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Rolf J. Langhammer\*

# Endogenous Tariffs and Economic Transformation

## The Case of Russian Trade Policies

*There is a widespread consensus that trade policy reforms in the successor states of the former Soviet Union in general and in Russia in particular are subject to major obstacles which are larger than in Central and Eastern European transformation countries. The following paper discusses some crossroad decisions facing the implementation of Russian trade policies and analyses the major external constraints facing the Russian economy in this regard.*

Trade policy reforms comprise decisions to be taken on four forms of intervention into trade in goods and services: the rationing of foreign exchange, the imposition of non-tariff barriers on imports, the introduction and collection of tariffs and, finally, the use of other domestic policies to indirectly influence volume and direction of trade, such as monopolies, reference prices and quality requirements. They are thus essential for linking domestic goods markets to world market prices. Yet, unlike in market economies in which usually goods prices are flexible and not significantly decoupled from world markets, at the beginning of transformation many former socialist economies (including Russia) had pervasively regulated domestic goods markets which were almost entirely isolated from world markets. Price liberalisation is hence seen as an indispensable companion piece to trade policy reform.<sup>1</sup> Furthermore, from the political economy perspective, a simultaneous implementation of stabilisation measures and trade policy reforms is supported in order to signal credibility and the commitment of governments to enforce strong reform measures. Exporters would also gain more from trade policy reforms if real exchange rates depreciated and domestic absorption were reduced.

Thus, even if the paramount importance of

institution-building as the most crucial prerequisite of successful transformation is accepted, trade policy reforms remain at the centre of reform measures together with price liberalisation and stabilisation. They are seen as the most straightforward way to expose enterprises to world market prices and to exhibit the degree of unavoidable depreciation of the real capital stock in import-competing industries.

While this is generally agreed upon, there is also widespread consensus that trade policy reforms in the successor states of the former Soviet Union in general and in Russia in particular are subject to major obstacles which are larger than in other Central and Eastern European transformation countries. This is expected because of the rudimentary character of market-driven institution-building and the non-enforceability of major pillars of trade policy reforms<sup>2</sup> as well as because of pervasive rent-seeking behaviour using discretionary and discriminatory quantitative restrictions as a source of generating income. Russia's large domestic market and resource base might pose additional barriers to trade policy reforms as the external sector is relatively small. Rents gained from resource extraction might dilute efforts to rationalise trade policies for the industrial sector and to make the export sector less dependent on primary commodities.<sup>3</sup> Rent-seeking behaviour, known in the theory of trade policies as "endogenous

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<sup>1</sup> Cf. David Lipton, Jeffrey Sachs: Privatization in Eastern Europe: The Case of Poland, Brooking Papers on Economic Activity, No. 2, 1990, pp. 293-341.

<sup>2</sup> To mention a few of them, trade policy reforms, to be effective, need public control over customs territories, efficient customs collection mechanisms and valuation procedures.

tariff-making", is therefore expected to offer a theoretical base for explaining early designs of trade policies in Russia in the transformation process.

### Endogenous Tariff-making: Lessons from Theory

There is a vast body of literature on endogenous tariffs with major contributions by Brock and Magee.<sup>4</sup> The basic pillars can be summarised as follows:

□ Tariffs are endogenous if the policy can be explained as the rational maximising behaviour of lobby groups. Policies are redistributive and equilibrating variables, i.e. they equate, at the margin, pressures for and against a given type of redistribution through tariffs.

□ Lobbying is endogenous. The rational lobby will maximise the income of its membership, which is a weighted average of its expected income under each of the possible political outcomes of endeavours to bring a party or a group to political power, less the lobbying costs. While the model has been basically framed for the USA and the binary decision (Republicans versus Democrats), it can be extended to more than two outcomes. Political coalitions as well as implicit participation of lobby groups in governments are also accessible through the theory. The latter is important for Russia with certain lobby groups such as the industrial lobby or the military-industrial complex represented in the government through ministers. In some cases, the foundation of new ministries even emerges as the result of lobbying activities.<sup>5</sup>

□ There is an equilibrium of political efficiency. In this equilibrium, there is no new policy that will increase the welfare of one of the parties in terms of getting into power.

