

**Political Economy of Russian Trade Policy:  
Early Transition, Customs Unions,  
WTO Accession and Protection for Industrial Diversification**

**David G. Tarr**

Adjunct Professor of Economics  
New Economic School, Moscow

Paper prepared for conference on  
“The Political Economy of Trade Policy in the BRICS”  
March 27-28, 2009  
New Orleans, La

Abstract: This paper discusses the political economy behind the principal trade policy decisions in Russia since independence. I discuss why export restraints were widely employed in the early transition years and why the export quotas proved more difficult to remove than anticipated. Why it was so difficult to resolve the monetary basis for the collapse in trade among the newly independent states. Why the search for rents for Russian industry motivated the creation of a customs union among selected countries in the Commonwealth of Independent States, but also proved its undoing. How Russian leaders initially were exceptionally insightful in seeing WTO accession as a golden opportunity for domestic reform, but why in recent years they have turned to industrial policy for diversification. I discuss the possibly unique political economy of Russia in which political contributions are extracted without political influence.

JEL classification: F13; F14; F15 ; K00.

Contact information. [Dtarr@worldbank.org](mailto:Dtarr@worldbank.org)

# **Political Economy of Russian Trade Policy: Early Transition, Customs Unions, WTO Accession and Protection for Industrial Diversification**

**David G. Tarr**

In this paper I discuss the political forces and reasoning that have shaped the key trade policies of Russia since independence. I begin in section I with a discussion of the Russian government's decisions in the first years after independence, separately regarding its trade with the west and its trade with the newly independent states of the former Soviet Union; I include a discussion of the role of the IMF. I next discuss Russia's efforts to create a customs union with some of its neighbors in the region—both the effort in the 1990s and the recent effort to strengthen the customs union. WTO accession has been the major trade policy issue in Russia for the past decade, and the political economy forces shaping this issue is the subject of section III. In section IV, the recent effort to achieve diversification through industrial policy and state subsidies is explained and contrasted with alternate more efficient mechanisms. I offer conclusions in section V.

## **I. The Early Transition Years: 1991-1993**

Russian trade in the former Soviet Union was bi-furcated. On the one hand there was trade in the former Soviet states (which had been internal trade). On the other hand, there was trade with the West. The trade adjustment pattern and political economy of the trade policy that developed in the post-Soviet period were very different between the two regions. While some western observers feared that import competition from the west would cause major disruptions, in fact, I argue that these disruptions were very minor in the first few years of the transition. On the other hand, there was a major contraction in trade with the countries that comprised the former Soviet Union that was an important reason for the significant output decline.

### **Russian Trade with the West**

With the breakup of the former Soviet Union, Russia was confronted with the fact that there were enormous disparities between prices in Russia and world market prices. On the one hand, commodities and other raw materials were priced dramatically lower in Russia than on world markets. At prevailing exchange rates in 1992, crude oil prices in Russia were only 1/1000<sup>th</sup> of world market prices (Michalopoulos and Tarr, 1992). On the other hand, Russia confronted the “soft goods” problem for its manufactured products. That is, its manufactured products were of too low a level of quality to be marketable in western markets.

**Political Economy Reasons for the Choice of Export Restraints.** The Russian government took the position that, given the huge disparities between domestic and world prices, its industries needed a transition period to adjust to world market prices. Sergei Glaziev, the Minister of Foreign Economic Relations for the Russian Federation at this time, argued that export restraints were preferable to import restraints for political economy reasons (Glaziev, 1994, 59). That is, once import protection is granted, it is difficult to remove, due to the well-known free-rider problem associated with tariff protection: those who benefit from its removal are many but dispersed and they will not lobby for the removal of import protection; but those who gain from the import protection will lobby. On the other hand, export restraints on raw material producers will more easily be removed. The political economy of the removal of the trade protection is reversed with export restraints. Those who gain from the removal of the export restraints are concentrated interests who will be the strongest lobbyists in the process. Then, when the government want to remove the export restraints, it would not be faced with unopposed entrenched lobbying opposition. Given that the Russian government only wanted protection as a temporary measure to ease the transition, he argued that the Russian government chose export restraints and virtually no import protection partly because of political economy reasons.

Exports in Russia were constrained by three mechanisms: export quotas, export taxes and foreign exchange surrender requirements. Removing export quotas, while accomplished in the long run, proved much more difficult than anticipated. Industrial ministries and the Ministry of the Economy pushed to maintain export quotas. These ministries wanted to have an instrument to force raw material producers to supply domestic markets of their choice (Glaziev, 1994, 59-61). With the progressive liberalization of the economy, the power to distribute export quotas was their sole remaining instrument with which they could capture rents or influence economic activity.

**The Myth of Low Protection.** Formal import protection, in terms of explicit mechanisms such as tariffs or licenses on imports, was very low in the 1992-1994 period. Given the soft goods problem, some Western observers (e.g., McKinnon, 1991) recommended high tariffs for fear that Russia would be overrun by imports in sectors where it could not compete. In fact, however, import competition was very weak during this period due to the extremely undervalued ruble. Significantly due to the extensive export restraints, the real exchange rate in Russia was very undervalued. In 1992, workers in Russia were earning only about \$10 per month at prevailing market exchange rates. In these circumstances, for firms that had to buy foreign exchange, imports were not competitive.

