Russia in the WTO: Myths and Reality
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Executive summary

1. Russia's accession to the World Trade Organization (WTO) will cause much deeper changes to the Russian economy and society than mere adjustments in import tariffs affecting only certain industries. Given the extent of the impact, we need a broad perspective to fully understand the case for accession and the implications of membership. The discussion centers around the basic issues of whether to join and when; we also raise the question of what policies Russia should pursue as a WTO member to benefit fully from the accession. This report seeks to answer these questions from the standpoint of a "concerned observer" of the total economy, rather than from a particular industry's point of view.

2. The aim of the report is to formulate clearly the arguments that are made in debate over WTO accession. We sum up and assess the eight most common myths about Russia’s WTO membership, and find that:

   - Many popular assumptions about Russia in the WTO are wrong: the reduction in tariffs following accession will in fact be insignificant – and could be more than offset by lower real exchange rates of the ruble due to foreign debt repayments and lower oil prices. Further, WTO accession will very likely give a strong boost to foreign direct investment, particularly in the services industry.

   - Other anti-accession arguments are backed by sectoral rather than national interests. For example, the financial industry has been resisting WTO accession, claiming that membership would effectively wipe out the Russian banking sector. In fact, the lack of competition in Russia’s financial sector imposes a heavy burden on the Russian economy. There is no reason to believe that this sector, which has enjoyed protection for 10 years now, will become more efficient in the foreseeable future without exposure to foreign competition.

   - Many of the myths bear no direct relevance to WTO accession, such as the country’s poor investment climate, lack of industrial restructuring, a non-competitive financial sector, and corruption and inefficiency in government. To achieve any form of economic success, Russia will have to deal with these problems with or without WTO membership.

3. Resolving core economic issues will help Russia to realize the benefits of WTO membership, the “accession dividend”. Integration into the global economy will require substantial reallocation of capital and human resources across sectors and regions. It will also mean changes in organizational structures and employee incentives at the firm level. This report finds that fostering greater mobility – the geographic and professional mobility of the workforce, capital mobility, and intra-corporate mobility – is a key success factor for Russia’s future. It also shows that these forms of mobility are interrelated, and that they reinforce each other. And importantly, they are linked to the development of information technologies inside the country.

4. Russia needs a positive external stimulus to break the current vicious circle that was created, and is fuelled, by lack of reforms. WTO accession can provide this stimulus. In fact, the sooner Russia joins, the easier it will be to leverage Russia’s main competitive advantage in the global economy – the advantage Russia is now gradually losing: high education and skill levels.

5. To conclude we suggest, as a framework for discussion of the WTO issue, concrete measures to promote mobility in the economy. By proposing this framework, we hope to inform the public policy debate, helping individuals and organizations in Russia to weigh the issues in a broader perspective, consider how they can benefit from accession, and find their niche in the global economy.
1. Russia’s WTO accession: A broader perspective

"Can we allow ourselves to keep a distance from the process that is leading us into an abyss?"
A member of Russia’s Federation Council, quoted by “Itogi” weekly on May 19, 1999.

Defining the agenda

Russia's accession to the World Trade Organization (WTO) ranks among the most important current issues of Russian economic policy. The discussion in the media and among professionals often focuses on a narrow range of problems related to the specific terms of Russia’s accession, namely determination of tariff rates and subsidies applicable to selected goods or commodity groups. Because WTO accession will cause more significant changes in the economy than the mere opening up of certain markets, one should consider the arguments for accession and the implications of membership in a much broader perspective.

First, one might ask whether the criticisms of WTO accession are based on solid arguments. The first section of this report reviews eight of the most common myths about WTO accession and attempts to identify the issues behind them. A close look at these issues (whether advanced by pro- or anti-globalization campaigners) shows that the debate is not really about joining or not joining the WTO. Most of the myths involve more general problems of Russia's economic situation, especially the poor investment climate. Unreformed industries and agriculture, a non-competitive financial sector, and corrupt and inefficient government: these areas must be addressed whether Russia joins the WTO or not.

On the other hand, WTO accession may become a kind of reference point for the economy's transformation if the need for integration into the global economy is used for greater efficiency. Therefore, the key issue is not whether to join or even when to join, but rather how to join and what policies to pursue once Russia is a member of the WTO. These questions have to be addressed not only by the “government”, but by all players in the economy, including industries, companies, firm owners, managers, employees, officials, and legislators. At the end of the day, individual enterprises and professionals are the actors that integrate into the global economy. In this report, we do not offer an ultimate solution to how to fit everyone comfortably into the global economy. Instead, we propose a framework – the concept of mobility presented in section 3 – which can provide a constructive setting for the discussion of Russia’s accession to the WTO.

International trade: Some general arguments

Before a more thorough review of the myths about Russia’s WTO accession, we would like to restate some observations about international trade in general.

First of all, we have the standard economic arguments in favor of international trade. The benefits to individual countries of international trade follow from the principle of comparative advantage, whereby a country specializes in producing goods that are more efficient to produce in that given country, as opposed to goods that would be more efficiently produced in another country. The resulting international division of labor leads to economic growth and increased global efficiency. Important to our discussion, a country's accession to the WTO gives its enterprises access to less expensive imported components and raw materials, while making cheaper goods and services (including financial services) available to the population, helping to improve living standards. International trade is mutually beneficial. US and EU interest in Russia's WTO accession does not imply that Russia stands to lose from joining.

1 Some of the myths, especially the last two, may seem trivial to members of international business community; however, they have quite a few advocates in Russia, including some in the ruling elite.
Second, the WTO accession provides an opportunity to protect Russian exporters in external markets. The number of antidumping case against Russian enterprises is already close to one hundred. Moreover, as OECD economies slow down, this trend will only gain strength.

Third, WTO rules contain a number of provisions that are beneficial for any economy. These include provisions protecting the rights of foreign investors as well as one protecting intellectual property rights (which can help promote development of Russia’s domestic software and technology market).

Fourth, an open economy is a key instrument in building constructive international relations. Trade and mutual investment make economies interdependent, limiting hostile manifestations of foreign policy. As a result, foreigners are perceived as professional peers, business partners, buyers and suppliers of goods and services – rather than as abstract enemies.

But let us also consider some of the general points that would take a more critical view of WTO accession. Although the economy as a whole wins with accession, certain industries do stand to lose. It is important to distinguish between national and sectoral interests in the debate over accession. Each industry is interested to gain access to foreign markets, imported components, and raw materials, as well as to protect the domestic market from importers of competing products. Naturally, the interests of different industries often run counter to each other; hence, WTO membership will require Russia’s business community, government, and the entire society to make compromises. The accession negotiations will be the first true test of the ability within the government, business elite, and society to conclude a binding social contract. This is an immense challenge even for nations with much more developed civil societies, where industry interests often prevail over the public interest. The underdeveloped civil society in Russia and the current absence, or embryonic state, of certain industries that will emerge and grow as a result of integration into the global economy (the service industries, and in particular information services) further exacerbate the problem.

