Russian Trade Policy Reform for WTO Accession

Edited by
Harry G. Broadman
Recent World Bank Discussion Papers

No. 333 Participation in Practice: The Experience of the World Bank and Other Stakeholders. Edited by Jennifer Rietbergen-McCracken
No. 334 Managing Price Risk in the Pakistan Wheat Market. Rashid Faruqee and Jonathan R. Coleman
No. 335 Policy Options for Reform of Chinese State-Owned Enterprises. Edited by Harry G. Broadman
No. 336 Targeted Credit Programs and Rural Poverty in Bangladesh. Shahidur Khandker and Osman H. Chowdhury
No. 337 The Role of Family Planning and Targeted Credit Programs in Demographic Change in Bangladesh. Shahidur R. Khandker and M. Abdul Latif
No. 338 Cost Sharing in the Social Sectors of Sub-Saharan Africa: Impact on the Poor. Arvil Van Adams and Teresa Hartnett
No. 339 Public and Private Roles in Health: Theory and Financing Patterns. Philip Musgrove
No. 340 Developing the Nonfarm Sector in Bangladesh: Lessons from Other Asian Countries. Shahid Yusuf and Praveen Kumar
No. 341 Beyond Privatization: The Second Wave of Telecommunications Reforms in Mexico. Bjorn Wellenius and Gregory Staple
No. 342 Economic Integration and Trade Liberalization in Southern Africa: Is There a Role for South Africa? Merle Holden
No. 343 Financing Private Infrastructure in Developing Countries. David Ferreira and Karman Khatami
No. 344 Transport and the Village: Findings from African Village-Level Travel and Transport Surveys and Related Studies. Ian Barwell
No. 345 On the Road to EU Accession: Financial Sector Development in Central Europe. Michael S. Borish, Wei Ding, and Michel Noél
No. 346 Structural Aspects of Manufacturing in Sub-Saharan Africa: Findings from a Seven Country Enterprise Survey. Tyler Biggs and Pradeep Srivastava
No. 347 Health Reform in Africa: Lessons from Sierra Leone. Bruce Siegel, David Peters, and Sheku Kamara
No. 348 Did External Barriers Cause the Marginalization of Sub-Saharan Africa in World Trade? Azita Amjadi Ulrich Reincke, and Alexander J. Yeats
No. 350 Who Benefits from Public Education Spending in Malawi: Results from the Recent Education Reform. Florencia Castro-Leal
No. 351 From Universal Food Subsidies to a Self-Targeted Program: A Case Study in Tunisian Reform. Laura Tuck and Kathy Lindert
No. 353 Telecommunications Policies for Sub-Saharan Africa. Mohammad A. Mustafa, Bruce Laidlaw, and Mark Brand
No. 354 Saving across the World: Puzzles and Policies. Klaus Schmidt-Hebbel and Luis Servén
No. 355 Agriculture and German Reunification. Ulrich E. Koester and Karen M. Brooks
No. 356 Evaluating Health Projects: Lessons from the Literature. Susan Stout, Alison Evans, Janet Nassim, and Laura Raney, with substantial contributions from Rudolpho Bulatao, Varun Gauri, and Timothy Johnston
No. 357 Innovations and Risk Taking: The Engine of Reform in Local Government in Latin America and the Caribbean. Tim Campbell
No. 358 China's Non-Bank Financial Institutions: Trust and Investment Companies. Anjali Kumar, Nicholas Lardy, William Albrecht, Terry Chuppe, Susan Selwyn, Paula Perttunen, and Tao Zhang
No. 359 The Demand for Oil Products in Developing Countries. Dermot Gately and Shane S. Streifel
No. 361 China: Power Sector Regulation in a Socialist Market Economy. Edited by Shao Shiwei, Lu Zhengyong, Norreddine Berrah, Bernard Tenenbaum, and Zhao Jianping
No. 362 The Regulation of Non-Bank Financial Institutions: The United States, the European Union, and Other Countries. Edited by Anjali Kumar with contributions by Terry Chuppe and Paula Perttunen
No. 363 Fostering Sustainable Development: The Sector Investment Program. Nwanze Okidegbe
No. 364 Intensified Systems of Farming in the Tropics and Subtropics. J.A. Nicholas Wallis

(Continued on the inside back cover)
Russian Trade Policy
Reform for WTO Accession

Edited by
Harry G. Broadman

The World Bank
Washington, D.C.
Discussion Papers present results of country analysis or research that are circulated to encourage
discussion and comment within the development community. The typescript of this paper therefore has
not been prepared in accordance with the procedures appropriate to formal printed texts, and the World
Bank accepts no responsibility for errors. Some sources cited in this paper may be informal documents
that are not readily available.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s)
and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to mem-
bers of its Board of Executive Directors or the countries they represent. The World Bank does not guaran-
tee the accuracy of the data included in this publication and accepts no responsibility for any consequence
of their use. The boundaries, colors, denominations, and other information shown on any map in this vol-
ume do not imply on the part of the World Bank Group any judgment on the legal status of any territory
or the endorsement or acceptance of such boundaries.

The material in this publication is copyrighted. Requests for permission to reproduce portions of it
should be sent to the Office of the Publisher at the address shown in the copyright notice above. The
World Bank encourages dissemination of its work and will normally give permission promptly and, when
the reproduction is for noncommercial purposes, without asking a fee. Permission to copy portions for
classroom use is granted through the Copyright Clearance Center, Inc., Suite 910, 222 Rosewood Drive,
Danvers, Massachusetts 01923, U.S.A.

ISSN: 0259-210X

Cover photo: “Russian Shipyard.”

Harry G. Broadman is principal economist and program team leader for Russia operations in the World
Bank’s Europe and Central Asia Regional Office.

Library of Congress Cataloging-in-Publication Data

Russian trade policy reform for WTO accession / edited by Harry G.
Broadman.
   p. cm. — (World Bank discussion paper ; no. 401)
   Includes bibliographical references.
   ISBN 0-8213-4406-4
1. Russia (Federation)—Commercial policy. 2. World Trade
Organization—Russia (Federation). I. Broadman, Harry G.
II. Series: World Bank discussion papers ; 401.
HF1558.2.R87  1998
382'.3'0947—dc21     98-51347
92-76205 CIP
# CONTENTS

<table>
<thead>
<tr>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>v</td>
</tr>
<tr>
<td>Abstract</td>
<td>vi</td>
</tr>
<tr>
<td>Overview</td>
<td>1</td>
</tr>
<tr>
<td><em>Harry G. Broadman</em></td>
<td></td>
</tr>
<tr>
<td>Design of Tariff Policy for Russia</td>
<td>7</td>
</tr>
<tr>
<td><em>David Tarr</em></td>
<td></td>
</tr>
<tr>
<td>Russia and the “General Agreement on Trade in Services” (GATS)</td>
<td>31</td>
</tr>
<tr>
<td><em>Murray G. Smith</em></td>
<td></td>
</tr>
<tr>
<td>State Trading in Russia</td>
<td>51</td>
</tr>
<tr>
<td><em>Vladimir Drebentsov and Costas Michalopolous</em></td>
<td></td>
</tr>
<tr>
<td>Improving Russia’s Foreign Direct Investment Policy Regime</td>
<td>65</td>
</tr>
<tr>
<td><em>Joel Bergsman, Harry G. Broadman, Vladimir Drebentsov</em></td>
<td></td>
</tr>
</tbody>
</table>
FOREWORD

Following the breakup of the Soviet Union, the Russian authorities recognized that in order to convert to a market economy and propel growth it was necessary to integrate the country's markets with the international trading community. This realization led to efforts to liberalize foreign trade. These efforts have been one of the highlights of Russia's economic reform since 1992. Russian tariffs have been significantly lowered, quotas reduced and import trade subsidies diminished. But the government still faces enormous challenges in providing balanced incentives to its import competing and export industries, introducing efficiency and competition in its services sectors, and attracting new foreign direct investment and technology.

Since 1993 Russia has manifested considerable interest in membership in the GATT and in accession to the World Trade Organization (WTO)—the successor to the GATT that formally came into being in 1995 following the Uruguay Round. Bringing the Russian Federation into the rules-based WTO system is an objective broadly shared by the world community. Accession to the WTO comes at a critical juncture for the Russian government to focus on many important policy issues to stimulate growth. As part of the process of making liberalization commitments that Russia will be required to have by the existing members of the WTO, accession provides an opportunity to lock-in reforms.

As part of the World Bank's policy dialogue with the Russian authorities on structural reforms, the Bank undertook a project, managed by Harry Broadman, which focuses on four of the most important topics that have attracted much attention during the ongoing WTO accession process: (i) the dispersion of Russia's tariff structure; (ii) trade and investment in the services sectors; (iii) the treatment of state-trading enterprises; and (iv) the policy regime governing foreign direct investment. This volume contains policy papers on each of these issues.

The World Bank has been involved in assisting many transition economies in reforming their trade and investment regimes. In publishing this volume we very much hope it proves to be helpful to policy-makers in Russia and to the international community that focuses on Russian affairs and economic transition.

Michael F. Carter
Country Director for Russia
Resident Representative in Moscow
ABSTRACT

Since 1993 Russia has manifested considerable interest in membership in the GATT and in accession to the World Trade Organization (WTO)—the successor to the GATT that formally came into being in 1995 following the Uruguay Round. Bringing the Russian Federation into the rules-based WTO system is an objective broadly shared by the world community. Accession to the WTO comes at a critical juncture for the Russian government to focus on many important policy issues to stimulate growth. As part of the process of making liberalization commitments that Russia will be required to have by the existing members of the WTO, accession provides an opportunity to lock-in reforms. This volume contains four policy papers that focus on four of the most important topics that have attracted much attention during the ongoing WTO accession process: (i) the dispersion of Russia's tariff structure; (ii) trade and investment in the services sectors; (iii) the treatment of state-trading enterprises; and (iv) the policy regime governing foreign direct investment.
OVERVIEW

Harry G. Broadman*

Introduction

For the last few years Russia’s authorities have been in the process of negotiating accession to the World Trade Organization (WTO), which was founded in 1995 as the successor to the GATT. Accession to the rules-based WTO comes at a critical juncture for the fragile Russian economy as the government focuses on policies to stimulate growth. As part of the process of forging agreements to liberalize its trade policy regime that Russia will be required to commit to by the existing members of the WTO, accession provides an opportunity to lock-in hard-won economic reforms and engender new ones.

Efforts to liberalize foreign trade have been one of the highlights of Russia’s economic reform since 1992. Indeed, early on in the reform process the authorities adopted the view that following the breakup of the Soviet Union, growth would be spurred on with greater integration with the world marketplace. The result is that tariffs have been significantly lowered, quotas reduced and import trade subsidies diminished. But the government still face enormous challenges in providing balanced incentives to the country’s import competing and export industries, introducing efficiency and competition in its services sectors, and attracting new foreign direct investment and technology.

There are admittedly many points of debate surrounding Russia’s WTO accession negotiations. Most of these are generic to all transition economies that have sought or are still seeking membership in the WTO. Four important questions have attracted much attention in the case of Russia.

- *The Dispersion of the Tariff Structure:* There is great variability in the structure of Russian tariffs. What is the scope for increasing tariff uniformity within the process of Russia’s WTO accession and what are the benefits and costs of doing so?

- *Trade and Investment in the Services Sectors:* Under the WTO, the world trading system for the first time incorporates international rules regarding trade and investment in the services sectors—a wide range of activities including banking, insurance, accounting, telecommunications, construction, aviation, legal services, ports, among others. Within the context of the GATS (General Agreement on Trade in Services) framework, how can Russia best position itself to foster the development of these dynamic industries?

* Harry Broadman is Principal Economist and Program Team Leader for Russia Operations, The World Bank.
Overview

- **WTO Treatment of State-Trading Entities**: State trading organizations dominated international trade under central planning. Today in Russia, trade is increasingly conducted by private firms and the role of state trading has shrunk considerably. How much state trading still occurs in Russia and, within the context of WTO accession, how different are the trading practices of these entities compared to those found in incumbent WTO members?

- **Reform of the Policy Regime Governing Foreign Direct Investment**: In today’s globalized marketplace, countries compete against one another for attracting flows of foreign direct investment (FDI), and trade and foreign direct investment are increasingly seen as complements in spurring growth. How does Russia’s FDI policy regime compare with international best practice, and what reforms are needed?

As part of the World Bank’s policy dialogue with the Russian authorities on the structural reform program, the Bank undertook to write four papers that address these questions. This monograph contains these papers. In this chapter, the main points of the four papers are briefly summarized.

Summaries

**Design of Tariff Policy**

*David Tarr’s* paper is predicated on the notion that an effective tariff policy is central to the integration of Russia in the international economic system. He notes that tariffs are, with very few exceptions, the only acceptable policy tool for protection under the GATT/WTO. Moreover, they are superior to alternative instruments of protection, such as quotas, licenses and technical barriers to trade. Today’s Russian tariffs average 13%-14%, with ad valorem maximum tariffs of 30% but with some specific tariffs that have ad valorem tariff equivalents higher than 30%.

The analysis in Tarr’s paper strongly suggests that there is little economic justification and there are many dangers in providing differentiated tariff protection to various sectors of industry and agriculture in Russia today. Most of the arguments in which tariffs differentiated by product are the optimal policy intervention are of little practical significance. There are few products in which Russia has monopsony power or industries in which it can gain advantage through "strategic" application of tariffs.

In many circumstances where tariffs are second best policy instruments, such as to raise public revenue or to cope with balance of payments problems, Tarr argues that a uniform tariff rate is the most practical and efficient alternative. Where Russia may be interested in using the tariff as a bargaining instrument in multilateral negotiations, it is immaterial whether the tariff is uniform or differentiated -- the issues have to do with its capacity to use the tariff as a bargaining instrument and what it bargains for. Differentiated tariff protection in support of infant or
Restructuring industries is typically ineffective at addressing the alleged market failure problem. Indeed, governments are not very good at picking winners and there are serious dangers that the policy would be overwhelmed by requests for protection from vested interests irrespective of its economic merits.

Tarr postulates that a uniform tariff conveys a number of advantages, the most important of which is that if the tariff is uniform, the gains to industry lobbying are much smaller (and may be negative), creating a free-rider problem for lobbyists and dramatically reducing the incentive to promote protection. The result is that (i) the level of protection is likely to be lower; (ii) there is a direct saving of resources from reduced lobbying; (iii) the reduction to the gains from lobbying for protection provides a vastly improved incentives for entrepreneurship, leading to better and cheaper products; and (iv) the reduction in resources devoted to lobbying will result in less corruption in government, which may have positive spillover effects into other dimensions of government activity.

Tarr concludes his paper with several policy recommendations. Russia should eliminate technical barriers to trade so that protection is only by tariffs. Maximum tariff rates should be sequentially reduced such that the maximum rate is 10% by 2001. At the same time, the low rates should be reduced so the minimum is 10% by 2001 and exemptions should be eliminated except to provide duty free access to imported inputs used in exports. He also calls for specific tariffs to be reduced and eliminated in order to improve transparency. Finally, he suggests that Russia should bind its WTO tariff rates closer to applied rates.

**Services Trade and Investment**

The legal and policy framework provided by the WTO’s General Agreement on Trade in Services (GATS) offers a blueprint for reform of the services sectors in the Russian economy. In his paper, Murray Smith emphasizes that participation in the GATS is essential for Russia’s accession to the WTO. But notwithstanding that requirement, there are compelling reasons for Russia to implement a sound regulatory regime for the services sectors that is compatible with the GATS framework. Put differently, because the GATS provides the openness, transparency and predictability for international trade and investment in services that is crucial for economic growth in Russia, WTO accession will help in lock in reform of the Russian services policy regime. Foreign competition for services in the Russian economy will stimulate the development of Russian services enterprises and foster specialized skills and knowledge in the Russian labor force.

Smith argues that Russia will need to take a comprehensive approach to the implementation of commitments under the GATS in order to ensure that regional governments will be obliged to meet GATS rules and obligations. This will contribute greatly to economic integration within the Russian Federation. In a similar manner, meeting the requirements of GATS for regional agreements, will require greater integration among CIS countries. Since CIS partners are also seeking to accede to the WTO, participation in GATS will deepen integration within the CIS.
In key services sectors, especially financial services and telecommunications, Smith stresses that Russia needs to develop strategies for policy reform and to announce clear timetables to open these sectors to international competition. While such sectoral liberalization strategies need to be commenced now, their implementation can be phased in over several years. Committing to the schedules of sectoral liberalization in the GATS will make these policies credible and stimulate investment by domestic and foreign firms.

In Smith's view, Russia could complete WTO accession negotiations within two years, but this would require that the government places a much higher priority on the negotiations and that the necessary implementing legislation is passed by the Duma. Since it is likely that a major negotiation under the GATS will start within two years, with the result that the “price” of GATS admission will only rise, Russia has an additional incentive to complete the accession to the WTO before these new negotiations are engaged. In this context, if Russia wishes to complete the WTO accession negotiations within two years, then Smith believes the authorities must be prepared to: (i) assign a high priority to the GATS negotiations and allocate sufficient staff and financial resources to the team charged with coordinating the negotiations; (ii) address difficult policy issues such as clarification of the property rights regime; (iii) commit to market access for, and national treatment of, foreign service providers in most services industries, either immediately or after a phase-out period; (iv) commit to a clear timetable for liberalization of key services industries; and (v) implement these commitments in legislation which will bind regional governments.

State Trading

Vladimir Drebentsov's and Costas Michalopoulos's paper examines the evolving role of state trading in Russia. They note that whereas state trading entities dominated international trade under central planning, in today's Russia (and most other economies in transition), trade is primarily conducted by private firms. They argue that past experience with notifications of GATT members under Article XVII offers little clarification on the meaning of state trading enterprises (STEs). Over the period 1980-1994 few countries bothered to notify the existence of such enterprises. In fact most notifications came from developed countries. In an effort to clarify what enterprises should be classified as STEs, a working definition was agreed during the "Understanding" negotiated in the Uruguay Round as: "Government and non-governmental enterprises, including marketing boards, which have been granted special rights or privileges, including statutory or constitutional powers in the exercise of which they influence through their purchases or sales the level or direction of imports or exports."

How much state trading goes on in Russia today, is of importance both with respect to Russia's accession to the WTO—and in particular regarding the enforcement of GATT Article XVII—as well as in the context of the treatment that Russian exporters receive in major international markets. Russia inherited a complex system of centralized exports and imports implemented through a number of specialized state trading firms, so called foreign trade organizations (FTOs), which exercised a foreign trade monopoly for the state in the Soviet era.
Drebentsov and Michalopolous argue that over time, privatization has reduced the role of the FTOs. But elements of state trading remain in three main areas: (a) Companies which either are fully state owned or state controlled which exercise monopoly in the export trade of their respective products (e.g., natural gas, diamonds, pipelines); (b) companies engaging in barter trade with other CIS or centrally planned economies; (c) other companies whether FTOs or not which do not have monopoly positions but may enjoy certain privileges or advantages in trade. They estimate that about 11% and perhaps as much as 20% trade is still controlled by the state.

The authors contend that problem is not so much the absolute size of the share, which predominantly involves exports of energy and a few raw materials. It is the lack of transparency in the relations between the state and enterprises engaged in international trade, whether formally privatized or not. While this problem is, unfortunately, not limited to firms involved in trade, the system is especially opaque in trade with the other CIS and a few centrally planned economies. The problem is compounded by a general weakness in governance that results in weak enforcement of announced government policies.

Drebentsov and Michalopolous believe that for Russia's to successfully gain accession to the WTO the government needs to take urgent steps to clarify the status and privileges of a number of firms engaged in international trade (FTOs and some others) and provide appropriate explanations to the WTO working party dealing with Russia's accession, and express readiness to notify it of the status of state trading even prior to completing accession process. Otherwise, the process could be significantly delayed. They stress that the government should make all efforts to accelerate market reforms and minimize state trading activities within the meaning of Article XVII of the GATT and otherwise. Particular emphasis should be placed in: (a) reducing the role of monopolies in state trading, through bona fide privatization and elimination of barriers to entry created through special privileges accorded to individual companies; (b) creating transparent relations between the state and individual companies of agencies that enjoy special privileges that are notifiable under Article XVII of the GATT; (c) take steps to immediately and effectively terminate the state trading aspects of the intergovernmental agreements—as called for by existing policy. Such policies would be both beneficial to its economy and expedite accession to the WTO.

Foreign Direct Investment

As the paper by Joel Bergsman, Harry Broadman and Vladimir Drebentsov emphasizes, foreign direct investment (FDI) is crucial for Russia's economic growth. As the much-discussed "global market" has become a reality over the last ten years, all countries—developing and developed alike—find it difficult to stay competitive without inflows of foreign direct investment. FDI brings to host countries not only capital, productive facilities, and technology transfers, but also employment, new job skills and management expertise. These ingredients are particularly important in the case of Russia today, where the pressure for firms to compete with each other remains low. With blunted incentives to become efficient, due to inter-regional barriers to trade, weak exercise of creditor rights and administrative barriers to new entrants—including foreign invested firms—Russian enterprises are still in the early stages of restructuring.
Bergsman, Broadman and Drebentsov cite empirical evidence that suggests that, for emerging economies, a one percentage point increase in FDI (measured as a proportion of GDP) leads, *ceteris paribus*, to an extra 0.8 percentage point increase in per-capita income. They argue that more and more countries are becoming increasingly open not only to trade flows (e.g., lower tariffs and fewer quantitative restrictions), but also to FDI flows (e.g., fewer restrictions on which sectors are open or percentage of foreign ownership allowed and abandonment of case-by-case approval procedures). Multinational corporations (MNCs) today locate important facilities where there are market-friendly policies. What MNCs are looking for is a set of policies that simultaneously provide security of market access and nondiscrimination vis-à-vis domestic investors. They stress that partially beneficial policies are no longer appropriate.

In the view of Bergsman, Broadman and Drebentsov, the policy regime governing FDI in the Russian Federation is still characterized by the old paradigm of FDI, established before the Second World War and seen all over the world during the 1950s and 1960s. In this paradigm there are essentially only two motivations for foreign direct investment: access to inputs for production, and access to markets for outputs. These kinds of FDI are useful, but often based either on exports that exploit cheap labor or natural resources, or else aimed at protected local markets and not necessarily at world standards for price and quality. The fact is that Russia is getting relatively small amounts of these types of FDI, and almost none of the newer, more efficient kind—characterized by state-of-the-art technology and world-class competitive production linked to dynamic global (or regional) markets.

