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Introduction and Summary to

Handbook of Trade Policy and WTO Accession for Development in Russia and the CIS

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Abstract: This paper is the introduction and summary chapter of the 43 chapter volume entitled *Handbook of Trade Policy and WTO Accession for Development in Russia and the CIS*. The key policy conclusions of each of the chapters are highlighted in this paper. The *Handbook* will be published only in Russian in 2005, but an English language version of the majority of the papers described here is available on the website www.worldbank.org/trade/russia-wto. This paper first explains the potential importance of World Trade Organization (WTO) accession as a development tool, and discusses the recent successful development models and the role of trade policy in their development. The paper then summarizes the three parts of the Handbook: the first part treats trade policy (with applications to Russia and the Commonwealth of Independent States (CIS)); the second part treats World Trade Organization institutions and disciplines, again with Russia and CIS applications; and the third part focuses on various aspects of the impact of WTO accession on Russia. The numerous papers that relate trade policy and WTO accession to experience in Russia and the CIS are likely to be of special interest to native English speakers, since these papers are new to the literature. The papers in the *Handbook* are intended to be non-technical materials accessible to a wide policy audience. The *Handbook* forms the basis of a World Bank Institute course on trade policy and WTO accession, which has been delivered and will be delivered again on multiple occasions.

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Introduction and Summary to *Handbook of Trade Policy and WTO Accession for Development in Russia and the CIS*

David G. Tarr and Giorgio Barba Navaretti¹

I. INTRODUCTION

In this paper, we briefly summarize each of the 43 chapters in the Handbook. We begin, however, with a brief section in which we elaborate the basic themes of the Handbook. The Table of Contents for the Handbook is an appendix to this paper.

WTO Accession: A Crucial Historical Opportunity

There are 148 member countries of the WTO. In 2003, trade among them represented 97% of the world's trade turnover. Russia, along with Azerbaijan, Belarus, Kazakhstan, Tajikistan, Ukraine, and Uzbekistan of the Commonwealth of Independent States (CIS) are among the 31 countries attempting to accede to the World Trade Organization (WTO) in mid-2005. WTO accession will impact on a wide range of policies and institutions, including, but not limited to, tariff policy, customs administration, standards, rights of foreign investors (especially in services), agricultural policy, intellectual property and possibly government procurement. It therefore represents a time for evaluation of a very wide range of regulation and an opportunity to implement important trade, foreign direct investment and institutional changes.

The emphasis of this volume is on how to use the WTO accession process as a tool for economic development. WTO accession can galvanize domestic support for liberalization of trade and foreign direct investment and represents a unique historical opportunity to lock-in reforms of the trade and foreign direct investment regimes in a movement toward an open economy model of economic development. (We explain below the value of an open economy.) Given the concentrated benefits to industries that achieve protection, industry groups will typically lobby for protection and exemptions. On the other hand, since the benefits to consumers are diverse and less concentrated, they typically do not lobby against protection, but hope others with similar interests will lobby on their behalf. This so called “free rider problem” in political decision-making results in an absence of representation of the views of the consumer and broader economic interests in political discussions of tariffs. Lobbying and political economy considerations often allow special interests to strongly influence policy so that reforms are slow. WTO accession, however, requires across the board reform in many sectors, and the pressure of a WTO negotiation engages policymakers at the highest levels of government. Experience has shown that high-level policymakers, who have the economy-wide interest in mind, will often intervene to encourage reforms and overcome resistance of slow moving ministries. (Liberalization of barriers against foreign direct investment in China’s service sectors is a case in point.) So it is possible to achieve reforms in the context of WTO accession where these reforms

¹ We thank Carsten Fink, Bernard Hoekman, Will Martin and Gianni Zanini for comments on this paper. The views expressed are those of the authors and do not necessarily reflect those of the World Bank or its Executive Directors.

would not normally be achieved so quickly. That is, commitments at the WTO make it easier for a government to do a trade policy designed to promote growth and poverty reduction.

Additional advantages of WTO membership are that Members of the WTO obtain rights in international trade. Members are granted permanent most-favored nation status to the markets of other member states. Members are also able to use the WTO's dispute settlement procedures to protect their trade interests, such as in antidumping cases. Trade disputes among WTO members are resolved based on WTO legal agreements under which smaller countries have the potential to win disputes against large countries. And all WTO agreements require unanimous consent of all the members, and this helps provide a voice for the smaller member countries. On the other hand, non-members will be influenced by the new rules of this dominant organization in international trade, without a voice in their formation.

Recent Models of Successful Trade Policy for Development

We believe that developing and transition countries can learn from the small number of countries that have experienced sufficiently high rates of sustained growth in the past 20-30 years to transform their economies. The examples of success stories that can be mentioned are the East Asian tigers of Hong Kong, Singapore, the Republic of Korea and Taiwan(China), which are all rich countries now; Chile and Mauritius, which are middle income countries now; and China should also be mentioned for its rapid growth over this period. What is common to all of them is that they all sharply increased their exports and rapidly integrated in the world economy. Although they achieved this export expansion with quite different trade policies, all of them either started with low import protection or progressively liberalized import protection, and those that initially protected provided incentives to exporters that offset the tax that import protection imposes on exports. This included assuring that exporters obtained imported inputs tariff free.

We can group the trade policies of these economies into three groups. (1) Hong Kong and Singapore practiced free trade and they are now among the richest economies in the world. Chile used uniform tariffs that it progressively lowered to rather low levels at present and experienced strong growth for 20 years.² The World Bank has traditionally recommended the low and uniform tariff strategy of these countries as the best trade policy model for economic development, since these classic models of development require the least amount of institutional development, and are the easiest to achieve from a political economy perspective (see the uniform tariff strategy paper by Tarr below); (2) Both Mauritius and China had high and diverse tariff protection initially that came down over time, but in the initial stages they used export processing zones as the key instrument in their trade policies in order to encourage exports and provide exporters with incentives as close as possible to importers.³ Export processing zones, however, have failed in many countries, such as Senegal, Brazil and Iran, so they should not be viewed as a key to successful development.⁴ In general, the export processing zone model is

² Our website, www.worldbank.org/trade/russia-wto, has some additional country examples that we do not present in this book. See the paper by Ambassador Jara for a discussion of the Chile experience and the paper by Arvind Panagariya, "Miracles and Debacles of Trade Policy," for a discussion of the China and India experiences.

³ China also used duty exemptions in a manner similar to "temporary admission," so that exporters had duty free access to imported intermediates in a much wider area of the country than simply the gated export processing zones.

⁴ See Dorsati Madani (1999), "A Review of the Role and Impact of Export Processing Zones," Policy and Research

viewed as inferior to low uniform tariffs, since it attempts to do for a subset of the economy what low uniform tariffs do for the entire economy; (3) Republic of Korea and Taiwan (China) are examples of economies that successfully developed but they started with significant and diverse import protection. These countries, however, progressively lowered protection. Moreover, since import protection implicitly imposes a tax on exports, Republic of Korea and Taiwan (China) implemented complicated programs (like **indirect** duty drawback)⁵ to provide exporters with incentives equivalent to sectors that received import protection. Their programs required a very competent and non-corrupt government bureaucracy to administer. Two country case studies in this book, Japan and Republic of Korea, both explain the key role of an efficient regulatory regime in offsetting the anti-export bias of the trade regimes of Republic of Korea and Japan. In most developing countries, exporters complain that the mechanisms for provision of tariff free access to imported intermediate products do not work. Notably, they do not receive the payments that are due to them under duty drawback programs. In general, the evidence suggests that most developing and transition countries do not possess the required efficient non-corrupt bureaucracy to effectively administer the complicated Republic of Korea or Taiwan (China) type regulatory regimes. Thus, we recommend great caution in countries trying to emulate the Republic of Korea or Taiwan (China) trade policy model of development.