The pro-trade arguments above are static. In the dynamic setting, there is a case for protectionism – the so-called “infant industry argument”. This theory maintains that if an industry is almost competitive in the global economy, temporary protection (using tariffs or quotas) can prove beneficial providing the industry becomes competitive before markets are fully opened. In principle, this argument is valid, but in practice it is often abused. Many developing countries have applied this rationale to justify protectionism, and in most cases, the following has occurred. First, every industry claims to be nearly competitive, and demands protection (and, since new and emerging industries lack political clout, the protection is given to the old sectors which is the opposite results of what the theory suggests). With every industry shielded from competition, protection of all markets brings about a substantial appreciation of the domestic currency, and the living standards of general public suffer and industry itself only makes marginal gains. Second, there is always a strong temptation to extend the protection period to industries that have not improved competitiveness, a process in which industrial lobbies again play a crucial role. An important note is that immediate WTO accession addresses both of these problems; negotiations can result in temporary protection for some markets, but WTO rules include a commitment to open up once the protection period is over.

Finally we observe that clearly, WTO accession requires much time and effort. The national legislation must be made consistent with numerous WTO rules, and the exact terms of accession need be agreed upon with the WTO and with each of its member states.
2. Common myths about Russia’s WTO membership

Myth 1. "We’ll be flooded with imports, our industry will fold, we’ll all be out of work"

Reformulation: Since WTO accession implies a fully open economy, Russian goods will be crowded out by imports, leading to mass unemployment.

Let us review the key components of this myth:

- "Currently, tariffs protect us from competition."
  - Not true. Tariffs provide Russian industry with very little protection at present. First, the average Russian tariff rates applied to various two-digit industries range between 7% and 15%, which is a relatively low level of protection in an international context. Second, existing official import tariffs are rarely applied. Up to 50% of all imports evade customs duties (see Table 1), although there are recent signs that customs administration is gradually improving.

Table 1. Russia's import tariffs are currently quite low; besides, only half of official tariffs are actually collected. The table below presents the weighted average tariff rates (across all categories of imported goods) versus the actual collection of import duties.

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal weighted average tariff rate</th>
<th>Effective tariff rate (actual duty collected/import)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>14%</td>
<td>4%</td>
</tr>
<tr>
<td>1997</td>
<td>14%</td>
<td>7%</td>
</tr>
<tr>
<td>1998</td>
<td>12%</td>
<td>7%</td>
</tr>
<tr>
<td>1999</td>
<td>8%</td>
<td>5%</td>
</tr>
</tbody>
</table>


- "Accession to the WTO will reduce tariffs dramatically."
  - Not true. Tariff rates are negotiable at the time of accession. Since they are already quite low, the decline will be very moderate. In fact, for some product categories, Russia’s accession negotiators are even proposing an increase in tariff rates. Once accession agreements are signed, however, the tariff rates will be fixed—something many Russian producers may find hard to accept as they are used to manipulating tariffs arbitrarily. Both the producers and the government must therefore carefully consider the tariff rates for various industries before the tariffs are fixed.

- "The government will be left with no means of protecting domestic producers."
  - This is not exactly true, since WTO members may temporarily raise tariffs or use non-tariff measures subject to valid economic justification. Also, there is another, a more important argument. If one looks at the ruble’s real exchange rate fluctuations in the 1990s (Figure 1), one clearly sees that its impact on the competitiveness of Russian firms is much greater than that of tariffs, even if official tariffs were enforced with 100% efficiency. Unlike tariffs, the exchange rate is very hard to avoid. Also, the exchange rate is a better regulator than tariffs from the economics point of view, since it does not upset the price ratio of various tradable goods and services. The government will be able to influence the real exchange rate: for instance, repayment of Russia’s large sovereign debt (including advance repayment if needed) is a powerful tool for non-inflationary depreciation of the ruble.
Figure 1. The exchange rate is the major source of protection for domestic producers: annual changes in the real exchange rate are much larger than changes in import tariff rates.


- "Opening up the economy will finish off Russian industry."

Research conducted on other countries shows that, in the long term, foreign trade has a positive influence on economic growth. In the short term, however, openness may involve adverse social consequences. What will happen to Russian industry if imports increase drastically?

In the case of Russia, CEFIR estimates show that many industries would register productivity growth already in the second year after an increase in imports, thanks to increased competition and better access to imported components. In the short term however, many industries may experience output declines and higher unemployment. In the first year following an import surge, CEFIR estimates that output would drop in food processing industries and most machine-building industries – foremost in vehicle production, electrical equipment, and the steel industry – though the magnitude of the decreases would be quite moderate. Since the terms of accession remain unclear, these estimates are based on uniform increases in imports across product categories.\(^2\) In this case, food processing would be hit the hardest: all other things being equal, a 1% percent increase in food imports would result in an average slump of 0.16%. Our region-level analysis implies that uniform increase in imports would depress employment in the short-term, mostly in Chukotka, Kamchatka, Kalmykia, Magadan Oblast, Novgorod Oblast, and Altay Kray.\(^3\)

Given the significance of the short-term costs of WTO accession, one should also consider the implications of not joining. Unfortunately and most likely, staying out of the WTO will not help Russia to avoid economic and social losses. As long as Russian industry remains unstructured and non-competitive, imports will continue to rise. With or without accession, this will increase competition and push inefficient enterprises to restructure, and force the least efficient enterprises to close down. Ultimately, it may turn out that the hard choices will simply be postponed for several years while the chance to integrate into the global economy is lost. Indeed, WTO accession may provide Russian enterprises with new opportunities and incentives to

\(^2\) All the data, estimates and references are mentioned below are available on request via www.cefir.org or wto@cefir.ru.

\(^3\) The results indicate the average effect on broad industries; the effect of accession could vary significantly across smaller sub-sectors within a single broad industry. Certainly, the accession effects should be considered at the level of individual product categories and even individual enterprises rather than at the level of broad industries.
boost productivity. Workers made redundant by closing inefficient enterprises may be employed by emerging sectors. To accelerate this process while minimizing the short-term costs of accession, Russia should immediately take adequate measures to improve labor and capital mobility, as discussed below.

Conclusions

- Tariff reductions will be reasonably small, and may be more than offset by a lower real exchange rate due to foreign debt service and weaker oil prices. These difficulties, as paradoxical as it may seem, will help protect the "middle class of Russian industry" that started to recover in the aftermath of 1998 crisis. In terms of protecting domestic producers through exchange rates, the coming year may be a favorable time for accession.

- The government's ability to protect selected industries after accession will indeed be limited. Therefore, the accession negotiations should identify priority industries to protect.

- True, WTO accession may bring about a decline of production in selected industries, in certain regions. Therefore, the problems of restructuring production and minimizing structural unemployment need to be addressed as soon as possible. However, not joining the WTO will do nothing to avoid these problems.

Myth 2. "Russian agriculture will die out. Food will become scarce"

Reformulation: WTO accession will open Russian markets to cheap agricultural imports, with which Russian agriculture will be unable to compete. Russian agriculture will cease to exist, depressing living standards in rural areas and making the nation dependent on imported food. In times of low oil prices, Russia could experience food crises.

Discussion

- "Agriculture will be left completely unprotected…”
Agriculture enjoys strong protection in all countries; indeed, the EU, USA, and Japan provide the highest levels of protection to their farmers. In Russia, agricultural subsidies amount to relatively little. Russia’s agricultural tariffs are also much lower than average rates within the WTO. In fact, due to poor customs administration, even these low tariffs do not provide much protection. In sum, agriculture cannot be referred to as a protected sector in Russia. Would the situation deteriorate even more following Russia’s WTO accession? If protection is understood as the discretion to make changes to tariffs, as most domestic consumers view it, then a further deterioration is likely. On the other hand, it can be avoided if the accession negotiations set sufficiently higher (yet truly effective) tariffs on agricultural products that need this type of protection.