Bergsman, Broadman and Drebentsov recommend that the Russian authorities phase out simultaneously three core pillars of the current FDI policy regime -- (i) all existing high tariffs and non-tariff protection for the domestic market; (ii) tax preferences for foreign investors (including those offered in Special Economic Zones), which bring few benefits (in terms of increased FDI) but engender costs (in terms of foregone fiscal revenue); and (iii) existing restrictions on FDI to a limited number of sectors and activities. This set of reforms would allow Russia to switch to a modern approach towards FDI. Moreover, the authors suggest the following policies: (i) vetoing the recently amended FDI law; (ii) abolishing conditions that are inconsistent with the agreement on trade-related investment measures (TRIMs) of the WTO, such as local content restrictions; (iii) “National Treatment” should be adhered to both for right of establishment and for post-establishment operations; (iv) enforcement of property rights should be strengthened; (v) investor-State dispute resolution mechanisms should be made more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration; (vi) foreign investor registration procedures should be simplified, rules-based, and made transparent; and (vii) guarantee schemes covering basic non-commercial risks should be maintained and extended.
DESIGN OF TARIFF POLICY FOR RUSSIA

David Tarr

The Benefits of an Open Trade Regime for Russia

Worldwide experience in the last 50 years demonstrates the benefits of open trade regimes: the OECD countries brought trade barriers down through successive WTO negotiations and experienced sustained growth in trade and incomes. Many developing countries governments initially felt differently and attempted to promote industrialization behind high protective barriers. But in the last ten years or so, the balance of opinion has shifted in these countries as well, as evidence accumulated that high rates of protection significantly depress economic development, and that open trade regimes are more conducive to growth. Moreover, virtually all recent development success stories have been based on strong industrial export growth and relatively low barriers to imports—Chile, Hong Kong, Malaysia, Mauritius, and Singapore—or continually falling barriers—the Republic of Korea and Taiwan (China). Industrial sectors in these economies not only have higher export growth but generate more employment as well; and trade reforms have usually been accompanied by increased flows of foreign investment.

An effective trade policy is central to the integration of Russia in the international economic system and the growth that will generate: It provides the links with the international markets, and, together with the exchange rate, it forms the transmission mechanism through which international trade affects domestic resource allocation, the efficient and competitive restructuring of industry and agriculture, access to new and diverse technologies, improved incentives to exporters, and reduction of smuggling, rent-seeking and corruption in customs.

Tariff policy is the centerpiece of trade policy in a market system. Tariffs are, with very few exceptions, the only acceptable policy tool for protection under the GATT/WTO; and they are superior to alternative instruments of protection, such as non-tariff barriers (NTBs) like

---

* David Tarr is Lead Economist, Development Research Group, The World Bank. I would like to thank Constantine Michalopoulos for his extensive contributions to this paper, Vladimir Drebentsov and Oksana Chernukha for the analysis of the Russian tariff structure in the paper and Harry Broadman for comments and direction.

1 Sachs and Warner in a recent article (1995) have estimated that open economies have grown about one percent per year faster than closed economies, and that the difference is greater among developing countries. For a review of the extensive literature on the link between open trade regimes and economic growth see Edwards (1993). See also Dollar (1992).
quotas, licenses and technical barriers to trade (TBTs), because they are less likely to lead to rent seeking and corrupt practices, and because tariffs limit the exercise of domestic monopoly power where it exists whereas NTBs do not.3

Russia's tariff regime has evolved over time without any explicit objectives or a strategic vision. In the aftermath of the breakup of the Soviet Union and central planning, consistent with the government's general desire to promote greater contacts with the international market, tariff barriers were not set high (Konovalov, 1994; Glaziev, 1994; Gros, 1994). Domestic industry and agriculture did not face significant competition from abroad however, because of the large undervaluation of the ruble. As the ruble appreciated in real terms, the pressure of international competition on domestic producers increased, as did their pressure on the government to raise tariffs and protection in general. The result of these conflicting pressures is today's Russian tariff which averages 13%-14%,4 but which is rather diverse with maximum ad valorem tariffs of 30%, but with some specific tariffs that have ad valorem tariff equivalents higher than 30%.

This paper examines the arguments for and against a uniform tariff structure in the Russian context. Arguments against uniformity are: terms of trade; “strategic,” infant or restructuring industry considerations, revenue or balance of payments purposes, and tariffs as a negotiating tool at the WTO. Arguments in favor of uniformity are: political economy considerations; administrative convenience; and reduction of smuggling and corruption in customs. We maintain that tariff uniformity is clearly the best choice and develop a set of strategic guidelines which could help Russian policy makers in the design of future tariff policy.

Arguments for Tariffs and for Non-Uniform Tariffs

There are several arguments in favor of government intervention through tariffs. Some of these arguments support tariffs as first best policies and if these arguments are accepted would call for non-uniform tariffs. These include tariffs: (a) to exploit a monopsony position and thereby improve the terms-of-trade; and (b) to maximize benefits from a "strategic" application of protection. Often governments wish to pursue other objectives than the pursuit of real income5 or there may be constraints on the use of the first best instruments to achieve those objectives. Other objectives that call for the use of tariffs include: (c) as instruments for temporary protection of a specific "infant" or restructuring industry; (d) to raise budgetary revenue; (e) to reduce imports because of balance of payments problems; and (f) as bargaining tools to extract

---

2 It is the intention of the Government of Russia to reduce TBTs by reducing the number of goods subject to mandatory certification, by simplifying certification procedures, and by harmonization of Russian standards in priority sectors with internationally accepted ones.

3 See, for example, Bhagwati (1965) and Takacs (1978).

4 This excludes the temporary 3% tariff surcharge.

5 The precise technical term employed by economists is economic welfare. Real income and economic welfare will be used interchangeably in this paper.
concessions from trading partners. First best policies in the pursuit of objectives c, d and e include, respectively, subsidies, indirect taxes, and devaluation and other macroeconomic policies. When the first best policies are not available, we argue below that low and uniform tariffs are preferred to a high and varied tariff structure.

**Tariffs to Exploit Monopsony Power.** One generally accepted theoretical reason for a country to impose tariffs on individual products is in order to exploit its monopsony power and thereby improve its terms-of-trade. If a country is large enough that it imports a significant share of the world’s supply of a particular product, a tariff on that product could lower the price it must pay to world suppliers, which would improve its terms-of-trade. Consistent with this argument, the government could impose tariffs at different levels on different products to exploit the monopsony power it possesses; and the "optimal" tariff on each product would be different.

While this theoretical argument is valid, in practice, one can think of very few products where Russia possesses sufficient monopsony power for this to be a relevant consideration. Even in cases where countries have attempted to impose tariffs based on this rationale, the tariffs have been typically quite small (1-10%) because the share of world imports must be large for them to be large. Then, the actual tariffs in Russia are typically larger than the values optimal tariffs could reasonably be expected to take. For all practical purposes, tariff policy in Russia can be established without reference to this basically theoretical issue.

**Tariffs to Gain Strategic Advantage.** In recent years, a number of arguments have been developed justifying tariffs based on strategic considerations in industries with excess profits that are highly concentrated on a global basis. Among others, Brander and Spencer (1985) developed models that showed that in the presence on an international oligopoly, tariffs could increase a country’s welfare by enabling excess profits to be shifted from foreign to domestic firms. Another argument, for example by Krugman (1992), showed that given the existence of increasing returns to scale in the firm, protection to allow domestic firms to gain initial competitive advantage at the expense of foreign firms could be reinforced by internal economies of scale and would allow domestic firms to appropriate excess profits.

Despite its popularity among theorists in the 1980s, today strategic trade theory is not regarded as a significant policy choice. First, there is doubt whether excess profits really exist (except in the very short term) in many industries worldwide, and are not easily dissipated by new entrants or utilization of excess capacity. It has been shown by Eaton and Grossman (1986) that the policy conclusions of strategic trade policy models are completely reversed based on assumptions about which little is known. For example, whether firms compete in prices or quantities will reverse the optimal policy conclusion from subsidizing an industry to taxing the

---

4 Income distribution objectives would call for higher tariffs on products with higher luxury content. Income taxes would be best for the purpose of income redistribution, but might not be available. Thus use of tariffs for income distribution purposes entails efficiency and growth losses. Commodity taxation, like a sales tax which does not discriminate by source, would also involve less efficiency loss that tariffs.
industry. Finally, one of the principal authors of this literature has concluded that the risks of following strategic trade theory far outweigh the possible gains (Krugman, 1989, 1992), since a country might make small gains in some circumstances, but it is more likely to be misapplied and lead to large losses.

On balance, it would appear that this argument for differentiated tariffs would be even less applicable to a country like Russia, which seldom has any manufacturing firms competing oligopolistically in international markets with excess profits.\footnote{Russia does have significant world market share in platinum, nickel and diamonds, the latter of which is characterized by oligopoly internationally.}

**Infant Industry and Restructuring Protection.** The use of tariffs to effect welfare improvements over the longer run has been defended most often on *infant industry* grounds. The infant industry argument posits that certain industries are initially uneconomic but may become competitive (at world prices) in the long run because costs may decrease over time by virtue of learning-by-doing effects. Market failures, due to gains that are external to the firm, may prevent the development of such industries which exhibit positive discounted present values. For example, a firm may be unwilling to invest in technical know-how which may become freely available to other firms, i.e., the activities of an individual firm could generate externalities not capturable by the firm. (If there were no externalities the firm would be willing to make the investments and there would not be any need to depart from laissez-faire policy.)

Similar arguments have been made in the context of economies in transition where it is argued that if some firms which are in the process of *restructuring* are given protection for a time, they will be able to increase their productivity and become viable in the longer term. A firm may be faced with imperfections in its markets for inputs which raise its costs-- e.g because of an inefficient banking sector prevents from getting credit.

It is argued that temporary tariffs may be necessary to protect these infant and restructuring industries so they can generate benefits for the economy as a whole. Under the infant industry argument for protection, the optimum tariff structure would not normally be uniform, because protection would be accorded only to specific industries affected by market failure or externalities, and protection would not be warranted for other industries.

As Baldwin (1969) has explained, however, a tariff will not typically address the market failure problem so it is not better than laissez-faire policy. Consider, for example, the case of the inability of the firm to appropriate the gains from investment in technical know-how.

A duty raises the domestic price of a product, and from the viewpoint of the domestic industry as a whole, makes some investments in knowledge more profitable. But the individual entrepreneur still faces the same externality problem as before, namely, the risk that other firms in the same industry will copy, without cost to themselves,
any new technology discovered by the firm and will then drive the product's price or factor prices to levels at which the initial firm will be unable to recover the costs of acquiring knowledge [Baldwin (1969, p. 298)].

Thus, a tariff does not correct the problem. Indeed, it has been shown more generally that the best intervention is a policy that attacks the problem at the source (Bhagwati and Srinivasan, 1969). In this case, appropriate interventions directed at the source of the distortion, which could be imperfect appropriability, labor turnover, or capital market imperfections, are not tariffs, but rather measures such as the provision of information, patent protection or more effective use of instruments to allow collateral.  

Sometimes a government may argue that the whole manufacturing sector is an infant. Although protection is unlikely the appropriate response, if any protection is offered for this purpose, a uniform tariff would be called for, not a diverse structure.

At the practical level, the arguments for a diverse tariff structure rest on the ability of governments to: (i) “pick the winners,” that is to identify the candidates that are most likely meet the conditions justifying intervention, and choose and maintain the appropriate level for the policy variable (tariff, subsidy); (ii) be immune to the pressures from vested groups that inevitably arise once the willingness to grant special status is established; and (iii) prevent any protection granted from becoming permanent. The empirical evidence in both developed and developing countries during the past three decades casts doubt on most governments’ ability to meet these conditions. Endorsement of a more general approach—with little differentiation in the level of assistance—thus emanates from a wider skepticism about the practical merits of targeting of any kind, see Westphal (1990) and Krugman (1989, 1992).

Revenue Considerations. Trade taxes are not optimal instruments to achieve a revenue objective because they significantly distort production and consumption choices. Preferred instruments to raise revenue are taxes such as income taxes or commodity taxes (excise, VAT, etc.). These are preferred taxes because, since they are applied neutrally to domestically produced and imported goods, they impose less distortion or inefficiency costs. The use of tariffs to raise revenue presupposes that other trade-neutral tax instruments are not available or cannot be used beyond existing levels; in other words, domestic taxes have to be taken as given either because the tax base cannot be enlarged rapidly enough or the marginal costs of increased domestic tax collection are very high (Corden, 1974; Balassa, 1989; and Mitra, 1992).

[8] For a similar view see Krueger, 1984. If for purely political, rather than economic reasons, a government wishes to achieve a minimum output level in a given industry, the best intervention is a production subsidy, since it avoids the consumption distortion costs of the tariff. A production subsidy also has the advantage that it gears the infant industry to attain international competitiveness by avoiding discrimination between sales to the domestic and export market.
It could be argued that given the state of public finances and tax collection in Russia today, a case can be made for using tariffs as a source public revenue. In this case then, should the tariff be diverse or uniform?

One of the best known arguments for a non-uniform structure is the inverse elasticity rule. If the economy is characterized by only final goods (and ignoring rent-seeking, administrative and smuggling costs), the most efficient way to generate the tax revenue is to impose higher tariffs on the goods with the lower elasticity of demand (Ramsey, 1927). This causes the least distortion since it diverts the least resources. The simplicity of this rule has appeal to theoretical economists. The rule becomes exceedingly complex, however, in practice due substitution effects between goods, the presence of intermediate goods and goods that cannot effectively be taxed. Application then requires not just the own elasticities, but a complete set of cross-elasticities of demand, including the substitution elasticities with untaxed goods such as household leisure and underground economy goods. In practice this information is never available for a system such as the Russian tariff structure, so information requirements make the application of Ramsey type rules impractical, and we know of no country that has actually tried to implement them.

A still more important reason to avoid Ramsey type rules for diverse tariffs, is that political lobbying will develop that will lead to the application of tariffs that will differ from uniformity in economically inefficient ways. We return to the lobbying argument below.

**Balance of Payments Considerations.** Tariffs are sometimes employed to deal with a balance of payments problem. Again, they are not the best instrument. A balance of payments problem is a macroeconomic problem. Then, as discussed above, the optimal response is to attack the problem directly through macroeconomic tools, i.e., a combination of actions to reduce domestic spending (expenditure reduction) and policies that encourage exports and discourage imports (expenditure switching). Expenditure reduction can be accomplished through fiscal or monetary tightening, which reduces domestic absorption for any given level of output. Expenditure switching, which is best accomplished through a depreciation of the real exchange rate, raises the domestic price of tradables relative to non-tradables thereby encouraging exports and discouraging imports. Across-the-board import surcharges are often applied for balance of payments reasons; this achieves the same impact on reducing imports as exchange rate depreciation, but it fails to achieve the beneficial effects on the export side. The optimal tariff structure, given that it is a surrogate for a devaluation (without export incentives), must be uniform inducing resources to flow into import competing industries in general rather than any particular import competing industry.

---

9 All the own and cross-elasticities of the Slutsky substitution matrix are required; given its symmetry, the number of elasticities equals $n(n-1)/2 + n$, where $n$ equals the number of tariff lines (see Atkinson and Stiglitz, 1980). If there are 1000 tariff lines (and the Russian system contains more than this), the required own and cross-elasticities to calculate the optimal tariffs exceeds 500,000. This is an impossibly large number since even for much smaller systems, approximation rather than estimation techniques must be employed (see Tarr, 1991).
**Tariffs as a Negotiating Tool and WTO Accession.** Finally, countries may use tariffs as a bargaining tool to extract concessions from trading partners in the context of future multilateral trade negotiations within the context of the WTO. For countries applying to accede to the WTO, the future level and structure of tariffs is an important element in negotiations for accession to the WTO. In this context it should be noted that the accession negotiations focus not on the actual level of tariffs, i.e. the "applied rate," but on the so called "bound" rate which is the maximum legal level of the tariff for each individual tariff line which a country could not exceed without either a renegotiation or giving compensation by reducing the tariff level for other products.

Within the rules and disciplines of the WTO, each country has considerable scope as to how restrictive or liberal its trade regime will be. There are no specific rules as to the maximum level at which a country has to bind its tariffs at accession or its degree of uniformity. Indeed some developing countries which are already WTO members have not "bound" all their tariff lines-- meaning they can legally increase these rates without negotiation or compensation. Countries thus have a strategic choice to make during the accession negotiations phase: How liberal its tariff regime will be, consistent with the overall WTO disciplines.

Some governments have chosen to try to avoid legally binding commitments to a liberal trade regime in the context of accession. Accordingly, their initial tariff "offer" includes many tariff lines which are unbound-- implying that they reserve the right to set legal maximum rates in the future, as well as a large number of commodities for which the proposed bound rate is significantly higher than the presently applied rates.

There are two sets of arguments that have been advanced in favor of this strategy: The first is of an economic nature and has to do with the future tariff policy most conducive to development and is similar to the infant industry and restructuring arguments discussed earlier. The other has to do with negotiating strategy and tactics to be pursued in the context of the accession process.

According to the first set of arguments, it would be unwise for a transition economy to commit itself legally to a low, and relatively uniform tariff structure at present, as its industry has not yet undergone significant restructuring. Therefore, it would be desirable to have bindings set at a high level or even for certain items not be bound at all so that the government could raise them subsequently as part of an industrial policy or restructuring that uses protection in order to promote future industrial development.

The other set of arguments starts from the premise that at accession, applicants can not negotiate significant improvements in their own market access: The tariff levels of WTO members are bound at fixed levels and the negotiations are solely over the level of the bindings of the acceding member. Hence, it would be desirable to try to maintain significant levels of...
legally bound tariffs, which it can use as bargaining chips to obtain improved access in future negotiating rounds. At a tactical level, it is also argued that any initial offer would have to be at a higher level than that which is finally agreed upon for two reasons: first, it may be possible for a country which is important in international trade to use the tariff level as a bargaining tool on other issues of market access (for example, in the case of transition economies, this could be over understandings over such issues as its designation as a "non market economy" in the context of antidumping). Second, past practice in WTO accessions suggests that acceding countries are bound to face some demands to liberalize their tariff regime by existing members, almost irrespective of the level of protection they initially propose (Michalopoulos, 1998). Thus, some negotiating margin is necessary in the initial offers to ensure that countries are not forced to liberalize their trade beyond what they consider economically justified.

There are significant dangers to such a strategy, however. First, it is doubtful that in the long term efficient restructuring of transition economy industry can be done behind high tariff walls. Indeed, as the studies cited above on targeting document, industrialization behind high rates of protection may permit the survival of uncompetitive industries that hold little promise for increased productivity and efficiency that is critical to long term sustainable development. That is, this argument is not a new argument, but the restructuring or infant industry argument in the framework of the binding commitment of tariffs at the WTO.

Regarding the use of the initial tariff offer as a bargaining tool at the WTO, the initial tariff offer could be uniform without loss of bargaining power. That is, there is no reason to believe that an initial diverse tariff offer which is based on political economy or other considerations would present a superior bargaining position at the WTO than a uniform tariff offer. Thus, the bargaining power argument is not an argument against uniformity, but an argument about the level of the tariff. Regarding the level of the initial tariff offer at the WTO, it is clear that the leverage acceding countries have is quite small: While tactically, the maintenance of some margin of flexibility in the original offer is probably wise, the offer has to be used judiciously as a bargaining tool. Past practice suggests that: (a) countries have been asked to bind all their tariffs, even though existing WTO developing country members have not done so; (b) accession negotiations have gone much faster when countries have proposed lower and relatively uniform tariff rates with bound rates close to applied ones; indeed in some cases where countries have made initial tariff offers with a large divergence between applied and proposed bound rates, WTO members have refused to negotiate at all, until a different offer was put on the table which contained smaller divergences--a situation which led to considerable delays in the accession process (Michalopoulos, 1998).

But even if a country were to succeed in negotiating a structure of bound rates significantly divergent from today's applied rates, it may have gained a pyrrhic victory: By

---

10 This designation, which arguably has been detrimental to its market access is not dependent on its accession WTO and, in principle, could continue after it has become a member. See Michalopoulos and Winters (1997).
negotiating such a structure it would create an opening for domestic interests to exert political pressure for additional protection in the future. The government would lose the "political cover" the legally binding WTO commitments offer against domestic protectionist interests which may otherwise succeed in subverting the current trade regime and making it far more protective, to the detriment of long term efficient industrialization.

Binding at closer to the current applied level does not mean that the country would be powerless to deal with legitimate problems that increased imports may create for domestic industry. Increased protection to "safeguard" against serious injury to domestic industry is permitted under WTO rules -- but it is supposed to be decided on the basis of a detailed and transparent investigation to demonstrate injury which is then notified to the WTO and subjected to the scrutiny of other members. This is far more difficult to do than for a powerful domestic industry to simply seek government support to raise tariffs beyond the applied level but below the higher bound level -- which a government can do without any constraint. The point about WTO is not that it prohibits protection, but rather that it permits it only according to certain rules; and that obeying these rules makes protection more transparent as well as more difficult to initiate and spread.

In sum, for a transition economy acceding to the WTO, binding tariffs at low uniform levels is likely to be helpful to the longer term development of an internationally competitive and efficient industrial structure as well as facilitate the accession process.

Arguments in Favor of a Uniform Tariff

Most policy-oriented analyses (Harberger (1988), Balassa (1989), Thomas and Nash (1991) and Mitra (1992)) start with the assumption that if any protection is to be granted at all, it should not favor any specific industry or set of industries; in other words, uniform effective protection should be provided to all industries. The arguments supporting a uniform tariff are based on political economy considerations, lobbying, administrative and smuggling costs, and adverse experience with picking winners.

Political Economy Considerations. Political pressures from constituents frequently induce governments to depart from trade policies that are preferred on grounds of economic welfare. Diverse and inefficient tariffs typically arise due to a "free-rider" problem in political lobbying. Political interests who want tariffs are typically the companies or unions in the industries because the gains are concentrated in relatively few hands and they are able to capture a sufficient amount of the gains that they will devote resources to lobbying for the tariff. On the other hand, those who lose from a tariff are the consumers of the product; although there a great many more of these people, their costs are smaller and not sufficient to induce them to spend resources to lobby their government to avoid the tariff. They would prefer someone else do it for them and to "free-ride" on the efforts of similarly minded individuals. The result is that typically
only the industry that gains from the tariff lobbies the government and governments sometimes yield to this one-sided pressure.