A key theme of this Handbook is that import protection imposes a tax on exports.⁶ By imposing a tariff on imports, a country may believe it is only helping an import competing industry. But all export sectors are hurt by an import tariff. A key reason is that a tariff reduces the demand for foreign exchange and therefore appreciates the real exchange rate. This makes exporting less profitable in domestic currency. Another reason is that the cost of inputs increases when exporters use the taxed good as an input. The general equilibrium nature of tariff policy regarding its impact on exports is a crucial point that we hope will be clarified through this Handbook. Since import protection penalizes exporters, it appears that lowering protection is a crucial necessary (but not sufficient) condition for sustained rapid economic development in transition countries.

An open trade regime must be complemented by behind the border policies and institutions to foster development. In chapter 10, we argue that a stable macroeconomic environment conducive to business development with a clear, transparent regulatory environment with neutral incentives to all firms and industries are also crucial. Clear, transparent and neutral incentives (those which do not distinguish by sector or firm) are crucial in the Transition countries so that scarce entrepreneurial talent is rewarded for innovation and is not diverted away by higher rewards for rent-seeking activities, which are typically associated with corruption. Sound competition policies (including especially avoiding barriers to entry and investment), flexible labor market policies and adequate infrastructure are also very important. We must also recognize that historical conditions and geography will also affect the development

Working Paper 2238, The World Bank. Available at <http://econ.worldbank.org>.

⁵ An example of indirect duty drawback is where an automobile producer exports cars that use **domestic** steel; but domestic steel uses imported iron ore on which tariffs are paid. With indirect duty drawback the automobile producer will receive a rebate of the imputed value of the tariffs on the iron ore embodied in the automobile. With conventional duty drawback no rebate would be allowed since the steel is domestically produced.

⁶ This is known in international trade theory as the Lerner symmetry theorem.

potential of a country. For all these reasons, we say that an open trade and foreign investment regime is a necessary, but not a sufficient condition, for rapid development.

The remainder of this paper is a summary of the main conclusions emerging from the individual papers of the volume. Given the focus on WTO accession as a tool for development, the book begins with a section on trade policy. The second section deals with the institutional aspects of the WTO. Finally, although the first two sections contain some Russia and CIS specific applications, the third section focuses on the effects of trade liberalization on Russia since the early 1990s and the further expected effects of accession to the WTO. Chapters are summarized according to themes, and not necessarily in the order in which they appear in the Handbook.

II. TRADE AND TRADE POLICY

-- Part I of the Handbook

Trade Policy Principles

In chapter 2, Giorgio Barba Navaretti and Paolo Epifani review the theoretical literature on the effects of trade policy. They argue that, in general, all instruments of import protection as well as export promotion distort production and consumption decisions; therefore, they are generally welfare reducing. (There are theoretical exceptions to this rule which are discussed.) Even when trade policy reduces national income and causes serious inefficiency in the economic system, it will typically benefit some firms or individuals at the expense of the rest of society.

Sometimes trade policy is used to treat market imperfections (such as unemployment due to labor market inflexibility) or other objectives, such as minimum output of a sector. In general, economic theory has shown that policies addressing such imperfections directly, like labor market reforms for unemployment or production subsidies for minimum output goals, are more effective and less costly to society than trade policy interventions.

Effects on growth and poverty

Effects on Growth. Giorgio Barba Navaretti and Marcello Spanò argue in chapter 3 that trade openness is a necessary condition for faster long term growth. There are no sustainable development miracles without a substantial expansion of exports and integration into the world economy. There is no evidence that protection and trade barriers favor long term sustainable growth. Trade is expected to foster growth as far as it leads to an efficient use of resources. Trade barriers typically shelter domestic producers from the international market. Although this may be advantageous for protected sectors, it is unlikely to induce an efficient allocation of resources in the whole economy. Trade liberalization, in contrast, encourages an efficient exploitation of resources which in turns may trigger economic growth. Equally, access to foreign technologies and inputs provides developing countries with the opportunity of using and applying the results of R&D in foreign countries. The empirical evidence supports this prediction that trade leads to faster growth. At the same time, several studies, particularly conducted during

the 1980s and the 1990s, provide robust evidence of how protectionist strategies, like import substituting industrialization, have proven to be unsustainable in the longer term and not a viable shortcut to prosperity.

However chapter 2 also notes that trade openness in itself is not a sufficient condition to achieve faster growth. It needs to be coupled with other policies, like macroeconomic stability and institutional reforms, without which trade policy changes are likely to be ineffective. And depending on initial conditions in the country, including the initial institutional environment, the trade liberalization path is likely to be unique to the country. That is, there is no one trade and foreign direct investment policy regime that is likely to fit all countries.

Effects on poverty and income distribution Most of the literature reviewed in chapter 2 shows that trade openness has been effective in reducing absolute poverty. Although a large part of the effect is indirect, through growth, the poor can also benefit from a favorable reallocation of resources induced by trade liberalization. Many poor rural households in developing countries would likely benefit from a reduction of trade barriers in agriculture. Moreover, poor urban households would gain from increased access to cheaper imported consumer goods. However, the reallocation of resources across activities may have ambiguous effects on income distribution and some poor households may lose even if the majority gains. Trade liberalization engenders important redistributive effects, and, as argued in chapter 2, it may leave behind both winners and losers.

Country Case Studies

Choong Yong Ahn in chapter 4 and Junichi Goto in chapter 5 explain the role of an efficient regulatory regime in offsetting the anti-export bias of the trade regimes of Republic of Korea and Japan. Harry Broadman discusses the experience of Central and Eastern Europe and the former Soviet Union (chapter 6).

Republic of Korea is probably the most studied and controversial example of an export led development miracle. Republic of Korea initially protected its domestic market and employed a gradual process of trade liberalization that was coupled with interventionist measures, as Republic of Korea's government mastered a successful strategy of investment coordination favoring export growth. Although there are different explanations for the Korean development miracle, it appears clear that Republic of Korea's growth rates were dependent on both its progressive trade liberalization over time and Republic of Korea's effective use of policy instruments designed for export-led industrialization. The Republic of Korean government has consistently reduced the disincentives to exporting by guaranteeing export producers free and automatic access to imported intermediate inputs and export financing, and by granting additional capital market incentives. Policymakers assured that, despite the protection, it was at least as profitable to export as to sell in the domestic market.

Japan. Japan is similar to Republic of Korea for its great emphasis on exports. While Japanese market was heavily restricted from foreign imports, counterbalancing measures were introduced by the Japanese government to avoid the anti-export bias implicitly stemming from

protectionist measures and, rather, to promote exports. Japanese exporters were never disadvantaged relative to producers for the domestic market because of effective economic and trade policies. One of the essential ingredients of the Japanese success was extremely efficient and impartial civil service which designed and enforced a successful mix of policies, such as guaranteeing tariff free access to intermediate inputs for exporters. As for Republic of Korea, this is another example of a strategy that can be implemented only if bureaucracies are very capable and impartial, a condition rarely available in developing countries.⁷

Central and Eastern Europe and the former Soviet Union. Harry G. Broadman in chapter 6 summarizes the results of the larger study of these countries conducted for the World Bank entitled “From Disintegration to Reintegration: Europe and Central Asia (ECA) in International Trade.” He shows that today, most of the 29 countries in ECA are significantly (re-)integrated into the global economy, far more so than at the start of transition. Current exports and imports of ECA countries account for more than two-thirds of the region’s total output of goods and services. But two “new” intra-regional trade blocs have emerged. One bloc includes the eight countries in central Europe that recently acceded to the EU and countries in South Eastern Europe. This bloc contains countries that are fast growing and tending toward the advanced countries in Europe. The other bloc includes the CIS countries, registering significantly slower growth, little reduction in poverty and pulling back towards a Russia-centric sphere, still dominated by commodity trade and risking non-participation in the international division of labor.