Currently, the cheap ruble acts as the main protective factor for agriculture and industry alike (see Myth 1, Figure 1). After the 1998 devaluation, Russian agriculture began to recover from its collapse. In addition to the exchange rate, distance protects agriculture: transportation costs increase prices of the European imports by several dozen percentage points in most Russian areas.

Finally, WTO rules do not call for an end to agricultural subsidies; they simply require that a ceiling be put on government subsidies. Currently, Russia’s accession negotiations involve an annual aggregate subsidy amount of US $16 billion, more than Russia can afford under any reasonable scenario of economic development.
The problems of Russian agriculture have much in common with those plaguing its industry: a lack of skilled management to develop marketing and sales, soft budget constraints, opportunistic behavior (often taking the form of downright theft), lack of contract law enforcement, lack of access to credit, and so on. In the agricultural sector, these problems are exacerbated by the vagueness of land titles. Unlike industrial enterprises, the main asset of the agricultural enterprises (former collective and government farms) is not their equipment or land. Rather, it is the implicit political claim to obtain subsidies (explicit or implicit) to purchase fertilizers, fuel and other inputs (which are then stolen for use in private farms).\(^4\) In reality, government subsidies to farms represent nothing but social transfers in support of the farmers, which is highly inefficient with only a minor share of government funds ever reaching the farmers. The existing system has become the chief means of survival for the rural population, but it offers no incentives for the development of efficient agriculture.

Russian agriculture needs serious institutional changes, especially the creation of a lending and insurance system for agricultural producers. Land reform and building a functional land market are key. The average size of personal land holdings is too small for efficient cultivation. On the other hand, once a land market is in place, one can expect a rapid consolidation of plots. Consider Moldova's example: in the first year of land reform, the average plot size grew several hundred times (from 1.5-3 hectares at the start of reforms to 680 hectares afterwards).

Government support to the agricultural sector must be completely revamped, separating development and social objectives. The latter must be paid in cash directly to residents of rural areas (for instance, through higher pensions) rather than to agricultural enterprises. In order to increase productivity, government should invest in infrastructure, such as a new crop of motor tractor stations, the creation of multi-farm seed stocks, or improvements in the transportation system.\(^5\) In addition, the government may fund agricultural research and development as well as projects improving factor productivity in agriculture.

The private sector will also invest in agriculture as the trade in land develops and plots consolidate. This process has already started: following 1998, private capital began flowing into agriculture. Most often, it is the large industrial companies that invest into the most profitable and obvious links of the food chain, such as distribution and sales. However, there are also private entrepreneurs investing in production per se. The fastest growth is observed in the exporting sectors.\(^6\) An open economy inevitably requires specialization in those goods where the country has some comparative advantages, such as in the production of mustard, sunflower, and other oil crops. Therefore, despite difficulties in accessing the external markets due to the high level of governmental support for agriculture in other countries, there are prospects for Russia to increase agricultural exports.

Conclusions

- **Today, agriculture enjoys no real protection from foreign competition, except for protection in the form of the ruble exchange rate and transportation costs.**
- **Russia needs a new, carefully designed system of tariffs and subsidies for agriculture, along with improvements in customs administration.**

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\(^4\) Economists from the US Department of Agriculture estimate that resources absorbed by Russian agricultural enterprises suffice to increase yields by 43%, even using traditional Soviet technology. Apparently, this figure could be used as the lower bound for estimating the scale of inputs theft.

\(^5\) The development of transportation is key to turning an import-dominated industry into an export sector. For instance, experts believe that development of inland water transport could enable the export of potatoes to Iran.

\(^6\) For instance, the area under flax cultivation has almost tripled over the two last years.
With regard to agriculture, the issue is not whether to join the WTO, but how to promote development in this sector. The existing system offers no incentives to increase factor productivity and is an inefficient means of providing social support to farmers. Land reform and the development of agricultural credit and insurance should be immediate priorities.

Russia's agriculture can integrate into the global economy by specializing in crops in which it has a comparative advantage.

**Myth 3. "The financial sector will wither, and all our money will move abroad"**

Reformulation: Russia’s banks, insurance companies, and pension funds are too small to compete with foreign firms. WTO accession will bring about the demise of our financial system while foreign banks collect Russian households’ savings and move them abroad.

**Discussion**

"The banking sector needs to be protected…"

Today in Russia, many people favor continued protection of the financial services market in order to enable Russia’s financial institutions to stand on their own. However, as the experience of the last decade has shown, without a credible threat of foreign competition Russia’s financial companies have lacked proper incentives to improve their operations. Only in the sectors that were subject to strong foreign competition, such as investment banks, have strong domestic financial institutions emerged. Meanwhile, the institutions protected from competition, such as banks, insurance companies, and private pension funds, are highly inefficient.

The underdevelopment of financial institutions is taking a heavy toll on the Russian economy, although we are not aware of reliable estimates of the costs. The evidence from other economies suggests that the costs are very high. According to cross-country analysis by Rajan and Zingales, industries in countries with a higher level of financial development grow by an average of 1% a year faster over the long-term (controlling for country- and sector-specific characteristics). Naturally, financial underdevelopment causes the most damage to complex industries such as engineering, pharmaceuticals, microelectronics, and the like. The lack of a well-developed, modern financial sector clearly represents one of Russia’s most pressing problems.

WTO accession should help resolve this problem through the introduction of foreign financial institutions and insurance companies to the Russian market. The economy as a whole only stands to gain from such a development.

In fact, foreign competition in the banking sector is already becoming a reality as most large Russian companies transfer the bulk of their funds to foreign banks and many companies tap the foreign debt market. Unfortunately, small businesses and the general public have hardly any choice in private banking. Sberbank holds a virtual monopoly of the retail market, and offers a negative (!) interest rate on deposits in real terms.

The liberalization of the market for financial services in the course of Russia's WTO accession is unlikely to bring about any immediate changes. Nowadays, the key entry barrier for foreign banks is not the 12% ceiling on the share of foreign capital in the Russian banking system (a ceiling that has never been binding and is now lifted), but rather a poor investment climate. An inflow of bank capital into Russia will occur only as market institutions develop, political risks recede, banking regulations are reformed, foreign investment grows, and new Russian businesses, including small- and medium-sized businesses, come of age. So, it will take some time for large foreign players to venture into the Russian banking scene. Normally, large international banks and insurance companies enter on the backs of their main clients, multinational corporations. However, the huge niches in the retail savings, insurance, and pension mar-
kets might also attract foreign banks. The most efficient and forward-thinking Russian banks will use this time to consolidate their positions. Even after the advent of foreign financial institutions, Russian banks, insurance companies, and pension funds will still be able to continue their retail operations.

- "...while capital flows must be controlled."