The advantage of a uniform tariff is that it makes the gains to the industry much smaller, creating a kind of free-rider problem for the lobbying industry and dramatically reduces the incentive to lobby for protection. If a country employs a uniform tariff, an industry would not receive concentrated gains from its lobbying, since if it succeeded in raising the uniform tariff, it would have to bear the costs of raising the tariff for all the other products. These costs would include the higher cost of imported intermediate inputs and the lower price of its exports from induced changes in the real exchange rate. Any gains from raising the tariff would be dispersed, and would have to be weighed against the dispersed costs that the higher tariff in other industries would impose.\textsuperscript{11}

The fact that a uniform tariff provides reduced gains to lobbying for protection conveys several advantages: (1) most important is that the level of protection is likely to be lower for reasons discussed above; (2) lobbying for protection is unproductive activity and a waste of resources. There is a direct saving of resources from the reduced lobbying; (3) the reduction to the gains from lobbying for protection provides a vastly improved signal to entrepreneurs. Entrepreneurs need to believe that they have more to gain by creating better and cheaper products or production processes than they do by lobbying their government. Entrepreneurial talent is quite scarce and valuable and if diverted into rent-seeking the growth rate of the economy can be adversely effected; and (4) the reduction in resources devoted to lobbying will result in less corruption in government, which may have positive spillover effects into other dimensions of government activity.

Administrative Convenience. Uniform tariffs convey a number of administrative advantages. First, if tariffs are uniform, there is no incentive to misclassify goods. This enables customs authorities to concentrate on assuring that the value of the imported goods is not understated, and will reduce corruption related to customs clearing. In addition, the transparency and administrative simplicity of uniformity in customs clearance procedures will lower the administrative costs of trading. For example, traders will not have to obtain information on the category under which their products will fall.

Reduced Smuggling. A diverse tariff structure will provide an incentive to smuggle products which are subject to a high tariff. If the tariff is uniform, the strong incentives for smuggling that are presented by the high "outlyers" of a diverse tariff structure are considerably reduced.

\textsuperscript{11} In addition, since some imported inputs are used by import-competing sectors, a uniform tariff leads to a lower level of lobbying since it raises the costs of the import competing sectors. See Panagariya and Rodrik (1993) for details.
Empirical Evidence Indicates that Movements Toward Uniformity are Beneficial

In practice, empirical evaluations using computable general equilibrium models of actual economies have found that movements toward uniformity of the tariff structure increase real income. In the case of Turkey, a study by Harrison, Rutherford and Tarr (1993) found that uniformity in the incentives to importers and exporters would provide more than two-thirds of the gains to the economy of going to full free trade. That is, quantitatively the most important distortion in the trade regime of Turkey was not the overall height of the tariff, but rather non-uniform import tariff and export subsidy rates.

The reason for these results is that the distortion costs to the economy increase more than proportionately with the height of the tariff, i.e., a uniform tariff of 10% is much less costly to the economy than a structure that has a 20% tariff on half the products and zero tariffs on the rest. Turkey had succeeded in lowering its overall average tariff to under 15%, as in Russia; but the bulk of the distortion costs came from the relatively few sectors where tariffs or export subsidies were quite high.

Another example is the case of Chile which has a uniform tariff of 11%, and has elected to participate in a free trade area with MERCOSUR (Brazil, Argentina, Paraguay and Uruguay). Chile refused to join the MERCOSUR customs union in part because the customs union employs a common external tariff that is not uniform. Harrison, Rutherford and Tarr (1997) have estimated that the free trade area with MERCOSUR is substantially better for Chile than the customs union because the non-uniformity of the MERCOSUR common external tariff would impose considerable distortion costs on Chile. Similar results, although not as strong, were found in the cases of the Philippines (Clarette, 1989) and India (Mitra, 1994).

International and Russian Experience with Tariff Uniformity

International Experience with Tariff Uniformity. It would of course be useful to provide an estimate of how Russia compares to international experience in tariff uniformity. Unfortunately data do not exist that would allow precise international comparisons of either tariff uniformity or escalation. Although the MFN ad valorem tariff rates are available, estimates of the ad valorem equivalence of either specific tariffs or non-tariff barriers are not. The latter data are not available because tariff equivalence estimation is very time and data intensive, and involves thousands of tariff lines in many countries.

---

12 The distortion costs of the tariff increase with the square of the tariff rate. See Morkre and Tarr (1980, chapter 2) for a derivation.
13 This study showed that a movement away from uniformity for Chile would be costly.
14 We have performed estimates based on the ad valorem data.
We have, however, performed calculations based on the ad valorem rate—estimates which should provide a lower bound biased estimate of actual tariff dispersion when the tariff equivalence of the NTBs is taken into account. Despite the arguments in favor of relatively uniform protection, the actual experience with tariffs worldwide suggests that most countries differentiate their tariffs substantially (we discuss specific country examples below). Typically the protection pattern involves low tariffs for unprocessed commodities and raw materials as well as capital goods, and much higher tariffs for processed final goods. The basic reason for this is the influence of vested interests in maintaining protection on the final goods produced in the country, but who also lobby for tariff free access to their inputs. When there is no domestic intermediate goods industry, or the intermediate industry is small, there is no effective opposing lobbying influence for tariffs on these intermediates; the result is low tariffs on intermediates and high tariffs on selected final goods—a situation known as tariff escalation.

The tariff escalation that characterizes many countries' trade regimes, both developed and developing, causes especially serious problems in inefficient resource allocation: This "escalating" tariff structure tends to favor final goods production at the expense of intermediates, and in the long run encourages assembling type activities. That is, intermediate goods production is discouraged because it is disfavored relative to final goods and assembling activities. Thus, because an intermediate goods industry doesn't exist today to lobby for equal protection, incentives are established which hinder its eventual creation.

Since tariffs on inputs affect the incentives for resources to move into or out of a sector, nominal protection, or the tariff rate that applies for a particular good, will not well reflect the extent to which the sector is favored or disfavored relative to another sector. Thus, the concept of "effective protection" is frequently employed, where effective protection measures tariffs on the sector's output relative to tariffs on its inputs and its value added. Although effective protection is not a perfect measure of the impact of the tariff regime on resource allocation, the presumption is that activities with high effective protection are better able to attract resources and therefore to grow at the expense of others. In Box 1, we provide a discussion of the concept of the effective rate of protection. In general, the effective rate of protection increases as the tariff on output increases, the tariff on inputs decreases, and the value added at world prices of the sector decreases.

Based on unpublished calculations using the "TRAINS" database by Ulrich Reineke at the World Bank.
Box 1: A Note on Effective Protection or Assistance

The effective rate of protection (or assistance) for the output of an individual industry is defined as the percentage by which the entire set of a nation’s trade barriers raises the industry’s value added per unit of output. The formula for calculating an ERP or ERA is:

\[ \text{ERA} = \frac{\text{assisted value added} - \text{unassisted value added}}{\text{unassisted value added}} \]

Originally the effective rate concept covered only tariffs and was called the ‘effective rate of protection’. Now effective rates are used to measure a wide range of interventions and are called ‘effective rates of assistance’.

The three pieces of information needed to calculate an effective rate of protection are:
- value added with assistance (or protection);
- nominal protection on output; and
- nominal protection on inputs.

Nominal protection on outputs and inputs are used to adjust observed (or with assistance) value added to a free trade, or unassisted, basis.

Assume the local producer is able to charge a price that is 50 per cent above the world price (that is, the cif price of imports). Put another way, the nominal rate of protection (NRP) for shoes is 50 per cent. Assume also that a pair of shoes can be imported for $100 before the tariff is imposed. These can be produced locally using one pair of soles and uppers that are also imported and costing $85 before tariffs. The tariff on soles and uppers is 35 per cent in each case. At these assumed tariff rates the local price of the shoes would be $150 and the soles and uppers used as inputs cost the producer $114.75 (These costs are summarised in the table below). Value added measured in world prices is $15. When the effects on domestic prices of protection is taken into account, value added is $35.25. It follows then that the ERP is 135 per cent (that is, the proportion by which value added measured at domestic prices exceeds value added at world prices). It costs $35 of local resources to earn $15 foreign exchange.

This example demonstrates that a cascading rate structure will lead to an effective rate of protection that is higher than the tariff rate on the output (that is the nominal rate of protection). This is an example of one hypothetical firm and it is worth considering how this analysis would change under different conditions. There are two factors that can be varied: the value added generated by the productive activity and the relationship between the output and input tariffs.

### Effects of cascading tariff on effective rate of protection

<table>
<thead>
<tr>
<th>World prices</th>
<th>Tariff rate</th>
<th>Domestic prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>%</td>
<td>$</td>
</tr>
<tr>
<td>Shoes</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>Soles and uppers</td>
<td>85</td>
<td>35</td>
</tr>
<tr>
<td>Value added</td>
<td>15</td>
<td></td>
</tr>
</tbody>
</table>

Effective rate of protection: 135%

Although it is well known that Chile has a uniform tariff, there are quite a few countries with tariff structures that are uniform or at least close to uniform. Two countries have uniform tariffs due to the fact they practice free trade: Estonia and Hong Kong. Another three, Bolivia, the Kyrgyz Republic and Chile have virtually uniform tariff schedules of 10, 10 and 11 percent, respectively. Singapore has a simple tariff average of 0.5% and a standard deviation of less than 3%. Azerbaijan has a 15 percent maximum tariff and Bosnia-Herzegovina is reported to be about to move towards a uniform tariff. A number of other countries, including Brunei Darussalam, Equador, Honduras and Mexico, have tariff averages (under 13%) with small variances (under 6 percent).

At the other end of the spectrum are countries such as Bangladesh, and India with tariff averages of 84 and 56 percent and tariff variances of 26% and 24%. Korea, Mexico, South Africa and Turkey have more than 10,000 tariff headings, while for most other countries average about 6,000 tariff heading. A large number of countries have granted exceptional levels of protection for a limited number of products. The list of these countries includes some of the poorest countries but also some of the most prominent OECD countries, i.e., Cameroon, Canada, China, Egypt, European Union, Hungary, India, Indonesia, Israel, Nepal, Nicaragua, Norway, Saudi Arabia, Solomon Islands, Turkey, United States.

The Russian Tariff Structure. The import weighted average tariff in Russia is about 13.6% with a standard deviation of the tariff at the 3 digit level of about 7%. Due to exemptions the collected rate of import tariff is closer to 10%.

A very important element of the Russian tariff structure are the specific tariffs. For many tariff lines a mixed system applies, in which the maximum of the ad valorem or the specific tariff is applied by customs. Because of their lack transparency, specific tariffs should be avoided.

Tariff Escalation in Russia

To provide a preliminary indication of the extent of tariff escalation in Russia, we classify in Figures 1 and 2 goods into three overall activities: unprocessed (stage 1 and lightly shaded in the figures), semi-processed (stage 2 and heavily shaded in the figures) and final goods (stage 3 and unshaded in the figures). The Russian tariff structure was aggregated and a concordance was established between the three digit harmonized system code and the ISIC code for production. Averages tariffs for each of the 3 digit categories was calculated and the results by stage of processing are shown in Figures 1 and 2 for important sectors. The aggregation procedure will tend to reduce dispersion of the tariff structure since the high and low tariffs in a sector will be averaged. Thus, these numbers should be considered a lower bound estimate of the extent of tariff escalation.

Sectors in Figure 1 show unambiguous tariff escalation, where sectors in Figure 2 are less clear. We find that the Russian tariff exhibits tariff escalation in the following sectors: leather
products, wood products, petroleum and coal products, iron and steel and fabricated metal products; in addition, apparel products are much more heavily protected than raw materials and textile products. On the other hand, no clear pattern of tariff escalation is present in “non-classified food products, industrial chemicals, other chemicals, petroleum refineries, rubber products, other non-metallic mineral products, non-ferrous minerals, other manufactured products.

Based on our above aggregated view of the Russian tariff structure, we conclude that it does not exhibit extensive tariff escalation. Nonetheless, it indicates that leather products, petroleum and coal products and selected others are sectors where escalation likely results in very significant rates of effective protection.
Some General Guidelines for Russian Tariff Reform

The above analysis strongly suggests that there is little economic justification and many dangers in providing differentiated tariff protection to various sectors of industry and agriculture in Russia today. Most of the arguments in which tariffs differentiated by product are the optimal policy intervention are of little practical significance: There are few products in which Russia has monopsony power or industries in which it can gain advantage through "strategic" application of tariffs.

In many circumstances where tariffs are second best policy instruments, such as to raise public revenue or to cope with a balance of payments problem, a uniform tariff rate is the most practical and efficient alternative. And in the case where Russia may be interested in using the tariff as a bargaining instrument, it is immaterial whether the tariff is uniform or differentiated -- the issues have to do with its capacity to use the tariff as a bargaining instrument and what it bargains for.

In the few cases where a differentiated tariff structure could be justified -- usually also as a second best -- in support of infant or restructuring industries, there are very serious political economy dangers for going that route: There are very few cases in which true "infant industry" learning by doing effects are present; tariffs are typically ineffective instruments at addressing the market failure problem; governments are not very good at picking them and there are serious dangers that the policy would be overwhelmed by requests for protection from vested interests irrespective of its economic merits.

Examining the present structure of Russia's applied tariffs in the light of worldwide experience and the analysis of the various arguments and justifications for imposition of tariffs, the following general strategic guidelines are suggested:

**Uniformity.** While the tariff schedule does not show as much escalation as in many other countries, there are several sectors with tariff peaks and substantial effective rates of protection, which are likely to attract resources. There is little evidence that these are sectors in which "learning by doing" would result in significant productivity improvements over time.

Priority should be given to reducing these high rates and moving the tariff schedule towards greater uniformity. The costs in the form of the inefficiencies in resource allocation rise more than proportionately with the height of the tariff. As a consequence the greatest gains will come from reductions in the maximum rates. In addition, very high tariffs may be prohibitive of imports, so that there will be revenue gains from reductions in the rates. Reductions of the high rates will also reduce smuggling, corruption and rent-seeking disproportionately.

---

16 See Morkre and Tarr (1980, chapter 2).
Raising the low rates, those rates that are less than 10%, is more controversial, especially on intermediate and capital goods. If there is no duty drawback or its equivalent in place, increasing the tariff on intermediate goods imposes a tax on the exportable goods that use the intermediate—this is bad since there are too few resources devoted to exports due to the tariffs. Moreover, it may be argued that raising tariffs on imports of raw materials and intermediates penalizes "technology" imports that are critical for raising productivity. Against these potential costs, one must weigh the fact that permitting imports of intermediates and capital goods at lower rates than 10% penalizes the development of Russia's own significant intermediate and capital goods industries (relative to final goods sectors)—as well as represents a foregone opportunity to raise revenue. And with a diverse tariff structure, the political economy, corruption and smuggling problems persist.

Moreover, it may be argued that raising tariffs on imports of raw materials and intermediates penalizes "technology" imports that are critical for raising productivity. Against these potential costs, one must weigh the fact that permitting imports of intermediates and capital goods at lower rates than 10% penalizes the development of Russia's own significant intermediate and capital goods industries (relative to final goods sectors)—as well as represents a foregone opportunity to raise revenue. And with a diverse tariff structure, the political economy, corruption and smuggling problems persist.

To reduce the added anti-export bias that raising tariffs on intermediate and capital goods imposes, Russia and many countries employ mechanisms that allow exporters duty free access to imported intermediates. This includes duty drawback procedures, temporary admission and export processing zones. Coupled with effective duty free access to imported intermediates for exporters, the welfare tradeoff from raising tariffs on intermediate and capital goods is much more likely to be positive.

In these circumstances, the elimination of exemptions provides the benefit of additional revenue to the government, reducing or eliminating the revenue loss which may accompany a reduction in tariffs. And the elimination of exemptions provides a uniform incentive environment which does not favor any one class of producer or consumer over another.

The principal problem with provision of duty free access to exporters of imported intermediates is that the administration of these schemes can be very costly, and lead to cumbersome procedures and delays when tariffs are high. Exporters complain of delays and lack of payment. When tariffs are high there is also the risk of fraudulent claims. Moreover, these schemes do not remove all the anti-export bias of tariffs. In addition, duty drawback schemes could reduce the incentive for real import liberalization which is the first best policy choice, if the schemes are perceived as an alternative to long term reform.

In general, raising tariffs on intermediates presents a conflict between the need to provide balanced protection to intermediates and final goods (i.e., reduce effective protection on final goods) and the need to reduce the anti-export bias of exports. Duty drawback and similar

---

17 The "Lerner" symmetry theorem has shown that a tax on imports imposes a tax on exports. One of the principal reasons is that tariffs appreciate the real exchange rate, which makes exporting less attractive.

18 Tariffs on intermediates also convey the benefit of reducing the incentive to produce import competing products that use the intermediate—this is good because, due to tariffs, the economy allocates too many resources to these activities. A more complete treatment of this subject may be found in Panagariya (1992).

19 For example, to avoid anti-export bias, duty drawback schemes would have to be extended to indirect exporters as well (i.e., firms which do not export themselves but which sell to exporters). Administration of such mechanism are too complicated in practice and are not recommended for Russia.
schemes appear to resolve the conflict but they do so at the expense of administrative complexity. The empirical evidence suggests these schemes become ineffective and very difficult to administer at high tariff rates (in excess of 15 or 20 percent) because of leakages, delays in payment and fraudulent claims (see Mitra, 1992). The experience of Russia is consistent with the international experience in this regard and emphasizes again the importance of reducing the overall level and diversity of the tariff.

**Several Tariff Bands (or Tariff Simplification) is not Tariff Uniformity.** It is sometimes argued that for administrative convenience the tariff structure should be simplified into 3 to 5 tariff bands. For example, with five tariff bands, tariffs could be either 0, 10, 20, 30 or 40 percent (or 0, 5, 10, 15 or 20 percent), but values in between would be prohibited. It should be clear that tariff simplification is not tariff uniformity, and simplification will allow very high rates of effective protection. Importantly, such a system suffers from virtually all the problems of a diverse structure, including encouraging lobbying for high protection by industry groups and it will encourage misclassification at customs relative to a uniform system.

If, on the other hand, tariff simplification is used as a vehicle to move toward low and uniform tariffs by limiting the number of tariffs, and reducing both the level and the dispersion of the tariff structure in the process, then tariff simplification is a very useful step. More generally, a tariff structure that is low and has a small standard deviation will convey many of the same benefits of a low uniform structure. For example, with a sufficiently small standard deviation there will be little gains from lobbying or incentive for corruption and in customs for misclassifying. Tariff simplification by itself, however, without reducing the level or the dispersion of the tariff structure, will convey relatively small benefits from reducing administrative costs.  

**The Tariff Level.** While many arguments have been made in favor of "low" tariff levels -- as well as uniform ones, there has been little effort to define "low." The OECD have on average reduced their tariffs on manufactures to less than 5% -- with a few peaks, especially in textiles and leather products. The main problem in most countries is agriculture where, as a result of the tariffication following the Uruguay Round, tariff schedules are quite high -- reflecting the previously high supports and protection. In Russia's case a strategic decision may be appropriate to aim at a 10% uniform tariff. Anything higher, would result in significant increases in the effective rates of protection with the associated inefficiencies. A uniform rate at 10%, without exemptions, would also be helpful in generating substantial revenue. (Sequencing is discussed below.)

---

20 In their excellent paper Subramanian et al. (1993) generally argue in favor of uniformity for most of the reasons in this paper. The authors also appear in practice to be willing to accept a system with several tariff bands. For consistency, we interpret their position as supporting several bands with a low standard deviation as part of a process of moving toward uniformity.
**Applied vs Bound Rates at the WTO.** Russia has apparently chosen to make an initial tariff offer which is consistent with a bargaining strategy. This strategy contains a number of risks as outlined above. Based on the preliminary consultations on the offer, some WTO members have noted informally that the negotiations are likely to be long and difficult. The Russian authorities may wish to consider showing flexibility in these negotiations and a willingness to bind at tariff levels close to the applied ones. This would not only help with WTO accession, but most important, it is likely to contribute to the longer term development of a competitive and efficient industrial structure.

**A Strategy for Implementing a Low and Uniform Tariff in Russia**

*Eliminate Technical Barriers to Trade.* Protection should only provided by tariffs. Consistent with the declared intention of the Government of Russia, it should proceed to reduce TBTs by reducing the number of goods subject to mandatory certification and simplifying certifying procedures by the end of 1998; and it should harmonize Russian standards in priority sectors with internationally accepted ones by end 1999.

*Reduce the Maximum Rates.* A good timetable for Russia would be to impose a 20% maximum ad valorem tariff in 1999, a maximum 15% in 2000, and 10% maximum in 2001. In calculating the actual applied tariff rates, it is crucial to include all surcharges, duties and discriminatory portion of excise taxes21

*Reduce and Eliminate Specific Tariffs.* Consistent with the declared intention of the government of Russia, specific tariffs should be eliminated; they can be replaced by ad valorem tariffs or the mixed system currently employed by the government of Russia could be employed during a transition. For sectors with a mixed ad valorem-specific tariff system (where the maximum of the two tariffs applies), it would be advisable to cut the specific tariff by 50% in 1999, by another 50% in 2000 and eliminate specific tariffs by 2001.

*Raise the Low Rates, Eliminate Exemptions and Provide Duty Free Access to Imported Inputs Used in Exports.* Based on the principles discussed above, a good timetable for Russia would be to increase the minimum tariff to 3% in 1999 (Russia will apply this policy by virtue of the agreed tariff surcharge), 6% in 2000 and 10% in 2001. At the same time exemptions should be eliminated except for policies that provide duty free access to imported inputs for exporters.

*Bind Tariff Rates at the WTO at Rates Closer to Applied Rates.* The Russian authorities should be prepared to show flexibility and willingness to bind tariff levels closer to the applied ones. To do so, is likely to be helpful to the longer term development of an internationally competitive and efficient Russian industrial structure as well as facilitate the accession process.

---

21 That is, if a 20% excise tax applies on domestic production of an item, but 25% applies on imported items, then the difference of 5% is part of the applied tariff.
References


INTRODUCTION

The services sectors have begun to emerge as a dynamic force in the Russian economy in recent years. Although the services industries received low priority in the Soviet System, since the advent of reform, activities ranging from banking to telecommunications to accounting to retail kiosks have been experiencing rapid development. But the services sectors could be an even more important engine for Russian growth. Much depends upon the policy and regulatory framework developed for these industries, especially the incentive regime governing trade and investment in them.

The challenges for Russian participation in the WTO’s General Agreement on Trade in Services (GATS) are substantial precisely because the legal and regulatory frameworks for the services activities are still evolving in Russia. This creates uncertainty among Russia’s major trading partners. It also creates anxiety among Russian policymakers about whether to make specific commitments under the GATS, because they, too, are uncertain about the future policy regime for services. At the same time, this creates the opportunity for the GATS negotiations to further shape Russia’s economic reform process and to ensure that accession to the WTO contributes to Russia's economic growth and development.