The role of oil in Russia’s trade has been increasing throughout transition, partly because of a realignment of administered prices, partly because of the increase of international oil prices and partly because of the loss of competitiveness of other Russian products like machinery, which accounted for a large share of Russia’s exports at the beginning of transition. Intermediate manufacturing products account instead for the largest share of Russian imports. This heavy reliance on commodity exports stands in sharp contrast with the pattern observed in the European transition countries. These countries were quite successful in expanding their exports in heavy industries like automotive, parts and machineries.

Russia has a stated goal of diversifying out of commodities into export of manufacturing and services. That diversification, however, will be dependent on complementary behind the border reforms. Broadman argues that countries that have liberalized trade and judiciously implemented behind the border complementary reforms, have been more effective in leveraging international integration to raise growth rates and reduce poverty. Behind the border reforms include economy-wide efforts in boosting domestic inter-enterprise competition and market flexibility, strengthening basic market institutions and incentives, developing trade-facilitating infrastructure, deregulating services sectors and attracting cutting edge foreign direct investment. Meeting these challenges will require certain policy reforms by developed countries and assistance from donors. But the lion’s share of actions will need to come from the countries in the region themselves. WTO accession should also be evaluated from this perspective.

⁷ On the other hand, our website background paper by Arvind Panagariya discusses several debacles in economic development when protection was employed for extended periods of time without understanding the need for an efficient bureaucracy to offset the protection.

Tariff Policy and the Russian Tariff Structure

Uniform Tariffs. In chapter 7, David Tarr examines arguments for and against a uniform tariff. 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. Tarr maintains that tariff uniformity is the best choice in practice. 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 kind of free-rider problem for the lobbying industry and dramatically reduces the incentive to lobby for protection. Then: (1) the level of protection is likely to be lower (the recent experience of Chile is a dramatic case in point); (2) 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 valuable entrepreneurial talent which will thus be encouraged to create better and cheaper products; 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.

Russian Tariffs and their Political Economy. Two chapters in the Handbook examine Russian tariffs. Tarr, Shepotylo and Koudoyarov, in chapter 43, examine the Russian tariff structure. They find that the average tariff has increased from 11.5 percent to about 13.5 percent. Despite the tariff simplification program of 2000, the Russian tariff structure became much more diverse between 2001 and 2003, with the variance of the tariff almost doubling in that time period. In chapter 8, Sergey Afontsev examines the political economy of tariff protection in Russia using the Grossman-Helpman political economy model and less formal models. Afontsev argues that in the 1993–1997 periods, higher import tariffs were granted to industries with higher import penetration, higher employment, higher share of loss-making enterprises and higher share in total imports. Also concentration and firm size mattered in obtaining protection at the industry level.

Globalization and Industrial Policy

Pattern of Globalization. In chapter 9, Giorgio Barba Navaretti presents data on worldwide trade and protection, as well as Russian trade. He notes that world trade increased rapidly after the Second World War, but until 1980 was essentially driven by North-North trade. This process was driven by a general reduction of trade barriers negotiated at the global level in successive rounds of GATT negotiations. In contrast, North South trade was hindered both by higher trade barriers in developing countries and high industrial country protection of “sensitive” products like agricultural and light manufacturing. Things changed drastically in the 1980s, when North-South trade barriers finally started declining and many developing countries significantly expanded exports. Several developing countries moved away from commodities to exporting light manufacturing. This pattern was driven by a general reduction of trade barriers. Tariffs and non-tariff barriers have been declining steadily since 1980, although the use of antidumping actions has been increasing.

Industrial Policy for Global Competitiveness. What reforms, policies or instruments should be employed to best achieve a reoriented restructured globally competitive industrial structure? In chapter 10, David Tarr argues that the general principle is that it is crucial for the government to provide a stable macroeconomic environment conducive to business development with a clear, transparent and neutral regulatory environment and neutral incentives to all firms and industries. Clear, transparent and neutral incentives (those which do not distinguish by sector or firm) are crucial so that entrepreneurial innovation is rewarded more highly than rent-seeking activities. The economy must provide its most talented members with the incentive to engage in entrepreneurial activities such as starting or expanding firms, developing new products and lowering costs. If the economy provides extensive subsidies or tax exemptions to industries or firms, or presents a difficult regulatory framework within which to do business, corruption will be encouraged and, crucially, talented people will find it more profitable to engage in the socially wasteful activity of lobbying the government for subsidies, protection, tax or regulatory relief. This socially wasteful lobbying is especially harmful because it attracts scarce entrepreneurial talent that would otherwise be devoted to helping the economy grow.

Sound competition policies, labor market policies and adequate infrastructure are also important aspects of good industrial policy for global competitiveness. Tarr elaborates on what constitutes effective policies in these areas.

Tarr explains various risks that targeting particular industries for special assistance entails. He concludes that experience in most countries has shown that a government policy of attempting to "pick winners" is highly counterproductive. Endorsement of a more general approach to industry development--with little differentiation in the level of assistance among industries-- thus emanates from a wider skepticism about the practical merits of *targeting* of any kind.

Exchange Rate Overvaluation

In chapter 11, Howard Shatz and David Tarr discuss the relationship between overvalued exchange rates and trade policy and argue that attempting to maintain an overvalued exchange rate has led to the adoption of protectionist policies. An overvalued exchange rate discriminates against exports and reduces the incentives and the ability of exporters to compete in foreign markets. Since import-competing industries are faced with increased pressure from foreign companies, the political pressures for protection eventually prove to be overwhelming and governments yield to lobbying and offer increased tariffs on imports. Worldwide experience has shown that defending the exchange rate has no medium-run benefits, since falling reserves will force devaluation eventually.

The chapter contains a discussion of the experience of several countries with overvalued exchange rates, including the experience of Kazakhstan in 1999. Although Russia lived through a period of overvalued exchange rates prior to the 1998 crisis and massive devaluation, Russia does not presently face this problem.

Adjustment Costs to Trade Liberalization

In chapter 12, Steven Matusz and David Tarr survey over 50 empirical papers on the costs of adjustment to trade liberalization. Although they are cautious regarding the results, they note that virtually all studies that quantified social adjustment costs find that social adjustment costs are very small in relation to the benefits of trade liberalization. They ask why these studies find that adjustment costs are so small and why there is little decline (usually an increase) in manufacturing employment in developing countries one year after trade liberalization. Regarding manufacturing employment, these results are explained by a number of considerations: (1) developing countries would be expected to have comparative advantage in labor intensive industries, so trade liberalization should favor labor; (2) it has been observed that a great deal of inter-industry shifts occurred after trade liberalization, which minimized the dislocation of factors of production; and (3) in many industries normal labor turnover exceeds dislocation from trade liberalization, so that downsizing where necessary could be accomplished without much forced unemployment. They note, importantly, that even small adjustment costs for the poor are likely to be very important and deserving of public policy concern.⁸

The explanation for the low social adjustment costs in relation to the benefits is as follows: (1) most importantly, adjustment costs are typically short term and terminate when workers find a job, while the benefits of trade reform can be expected to grow with the economy; (2) estimates of the duration of unemployment for most industries are not high, especially where workers were not earning substantial rents in the original job; and (3) normal labor turnover often exceeds job displacement from trade liberalization.