□ Political and economic efficiency are in a trade-off situation. Redistributive policies may be harmful to the entire economy but are politically efficient. On the other hand, the lack of an arena for lobbying activities and for funding political campaigns may be rewarded by greater economic efficiency in terms of allocation gains but such gains have to be paid by a loss of public (and democratic) discussion of all political issues. The equilibrium between the two efficiency

criteria meets the conditions of an Arrow-Debreu endogenous redistributive political equilibrium. Uncertainty inherent in the entire process suggests the development of a probabilistic voting model in which each player's optimal behaviour depends on the actions of the other players. Usually, 2x2 models (import-protectionist lobby group, pro-export lobby group, import-protectionist political party, and pro-export political party) are calibrated to exhibit the effects of political bargaining.

□ Each lobby will contribute exclusively to its most-favoured party (contribution specialisation theorem). Exceptions to this theorem (contribution to both parties) arise from imperfect information. Under such conditions, some kind of insurance premium is paid for finding access to all parties in future and for the fear of being penalised by the other party for contributing only to the favoured party if the other party should come to power. Game-theoretic models based on Stackelberg or Cournot-Nash have been developed to deal with uncertainty, imperfect information, ex-ante anticipation and actors' interactions.

It is of special importance for the empirical applicability of endogenous policy theory to expose its microfoundations, e.g. the characteristics of industrial lobbying. Here, the following prescriptions have been formulated:

□ Lobby effectiveness increases with the private-goods effects and decreases with the public-goods effects. Industry-specific gains from lobbying, which can be internalised by the contributors and prevent free-riders from benefiting, will trigger larger lobby contributions than, for instance, tariffs, protecting industries regardless of whether or not they contribute to the efforts of getting the tariff.

□ Differences in size of members of a lobby do matter, depending on the net marginal value products of each member. Larger members increase their lobby contributions while the smaller ones decrease theirs.

<sup>4</sup> Cf. Stephen P. Magee, William A. Brock, Leslie Young: *Black Hole Tariffs and Endogenous Policy Theory. Political Economy in General Equilibrium*, Cambridge, Mass. 1989, Chapters I and II, and the survey of literature cited there. In the following, tariffs are used as a catch-all variable for trade policies in general comprising tariffs and the price equivalent of all non-tariff barriers.

<sup>5</sup> This phenomenon is not confined to former socialist economies. In market economies, the existence of ministries for agriculture, for instance, represents an outcome of successful lobbying which was often denied to other sectors, such as services or industries. It does not seem far from reality to argue that the foundation of ministries for specific sectors or sub-sectors represents one of the best indicators of successful lobbying, as such ministries always defend the political entitlements of their clientele to rents and other forms of protection.

<sup>3</sup> It is known from the developing countries' experiences that small resource-poor economies usually understand the necessity of trade policy reforms much better than large, resource-rich economies whose often half-heartedly implemented efforts at trade liberalisation were jeopardised by price bonanzas in commodity markets, too (Dutch disease problem). On the developing countries' experiences, see Michael Michaely, Demetris Papageorgiou, Armeane M. Choksi: *Liberalizing Foreign Trade*, Vol. 7, *Lessons of Experience in the Developing World*, Oxford 1991.

With industry sales constant, for instance, an increase in the number of firms in the industry results in a per-member decline of contributions. The ineffectiveness of many consumer lobbies is rooted in this finding.

□ Lobbying contributions in favour of tariff protection are maximised if there is only one seller (no free-riders). Moreover, there is an inter-temporal variation of contributions, with increasing returns of lobby group benefits at the beginning when the benefits from lobbying are unequally distributed and thus push contributions. This period is followed by one of decreasing returns when the increase in benefits falls below its marginal costs and when equalisation tendencies for net gains between the individual lobbyists become powerful.

□ Lobbying power functions include concentration measures and value of industry sales as important determinants of tariff protection. If tariffs rise monotonically with expenditures for receiving protection through tariffs, one would expect tariffs to be positively correlated with industry concentration and the size of sales.

□ The size of political jurisdiction has a positive impact on lobbying expenditures for protection. Increasing size furthers expenditures as the individual gains from protection promise to be larger than for free traders for which trade with the rest of the world shrinks relative to the domestic market. The equilibrium tariff would rise. This might explain why larger economies tend to be more protectionist than smaller ones. Opposing groups such as consumer lobbies are then supposed to become weaker as their natural problem of a large number of free-riders and small gains accrued by individuals aggravates with the increasing size of political jurisdiction. To be brief, to protect consumer income pays less in large entities than to protect factor income.