In fact, imports were so uncompetitive that the Russian Government subsidized the purchase of imports. The World Bank (1993, 37-39) estimated that the subsidies to imports amounted to US\$ 18.6 billion in 1992, which was a staggering 17.5 percent of GDP. Machinery and equipment received 49 percent of the import subsidies and food products received 35 percent of the subsidies, with subsidies varying by sector from a

low of 61 percent for food imports to a high of 90 percent on food processing equipment (World Bank, 1993, table 2.11).

### **Trade with the Former Soviet Union**

Trade with the former Soviet States had been internal trade determined by the planning mechanism. Factories and industries were located throughout the former Soviet Union for reasons that frequently did not conform to market principles, but the industrial structure of the 15 independent states was highly interlinked. Factories often produced intermediate products that were specialized to the former Soviet Union (FSU) and had transportation links to their main clients, but alternate transportation links outside the FSU, such as between central Asia and China, were not well developed in many cases. Nonetheless, in the immediate aftermath of the breakup of the former Soviet Union (FSU), trade among the new independent states collapsed. Russian exports and imports, for example, to the former Soviet states fell to between 10 and 15 of their value in 1991 (Michalopoulos and Tarr, 1994, table 1.2). Given the interdependence of this trade, the sharp contraction that occurred in this trade was very costly and contributed to the sharp decline in output that occurred in the FSU in these years.

Michalopoulos and Tarr (1992; 1994; 1996) have argued that the root cause of the collapse of trade was an inadequate payments system among the countries of the FSU, which during the 1991-1993, was due to the common ruble zone without monetary coordination. That is, after the breakup of the FSU in the autumn of 1991, all countries in the FSU belonged to a common ruble zone. All the central banks could create non-cash rubles, without coordination. In this circumstance, there was a free-rider problem in the emission of money by central banks. Each bank could excessively create money in the hope of free-riding on the monetary restraint of other central banks in the common ruble zone. This made the achievement of macro and monetary stability impossible, and also induced a collapse in FSU trade. Exports yielded only credits in the banking system that the home country central bank could create independently, i.e., exports to the FSU were seen as valueless. This led to the almost immediate introduction of massive export restraints within the FSU.<sup>1</sup>

It was clear that for macro stability and the resumption of non-barter trade either monetary coordination among the central banks of the ruble zone had to be established or the countries had to introduce their own currencies. But central coordination was never achieved and the introduction of national currencies was delayed between one and two years (by the end of 1993 only Tajikistan did not have its own currency) due to political economy considerations.<sup>2</sup>

A major reason for the delay in the establishing effective payment mechanism is that the non-Russian states of the FSU, especially the energy importers, preferred the

---

<sup>1</sup> As early as January and February of 1992, my meetings with trade officials in Estonia, Latvia, Lithuania and Russia confirmed that export restraints had become a key feature in intra-FSU trade.

<sup>2</sup> See Odling-Smee and Pastor (2002, 5) for a list of when the countries introduced their independent currencies.

common ruble zone without monetary coordination. Independence resulted in a massive adverse terms of trade shift that hit the energy and raw material importers. Russia, Kazakhstan and Turkmenistan (and now Azerbaijan) were large energy exporters. The others, except Uzbekistan, were large energy importers. Tarr (1994) has shown that the energy importers suffered an adverse terms of trade loss of between 30 and 50 percent on intra-FSU trade. Second, the soft goods problem remained for the FSU in their internal trade as well. Once these industries had to meet a quality standard and were not guaranteed sales under the plan, demand was a major issue.

By staying in a common ruble zone without monetary coordination, the energy importers were using the common ruble zone to get Russian subsidies during the transition. As Yegor Gaidar (2002, 33) notes:

*Other republics were sensibly seeking to cover part of the costs of post-socialist transition by printing money and exporting inflation while the ruble area provided such an opportunity....the scale of the transfer from Russia to the other CIS countries was close to 10% of Russian GDP.*

For these reasons, Russia regarded monetary coordination in a common ruble zone as unrealistic and pushed early on for the introduction of independent currencies. Ukraine, in November 1992, was an early adopter of its own currency. But Gaidar (2002, 33) reveals that:

*The Ukrainian authorities had no desire whatsoever to abandon the ruble area, nor were they willing to discard the opportunity of exporting the Ukrainian emission to Russia and the other CIS states. It was only the firm stand taken by Russian authorities that compelled Ukraine to make the decision to introduce its own currency in November 1992.*

Several authors (Aslund, 2002; Granville, 2002; Pomfret, 2002) are critical of the International Monetary Fund (IMF) for what they see as the IMF's role in pushing for the infeasible monetary coordination of the common ruble zone and not advocating independent currencies early enough. Odling-Smee and Pastor (2002) maintain, however, that the IMF provided neutral advice to the new independent states between the options of establishing central coordination of the ruble zone or establishing new currencies. Odling-Smee and Pastor (2002, 18) argue that as the evidence on the advantages of independent currencies became stronger, the IMF began in late 1992 to privately advise countries to introduce independent currencies, despite maintaining its public posture of neutrality between the two options.

Like the critics, Gaidar believes that the IMF was an advocate of monetary coordination in the early period, and that the IMF did so in an effort to assist the other states of the common ruble zone. He cites Odling-Smee and Pastor (2002, 14) when they state:

*In view of the size of Russia and its commitment to seek macroeconomic stability, and the absence of similar commitments elsewhere, it seemed in the first half of 1992 that a cooperative ruble area arrangement...would be more likely to produce macroeconomic stability in most countries of the region than a system of national currencies.*

Gaidar concludes that the IMF dropped this coordination advice only when it became apparent that the lack of independent currencies was threatening macro-stability in Russia itself.

