlier central-planning regime. Yet, Russia still faces the daunting challenge of restructuring its incumbent enterprises and engendering new business development by improving its investment climate. Its import-competing and export industries need balanced incentives, its services sectors need efficiency and competition, and the economy overall needs to attract new foreign direct investment (FDI) and technology.

Most students of the Russian economy, both within and outside the country, can see clearly that WTO accession thus comes at a critical juncture in Russia's transition to a market economy. For more than four years, in the wake of the 1998 default and devaluation crisis, the Russian government has been focusing with renewed effort on structural reform policies to sustain the economy's recent growth. As the price of oil—Russia's major export—gyrates (and recently has softened) and the import-substitution effects of the ruble's devaluation, which have had strong salutary effects on Russia's domestic production and non-oil exports, become more diffused over time, enduring structural reform becomes more important. Russia's membership in the WTO's multilateral, rules-based system will help lock in hard-won reforms. Consequently, prospects for the country's enduring economic growth and prosperity as well as its integration into the world economy will improve.

Conventional wisdom—at least if one relies on press reports of negotiations and on official government statements—holds that Russia's application for accession to the WTO appears to be in its final phases. Indeed, many believe that WTO membership for Russia might well conclude sometime in late 2004, but more likely not until 2005 or even 2006. Key challenges—legal, economic, technical, and political—that remain, however, may make this timetable unachievable. Some challenges arise in the negotiations (bilateral and multilateral) between Russia and the incumbent WTO members, for example, in the most recent meeting of the Working Party on the Accession of the Russian Federation to the WTO ("Working Party"), which took place in Geneva on October 30, 2003.

Equal, if not more formidable, challenges to Russia's WTO accession are emanating from within Russia itself. Greater recognition of these "behind the border" challenges and devising strategies to overcome them are critical to bringing Russia's WTO accession about sooner rather than later and with it the realization of integration's benefits to Russians and to the world economy.

## The Structural Reform Challenge for WTO Accession

Looking back over the past decade of reform, Russia has progressed significantly in engendering macroeconomic stabilization. In no small measure, this has primarily been the result of the country's economic authorities' deft

management of the implementation of fiscal, monetary, and exchange rate policies despite several external and internal economic shocks buffeting the economy since the early 1990s. In recent years, the rise in world oil prices and the export-promotion and import-substitution effects of the devaluation of the ruble brought on by the August 1998 debt default and ensuing crisis have naturally aided the country's macroeconomic performance. Still, since the Russian Federation's founding and especially in the past few years, the world has unquestionably witnessed an increasingly credible commitment to growth in Russia's macroeconomic policy and, concomitantly, greater integration in the global economy.

**WTO accession comes at a critical juncture in Russia's transition to a market economy.**

Following the initial liberalization of the foreign-trade regime that took place soon after the federation's creation, tariffs have continued to decrease. Today, Russia's average tariff rate is lower than the average rates in most developing countries: the country's average trade-weighted statutory tariff rate is about 12 percent.[2] In 2001 the number of import duty bands was consolidated from more than 3,000 separate tariff lines to 5—5 percent, 10 percent, 15 percent, 20 percent, and 25 percent. This greater uniformity in tariff structure has resulted in generally lower duties and reduced the incentives for discretion and corruption in the customs framework. Still, many of Russia's tariff lines are "combined" rates—ad valorem (where the duty is based on a percentage of the value of the imported good) and specific tariffs (where the duty is based on a fixed rate multiplied by the quantity of the imported good)—with the applied rates exceeding 25 percent.[3] All these actions clearly bode well for a country seeking greater global economic integration in terms of the prospects for and the anticipated impacts of Russia's WTO accession.

The ultimate gauge of the chances and consequences of Russia's WTO accession, however, is the progress to date of the nation's structural reforms, that is, the extent to which the economy's underlying microeconomic and institutional regime is consistent with market principles and practices. This is not to suggest that Russia has not made significant headway, especially in the last three years, in transforming structural policies in several key areas, including tax reform, land reform, administrative reform, and judicial reform. In many ways, these accomplishments constitute a hefty structural-reform down payment and thus create a promising backdrop for Russia's WTO accession.

Major structural reform challenges, however, still remain. How these challenges are met ultimately will determine the incentives and constraints on Russia's greater integration into the world trading system and the ben-

efits arising from integration. As is the case in most other transition economies, this will require Russia to tackle the pronounced political-economy problems that stand in the way of needed structural reforms, not only those that directly affect external transactions (the conventional view of the relationship between trade and structural reforms) but also the equally important domestic, structural reforms that strongly influence the extent and nature of trade flows and their impact on the real economy.