### Relevance for Russian Trade Policies

The heritage of Communist rule has been described as the complete destruction of horizontal co-operation among individuals.<sup>6</sup> Instead, individuals tried to protect themselves by joining one of the large number of small overlapping "circles" characterised by insider patronage, mutual trust and low transaction

costs relative to transactions with outsiders. Politicians became self-interested in the sense that they founded institutions to maximise their own chances of occupying key policy-making posts and to impose institutional disadvantages on competitors.<sup>7</sup> While such a background provides fertile ground for a wide spread of rent-seeking activities, one important qualification must be made. The post-Communist period produced the collapse of remaining vertical hierarchies, extremely weak governments with no legitimacy (except for the Presidency) and subsequently a weak executive apparatus to enforce law and legal protection. Private enforcement of private laws became the rule. Such a decay of public legitimacy and power bears risks for protectionist and non-protectionist lobby groups alike, for various reasons.

First, enforcement is an integral part of endogenous tariffs. Unless rents can be enforced, lobbying expenditures can have no pay-off. With the collapse of vertical hierarchies in post-socialist Russia, the enforcement of any trade policy measure is generally uncertain. So is the return from lobbying activities at the legislative level. Under such uncertainty (which should not be confused with risk), there seems to be a prisoner's dilemma in which the best strategy for each "circle" is to lobby for redistributive policies whether or not the other circles lobby as well. Given the uncertainty of policy enforcement, there is a probability of high sunk costs from spending resources for lobbying. However, in a polypolistic environment the price to be paid for lobbying may be smaller than in an organised and transparent society with powerful lobbying opponents. Lack of transparency helps those who lobby for protection. This lack may outweigh some of the risks related to non-enforceability of protection.

Second, the important shelter of a powerful ministerial structure has collapsed. Under the "ancient regime", a large number of ministries existed even at the branch level. Inter-republic trade flows were said to be favoured within a ministry over intra-republic trade across ministries.<sup>8</sup> Lobby groups now have to adjust to a new ministerial structure more designed to meet allocative functions (e.g. Ministry for International Trade) than to protect sectors or branches.

Third, Russian policies after 1991 have been

<sup>6</sup> Cf. Vitali A. Naishul: Institutional Barriers to Market Transactions in and Between CIS Countries, Kiel Working Papers, No. 624, Kiel, April 1994, p. 9.

<sup>7</sup> Cf. Philipp G. Roeder: Varieties of Post-Soviet Authoritarian Regimes. Post-Soviet Affairs, Vol. 10, 1994, pp. 61-101.

<sup>8</sup> Cf. International Monetary Fund, The World Bank, Organisation for Economic Co-operation and Development, European Bank for Reconstruction and Development: A Study of the Soviet Economy, Vol. 1, Washington D.C., February 1991, p. 193.

generally characterised by a large amount of incoherence, instability and discretionary actions. Thus, lobby groups receiving benefits from tariff protection may see these benefits eroded by the simultaneous implementation of counteracting policies, e.g. reduced domestic subsidies or otherwise tightened budgetary constraints.

Fourth, the process of tariff-making itself may be a source of income generation in the legislative body. Rent-seeking may thus be common not only at the level of customs posts but even in ministries and parliament. Limits to rent-seeking are not only set by decreasing returns when the marginal costs of lobbying rise relative to the gains but also by the small tax base and the still low level of directly productive activities.

Fifth, as concerns the choice of the tools of protection, the underlying conditions of institutional disorder in the division of labour between the various governmental layers (*oblast* level, republics level, federal government level) suggest a clear preference for quantitative restrictions (QRs) over tariffs. Granting QRs bureaucratically (that is, without auctioning them) is easy to administer and to control. They ensure the effectiveness of the measure better than tariffs, and they provide more chances for generating income for the donors of protection. Such QRs may include bilateral inter-governmental contracts on a barter basis, especially between the former republics, which suffer from shortage of both foreign exchange and cash roubles, or inter-company contracts backed by government protection.