## **II. Russia and Customs Unions in the CIS: Empire Restoration or Rents for Russian industry?<sup>3</sup>**

### **The Eurosec Customs Union in its First Incarnation**

Russia participates in the Commonwealth of Independent States (CIS), a 12 country free trade agreement, and through the CIS and Russia's numerous bilateral free trade agreements, enjoys tariff free access for its exports to the markets of these partner countries on virtually all trade. Nonetheless, in 1995 it joined with Belarus and Kazakhstan in forming a customs union. (It came to be known in 2000 as "Eurosec," and I use this term.) In the campaign for the Presidency in 1996, Boris Yeltsin was in a tight battle with the leader of the Communist Party Gennady Zyuganov. In 1996, the Kyrgyz Republic became a new signatory to the Eurosec customs union. Yeltsin brought the Kyrgyz President, Askar Akaev, to Moscow so that Russia television could show the two of them going around Moscow together celebrating the Kyrgyz signing on as part of the customs union. Clearly, Yeltsin saw the extension of the customs union to the Kyrgyz Republic as politically advantageous. It appealed to Russian nationalism to restore a sense of Russian influence over the former Soviet republics. So, Russian nationalism is one possible explanation for creation of the customs union.

There was, however, a political-economic rationale for Russia to expand the Eurosec customs union. Unlike the EU, where the various member states influence the common external tariff, the common external tariff of Eurosec was the Russian tariff. By 1995, Russia had introduced a tariff structure that protected the less competitive manufacturing sectors of Russia, with products like cars getting high protection. Since the common external tariff protected Russian industry, by extending Eurosec, the costs of protecting Russian industry would partly be borne by consumers of new member states.

The political economy in the cases of the less industrialized members of Eurosec, like the Kyrgyz Republic and eventual member Tajikistan, was just the opposite. If the common external tariff were enforced, these countries would bear the trade diversion costs. Consumers of these countries would have to pay high prices for Russian imports that could only compete under the preferential tariff umbrella. But the products these countries exported were subject to low tariffs in Russia, so the exporters from these countries were not protected in Russian markets.<sup>4</sup> Recognizing the uneven costs and

---

<sup>3</sup> See Michalopoulos and Tarr (1997) for a more detailed analysis of the issues in this section.

<sup>4</sup> At the request of the Kyrgyz authorities, in 1996 I conducted an evaluation of the impact of their participation in the customs union. This analysis appeared as part of Michalopoulos and Tarr (1997).

benefits of the customs union, the member countries of the Eurosec customs union began to apply the common external tariff on an “a la carte” basis. For example, as early as 1996, Kazakhstan suspended application of the common external tariff on cars, since its consumers complained about trade diversion costs away from Korean cars. Estimates are that the common external tariff is applied on only about 50-60 percent of the tariff lines, depending on the country.

### **The New Eurosec Customs Union**

As fatigue with the long difficult WTO accession process wears on Russian decision-makers, Russia today is trying to revive the Eurosec customs union with Belarus and Kazakhstan. The most important lesson from the earlier experience (Michalopoulos and Tarr, 1997) is that widening protection of industries through a customs union is really an import substitution policy that has proven to be unsuccessful.<sup>5</sup> The Eurosec customs union is too small an economic region to approximate world market prices on most products. But reformers in Russia (who are diminished in number and influence) would like to see the customs union focus on trade facilitation and the reduction of non-tariff barriers. This kind of deeper integration will likely yield benefits, including benefits to excluded countries. A second lesson from the earlier experience for Russia is that a supranational tariff setting body will likely be required that will more evenly share the benefits and costs of the customs union. This will likely be difficult to achieve, and is likely why the revival of Eurosec on planned for the more industrialized partners, whose interests regarding which sectors to protect are more likely to coincide.

## **III. WTO Accession**

Russia applied for membership in the GATT in 1993 and its successor organization, the WTO, took up consideration of its membership. WTO accession never received strong support from President Boris Yeltsin or his Administration. Soon after President Vladimir Putin came to office, however, Russia made WTO accession a priority. Given that the WTO affects so many aspects of economic activity, such as customs, standards, services regulations and foreign direct investment, intellectual property, agricultural practices and policies and tariffs on goods, after Putin initially took office, WTO accession became the overriding issue in Russian trade policy.

### **WTO Accession as an Instrument of Economic Development and Domestic Modernization**

According to some experts, Putin was strongly influenced by Gaidar’s analysis of the cause of the collapse of the FSU, and concluded that a strong economy is the key to Russia’s political strength in the world.<sup>6</sup> Putin called the WTO a tool of economic

---

<sup>5</sup> See similar comments in Olcutt, Aslund and Garnett (1999, 170-172). Grossman and Helpman (1995) argue that due to the standard free-rider problem in tariff setting, preferential trade agreements would typically be expected to be trade diverting.

<sup>6</sup> Ickes and Gaddy (2009).

modernization and stated in his annual address in 2002 that whoever knows how to use the WTO will become stronger.<sup>7</sup>

In my view, it was remarkably insightful of Putin to recognize that WTO accession is a key tool of economic growth through its impact on domestic liberalization and modernization. Most applicants to the WTO see accession in mercantilist terms, i.e., as a means of obtaining better market access for their exporters. The real gains from WTO accession, however, come from using WTO accession as a key step in creating an open economy model of economic development. The estimates of the gains from the Uruguay Round, such as those in Harrison et al., (1997), showed that the more countries made commitments to liberalize in the Uruguay Round, the more they gained; countries that did not commit to liberalization gained very little. That is, improved market access to partner country markets in the WTO was worth very little compared to own liberalization. This led L. Alan Winters to coin the term WYDIWYG: What You Do Is What You Get.