## Russia's Record on Structural Reforms

It has become common among analysts of transition economies to gauge the progress of structural reform that has taken place in a country by examining three key facets of a market-based economy: the extent to which enterprises are privately owned and operate as bona fide business entities; the degree to which the overall legal and institutional framework facilitates commercial activity; and the extent of competition among enterprises.[4]

### Business Privatization and Corporatization

The privatization of Russia's state-owned enterprises was more rapid and widespread than in other former Soviet Bloc countries. The changes in ownership accomplished by Russia's privatization initiatives proved highly beneficial for the country by creating a class of private-property owners that (at least in principle) would demand policies to protect their newfound property rights. Yet, the poor quality of some of the early Russian privatization processes as well as inadequate initial attention to establishing basic market institutions, such as sound corporate governance practices, adherence to international accounting standards that ensure greater financial transparency, and effective competition and bankruptcy policies, engendered weak if not regressive commercial incentives that distorted and misallocated resources while undermining Russia's transition to a market economy and integration into the global economy.[5]

Under the Mass Privatization Program (MPP) in the early 1990s, 70 percent of the 76,000 enterprises privatized transferred majority ownership to existing managers, employees, and other insiders. Even the MPP's framers, among others, have acknowledged that, despite nascent institutional reforms—for example, in the areas of corporate governance, competition policy, accounting, and capital markets—the program's implementation was quick. Supporters of this strategy thought that rapid and large-scale privatization was necessary in the face of a small prospective political window of opportunity to facilitate and lock in Russia's transition from a Com-

munist to a market-oriented economy with a significant share of new private-property owners.

In the mid-1990s, through the Loans for Shares Program, the government gave the then-emerging financial and industrial groups (FIGs) controlling shares in the largest and most attractive firms yet to be privatized in return for loans to the national budget. As many have noted, in the end the loans were not repaid but the FIGs still gained control of the firms.[6] Needless to say, the Loans for Shares Program's lack of transparency raised serious concerns within Russia and abroad about the fairness and equity of this type of privatization, the resulting concentration of market (and ostensibly political) power—principally but not exclusively in the natural resources sectors—and the need to implement fundamental corporate governance practices.

Since 1997, Russia has been undertaking "Case-by-Case" (CBC) privatization—in principle, an international best practice for selling large state firms to private owners. Russia's CBC program has targeted the state's largest nonprivatized enterprises remaining, often pursued strategic investors, employed increasingly competitive tenders and auctions as well as more transparent procedures, and often utilized independent financial advisers. In these respects, the quality of Russia's privatization practices has improved.

Overall, Russia's government has cumulatively privatized more than 140,000 enterprises since 1992. Although the Russian government is still a shareholder with at least a 25 percent stake, in about 2,500 joint-stock companies and approximately 14,000 unitary state enterprises (in which the government is the sole shareholder) also remain, there is little doubt that, since the formation of the Russian Federation in the early 1990s, private businesses have become increasingly important in the Russian economy. Indeed, official statistics indicate that the private sector accounts for at least 70 percent of Russia's gross domestic product (GDP). This bodes well for Russia's integration in the global economy.

## Commercial Legal and Institutional Framework Reform

The legal and institutional framework governing Russian commerce has become increasingly based on market principles. Examples include a modern company law; a new land code; a securities law that provides enhanced (but still inadequate) protection of minority shareholder rights and penalties for insider trading; modern competition policy as well as bankruptcies laws; and the establishment of various governmental institutions, such as the Federal Securities Commission and the Ministry of Antimonopoly Policy and Support for Small Enterprise, that can be potent policy instruments for implementing structural reforms.

Despite the development of this relatively sound legal and institutional regime, however, the legacy of insider control in Russia's businesses and of rent-seeking incentives that has characterized the nexus between government and business result in weak corporate governance practices, including dilutions and swaps of shares that reduce minority shareholders' voting rights. The stripping of assets and abuse of transfer prices also have commonly occurred, including the sales of assets and products at below-market prices to firms controlled by related parties. Except for the very largest firms raising capital on the domestic or international money markets, the disclosure of financial information relating to business activities and governance practices is sporadic, often not made public, and rarely in compliance with the International Accounting Standards and International Standards for Auditing.