Sixth, import protection can be provided directly by raising import tariffs on a net basis (taking import subsidies into account) or, alternatively, indirectly by lowering export subsidies net of taxes (for instance by raising export taxes). Likewise, import liberalisation can be implemented either by cutting import tariffs (net of import subsidies) or by raising net export subsidies (for instance, by reducing export taxes). Under given conditions, both Russian donors and recipients of import protection (or import liberalisation) can be expected to prefer measures taken on the export side. Compared to controlling the inflow of goods, outflow control allows for much

better control over and enforcement of trade policies, from both the governmental and the company side. It thus provides more certainty on the profitability of lobbying expenditures.

Seventh, compared to the former Soviet Union, Russia as a political jurisdiction has become smaller and more homogeneous. Under such conditions, theory would suggest that the equilibrium tariff would decrease along with falling protectionist lobbying expenditures relative to free-trade expenditures. Moreover, the industrial structure of Russia is more biased towards capital goods and intermediates than was the structure of the former Soviet Union, in which the finished goods industries were concentrated in the other former republics (Belarus, Baltic states, Caucasian states) and the food industry (Moldova, Caucasian states) carried more weight.<sup>9</sup> Following the familiar structure of protection in market economies, in which protection rises with increasing stage of production (tariff escalation),<sup>10</sup> one could expect the average import tariff to be lower in Russia than in those successor states specialised in finished goods.

Eighth, lack of transparency in trade policies facilitates the collection of rents. In trade policies, an effective tool to make even tariffs non-transparent is to fine-tune product specification by raising the number of tariff items. In doing so, the requirements of most-favoured nation treatment and trade liberalisation can be met and at the same time rents from protection can be allocated to pre-assigned recipients as the product specification is intended to exclude foreign suppliers from entering the market under MFN conditions. Alternatively, tariffs for identical goods can be differentiated according to the status of importers or the use of goods.<sup>11</sup>

Ninth, different time preference rates of the agencies collecting tariffs may influence tariff policies. For instance, export taxes levied on primary commodities may partly or completely accrue to the entities extracting the commodities (the Siberian *oblasts* and republics, for instance).<sup>12</sup> If these entities aim at achieving a minimum rate of return over a longer period, tax levels will be lower than those imposed by the federal government trying to

<sup>9</sup> Cf. Misha V. Belkindas, Matthew J. Sagers: A Preliminary Analysis of Economic Relations Among Union Republics of the USSR: 1970-1988, *Soviet Geography*, Vol. 31, 1990, No. 9, pp. 629-656.

<sup>10</sup> This is equivalent to the observation that in finished goods industries the effective rate of protection (protection of domestic value added) usually exceeds the nominal rate.

<sup>11</sup> To give examples of such discrimination, not far from reality: non-residents may face other tariffs than residents; imports of capital goods for "developmental" purposes may be exempted from tariffs; imports of intermediates for export industries may be privileged over imports of identical products for domestic consumption; finally, imports of raw materials such as vegetable oils can be taxed differently according to whether they are used in industry or for final household consumption.

maximise tax revenues in a short period for budgetary purposes.

Taking this (incomplete) list of determinants of endogenous tariff-making in Russia into account, the outcome is ambiguous in the sense that the formation of lobby groups is not as clear as in the US context of 2x2 models. But endogenous tariff seeking is seen as important in an environment of pervasive rent-seeking and losers from transformation policies. Overall, one may hypothesise a clear preference by lobbyists for QRs based on the legacies of planning in physical units in a command economy. Should a combination of QRs and tariffs be introduced, for instance, in terms of tariff quotas, the QR is likely to be preferred as the binding element. However, barriers against operating highly discretionary and non-transparent trade policies could be raised by external donors and trading partners. They are likely to make GATT membership and access to external funds contingent upon compliance with Western demands for a rational and non-discriminatory Russian trade policy.