In response to demand from the Russian government to the World Bank, and calls from business community for estimates of the likely impacts, in several papers my coauthors and I have estimated the impact of WTO accession on Russian aggregate welfare, household and poverty effects, sector and regional impacts.<sup>8</sup> We have shown that, by far, the largest gains to Russia from WTO accession will arise from Russia's own commitments to liberalize, especially with respect to its commitments to foreign investors in business services. Gains from improved market access for exporters are only a small portion of the gains.<sup>9</sup> Thus, our results support Putin's early analysis of the key link between WTO accession and domestic reform.

Soon after Putin took office, he created the massive Ministry of Economic Development and Trade and appointed a reformer, Germain Gref, as its head. Gref was formally responsible for the accession process. Maksim Medvedkov was brought in to head the negotiations and has worked tirelessly on the task to this day. Minister of Finance, Alexsei Kudrin became head of the Russian inter-agency Working Group on WTO accession.<sup>10</sup> Some of the key lobbying forces for and against WTO accession are the following.

### **Lobbying Forces for and Against WTO Accession**

Leaders of the newly privatized exporting sectors were the main supporters of WTO accession. Although Russia is seen as an energy based economy, the privatizations of the late 1990s, converted numerous inefficient state enterprises into profitable

---

<sup>7</sup> Aslund (2007).

<sup>8</sup> See Jensen, Rutherford and Tarr (2007), Rutherford and Tarr (2008), Rutherford and Tarr (forthcoming-a) and Rutherford and Tarr (forthcoming-b).

<sup>9</sup> Even with additional market access from the Doha agenda factored into the calculation, again it is own liberalization, especially in services that dominates the estimated gains to Russia. See Rutherford, Tarr and Shepotylo (2005).

<sup>10</sup> See Aslund (2007) for a more detailed description of the political-economic forces shaping Russia's WTO accession.

companies, many of whom were significant exporters. Aslund (2007a, 181-187) has noted that in the post-Soviet era, the big state enterprises were characterized by various problems such as massive overstaffing, extortion by organized crime and obligations to make charitable contributions to local and regional governments. In the initial stage of restructuring, Russian oligarchs were far superior to Western businessmen in addressing these problems. Western business consultants typically advised foreigners to stay away from un-restructured Soviet enterprises with more than 1,500 employees, because they did not know how to manage them. Many big Western investors who did not heed this advice failed miserably. Although controversial, Russia found ways to transfer large factories to natives who transformed them into profitable enterprises that paid large taxes.

As a result of these privatizations, several new exporting sectors emerged--principally chemicals, steel, non-ferrous metals and fertilizers. They were all hit by protectionist measures in their export markets, notably by antidumping actions (where non-members to the WTO are not entitled to an injury determination) and by EU steel quotas that would be illegal for a WTO member. Some of the leaders of these industries became key supporters of WTO accession. Many of these leaders joined the Russian Union of Industrialists and Entrepreneurs. Alexei Mordashov, the CEO of the large private steel company Severstal, became the chief spokesman for the organization on trade issues favoring WTO accession. Among other actions, they sponsored several seminars on WTO accession and commissioned some works, including a pamphlet debunking the myths of WTO accession by two of the country's brightest young liberal economists (Guriev and Yudaeva, 2001).

The main early opponent to WTO accession was Oleg Deripaska, who had major business interests in aluminum, autos and aircraft. The Russian auto sector mobilized behind him and they obtained very high protection on imported used cars<sup>11</sup> (which were competing successfully with Russian autos that had not been modernized). Having achieved his objective, he toned down his opposition to WTO accession.

The agricultural sector, led by Minister of Agriculture Alexei Gordyev, was and remains an implacable opponent of WTO accession. There were two issues, state subsidies and sanitary and phyto-sanitary (SPS) measures. Although trade distorting subsidies in agriculture were small, the agriculture sector did not want to be constrained in the amount of subsidies it could offer. In the case of SPS, Russia has used these measures in chicken, pork and beef as non-tariff barriers to constrain imports in a manner that has infuriated agricultural exporters, especially the US. The bilateral market access agreement with the US, calls for rather radical changes in the methods of certifying US meat processing facilities—delegating most responsibilities to the US Department of Agriculture (see Tarr, 2007).

---

<sup>11</sup> Russia employs a “mixed” tariff system for about 1,700 of its Russia’s approximately 11,000 tariff lines. Under the mixed tariff system, Russia employs both ad valorem and specific tariffs, where the applied tariff is the maximum of the two. It is through the specific tariff that the used car tariffs have been increased to very high levels. See Shepotylo and Tarr (2008) for details.

Opposition also arose from several services sectors, such as banking and telecommunications. Resistance in the banking sector galvanized on the issue of branch banking and Putin declared it as a deal breaker. The US, despite insisting on a branch banking commitment in the case of accession of all non-LDC countries, signed its bilateral market access agreement on Russian WTO accession without a commitment on branch banking.