**Russia has unquestionably committed to greater integration in the global economy.**

These realities have many deleterious consequences on the Russian commercial marketplace. Some more than others stand out as powerful metaphors for the need for further structural reforms, as reflected in the following problems. To name one example, the equity shares of some of the largest Russian firms trade at a fraction of their potential market value.[7] These enterprises' inability to attract equity investors and thus their excessive reliance on reinvestment of retained earnings or profits to engender new investment is palpable. Bank-supplied and other forms of credit/debt financing are limited, which is reflected in the low rate of intermediation of savings into investment capital. As for FDI, flows into Russia, whether measured in absolute terms or as a proportion of country size, are small compared to other transition economies, and the FDI flows that do occur are heavily skewed to just a few regions of Russia.[8] Finally, the number of new businesses and creations of start-ups in Russia is strikingly low.[9] Without correcting these problems, the transition of the structure and operation of Russia's economy from central planning to market incentives will remain incomplete.

## Reforms to Increase Market Competition

In recent years, the Russian government has recognized that the ownership changes produced through privatization did not lead to competitive changes in business structure and conduct. Policymakers therefore view entry into the WTO and exposure to its rules-based disciplines, as well as increased competition from the global marketplace, as complementary to domestic-oriented policy initiatives and as key tools to engender a more competitive Russian business sector.

Some of Russia's major industrial sectors, such as aluminum, petroleum, and automobiles, contain incumbent firms that dominate their principal product markets. At the same time, mergers, acquisitions, and takeovers have increased the pace of horizontal and vertical integration in recent years. In some cases, the benefits that such integration might create through enhanced economies of scale and scope are questionable. Structurally heavy integration allows firms to exercise discretionary behavior as well as market power and to deter entry by rivals into the market. Indeed, although so-called administrative barriers have received much attention as impediments to establishing business operations in Russian industry, the real barriers to entry are structural and economic in nature.

**Foreign direct investment flows that do occur are heavily skewed to just a few regions.**

Notwithstanding the salutary external competitive effects that the devaluation of the ruble has had, the lack of underlying robust competitive pressure on many Russian firms is largely a remnant from the era of central planning under the Soviet system. The enterprises' drive for self-sufficiency to acquire inputs and to distribute their outputs (what economists refer to as "vertical integration") as well as for decentralization has led to regional market segmentation and a lack of a unified economic space. At the same time, subsidies have stifled competition, initially through national and regional budgets, then through the forbearance of taxes and other arrears, and at present through charging below-market prices to firms for energy and other infrastructure services. At the regional level, invisible barriers provide protection and support for local champions. Indeed, local businesses often "capture" regional governments and are major violators of antimonopoly laws.[10]

Due to the general weakness of rules-based incentive regimes and tolerance for discretionary policy implementation, lax enforcement of existing laws and regulations undermines interenterprise competition in Russia. Thus, for example, despite a relatively sound insolvency law, creditors possess little confidence in the ability to exercise their rights. Although recent judicial reforms have improved access to court mechanisms for commercial dispute resolution, many businesses seek to settle disputes through informal, out-court mediation or arbitration (and in some cases through the use of the mafia), the durability of which is questionable.

Businesses in Russia's manufacturing sectors, which rely on Russia's utility service infrastructure providers to operate, generally face service monopolies that effectively serve as major bottlenecks to competition among

manufacturing firms. Despite the official label of infrastructure providers in Russia's nomenclature as "natural monopolies" (only in part a holdover from the central planning era), their monopolistic structures are hardly natural due to advances in technology, growing market expansion, and interdependence among services sectors in Russia (as well as most of the rest of the world). To be sure, the realization among Russian policymakers is growing that the infrastructure services sector—indeed, almost all of the country's services sectors including, among others, financial services, construction, legal services, accounting and business consulting services, and insurance—are underdeveloped (often in dilapidated shape due to low prices that create disincentives for investors, engendering underinvestment and poor maintenance) and in need of competitive restructuring.

Yet, appreciation of these sectors as the lifeblood of the country's export manufacturing future, let alone of the sectors' own prospects for generating future employment and economic growth, is much smaller. The services sectors will continue to comprise the Achilles heel of the Russian economy and pose a significant threat to undermining the sustainability of the country's newfound growth unless the government reforms and competitively restructures them. In this sense, accession to the WTO, whose charter includes provisions that obligate members (to varying degrees) to liberalize trade and investment in services through the General Agreement on Trade in Services (GATS), could play a vital role in enhancing structural reform of the Russian economy and increasing Russia's integration into the world economy.