This paper starts with a brief overview of the role of services in the Russian economy. This is followed by a summary of the requirements for participation in the GATS under the WTO. The negotiating dynamics of accession to the GATS is then explored. The paper then turns to an examination of the specific challenges that Russia faces in participation in the GATS. Finally, the costs and benefits of alternative approaches to services are examined in order to analyse the strategic choices for Russia.

SERVICES IN THE RUSSIAN ECONOMY

The services sectors in the Russian economy account for about 55 percent of total productive output, which is low compared to other upper middle income economies, and which contrasts sharply with the much larger share of services in total output in the high income industrial economies of more than two-thirds.

**Services and Economic Development.** The very substantial role of services in the high-income industrial economies suggests that if the policy regime is appropriate, the services sectors in Russia could continue to expand. A policy regime that promotes productivity in the services...
sector will make an important contribution to overall growth and development in Russia. Indeed efficient services industries can make a critical contribution to the competitiveness of exports of goods as well as leading to direct exports of services by Russian suppliers.

There are many examples in other countries that illustrate the crucial role of competitive and efficient services in stimulating the exports of goods. For example, the deregulation of ports and maritime shipping in Chile played an essential role in the development of horticultural exports that have become an important sector in the Chilean economy. Australia and Canada share with Russia the characteristics of vast geographic expanses and diverse natural resources. They have achieved a high standard of living with a small proportion of the population engaged in goods production, but their competitiveness in export markets and their standard of living depends upon the efficient provision of services ranging from transportation to telecommunications to financial services to professional services, such as accounting and law.

*The International Dimension.* It is important to recognise that even in the most open economies, services activities inherently tend to be less exposed to international competition than goods-producing industries. First, services activities almost always involve direct interaction with a local customer. Second, differences in language, culture and social institutions create natural advantages for domestic suppliers of services even if there are no discriminatory restrictions on foreign service suppliers. Russia with its large population and its geographic expanse will have a large proportion of domestic service providers even if its services regime were to become as open to international competition and as transparent as the major OECD countries.

For most countries, and especially for large countries, such as Russia, the most important mode of service supply is through “commercial presence” (or foreign direct investment). Foreign firms who invest in Russia often bring in specialized personnel, at least for temporary periods, but the foreign firms will recruit and train Russians in their operating methods and technologies. Once they have gained experience and knowledge, these employees may move to domestic firms or start new ventures. Thus, foreign investment in services will enrich the pool of expertise in highly skilled labour markets in Russia.

Since a number of important services sectors, e.g. telecommunications and financial services, in Russia are going through a process of rapid structural change and development, there is reluctance by Russian firms to have increased foreign competition until this process is perceived to be completed. Although transition arrangements may be appropriate to facilitate adjustment by domestic firms in these sectors, a clear commitment to a timetable for liberalization of the sectors will stimulate the domestic restructuring that is required.

Since local services suppliers have many inherent market-based advantages over foreign competitors, the foreign service providers can only be competitive in the marketplace if they bring with them specialized skills, knowledge and/or marketing capabilities that domestic firms lack. Thus, foreign competition in services industries is a critical factor in stimulating innovation and adaptation of new technologies or management practices by domestic firms. Indeed, the
longer term effects of opening services markets to foreign competition may include increased foreign market share in the supply of services, but the dynamic growth effects in terms of expanded services output, enriching the pool of skilled workers and enhanced competitiveness of local service providers are likely to be much more significant.

It may seem paradoxical to Russian policy makers, but the more that Russian services industries are open to international competition, the stronger will be the presence and competitiveness of these Russian services industries in markets outside Russia. In particular, healthy, competitive, and efficient services sectors in Russia will help to sustain economic links with the Russian speaking communities in contiguous countries, while backward and protected services industries in Russia will lead to greater foreign presence in services activities in these contiguous countries.

The openness to international competition of the services industries is influenced by three factors: openness, transparency, and predictability. The first factor, openness, is the extent to which the policy regime and administrative practice discriminate in favour of domestic firms or limit the opportunities for foreign firms to compete in providing services. The second factor, transparency, is how transparent is the services policy regime and administrative practice. Even if the policy is relatively liberal, if it is difficult to obtain information about policies or to determine how administrative processes function, then lack of transparency can deter service providers from entering the market. The third factor is the predictability of the policy regime for services. Even if there are few restrictions on services transactions and foreign investment that apply to particular services industries, the possibility that ownership restrictions or discriminatory taxes and regulations will be imposed in the future acts as a deterrent to foreign investment in services markets.

The key points are that the openness, transparency and predictability of policy regimes that Russia develops for the various services sectors are critical to the competitiveness of Russian goods in export markets, are essential to the vigorous development of services exports and are vital to sustaining and nurturing economic links with contiguous countries with Russian-speaking populations.

What is Required to Join the GATS?

The requirements for Russian participation in the GATS are determined by the formal requirements for participation in the World Trade Organization (WTO) and the negotiating dynamics of accession to the WTO.

Formal Requirements. The formal requirements under the WTO are that all members of the WTO are subject to the "Single Undertaking" structure of the WTO, which means that all members must participate in all the agreements on goods including the GATT 1994, the GATS and the Trade Related Intellectual Property (TRIPs) Agreement. In particular, participation in the GATS requires an agreed schedule of covered services that specifies commitments for, and
limitations to, market access for different modes of supply for services and commitments for, and limitations to, the application of national treatment to covered services.

The key elements of the GATS and the GATS schedules of specific commitments are briefly summarized here; two sector cases—telecommunications and financial services—are highlighted below. A more detailed discussion is included in Appendix One of the GATS schedules.

General Obligations. The general obligations under the GATS include:

- **Most Favoured Nation (MFN) Treatment** is the commitment to non-discrimination among trading partners in services transactions.
- **Transparency** requires that legislation, regulations and administrative practice are published, and are notified to WTO members, and that an Enquiry Point (as well as a Contact Point for developing countries) is established to respond to requests for information for all legislation and policies affecting particular services industries.
- **Due Process in Domestic Regulation** is the requirement that all regulatory measures affecting trade in services are administered in a reasonable, objective, and impartial manner.
- **No Payments Restrictions** are permitted on international transfers and payments for current transactions and restrictions on capital transfers are subject to IMF obligations.
- **Recognition of Professional Standards** based on mutual negotiations.
- **Monopolies and Exclusive Service Suppliers** shall act in a manner consistent with MFN and the schedule of specific commitments and shall not abuse its monopoly position.

Schedule of Specific Commitments. Beyond these general commitments, the agreed GATS schedules list specific commitments to, and limitations on, market access and national treatment for covered services sectors or subsectors. The so-called “horizontal commitments” actually include specific limitations on market access or the application of national treatment to all covered services.

The market access commitments and limitations for covered services sectors or subsectors are specified for the four modes of supply:

- **Cross-border supply**: non-resident service suppliers provide services across international borders into the territory of the country.
• **Consumption abroad:** residents of a country purchase services in the territory of another country.

• **Commercial presence:** foreign service suppliers establish a commercial presence in the territory of a country, such as an agency, joint venture, subsidiary, or branch.

• **Presence of natural persons:** temporary entry and stay in the territory of a country by foreign individuals in order to supply a service.

*National treatment* is an important principle of non-discrimination, which like MFN, has been adapted from the GATT rules for goods to the GATS rules for services. While MFN implies that all restrictions on foreign services providers are applied equally to all foreign service providers, national treatment means that service transactions with foreign providers and foreign service suppliers are treated the same, and have conditions of competition, which are no less favourable than those for domestic service providers. While national treatment is an important principle of non-discrimination in the GATS, the commitments to, and limitations upon, the application of national treatment are the subject of specific commitments listed in the schedules for covered services sectors and subsectors. Particular services sectors or subsectors may not be covered by the schedule of specific commitments, in which case they are considered unbound. In this case, there are no commitments to allow market access or to provide national treatment for these services sectors or subsectors.

There is significant variation among services sectors in the extent to which WTO members have scheduled specific commitments. More than 70 WTO members have scheduled commitments for Professional Services, Other Business Services, Insurance Services, Banking and Other Financial Services, and Travel Agencies.\(^1\) If one excludes the least developed countries who are members of the WTO from the count, there is broad coverage of these services sectors by the high-income and middle income economies who are WTO members. In contrast, about 20-30 WTO members have scheduled specific commitments in the Education Services and the Recreation, Cultural, and Sporting Services sectors.\(^2\)

**Exceptions.** There are various exceptions to the obligations of the GATS. These include the following:

• **Exceptions from MFN** can take the form of either temporary exceptions which must be negotiated at time of accession and a general exception under Article V for regional integration agreements that cover substantially all services sectors and modes of supply.

---

2. Ibid.
Subsidies to domestic service providers are not subject to rules and obligations under the GATS except for an obligation to consult.

Public Procurement is excluded from GATS.\(^3\)

General Exceptions include necessary measures protecting public morals or order; protecting human, animal or plant life or health; preventing fraudulent practices, protecting privacy and safety; and securing tax collections under international agreements.

Balance of Payments restrictions are permitted under certain circumstances, but are subject to surveillance by the WTO and the IMF.

Security Exception is for measures taken for national security including military purposes and handling of fissionable materials or under the United Nations Charter.

In addition, there are sectoral specific exceptions, such as the “prudential” exception in the Financial Services Sector.

Dispute Settlement. The rules and obligations under the GATS and the GATS schedules of specific commitments are subject to dispute settlement under the Dispute Settlement Understanding of the WTO which provides an integrated dispute settlement process for the WTO. It is important to note that this dispute settlement process is state to state and is intended to ensure compliance with the rules and procedures of the WTO by the member governments. The remedy to a dispute is for governments to bring their policies and practices into conformity with the WTO.

There is no provision under the GATS for a private arbitral mechanism analogous to that contained in Chapter 11 of the North American Free Trade Agreement (NAFTA) or proposed in the Multilateral Arrangement on Investment (MAI) in the OECD. Thus, there is no opportunity for private firms to obtain financial compensation for government measures that are contrary to the rules and procedures of the WTO.

Summary. Since almost all high and middle income countries are full participants in the GATS, it is evident that countries with quite different economies, institutions and cultures are able to regulate services activities within the framework established by the GATS. Thus Russia should not find participation in the GATS limits its capacity to regulate domestic services activities. However, in order to participate in the GATS and the WTO it will be necessary for Russia to negotiate an agreed schedule of specific commitments for covered services. The key word in this discussion is an agreed schedule for covered services, thus the key issue becomes the negotiating dynamics of accession to the WTO.

\(^3\) Some aspects of services procurement are covered under the Government Procurement.
Negotiating Dynamics

The negotiating dynamics of accession to the WTO are very different than they were for countries negotiating in the Uruguay Round and this is especially true for participation in the GATS.

**Perspectives of WTO Members.** The present members of the WTO take a strong position that the special transition provisions in the WTO agreements that were available to countries who became original members of the WTO are not available to new members. The position is clear that countries seeking to join the WTO should use the time devoted to the accession negotiations to prepare for implementation of the WTO agreements and that there should be no transition allowed for acceding countries to implement the rules and procedures of the WTO.  

In the case of the GATS, the members of the WTO expect that countries acceding to the WTO will be much more liberal in their approach to scheduling commitments for market access and national treatment for services than were countries who participated in the Uruguay Round. At a minimum, WTO members expect that new members will participate more fully in the GATS, especially in sectors such as telecommunications and financial services, where recent negotiations under the GATS have achieved more comprehensive liberalization than was possible in the Uruguay Round. For example, in the telecommunications negotiations concluded on February 15, 1997, 69 countries, including all high income and almost all middle income economies, have made comprehensive schedules of specific commitments for telecommunications services.

Finally, WTO members expect that new members, especially transition economies, will take on new obligations that go beyond the existing obligations of the multilateral trading system. This is not a new phenomenon. The present rules and obligations of the WTO are the result of negotiations launched more than a decade ago in Punta del Este Uruguay. For example, when Mexico joined the GATT in the mid-1980s, Mexico eliminated most import licensing restrictions, and substantially reduced its tariffs in its protocol of accession. This was a dramatic departure from the past norms of special and differential treatment for developing countries, but it signalled the forthcoming changes in the trading system that were incorporated in the WTO as a result of the Uruguay Round.

Similarly, the accession of new members to the WTO reflects current developments in the trading system, as well as the norms that are already incorporated into the WTO. New members of the WTO, and especially transition economies, are being asked to take on WTO-plus obligations. For example, transition countries who are acceding to the WTO are being asked to join the Agreement on Government Procurement, (which is a plurilateral agreement essentially involving OECD member countries) as well as to make commitments on privatization and state

---

4 This point is elaborated upon in Smith (1996).
trading which go beyond existing obligations. Although these WTO-plus obligations may not be of great significance, it is important to recognize that Russia is joining a trading system that is still evolving. Indeed the standards for commitments are likely to continue to rise and this is an incentive for fast completion of the WTO accession negotiations by Russia.

The clock has already started on the implementation of the Uruguay Round agreements under the WTO and it is likely that new negotiations, including negotiations on services under the GATS will be launched in 1999. The tendency for continuous evolution of the trading system is reflected in the Statement on Electronic Commerce reached at the WTO Ministerial in Geneva in May 1998. Since other negotiations, such as on Agricultural Trade, likely will be joined to the Services Negotiations, this and next year present a window of opportunity for accession negotiations, before WTO members become involved in a major negotiation. Once a major negotiation is launched, countries in accession are more exposed to the pressures and conflicting positions of the various groups of countries in the negotiations.

**Russian Perspectives.** The approach that many countries took initially to participation in the GATS in the late 1980s-early 1990s was to do an inventory of their existing laws, policies and administrative practices to determine whether these measures are consistent with the GATS. Then their initial "offer" for the GATS was the status quo, essentially binding the degree or amount of market access and the limitations to national treatment. Such an inventory has been undertaken in Russia. However, simply preparing a GATS offer based on the status quo may not be an appropriate approach to the negotiation of the schedule of specific commitments.

On the Russian side, the uncertain and evolving regulatory and policy framework creates pressures for a very limited offer for services. Even if current practices are relative liberal, the Russian government may be reluctant to bind current practices, because they wish to retain the right to introduce restrictions in the future, or at least to leave open the possibility that if the Duma chooses to enact such restrictions in the future, then the issue of renegotiating services concessions and schedules will not arise. Although the initial GATS offer is confidential, the withdrawal of market access and national treatment commitments from the schedule after they have been formally presented as part of an offer will be viewed badly in the negotiations. Mindful of this, there are pressures on the Russian negotiators to be cautious in preparing the initial offer on services.

**Closing the Accession Negotiations?** Of course, accession to the WTO is a negotiation, and no one expects that the initial offers for any of the schedules for market access for agricultural and industrial products or the schedules of specific commitments for services will be the final basis for the accession protocol. However, if Russia takes a very cautious approach to the negotiation of services in the GATS, and seeks to have most services sectors unbound with respect to market access commitments and to national treatment, then the negotiations over the GATS will be protracted, and will slow the overall accession negotiations down. The limited GATS offer by China has contributed to difficulties with the accession by China.
In contrast, some economies such as the Kyrgyz Republic and the Baltic States have moved much more quickly in the accession process. A comprehensive and liberal GATS offer has been an important element contributing to their accession to the WTO. These countries have few restrictions on market access or national treatment and have committed to open regimes with full market access and national treatment for most services sectors.

It is evident that a comprehensive and ambitious approach to the GATS negotiations could facilitate the accession to the WTO by Russia. Although the challenges of Russian participation in the GATS are substantial, they are less intractable than in other sectors such as agriculture.

**What are the Challenges for Russia?**

There are many challenges facing Russia in participating in the GATS. This section examines some of the fundamental policy and institutional challenges to Russia's participation in the GATS. As in all countries, there are in Russia both political and economic sensitivities in individual services sectors and to particular policy issues in the GATS.

**Political Sensitivities.** In a number of countries, selected services sectors such as education services or entertainment and cultural services are sensitive industries, where countries are reluctant to allow liberalization of market access or to provide national treatment. However, Russia as a large country with a strong national language, does not seem unduly sensitive on these matters. But if there are such sensitivities in Russia they will find some support in this regard from at least some WTO members. Other WTO members, however, will press for commitments in these sectors, and the trend among countries acceding to the WTO is toward scheduling commitments in all services sectors.

Russia seems to have greater sensitivities about allowing access to the domestic market for natural or juridical persons. Thus, the political concerns of Russia seem to be more about market access commitments for, and national treatment of, some modes of supply. Such concerns may be reflected in horizontal limitations on the services offer, or may influence the specific market access and national treatment commitments in particular services sectors.

The movement of natural persons across borders is a sensitive issue in many countries and as a result, most countries have scheduled relatively limited commitments for temporary entry of specialized personnel. In no country does the GATS deal extensively with immigration. The focus of these commitments for temporary entry is to facilitate intra-corporate transfers of senior managers and professionals and to facilitate visa formalities. Russia will be expected to

---

5 The Baltic States have encountered a problem because of differences between the European Communities and the United States over whether they will have an MFN exemption for audio-visual to give preferences for European films and television, because these countries wish to accede to the European Union. However, the fact that this issue has become significant illustrates how comprehensive are the draft GATS schedules for these countries.
make similar commitments on the movement of natural persons, but these commitments should not prove unduly challenging.

The movement of legal or juridical persons across borders or commercial presence could raise more significant issues for Russia. The OECD member countries and a number of middle income countries have scheduled specific commitments for relatively open market access for, and national treatment of, commercial presence (or investment). There is more diversity among middle income countries in the extent to which they have scheduled commitments for market access of, and national treatment for, investment. However, again the trend is toward comprehensive scheduling of market access and national treatment commitments by middle income countries in the recently completed telecommunications and financial services negotiations.

There will be strong expectations that Russia will make market access and national treatment commitments for investment in most services sectors. If there are acute sensitivities about foreign investment in Russia, various possibilities will need to be explored. Schedules of market access and national treatment commitments can have a specific timetable for restrictions to be removed. For example, a number of countries, including Bulgaria, Hungary, Poland, Romania, Slovak Republic, and Tunisia are committed to liberalization of their basic telecommunications services by 2003. Others, such as Argentina, Brazil, Czech Republic, Singapore, Sri Lanka and all OECD member countries are moving much more quickly. (The specific case of telecommunications is discussed further below.)

Although various possibilities can be explored, it is clear that Russia will be expected to make market access and national treatment commitments for commercial presence and investment in most services sectors. The overall issue of limitations on foreign investment is unlikely to be a “horizontal” issue, simply because there will likely some variation across sectors in the degree of market access permitted for foreign investment and in the specific limitations on national treatment.

The issues of land ownership and property rights are continuing to be clarified in Russia. This poses challenges for commitments about market access for, and national treatment of, commercial presence or investment. Several aspects of the legal regime for property rights could constitute a potential limitation on market access and/or national treatment of investment under the horizontal commitments and limitations.6

The GATS does not require that all countries have the same system of property rights. For example, if a country has a requirement that most property is in the form of leases with a maximum term of 99 years, then this does not require a horizontal limitation upon either market access or national treatment, because there is no discretion in the administration of the measure.

---

6 If it can be argued that the property “regime” is consistent with national treatment, then it could be argued that it is not necessary to schedule a horizontal limitation for the property “regime”. However, the property regime will receive much attention, and scheduling a horizontal limitation pending reforms could serve to clarify the situation.
and there is no discrimination against foreign investors. Hong Kong has most land in lease tenures, and has not taken a horizontal limitation due to land ownership.

The situation with respect to land ownership in Russia is complex and highly charged. Local governments in Russia have considerable discretion over the control of real property. Although reforms are underway, undoubtedly WTO member governments will have views on how Russia should adapt its laws, including the property laws, in order to remove any impediments to, or discrimination against, foreign investment. While public ownership of land and buildings is in itself not an issue under the GATS, rectification of unclear terms of tenure and administrative discretion is a major issue. While Russia could argue that in practice the regime for property rights is more or less compatible with national treatment, and that it does not need to be scheduled as a limitation, WTO members and trading partners will be aware of the practices and issues with respect to land ownership in Russia, and it is better to identify sensitive issues early in the negotiation process.

**Economic Sensitivities.** Apart from political sensitivities, some services activities might face significant adjustment challenges with substantial liberalization, but in other services industries the impact of foreign competition will be limited. Many services sectors such as retail stores and restaurants are comprised of thousands of small firms. Chains such as McDonalds can have some impact in the marketplace, but their overall share of the market is likely to remain limited.

Only in certain sectors, such as telecommunications and financial services, where capital requirements are substantial, and, where there are significant economies of scale, is there significant potential for competitive challenges if the Russian market was to be opened tomorrow. However, there will be significant structural change in these sectors regardless of whether the Russian market is opened more in the near future.

In the case of financial services, there are a large number of relatively small banks operating in Russia. Even before the current crisis, there has been significant consolidation of the financial services sector in Russia, but more needs to occur. At the same time, the lack of effective financial intermediation in the Russian economy is a major obstacle to growth. In the case of telecommunications, the weak infrastructure inherited from the Soviet Union creates challenge for investment and upgrading of technology. At the same time foreign investment in this sector can bring new technology and help ensure that investment is channelled to the most economic and promising technologies. A deliberate schedule to open the domestic market in these sectors to international competition would promote the restructuring of these services sectors.

Federalism poses interesting challenges to the conduct and management of international economic relations. For example, the United States, Canada, India and Australia are examples of members of the WTO who have federal constitutional structures. Moreover, the European Communities has many of the characteristics of a federal system in its relationship with the
member states. Yet in turn, some of the EC member states are federal systems, notably Belgium and Germany.  

The issues for federal systems of participation in the GATS for trade in services are much more significant than is the case for the WTO agreements for trade in products. Although there may be variation in actual practice, all federal systems seem to accept that the federal government has the preeminent jurisdiction over trade in products for matters such as setting tariffs. The GATS deals with issues such as the movement of natural and legal persons across borders and with certain aspects of the domestic regulation of services. In many federal systems at least some aspects of the GATS involve the legal jurisdiction and regulatory authority of the subnational governments, so the issue of implementation of the GATS commitments by subnational governments arises. Only the main issues are identified here.

The issue of the relationship between national and subnational governments is partly a legal and constitutional question. Some federal constitutions, such as that of the United States give the federal government comprehensive authority to legislate to implement international agreements and to override state legislation and administrative practice. Others, such as the European Communities, have limited authority and competence on issues such as movement of natural or legal persons, which are central issues in the GATS.