The liberalization of capital flows in Russia is not directly related to the WTO accession. Further, there is no solid evidence from other developing economies either for or against capital account liberalization. For instance, capital controls have not helped in Brazil, but have been surprisingly effective in Malaysia. The claim that "everybody who wanted has already taken their money out of Russia" is not consistent with the estimates of capital flight, which shows no tendency to decline. The liberalization of capital outflows would definitely improve consumer welfare since the consumers could then access more efficient instruments for savings and investment. Unlike cash dollars and Sberbank deposits, investments into foreign economies bring good returns. On the other hand, the idea that "for capital to flow in, it must be allowed to flow out" is not exactly true either. Capital flows into a country only when that country has profitable investment projects. These projects do not appear out of thin air after the formal liberalization of the capital market. In some cases, this liberalization can provide incentives for an immediate inflow of capital that might consist mostly of short-term speculative funds. As the Asian crisis of 1997-1998 showed, such capital inflows are used to finance consumption or inefficient infrastructure investments. This is why many countries try to restrict these capital inflows. For instance, Chile established a special tax (or, more specifically, a reserve requirement) on short-term capital inflows. In any case, measures liberalizing capital outflows are not enough to improve the investment climate and attract foreign capital. They cannot substitute for judicial reform, introduction of international accounting standards, reform of bankruptcy procedures, better corporate governance, a higher quality of prudential regulation, and other key measures.

Conclusions

- From the standpoint of general economic development, the monopoly currently enjoyed by Russian banks, insurance companies, and pension funds must be broken. On the other hand, WTO accession does not guarantee an instant entry of foreign financial institutions. Russian banks will have time to prepare themselves to face competition.

- Again, the key issue is not whether Russia should join the WTO, but how to best encourage the financial sector's development through measures to improve the investment climate and provide better protection of creditor rights.

- Nor is the liberalization of the capital account directly related to Russia's WTO accession. The reversal of capital flight requires, first and foremost, a better investment climate.

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7 Notably, Russia was the only transition economy that, on the average, exported more capital than it imported in the 1990s.
8 In case of high capital inflows, the domestic currency would appreciate in the short term, depressing competitiveness of domestic industries. In the long term, however, industries gain as long as investments improve productivity.
9 These questions are discussed on in the section of capital mobility below.
Myth 4. "Lower tariffs will cause imports to surge, and discourage foreign investments"

Reformulation: Countries with relatively poor investment climates – like Russia – face the hard choice of “imports vs. foreign direct investment.” If the domestic market is protected by tariffs, building a plant within the country is cheaper than importing goods. Once the market opens up, goods will be produced abroad and imported as finished products.

Discussion

This argument is incorrect for the following reasons:

- International experience proves just the opposite. Not only do WTO member states receive more foreign direct investment (FDI), but WTO accession is usually accompanied by an increase in FDI. For instance, foreign investment in Bulgaria rose five-fold during the first post-accession year.

  We carried out a cross-country analysis of foreign direct investment as a share of GDP for a sample of 96 developing countries, as well as for the subsample of 42 nations that were not members of the GATT. Controlling for country specifics, development levels, and the size of the economies as well as the global economic outlook, FDI increased by 1.2% of GDP on average during the year following GATT accession. FDI falls in subsequent years, but remains 0.8% above pre-accession levels. Considering that in our sample foreign direct investment averages 1.5% to GDP, this increase is substantial.

- WTO accession gives Russian producers a chance to retain their existing export markets while opening new markets, so that exporting enterprises will attract more investments.\(^\text{10}\)

- WTO accession will require the adoption of a number of laws protecting investor rights and copyrights, and technical rules and standards to be brought into compliance with international standards. This process will offer foreign investors certain guarantees against discrimination by the authorities and dramatically improve the investment standing of the country.\(^\text{11}\)

- The reduction in import tariffs will actually have a positive rather than negative impact on vertical investments that are export-oriented and often use imported inputs. This is the dominant type of FDI in emerging economies.

- Lower tariff barriers adversely affect only investment this is intended to supply the domestic market (so-called horizontal investment) and even then, lower tariffs are not necessarily the problem. First, even horizontal investors import substantial amounts of components and materials into Russia. Second, the total costs of delivering imported goods to the local market that drive FDI include, but are not limited to, import tariffs. In Russia, tariffs represent only a minor share of such costs.\(^\text{12}\) Third, Russia still has a huge potential for horizontal investments, with a vast market and an underdeveloped services sector. In order to realize this potential, the country has to continue a campaign against interregional barriers that block the free movement of products and production factors, while improving the transportation infrastructure.

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\(^\text{10}\) The proponents of the myth always refer to the case of China, which attracts a lot of foreign investment although it has not yet joined the WTO. However, they normally fail to ask what is going to happen to FDI in China after the accession. Most foreign investment in China are vertical, i.e., export-oriented. Therefore, one may expect that foreign investment in China will grow even more once new export markets open up to Chinese goods.

\(^\text{11}\) According to Professor Arnold Harberger, who advised dozens of governments in developing and transitional economies, the capital inflows following Russia’s accession to the WTO will be so large that ruble may experience a dramatic real appreciation.

\(^\text{12}\) One would find it hard to believe that a 3% reduction in tariffs on European milk products would stop a foreign investor willing to open a dairy processing plant somewhere in Novosibirsk.
CEFIR examined the impact of tariff changes on the balance of imports and FDI in Russia between 1993 and 1996 (unfortunately, data for subsequent years were not available). All other things being equal, the effect on vertical FDI was trivial, while the effect on horizontal investment was negative but very small – a 1% fall in tariff rates only raised by 3% the share of imports in the total volume of imports and output of enterprises with foreign ownership. Even after adjusting for poor customs administration, this effect is minor and can be more than offset by improvements in the investment climate.

Conclusions

- **WTO accession gives Russia a unique chance to attract foreign capital.** The enterprises and regions that succeed in addressing issues of corporate governance and protection of investor rights will be able to gain substantial foreign investment. Horizontal investments (aimed at the domestic market) will flow into densely populated regions, while the vertical (export-oriented) investments will come to the border regions with skilled workforce. In order to attract investments, Russia needs to improve the investment climate and remove internal borders in its economy.

- **An improved investment climate is a prerequisite for long-term economic growth, with or without WTO accession.**

**Myth 5. "The WTO will protect us from arbitrary government action"**

"And the landlord will come and judge our disputes".

N.A. Nekrasov, "Forgotten Village"

Reformulation: **WTO accession limits the scope for bureaucratic discretion and therefore removes the urgent need for the administrative reform.** The source of this myth is the belief that government in Russia cannot be efficient or just; nor can it reform itself. The previous version of this myth involved unrealistically high hopes for the IMF reform program.

Discussion

WTO rules do offer foreign producers a mechanism for resolving conflicts with Russian authorities. If the authorities discriminate against foreign producers in favor of domestic producers, the response will be discrimination against Russian goods in foreign markets, thereby subjecting authorities to pressure from Russian exporters.

On the other hand, WTO accession will not prevent the authorities from harassing domestic businesses. In the absence of domestic regulatory and civil service reforms, there will be no improvement in either the investment or business climate. Lack of reform would likely trigger a massive capital flight through foreign financial institutions after WTO accession. Russia obviously needs highly skilled and honest civil servants to advocate the interests of Russian enterprises within WTO institutions. As Russia prepares to join, the country ought to reform its civil service and improve the system of incentives within the government bureaucracy. In the absence of administrative reform, Russian producers will lose from stricter control over intellectual property rights when they could otherwise stand to gain.