## Russia's Post-Crisis Structural Reform Agenda

Russia's default on its debt obligations in August 1998 and the loss of investor confidence surrounding that event caused a significant devaluation of the ruble.[11] The devaluation fostered substantial import-substitution and export-promotion opportunities for Russian firms and, along with the overall crisis of confidence, produced a wake-up call to Russian business to cut costs and make investments to enhance operational efficiency. The result has been significant restructuring of enterprises in certain sectors and regions.[12] In fact, some might argue that the market pressures emanating from the 1998 crisis have prompted changes in Russian business practices, especially with regard to corporate governance and property right protection, so as to attract new investment and move Russia's greater integration into the world economy as effectively as (if not more than) past government reform programs.

Although some have argued in the past that Russia, at least in its current state, is almost immune to market forces, the outcome of the 1998 crisis

demonstrates that Russian firms (and consumers) do in fact respond to incentives in ways similar to economic agents in other countries. The general implication of the impact of the 1998 crisis is thus positive: the market's invisible hand is at work in Russia.

In the arena of corporate governance, for example, certain trends have begun to emerge in some of the largest firms. The presence of independent directors on corporate boards is increasing; the publication of financial accounts and increased availability of company charters are becoming more routine; dividends are being paid; and some companies have voluntarily adopted internationally sanctioned shareholder protection principles (for example, those articulated by the Organization for Economic Cooperation and Development [OECD] and the World Bank).

**The services sectors will continue to comprise the Achilles heel of the Russian economy.**

Yet, this is not to suggest that complementary, proactive policy reforms, driven from within—that is, government initiatives—and from without—even greater exposure to global market forces, institutions, and rules-based disciplines through WTO accession—are not still essential for deeper and more sustainable behavioral changes and economy-wide structural reforms in Russia. The key issues on Russia's medium-term agenda for structural reform, as articulated in recent government pronouncements that largely build on reform strategies announced by the government more than four years ago and supported by international financial institutions, include:

- Strengthening enforcement of competition policy and antitrust measures to reduce structural barriers to the entry of new firms, abuse of horizontal and vertical market dominance, and anticompetitive mergers.

- Implementing measures, such as the facilitation of a market for corporate control combined with ending subsidies and hardening budget constraints, to countervail insider-dominated firms. These policies will help curb asset stripping, facilitate outside investment, and foster the restructuring of firms to make them more efficient and competitive.

- Increasing the competition to provide a wide array of services from utilities to banking to transport to legal services (among others).

- Establishing legal and institutional standards and practices that more effectively protect intellectual property rights.

- Continuing reform of the civil service and the judicial system, including realignment of salaries based on performance incentives, greater training for judges, and the establishment of professional standards and certification procedures for bankruptcy trustees to strengthen the rule of law and increase confidence in Russia's governance system.

- Completing the creation and implementation of regulations to adhere to the International Accounting Standards and International Standards for Auditing to enhance transparency and accountability.

- Modernizing the policy regime governing FDI. The government should continue to bring the FDI policy framework in line with international best practice: national treatment (so that policies toward foreign investors are no different than toward domestic investors) for foreign investors; binding international arbitration for investor-state disputes; substantial reduction of the sectors with limitations on, or even restrictions from, FDI; freedom for profit remittances; expropriation only for a bona fide public purpose and with prompt, adequate compensation; and an absence of trade-related investment measures.

Taken together, such initiatives should form the core of the agenda for the "second generation" of structural reforms in Russia, building on the record of the many basic reforms put in place since the founding of the federation more than a decade ago. Although many policymakers in Russia would agree with this agenda—indeed, most of these initiatives are, in one way or another, part of the government's domestic program—what is less appreciated is that these reforms would bring many of the nation's basic market institutions and practices in line with international standards and practices and thus facilitate Russia's further integration into the global economy, including its accession to the WTO.

## Prospects for Russia's WTO Accession

In 1994 the Russian government tabled its Memorandum on the Foreign Trade Regime, presenting a description of the nature of the country's trade and investment policies and the extent to which they have been liberalized. In 1995 the formal process of responding to questions on the memorandum by incumbent members of what was still GATT at the time, known as the question and answer phase, began. Working Party meetings and bilateral consultations on Russia's accession began in earnest in 1996 and have continued ever since, with offers tabled on liberalizing market access, opening

up trade and investment in services, and reducing tariffs. Overall, the Working Party has held 18 meetings, the last, as of this writing, in October 2003. Bilateral consultations have become more frequent; they are presently in full swing with more than 50 countries.