They note that zero adjustment costs are socially suboptimal in a dynamic economy, since it would imply insufficient search time by temporarily unemployed workers.⁹ Moreover, given sound complementary policies, adjustment costs associated with trade liberalization are unlikely to provide an adequate reason for delays in opening up to the outside world. Nonetheless, it is likely that policymakers can reduce such costs, and, as stated, adjustments costs for the poor deserve special attention. Concern for the adjustment costs of the poor implies the need to develop effective and efficient safety nets. Perhaps the most important complementary policies are ensuring macroeconomic stability and the credibility of policies so as to foster a quick, sustained private investment response in newly competitive sectors of the economy. Structural policy reforms to improve labor market flexibility and reform of the state enterprise sector may provide important complementary support. Of course, each of these policies is likely to be of great economic value on its own. The mutually supportive relations between trade, macroeconomic, labor market and other policies may then serve to increase the credibility and payoffs to each.

⁸ Moreover, private adjustment costs can be expected to be higher than social adjustment costs. A reduction in wages is a private adjustment cost, but if no unemployment occurred, there is no social adjustment cost.

⁹ Since information is imperfect, workers need to search for their best opportunities. Lack of adequate search time will result in workers employed in positions that do not use their skills most effectively.

Regional Trade Policy

General Principles and International Experience. Regional Integration Agreements (RIA) has become a major component of the trade policy strategies of most countries. Despite the fact that some of these arrangements are called “Free Trade Agreements” they are not free trade since they discriminate against countries not part to the agreement. These arrangements may improve the welfare of participating countries, but, since they can induce high-price imports from partners they can also harm the participating countries; and they usually harm the excluded countries. Empirical work often finds that North-South regional arrangements are beneficial to the participants, but unilateral trade liberalization is often superior. Extra caution must be shown in South-South arrangements, which, due to less competition from partner countries, are more likely to be harmful to the participants. Above all, we emphasize that by lowering the external tariff against the rest of the world, any regional integration arrangement can be made to be beneficial, even ones that are harmful to the participants with high tariffs. In chapter 13, Bernard Hoekman, Maurice Schiff and Junichi Goto discuss the economics of regional arrangements and elaborate on these issues.

Customs Unions in the CIS. In line with what is argued in general for Regional Integration Agreements, Constantine Michalopoulos and David Tarr in chapter 14 maintain that preferential arrangements that provide strong incentives to orient trade towards partners in the former CIS contain significant long-term risks. The main risks are that the regional preferences lock in traditional technologies and production structures, reduce innovation and competition, and hence result in inefficient industries that absorb scarce resources that could be better used elsewhere. This holds even for the existing Customs Union members, and for others with more restrictive trade regimes than those of existing members. Michalopoulos and Tarr tend to favor Free Trade Agreements over Customs Unions in the CIS, because Free Trade Agreements allow a country to unilaterally lower its external tariffs. But Customs Unions are especially dangerous since they prevent the unilateral reduction of tariffs to reduce or eliminate the adverse consequences of the regional arrangement.

The key difference between preferential arrangements among CIS members and other preferential arrangements such as NAFTA and the EU is that in the latter the markets are large enough to promote competition and encourage the flow of new technology, which increase the probability that distortions introduced through preferences are more than offset by new trade creation and the dynamic effects of investment embodying new technology.

EU Eastern Enlargement. Finally, an important event that may have an effect on Russia’s trade is **the EU Eastern enlargement**, given that the EU accounts for the largest share of Russia’s imports and exports, and also the accession countries are important trade partners. In chapter 40, Natasha Tourdyeva examines this issue. She maintains that in industrial goods, market access to the new member states will on average improve since tariffs in the largest markets, Poland and Hungary, will decline as these countries implement the common external tariff and adopt the EU’s Generalised System of Preferences (GSP). On the other hand, rather stringent EU standards will be applied to Russia’s exports to accession countries. Moreover, there may also be a case for antidumping decisions against Russia to be reviewed, if because of

the enlargement, the market share of Russia's imports becomes smaller than the minimum level defined by the WTO (3 percent of the total volume of imports) to start an anti-dumping action.

As for agricultural products, the effects are likely to be negative. There may be trade diversion away from Russian and other agricultural exporting CIS countries, as the EU-10 countries, especially Poland, are given substantial preferences in the EU. Agricultural producers in the New Member States will also become eligible for EU CAP measures, namely farm subsidies. This will make it even harder for Russian suppliers to compete in the enlarged EU market.

Trade and the Environment

International Experience. Environmentalists and the trade policy community have been engaged in a heated debate over the environmental consequences of liberalized trade. Proponents of open markets feared that environmental protection will be used as an excuse by some economic sectors to gain protection for themselves against competition from abroad. Environmentalists feared that international trade will provide excessive weight to maximization of market-measured GDP at the cost of environmental degradation. The concerns with environmental implications of trade involve both the domestic implications of policy reforms as well as the global environmental dimension of bilateral and multilateral trade agreements. However, according to Kristalina Georgieva and Muthukumara Mani in chapter 15, "Trade and the Environment Debate: WTO, Kyoto and Beyond," the evidence shows that countries that are more open to trade adopt cleaner technologies more quickly and increased real income is often associated with increased demand for environmental quality. Greater openness to trade also encourages cleaner manufacturing because protectionist countries tend to shelter pollution-intensive heavy industries. However, sector specific policies often provide incentives to over-exploit or deplete resources even in a relatively open trade environment. Therefore appropriate environmental policies should be implemented to complement trade liberalization.

Kyoto Protocol and growth in Russia. Russia has recently ratified the Kyoto protocol. Franck Lecocq and Zmarak Shalizi in chapter 16, "Will the Kyoto Protocol Affect Growth in Russia?" note that the Kyoto Protocol puts a cap on Russia's emissions of green house gases for the period 2008-2012. In principle, the Kyoto Protocol could endanger growth in the short and medium term, given that green house gases emissions and economic growth usually move in the same direction. Chapter 16 concludes that even under a very high economic growth assumption, Russia is not likely to produce as much green house gases as it is allowed under the Kyoto Protocol. Thus the Kyoto targets will not adversely affect Russia's growth. In addition, Russia will be able to sell excess allowances and the value of these sales far outweighs the other costs.

The Aral Sea Disaster. The desiccation of the Aral Sea was one of the greatest environmental disasters of the latter part of the 20th century. In chapter 17, David Tarr and Eskender Trushin note that the desiccation is due to the massive expansion of cotton production in Central Asia, mostly in Uzbekistan, and to the use of irrigated water from rivers that normally fed the Aral Sea. Could the environmental disaster have been avoided if the former Soviet Union had relied more on imported cotton and not diverted these rivers? Can it be concluded that if the

cost of the irrigated water had been properly considered, Uzbekistan did not have a comparative advantage in cotton production, and the Soviet Union should have imported the cotton?

Tarr and Trushin argue that the environmental disaster in the Aral Sea and Central Asia is due to the fact that water resources in Central Asia were not properly valued in the Soviet system. Fundamental market reforms providing incentives to poor farmers would have increased productivity and achieved greater output without the need to divert as much water. It is difficult to conclude that this would have saved enough water to avoid the environmental problems of the Aral Sea, but these reforms were anathema to the Soviet system. Importing Siberian water would likely have avoided the disaster, but this was a very expensive project and it faced nationalistic obstacles in Russia. Given these constraints on sustainable cotton production in Central Asia, evaluation of costs that include the water resources costs, would imply that Central Asia lacks a comparative advantage in cotton production and should be importing more cotton.

III. THE DISCIPLINES OF THE WORLD TRADE ORGANIZATION -- PART 2 of the Handbook

The second part of the Handbook deals with specific issues related to Russia's accession to the WTO. It first examines the functions, the rationale and the scope of the WTO and it then deals with specific elements of the agreements.

Overview of the World Trade Organization and its functions

In chapter 18, Marc Baccheta explains the basic functions of the WTO. The WTO is run by member governments. All decisions are made by the membership as a whole. Decisions are normally taken by consensus.