### **The Dual Pricing of Natural Gas Dispute**

In 2003, Russia had been making significant progress in its negotiations and in implementing WTO compliant legislation, when the negotiations began to seriously unravel over demands for Russia to eliminate dual pricing of natural gas. Russia charges a lower price for natural gas in its domestic markets than it charges on its exports. Members of the WTO Working Party, led in the negotiations on this issue by the European Union, demanded a unified Russian natural gas price between domestic and exports. Russia saw this demand as an effort by Europe to get Russia to transfer billions of dollars to Europe through lower gas prices. Russians believed that unified gas pricing would either result in large lost profits on sales in Europe (including Turkey) because of the decrease in export prices, or increased unemployment and resource misallocation costs at home caused by the imposition of higher prices, or a combination of both. President Putin indicated that unified gas pricing was a deal breaker and Russia would not join the WTO on those terms.

The EU and other WTO member countries, however, claimed that dual energy pricing is an export subsidy for Russian exporters (such as fertilizer exporters) whose products embody substantial natural gas. Some EU representatives also maintained that Russia was penalizing itself by selling gas at home at low prices, when it could sell gas at higher prices in Europe. As a result, they argued that the request for Russia to unify prices was in Russia's interest.

Peter Thomson and I explained (Tarr and Thomson, 2004) that pipelines allow Gazprom to segment the Russian market from the European (including Turkey) market and that Russia has market power in the European market. Based on this market power assumption, we estimated that, from Russia's perspective, there is no economic rationale to unify the price of natural gas it sells domestically and abroad. If Russia were to sell its natural gas to Europe at only full long run marginal cost plus transportation costs, lose about two percent of its GDP, i.e., Russia would indeed transfer billions of dollars per year to Europe. If, instead, Russia were to raise its domestic prices to the prices it charges in Europe, Russian industry would incur very large adjustment costs as the gas cost increases would adversely impact on investment and unemployment in the short run. Russia should raise its domestic prices to full long run marginal costs, but as Gazprom is a domestic monopoly, prudent regulatory policy in Russia implies that its domestic market power must be restricted.

The Tarr-Thomson paper apparently was instrumental in clarifying the economics of the dispute and led to its resolution. The bilateral market access agreement on Russian

WTO Accession signed between the EU and Russia on May 21, 2004, accepted dual pricing of natural gas, with the stipulation that Russia must agree to raise the price of natural gas to industrial users to full long run marginal cost.<sup>12</sup> The agreement put the Russian WTO accession negotiations back on track.

### **Political Contributions without Influence: the New Deal for the Oligarchs**

As has been well chronicled (Aslund, 2007a), Putin progressively diminished the influence of the business community and civil society on decision-making. In a famous meeting with 21 of the oligarchs in July 2000, Putin laid out the new rules under which they would operate. The oligarchs could keep the property they obtained during the Yeltsin years, but they would have to stay out of politics.<sup>13</sup> Moreover, Gaddy and Ickes (2009) indicate that the oligarchs would have to pay an increasing share of their profits in taxes, especially on export sales. And crucially for decision-making, in the future, the favored place for political contributions or investments would be the Kremlin, but all such investments would not secure influence, but only to protect them from appropriation of their property.<sup>14</sup>

Although, as mentioned above, the oligarchs engaged in some public lobbying activities through the Russian Union of Industrialists and Entrepreneurs, after the Khodorkovsky affair, the oligarchs were careful not to undertake any activities that might appear to challenge the Kremlin. In the context of the Grossman-Helpman (1994) model, the Kremlin would extract political contributions from the oligarchs, but they were told that these contributions would not influence trade policy decisions. Afontsev (2004) has formally examined the Russian government's tariff simplification plan of 2000 in the context of the Grossman-Helpman model. Consistent with the above view, he finds that contributions from business lobbies were the least important factor in explaining the tariff simplification reform in Russia in the year 2000; rather tariff revenues and the sum of producers and consumers surplus were considerably more important.<sup>15</sup>

---

<sup>12</sup> [http://ec.europa.eu/trade/issues/bilateral/countries/russia/pr210504\\_en.htm](http://ec.europa.eu/trade/issues/bilateral/countries/russia/pr210504_en.htm).

<sup>13</sup> Baker and Glasser (2005, 86-87) report that Putin stated: "You stay out of politics and I will not revise the results of privatization."

<sup>14</sup> Aslund (2007a, 225-231) similarly characterizes what transpired. He maintains that the oligarchs avoided the Kremlin in the Putin years, since being summoned to the Kremlin would usually mean an obligation to make a ten or twenty million dollar payment for some state project.

Some criticized the Kremlin for allowing the oligarchs to keep their property. Putin, however, realized that state ownership was a failed model of economic development, and that there were a limited number of entrepreneurs who could turn the moribund and corrupt state enterprises from loss makers into profit makers that the state could tax. One of Putin's aides, Vladislav Surkov, once explained that the stratum of truly leading entrepreneurs in Russia is "very thin and precious...they are the bearers of capital and intellect...The oil men are no less important than the oil; the state has to make the most of them." (Gaddy and Ickes, 2009)

<sup>15</sup> This contrasts to his test of tariff setting policy in Russia in the 1990s, where he finds that business lobbying expenditures were more important. See Afontsev (2002).