Conclusions

- **WTO accession does not obviate the need for reforming Russia’s regulatory system and civil service.** Indeed, the benefits of joining the WTO will be substantially diminished without such reforms.
Myth 6. "The WTO will break down into regional blocs, with no clear place for Russia"

Reformulation: The WTO's future is in doubt: the global economy is splitting into regional trade associations (American, European, and Asian) that are to become the key instruments of international trade. By joining the WTO, Russia loses the benefits of the CIS customs union and gains nothing.

Discussion and conclusions

It is indeed not clear how Russia can integrate into the regional trade blocs that seem to be gaining more and more strength. This is, however, one more reason to expedite Russia’s WTO accession in order to create at least one instrument for overcoming the regional borders. All of the economic functions of the CIS customs union can be preserved through bilateral negotiations or by forming a regional free trade association after Russia joins the WTO. One member of the CIS customs union, Kyrgyzstan, has already joined the WTO. That being said, some of the political functions of the CIS customs union may have to be achieved through other means.

Myth 7. "With or without WTO membership, Russia’s climate prevents investment"

Reformulation: The Russian climate makes production of all goods non-competitive; therefore, there is no place for Russia in the global economy.

Discussion

• "All production is more expensive in Russia, therefore trade brings no benefits."

  • This argument is not consistent with economic theory. The problem of gains of trade for countries that have absolute disadvantage in the production of any single commodity was solved in the 19th century by David Ricardo. He demonstrated that it is comparative rather than absolute advantage that secures mutual gains of trade.  

  • Therefore, the claim that Russia does not benefit from international trade just because its colder climate raises production costs is wrong. True, economies with absolute disadvantage have lower productivity and therefore GDP per capita, but closing such an economy down further reduces living standards. True, Russian firms are located in colder regions than those in other northern countries. However, over time competition will make industries that are not related to production and processing of natural resources relocate to moderate parts of Russia. This factor gives the Russian economy more growth potential. Moreover, climate is not the only determinant of productivity. There are other, significantly more important, factors such as human capital - which determines an economy's position within the international division of labor. Despite a much colder climate, Sweden, for example, outperformed Spain and Portugal in its economic development thanks to the skills of its workforce.

13 Oil produced in Russia may cost more than, say, in Kuwait. Production of VCRs is also more expensive (as compared to Japan), but by a larger margin than oil production. In such a case, Russia stands to gain from producing oil and buying VCRs, as it has been done since early 1990s. The rest of the world also benefits: in the same amount of time, the world gets more oil and VCRs than if Russia focused on oil and VCR production. Average global labor productivity increases and benefits all in this way. It is interesting that in his highly popular book "Why Russia Is Not America" – around which this argument is centered – Andrei Parshev also refers to Ricardo though his conclusions are directly opposite to Ricardo's.

14 Soviet-era industrialization, in fact, relocated production and population into substantially colder regions. Gaddy and Ickes estimate that, due to Soviet-era shifts in production, the average Russian experienced a temperature drop of one degree Celsius while the average American enjoyed a four-degree rise.
"The woes of the Russian economy are caused by geographic factors."

- Do geographic factors have any effect on long-term economic growth? Gallup and Sachs examined the implications of a tropical climate, access to the sea (population density in the coastal vs. landlocked regions), distance from developed countries, and other geographic factors for economic growth. According to their results, an unfavorable geographic location does play a role: countries located far from the sea or countries where most residents live outside of coastal areas tend to grow slower. Tropical countries grow slower, all other things being equal. Part of this could be attributed to the high incidence of tropical diseases in such countries: if one controls for economic costs of malaria – the only disease where reliable cross-country data is available – the effect of tropical climate becomes insignificant. Though Gallup and Sachs did not try to factor in the influence of a cold climate, they did control for the communist past (according to Parshev, the communist past represents a good proxy for cold climate). Gallup and Sachs discovered that this factor loses its significance once proxies for economic openness and quality of government institutions are taken into account. These measures include bureaucratic efficiency; corruption, contract law enforcement, indicating that it is not really climate that makes Russia differ from America.

- A simple proof of the secondary role of climate relative to political and legal factors is the map of output decline across Russia's regions in the 1990's. Figure 2 shows the decrease in GDP between 1990 and 1998 by region. Darker hues indicate heavier depressions. Russia’s southern (and therefore milder) regions experienced a greater drop in output than the North. Furthermore, Gallup and Sachs’ results imply that Russia's best-positioned regions include St. Petersburg, Leningrad Oblast, Kaliningrad Oblast, and Primorsky Kray. If only for their proximity to the sea, Leningrad Oblast and Kaliningrad Oblast ought to have outperformed Russia’s GDP growth by 1% per annum and Primorsky Kray should have grown an estimated 0.6% faster than the rest of the country. Despite its favorable location, Primorsky Kray is well known as one of the most troubled regions of Russia, indicating that institutional factors are more important than geographic factors in modern-day Russia.

Conclusions

Russia’s cold climate definitely increases production costs, but a cold climate is not in itself a decisive factor preventing Russia’s development; nor is it a reason for Russia to refrain from opening its economy. When production is located in colder areas, the population’s living standards decrease, though this is not related to openness because living standards would decrease even further in a closed economy than in an open economy in the same climate. On the other hand, Russia may eventually experience a relocation of production (other than natural resources) and labor to regions with milder climates.
Myth 8. "Russia’s problems stem from its mentality, and accession cannot change that"

"Russia is a thing of which the intellect cannot conceive ..."

F.I. Tyutchev.

Reformulation: As the reform years have shown, things that work in other countries do not work in Russia. The Russian mentality rejects free market thinking and individualism in favor of communalism and the collective spirit. Russian businessmen cannot innovate; Russian workers cannot work. (This line of reasoning is rooted in a belief that Russian people are somehow unique or special.)

Discussion

Russians are not the only people to believe they are unique. In the 20th century, many countries tried to follow a special development path that normally included isolation from world markets. But when the national path proved a failure, they inevitably reverted to open market economic policies. The experience of Latin American economies where, like in Russia, many believed their case to be very special, follows this pattern and provides a good example.

For many reasons, the output decline following the collapse of centralized planning hit Russia harder than other former communist countries. In fact, Russia’s reforms have
failed so far to raise either enterprise efficiency or living standards, and have instead given rise to many peculiar non-market institutions including widespread barter. This does not necessarily indicate that markets do not work in Russia. The Russian economy is actually still at the beginning of reform, because most Russian enterprises have yet to face competition and significant barriers continue to block the free movement of products, labor, and capital.

Productivity has in fact risen in sectors where a competitive environment evolved. External and domestic competition, and competitive labor markets have proven important factors in this regard (see Figure 3). Barter has also spread most in concentrated industries. According to estimates by Guriev and Kvassov, monopolized industries had 15-20% higher share of barter in sales than firms in competitive sectors in 1996-1997.

Figure 3. In Russia, as in other countries, competition forces businesses to become more efficient. The graph below shows the influence of competition on total factor productivity (TFP): the impact of foreign competition, as well as the impact of the competition in the local labor market have been high and significant. In recent years, domestic competition has also provided incentives for restructuring.

There is no country in the world where people like to work just for the sake of it; they won't spend time or effort on making the production of goods and services more efficient, if they can avoid it. Competition however does not allow inefficiency to remain, and Russia is no exception. To paraphrase Leo Tolstoy, thanks to competition, all happy countries are alike, while the others think up various reasons to limit such competition.