The WTO is the successor organization to the General Agreement on Tariffs and Trade (GATT). The WTO has added several new disciplines and agreements to the GATT, but it is ruled by a set of basic principles which were part of the GATT: *i) non-discrimination*, which through the rules of the Most Favored Nation and National Treatment requires that any country grant equal treatment to all member nations and that imported goods are treated like domestically produced goods; *ii) reciprocity*, which ties the access to foreign markets to the granting of access to the domestic market; *iii) promotion of free trade*; *iv) transparency*, according to which all members are obliged to publish and disseminate information on their trade regulations, to establish and maintain institutions allowing for the review of administrative decisions affecting trade and to notify changes in trade policy to the WTO; *v) free trade with safety valves* which allows for several exceptions to the GATT principles, on grounds of National health, Safety and the environment; and *vi) differential treatment for developing countries*.

The WTO has a dispute settlement procedure that gives a prominent role to retaliation against one country that does not abide by WTO rules. The dispute settlement and enforcement provisions contained in the WTO are essential to the functioning of the multilateral trading system. While the remedies provided by the WTO tend to favor larger countries, the dispute

settlement mechanism is a useful and effective policy tool for developing countries, and the bargaining position of developing countries is stronger as members of a multilateral agreement than in bilateral negotiation with larger parties.

Accession

31 countries, including six in the CIS, are now attempting to accede to the WTO. Constantine Michalopoulos in chapter 19 shows that for a variety of reasons, the process of WTO accession has been and is likely to continue to be lengthy, complex and challenging for all countries, especially the Least Developed Countries (LDCs). Recognizing that the process of WTO accession is inherently time consuming, there are a number of steps that acceding countries and WTO members could take to facilitate and expedite accession. *First*, governments seeking accession need to establish a central co-ordination point to provide direction and manage the multiplicity of legislative and regulatory changes in their foreign trade regime that are necessary for accession. *Second*, they need to adopt liberal trade policies, because such policies will both contribute to their effective integration in the international economy and facilitate WTO entry. *Third*, governments need to focus on and identify those areas of the WTO agreements in which weaknesses in their institutional infrastructure require that they delay implementation of WTO provisions.

WTO members can also take steps to help expedite the accession process. It is in the interest of WTO members for the organization to achieve universal membership sooner rather than later, as they would also benefit, if all countries adhere to the rules and provisions of the WTO. In this regard, they should attempt to ensure that accession is not delayed on account of developed countries own disagreements or disputes. Developed countries also need to continue to provide assistance to developing countries and countries in transition which are not members to strengthen their institutional capacities so that they are better able to meet the requirements of WTO accession.

Implementation

In chapter 20, J. Michael Finger and Philip Schuler point out that member countries of the WTO undertake many obligations that, particularly from the point of view of developing countries, are long and costly to implement. These relate to many areas of regulation that establish the basic business environment in the domestic economy, such as technical standards, sanitary and phytosanitary standards (SPS), and intellectual property law. These are more than policy commitments; they imply investment decisions. Their implementation will require that countries purchase equipment, train people, and establish systems of checks and balances, to name just a few actions.

Developing country institutions are often weak and would benefit from strengthening and reform. However, according to Finger and Schuler, existing WTO regulations in these areas fail to fully reflect the capacities of developing countries to implement SPS, customs valuation, intellectual property, and other such regulations. Avoiding implementation problems requires that there be great ownership of negotiated agreements. The absence of instinctive ownership of the reforms needed to comply with WTO obligations will make implementation very difficult and is

likely to push governments toward superficial adjustments aimed at avoiding clashes with trading partners.

Agriculture

In chapter 21, Evgenia Serova and Natalia Karlova argue that liberalization of agricultural trade has been lagging behind the liberalization of manufacturing products. The first agreement on agricultural trade was signed in 1994, as part of the Uruguay Round, but it sets rules which are much more flexible than those concerning trade of industrial products. One of the most significant exceptions is, for instance, the exemption of the agricultural sector from the ban on export subsidies or on quantitative restrictions on imports.

In general terms, the Agreement on Agriculture is based on three main principles:

- extension of access to domestic markets of the participating countries;
- reduction of domestic support provided to agriculture in the participating countries;
- enhancement of export-linked competition, reduction of export subsidies by the participating countries.

All provisions of this Agreement are aimed at implementing these three principles. Because of this delayed start of a global agreement in agriculture (the first agreement on manufacturing products dates to 1947) and because of the relatively loose provisions of the agreement itself, trade barriers in this sector remain on average much higher than for industrial products. In addition to the Agreement on Agriculture, the Agreement on Phytosanitary Measures, which also contains measures relevant for agriculture, was adopted at the Uruguay Round.

The Agriculture Agreement principles mean that the WTO imposes constraints on export and production subsidies in agriculture, as these are considered “trade distorting.” But government support to agriculture in areas such as training, social safety net income payments, infrastructure services, pest control, land reform, marketing and research is allowed without constraint by the WTO.¹⁰ Thus, regardless of the level of allowed trade distorting subsidies after accession, member countries have substantial scope for supporting agriculture within the restraints of the WTO. For transition countries, the key policy questions after accession will remain: how can they implement the necessary structural reforms, including land reform, to improve the efficiency, and how much support is appropriate for agriculture versus other sectors of the economy?

What are the expected effects for Russia of joining the Agreement on Agriculture? Serova and Karlova argue that there are essentially four sets of objections raised by the general

¹⁰ See S. Demyanenko and V. Galushko, “Shifting Agricultural Policy towards measures envisaged by the green box,” in S. von Cramon-Taubadel, S. Demyanenko and A. Kuhn (eds.)- *Ukrainian Agriculture—Crisis and Recovery*, Germany: Shaker Verlag, pp. 17-25.

public and some commentators, but none of these based on strong arguments. Rather, the effects on the Russian agro-food sector are likely to be positive. The first concern is that joining the Agreement on Agriculture will result in a reduction of tariff protection and a growing inflow of imports in the Russian market. But Russia's average weighted tariff for agricultural and food products is already under 15 percent which is less than for most major competitors. The second concern is that joining the Agreement on Agriculture would limit opportunities for providing export subsidies. But at present agri-food exports are not subsidized. On the contrary there are several constraints to exports: overrated railway tariffs for exports, non-harmonized standards, lack of certification agencies abroad, and export duties. WTO accession will imply the removal of most of these barriers. The third type of fear is a reduction of the domestic support of income in agriculture. However, Russia's agriculture suffers mostly from the underdevelopment of institutions like credit, and insurance, where support may be provided. The final concern is about food security, if Russia becomes more dependent on imported food products. But a good integration into the world market, with diversified sources of imports and market of exports enhances food security much more than strictly relying on domestic production.

Services

In chapter 22, Aaditya Mattoo notes trade and foreign direct investment in services is growing extremely rapidly and the developing countries are capturing an increasing share of this trade. The performance of the services sectors can make the difference between rapid and sluggish growth. Developing countries, in particular, are likely to benefit significantly from further domestic liberalization of their services sectors. The income gains from a reduction in protection to services are estimated to be multiples of those from trade liberalization in goods.

The General Agreement on Trade in Services (GATS) is part of the WTO and regulates trade in services through several modes, involving both capital and labor movements. First, there is a set of general rules that apply to all services sectors; second, there is a set of sector-specific commitments that determine the extent of liberalization undertaken by individual countries in specific sectors. The most important of the general rules are *transparency* and the *most-favored-nation* (MFN) principle. The former requires that all measures of general application affecting trade in services be published by a member, and that other members be informed of significant changes in trade policy. MFN acts like MFN in goods trade—it prevents members from discriminating between their trading partners regarding things like rights of foreign investors in a services sector.