#### **IV. Industrial Policy for Diversification: Retreat from WTO Accession?**

As the price of oil rose, \$55 billion was added to foreign currency reserves in 2005, \$120 billion in 2006 and \$170 billion in 2007, bringing the total to about \$600 billion in mid-2008.<sup>16</sup> This trailed only China and Japan in foreign currency reserves. Given that energy products face no protectionist pressures in export markets, with the rise in the price of oil and gas, the perceived need for WTO accession diminished in Russia. At the same time, the increase in the price of energy products raised the share of energy in Russian GDP and Russia became increasingly concerned about its lack of a diversified economy. In 2006, Putin still advocated WTO accession as he argued there was a need to more rationally participate in the international division of labor and integrate into world markets. Nonetheless, in October 2006, Putin announced plans to intervene to support many sectors (Aslund, 2007). Putin advocated higher customs duties on imported cars and virtually prohibitive timber export taxes to encourage timber processing industries. The latter, has led to a major dispute with the EU, and the former to demonstrations in the Far Eastern region of Russia. Russia's tariffs have increased from 2001 to 2005, with the structure of protection shifting over time so that its food processing and light industry sectors have become rather protected, with tariff rates of 20 and 23 percent, respectively by 2005 (Shepotylo and Tarr, 2008). He advocated agricultural subsidies, and, in late 2008, some kind of agricultural marketing board, with unclear objectives, was being considered. These proposals significantly retreat from the liberal vision of an open trade regime, but rather emphasize industrial policy based at least in part on import substitution industrialization combined with state subsidies, a strategy that is a proven failure at bringing economic development.

The lack of diversification of Russian industry is indeed a problem since it reflects the poor business climate and poor state of Russian institutions. Russia ranks 143<sup>rd</sup> in the world in the Corruption Perception Index of Transparency International (table 1), 106<sup>th</sup> in the world in the Cost of Doing Business Index of the World Bank (table 2),<sup>17</sup> 103<sup>rd</sup> in the world in the Logistics Perception Index of the World Bank (table 3), and, while Russia ranks better than the other CIS countries in the EBRD index of Services Reform, it significantly trails all transition countries that acceded to the EU (tables 4). For Russia to diversify its economy, it will have to address its problems of weak institutions and a poor business climate. Small and medium enterprises are key to the diversification and they are especially vulnerable to the high costs associated with a poor business climate and poor services. Seriously addressing the corruption and poor business climate problems are a very difficult challenge that will require strong political will from the highest levels.<sup>18</sup> Although counterproductive, it is tempting to attempt to achieve diversification through trade policy protection. A hopeful sign is that President

---

<sup>16</sup> Gaddy and Ickes (2009, 3). Russia lost \$200 billion in reserves in late 2008 in an effort to defend the value of the ruble.

<sup>17</sup> Russia is next to last in the cost of dealing with licenses.

<sup>18</sup> In recent years, Georgia has shown that it is possible to rapidly improve the business climate in a short period of time, where there is strong political will.

Medvedev has made the fight against corruption the hallmark of his Administration. In March 2009, he acknowledged that little progress was made in his first year in office and he has asked for additional laws to combat corruption.<sup>19</sup>

Despite a retreat on the rhetoric of WTO accession, the Russian chief negotiators have continued to work toward resolution of the remaining issues to accession. They reported significant progress in 2008. Notably the Working Party on Russian WTO accession accepted the Russian commitments on intellectual property, one of the major obstacles to accession. All remaining issues had been resolved and agreed except for agricultural subsidies, timber export taxes and rules on state trading enterprises. Georgia, however, which as a member of the Russian Working Party on WTO accession and must approve the Report of the Working Party to the General Counsel if Russia is to accede, has strong reservations about Russian accession.

## **VI. Conclusions**

### **WTO Accession: Unique Historical Opportunity for Reform.**

I have argued that the largest gains for Russia from WTO accession derive from its own liberalization commitments. Some will argue that if virtually all the gains come from own liberalization, why bother to go through the long painful contentious process of WTO accession, when the country can independently liberalize and achieve virtually all the benefits of accession. I would argue rather that WTO accession is a unique historical opportunity to dramatically move the country forward toward an open economy model of economic development. In a business as usual scenario, concentrated forces who want protection in their sectors will lobby to defeat liberalization, while those who gain from liberalization are diverse, and due to a free-rider problem, often do not lobby. The uneven lobbying often leads to excessive protection. WTO accession involves foreign business interests and foreign governments in the negotiations on the level of home protection. WTO accession compels policy-makers at the highest levels of government to engage in the process and they will often impose liberalization on slow moving Ministries and sectors. Moreover, commitments at the WTO “lock-in” reform in a manner that is not easily reversed by future less reform mined governments.

### **The Diversification Objective: Institutional Development—Not Import-Substitution- Industrialization**

---

<sup>19</sup> “Medvedev Declares Anti-Graft Initiative,” The Moscow Times, March 10, 2009.  
<http://www.themoscowtimes.com/article/600/42/375201.htm>

Diversification of Russian industry is an important objective. The various import substitution industrialization and state subsidy measures that have either been recently implemented, are proposed or considered, however, are characteristic of a failed model of economic development. The lack of diversification is due to the poor business or investment climate, which especially hinders small and medium enterprises. Diversification and improved long term growth will only come through addressing the problems in the business or investment climate.

### **Centralized Determination of Trade Policy**

During the past ten years, several events or actions have taken place that have substantially increased the power of the Kremlin. These include Presidential appointment of regional governors, increased majorities in the Duma for the President's Unity party, and disempowerment of the oligarchs. Together these allow the Kremlin to determine trade policy without the usual checks or influences that prevail in Western democracies. The perhaps unique aspect of the trade policy decision-making process in Russia is that the Administration has succeeded in establishing a system in which it extracts political contributions, but where the contributors know in advance that their contributions do not yield influence.