At this juncture, Russia has yet to negotiate tariffs for some one-third of a total of 11,000 categories of goods, with agriculture, machinery and equipment (aircrafts, trucks, cars), furniture, pharmaceuticals, and chemicals among the sectors in which progress has been slowest. In the area of nontariff barriers, negotiations have focused on requirements for product certification and standardization. Russia also has yet to agree on the extent of allowable protection for domestic producers of agricultural products and energy and on the restriction of foreigners' access to services (particularly banking, insurance, telecommunications, transportation, and health care).

The pricing of energy, particularly of natural gas, has become an especially contentious issue.[13] The energy sector dominates the Russian economy and constitutes the largest portion of the country's exports and earnings of hard currency. The government regulates domestic energy prices at below-market levels in part to provide individual consumers with affordable energy. The price of Russia's energy exports, on the other hand, are unregulated and set by market forces. The European Union, as well as some other WTO members, has argued that this dual-pricing regime, where the observed gap between the international and domestic price for Russia's natural gas has been as large as six to one, constitutes a subsidy to Russian real-sector manufacturing firms that violates the WTO agreement on subsidies.[14] These countries have pressed Russia to lower prices on gas exports and raise prices on domestic gas. Russian authorities have countered that the country's domestic energy prices are subsidy free under WTO strictures because they are uniform for all industrial sectors. Moreover, they argue that lower domestic and higher export prices reflect Russia's comparative advantage in natural gas production and its large share of the world's market. Thus, the Russian government maintains that its dual-pricing practice is not WTO illegal.

What has come out of the Working Party meetings thus far is that, as part of the WTO accession process per se, the Russian government will have to commit to a number of structural reform measures, many of which are already acknowledged as necessary by the government, as noted above. These measures are namely to reform the framework of incentives to foster the restructuring of inefficient and noncompetitive enterprises; lower policy-created barriers to entry; provide for stronger protection of minority shareholder rights and intellectual property rights; accelerate regulatory reform of infrastructure monopolies as well as strengthen incentives for better governance

and transparency; improve the policy regime on FDI; harmonize technical, sanitary, and phytosanitary (ensuring food safety and animal and plant health) standards with WTO strictures; and modernize the customs system and make it more transparent.

Enacting the laws and implementing the administrative regulations needed for these and other structural reforms is a large task for the Russian State Duma. The Duma is drafting or has drafted amendments to more than 40 major laws to conform with WTO standards. Not surprisingly, this process is proving to be easier under Putin than it was under President Boris Yeltsin, all other things being equal, in part because of the broad support Putin enjoys in the Duma. Under Putin's leadership, among other accomplishments, tax rates have been lowered to try to encourage investment; administrative barriers for business registration and licensing have been reduced to attempt to facilitate the market entry of new firms and enhance competition; and judicial system reforms have begun to be implemented.

> The implication of the 1998 crisis is positive: the market's invisible hand works in Russia.

Yet, Russia's accession effort is not progressing as fast as many would like or expect. The process of WTO accession is an inherently time-consuming endeavor, however, for any country. Country applicants must submit detailed information and data for the Working Party on a variety of facets of its economy, including but not limited to characteristics of the economy's various sectors (industrial, agricultural, services, etc.); the size and incidence of subsidies; the attributes of the intellectual property regime; public procurement rules; and the nature and extent of subfederal laws and regulations (which are key to understanding how Russia's economy functions because the regions have much vested political authority). For geographically large economies or those with rudimentary or poorly systemized data systems, such as Russia, this due-diligence task can be a real challenge.

Subsequently identifying changes in legislation and other regulatory requirements necessary to conform the applicant country's legal and institutional framework with WTO standards and the enactment of these measures—discussed above—are also time intensive. In Russia's case, this was particularly true when the relationship between the Duma and the executive was hostile, with Yeltsin legislating through presidential decrees. Although executive-Duma relations have clearly improved under Putin, the policymaking apparatus in Russia, like that in many other post-Soviet countries, remains weak institutionally. Policymakers not just at the federal level but also particularly at the regional level are not familiar with the economic

and legal issues involved in such a complicated endeavor as WTO accession. The transfer of institutional knowledge about WTO practices to policymakers in such countries will necessarily take a long time because many of the issues involved are quite subtle and unfamiliar to an entire generation that has not worked under a market system.

By the same token, WTO accession will be affected by the major political-economy challenges that lie in the structural reform road ahead. As with many nations with transition economies, a web of informal relations and strong vested interests still govern Russia, and the boundaries between the affairs of state and those of business are not sharply drawn nor fully obeyed. Passing such reforms, however challenging, would forcefully state to the international community that Russia is determined to join the rules-based world trading system.