### Russian Lobby Groups

The transition process has highlighted the crucial importance of lobbying groups in trade policies. At least five groups can be identified. As a first group, domestic industries facing import competition emerge.<sup>12</sup> After implementing the mid-March 1994 trade policy reform, average import tariffs range from 12 to 15 per cent with peak tariffs exceeding 30 per cent for many items. According to the government, protective purposes will remain an important motive for Russian trade policies in future. A second group has become active in bargaining for liberalisation. Major agents in this group are regions within the Russian Federation which are net importers of food and consumer goods, for instance the large cities. Critical domestic supply shortages have triggered this group to become pro-trade lobbyists. Foreign supply is reported to account for over half the consumer goods sold in retail trade. A third group of lobbyists are those underlining the importance of taxing

international transactions for revenue purposes. This lobby has enforced the introduction of import consumption taxes (excise taxes) on a number of high-income consumer goods (cars, alcoholic beverages, household equipment). A fourth group of lobbyists acts against the competitive behaviour of exporters in order to restrict the outflow of so-called strategic goods (minerals, ores) or goods essential for domestic consumption. While under international pressure export quotas and licences were principally removed by mid-1994, exceptions to this rule mushroomed. Goods subject to international agreements were exempted, including textiles and clothing. These goods are covered by EU-Russian regulations on dumping, export surge, orderly marketing behaviour etc. Surrogates for export quotas have been imposed for strategic goods in terms of export contract requirements. Such contracts are submitted to an administrative check on "correct" pricing to discourage supply below world market prices. Entry barriers into this market have been imposed by restricting the number of firms allowed to export such goods. This lobby group may comprise not only domestic bureaucrats but also foreign governments concerned about import surges of allegedly dumped products.

All lobby groups care about the effectiveness of their activities. This effectiveness seems to be seriously impaired for those goods which can be supplied easily through illegal cross-border trading practices (smuggling, invoice faking) or cross-border movements of individuals and private companies. As a matter of fact, registered imports of consumer goods are estimated to comprise only a part of total cross-border trading (about 70 per cent). Under such conditions, import quotas would remain ineffective and tariffs would thus be preferred to quotas in order to prove that import measures are consistent with GATT commitments. On the other hand, the effectiveness seems highest for exports of Russian strategic goods, and it is rational under the endogenous tariff theory to concentrate QRs (including entry restrictions for firms) on this group of goods.

However, there is a general challenge to the effectiveness of all lobbying activities. This challenge constitutes another lobby for sustaining a maximum of trade between the former republics in order to stabilise production. Given the artificially high level of inter-republican trade when the Soviet Union collapsed,<sup>14</sup> producers in both Russia and the other CIS states still see trading partners in the "near

<sup>12</sup> For a detailed analysis of the likelihood of different preference rates based on resource endowment differences cf. Rolf J. Langhammer, Matthias Lücke, Matthew J. Sagers: Regional Distribution of the Russian Federation's Export Earnings Outside the Former Soviet Union and its Implications for Regional Economic Autonomy, *Post-Soviet Geography*, Vol. 33, 1992, pp. 617-634; as well as Matthias Lücke: The Scope for Competition among Regional Governments in the Russian Federation, *Kiel Working Papers*, No. 649, Kiel, August 1994.

<sup>13</sup> A recent example is the rise in import tariffs for alternating current meters to protect non-competitive domestic suppliers. Cf. *Nachrichten für Außenhandel*, Frankfurt, 15. July 1994.

abroad" as essential suppliers and buyers of raw materials, intermediates and finished goods. It goes without saying that this holds primarily for importers of Russian energy exports which in the short run cannot be replaced by alternative sources in neighbouring states. The monetary disintegration of the rouble zone and the credit constraints imposed by the Russian Central Bank on the uncontrolled expansion of credit roubles in the other republics sharply reduced inter-CIS trade to levels which in some cases were below 10 per cent of the 1989 level.<sup>15</sup> Lobby interests on both sides have urged for the stabilising of inter-CIS trade. They succeeded in fixing trade volumes by bilateral inter-governmental contracts for essential products and inter-company contracts for less essential products. Lobbying for such contracts carries a rent as they reduce the risk of payment arrears and default. The challenge to the other five lobbying groups identified above is that indirect exports and imports via other CIS states may undermine Russian trade policy measures as inter-CIS customs borders are much less tightly controlled than borders to extra-CIS suppliers.<sup>16</sup> Yet, the dwindling degree of authority in the entire former Soviet Union can be gauged from the observation that even bilateral inter-governmental contracts usually fall short of fulfilment. In 1993, the fulfilment ratio ranged between 96 per cent for Russian petrol exports to CIS states and 34 per cent for CIS cereal exports to Russia only.<sup>17</sup> Generally, fulfilment ratios are reported to be significantly lower for exports to Russia than for imports from Russia. Hence, Russian lobbyists may have reason for concern that strategic goods bypass direct export restrictions and are exported indirectly via other CIS states. In the other direction, imports from non-CIS sources may circumvent import restrictions and may enter Russian territory through transit trade, which is crucial for many land-locked CIS states using Russian ports.