Mattoo argues that trade and FDI liberalization in services must be coupled with domestic reforms increasing the competitiveness of the industry. Flawed reform programs can substantially reduce gains. The largest gains come from eliminating barriers to entry, but many developing countries have given priority to a change in ownership through privatization, while retaining limitations on new entry. Effective regulation ranging from prudential regulation in financial services to pro-competitive regulation in telecommunications is critical to the success of liberalization, but regulatory weaknesses are too prevalent in developing economies. Liberalization also frequently requires complementary policies to help improve access to essential services for the poor. The experience of several countries has demonstrated that universal service goals can be achieved in competitive markets.

Intellectual property rights (IPR)

International Experience. Carsten Fink, in chapter 23, discusses intellectual property rights. IPR protect creations which result from intellectual activity in the industrial, scientific, literary, and artistic fields. IPR instruments include patents, copyrights, trademarks, geographic indications, layout designs for integrated circuits, plant breeders' rights, and trade secrets.

Fink notes that the Agreement on Trade-Related Intellectual Property Rights (TRIPS) was one of the key outcomes of the Uruguay Round and it is now one of the pillars of the World Trade Organization (WTO). It sets minimum standards of protection for all IPRs instruments, but also leaves governments important flexibilities to design IPRs regimes to suit domestic needs.

For the multilateral trading system, TRIPS marked a significant departure from narrow negotiations on border measures such as tariffs and quotas toward the establishment of multilateral rules for measures that affect trade beyond borders. This move reflected underlying trends in international commerce. Due to the growth of trade in knowledge and information-intensive goods, the economic implications of imitation, copying, and counterfeiting had in many industries become at least as relevant for international commerce as conventional border restrictions to trade.

Yet the TRIPS negotiations on intellectual property were marked by significant North-South differences. Developed countries, which host the world's largest intellectual property-producing industries, were the key advocates for comprehensive minimum standards of protection and enforcement of IPRs. By contrast, many developing countries, which see themselves mostly as consumers of intellectual property, felt that stronger standards of protection would serve to limit access to new technologies and products, thereby undermining poor countries' development prospects. Not surprisingly, the TRIPS Agreement remains one of the most controversial agreements of the WTO.

For example, stronger pharmaceutical patent rights required by TRIPS have raised concerns that greater pricing power by pharmaceutical companies would adversely affect access to medicines in poor countries. To address these concerns WTO members have reaffirmed the right of governments to use compulsory licenses to override the exclusive rights conferred by patents. In addition, a special mechanism was created in 2003 that allows developing countries with insufficient pharmaceutical manufacturing capabilities to import generic drugs.

The literature reviewed by Fink shows that, for middle income countries, stronger IPRs bring about benefits in terms of increased trade, foreign direct investment and technology transfer. The size of benefits, though, depends on complementary policy reforms, notably improvements in other aspects of the investment climate. In contrast, for small developing economies with little inventive and creative capacity, stronger IPRs may lead to rent transfers to foreign title holders.

Collecting Royalties for Authors and Writers in Russia. One of the themes of World Bank research on intellectual property is how the IPR laws can be used to collect royalties for

artists, scientists and inventors in developing and transition countries.¹¹ In Russia there is a cooperative of Russian authors, musicians and artists, known as the Russian Authors' Society, that attempts to collect royalties for its members. In chapter 24, Ekaterina Ananieva, an attorney for the Russian Authors' Society who has been actively engaged in this process, relates her experience. Typically, the Society represents musicians, since as a practical matter, large organizations, like publishing houses or companies that employ scientists, will seek royalties for authors or scientists directly.

She argues that Russia has an intellectual property law, but enforcement is a problem. To reduce violations and comply with TRIPs, the present legislation will have to be amended. A new law is under discussion and its approval is one of the pending conditions for the admission of Russia into the WTO. The draft law envisages introducing new exclusive copyrights and related rights, and increases the liability for violating the copyright.¹²

Contingent Protection

International Experience. The term *contingent protection* refers to trade restrictions – like anti-dumping duties, safeguard clauses and countervailing duties - that can be introduced under specific circumstances, providing protection from imports beyond the protection granted by the tariff schedules negotiated as part of GATT. In chapter 25, Giorgio Barba Navaretti and Angelica Salvi Del Pero argue that measures of contingent protection are now being increasingly used for legitimizing selective, unilateral protection.

Anti-dumping duties are the most frequently used measure of contingent protection. In principle, they are tariffs imposed by an importing country on imports of a product that has been sold at an unfairly low price in its domestic market by some exporting firms. Such tariffs are supplementary to the MFN tariff applied by a country and may be applied even if the applied tariff including the antidumping duty exceeds the bound tariff agreed within the GATT. Antidumping duties, however, are only applied to firms (not countries) that “dump;” they thus represent an exception to the WTO fundamental principle of non-discrimination.

A significant problem is that the GATT's definition and regulation of dumping is vague and the procedures for calculating whether dumping has occurred are loose and full of loopholes. This has allowed a number of WTO members to act unilaterally and impose antidumping duties based on very weak evidence of anti-competitive behavior, and it has made the case of any country which is challenged by an antidumping action extremely weak. Thus, the use of antidumping has typically evolved into a form of hidden, discriminatory and unjustified protection.¹³ From the perspective of the welfare of a country, antidumping actions are rarely initiated to challenge effective predatory pricing behavior; therefore countries hurt the welfare of

¹¹See *Poor People's Knowledge: Promoting Intellectual Property In Developing Countries*, J. Michael Finger and Philip Schuler editors, World Bank Trade and Development Series, Oxford University Press, 2005.

¹² The new law will also extend the length of a copyright from 50 to 70 years.

¹³ The rules of the WTO on antidumping are subject to negotiation in the Doha Development Agenda where some countries are pushing for tightening of the rules.

their own citizens from application of antidumping in a manner analogous to the application of a normal tariff.

Safeguards are temporary tariffs designed to assist an industry injured by imports. Safeguards are applied on a non-discriminatory basis. In dealing with political pressure for protection, safeguards are considered economically superior to antidumping, because consideration of the national interest is built into the evaluation process of safeguards. Antidumping is a judicial process in which the national interest typically has no role.

Although antidumping laws are legal within the WTO, the WTO does not require the adoption on an antidumping law. We recommend that acceding countries avoid adopting an antidumping law. As a second best choice, if an antidumping law is adopted, we recommend that the law require an evaluation of the national interest (including consumer interests) before application of antidumping duties.

Antidumping and Ukrainian Steel. In chapter 26, Igor Eremenko, Katerina Lisenkova provide a case study of the impact of antidumping and subsidies in Ukrainian steel. They argue that that accession the WTO for Ukraine will require the elimination of subsidies to Ukrainian steel. This will result in a benefit to Ukraine in a decline in antidumping actions against Ukrainian steel in its export markets. The authors quantify the impacts. Contrary to popular discussion in Ukraine, they show that the reduction in subsidies in Ukraine will also benefit the country as a whole. So, despite losses to the producers of steel, accession to the WTO, which entails both subsidy reduction and reduced antidumping against its exports, should be a win-win situation for Ukraine.

Trade facilitation and Customs Modernization

Trade Facilitation. Trade costs are associated with transportation charges, documentation requirements and delays in clearance at a national border. In chapter 27, John S. Wilson and Tsunehiro Otsuki argue that these trade costs have become as important as traditional border costs such as tariffs and quantitative restrictions. They argue that the ability of countries to deliver goods and services promptly and at low costs is a key determinant of their participation in the global economy. Streamlined procedures in customs fees and formalities, more transparent legal rights and obligations for traders, and harmonized regulatory requirements are certainly core reform goals in most countries to speed up trade flows.