However, domestic politics and economic interests can shape how the central authority chooses to handle these issues. For example, in response to sovereignty concerns, the United States was very circumspect with respect to state jurisdiction in the implementation of the Uruguay Round and the WTO despite the clear constitutional authority of the US federal government, while the European Commission used the implementation process for the Uruguay to expand its authority and competence vis a vis the EC member states.

Some key issues for the Russian federal government are:

- If the Russian Federation government legislates the implementation of the GATS schedules will this override subnational laws and regulations which contradict the federal legislation and the WTO commitments?
- Can the Russian Federation government enforce such legislation and regulations through the domestic courts?
- Can Russian citizens or legal persons enforce the relevant legislation through the domestic courts?

7 The legal and constitutional issues involved in implementing the Uruguay Round and the WTO are examined in a number of countries and jurisdictions in a volume edited by John Jackson and Alan Sykes, Implementing the Uruguay Round, 1997.

8 There have been disputes in the past under the GATT about the practices of Canadian provinces and US states in the distribution and taxing of alcoholic beverages, but these are quite isolated cases.
What are the consequences under domestic law if subnational legislation or administrative practice is found to contravene WTO obligations and commitments by Russia?

Can the Russian Federation government ensure the compliance of subnational governments with WTO dispute settlement findings?

These issues of subnational implementation and compliance will need to be considered in the negotiation process and in the preparation of the implementing legislation. With a relatively new constitution and limited experience by subnational governments in dealing with international economic arrangements, it is important that these questions are answered clearly in the implementing legislation. It is clear that the initial approach taken by the Russian Federation about how to deal with subnational governments will set the pattern for the future. Most importantly, if Russia implements its WTO, and especially its GATS commitments, in comprehensive implementing legislation that ensures that subnational governments comply with the obligations, this will contribute significantly to economic integration within the Russian Federation.

Russia has economic cooperation agreements with CIS countries including Belarus, Kazakhstan, and Kyrgyz Republic. As presently constituted, these agreements do not meet the requirements of Article V of the GATS. Thus, it would seem necessary to negotiate MFN exemptions for these regional economic cooperation agreements with CIS countries.

Now the MFN exemptions under the GATS, even if they are accepted by WTO members, are intended to be temporary. Therefore, if preferential regimes for services transactions are to be maintained, or the possibility for a preferential regime is to be maintained among CIS countries, and if those arrangements were to remain compatible with the GATS and the WTO, it would be necessary to bring these regional economic cooperation agreements into conformity with Article V of the GATS. The logical consequence is that the CIS agreements would need to be developed further to provide for market access and national treatment commitments for a broad range of covered services. Thus, the GATS would provide international pressure for economic integration among CIS countries and this pressure would not be confined to Russia, because other CIS countries are also in the process of negotiating accession to the WTO.

Sector Specific Issues

Telecommunications. On a global basis, telecommunications plays a pivotal role in economic growth and development. One of the key issues in telecommunications is the ability of firms in the sector of providing various types of services to interconnect with the basic telecommunications network. (This is also an issue in other network services such as

---

9 Article V and V bis of the GATS establish conditions for regional economic arrangements for trade in services in a manner analogous to Article XXIV of the GATT (1994) for trade in goods.
10 The MFN exemptions are to be reviewed after five years and this will be part of the negotiations on services to be launched in 1999.
distribution of electricity.) All the high income countries and most of the middle income countries who have scheduled commitments for telecommunications in the GATS have incorporated into their schedules an annex on regulatory policy. This annex incorporates competition policy principles that strengthen the general provision of the GATS dealing with the competitive practices of infrastructure monopolies and provides explicit rules for interconnection.

Russia's participation in the GATS on telecommunications on a similar basis to OECD member countries or most other middle income countries will accelerate the restructuring of the telecommunications sector in Russia and make a substantial contribution to the export of both goods and services. Efficient telecommunications are critical to the competitiveness of industries ranging from petroleum production to transportation to financial services to computer software manufacturing.

There are significant policy questions for Russia about specifically, how and over what time-frame to liberalize the telecommunications sector? Russia cannot avoid addressing the challenges arising from the global technological and liberalization forces that are sweeping the telecommunications sector. A strategy for the liberalization of the telecommunications sector that can be implemented over a period of years needs to start to be implemented now, but the schedule for market opening can be incorporated into the GATS commitments just as many other countries have done in the telecommunications negotiations.

**Financial Services.** Financial services is another sector that is fundamental to Russia's economic performance and growth, and where there are concerns about the capability of fledgling Russian firms to meet foreign competition.

The financial crisis attenuates the point that liberalization of financial services must be accompanied by effective and vigilant prudential supervision of the adequacy of the capital base of financial institutions and the vulnerability of their balance sheets. The GATS provides wide latitude for prudential measures under the Financial Services Annex, but the supervisory capacity of the financial regulators must be sufficient to meet the challenges.

There is clear argument that a liberal and transparent policy regime for Russia's financial services will lead to a better capitalized, more efficient financial services sector. A closed financial services sector, ridden by enterprise arrears, could exacerbate the banking crisis. On the other hand, it is economies like Singapore that have an open financial services sector with significant foreign presence, who have weathered the Asian financial crisis better than regional partners with more protected financial services sectors.

The restructuring of Russia's financial services sector is a critical issue in the economic reform process. Although there may be debate about the time frame for liberalization, the direction of policy change that is required is clear.
Technical and Institutional Issues in the Negotiations

Apart from the policy issues in the GATS negotiations, there are important technical and institutional issues that need to addressed if Russia is to participate effectively in the negotiations of GATS schedules and implement the commitments.

Among the key points are:

- technical precision is required in the drafting of the schedules of specific commitments to, and limitations of, market access and national treatment in order to ensure that the specific commitments accurately reflect policy sensitivities;

- there are challenges of implementation of the specific commitments with many ministries and agencies involved in the process to be addressed;

- there are challenges of implementation of GATS commitments by sub-national governments to be addressed; and

- there are substantial human resource challenges facing the Russian government, because of a lack of knowledgeable personnel and the drain of skilled specialists to the private sector.

Beyond the negotiations, what is required for notifications, establishing an enquiry point, and passage of legislation for implementation of GATS? Participation in the GATS does not end with the completion of the accession negotiations. Indeed the following challenges for ensuring ongoing implementation of the GATS are at least as substantial as the conduct of the negotiations.

These challenges include:

- fulfilling the WTO notification requirement that all changes in legislation and administrative practice that affect GATS obligations and commitments must be notified to the WTO;

- ensuring that all regulatory and administrative agencies continue to comply with GATS obligations and commitments; and

- meeting the requirements of the GATS for an Enquiry Point (and also a Contact Point) that respond to all information requests from private individuals and firms about legislation, regulations and administrative practice affecting particular service industries.
What Strategic Choices Does Russia Have?

Participation in the GATS raises fundamental issues about the *openness*, the *transparency* and the *predictability* of the legal, regulatory and administrative regimes for the services industries in Russia. The detailed aspects of the negotiations of GATS schedules as part of the accession to the WTO are technical and obscure, but the issues involved are critical to the next stage of the transition process. The issues of the rule of law and the system of corporate governance and accountability, the transparency and predictability of regulation and administrative practice, and the openness to foreign competition in the services sectors will to a substantial degree determine whether the legal and economic policy framework evolves in a manner which promotes growth in the Russian economy, or whether the institutional and policy framework drifts leading to continued stagnation.

Although participation in the GATS raises significant issues for Russia, participation in the GATS allows considerable flexibility in the evolution of the legal and regulatory regimes for services industries. The GATS creates a framework for policy and regulation in individual services industries, but there is considerable variation in how the policies and practices of individual countries evolve within the overall framework of the GATS. Thus, making specific commitments for market access and national treatment for services sectors should not constrain unduly the evolution of Russian policy and practice.

The accessions negotiations to the WTO will take time and more importantly the negotiations require extensive and thorough technical work and serious engagement of senior policy makers. If Russia takes an intensive, proactive approach to the accession negotiations, within two years it could complete the accession. The most important factor influencing the timing of accession to the WTO is the overall approach of Russian policy. If Russia takes a cautious, reactive and defensive approach to the accession negotiations, it could easily take considerably more than two years to complete the WTO accession process. The time required for the accession negotiations is largely up to Russia.

There is a risk that the GATS negotiations, (and the overall WTO accession negotiations) will drift, because of limited resources allocated by the Government, and because of a lack of willingness to address challenging policy issues. Once the schedules of commitments for services under the GATS (and the commitments and schedules for industrial and agricultural products) have been negotiated, these must be implemented in legislation in order to complete the accession. This will involve difficult and sensitive issues such as the clarification of the regime for property rights.

If Russia wishes to complete the WTO Accessions negotiations within the next two years, then the Government must attach a very high priority to the negotiations. The coordinating team needs more resources and must have full support across all the Ministries and Agencies of the Federation. There must be a high-level of political commitment in order to build a consensus
that will permit the comprehensive legislative implementation of all the measures required by the WTO and the schedules of commitments.

Whatever Russia chooses about the priority it places on the WTO accession negotiations, the GATS provides the global standard for the liberalization and regulation of the services sectors. All high income and middle income countries have taken on a full range of obligations under the GATS. Future negotiations under the GATS will reinforce this trend to a universal framework for the regulation of services.

Even if the accession negotiations take time, the GATS provides guidance for policy reforms that can be implemented in advance of the completion of the accession negotiations. Russia needs foreign direct investment (FDI) as part of an overall strategy for economic development and growth. In order to attract such investment, basic elements of investment policy and a more transparent regime for regulation and administrative practice need to be developed and implemented.\(^{11}\)

Of course, one of the advantages of participation in the GATS is that commitments for market access for, and national treatment of, investment are indeed "commitments" -- they are "locked in" which gives greater predictability and credibility to the policy regime. The greater certainty and predictability of the policy regime is valuable for both domestic and foreign investors. Some of this credibility for the policy regime can be obtained through the GATS offer even before the negotiations are completed, since withdrawal of elements of the offer would set back seriously the accession negotiations.

In short, Russia needs to push on the WTO accession negotiations in order to achieve its own goals of achieving sustained economic growth. Participation in the GATS and accession to the WTO will require further economic reforms in Russia and improve substantially the climate for investment for both domestic and foreign firms.

The imperative for Russia in acceding to the WTO is primarily a domestic imperative. But at the international level, there is an additional incentive to press for conclusion of the accession negotiations. As noted earlier, by the end of 1999, new negotiations on services likely will be launched and these could be joined with other negotiations on agriculture and industrial products. Such a major negotiation will complicate the WTO accession negotiations and expose Russia to the pressures of these negotiations if the accession is not completed within the next two years.

In the final analysis, in framing the approach to the GATS negotiations for Russia, it is important for the authorities to articulate a clear vision of the policy framework for the services sector that needs to be achieved in order to promote economic growth and development. The GATS can provide useful guidance to Russia in this process. But the key policy issues must be

\(^{11}\) Russia's FDI policy regime is assessed in J. Bergsman, H. Broadman and V. Drebentsov "Improving Russia's Foreign Direct Investment Policy Regime" in this volume.
addressed within Russia. By improving the investment climate and by promoting the restructuring of key services sectors, participation in the GATS could make an important contribution to economic growth.
Bibliography


STATE TRADING IN RUSSIA

Vladimir Drebentsov and Costas Michalopolous*

Introduction

The rapid progress countries in Central and Eastern Europe and the former Soviet Union (FSU) are making in introducing market reforms and in integrating into the international economic system has resulted in a fundamental change in the institutions used for the conduct of international trade. State trading organizations dominated international trade under central planning. Today, in Russia and most other economies in transition, trade is primarily conducted by private firms and the role of state trading, in some respects the last vestige of central planning, has shrunk considerably.

The issue of how much state trading is actually occurring has implications on two important policy issues: First, Russia and most previously centrally planned economies are applying for accession to the WTO without seeking any special consideration for state trading activities. Second, Russia and most FSU countries, continue to be classified as "non-market economies"1 in the context of anti-dumping regulations of the EU and the US, a classification which may result in discriminatory treatment that limits market access. If evidence shows that state trading practices in these countries are not significantly different than those of other countries, for example those that are already members of the WTO, this would pose questions as to whether these EU and US classifications and regulations should be reconsidered.

This paper examines the evolving role of state trading in Russia. First, there is a short discussion of the meaning of state trading. Next, we discuss the evolution of state trading in Russia until mid-1997. The following section analyses the implications of the findings for WTO accession and for Russia's designation as a "non-market economy". The final section presents conclusions and recommendations.

The Meaning of State Trading

Past experience with notifications of GATT members under Article XVII offers little clarification on the meaning of state trading enterprises (STE). Over the period 1980-1994 few countries bothered to notify the existence of such enterprises. For example in 1993 the last "full" reporting year under the GATT only 11 of 105 members notified. Most notifications came from

---

* Vladimir Drebentsov is Economist, Moscow Office, The World Bank; Costas Michalopolous is Special Economic Advisor, WTO (on secondment from The World Bank).

1 Foreign relations ministers of EU countries agreed to change this status to a market one for Russia in late April 1998, which is consistent with the recommendations of this paper. This is yet to be implemented in practice.
developed countries. Some members (Hungary, 1984, Yugoslavia throughout the 1980's and early 1990's) notified that they had no state trading activities, although there is ample evidence of state trade organizations playing a major role in both countries' trade at the time. Most of the enterprises notified were involved in trade in agricultural commodities, and a few in alcohol and tobacco and petroleum products [GAO, 1995].

In an effort to clarify what enterprises should be classified as STE a working definition was agreed during the "Understanding" negotiated in the Uruguay Round as follows:

"Government and non-governmental enterprises, including marketing boards, which have been granted special rights or privileges, including statutory or constitutional powers in the exercise of which they influence through their purchases or sales the level or direction of imports or exports." [WTO,1996]. It is too soon to tell what kind of enterprises will fall under this definition. But, the interest in some OECD countries, e.g., the US, so far appears to focus, as in the past, on concerns regarding the activities of state trading in the agricultural sector of other developed countries, such as Canada, Australia and New Zealand.[GAO,1996].

Throughout this period, GATT members, faced with all-encompassing state trading activities of centrally planned economies--most of which were not members of the GATT, classified these countries as "non-market economies" and applied special trading regimes to imports from them. For example, the EU and the US adopted special procedures regarding the determination of "normal" pricing in connection with anti-dumping measures taken against enterprises from these countries.

In anti-dumping, the focus in both the US and the EU has been on the country-- rather than the enterprise\(^2\). The EU Commission determines annually a list of countries designated as non-market economies whose enterprises by definition would be considered as engaging in state trading activities. The current list includes Russia, China and 15 other countries [Hindley,1997].

It is interesting in this regard that the trade agreement signed between the EU and Russia in 1994 does not appear to change this treatment. The relevant paragraph has a somewhat vague reference to the effect that: "In respect of anti-dumping or subsidy investigations, each Party agrees to examine submissions by the other Party and to inform the interested parties concerned of the essential facts and considerations on the basis of which a final decision is to be made. Before definitive anti-dumping and countervailing duties are imposed, the Parties shall do their utmost to bring about a constructive solution to the problem" and further, "The Parties agree that, without prejudice to their legislation and practice, when establishing normal value due account shall be taken overall, in each case on its merits, when natural comparative advantages can be shown by the manufacturers involved to be held with regard to factors such as access to

\(^2\) In the US there were a few cases where it was argued that an enterprise was judged to be functioning within a market environment even the though the country as a whole was judged a non market economy. See P.Ehrenhaft, 1997.
raw materials, production process, proximity of production to customers and special characteristics of the product”.

In the US there is no list, but the determination is made on a case by case basis in light of whether a country meets a set of criteria imbedded in the relevant legislation. The following criteria are used, and may be of interest in the discussion of state trading: (a) currency convertibility; (b) determination of wages through free bargaining between labor and management; (c) the extent to which foreign joint ventures are permitted; (d) the extent of government ownership or control of the means of production; (e) the extent of government control over the allocation of resources and the price and output decisions of enterprises; and (f) other factors the administering authority considers appropriate—usually related to the extent to which exporters are able to export goods on terms and conditions they fix without government interference [Ehrenhaft, 1997].

As can be readily seen, these criteria are far broader than those suggested in the definition contained in the “understanding” regarding Article XVII; but the last three criteria pertaining to ownership and government control over output and price contain elements also present in the definition of the Article.

Based on these procedures a number of antidumping actions have been taken both by the EU and US in recent periods against Russia and several other FSU countries. A recent analysis of these procedures suggests that they probably made only a small additional difference over the fundamental protective effect of the anti-dumping actions taken. However, the procedures undoubtedly introduced the possibility for greater arbitrariness and biases extraneous to the economic circumstances of the enterprises affected. [C. Michalopoulos and A. Winters, 1997]. No matter what the final judgement may be on the fairness of these procedures, it could be argued that, if in Russia state trading is no more prevalent than in some other market economies, it should no longer be treated differently by the US and EU in this or other respects.

Thus, how much state trading goes on in Russia today, is of importance both with respect to Russia’s accession to the WTO—and in particular regarding the enforcement of GATT Article XVII, as well as in the context of the treatment that Russian exporters receive in major international markets. It is of course possible that following Russia’s accession to the WTO, governments will stop treating Russia as a non-market economy; and that it is only a matter of time until accession occurs. On the other hand, accession negotiations have often taken a long time; and it is important to deal with the issue of how much state trading occurs in Russia today, even on an interim basis.

---

3 European Union 1994, Article 18 and joint declaration in relation to Article 18.
State Trading in Russia

The Russian Federation formally abandoned the state monopoly on foreign trade, which had been a key element of USSR planning, during the first months of independent existence. Yet, the country inherited a complex system of centralized exports and imports implemented through a number of specialized state trading firms, so called foreign trade organizations (FTOs), which exercised a foreign trade monopoly for the state in the Soviet era.

Over time, privatization throughout the economy reduced the role of the FTOs. But, elements of state trading remain in three main areas: (a) Companies which either are fully state owned or state controlled which exercise monopoly in the export trade of their respective products (e.g., natural gas, diamonds, pipelines); (b) companies engaging in barter trade with other CIS or centrally planned economies; (c) other companies whether FTOs or not which do not have monopoly positions but may enjoy certain privileges or advantages in trade.

Until 1995, the trade regime was characterized by an effort to restrain the main exports of energy and raw materials through first, quotas and licensing and, subsequently, export taxes, while imports were relatively free and, for a time, some categories were heavily subsidized through the federal budget. Protection to domestic manufacturers was provided by the relatively undervalued exchange rate and by the domestic prices of the main exportable inputs, such as natural gas and raw materials being kept below international prices.

State Needs and Other Privileges. Throughout this period, the government used the FTOs (and other companies, e.g., oil producers which had been privatized) to operate a system of centralized exports for so-called "state needs". In 1992-1994, these included a wide range of country’s commodity exports, such as petroleum and petroleum products, natural gas, electricity, aluminum, copper, nickel, some timber and cellulose, weaponry. Even in 1995, when both the commodity coverage and volumes of established export quotas for state needs contracted significantly, centralized exports still accounted for 15 percent of the total petroleum exports, and 11 percent of natural gas exports. Beginning in 1996, exports for state needs involved only crude oil shipments. Yet the government’s take during the year was increased from 15 to 25 percent of the total oil exports. The program was finally terminated in the fall of 1997 when most of previous decrees for oil shipments under "state needs" were abolished.

\[^4\] For a discussion of the trade regime during this period, see V. Konovalov 1994.
In 1992-1995, the main privilege granted to companies involved in state exports was their exemption from payment of export taxes. This privilege was terminated in July 1996 with elimination of the last export taxes. Since then, the priority access to oil export pipelines with a constrained capacity granted to companies involved in state export contracts, has become the major privilege; but such a privilege does not necessarily result in placing the activities of these privatized companies under the purview of GATT Article XVII.

Alongside with centralized exports, several other types of privileges were extended to certain Russian companies in 1992-1995 which could be construed as making their activities "notifiable" under Article XVII. Most notable were the preferential provision of export quotas and licenses, and the institution of special exporters - export trading companies registered by the ministry of foreign economic relations (MFER) as the sole legal exporters of the so called strategic commodities. Lists of such commodities have been periodically amended by the government, yet in early years of reform (1992-1993) they covered up to 70 percent of Russia's total exports.

Being nominated a special exporter, and getting a license to export within a quota set by the government was an important privilege--which would have made such companies fit the state trading criteria of Article XVII--especially in the light of the discretion and non-transparent criteria used by the MFER in selecting special exporters and distributing export quotas. However, both export quotas/licenses and special exporter lists were abolished by the government in March 1995, and there have been no similar privileges granted to Russian companies since then.

The only exceptions which remain are: (a) the privileges granted to companies Diamonds of Russia-Sakha (ALROSA) and Almazyuvleiirexport, which have the exclusive right to sell Russia's raw natural diamonds, and test lots of natural diamonds, respectively, on foreign markets; (b) the monopolies for the export of natural gas (Gazprom), and oil pipelines (Transneft)- as well for coal and electricity which are not involved significantly in trade; (c) state trading FTO in armaments (Rosvooruzhenie)- whose activities however, would not normally be covered under the provisions of state trading of Article XVII. At the same there is still a number of FTOs, some still state owned, others privatized (but with the state maintaining controlling

---

5 Access rights to oil pipelines with a constrained capacity--meaning all Russia's export pipelines apart from the Druzhba one, which goes to the Eastern Europe--are allocated on a pro-rata basis among oil producing companies. Yet since, according to the government Ruling, exports for state needs are automatically granted priority in allocation of the access rights, only capacity left after the fulfillment of contracts for state needs is actually got distributed.

6 Two types of export quotas and licenses still exist in Russia: firstly, export quotas are still in place for commodities, exports of which are restricted by various Russia's international obligations --such as VERs or US and EC import quotas for steel, textiles, satellite launchers, etc., secondly, licenses are required for hazardous exports--weaponry and goods dangerous to human health.
interest) or in the process of being privatized whose status regarding "privileges" in trade is unclear. The impression is that most of these companies actually do operate as commercial enterprises at present, however.

On the imports side, the main focus of centralized purchases was for agricultural foodstuffs and raw materials and their trends have closely followed those for centralized exports. In 1992, imports financed directly from the federal budget accounted for 40 (!) percent of total imports from outside of the CIS ($14.8 billion); in 1993 their share decreased to 23.3 percent ($6.5 billion), in 1994, to 9.2 percent ($2.6 billion), and in 1995-1996 to 3-4 percent, shrinking basically to purchases for consumption in governmental use. Beginning in 1995, there have been no funds allocated in the federal budget for centralized imports of agricultural commodities and foodstuffs - imports of which constituted the bulk of centralized purchases in previous years.