### **References**

- Afontsev, Sergey (2002), "Endogenous Tariff Protection and the Level of Trade Distortions in Russia," Economics Education and Research Consortium, Working Paper number 01/07, Moscow, Russia. Available in Russian and English at [http://www.eerc.ru/details/download.aspx?file\\_id=3583](http://www.eerc.ru/details/download.aspx?file_id=3583).
- Afontsev, Sergey (2004), "The Political Economy of Tariff Unification," Economics Education and Research Consortium, Working Paper number 04/12E, Moscow, Russia. Available in Russian and English at [http://www.eerc.ru/details/download.aspx?file\\_id=3766](http://www.eerc.ru/details/download.aspx?file_id=3766)
- Aslund, Anders (2002), "The IMF and the Ruble Zone," *Comparative Economic Studies*, 44 (4), Winter, 49-58.
- Aslund, Anders (2007), "Russian Accession to the World Trade Organization," *Eurasian Geography and Economics*, Vol. 48, No. 3, May-June, 289-305.
- Aslund, Anders (2007a), *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*, Washington D.C.: Peterson Institute for International Economics.
- Baker, Peter and Susan Glasser (2005), *Kremlin Rising: Vladimir Putin's Russia and the End of the Revolution*, New York: Scribner.
- Gaddy, Clifford and Barry Ickes (2009). "Putin's Third Way," *National Interest*, January 21.
- Gaidar, Yegor (2002), "A Political Decision," *Comparative Economic Studies*, 44 (4), Winter, 31-35.

- Glaziev, Sergei (1994), "The Origins of Russian Trade Policy," in Constantine Michalopoulos and David G. Tarr (eds.), *Trade in the New Independent States*. Studies of Economies in Transformation No. 13. World Bank, Washington DC
- Granville, Brigitte (2002), "Reply to Odling-Smee and Pastor," *Comparative Economic Studies*, 44 (4), Winter, 59-80.
- Grossman, Gene and Elhanin Helpman (1994), "Protection for Sale," *American Economic Review*, 84 (4) 833-850.
- Grossman, Gene and Elhanin Helpman (1995), "The Politics of Free Trade Agreements," *American Economic Review*, 85 (4), 667-690.
- Guriev, Sergei and Ksenia Yudaeva (2001), *Russia in the WTO: Myths and Realities*, Moscow: Center for Economic and Financial Research and the Club of 2015. Available at: [http://www.nes.ru/~sguriev/papers/wto\\_cefir\\_eng.pdf](http://www.nes.ru/~sguriev/papers/wto_cefir_eng.pdf)
- Harrison, Glenn, Thomas Rutherford and David Tarr (1997), "Quantifying the Uruguay Round," *Economic Journal*. Vol. 107 (444), September, 1405-1430.
- Jensen, Jesper, Thomas Rutherford and David Tarr (2007), "The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organization," *Review of Development Economics*, 11, 482-506
- McKinnon, Ronald (1991), *The Order of Economic Liberalization*, Baltimore: Johns Hopkins Press.
- Michalopoulos, Constantine, and David G. Tarr (1992), Trade and Payments Arrangements for States of the Former USSR, Studies of Economies in Transition No. 2, Washington D.C.: The World Bank.
- Michalopoulos, Constantine, and David G. Tarr. 1994. *Trade in the New Independent States*. Studies of Economies in Transformation No. 13. World Bank, Washington DC
- Michalopoulos, Constantine, and David G. Tarr. eds. 1996. "Trade Performance and Policy in the New Independent States," in the Directions in Development Series, Washington: The World Bank.
- Michalopoulos, Constantine, and David G. Tarr. 1997. "The Economics of Customs Unions in the Commonwealth of Independent States," *Post-Soviet Geography and Economics*, Vol. 38 (3), 125-143. Also "The Economics of Customs Unions in the Commonwealth of Independent States," Policy and Research Working Paper No. 1786, World Bank. Available at: [http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000009265\\_3971104185005](http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000009265_3971104185005)
- Morkre, Morris and David Tarr (1980), *Effects of United States Restriction on Imports: Five Case Studies and Theory*, Washington D.C.: US Government Printing Office.
- Odling-Smee, John and Gonzalo Pastor (2002), "The IMF and the Ruble Area, 1991-1993" *Comparative Economic Studies*, Vol. 44 (4), 3-29.
- Olcutt, Martha Brill, Anders Aslund and Sherman Garnett (1999), *Getting it Wrong*, Washington D.C.: Carnegie Endowment for International Peace