**Russia's accession to the WTO cannot occur without international support.**

Particularly problematic for Russia in this regard are its rather weak institutional mechanisms and incentives for interagency coordination and consensus building, epitomized by the services offer for the WTO's GATS, which requires that line agencies are willing to deregulate their sectors and expose them to cross-border and domestic competitive trade and investment. As with many transition economies, Moscow has no single, powerful honest broker at the ministerial level to serve as the chief trade negotiator like the U.S. trade representative in the United States or trade ministers in many other OECD countries. Wrestling with vested interests represented by line agencies, as well as powerful business lobbies (e.g., in the automobile, agriculture, aluminum, banking, insurance, telecom, and civil aircraft sectors), is thus an exceptionally difficult challenge for Russia precisely because there is no single person or body representing the interests of the country's business as a whole. The result is that, absent a change in the stature of the chief trade negotiator (and accompanying organizational and structural changes), Putin's leadership will be crucial in formulating interagency policy positions and decisions as well as in dealing with the Working Party (or other heads of state) in the accession endgame.

Finally, the actual negotiation phase for accession, especially for large applicant countries such as Russia or China, takes time. Russia must begin to address the commercial interests of all WTO members and formalize these commitments in the final Working Party Protocol (which defines the terms, rights, and responsibilities of a country's WTO membership). This stage, carried out largely in bilateral meetings, has already required protracted negotiations on issues such as energy pricing, with even more intensive negotiations to come as Russia moves further along in the overall accession process.

Three factors that, although not unique to Russia, are certainly magnified in Russia's case exacerbate the aforementioned challenges that largely affect the time typically involved in the accession process. First, the number of officials, businesses, and groups representing consumer interests, not only at senior levels but also more importantly at the staff level where day-to-day procedures are carried out, who are trained in the technicalities of WTO matters is insufficient. The need for the relevant education, especially at the regional and local levels, cannot be overstated. Second and somewhat related to the previous point, conflicts between federal and regional authorities in Russia over the consequences of and who has jurisdiction over liberalization of the country's trade regime are numerous. Third, partly as a result of the time that has passed in Russia's accession process, an opposition of entrenched groups that believe WTO accession will reduce their profits through reduced protection and increased competition has begun to coalesce. To be sure, the short term will see winners and losers, as is the case for most policy changes. The net benefits of WTO accession to the country as a whole, however, are positive. The government must make this case and do so economy-wide. At the same time, it needs to establish mechanisms to help cushion the inevitable transition costs that certain sectors will bear in the short run.

In effect, the lag in Russia's WTO accession is in large part a reflection of the sheer scale and scope of the structural reform policy challenges Russian authorities have been facing since the early 1990s and continue to face today. As even casual observers of Russia know, in the context of the country's political economy, addressing such structural reforms since the transition began has always been difficult as well as something of a moving target. Not surprisingly, an especially difficult environment in which to negotiate an international trade agreement emerges. On the other hand, the recent push for WTO accession by the Russian government reflects the firmest commitment by the country to date finally to face up to key structural reforms. This move reflects the recognition that WTO accession itself will abet the process of structural reform.

## Impacts of WTO Accession on Russia's Economy[15]

In assessing the impact of WTO accession on an economy, examining not only the effects on different sectors and regions but also the effects on labor markets and on social protection, especially of the poor, are critical. Estimating the aggregate or macroeconomic effects of WTO accession, as well as the microeconomic impacts on business sectors, is a first step in that process. The principal results of a recent preliminary study on this question for

Russia are that, in the medium term, the Russian economy will gain about 8 percent of the value of Russian consumption overall from WTO accession and wages are expected to rise.[16] The potential gains are much larger in the long run.

Although the study shows that WTO accession will likely bring gains to some sectors, it may bring losses to others. In particular, the analysis suggests that export-intensive sectors are likely to gain while highly protected domestic sectors that export little are likely to lose. Importantly, workers in business-services sectors will likely gain from FDI even if owners of capital in these sectors lose.[17] This analysis of the impacts of WTO accession rests on three basic economic principles that help predict which sectors will expand and which will contract. First, an economy has a limited amount of labor and capital, so not all sectors can expand in the medium term. If labor and capital expand in some sectors, they must contract in others. Thus, some sectors will contract, or lose, relative to others.