### Some Crossroad Decisions

□ Any national trade policy requires the definition of customs borders and customs areas. This process is not yet completed in the CIS states including Russia. Intra-CIS and extra-CIS trade flows are treated somewhat differently but there is no official preferential trading arrangement, no free-trade area

with specification of rules of origin, and no customs union with a common external trade policy. Declarations given at CIS summits concerning co-operation in an economic community are vague and without substance. The implementation of policies with respect to intra-CIS trade relations often appears inconsistent and contradictory. Russian imports from other CIS states, for instance, are exempted from import tariffs and VAT while strict controls still continue to exist for exports. There are a number of arguments for the case of nationally autonomous trade policies in line with nationally autonomous monetary policies. Very importantly, transparency is improved and national trade policies can be used to implement different national policy objectives and to adjust to different economic structures. Should countries decide to merge economically, for instance, by accepting the Russian rouble as the sole legal tender, national trade policies would have to be revised in the light of a customs union or at least a free-trade area with the Russian Federation. Such a process seems to be under way since 1993 as a result of ill-fated experiments with autonomous monetary policies in many CIS states.

□ Trade policies are instruments to achieve policy targets. Which targets should be achieved in individual CIS states is not clear. Protection of domestic industries, export promotion, and revenue generation are three possible targets which might require different trade policies. To maximise revenues, for instance, tariffs schedules should theoretically be designed according to the different price elasticities of demand (low tariffs on products with elastic demand, higher tariffs on products facing inelastic demand). However, such differentiated tariffs are very difficult to implement in an early stage of "institutional maturity", and they usually conflict with the target of neutral protection, which means that there should be no discrimination between import-competing industries. This holds as differentiated nominal tariffs with tariff levels selected on grounds of price elasticities would

<sup>15</sup> Cf. Rolf J. Langhammer: Salient Features of Trade Among Former Soviet Union Republics: Facts, Flaws and Findings, in: *Aussenwirtschaft*, Vol. 47, 1992, No. II, Table 1; as well as John Odling-Smee: *Economic Review: Common Issues and Interpublican Relations in the Former USSR*, IMF, Washington D.C. 1992, Table 1.

<sup>15</sup> Cf. Rolf J. Langhammer: Designing New Trade Policies for the CIS States. Legacies, Barriers, and Prerequisites, Kiel Working Papers, No. 625, Kiel, April 1994, Appendix Table 1; and Wladimir Korowkin: *Wirtschaftsbeziehungen zu den übrigen Staaten der ehemaligen Sowjetunion*, Kiel Working Papers, No. 619, Kiel, März 1994.

<sup>16</sup> On border controls within CIS states cf. Denis Kiselyov: Enterprise Reponse to Changes in the Foreign Trade Regulations in the Course of Russian Economic Reform, paper presented at the Workshop on Enterprise Behaviour under the Conditions of Economic Reform in the Russian Federation, 6-8 July 1993, IIASA, Laxenburg (mimeo) and Andrei Illarionov: Russia's Foreign Trade. Special Report, in: *Russian Economic Trends*, Vol. 3, 1994, No. 1, p. 81.

<sup>17</sup> Cf. *Ekonomika i Zizn'*: No. 19, Moscow, May 1994, p. 18.