Increasing awareness of those trade-related transactions costs has called for multilateral rule making and regional or plurilateral coordination regarding trade facilitation. Trade facilitation is one of the four Singapore issues set forth at the 1996 Ministerial Conference; while the other three Singapore issues have been dropped from the Doha agenda, in July 2004, trade facilitation received a mandate for further negotiation. Trade facilitation is generally referred to as a reduction of transaction costs associated with unnecessary administrative burdens on cross-border movement of goods and services between sellers and buyers. Despite the potential benefits of trade facilitation, many countries have not reduced these trade costs; and cooperation in terms of trade facilitation has not been fully developed in the international arena. Many developing countries are reluctant to make a full commitment to the investment and institutional

reforms associated with trade facilitation. But uniform application of multilateral agreements is desirable in order to achieve the ultimate goal – removal of trade facilitation barriers worldwide.

Customs Modernization—International and Russian Experience. In chapter 28, Luc de Wulf summarizes the results for the large study he led for the World Bank in best practices in customs modernization. In chapter 29, Carlos Ferreira summarizes the World Bank-Government of Russia project on customs modernization in Russia. Surveys of traders in Russia have shown that the number of complaints about the Russian customs service has declined subsequent to implementation of this project.

Standards and Technical Regulation

International Experience. In chapter 30, Spencer Henson notes that with the decline in traditional barriers to trade, attention has focused on the potential role of standards as technical barriers to trade. At the same time, consumers in both industrialized and developing countries are increasingly demanding safer, higher quality and more consistent products that require that systems of standardization are put in place. The question for the world trading system is how to provide for the legitimate rights of a country to use standards to provide for the quality and safety of products without standards becoming a technical barrier to trade. The World Trade Organization (WTO) through the Agreements on Sanitary and Phytosanitary (SPS) measures and on Technical Barriers to Trade (TBT) has played a significant role in this respect. Hensen notes that Members are required to provide scientific evidence when applying SPS measures that differ from international standards. Further, Members are obliged to achieve consistency in the application of SPS measures, to avoid arbitrary or unjustifiable distinctions in the levels of protection it considers to be appropriate if the distinctions would act to distort trade. Nonetheless, there are now a number of documented cases where developing countries have faced restrictions because of their inability to meet mandatory standards, and lost markets due to their inability to meet voluntary standards. At the same time, other countries have managed to gain access to high-value markets in industrialized countries despite the existence of exacting standards and indeed may have gained a competitive advantage in the process.

Technical Regulation in Russia. In chapter 31, Alexander Rybtsov explains the recent reforms in the Russian system of standards and technical regulation. He notes that under the new law, the quality of products has been removed from the area of technical regulation by the government; technical regulation is limited solely to safety issues. Moreover, the system of technical regulation in Russia is being completely reorganized and simplified.

Foreign Direct Investment and the WTO Agreement on TRIMs

International Experience. In chapter 32, Giorgio Barba Navaretti and Angelica Salvi del Pero discuss Trade Related Investment Measures (TRIMs). Measures regulating foreign direct investment (FDI) with particular requirements on trade are defined as TRIMs. These are requirements imposed on investors by host countries seeking to protect and foster domestic industries or to redistribute profits generated by foreign investors towards domestic residents. These measures hinder both FDI and potential trade flows and they are rarely welfare improving. TRIMs introduce distortions in the domestic economy and often impede an efficient allocation of

resources. They are also rarely effective as ‘second best’ instruments to correct existing distortions.

TRIMs are explicitly regulated under the WTO TRIMs agreement. The inclusion of TRIMs within WTO prevents countries from raising indirect trade barriers in conflict with the process of global trade liberalization negotiated under the WTO. Furthermore, it creates a commitment to avoid bad outcomes of domestic policy games and it favors the international harmonization of rules so as to increase transparency and reduce transaction costs.

The activities of most multinational enterprises (MNEs) involve an increasing degree of geographical fragmentation of production, particularly when investments are carried out in countries with relatively cheap labor. Investments of this type have become overwhelming at the end of the 20th century so that MNEs now account for well over half of all world trade flows. But these trade flows are severely hindered by high trade costs (either tariffs or trade costs that can be reduced by trade facilitation). Therefore, in order for Russia and the CIS countries to obtain an increase FDI and to participate in these international production networks, trade liberalization and trade facilitation are likely necessary complementary reforms.

Russian experience. Since the start of transition Russia has attracted a limited amount of FDI. In relation to the size of its economy, Russia has one of the lowest ratios of FDI inflows to GDP of all the European transition countries. The authors argue that to attract more investment Russia must improve its investment climate, and clarify its contradictory regulatory framework on FDI, which contains both incentives and restrictions for foreign investors. Both restrictions and preferential measures towards FDI should be phased out and replaced by a simplified, rules based regulatory system. Moreover, several measures are in conflict with TRIMs, particularly ‘local content’ and supply to local market requirements. These inconsistencies will have to be phased out.

Government Procurement

The Government Procurement Agreement (GPA) of the WTO is a plurilateral agreement signed by the EU (including its 25 member countries) and 12 other countries; nine other countries are negotiating accession. Countries that sign the agreement provide access to their own government procurement markets to other countries that have also signed the agreement; they obtain reciprocal access in return to the markets of the Members of the GPA. In chapter 33, Konstantin Perov describes the system of government procurement in Russia and assesses what changes would have to be made to so that the Russian system of government procurement would be consistent with the Government Procurement Agreement of the WTO.

IV. THE EFFECTS ON RUSSIA AND CIS COUNTRIES OF TRADE LIBERALIZATION AND WTO ACCESSION – Part 3 of the Handbook

Estimated Effects of WTO accession

In chapter 34, David Tarr and Thomas Rutherford estimate the effects of WTO accession. A large number of laws have already been passed in mid-2005 in anticipation of accession, and many changes will occur for several years following WTO accession. The authors estimate that the cumulative impact of all these changes will result in a welfare gain to Russia of about 7 percent of the value of Russian consumption in the medium term. The vast majority of households are expected to gain from WTO accession. The gains are between 2 percent and 17 percent of household consumption in the medium term. In the long run, when the positive impact on the investment climate and productivity materializes, the gains will be larger.

A central point of this paper is that WTO accession cannot be examined by just considering tariff liberalization. Rather, WTO accession entails a much broader process of pro-market reforms including liberalization of services. Indeed, this paper estimates that liberalization of barriers to FDI in the services sectors is the most important source of gains from WTO accession, accounting for more than two-thirds of the overall welfare gain. Russian commitments to multinational service providers would encourage more FDI in Russia. This would give Russian businesses improved access to the services of multinational service providers in such sectors as telecommunications, banking, insurance, and transportation. This should lower the cost of doing business and should also lead to productivity gains for firms using these services.

Tariff reduction will lead to significant gains but is not the most important source of gains from WTO accession. Tariff reduction would yield 1.3 percentage points of improvement in consumption. Tariff reduction should lead to improved allocation of resources in Russia, as resources will be induced to shift to sectors where they are more highly valued at world prices. More important, tariff reduction would more readily permit Russian businesses to import products that contain new and diverse technologies. This would lead to productivity gains. But the Russian tariff is at present not very high—aggregate tariff revenues are only 1.6 percent of GDP, or about 7 percent of the value of imports. Therefore, this would not yield the largest macroeconomic effect, although it would be important for a few sectors. Finally, improved market access is valuable due to improved treatment of Russian exporters in antidumping cases, but is the least important of the three key changes that would result from WTO accession.

Effects of trade liberalization on the productivity of Russian firms

In chapter 35, Ksenia Yudaeva looks at the effects on the productivity of Russian firms. The main conclusion is that trade policy had a smaller effect on the performance of Russian firms than other institutional and macroeconomic reforms, which took place along with trade reforms. This is understandable, given the scope and the extent of Russian reforms in the early stages of transition.

It is possible to distinguish two different patterns in firms' behavior. In the early stages of transition, productivity declined significantly. This is partly explained by the fact that inter-company technological and customer supplier links between different firms created many rigidities and bottlenecks in the system and firms were unable to adjust in a sufficiently flexible way. The reaction to the 1998 crisis was instead different and much more encouraging. A large part of the firms analyzed were able to increase productivity as they managed to re-organize production and overcome the earlier constraints. This result is encouraging regarding the potential effects of WTO accession, as it shows that further trade liberalization will likely lead to an active restructuring of companies.