**Providing aid for trade liberalization could facilitate Russia's WTO accession.**

Second and conversely, not all sectors can contract. Some people fear accession to the WTO because they believe that a reduction of tariffs will lead to a surge of imports and, in turn, create widespread unemployment. Yet if unemployment is rampant, how will Russia pay for these imports? Foreigners will demand hard currency for the goods and services they export to Russia, which will necessitate that the Russian economy pay for the increased imports with hard currency. Russia will therefore have to export more to pay for the imports. Tariff reductions will indeed lead to increased demand for imports, but a rise in import demand will increase the demand for hard currency, which in turn will depreciate the real value of the ruble, and a depreciated ruble makes exporting by Russian firms more profitable. Thus, all else being equal, the ruble will depreciate so that Russia can pay for the imports through increased exports; if not, Russia will not be able to import more goods. Increased exports will therefore improve some sectors at the expense of those that are exposed to increased imports.

Third, the value of Russia's industrial output as a nation will expand as a result of the greater openness to trade engendered by accession to the WTO. Although some sectors will contract, the total value of output of all industries (as measured by GDP) and the payments to labor and capital will increase.

The study suggests that four particular effects of WTO accession will bring gains to Russia:

- *Liberalization of barriers to FDI in services.* Russian commitments to multinational service providers will encourage them to increase FDI to supply such services to the Russian market. Russian businesses will therefore have improved access to services in such areas as telecommunications, banking, insurance, and transportation. The cost of doing business should decline, and the productivity of Russian firms should increase. Gains to Russia from the liberalization of barriers to FDI in services are estimated to equal about 5.5 percent of the value of Russian consumption, or almost 70 percent of the total gains to Russia of accession to the WTO.

- *Improved resource allocation from reductions in Russian tariffs.*[18] Reductions in Russian tariffs will improve the allocation of domestic resources because they will induce the country to shift production to sectors where production is valued more highly based on world market prices. This impact, known as gains from trade, is the fundamental effect of trade liberalization. In addition, Russian businesses will be able to import modern technologies more easily, increasing Russian productivity. The study estimates that gains to Russia from reductions in tariffs are likely to be about 2.5 percent of the value of Russian consumption, or nearly 30 percent of the total gains from WTO accession.

- *Enhanced antidumping and countervailing duty rights and improved market access.* Russia has already negotiated most-favored-nation status on a bilateral basis with most of its important trading partners (except for Poland and the Baltic countries), so Russia's exporters will not see an immediate reduction in the tariffs they face and thus not anticipate any large effect. Russia will, however, have improved rights under antidumping and countervailing duty investigations in WTO members' export markets, the source of the estimated improved access to export markets. The gains to Russia from improved market access might equal only about 0.5 percent of the value of Russian consumption, or slightly more than 5 percent of the total gains to Russia from WTO accession.

- *Increased economic growth.* The long-run improvement of the investment climate in Russia should lead to an expansion of the country's capital stock, which could greatly increase gains from the three effects described above. In addition, estimated employment effects of WTO accession across Russia's industrial sectors are of particular interest. Preliminary analysis suggests that the sectors in which employment would increase the most are ferrous metals, nonferrous metals, chemicals, gas, and telecommunications. All but telecommunications are sectors that currently export most intensively and therefore are likely to gain the most from a

decline in the value of the ruble. Ferrous metals, nonferrous metals, and chemicals would likely receive improved treatment in antidumping actions. The sectors in which employment is expected to contract the most are food industry, light industry, construction materials, and machinery and equipment. Tariffs are relatively high in these sectors (the first three are the only sectors with tariffs greater than 10 percent), and exports as a share of output are low compared to the sectors expected to expand (thus they would benefit less from a decline in the real value of the ruble).

Estimating the employment effects on Russia's services sectors is more difficult because uncertainty regarding the extent to which multinational services providers that enter Russia following accession will employ expatriates, as opposed to hiring domestic workers, is greater. Based on the presumption that such uncertainty decreases in sectors with a greater number of highly skilled domestic workers (and that thus employ more Russian than expatriate workers), the study estimates in general that employment expansion in the services sectors will be greatest in telecommunications, transportation, and financial services.

The upshot of this analysis is that effective provision of national treatment to multinational service providers as a result of WTO accession would make improved access to business services the greatest source of gains for Russia because the business-services sectors are relatively highly protected at present.

## Facilitating Integration

Russia's accession to the WTO cannot occur without the support of the international community. As Russia works on meeting its WTO accession requirements so as to achieve membership on "commercial terms," incumbent members must resist the temptation to raise the admissions bar. Providing clear signals and strong support for Russia's continued structural reform efforts through the WTO accession process is not just desirable; it is necessary to ensure that the current domestic reform momentum is maintained and, more crucially, to help the Russian government resist an emerging strong protectionist lobby. Russia's accession to the WTO and its further structural reform are not just in Russia's interest, but also in the world trading community's interest.