The government has employed state trading for imports of products, that used to be in great shortage on the domestic market, on a clearly declining basis. With the emergence of private trading companies that successfully saturated the Russian consumer market, the government has gladly withdrawn itself from import activities. This has also put an end to import subsidies that the federal government used to grant prior to 1995. Since neither import quotas/licenses, nor the institute of special importers have ever existed in Russia, budget financing of centralized imports via FTOs was the sole privilege that could be construed as making these companies' activities fall under Article XVII. But with the end of this financing the "privileges" of these companies also ended.

**Intergovernmental agreements with CIS and Centrally Planned Economies.** These agreements, which envisage mutual shipments of specified goods--the so-called interstate barter--are used by the Russian government in relations with commonwealth of Independent States (CIS) members and several former COMECON countries (Cuba, Mongolia). They also appear to entail elements of state trading--although the precise relationships between the government and the companies engaging in these transactions are opaque and difficult to pin down.

Following the break-up of the Soviet Union and in an effort to sustain trade relations in the face of a collapsing payments system, Russia and the other CIS countries established a series of barter agreements based on lists of commodities (sometimes quite lengthy) and quantities of goods to be exchanged. The prices and implicit exchange rates for the bartered goods were often different than market prices. As a rule, the amounts exchanged fell far short of the amounts originally agreed upon for a variety of reasons [Konovalov, 1994] and the importance of the agreements and their scope declined drastically over time. They were supposed to have been

---

7 Strictly speaking, what has been said in the previous footnote with respect to hazardous exports is valid to imports of the similar nature, too. Yet since such licensing does not employ any quantitative restrictions, or price setting, it doesn't fit the definition used for purposes of Article XVII.

8 CIS consists of all the independent states that emerged from the breakup of the Soviet Union except the Baltics.
terminated within CIS at the end of 1996. But some agreements appear to be still in place (see below) and the manner of their operation raises a number of questions.

All of them had attachments with lists of commodities the signatories were obliged to ship to each other on a barter basis via specified trading companies. In Russia the main beneficiary of such agreements has been the company Roscontract. In fact, this company was established in 1992 as a private enterprise to be operated on a profit basis and in order specifically to intermediate intergovernmental barter agreements from the Russian side. At the time it also received a loan from the federal budget for this purpose--whose repayment to date is unknown.

Strictly speaking, the commodity lists in these agreements are not binding, and in fact, in most cases the targets set have never been achieved. However, articles of the agreements do provide for foreign trade privileges: specific companies are explicitly nominated by the government as its agents, and trade under the agreements is exempt from export and import duties. So, at least in the part that they are fulfilled, activities of companies involved in these agreement could be construed to fall under the meaning of state trading under Article XVII. But it appears from personal interviews with Roscontract and Ministry of Foreign Economic Relations (MFER) officials that Roscontract has stopped its involvement in the interstate barter deals as of the beginning of 1996. Unfortunately, we have to express caution with respect to such a conclusion, because the language of Russia's intergovernmental agreements with Georgia and the Kyrgyz Republic for 1996-1997 is absolutely identical to that of previous ones, including both explicit nomination of Roscontract for intergovernmental barter intermediation, and the inclusion of lists of commodities to be shipped in agreed volumes to and from Russia.

Besides, confirmed shipments under the “sugar-oil” agreement with Cuba and signed two barter agreements with Uzbekistan in 1997. One for the exchange of 18.2 thousand tons of cotton for 100 thousand tons of Russian wheat in 1997, and the second, a three-year one, for the exchange of Russian fuel, non-ferrous metals, and agricultural equipment for Uzbekistanian cotton. Two Russian trading companies, Rostekstil and Contex, participating in the first barter deal were explicitly named. Although it is not clear at first glance what privileges these companies obtained, some concessions seem likely to have been granted. Otherwise, the very agreement would have been meaningless, and nobody would have competed for participating in the deal, which was not the case.

---

9 According to MFER, 6 million tons of Russian oil should be exchanged for 2 million tons of Cuban raw sugar in 1997.
10 At least on the Russian side there were no export or import duties applicable to such deals with the CIS in 1997, so on this ground companies selected by the government remained on level with all other traders.
11 Of course, one should also note in the same connection that Gazprom is involved in a large number of state trading relationships with many countries in the CIS and Eastern Europe, e.g., the Czech Republic.
An effort was made to develop a quantitative estimate of the extent of state trading in Russia in 1997 relative to the total turnover of trade (the value of exports plus imports) for that year as well as to make some judgements on the evolution of the situation since then. Table 1 presents a summary of our analysis. The estimates presented on the FTOs and Roscontract should be considered as orders of magnitude subject to considerable margin of error. On the whole an effort was made to include the activities of all state owned or controlled firms which could be considered to be extended privileges of some kind and thus fall under the purview of Article XVII of the GATT.

Table 1
State Trading in Russia
(in US$ billion)

<table>
<thead>
<tr>
<th>Type of State Trading Enterprise</th>
<th>Value of International Trade Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gazprom</td>
<td>16.4</td>
</tr>
<tr>
<td>FTOs (listed in Annex)*</td>
<td>10.0</td>
</tr>
<tr>
<td>Roscontract</td>
<td>7.0</td>
</tr>
<tr>
<td>Oil exports for state needs</td>
<td>3.0**</td>
</tr>
<tr>
<td>RAO UES</td>
<td>0.5</td>
</tr>
<tr>
<td>Total State Trade</td>
<td>36.9</td>
</tr>
<tr>
<td>Total Exports plus Imports</td>
<td>139.0</td>
</tr>
</tbody>
</table>

*Excludes Rosvooruzhenie (approximately US$3.5 billion; also total excludes Transneft which also could be conceivably viewed as a "privileged" monopoly.
**Abolished by fall 1997

The total value of state trading activity in Russia for 1997 is estimated at US$ 36.9 billion or 26.5% of total trade (exports plus imports). Of this the largest amount US$ 16.4 billion involves activities of Gazprom. Another roughly US$ 10.0 billion is accounted by the turnover of FTOs listed in Annex, including the diamond export monopolies. It is probably a maximum for this category of firms--as many of them have been privatized or are operating on a commercial basis, even if state owned. The estimate for Roscontract is based on extrapolation to 1997 of turnover of CIS interstate barter over previous years, and is also probably a maximum, as some of the activities that it undertook may have been on a strictly commercial basis. The state needs program for oil exports had accounted for another US$ 3.0 billion before it got abolished.
Finally, there are smaller amounts involving the fees of Transneft (state owned oil pipeline monopoly), which are not included, and exports by RAO UES (state owned electric grid monopoly).

With the exception of the trade under intergovernmental agreements, the bulk of the trading activities involves exports rather than imports; and in energy and raw materials the "privileges" enjoyed by the exporting organizations did not involve subsidies. These companies rather did not pay export taxes which typically caused the domestic price of energy to be lower than the international price. Since there are no export taxes in Russia at the moment, such privileges, in principle, do not exist.

In 1998, and assuming announced government policies are implemented, the total state trading is likely to decline for a number of reasons: the oil exports for state needs have been eliminated; the role of state owned FTOs is supposed to decline as more are privatized and start to function on a commercial basis; and the role of Roscontract and other FTOs as intermediaries in intergovernmental agreements is supposed to diminish gradually (but note the caution on this issue above). If all this were to be accomplished, the total state trading as a percent of total volume of trade might fall to about 14-16%, which would still constitute sufficient basis for applying procedures envisaged under the GATT Article XVII.

Implications

The main implication of this analysis, is that while Russia has made tremendous progress in privatizing its economy and operating enterprises on a commercial basis, at least about 11% and perhaps as much as 20% trade is still controlled by the state. The problem is not so much the absolute size of the share—which predominantly involves exports of energy and a few raw materials (diamonds), but the lack of transparency in the relations between the state and enterprises engaged in international trade, whether formally privatized or not—a problem—which, unfortunately, is a more general problem and not limited to firms involved in trade. The system is especially opaque in trade with the other CIS and a few centrally planned economies. The problem is compounded by a general weakness in governance which results in weak enforcement of announced government policies.

The implications of these findings for Russia's accession to the WTO are twofold: (a) The Russian government would need to take urgent steps to clarify the status and privileges of a number of firms engaged in international trade—e.g., Roscontract and some of the FTOs; and (b) provide appropriate explanations to the WTO working party dealing with Russia's accessions, and express readiness to notify it of the status of state trading even prior to completing accession process. Otherwise, this process could be significantly delayed.

Finally, a few comments are appropriate on the implications of these findings for the designation of Russia as a nonmarket economy in the context of determination of dumping in the
US and the EU, two very important markets for Russia's exports. As noted earlier, this designation may not have been significantly more detrimental to Russia's exports beyond the inherently protective characteristics of antidumping or threat of anti-dumping actions. However, the designation carries with it the potential for damaging action and the introduction of non-transparent processes—ironically in this case on the part of the major industrialized countries. Moreover, the designation tends to encourage both the EU and the US to enter into cartel-like price and quota understandings with Russia—see e.g., the EU—Russia arrangements on steel and the US agreements with several CIS countries on uranium and aluminum [Michalopoulos and Winters, 1997]. This reinforces existing monopolistic tendencies within Russia and intensifies the problem of creating competitive market conditions.

There is little doubt that today Russia is a market economy and should be treated as such, although many of its markets are characterized by significant imperfections. Even if the highest of the range of estimates is used for state trading—26%, this is certainly consistent with the share present in other economies—for example many developing countries with significant public sector involvement in exports of raw materials and energy—which are not designated "non-market economies".

A similar conclusion can be reached regarding the other criteria that the US uses in classifying "non market economies" (see above p. 3): First, there is little doubt that Russia meets the test of currency convertibility as it has been recognized by the IMF to meet obligations under Article VIII (of the IMF) for full current account convertibility. Second, on wage determination there are clearly no wage controls or significant government interference in wage setting. Third, there are few limitations on joint ventures—for example in defense, financial sector, transportation and communications—which in any case would have to dealt with in the context of Russia's commitments under the GATS, or, even more generally, as a part of upgrading the FDI regime.

More specifically, regarding the issue of antidumping, government interference, where it has existed, has focused on having exporting firms raise their export prices to international levels rather than selling abroad at less than the domestic price.

It is of course possible—although it would be odd indeed, that Russia becomes a member of the WTO but continues to be designated a non-market economy by the US for purposes of anti-dumping [Michalopoulos and Winters 1997]. Common sense and congruence in policy however, would suggest that upon admission into the WTO—if not before, Russia and many other CIS countries are designated as market economies reflecting the progress they have made in privatizing their economies and terminating one of the last vestiges of the cold war.
Recommendations

1. State trading has the potential of introducing significant distortions in trade by putting Russia on an uneven footing with other transition economies both in terms of treatment by the main trading partners, and in the process of WTO accession. The Russian government should make all efforts to accelerate market reforms and minimize state trading activities within the meaning of Article XVII of the GATT and otherwise. Particular emphasis should be placed in:

(a) reducing the role of monopolies in state trading, through bona fide privatization and elimination of barriers to entry created through special privileges accorded to individual companies;
(b) create transparent relations between the state and individual companies of agencies that enjoy special privileges that are notifiable under Article XVII of the GATT;
(c) take steps to immediately and effectively terminate the state trading aspects of the intergovernmental agreements--as called for by existing policy. Such policies would be both beneficial to its economy and expedite accession to the WTO.

2. The United States and other members of the WTO should follow the European Union in considering termination of the designation of non-market status in the context of antidumping for Russia at the earliest possible and no later than when it becomes a member of the WTO. In the meantime, these countries should monitor carefully the progress made by Russia in introducing market oriented reforms and reduce state trading to ensure its fair treatment in antidumping cases--in particular that the designation of Russia as a non-market economy does not result in a less favorable treatment than for "market" economies.
REFERENCES


ANNEX
List of state owned/controlled trading firms (FTOs), as of end-1997

<table>
<thead>
<tr>
<th>NAME</th>
<th>OWNERSHIP STATUS</th>
<th>AREA OF SPECIALIZATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almazyuvelir Export</td>
<td>State owned</td>
<td>Diamonds</td>
</tr>
<tr>
<td>Atomenergoexport</td>
<td>Privatized (golden share*)</td>
<td>Nuclear energy equipment</td>
</tr>
<tr>
<td>Avtopromimport</td>
<td>Approved for privatization</td>
<td>Motor vehicles</td>
</tr>
<tr>
<td>Diamonds of Russia-Sakha</td>
<td>State owned</td>
<td>Diamonds</td>
</tr>
<tr>
<td>Lenfintorg</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Litintern</td>
<td>Privatized (golden share)</td>
<td></td>
</tr>
<tr>
<td>Litsenzintorg</td>
<td>Approved for privatization</td>
<td>Licenses and patents</td>
</tr>
<tr>
<td>Mashinoexport</td>
<td>Approved for privatization</td>
<td>Machine-building industry products</td>
</tr>
<tr>
<td>Mashinoimport</td>
<td>Approved for privatization</td>
<td>Machine-building industry products</td>
</tr>
<tr>
<td>Nafta-Moskva</td>
<td>Privatized (golden share)</td>
<td>Petroleum</td>
</tr>
<tr>
<td>Novoexport</td>
<td>Approved for privatization</td>
<td>Miscellaneous exports</td>
</tr>
<tr>
<td>Prodintertorg</td>
<td>State owned</td>
<td>Food industry products</td>
</tr>
<tr>
<td>Prodintorg</td>
<td>State owned</td>
<td></td>
</tr>
<tr>
<td>Promexim</td>
<td>Approved for privatization</td>
<td>Miscellaneous industrial goods</td>
</tr>
<tr>
<td>Prommashimport</td>
<td>Approved for privatization</td>
<td>Industrial machine building</td>
</tr>
<tr>
<td>Promsiryoimport</td>
<td>Approved for privatization</td>
<td>Industrial raw materials</td>
</tr>
<tr>
<td>Raznoimport</td>
<td>Privatized (golden share)</td>
<td>Miscellaneous imports</td>
</tr>
<tr>
<td>Roscomagenstvo</td>
<td>Privatized</td>
<td>Miscellaneous external trade</td>
</tr>
<tr>
<td>Rostekexport</td>
<td>Privatized</td>
<td></td>
</tr>
<tr>
<td>Rosvneshtorg</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>NAME</td>
<td>OWNERSHIP STATUS</td>
<td>AREA OF SPECIALIZATION</td>
</tr>
<tr>
<td>-----------------------</td>
<td>--------------------</td>
<td>-----------------------------------</td>
</tr>
<tr>
<td>Rosvooruzhenie</td>
<td>State owned</td>
<td>Armaments</td>
</tr>
<tr>
<td>Selkhozpromexport</td>
<td>State owned</td>
<td>Agricultural goods</td>
</tr>
<tr>
<td>Sojizpromexport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Sozuzpushchina</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Sudoimport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Sojuztransit</td>
<td>Privatized (golden share)</td>
<td></td>
</tr>
<tr>
<td>Tekhmashimport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Tekhnointorg</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Tekhnopromexport</td>
<td>State owned</td>
<td>Industrial technology, equipment</td>
</tr>
<tr>
<td>Tekhnopromimport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Tekhnostroyexport</td>
<td>Privatized (golden share)</td>
<td></td>
</tr>
<tr>
<td>Tyazhpromexport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Vneshintorg</td>
<td>Privatized</td>
<td>Miscellaneous trade</td>
</tr>
<tr>
<td>Vneshstroyimport</td>
<td>Approved for privatization</td>
<td></td>
</tr>
<tr>
<td>Zarubezheconomservice</td>
<td>Approved for privatization</td>
<td></td>
</tr>
</tbody>
</table>

* "Golden Share" involves continued government control of company operations.*
Recent Trends in Foreign Direct Investment

As the much-discussed "global market" has become a reality over the last ten years, all countries find it more difficult to stay competitive without FDI. Noteworthy, the most competitive economy in the world, the United States, is not only the largest single source, but also the largest single destination of FDI. The countries of the European Union are also among the largest sources and destinations of FDI. Among the developing countries, and among the transition countries of both Europe and Asia, the fastest growing ones are the biggest recipients of FDI. The empirical evidence suggests that for emerging economies, a one percentage point increase in FDI (measured as a proportion of GDP) leads, ceteris paribus, to an extra 0.8 percentage point increase in per-capita income. Of course, part of the cause-and-effect is that growth attracts FDI. But there are important causation forces from FDI to competitiveness -- FDI brings at least four things of value: financial capital, management skills, technology, and access to export markets -- and therefore sustains growth as well.

Russia can and should take full advantage of benefits associated with inflows of FDI. Given the country’s large endowment of natural resources and educated labor force, as well as its potentially large market, this might seem as a not too difficult task. Yet the record is discouraging. In spite of explicit efforts by government to lure investors, Russia has received far less FDI than it could, both relative to its economy’s size and in comparison with other emerging markets. This result implies, in part, a flawed policy strategy regarding FDI. There is little comprehension of important changes in a world-wide pattern of FDI over the last decades. The key word for these changes is globalization of FDI.

"Globalization" is a widely used expression, which covers three main mutually reinforcing processes:

- Country policies: More and more countries have continued to liberalize their economic policies over the last decade or two, becoming more open both to trade flows (lower tariffs, fewer quantitative restrictions, currency convertibility) and to FDI flows (fewer restrictions on which sectors are open or percentage of foreign
ownership allowed, abandonment of case-by-case approval procedures, etc.). The ones that are not open are experiencing difficulties in maintaining growth.

- **Company behavior**: More and more multinational corporations (MNCs) are adopting integrated regional or even global strategies, using both subsidiaries and strategic allies to locate *interdependent* facilities in various countries so as to maximize their competitive edge worldwide. This is a change from the dominant behavior of 10 or 20 years ago, when MNC subsidiaries in foreign countries were operated more or less independently of each other and were located anywhere there was a market and without regard to whether the locale offered the conditions necessary for world-competitive price and quality production.

- **Technology**: Huge improvements in international transportation and communications, combined with greater use of electronic controls and information storage and transmission, have made the opening of countries, and the change in behavior of companies, viable and important. Computer-aided design and manufacturing ("CAD-CAM") make it possible to design a product, and the software that will control some of the machines that produce it in one location and have the production process changed and running in another location anywhere in the world in a matter of hours or at most a day or two. Other changes in communication technology have also drastically reduced many of the costs of locating interdependent activities in more than one location.

The changes in technology, behavior and policies reinforce and validate each other. Globalization is a positive-feedback process. Because of this, the world is separating into two kinds of countries: those that offer competitive conditions for production, attract FDI, trade, and experience continuing increases in productivity and hence in incomes, and those that do none of these things and stagnate.

In the course of globalization it has become apparent that international trade and FDI complement each other. Of course in some transactions FDI is a substitute for trade; especially in large markets a foreign company may decide to locate production facilities in the market as an alternative to trying to export from its home country. But in today’s globalizing world, trade and FDI go together. In fact, for many MNCs the edge between trade and FDI becomes thinner and thinner. As one business executive noted at a recent meeting of the OECD Trade Committee: “Firms trade to invest and invest to trade.” Today, of all world trade, intra-firm trade among MNCs accounts for about one-third, and MNC exports to non-affiliates accounts for another one-third. Thus, only the remaining one-third of world exports does not directly involve MNCs.²

Within this context, the location of the most efficient, up-to-date, competitive facilities is decided more by MNCs and less by arms-length, market forces. As a result, even very large countries find it more difficult to “go it alone.” In terms of economic development it has become very costly for any country, developing, developed or transitional, to be outside this web of globalized production.

Two other aspects of MNC behavior are also results of the above-mentioned changes in the world economy and forces that validate and increase those changes:

- **Inter-company collaboration:** Spurred by the success of the Japanese example ("keiretsu"), more and more companies are actively collaborating with suppliers in the design of their products and/or processes, and are taking actions to nurture long-term relations (e.g. less subject to being switched on-off in response to short-term changes in demand or other short-term forces). Just-in-time inventory policy is only a part of this. Some elements of these trends have increased the importance of locating interacting facilities near each other, in opposition to the forces that decrease the costs of distance described above.

- **Intense competition among companies and countries:** The greater openness of national economies and the growing multinational consciousness of businesses have dramatically increased competition in product and factor markets almost everywhere. Comfortable, "quiet life" production at less than world-standard quality and price is a rare luxury for management and labor as well. Prospects for such production have no appeal for MNCs, and today, investors are very reluctant to locate important facilities anywhere that offers them second-class conditions. What MNCs are looking for is a set of policies that simultaneously provide security of market access and nondiscrimination vis-à-vis domestic investors. Partially beneficial policies are not appropriate anymore; for to put at stake state-of-the-art investments, MNCs need to be sure in stability along the whole trade-investment continuum. MNCs do establish facilities in higher-cost or higher risk locations when there are attractive markets; but they are often not integrated into their international strategies, may not have their best technologies, and do not bring the full potential benefits of FDI. Hence keeping a restrictive or even a distorted type of FDI regime prevents an economy from harvesting all benefits associated with the modern-type inflow of capital.

Having a less favorable FDI regime relative to what other countries offer is especially detrimental to the economy because countries compete for FDI among themselves. In the 1950s and 1960s, countries competed for export-oriented FDI but did not have to compete for FDI that was oriented to domestic markets -- just a large market, with protection from imports, was enough. Thus, a country such as Russia would not have offered tax holidays, cheap land, or other incentives. Today, with globalizing investment becoming more important, even countries with large markets have to compete. Privileges often offered to FDI seem as a natural response to this competition. However, the most effective instruments of such competition do not include tax concessions or other types of foreign investment preferential treatment (see below). Rather a
reasonable, transparent and stable tax system is necessary to attract modern FDI; extremely low rates or special treatment is not. Most of the countries that are succeeding in attracting this kind of FDI are in fact not offering such special treatment – the exceptions are a few Asian countries that have been caught in a bidding war amongst themselves. Russia needs to undertake a comprehensive review of its FDI policy regime and substitute a stability-and-safety package for old-type privileges if it wants to attract today’s foreign investor.

Russia’s harmonization with the realm of globally operating MNCs is discretionary. But Russia is also acceding to various international economic institutions, of which the World Trade Organization (WTO) is of key importance for shaping national policies towards FDI. Russia, as a nation acceding to WTO, will have no other option but to harmonize its regime with WTO requirements. It is important for the government to have a clear understanding of both those regimes and the inconsistencies with them that current policy presents.