The specificity of the Russian “soul” can be understood rather as a unique ability to survive: thrown in deep water to either sink or swim, a Russian businessman will swim against all odds. The high level of basic education in Russia can partially explain this. Normally, Russian businessmen have, by international standards, a good university or college education. More importantly, they are able and willing to learn (in the broad sense of the word), and are flexible enough to adapt to a dynamic environment.
In an open economy, the key to success is the entrepreneur's ability to find a niche that provides a potential for rapid growth. Good examples of Russian businessmen’s ability to compete can be found in the software market. Take Reksoft: ten years ago, this company started developing customized software for foreign companies with only six employees. Having streamlined its software development processes over a couple of years, Reksoft began producing off-the-shelf software. In 1996, the company launched its first off-the-shelf product in the domestic market: the Barsum billing system for telephone calls. Other successful Reksoft products include a comprehensive hotel automation system known as Edelweiss, marketed in both Russia and the West, and Dynasite, a website content management system. In 2000, Reksoft had 100 employees and sales reached US$ 2.5 million. According to Reksoft’s managers, the secret to their success is high skills of their employees. The next significant factor was their pioneering entry into the Western market for customized software. Finally, Reksoft has practiced and combined all software business models in its ten years of operation: the Indian model, the Israeli-Scandinavian model, as well as the emerging Russian model.

The quality of the Russian labor force is also often disparaged, with complaints about lack of discipline, drinking problems, and other troubles. Though such complaints are certainly true, one should bear in mind that many negative social phenomena are related to the economic difficulties.15

Conclusions

Russian businesspeople are no different from others in responding to competition. What is special about Russian is that the high concentration of market power inherited from the USSR complicates the development of a competitive environment. WTO accession may significantly improve the situation by increasing competition. A pre-requisite for success will be to develop skills in the Russian workforce, as well as to maintain the generally high educational level.

15 Alcoholism and other social problems are related to economics. For instance, per capita number of patients hospitalized for alcoholism-related problems decreased by 0.2% in the Russian regions in the 1990’s with every 1% of increase in real per capita income (controlling for unemployment, social inequality, urban population share, macroeconomic factors, and regional differences). Therefore, incidences of alcoholism may be expected to fall once the economy rebounds.
3. Mobility: The key to success

As argued above, neither WTO accession alone will help Russia survive in the global economy, nor staying out of the WTO will save Russia from structural unemployment and lack of investment or from the need to continue reforms. If Russia joins the WTO, the benefits from accession will be much higher, and the social costs lower, if greater opportunities are provided for the free allocation of the factors of production (capital, labor and human capital) among companies, industries, and regions. The mobility concept presented in this section develops this idea as a framework for discussion of what actions need to be taken after Russia joins the WTO.

The necessary ingredients of competitiveness in a global economy include:

- Capital mobility
- Labor mobility, including horizontal (geographic) and vertical (professional) mobility, i.e., ability to accumulate human capital
- Corporate mobility, meaning the ability of businesses to innovate and change their organizational structures
- Information mobility, a prerequisite for reducing transaction costs in the market for goods, labor, and capital, while enhancing other types of mobility.
**Labor mobility**

**Geographic mobility**

With or without the WTO, Russia has to restructure its economy and move people from less productive jobs to more productive ones. WTO accession will encourage and speed up this process, though new job vacancies may not necessarily appear in the locations where workers are now.

Deregulation of business activities is a necessary, though not sufficient, condition for absorbing released labor. Deregulation promotes small business development in metropolitan and prosperous areas. In the meantime, the rapid growth of the service sector in depressed factory towns with high unemployment is rather unlikely given the low demand. This in turn requires that steps be taken to make it easier for workers to move from one location to another.

Today, geographic mobility in Russia is rather low. Administrative barriers, underdeveloped housing markets, and lack of information are restricting internal migration. Besides, CEFIR research shows that low wages and lack of access to financial means to relocate are also substantially constraining mobility. Traditionally, young people constitute the most mobile section of the population, but it is precisely the young specialists who are suffering most from the underdeveloped housing market and from the lack of liquidity needed to finance their moves.

Low geographic mobility does not mean that workers are reluctant to look for new jobs: approximately 10% of workers find new jobs within the same city every year while about 10-15% of the population have two or more jobs. Temporary informal migration is also rather high. According to some estimates, about 10-15% of heads of households in depressed regions temporarily migrate to other regions in search of work. A review of recent migration data indicates that people mostly move to European Russia, though migration flows are modest so far. Table 2 presents aggregated data on migration between today’s federal districts. One can clearly see that mobility is rather high within districts whereas mobility across administrative boundaries is virtually absent despite huge differences in living standards and unemployment. An identical pattern is observed at the oblast level.

<table>
<thead>
<tr>
<th>Source Regions</th>
<th>Central</th>
<th>North-West</th>
<th>South</th>
<th>Volga</th>
<th>Urals</th>
<th>Siberia</th>
<th>Far East</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central</td>
<td>11,2</td>
<td>0,7</td>
<td>0,7</td>
<td>0,9</td>
<td>0,3</td>
<td>0,4</td>
<td>0,2</td>
</tr>
<tr>
<td>North-West</td>
<td>2,7</td>
<td>13,9</td>
<td>1,1</td>
<td>1,5</td>
<td>0,4</td>
<td>0,5</td>
<td>0,3</td>
</tr>
<tr>
<td>South</td>
<td>1,7</td>
<td>0,6</td>
<td>15,2</td>
<td>1,1</td>
<td>0,7</td>
<td>0,6</td>
<td>0,4</td>
</tr>
<tr>
<td>Volga</td>
<td>1,1</td>
<td>0,5</td>
<td>0,6</td>
<td>16,2</td>
<td>1,2</td>
<td>0,4</td>
<td>0,3</td>
</tr>
<tr>
<td>Urals</td>
<td>1,3</td>
<td>0,5</td>
<td>1,4</td>
<td>3,4</td>
<td>15,8</td>
<td>1,2</td>
<td>0,3</td>
</tr>
<tr>
<td>Siberia</td>
<td>1,1</td>
<td>0,4</td>
<td>0,9</td>
<td>1,0</td>
<td>0,8</td>
<td>21,7</td>
<td>0,9</td>
</tr>
<tr>
<td>Far East</td>
<td>3,7</td>
<td>1,4</td>
<td>3,0</td>
<td>2,6</td>
<td>1,0</td>
<td>3,9</td>
<td>20,1</td>
</tr>
</tbody>
</table>

What can be done to improve geographic mobility? Key measures include the public promotion of geographic mobility, removal of administrative barriers, the development of mortgage institutions, and incentives for migrants to retrain. For instance, vouchers may be distributed to pay for migrants’ transportation and accommodation in special hostels. Importantly, this process needs free public access to information about the national labor market – information mobility – and more opportunities for workers to gain new skills – professional mobility.

The development of mortgage institutions is central to increasing the population’s geographic mobility. Despite the belief that the lack of a proper banking system delays the development of a mortgage system, full-fledged banks are not really required to offer mortgages. What is needed is a national mortgage corporation to buy mortgages and issue various tradable securities collateralized by real estate. In this way people could effectively bor-

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16 Data on mobility across and within Russia’s regions are available on request at www.cefir.org or at wto@cefir.ru.
row in the securities market. Such a corporation should be a private, though regulated, company similar to Fannie Mae in the US or a private pension fund. This institution would create a long-term financial instrument and would also add jobs in Russian banks that would both issue initial loans and provide demand for insurance services.