One key way that the international community could facilitate Russia's accession is by providing aid for trade liberalization. Experience shows that developing countries have incurred substantial costs in tailoring their laws to meet international standards. For example, Argentina spent more than

an estimated $80 million to meet WTO sanitary standards for its meat and fruits, while Mexico invested more than $30 million to upgrade its intellectual property rights to meet WTO standards. The World Bank estimates that the implementation costs for three of the six Uruguay Round agreements (those on standards, customs valuation, and intellectual property laws) for developing countries as a whole would amount to about $150 million.[19] Harmonizing technical standards and reforming customs, for example, could be especially demanding for Russia. Excluding the costs to commercial enterprises, the administrative costs alone of modernizing Russia's standards system to meet WTO requirements could well exceed $35 million in technical and legal assistance. Substantial assistance for the development of trade-related institutions compliant with WTO rules is thus key for Russia's successful WTO accession and is in everyone's interest.

## Notes

1. See www.wto.org (accessed January 11, 2004). As of April 2003, the WTO had 146 members.
2. International Monetary Fund (IMF), "Staff Report for the Article IV Consultation," April 10, 2003, p. 26, www.imf.org/external/pubs/ft/scr/2003/cr03144.pdf (accessed January 21, 2004).
3. See David Tarr, "Design of Tariff Policy for Russia," in *Russian Trade Policy Reform for WTO Accession*, ed. Harry Broadman (Washington, D.C.: World Bank, 1999).
4. See Harry Broadman and Francesca Recanatini, "Corruption and Policy: Back to the Roots," *Journal of Policy Reform* 5, no. 1 (2002): 37–50.
5. For a more detailed analysis, see Harry Broadman, ed., *Russian Enterprise Reform* (Washington, D.C.: World Bank, 2000).
6. See Chrystia Freeland, *Sale of the Century* (New York: Crown, 2000).
7. Bernard Black, "The Corporate Governance Behavior and Market Value of Russian Firms," *Emerging Markets Review* 2 (2001): 89–108.
8. See Harry Broadman and Francesca Recanatini, "Where Has All the Foreign Investment Gone in Russia?" 2002, http://econ.worldbank.org/files/2319_wps2640.pdf (accessed January 21, 2004) (World Bank working paper).
9. See Harry Broadman and Francesca Recanatini, "Is Russia Restructuring?" *Journal of Corporate Ownership and Control* 1 (2003): 21–32.
10. Harry Broadman, ed., *Unleashing Russia's Business Potential: Lessons from the Regions for Building Market Institutions* (Washington, D.C.: World Bank, 2002).
11. For a provocative account of the events leading up to and immediately following the August 1998 crisis, see Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (New York: PublicAffairs, 2003).
12. See Broadman and Recanatini, "Is Russia Restructuring?"
13. On the issue of pricing of natural gas, see David Tarr and Peter Thomson, "The Merits of Dual Pricing of Russian Natural Gas," July 19, 2003, www.worldbank.org.ru/ECA/Russia.nsf/0/3dadd18177f8a6ddc3256df000294749/$FILE/russian_natural_gas_eng.pdf (accessed January 21, 2004).

14. See Sabrina Tavernise, "Talks on Russian Entry Into WTO Hit Snag," *New York Times*, October 18, 2002, p. A1.
15. This section draws heavily on preliminary analysis in Jesper Jensen, Thomas Rutherford, and David Tarr, "Economy-Wide and Sector Effects of Russia's Accession to the WTO," paper presented at the Ministry of Economic Development and Trade–International Labor Organization conference, Saint Petersburg, Russia, February 21–22, 2003.
16. See ibid.
17. The quantitative analysis employed a computable general equilibrium model of the Russian economy divided into 35 sectors. Primary factors include capital, skilled and unskilled labor, and sector-specific workers. Tariff data and trade data were taken from the Customs Committee of Russia and official publications. Experts on Russia estimated barriers to FDI in key sectors. Although the actual tariff changes remain subject to negotiation, the analysis assumed that tariffs decline by 50 percent across the board, discriminatory taxes on multinational service providers terminate, and seven exporting sectors (chemicals, ferrous metals, nonferrous metals, light industry, food industry, "other" industries, and "other" food producing industries) that have been subject to antidumping duties obtain improved export prices due to improved market access (from 0.5 percent to 1.5 percent).
18. After accounting for exemptions to the tariff, the collected tariff equals about 7 percent of the value of imports.
19. Michael Finger and Philip Schuler, "Implementation of Uruguay Round Commitments: The Development Challenge," 1999 (World Bank working paper).