In the next section we review the relevant WTO FDI agreements. This is followed by an analysis of the current FDI policy framework in Russia. Subsequently we present an overview of best international FDI practices. The paper concludes with recommendations for improving Russia’s FDI policy regime—stemming both from the necessity to attract modern-type FDI and to comply with WTO norms.

Impact of Joining International Institutions for a Country’s FDI Policy Regime

The “Agreement on Trade-Related Investment Measures” (TRIMs Agreement), entered into by WTO members during the Uruguay Round, has a direct bearing for shaping the FDI regime of a country seeking WTO membership, which Russia currently is. Acknowledging that certain measures towards investment have apparent restrictive or distortive implications for international trade, the TRIMs Agreement stipulates that no signatories shall apply any TRIM inconsistent with the Article III and Article XI of the GATT 1994. Fleshing this out, the Appendix to the TRIMs Agreement lists some types of prohibited TRIMs. Among such measures, be it a mandatory requirement or a prerequisite for obtaining some privilege, are:

(i) those that require particular levels of local sourcing by an enterprise - “local content requirements”;

(ii) those that restrict the volume of imports which an enterprise can buy or use to the volume or value of products this enterprise exports - “trade balancing requirements”;

(iii) those that restrict the volume of imports to the amount of foreign exchange inflows attributable to an enterprise - “sufficient foreign exchange earning capacity requirements”; and finally

(iv) those that restrict exports by an enterprise either in terms of the particular type of products (or their volume or value), or, generally, in terms of a proportion of local production - “supply to local market requirements.”
It seems at the moment that the second and the third clusters of potential non-compliance are not relevant to Russia. Indeed, there are no such restrictions in existence so far. Yet as the next section of this paper demonstrates, Russia is a clear case for both the first and the fourth groups of inconsistent TRIMs. It is particularly so if one bears in mind that, as the text in the previous paragraph indicates, prohibited TRIMs include not only explicit bans or restrictions, but also any condition of a nature described in one of four clusters above, which is necessary to comply with to obtain an advantage.

Another item that is critical with respect to the TRIMs Agreement pertinent to Russia is as follows: the Agreement requires the mandatory notification of all non-conforming TRIMs covered by the above list (whether they are implemented at the federal or sub-national level), and calls for elimination of such TRIMs over a transition period. The transition period varies according to a country’s status. Since Russia has, to date, notified the WTO Secretariat that it is going to accede to this organization as a developed country, the transition period will be just two years, contrary to the five years granted to developing countries. Similarly, neither potential extension of the transition period nor an allowed deviation form the provisions of the TRIMs Agreement, that are available to developing countries, could be utilized by Russia.

Alongside with the WTO, there is another international agreement on FDI, which is still at a stage of negotiations yet might be of interest to Russia in the future. By this we mean the Multilateral Agreement on Investment (MAI) -- the OECD countries’ initiative. When, and if, coming into existence, the MAI would replace a current world-wide network of bilateral investment treaties (BITs), regional agreements and OECD-type vehicles (Codes of Liberalization or Declaration and Decisions on International Investment and Multinational Enterprises). One of the MAI’s main advantages over regular existing instruments is apparent. While BITs commonly provide coverage only for the after-establishment period, the MAI would ensure investment protection at the pre-establishment stage (i.e. before the investment is made). Russia might consider early joining the MAI negotiation process as an observer, which has already been done by several non-OECD nations that are implicitly competing with Russia for FDI inflows in the international capital market (including Argentina, Brazil and Slovak republic).

Russia’s FDI Policy Regime: Achievements and Challenges

It should be acknowledged that the Russian government has been constantly and explicitly trying to attract FDI, and hence make the FDI regime more attractive. However, a

---

3 The term “advantage” is not defined in the TRIMs Agreement. However, it is understood to cover all forms of preferential treatment, including tax-based or interest rate-based ones.

4 Unavailability of the latter temporary deviation acceptable to WTO, if carried out by a developing country for balance-of-payments purposes, seems to be a particular loss for the Russian government, given persistent attempts by the authorities to introduce language on trade restrictions for balance-of-payments purposes into the national legislation and other normative acts. Accession to WTO makes these attempts useless, for Russia will not be permitted to use this excuse.

5 Today, there are over sixteen hundred active BITs entered into by various countries.
relatively small amount of accumulated FDI suggests that the government has not been very successful. Of course the lack of political and economic stability has been an important stumbling block and even a first class policy towards FDI would not suffice to overweigh that. While acknowledging the importance of macro stability, nonetheless, Russia's FDI regime has serious flaws.

The most serious challenge the Russian government faces at the moment is to switch from an obsolete approach towards luring foreign direct investment to a modern-type one. The former, in the case of Russia, involves relatively high tariff protection of the domestic market, and on top of that, specific privileges offered to FDI. The latter approach would require getting rid of both these sticks and carrots, and providing foreign investors with a climate conducive for attracting cutting-edge capital. We will come back to this issue. Let us start with a review of specific problems of the Russian FDI policy regime.

**TRIMs Inconsistent with WTO Rules.** The first and the smallest cluster of such problems comprises procedures inconsistent with the TRIMs Agreement. The government has notified the WTO Working Party of just a single prohibited TRIM so far. Moreover, the government has stated that even that TRIM is not implemented. Indeed in December 1997 the government submitted to the WTO Secretariat an Addendum “Regime in the Area of Trade Related Investment Measures”, which claims that while “[the] Russian national legislation currently in effect contains no general trade-related investment measures inconsistent with the requirement of the TRIMs Agreement”, the Chapter II of the Federal Law “On Production Sharing Agreements” (PSA) contains the following language:

Grant Russian legal entities, all other factors being the same, a preferential right to participate in the performance of operations under the [Production Sharing] Agreement as contractors, suppliers, carries or otherwise... The Parties shall stipulate in the Agreement that at least a certain portion of the basic equipment for mineral production and processing... to be purchased by the investor with subsequent cost recovery out of compensatory share of products shall be manufactured within the Russian Federation.

The government has stated that “for full implementation of this law, the adoption of additional normative legal acts is required”, and that no actual contracts signed so far under an umbrella of the PSA legislation contain conditions specified in the law.

At least three additional TRIMs Agreement inconsistent measures have been contemplated by the Russian authorities in 1998. Even in 1997, when notification was submitted, the PSA law did affect actual agreements -- if not yet contracts -- of partners involved in deals covered by the PSA legislation. Two examples are the Prirazlomnoye and Sakhalin-I oil field projects. In the former case, the Russian government issued a decree explicitly naming a Russian producer (Sevmash company) the main equipment supplier for the project. In the latter, the agreement states that at least seventy percent of equipment for the project shall be procured from Russian producers. These requirements constitute a clear case of the first-type TRIMs prohibited in the Illustrative List annexed to the TRIMs Agreement.
The realm of PSAs does not constitute the sole example of WTO-inconsistent TRIMs. The Federal Law "On Privatization of the State Property and on Principles of Privatization of Municipality’s Owned Property in the Russian Federation", approved on July 21, 1997, contains the following TRIMs Agreement inconsistent language (Article 21.5):

*While selling privatization objects at a commercial tender, there might be established an investment condition in a form of a winner’s obligation to carry out prescribed measures for tariff and non-tariff protectionism of the Russian producers, including procurement of the Russian raw commodities, materials and semi-processed goods...*

Moreover, on April 23, 1998 the Government issued Resolution No. 413 “On Additional Measures to Attract Investment for the Development of Domestic Automobile Industry”, which *inter alia* establishes an explicit link between granting an investor the right to import under the “Free Warehouse Customs Regime” – an exemption from paying import duty on any imports used in a project by an investor -- and “share of costs incurred on the territory of the Russian Federation.” In view of the earlier comment that TRIMs Agreement inconsistent measures include not only mandatory ones, but also those conditions that are prerequisites for obtaining an “advantage”, such a “local content” TRIM constitutes a clear breach. Similar infringement of the TRIMs Agreement will be established by another government Resolution. That Resolution creates a direct link of government’s approval of the national air carrier Aeroflot’s purchases of foreign made aircraft to its purchases of domestically produced airplanes (in proportion of one imported plane per four Russian-made ones).

Another apparent example of TRIMs Agreement inconsistency has been recently created by the national quasi-state bank, Sberbank, which announced a new lending policy in mid-1998. It started to grant preferential interest rates on commercial loans to companies purchasing Russian-made products (24 percent vis-à-vis 27 percent for purchases of imported goods), which again falls under the first-type of prohibited TRIMs.7

Finally, resolutions falling in the fourth group of prohibited TRIMs are issued from time to time. The most recent examples were resolutions establishing an export quota or a temporary export tax on exports of fuel oil during the winters 1995/1996 and 1996/1997. It was also reported that in 1997 the Prime Minister ordered oil companies that did not honor agreed shipments to domestic agricultural consumers would be deprived of access to export pipelines. Such measures are typically considered to be TRIMs Agreement inconsistent.

**General Problems of the FDI Regime.** Although the above problems are significant, they should not pose a difficult dilemma for the Russian authorities. Indeed, if Russia is keen on WTO accession, the government has eventually no choice but to face the necessity to eliminate

---

6 Sberbank is formally a commercial bank, yet it is predominantly owned by the Central Bank of Russia.
7 In fact, even if there was no TRIMs Agreement, this measure would still be considered WTO inconsistent, for this is exactly a type of measures prohibited not only by TRIMs Agreement, but also by an earlier Agreement on Subsidies and Countervailing Measures.
inconsistent TRIMs. It is not as simple with other peculiarities of the Russian FDI regime, where government agencies exercise much greater discretion, and hence, might consider changing the current approach only if convinced that revisions would serve Russia’s interests. This is a much bigger cluster of problems than the previously discussed ones. For simplicity of analysis it is convenient to divide it into two groups: (i) remaining excessive restrictions on FDI, and (ii) unnecessary privileges granted to FDI.

Restrictions on FDI. Many countries have restrictions for FDI in sectors considered strategic, either in terms of national defense or economic stability (financial sector), or vital for preserving national identity (most commonly, culture and mass media). Formally, Russia does not deviate significantly from this pattern. The Federal law establishing the set of activities with banned or restricted FDI does not look completely unreasonable. In fact, in the first list attached to this law -- which establishes activities banned outright for foreign investors -- there are only a relatively few areas that are excessively prohibitive. The second list attached to this law -- comprising activities with restrictions for FDI -- is more problematic. On top of military-related or dual technologies, it includes (i) many infrastructure sectors -- (a) federal electric energy distribution systems, (b) communications, (c) marine transportation, (d) aviation, (e) railroads, (f) civil airports construction, (g) highway maintenance and surveillance, etc.—as well as (ii) production of maps and globes, (iii) pharmaceuticals, (iv) ethyl alcohol, (v) alcoholic beverages, (vi) specialized investment funds, (vii) land research and development, (viii) auditing, among many other sectors. It is difficult to rationalize the need to restrict foreign investors’ participation in many of these activities, particularly given that many of these sectors desperately need an injection of modern technology or managerial skills that FDI brings in.

With regard to restrictions in Russia’s financial sector, many countries have restrictions of this kind. Still, the current ceiling for foreign capital in (ix) banking -- 12 percent -- might be increased without a real threat to national banking independence while contributing to enhancing efficiency of banking services. The latter is particularly important at the current stage of market transition in Russia, where resumption of economic growth is hampered in part by the lack of efficient financial intermediation for domestic savings and by the shortage of affordable commercial credit to the real sector. The same is true with respect to (x) insurance, where direct activities of foreign owned companies are entirely prohibited, and foreign ownership is limited to 49 percent of Russian insurance companies’ charter capital.

The next layer of restrictions is associated with the State Privatization Program (SPP), which is approved on an annual basis. The current draft SPP is more liberal towards FDI than its predecessors. It reduces several types of previous restrictions and limitations -- like discretion of local authorities to allow foreign participation in privatization of medium and small companies, the right of the Federal Security Service to recommend annulling results of privatization auctions if it has objections to a foreign winner, and so on. This liberalization is rooted in the federal law establishing lists of sectors where FDI is either banned or restricted.

8 The most recent example of exercising this right has been a passage by the Duma of a law establishing a 25 percent ceiling on foreign ownership of RAO UES shares.
Preferential Treatment of FDI. Simultaneously with considering easing most of the above restrictions, the government should eliminate specific privileges offered to foreign investors. One of them is free customs warehouse imports. In addition to that, the government grants import duty exemptions. The most recent example of the latter is a decree that slashes by a half all import duties due on shipments of those foreign companies that will bring over $100 million in investment into the country.

There is much cross-country evidence that tax concessions are not only inefficient mechanisms for facilitating FDI, but they are quite costly to the fiscal balance—an obvious point that cannot be over-emphasized in the Russian context. In fact, a lot of countries that in the past have experimented with this approach to attract FDI, including Indonesia, Morocco, Romania, Latvia and China, have since started to phase out tax preferences for FDI. The Russian government, whose finances are under enormous pressure, has even more incentives to follow that path. The same is relevant to Russia’s Special Economic Zones. Most of them have never moved further than just being established by a decree. Yet three that have become operational — Ingushetia, Nakhodka and Amber (“Jantar”, Kaliningrad) — arguably have engendered more abuses and distortions than advantages.

Indeed, as early as 1992 the World Bank’s Foreign Investment Advisory Service (FIAS) warned the Russian authorities that “if the special [tax] treatment goes only to foreigners, then there will be... the formation of hundreds and then thousands of false joint ventures or foreign-owned companies, in which local entrepreneurs find friendly foreigners to lend their names to enterprises and thus reduce tax liability.” Serious foreign direct investment is not primarily attracted by tax concessions, nor by the same token inhibited by reasonable tax rates. What matters more is consistency, transparency and predictability of the tax system. Indeed, the authorities’ own analysis of foreign investors’ complaints about Russian taxation highlights the problems of instability, inconsistency and non-transparency.

Of much higher priority to foreign investors relative to tax breaks is an ability to present an appeal on rulings by the tax service without suffering up-front fines and levies, and, in case amicable resolution is not possible, the ability to apply to an efficient dispute settlement mechanism. The lack of independent and efficient arbitration is one of the main stumbling blocks for FDI in Russia. This is particularly so given the sheer number of overlapping regulations and numerous inconsistencies between various laws and other normative acts, such as Presidential Decrees, Internal Directives of the government and ministries, federal and local procedures, etc. This muddle does not contribute to building foreign investor’s confidence. An example of what this incoherence causes for the country occurred in May 1998 when

---

10 Russia. The Climate for Foreign Direct Investment.— FIAS, August 1992.
11 See for example, Internal Barriers to Foreign Investment in Russia, paper prepared by the Prime Minister’s Advisory Council on Foreign Investment in Russia, 1994.
parliamentary passage of restrictions on foreign ownership of RAO UES contributed significantly to turmoil on the Russian financial market.

The latter issue raises another important barrier faced by foreign investors in Russia. This is "red tape" involved in foreign investor activities. It starts with registration procedures that are openly considered by investors as one of most cumbersome processes in the world. Instead of being a one-stop-low burden exercise, an investor obtaining government approval faces the necessity of getting clearance by at least 5 to 6 ministries and agencies, which takes from 3 to 6 months".\(^\text{12}\) Of course, domestic investors have to deal with a lot of red tape, too. But putting additional burdens on foreign investors, who by definition face distinct disadvantages in carrying out business transactions in a different culture than their home turf, seems counter-productive. It is certainly contrary to the notion of "national treatment." Clearly, comprehensive simplification of business registration/licensing procedures would generally be conducive to development of Russia's market economy.

**International Experience in Reforming FDI Policy Regimes**

The old paradigm of FDI, established before the Second World War and seen all over the world during the 1950s and 1960s, still characterizes FDI in the Russian Federation in 1998. In this paradigm, there are essentially only two motivations for foreign direct investment: access to some inputs for production, and access to markets for outputs. The inputs that attracted investment were varied, including natural resource deposits, low-cost labor, and lesser ones such as good climates for tourism. The attraction of inputs continues to be important to this day although the importance of low-cost labor is decreasing. Countries that were strong in one or both of these attractions received a lot of FDI, even if their political, legal, or economic conditions were second-rate. Countries without large and growing markets, and without natural resources or very cheap labor, were not important destinations for FDI. Brazil, for example, received relatively large amounts of FDI during the 1950s and 1960s, almost all aimed at producing for the large and protected market, and most of it manifested in high-cost, low-productivity facilities that would never export and were not intended to strengthen their parent companies in any significant way.

These two kinds of FDI also differed sharply in their relationship with trade. Input-seeking FDI greatly increased trade and in fact was dependent upon it. Market-seeking FDI was a substitute for trade and in many cases depended on trade restrictions. Most FDI in those days was "greenfield" investment – that is, it was embodied in the construction of new factories.

Global flows of FDI have tripled in the last ten years, while those flows to developing and transition countries have increased by a factor of 10. A significant part of this explosive growth has not been in greenfield activities but rather in mergers and acquisitions (M&A). Inward M&A in the developed countries – mostly the European Union and the US – has been

\(^{12}\) For details see *Foreign Investment in Russia: Trends and Prospects*. The second Report by independent experts, Imperial, 1995.
running at 40 to 60 percent of inward FDI during the 1990s, and in the transition countries of Central and Eastern Europe, the ratio has been about 50 percent. The dominant motivating force behind this M&A activity has been to rationalize and strengthen the competitive edge of the investing company by giving it facilities for global or regional strategies of creating interdependent production, administration, research and development, accounting, design, and other parts of its business. Of course, some additions to physical capacity usually follow these mergers and acquisitions. But the driving force is the search for corporate-wide (i.e. worldwide) efficiency and competitive advantage. Sheer large markets do not suffice to attract this kind of FDI. Hence, unfortunately, not much of it is seen in countries such as China or Russia.

In this newer paradigm, almost all FDI is complementary to trade. Brazil, which received US$16 billion in FDI in 1997, has experienced increasing FDI that integrates it into multinationals’ international production strategies. Already several years ago, Ford engines were made in Brazil, exported to Canada where they were assembled into finished automobiles, and then sold in the United States. In March of this year Ford announced plans to build two of its new “world car” models in Brazil, which will require new investment of around US$1 billion before the year 2000. This is in addition to the $2.5 billion they had already planned to invest in Brazil. Ford plans to build on its domestic sales base to use the country as its base for exporting not only to the Mercosur region (neighbors in South America) but also to other continents. This is the kind of foreign direct investment that most strengthens economies into which it goes, and that provides the best foundation for continuing increases in productivity and income. The $10 billion of FDI that Brazil received in one month in 1998 is about equivalent to the FDI Russia has attracted in the seven years 1991-1997.

Other reforming countries are also attracting this internationally linked FDI: Ninety percent of all television receivers sold in the United States are made in Mexico, almost all of them by subsidiaries of multinationals from Japan, Korea and other Asian economies. Hungary is one of the world leaders in attracting FDI without natural resources or particularly cheap labor, and this FDI has sparked enormous growth in exports of high- and medium-tech manufactured goods, especially machinery and equipment, and machine parts. Costa Rica has similarly attracted a lot of high-value FDI, including recently an Intel chip assembly and testing plant; Costa Rica has higher wages than Mexico or its neighbors in Central America, but attracted Intel with its rule of law and strongly facilitating investment climate. The Annex presents a detailed analysis of the sequence of economic reforms undertaken by Mexico, and the results in terms of both quantity and kinds of FDI that were attracted.

13 For an analysis of why Intel chose Costa Rica, see Debora Spar, Attracting High Technology Investment: Intel’s Costa Rica Plant, Occasional Paper 11, FIAS, April 1998. The Conclusions chapter says, in part: “What drew Intel to Costa Rica, and what was vital in convincing the company to invest, were the basic characteristics of Costa Rica’s political and economic system. The country is a democracy, it is stable, it is liberal, and generally committed to economic openness and progress. Its government’s attitude toward private enterprise is basically facilitating, rather than harassing. It also has a fully transparent legal system... Note the other locations of Intel’s largest overseas facilities: Ireland, Israel, Malaysia. While clearly different in many respects from Costa Rica, they share a common pool of political and economic assets. They are stable, democratic, and relatively free of the corruption and legal fluctuations that plague many of their neighbors...”
Conclusion and Recommendations for Implementation

There is a short set of characteristics that determine which countries are part of the global web of FDI and multinational production. These elements of attractiveness have changed a bit over the last couple of decades as globalization has taken hold, but basically derive from first principles of economics. An up-to-date list would now include the following six items:

- political and economic stability, to provide reasonable predictability for making business decisions.
- government behavior that basically facilitates doing business, rather than harassing it.
- a minimally decent legal framework and functioning legal system; security of property and of persons, and enforceability of contracts.
- a good export environment, including (a) policies, regulations, and procedures; (b) economic framework (exchange rate etc.); and (c) physical infrastructure.
- the automatic availability of the above four conditions to all companies through law, without a need for special treatment, particular deals, or discretionary decisions by either elected officials or civil servants.
- technical facilities and skills: supplier companies (both manufactured supplies and also service supplies, e.g. accounting); workers that are educated and therefore trainable; and strong non-commercial support institutions (universities, research labs, etc.).

Arguably Russia ranks low on the first five of these six basic characteristics. That is why it is receiving such a small amount of FDI, relative to what it needs and to its potential.

Accession to the WTO will certainly be a positive step for Russia. It would be both an actual and symbolic step towards Russia’s harmonization with international economic policy practices and bring it in line with the new paradigm of FDI. As noted above, it would require Russia to bind itself to avoid many practices that impede investment as well as trade, and to take other positive steps that will attract high-quality FDI. The simultaneous or closely coordinated formulation of trade policy and FDI policy is an important step forward for Russia. In this respect it is worth noting that in its 1996 World Investment Report, the United Nations Program on Transnational Corporations analyzed the new paradigm and concluded:

The decision to locate any part of [a company’s operations] wherever it is best ... means that FDI and trade flows are determined simultaneously. They are both the immediate consequences of the same locational decision... [This] presents new challenges for
national policy makers. The need for coordinated policy approaches acquires greater importance. National trade and FDI policies have typically evolved separately, frequently influenced by different goals, and administered by distinct, often loosely connected agencies. This separation is not suited to a world in which trade and FDI are closely interlinked. (pp. xxiv-xxvi)

Beyond the six basic sets of conditions enumerated above, a good investment climate for a country such as the Russian Federation is made up of many specific elements. There will be a payoff from improving conditions for every kind of business, and for business generally. Rather than make a long list of these specific elements, we focus on the most important areas for remedial actions in Russia today.