lead to higher effective protection than nominal protection and to higher protection of finished goods industries than of intermediates (the former usually facing higher price elasticities than the latter). Thus, following the revenue target might lead to the same pattern of inefficient import substitution in industries close to the consumers as in many developing countries in the sixties and seventies. It is well-known that the target of revenue generation plays an important role in low-income countries with weak tax administration and with an insufficient base either for direct taxation or for taxing domestic rather than international transactions. Therefore, some low-income CIS states, for instance in Central Asia or in the Caucasian region, could be tempted to operate domestic trade policies basically under the target of revenue generation, by issuing differentiated tariff schedules with the effect of large spreads of tariff equivalents. Such differentiation would conform with endogenous tariff theory, as the success of lobbying is expected to vary across sectors if the sectors have different political and economic leverage. Given the early stage of institutional reforms, there is still scope for avoiding an inadequate focus on fiscal objectives. The first-best solution would be to develop domestic revenue sources (VAT, excise taxes, sales taxes, taxes on income or fortune), and the second-best to meet the revenue target by minimising tariff spreads or even by taxing imports uniformly. The same reluctance to use trade policies as an instrument for targets other than import protection and export promotion seems advisable with respect to income distribution and balance of payments purposes. Changing the income distribution – the core objective of rent-seeking – should be approached by domestic policy measures (income transfers and subsidies) while balance of payments targets should be achieved by exchange-rate flexibility instead of trade policies such as import surcharges or export subsidies. Paying attention to such principles would leave protection or export promotion as the major targets of trade policies.

□ To start with short-term economic targets, export expansion towards any partner country offering hard currency earnings appears to be a prime target worth following by the CIS states for several reasons. First, CIS states seriously lack foreign exchange to stabilise the exchange rate and to ease the hard budget constraint with respect to external savings. These constraints exist as the CIS states are not credit-worthy in international loan markets. Nor do they attract foreign direct investment on a large scale. Foreign public aid cannot compensate for the

reluctance of international investors and private donors. Therefore, access to external savings is very much limited and can be eased only by squeezing imports or expanding exports. The experience of many developing countries with the former has been disenchanting because production declined as a result of reduced capital goods imports. Hence, only the latter way is advisable. Second, export diversification helps to release CIS states from exogenous commodity price shocks and from concurrent exchange rate volatility (Dutch disease problem). It stabilises flows of export earnings. Third, export diversification is instrumental for linking domestic producers to international networks and for acquiring technological and commercial skills. Fourth, export diversification contributes to shifting CIS production towards sectors with a more income elastic export demand than commodities. Fifth, it may ease political tensions between CIS states, which could arise if the countries underbid each other in homogeneous commodity markets (either by “devaluation races” or export subsidisation). The experience with commodity exporters from some developing countries suggests that such competition is very likely.

□ The early state of administrative capacity in CIS states suggests that all tools should be marked by simplicity, transparency and conformity with the market mechanism. This requires that quotas be phased out as soon as possible. Quotas, if not auctioned, clearly signal allocative inefficiency following lobby activities. Auctioning quotas is inferior to tariffs for administrative as well as theoretical reasons. There are few exceptions which emerge exogenously. Quotas for exports of multi-fibre products, for instance, should be auctioned in order to enable CIS governments to collect the quota rents which would accrue to domestic producers if quotas were allocated on non-price grounds (e.g. on the “first come, first served” principle or on other bureaucratic principles). Still, the question arises whether the principle of abandoning quotas should be applied to the total foreign trade of CIS states, including intra-CIS trade. This question is open to debate. It has been argued in favour of transitional arrangements that intra-CIS quotas should be maintained, for those products which could be re-exported because of domestic underpricing relative to world market prices.<sup>18</sup> The case against such arrangements is based on the fear that quotas could proliferate and extend rather than shorten the transition process. Again, taxes appear to be the preferable tool. However, with



monetary disintegration proceeding rapidly within the CIS region and with similar trends emerging in the real sector the ultimate target should be for each CIS state to treat intra-CIS trade and extra-CIS trade equally. This target, which would also meet the administrative criteria of simplicity and transparency, should be achieved as soon as possible. It would not preclude preferential relations in a later period but the principle of non-discrimination should have short-run priority. Future institutional re-integration would be facilitated if the tariff schedules of the individual CIS states were similar and as uniform as possible. Thus, the cross-road situation of discrimination versus non-discrimination should be answered in favour of non-discrimination. Again, however, endogenous tariff theory would explain why, in spite of economic arguments pro non-discrimination, preferential trading relations between CIS states would be furthered.

### International Perspective

The integration of Russia into the international trading order is an important precondition for the success of the entire transformation process for two reasons. First, it enhances the credibility of the transformation process for all economic agents by committing CIS trade policies to internationally binding rules and thus by tying the hands of CIS governments, preventing them from altering policies ad hoc. Domestic opposition to trade liberalisation can be disciplined if the violation of such commitments carries costs for the CIS economies in terms of worsened access to foreign goods markets and external savings. Both domestic and foreign investment are expected to respond positively to such commitments. Second, it increases transparency and lowers transaction costs concerning tariff schedules, customs valuation practices and other important rules of international trading.