Professor Dumulen's Myths of WTO Accession

In chapter 36, Ippolit Dumulen provides a note in which he maintains that foreign trade provides employment and contributes to growth of the economy. He argues there are four key myths about WTO accession in Russia. First, it is a myth that WTO accession will destroy whole branches of the economy. Rather than foreign competition, the larger problem for sectors like civil aircraft, which have very competitive prices, is their production capability. Second, tariff bindings at the WTO will not destroy Russian industry but rather will provide stability. Third, Dumulen maintains that Russia will not lose its sovereignty in its international economic relations after WTO accession; rather it will operate in international trade guided by the rules of the WTO. Finally, he argues it is a myth that accession will not benefit Russian exporters, since bilateral MFN status is inferior to permanent multilateral MFN status. And after accession, Russia will be able to participate in the rule making of the WTO.

The Merits of Dual Pricing of Russian Natural Gas

During the accession negotiations to enter the World Trade Organization, the question has arisen whether Russia should charge the same price for the exports of its natural gas as it charges in its home market. In chapter 37, the economic analysis of David Tarr and Peter Thomson suggests that pipelines allow Gazprom to segment the Russian market from the European (including Turkey) market, that Gazprom has market power in the European market and is a near monopolist in Russia. Based on this market power assumption, they develop and estimate a price discriminating oligopoly model in which Gazprom is optimizing the price and quantity that it sells in Europe.

Tarr and Thomson argue that the Russian market would be better served by the introduction of competition, but while Gazprom retains its near monopoly domestically, it is not efficient to allow Gazprom to extract the full monopoly price domestically. Rather Russia should allow Gazprom to raise its **domestic** prices of natural gas from about \$15 to \$20 per thousand cubic meters (TCM) in mid-2003 to the full long-run marginal costs (about \$35 to \$40 per TCM). This would result in benefits to Russia of about \$1.24 billion dollars per year. The analysis also reveals that, it is in Russia's interest to exploit its monopoly power on gas sales in Europe. It follows that there is no economic rationale, from Russia's perspective, to unify the price of natural gas it sells domestically and abroad. If Gazprom were to sell its natural gas to Europe at only full long-run marginal cost plus transportation costs, Russia would lose between \$5 billion and \$7.5 billion per year. On the other hand, consumers in Europe would gain even

more (between \$7.5 billion and \$10 billion per year), as they would consume more gas at lower prices. If, instead, Russia were to raise its domestic prices to the prices it charges in Europe, very large adjustment costs would be triggered that cannot be justified on the basis of Russia's comparative advantage.

Labor Market Adjustments to Trade Liberalization in Russia

In chapter 38, Irina Denisova and several others have examined the impact on Russian labor markets of the enormous trade shocks in the Russian economy during the 1990s. This period includes, of course, the period of the transformation from communism to a market economy. Briefly stated, they find that the trade shocks of this period had only a small effect on the Russian labor market, and they note that real wages in the Russian labor market are relatively flexible in comparison with Central and Eastern Europe. Thus, it is possible to conclude that the Russian labor market has adapted reasonably well to these shocks. Moreover, the magnitude of the shocks likely to be faced by Russia as a result of WTO accession will be dramatically smaller than the shocks Russia faced from the collapse of communism. They therefore expect the Russian labor markets to be able to adapt well to the shocks from WTO accession.

Dutch Disease, Natural Resource Dependent Economies and Implications for Russia

In chapter 39, Natasha Volchkova examines Russia's dependency on energy exports. She notes that oil is Russia's main export item and high oil prices are the major source of Russian current GDP growth. Russia holds the world's largest natural gas reserves, the second largest coal reserves and the eighth largest oil reserves. Russia is also the world's largest exporter of natural gas, the second largest oil exporter and the third largest energy consumer. However, these sources of income are quite volatile and unpredictable and hardly can be regarded as a reasonable base for prolonged economic growth. Moreover, as indicated by a number of studies, to some extent it could be regarded as an obstacle to development. This problem is defined as "Dutch disease," the relatively large returns from natural resources discourage investments in other sectors of the economy. Moreover, exports of natural resources induce an increase in the cost of domestic factors of production (e.g. labor) and a real appreciation of the exchange rate, thus reducing the competitiveness of Russian goods. This can be a serious problem for Russia, as it needs to diversify its economy away from commodities in the long term.

Volchkova argues that the key concerns for Russia should not be natural resources per se, but how far the availability of oil revenues deflects the government from introducing policies to mitigate the possible negative effects of this windfall in revenues. In this respect, the introduction by Russian authorities of a stabilization fund aimed at sterilizing the short-term effects of oil revenues and at saving resources for future spending is an encouraging step forward.

Economic Geography and the Regions of Russia

In chapter 41, Masashita Fujita, Kazuhiro. Kumo and Natasha Zubarevich relate the new economic geography literature to Russia. During the Soviet era, the location of cities and economic activity was not done on the basis of economic efficiency. Now that the population is free to move within Russia, we would expect a realignment of the population. We would expect

people to move to locations where wages and the quality of public services are higher. Given that wages tend to be higher in larger cities due to economic efficiencies of production (known as agglomeration effects), we expect to see in Russia growth of the larger cities and emergence of new larger cities.

Moreover the Soviet system located a significant share of the population in rather cold climates. Fourteen out of the 15 coldest cities in the world with a population over one million are located in Russia. Since it cost a lot more to produce goods and to live in very cold climates, as energy prices rise to market levels over time, we would expect to see a movement of the population to the warmer parts of Russia, i.e., the west and the south. So we expect a growth of European Russia.

The authors argue that WTO accession, as a step toward openness, will reinforce the forces of agglomeration and concentration of economic activity. The authors argue that WTO accession, like the core forces of agglomeration, should increase incomes overall, but increase the disparity between the regions.

The policy choices for reduction of gross income disparities are: economic subsidies for the weak regions, direct income support, or migration. The authors argue that all have advantages and disadvantages. Economic subsidies to weak regions develop poor regions but encourage labor to remain in regions where it is used inefficiently. Income redistribution does not develop the economy of a region but helps the poor most directly. And migration, while efficient and contributing to productivity in receiving regions and increasing the incomes of migrant families, contributes to the loss of agglomeration externalities in the *sending* region and the increase in income disparities.

Trade Policy and WTO Accession: Implications for the regions of Russia

In chapter 42, Junichi Goto, Kazuhiro Kumo and Natasha Zubarevich summarize the results of the OECD report on this subject and contribute their own assessments. They argue that WTO accession should result in benefits and costs for a region. On the benefits side, it will result in more transparent regulation of regional economies, stimulate their openness, accelerate institutional reform in the regions and reduce protectionism of local producers. Therefore Russia's accession to the WTO will serve as a catalyst for structural and institutional reform in the regions where these reforms are delayed because of disinterested local bureaucracies and limited opportunities for private initiative. Such an outcome should increase the attractiveness of Russian regions for investment.

One can anticipate varying social costs. WTO accession will not result in massive unemployment as the threat for the Russian labor market is clearly overstated. Local increases in the unemployment rate however may be considerable, especially in one-company towns in the Volga Federal District and Central Federal District. On the other hand, the growth of spatial discrepancies due to the acceleration of agglomeration externalities is underestimated. It would be wise though to project for even larger financial costs of implementing a leveling policy.

Overall the successes and failures of WTO accession will not so much be the result of exterior influence but of domestic Russian policy including the priorities of regional policies. A positive net outcome requires purposeful preparation for WTO accession by both government and business including preparation at the regional level

Appendix

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in Russia and the CIS: A Handbook*

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