Regional and local authorities fear that higher mobility will increase competition among regions and that many regions will face a massive outflow of labor and investment. This may be largely true, but is not necessarily bad. Increased labor mobility would make regional and local authorities expend much greater effort to attract and retain skilled labor and capital. This is hard, but feasible, as shown by the economic development of the Novgorod Oblast in the recent years.

If they make an effort, regional authorities can attract investment and can create jobs. Novgorod Oblast, has established an appropriate regulatory framework to attract investment. Joint ventures operating within the oblast enjoy various tax concessions and are exempted from local and regional taxes until the investment project pays back in full. They have managed to significantly reduce the number of bureaucratic barriers (unlike, in Kaliningrad Oblast, which has more advanced legislation, but fails to attract investments due to the poor performance of its local officials). Significant amounts have been invested into the transportation system and tourism. The oblast is well known abroad; in 1997, it was the first Russian region to obtain an honorary award of the Council of Europe for its international successes. The oblast has managed to attract sizable amounts of foreign and Russian investment. Compared with the Kaliningrad Oblast, Novgorod Oblast had twice as much investment per capita in 2000 and foreign investment was five times higher. There are 32 joint ventures operating in the Oblast, with 2.5% of its population employed by joint industrial ventures. In Russia as a whole, including Moscow, the respective figure averages at just 0.5%. As a result, production began growing in the oblast in 1997. In 1997, 1998, and 1999, growth amounted to 1%, 5%, and 15% respectively, outperforming the national average figure by the total of 16%. Novgorod’s growth is also concentrated in export-oriented industries, such as chemicals, forestry, and petrochemical engineering.

Professional mobility

Russian workers are among the best educated in the world, particularly compared to workforces in countries with similar levels of per capita income. To fully capitalize on this potential, however, Russia must increase professional mobility. The modern world needs not just educated workers, but workers who are willing and able to learn new skills and adapt to new conditions. Professional mobility is an even greater problem for Russia than geographic mobility. Though the nation has a well-developed system of secondary and higher education, it lacks an adequate system for retraining and continuous education. As a result, the Russian labor market is rather inert, impeding the economy's restructuring, the exception being in job areas that require no serious professional training, such as shuttle trading.

Russia needs greater professional mobility not only to overcome the adverse effects of economic restructuring, but also to develop successfully in the years ahead. As mentioned, the modern world is highly dynamic with new industries emerging very fast and with technological progress completely redefining jobs in old sectors. As a result, the economy may undergo structural shifts of tectonic magnitude within a generation. Workers must be ready to face the fact that no basic education will remain sufficient, and that they will have to continue training throughout their lives. In the modern global economy, one must run rather than walk to keep up with competitors, and in order to overtake them one must run very fast. Countries with high professional mobility are able to rapidly develop without lengthy economic upheavals, while more inert countries may experience substantial delays and slower development due to insufficient flexibility.

To illustrate this point, consider the contrast of experiences between the State of Massachusetts in the US and Wallonia, the French-speaking part of Belgium. In the late 1960’s, Massachusetts needed to substantially restructure its economy, as the state's traditional shoe-making industry was no longer competitive. The problem was successfully addressed by capitalizing on the state's academic potential, thanks to the presence of two leading universities, Harvard and MIT. As a result, by the 1990’s, Massachusetts grew to become one of the most successful US states, a second Silicon Valley, with a very high standard of living and a record low unemployment just above 1%. By contrast, when Wallonia’s traditional metal industry could no longer compete in the postwar years, poor professional mobility kept the region from adapting quickly. It now faces serious economic problems, lagging behind the traditionally less developed Dutch part of Belgium, Flanders.
The educational reform now underway in Russia stands to make a substantial contribution to increasing professional mobility. The government’s strategy appears adequate, but needs faster implementation. Delays can be very costly, as Russia may find itself on the wrong side of the growing digital divide. The public needs to shift its attitude towards education: it should be viewed as an industry that produces knowledge rather than as a part of the welfare state. Certainly, education is not conventional industry: there are economies of scale and scope, there are huge (positive) externalities on other sectors. Quality certification is crucial in education. Education must therefore be regulated as an industry is through taxes, quality control, and control of market structure. Protection of equal rights for all educational institutions, regardless of their funding sources and ownership structure, is also important. Modern corporate governance must also be introduced into both private and state-owned educational institutions.

Professional mobility requires information mobility, or free flow of information. Broader availability of Internet access will substantially change the demand for educational services because people will gain a better understanding of their abilities and needs. Greater geographic mobility will also increase the effect of professional mobility (since industries are geographically concentrated, education or change of occupation often involve a change of residence). Lack of information and professional mobility are the core reasons that Russia has relatively low returns to education, despite having a strong educational system. Also, labor mobility alone is not enough, as it must rely on corporate mobility and capital mobility.

**Corporate mobility**

Corporate mobility requires the introduction of more flexible management structures that will be more responsive, on the one hand to changes in market conditions, and on the other to technological and organizational innovations. To address problems of corporate mobility, Russia has to assure better professional training for its managers. Russia needs a management revolution; the nation needs people who are able to move from a hierarchical (feudal or military) corporate structure to a modern network-based structure.

Incentives to learn, innovate and adopt superior organizational structures can be provided to both managers and workers through simple instruments, such as stock options. Such incentives will not only motivate existing employees, but would also bring in new professionals with better skills. In order for option-based incentives to be fully effective, however, Russia needs to develop a liquid stock market (see the Capital Mobility Section) and reduce (or abandon altogether) the capital gains tax.

Changes in the organizational structure of corporations and their internal incentives will have to be complemented by the development of an advanced service sector, both in the area of business consulting, auditing, and strange as it may seem, in wholesale trade. Creation of more efficient trading networks would improve transmission of market signals to producers, making them more efficient. WTO accession, along with greater information mobility, will help to accelerate this process as foreign companies enter the service sector and Russian companies perform better. Furthermore, the adoption of international accounting standards is needed to make corporate activities more transparent. This factor is crucial not only in terms of greater corporate mobility, but also from the viewpoint of capital mobility.

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17 The only drawback of the current educational reform is its isolated nature. Professional mobility ought to be linked to geographic mobility; for instance, by issuing education vouchers that workers leaving depressed regions might use to pay for retraining in their new homes.

18 In developed countries, each additional year of education brings on average a 10% wage increase (controlling for other personal characteristics); in successful transition economies (e.g. Czech Republic), this figure has already achieved 7% and keeps growing following an initial drop in the early reform years. In Russia, the returns to education remain stuck at 4%.
**Capital mobility**

Russia will be able to overcome the short-term costs of WTO accession and restart sustainable growth only if it enables redistribution of capital to promising industries. At the initial stage, this means improving the investment climate and reducing transaction costs in the capital market. In terms of government policy, this problem involves the following issues: tax policy, regulatory reform, capital market infrastructure, and improved corporate governance for better protection of investor rights.