- Pomfret, Richard (2002), "The IMF and the Ruble Zone," *Comparative Economic Studies*, 44 (4), Winter, 37-48.
- Rutherford, Thomas F., and David G. Tarr (2008) "Poverty Effects of Russia's WTO Accession: modeling "real households" and endogenous productivity effects," *Journal of International Economics*, Vol. 75 (1), 131-150.
- Rutherford, Thomas F, and David G. Tarr, (forthcoming- a), "Regional Impacts of Russia's Accession to the WTO," *Review of International Economics*. World Bank Working Paper available at <http://econ.worldbank.org/external/default/main?searchTxt=Rutherford&detailMenuPK=64264748&docTY=620265&menuPK=64264748&pagePK=64166018&piPK=64165415&siteName=EXTDEC&theSitePK=469372>.
- Rutherford, Thomas F, and David G. Tarr, (forthcoming-b), "Services Liberalization in the Regions of Russia under WTO Accession: Regional Household and Poverty Effects," *International Journal of Services and Economic Management*.
- Rutherford, Thomas, David Tarr, and Oleksandr Shepotylo. 2005. "The Impact on Russia of WTO Accession and The Doha Agenda: the importance of liberalization of barriers against foreign direct investment in services for growth and poverty reduction," in Thomas Hertel and L. Alan Winters (eds.), *Putting Development Back into the Doha Agenda: Poverty Impacts of a WTO Agreement*.
- Shepotylo, Oleksandr, and David G. Tarr (2008), "Specific tariffs, tariff simplification and the structure of import tariffs in Russia: 2001-2005," *Eastern European Economics*. Vol. 46 (5), September – October 2008, 49-58.
- Tarr, David G. 1993. "How Moving to World Prices Affects the Terms of Trade in 15 Countries of the Former Soviet Union", World Bank Policy Research Working Papers, WPS 1074.
- Tarr, David G., 1994. "The Terms-of-Trade effects of moving to world prices on countries in the former Soviet Union", *Journal of Comparative Economics*, Vol.18, pp.1-24
- Tarr, David G. (1999). "Design of Tariff Policy for Russia," in H.G. Broadman (ed.), *Russian Trade Policy Reform for WTO Accession*. World Bank Discussion Paper No.401, World Bank, Washington DC.
- Tarr, David (2002), "On the Design of Tariff Policy: Arguments for and Against Uniform Tariffs," in B. Hoekman, A. Mattoo and P. English (eds.), *Development, Trade and the WTO: A Handbook*, Washington: World Bank, 2002. Available in Russian at [www.worldbank.org/trade/russia-wto](http://www.worldbank.org/trade/russia-wto).
- Tarr, David G., 2007. "Russian Accession to the WTO: An Assessment," *Eurasian Geography and Economics*, Vol. 48, No. 3, May-June, 306-319.
- Tarr, David, and Peter Thomson (2005), "The Merits of Dual Pricing of Russian Natural Gas," *The World Economy* Vol. 27, Issue 8. August, 1173-1194
- World Bank (1993), *Russia: Joining the World Economy*, Report No. 12108-RU. Washington DC: The World Bank.

**Table 1. 2007 Corruption Perception Index by Country for Eastern Europe and Central Asia**

SEE		EU - 8		CIS	
Country	Country Rank	Country	Country Rank	Country	Country Rank
Croatia	64	Slovenia	27	Georgia	79
Bulgaria	64	Estonia	28	Armenia	99
Romania	69	Hungary	39	Moldova	111
Serbia	79	Czech Rep	41	Ukraine	118
Bosnia	84	Slovakia	49	Russia	143
Montenegro	84	Latvia	51	Kazakhstan	150
Macedonia	84	Lithuania	51	Belarus	150
Albania	105	Poland	61	Tajikistan	150
				Azerbaijan	150
				Kyrgyzstan	150
				Turkmenistan	162
				Uzbekistan	175

Source: Transparency International

**Table 2. Ease of Doing Business by country, April 2006 to June 2007**

EU-8		SEE		CIS	
Economy	Ease of Doing Business	Economy	Ease of Doing Business	Economy	Ease of Doing Business
Czech Rep	56	Albania	136	Armenia	39
Estonia	17	Bulgaria	46	Azerbaijan	96
Hungary	45	Bosnia	105	Belarus	110
Latvia	22	Croatia	97	Georgia	18
Lithuania	26	Macedonia	75	Kazakhstan	71
Poland	74	Montenegro	81	Kyrgyz Rep	94
Slovakia	32	Romania	48	Moldova	92
Slovenia	55	Serbia	86	Russia	106
				Tajikistan	153
				Ukraine	139
				Uzbekistan	138

Source: IFC Doing business database, Doing Business 2008 report

**Table 3. Logistics Performance Index, by Country for 2008**

EU - 8		SEE		CIS	
Country	Rank	Country	Rank	Country	Rank
Hungary	35	Romania	51	Ukraine	73
Slovenia	37	Bulgaria	55	Belarus	74
Czech Rep	38	Croatia	63	Russia	99
Poland	40	Bosnia	88	Kyrgyz Rep	103
Latvia	42	Macedonia	90	Moldova	106
Estonia	47	Serbia and Montenegro	115	Azerbaijan	111
Slovak Rep	50	Albania	139	Uzbekistan	129
Lithuania	58			Kazakhstan	133
				Tajikistan	146

Source: The World Bank. <http://info.worldbank.org/etools/tradesurvey/mode1a.asp>

**Table 4. Services Reform Index by Country in the Region**

EU-8			SEE			CIS		
Country	2000	2007	Country	2000	2007	Country	2000	2007
Czech Rep	3.0	3.6	Albania	2.0	2.3	Armenia	2.3	2.5
Estonia	3.5	3.6	Bosnia	2.0	2.5	Azerbaijan	1.9	2.0
Hungary	3.8	3.9	Bulgaria	2.8	3.2	Belarus	1.4	1.6
Latvia	2.9	3.2	Croatia	2.7	3.2	Georgia	2.4	2.5
Lithuania	2.9	3.1	FYR Macedonia	2.1	2.6	Kazakhstan	2.3	2.8
Poland	3.5	3.6	Montenegro	1.4	2.1	Kyrgyz Rep	1.7	1.9
Slovak Rep	2.4	3.3	Romania	3.0	3.3	Moldova	2.3	2.4
Slovenia	3.0	3.0	Serbia	1.7	2.3	Russian Fed	2.1	2.8
						Tajikistan	1.0	1.5
						Turkmenistan	1.0	1.0
						Ukraine	2.1	2.5
						Uzbekistan	1.6	1.9

Sources: EBRD Transition Indicators Database