One of the most damaging elements is the tax system, in which instability, a heavy burden, and arbitrary enforcement are a major deterrent to foreign investors. The recently passed portion of the Tax Code will help in this regard, but more needs to be done. Repeated efforts to amend or change the June 1991 law on FDI are another source of serious uncertainty for investors. That law, while it has its weaknesses, is not a major impediment to FDI; the recent amendments to that law, however, are a step backward.

There need to be stepped up efforts in dealing with crime, corruption, lack of security of property and persons, and enforcement of contracts. This multifaceted problem, for foreign investors and Russian citizens and companies alike, is getting worse rather than better. It is a major deterrent to FDI, and especially to cutting-edge, world-class FDI facilities. Even when appropriate legislation exists, the courts are unable to enforce procedures and outcomes. It is important to strengthen the legal/judicial framework to allow for credible property rights and adequate contract enforcement. Many countries have paid increasing attention to the problem of corruption, and the debate on possible policy options is on-going. There is no single solution.

Recent insights suggest that corruption arises when institutions have monopoly positions, there is the ability to exercise discretion and incentives for accountability are weak. Additional laws themselves are unlikely to bring about significant reduction in corruption. Effective reform must be directed to changing the system: (i) introduction of independent oversight of agencies; (ii) clarifying and making transparent how much official discretion can be exercised; and (iii) utilizing penalties and rewards for conduct. Russian authorities should give consideration to establishing independent anti-corruption oversight ("watchdog") bodies at the federal and regional levels; models can be found in other countries, such as Hong Kong, Singapore, Botswana and Chile. These two sets of problems are so severe that most actions on other elements of the business climate that the Federation Government (including the Duma) might take will probably not succeed in attracting much more FDI, with the exception of production sharing agreement legislation for the exploitation of minerals and hydrocarbons.

---

Rules-based, streamlined business licensing at the Federal and local levels needs to be put in place. Measures are needed to address the problem that the setting of license fees is subject to the discretion of local authorities, which results in price discrimination and arbitrary rule. Reforms here are a top priority. They should be based on other countries’ experiences and on enacting legislation that sets precise, streamlined limits at all levels of government on the time and money required to get a business license in most sectors, and codifies sizeable criminal sanctions for officials who violate this rules-based system. For certain sectors, such as human health, the environment and national security, more stringent procedures could be applied.

The industrialized countries have large markets, and they also provide the conditions described above. That is why they receive over two-thirds of all FDI flows -- in spite of generally high labor costs, high tax rates, and other factors often said to repel FDI. Brazil, Mexico, Hungary, the Czech Republic, and Poland are examples of other countries, large and small, that are providing the right conditions for production and trade and thereby attracting efficiency-seeking investments. A few other small countries, such as Botswana, Costa Rica and Estonia, have created a competitive advantage for themselves where none existed in nature, by developing business-friendly laws, regulations, and administrative practices. Within the Russian Federation, regions such as Novgorod, Nizhny Novgorod, Vladimir, Samara, Ekaterinburg, Kazan, and Novosibirsk have done the same thing – attracting investors by creating better business conditions.

The inherent attractiveness of Russia as a place for foreign direct investment means that Russia does not have to be perfect on every item discussed here. Moreover, the necessary improvements would be just as beneficial for Russian companies as for foreign-owned ones. The single most important task is to create a decent environment to do business honestly and efficiently.

Summarizing, we want to reiterate that eliminating simultaneously three core pillars of the current Russian FDI policy regime -- (i) relatively high tariffs and non-tariff protection for the domestic market, (ii) tax preferences for foreign investors, and (iii) restrictions on FDI to a limited number of activities -- would allow Russia to switch to a modern approach towards FDI. Specific policy recommendations include:

- Vetoing the recently amended FDI law;
- Phasing out existing tax concessions (including those offered in Special Economic Zones) to foreign investors;
- Measures inconsistent with TRIMs Agreement of the WTO should be abolished;

- "National treatment" should be adhered to both for right of establishment and for post-establishment operations;

- The number of restricted sectors and limitations on foreign direct investment should be substantially reduced;

- Enforcement of property rights should be strengthened;

- Investor-State dispute resolution mechanisms should be made more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration;

- Foreign investor registration procedures should be simplified, rules-based, and made transparent;

- Guarantee schemes covering basic non-commercial risks should be maintained and extended; and

- Restrictions for foreign investment in services sectors should be reduced.
ANNEX

LIBERALIZATION AND THE ATTRACTION OF “GLOBALIZING” FDI: THE CASE OF MEXICO

A New Kind of Foreign Direct Investment. The last 10 or 15 years has seen the rise of a new kind of foreign direct investment (FDI). The two older, still-extant paradigms are (a) market-seeking, and (b) resource- or cost-reduction seeking. The new, third kind can be called (c) “globalizing,” and has the following characteristics:

- Especially within the manufacturing sector, most of it is not focused only on either local resources (i.e. cheap labor, climate, raw materials) or domestic markets, but rather is looking for a combination of both market access and cost-effective production. Much of it has significant shares of its sales both in export markets and in the market of the host country.

- A fair amount of it has been implemented in transactions in which mergers and acquisitions (M&A), including privatizations, played a major role -- rather than greenfield activity. This characteristic is especially marked in FDI among the developed countries and may be less common in the LDCs. Of course most M&A deals are followed by some greenfield; the distinction can get a bit fuzzy.

- None of it is “stand alone” -- i.e. it is not an independent profit center that is permitted by the MNC headquarters to more or less do as it sees fit, independently of the rest of the organization, as long as it makes a profit. Rather, it is part of a strategic plan by one or more multinationals to optimize locations of various parts of one or more production chains that have production locations in various countries and markets in various (same and/or other) countries. This “plan” may be internal to one MNC, to get or maintain a competitive edge in some final or intermediate markets, or it may be a coordinated plan of more than one MNC, with some sort of strategic alliance, tacit or explicit, among them. The best single empirical distinguishing characteristic may be that the location decision in question depended on other location decisions.

- Labor intensive activities fall within this globalizing FDI if the labor in question is highly educated and highly skilled, and the activity is closely linked with other operations of the MNC. A lot of this is in what are de facto service activities, although some are in companies that are clearly service companies while other are service parts of manufacturing companies (e.g. engineering or software design of manufactured products). Thus, writing computer code in Bangalore or designing high-pressure boilers for electric power generation plants in China should be included.
Globalizing FDI will not go to second-best locations (however defined) because its companies operate under severe competitive pressures that in effect do not permit second-best locations. Since very little globalizing FDI is tied to any one country — although it may be tied to a region — it is free to avoid unfavorable locations. In operational terms, and in addition to the characteristics of a good investment environment that are described in the main text of this paper, globalizing FDI in particular wants:

- An absence of restrictions and requirements and harassment by government, especially on entry (i.e. establishment of foreign-invested firms), imports, exports, percentage foreign ownership, employment of expatriates, and local procurement. Restrictions both on establishment and on operations are important; globalizing FDI requires flexibility to alter its mode of production, process, and sources of procurement, without having to get time-consuming or risky government permission.

- High-quality transportation and telecommunication links with the rest of the world.

- Some kind of minimal quality-of-life; e.g. absence of significant crime/corruption.

Both of the older kinds of FDI still operate and can be quite valuable for a country to attract. But the globalizing FDI is the main kind that serves dynamic markets, and is automatically high-productivity. It is therefore the most valuable kind to try to attract. World Bank (FIAS) research and experience suggest that only about a dozen developing and transition countries are attracting significant amounts of globalizing FDI.

The Case of Mexico. Throughout the 1950s, '60s and '70s the Mexican economy grew steadily, with exceptional macroeconomic stability and an import-substitution strategy. Its large market limited the inefficiencies inherent in this strategy, as did its long border with the United States, which kept protection levels below the extremes of some South American countries that also erected high barriers to import competition.

FDI came to Mexico mainly to serve the domestic market. High production costs, the result of both natural factors such as deficient infrastructure and poorly educated workers and also policy-imposed factors such as domestic procurement requirements, were passed on to Mexican consumers, and most foreign-invested companies did not export — indeed, they could not be competitive in export markets. The exception was the maquiladora industry, which began as simple labor-intensive assembly of garments and electrical assemblies; parts were imported from the US and products re-exported to the US, under a provision of US law that limited duties to the value added in Mexico.

Petroleum, petrochemicals, all infrastructure services, banking and finance, and many other sectors were closed to foreign investors. Except for the maquiladoras and the automotive industry, foreign investors were restricted to less than 50 percent ownership of a company (in some sectors, less than 40%), and this severely limited FDI in contrast to countries such as Brazil.
where no such limitations were imposed. The ownership restrictions were especially important impediments to high-tech, cutting edge technology, and globalizing FDI that needs to export, because multinationals do not want to share their best technology with foreign partners that are forced upon them, and cannot plan to supply export markets competitively if they cannot assure production at world standards of quality and price.

Increasing inflation in the 1970s, the first devaluation in 25 years in 1976, and the exhaustion of import substitution possibilities ended this era of stable growth. Explosive growth in hydrocarbon exports, which began in the 1970s, turned out to be more a curse than a blessing as Mexico's fiscal and exchange rate policies were allowed to deteriorate in a wave of excessive overconfidence. With the debt crisis of 1982, the need for a new approach became acute and obvious to all.

Mexico implemented macroeconomic reforms beginning in August 1982 in order to reduce inflation, service its restructured debt, and stabilize the economy. The balance of payments problem was solved, in a static sense, very quickly although with much pain. But it soon became clear that to resume growth Mexico would need to complement these reforms by a more liberal trade and investment regime -- consistent with the global operations of multinational firms, and indeed to provide the appropriate framework for Mexican-owned firms to attain international competitiveness as well. As the economy recovered in the mid-1980s, trade barriers were eliminated, both imports and exports rose, and FDI became essential -- not only to finance the external deficit, but mainly to increase efficient export capacity and employment.

Following the trade liberalization in the mid-1980s, the first move to liberalize FDI came in 1989. By then it had become obvious that the most dynamic trade flows were generated by multinational firms who would specialize in the production of one or a few products, not only selling them in Mexico but also exporting them to the world. Such operations required the freedom to import, expand capacity, and change products or processes without restriction or even delays while awaiting government approval.

New regulations on foreign investment, issued in 1989, were drastic modifications in the restrictive law which dated from 1973. The regulations liberalized FDI establishment in several ways, and were complemented by liberalization of regulatory practice that was just as important, even though it was informal. Formally, majority Mexican equity was no longer required, except in a few sectors such as banking, oil, and electricity, if a proposed investment met certain criteria. In practice virtually every normal investment was deemed to meet these criteria, and permission was given automatically and quickly; the only exceptions were undesirable or truly sensitive activities such as toxic waste dumps, gambling casinos, weapons assembly, nuclear technology, etc. The regulations also simplified the registration procedures for foreign investors, and removed or simplified restrictions and red tape that had previously been involved in government approval of various aspects of technology transfers.

Foreign investments that were within the restrictions on percentage ownership had not, and still did not, need government approval -- they were treated as Mexican companies in every
way. But for foreign investments that wanted to exceed the limits, it had been possible, and still was possible, to request an exemption. This exemption was granted (or refused) by an inter-ministerial body called the National Foreign Investment Commission (Comision Nacional de Inversion Extranjera -- CNIE). Under the new regulations, the CNIE only had to rule over a much smaller number of exceptions to a much more liberal regime. Procedurally, the CNIE stopped its practice of detailed evaluation of requests for exemptions, with bargaining on conditions and, sometimes, refusal. Instead, it processed applications routinely and approved virtually every request, without imposing conditions, with the few exceptions noted above.

As to technology transfers, the former practice whereby the Ministry of Industry had to approve all contracts for technology transfers was abolished. The Ministry's practice had been to evaluate these contracts and in many cases to substitute its judgment for that of the Mexican companies, both in regard to whether the particular technology was or was not appropriate, and in regard to the price paid (royalties, etc.). Mexican private companies, the supposed beneficiaries of this practice, were the loudest voices against it, and as of 1989 the practice was discontinued.

Overall, the change in Mexico's attitude toward FDI went far beyond the change in regulations. The Government's basic attitude switched from suspicion and regulation, to promotion and facilitation. As another part of the implementation of this change, the Government created a new autonomous agency, the Mexican Investment Board, to promote FDI in Mexico. Supported half by the government and half by the private sector, the MIB has the task of attracting desired investment to Mexico and facilitating the paper work of foreign investors with regulatory authorities, including those at the provincial government level.

These reforms, plus some recovery in domestic demand in the second half of the 1980s, brought increased FDI flows, but only in 1989 did the amount reach $3 billion and in 1990 it fell by 10 percent. Thus the government realized that its new FDI regulations and more liberal procedures were not enough to attract foreign capital in large amounts. The next step was NAFTA, the free trade agreement with the US and Canada.

NAFTA negotiations started in 1991. For Mexico the main objective of this "free trade" agreement was in fact not free trade but rather to attract more world-class FDI. Mexico already had very good access to US markets, except for a few products where restrictions remained even under NAFTA.
The investment dimensions of this trade treaty were both explicit and implicit. Explicitly, NAFTA was the first trade agreement to contain wide and specific regulation on investment. In particular, the 'national treatment principle' commits the Government to guarantee to a North American investor treatment which is just as good as it gives to the national. NAFTA also removed restrictions in sectors which the 1989 regulations had left protected, such as car parts, banking, and electricity generation. Beyond these explicit provisions, NAFTA made it much more difficult for future Mexican governments to reverse the liberalizing reforms of the mid- and late-1980s. By locking in those reforms, the agreement greatly reduced uncertainty over the regulatory framework, as well as over market access to North America. This was another necessary dimension of a Mexican environment that would attract globalizing FDI.

The automobile industry shows how FDI in Mexico changed with globalization. Created in the 1950s, the industry for the most part produced high-cost cars and trucks of less than up-to-date technology. Some parts were imported, but more and more were made in Mexico as the government imposed domestic content requirements on the assemblers. The auto assembly industry was not subject to restrictions on foreign ownership, but had to meet requirements for buying parts within Mexico. In the auto parts sector a 49% restriction on foreign ownership remained in place, protecting Mexican-owned auto parts producers. This last restriction is now in a seven-year phase out period under NAFTA.

Beginning in the 1970s, even before the liberalization, a search for economies of scale led to the appearance of a few auto parts producers, some with foreign investment, which sold both to assembly plants in Mexico and also to assembly plants in the United States. Until the late 1980s, however, such instances were rare.

With the changes that began in the mid-1980s, automotive exports have grown rapidly, and imports have also increased as an extensive network come into existence in which products and components are traded worldwide, but especially between Mexico and the US. The export of components, including high-tech parts such as engines and transmissions, was a result of major new investments made in new plants in Mexico by Ford, General Motors and Nissan. These investments represented a change from previous investments by the same firms, in that the recent ones were designed to play a specific role in the global strategy of the parent company, supplying their worldwide network from Mexico. Purely Mexican-owned auto parts producers have also succeeded in becoming strategic partners in these networks, notably of Ford.

Mercedes Benz, since the 1980s a minority partner in a Mexican truck producer, also reacted to the reforms and made Mexico a part of its North American strategy. It acquired control of its partner, and in 1992-93 invested $300 million in modernizing and expanding its facilities including the addition of a passenger car production line.

The same transformation took place with Xerox and IBM, which before the liberalization were among the few foreign invested facilities in Mexico with a significant presence in international trade, and which since the liberalization have, along with many new entrants to this kind of activity, dramatically increased the world-wide integration of their Mexican subsidiaries.
FDI flows into Mexico started to increase again as investors anticipated the effects of NAFTA and continuing liberalization in Mexico. In 1991 the amount exceeded $4 billion for the first time, and has continued to rise since then. Much of this increase was in globalizing FDI, in response to the trade liberalization and the expectation of a successful NAFTA negotiation, but the expectation of growth in the Mexican market was also an important driving factor.

There were still important de facto obstacles to globalizing FDI coming to Mexico during the early 1990s. For greenfield investments (new, wholly-owned factories) the reforms were sufficient. But mergers, acquisitions, and joint ventures were still impeded by a combination of remaining legal restrictions in some key sectors and by informal mechanisms. Despite the change in regulatory practice in 1989, the reluctance of domestic investors to give up operational control to foreigners was partly an inheritance of past policies and practices. In addition, large Mexican conglomerates were strong, cash rich, had long experience with local markets, and were the beneficiaries of privatizations and close relations with the government. These factors kept the level of FDI below $5 billion per year, even though there was great expectation of successful NAFTA negotiations.

In 1993, with NAFTA approval in the near future and a more favorable political climate, the government codified both the regulations of 1989 and the coming NAFTA rules on FDI in a new FDI law. The old 1973 law was repealed. This new law made few de facto changes in the liberal climate that had prevailed since 1989, but by putting the new rules and practices in a law, rather than in regulations which could be more easily changed, reduced still further any uncertainty that investors might have about the future of the reforms.

Ironically, at the end of the same year that NAFTA was approved, 1994, risky monetary and credit policies by the outgoing Administration in Mexico precipitated another foreign debt crisis. One of the few good effects of this painful crisis was to accentuate the attractiveness of Mexico for globalizing FDI and to remove or reduce many of the most important remaining
obstacles. The peso devaluation improved export profitability, while many producers of industrial materials wanted to be linked to a global network as a pre-condition to continue in operation. In non-tradables, however, profits fell and some foreign investors who had entered Mexico recently and who depended completely on Mexican consumer demand, pulled out. This was the case of retailers JC Penny and K-Mart, or franchises like Twinnings.

In 1995 and 1996 the Government liberalized FDI in natural gas distribution and the banking sector, even though these had remained restricted even after NAFTA. Foreign investors responded quickly. All of the recent regional gas distribution concessions to private enterprise include foreign parties in partnership with a local business, such as Repsol of Spain, Gas de France and Novo Industries of California. Gas deregulation gave additional impetus to the earlier liberalization in electricity generation, as the new generators will use gas as a fuel. In electricity both GE and Mitsubishi participated in the first two private generation projects, approved in 1996 and 1997.

The share of M&A increased sharply as many local firms faced losses from the peso devaluation and were unable to maintain operations without a link to foreign markets and global networks. At the same time, the government removed many of the remaining sectoral restrictions on foreign ownership, importantly in banking, gas, and electricity generation. Foreign investors came to control some of the firms in which they had entered initially with a minority stake, such as the retailer Cifra (now controlled by WalMart), Iusacell (a cellular telephone firm now controlled by Bell Atlantic) and many banks.

Much globalizing FDI went into maquiladoras, which left behind the simple assembly focus of their beginnings decades earlier and came to include quite a few complex, medium- or even high-tech manufacturing processes. It is estimated that 90% of maquila investment during the last few years is of the globalizing type. Although many existing plants still have a limited focus on assembling from largely foreign components, even they are gradually comprising more complex processes. One example is the large Delphi plants owned by GM, employing many Mexican engineers in product design. The standards of operation, quality, and efficiency of these plants are of the same or higher levels than those of their sister plants in North America. Other examples include AT&T, GM, Emerson Electric and Sony. This change towards sophisticated, integrated manufacturing anticipates the *de facto* end of the maquiladora status, as under NAFTA any exporter from Mexico to the US or Canada will benefit from the same privileges as do the maquiladoras, after a seven-year phase-out period that ends in 2001.

Large acquisitions, an intensification of globalizing manufacturing activity, and more deregulation thus explain the jump in FDI inflows from 1994 onwards. Most of this FDI was of the globalizing type.

A summary view of the policy changes described here, and the results in terms of FDI flows to Mexico, is presented in the Table 1. The story in its simplest form is that Mexico
executed a series of reforms in three areas of policy, over a period of about 14 years (from 1982 to 1996):

- Monetary, fiscal, and exchange rate reforms, to stabilize the economy, began in 1982.

- Trade reforms, which liberalized imports (licensing was abolished and tariffs lowered) followed around 1985.

- Removal of restrictions on FDI began in 1989, with the freeing of more and more sectors from restrictions on the percentage of foreign ownership, abolition of TRIMS (notably, domestic content requirements), and the privatizations of former government monopolies and the opening of those sectors to FDI. NAFTA, negotiated during the early '90s and implemented in 1994, increased and locked in all those reforms in both trade and foreign investment rules. Other regulations which restricted the freedom of foreign-invested firms to change their operations were also abolished or relaxed. Additional sectors were liberalized in 1995 and 1996.

The results have included a remarkable increase in the quantity of FDI inflows, rising from the levels around $2 billion per year in the late 1980s, to around $4 billion during the early 1990s and averaging $10 billion per year since 1994. But even these dramatic increases in amounts are perhaps less important than the changes in quality, as most of the additional FDI during the last five years has created world-class facilities that are competitive in price and quality with others all over the world, and that therefore can, and do, include Mexico as parts of the global strategies of multinational corporations. The days of high-cost, old technology factories producing for Mexican consumers only are gone, as are the days of manufactured exports consisting mostly of simple, low-value-added products based on cheap Mexican labor. Mexico today is more and more integrated in world-class production linkages, and this includes not only foreign-invested companies but also a growing number of purely Mexican firms that have also taken advantage of the changed policy framework.
<table>
<thead>
<tr>
<th>Year</th>
<th>FDI Inflows ($ bn)</th>
<th>Approximate Shares (%)</th>
<th>Approximate Shares (%)</th>
<th>Estimated Shares (%) of Globalizing FDI</th>
<th>Policy Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>3.0</td>
<td>10</td>
<td>90</td>
<td>60</td>
<td>Non-Tradable FDI</td>
</tr>
<tr>
<td>1990</td>
<td>2.6</td>
<td>10</td>
<td>90</td>
<td>60</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1991</td>
<td>4.8</td>
<td>20</td>
<td>80</td>
<td>60</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1992</td>
<td>4.4</td>
<td>20</td>
<td>80</td>
<td>60</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1993</td>
<td>4.4</td>
<td>30</td>
<td>70</td>
<td>60</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1994</td>
<td>11.0</td>
<td>30</td>
<td>70</td>
<td>60</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1995</td>
<td>9.5</td>
<td>50</td>
<td>50</td>
<td>20</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1996</td>
<td>7.6</td>
<td>50</td>
<td>50</td>
<td>15</td>
<td>Tradable FDI</td>
</tr>
<tr>
<td>1997</td>
<td>12.1</td>
<td>60</td>
<td>40</td>
<td>15</td>
<td>Tradable FDI</td>
</tr>
</tbody>
</table>

Source: Bank of Mexico on FDI flows and FIAS' estimates on shares.