In terms of tax policy, Russia should follow the *investment-rather-than-taxes* principle. Providing incentives for private investment will do much more for the economy’s development than collecting taxes and then trying to boost investments through government spending. The evidence of the last decade shows that government investment has been much less efficient in Russia than private investment. Capital gains should be exempt from taxation at least temporarily, perhaps for five years. Beyond cutting tax rates, the government needs to make taxation predictable, creating a level playing field for all companies so that less efficient companies are not able to outmaneuver better contenders through lobbying. This is a core principle of the WTO and Russia stands to gain from its adoption. Federalism reform and judicial reform also have major roles to play in this process. The creation of an independent judiciary to protect enterprises from bureaucratic racketeering is especially needed. For example, a law could stipulate that if the court finds that government inspection has disrupted business and entailed losses, such losses would be recoverable within the limits of taxes paid by that business over one or two years.

Russian investors must be given the same rights as foreign investors, namely, Russian individuals and businesses should be allowed to invest in foreign currency denominated assets. This is in turn related to the development of sorely needed private pension funds and mutual funds. Two crucial steps are passing the Law on Investment Funds and giving private pension funds the same rights as the Federal Pension Fund.

**A critical pre-requisite of capital mobility is property rights protection.** In order to provide owners with confidence in their property rights, and to create incentives for investment, Russia needs to introduce a statute of limitations on the reversal of privatization decisions, or even a full amnesty for privatization deals.

Capital mobility clearly requires corporate mobility, primarily through better corporate governance and greater transparency. Greater capital mobility will also provide incentives for better corporate mobility. Capital will then be free to flow to more promising companies, increasing the penalty for companies that fail to restructure.

**Information mobility**

The development of an information society – and the accompanying greater access to new communication technologies such as the Internet – are vitally important for Russia’s move toward sustainable economic development. Increased Internet access will significantly enable information mobility, accelerating the migration of capital and labor into more efficient sectors and making the entire economy more efficient.

Computerization will raise labor productivity in both the private and public sectors. Information technologies can help bring about the replacement of hierarchical corporate structures with decentralized networking structures, increasing companies’ flexibility. Greater Internet access will also reduce the transaction costs of moving between regions or changing occupations.

Information mobility is intricately related to all other types of mobility. First of all, the public needs to improve its computer and Internet skills, a major step towards greater professional mobility. Computerization will require substantial capital expenditure, unavoidably raising the issue of funding. Although the Internet is an infrastructure good, like a highway system, purely public financing for its development is problematic due to fiscal limitations and the historic inefficiency of government in-

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19 According to Jorgenson, two thirds of US productivity growth in the second half of ‘90s might be attributed to IT use.
vestment. Hence rapid development of IT infrastructure is only possible through participation of the private sector.

**Mobility: A framework for discussion**

At the end of the day, success in the global economy depends greatly on achieving higher mobility, in the broad sense of the word. For Russia, this means taking a number of specific measures in the areas of mobility outlined above. Most of these are well known and even included in the government’s reform program. In this report, the focus is on the interrelationships between the various “mobility components”. The purpose is to generate new thinking about innovative ways in which Russia, Russian industry and even individual Russian firms can integrate into the global economy.

Considering the linkages between the various types of mobility, we can see two radically different scenarios of economic development: (i) a vicious circle of survival without modernization and (ii) accelerated development across all dimensions. The first scenario is familiar to many: it includes moderate growth in response to higher oil prices and stagnation, or even depression, when oil prices drop. The positive scenario is as easy to describe: better professional, corporate, capital, and information mobility work together to create new growth enclaves that attract skilled labor, domestic and foreign capital, and improve the quality of corporate governance. The inflow of investment into the “new economy” will further improve the quality of education and the population’s mobility, in turn improving the investment climate. The nation will then find itself, along with developed countries, on the right side of the digital divide and will enjoy accelerated growth.

How can Russia break its current “vicious circle” and launch the positive scenario? Thanks to the high educational level of its workforce, Russia has a good chance of doing so. Education is the key competitive advantage in the modern global economy. Human capital will bring investment to the service sector and the new economy if Russia joins the WTO and creates further incentives for greater mobility and development of its education system. However, in case of delays and the perpetuation of current trends, Russia will not be able to maintain its high educational level indefinitely. Under the “vicious circle” scenario, Russia also stands to gain from opening up its economy, though it may miss the opportunity to defeat the vicious circle for good.

4. **Concluding remarks**

Russia’s WTO accession is inevitable, as in the modern world it is impossible to resist globalization. Moreover, the sooner Russia joins, the less painful its accession will be. Nonetheless, it is crucial to understand that WTO accession does not just mean lower tariffs; accession will bring much broader changes to Russia’s economy and society.

This report does not claim to propose ultimate solutions to Russia’s accession-related problems. Our objective has been to clearly formulate the important issues and arguments, and then propose a framework for discussion. We wish to inform the public policy debate, and to help individuals and organizations in Russia to weigh the issues in a broader perspective, consider how they can benefit from accession, and find their niche in the global economy.
Epilogue: A tale of two countries

Once upon a time, there were two developing countries: A and B. Both countries were located at the same latitude, not far from rich countries, and both were shored by warm seas. The countries had the same religion and the same system of government. Both had plenty of mineral resources, vast arable lands, and more than half of the population of both countries worked in agriculture. Both nations became independent at the same time, and got to work building their economies.

Country A opted for openness and spared no effort to attract foreign capital, mostly through the creation of free trade zones. New industrial centers sprouted up through the development of engineering, processing, chemical, and light industries. As a result, the share of agriculture in the nation's GDP dropped from 35 to 20% over 25 years. At the same time, the share of industrial production rose from 17 to 35%, with manufacturing industries rising from 7 to 20% of GDP. These structural changes brought about a steady per capita GDP growth, averaging 3.8% per annum over the 25 years in question. Throughout these years, the country pursued a policy of maximum openness, exports accounted for over one half of its GDP, and its mix of exports gradually shifted from raw commodities to finished products with a diversification of exports on the increase protecting the economy from the volatility of world prices.

Country B, from the very first years of its independence, opted for a different path of development based on import substitution industrialization and agricultural self-sufficiency, accompanied with government control over national resources and, subsequently, over its industry. As a result of such policies, many industries were saddled with inefficient enterprises that were surviving through high tariff and non-tariff import barriers. The funding of the nation’s import substitution policy was largely based on revenue from the export of raw materials and agricultural resources. In parallel, the nation pursued a policy of limiting foreign ownership in the economy. In the first 10 years after its independence, the country's key industries were therefore dominated by large government monopoly enterprises protected from external competition. This situation led to continuous fiscal pressure and the gradual reduction of investment. In 15 years, a decline in the world prices for the major export commodities brought about a huge rise in the fiscal deficit (from 3% to 20% of GDP in two years) and external imbalances (the trade surplus of 2.5% GDP was replaced by a 15% deficit). Soon, the situation was exacerbated by a drought and falling agricultural output, with the trade deficit ballooning further. In 25 years, the share of agricultural output dropped from 25 to 16% of GDP while the share of industrial production rose from 25 to 35% of GDP. But the share of manufacturing industries registered only a marginal growth, from 15 to 18% of GDP. The nation's per capita GDP growth averaged a mere 1.7% per annum.

In 25 years, due to pressing problems caused by domestic and external imbalances, Country B had to abandon its import substitution policy and opt for greater openness.

Figure 4. Country A opted for an open economy from the outset, while Country B sought to protect itself from external markets. As a result, the difference in living standards increased 1.7 times. The figures below show economic openness and per capita GDP in Countries A and B over 25 years.

Export of goods and services, % of GDP  Per capita GDP, in 1995 US dollars

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20 The true names of the counties can be found at www.cefir.org.