As concerns participation in the international trading system, two crossroad decisions have to be taken:

□ First, Russia has to decide whether it wants to maintain discriminatory treatment by means of differentiated tariffs between intra-CIS trade and extra-CIS trade. The alternative is MFN treatment. As already discussed above, there are a number of arguments pro MFN treatment in a forward-looking

view, while the status quo may speak for tariff differentiation. Economically, there is much evidence from the experiences of many developing economies (regional preferential trading arrangements) and of preferential trading regimes in OECD countries (GSP, special preferences such as the Lomé Convention or the Caribbean Basin Preferences) that differentiated tariffs are not an adequate means of stimulating trade. Instead, they are a second-best alternative to aid transfers (provided that tariff revenues foregone accrue to the beneficiary). They are more conducive to diverting trade to less efficient suppliers than to creating trade at the expense of inefficient domestic suppliers. If conditions of so-called "natural" trading partnership exist (i.e. if geographical proximity and complementarity of resources foster neighbourhood trade), neighbourhood trade will develop anyway without preferences. Administratively, differentiated tariffs require strict controls over market segmentation by checking rules of origin. Such control mechanisms are not available in Russia and other CIS states. To lobby for them would be unproductive unless enforcement were guaranteed. Very often, such rules have proven to be protectionist instruments to limit the value of preferences if there was such a value. Again, for the sake of simplicity and transparency and to minimise bureaucratic red tape, CIS states should not embark on such policies of market segmentation. In the short run, intra-CIS trade will continue to benefit anyway from traditional inter-company links, close geographic proximity and infrastructural constraints (transportation networks). To some extent, CIS states are likely to be "natural" trading partners. At least it will take time to decouple such ties even if they are not economically viable. Institutionally, it appears much easier for all CIS states to join the GATT framework if they commit themselves to strict MFN treatment in their trade policies. This is true, as non-discrimination is still the major pillar of the GATT, notwithstanding the options which Contracting Parties "in the stage of development" can use to apply for special and differential treatment under the 1979 Enabling Clause. There is some evidence that such treatment has often been a Pyrrhic victory for developing countries as it detracted policies from the target of efficient resource allocation. It goes without saying that anchoring MFN treatment in CIS trade policies has nothing to do with the privileged treatment of CIS exports by OECD member states or extending the individual OECD countries' schemes under the generalised system of trade preferences to CIS exports. Such treatment would be a unilateral concession which does not require reciprocity from

<sup>18</sup> Cf. Constantine Michalopoulos, David Tarr: Trade and Payments Arrangements for States of the Former USSR. Studies of Economies in Transformation, Paper No. 2, Washington D.C., The World Bank, 1992, p. 10.

CIS countries. One should, however, be cautious before engaging in preferential trading arrangements with non-CIS states such as a Black Sea Preferential Trading Area or entering existing schemes like the ECO (Economic Co-operation Organization: Turkey, Iran, Pakistan). Again, the experience of developing economies suggests slow progress, lots of distributional conflicts, and high costs of market segmentation. On the other hand, there is little to argue against regional co-operation (for example, a Black Sea Economic Co-operation) to economise on the joint production of goods of common interest (inter-country transportation networks) or to co-ordinate national policies which refer to cross-border mobile resources (joint marine resource management, for instance). *Regional trade integration* should clearly be distinguished from *regional economic co-operation*.

□ The second crossroad decision to be taken refers to tariff binding versus unilateral, reversible tariff cuts. Again, the experience of developing economies is worth recalling. Irrespective of the Uruguay Round negotiations, many economies removed NTBs and lowered tariffs unilaterally during 1986 to 1991, as part of structural adjustment programmes but also independently of external pressure.<sup>19</sup> Often, the idea of receiving "credit" for such unilateral endeavours has been an important motive. It may reflect the disenchanting experience of many Contracting Parties that their bargaining power in the GATT is not high because of the mercantilist behaviour of large partner countries and the importance of the "principal supplier rule" (negotiations are made preferably with those countries from which one can expect the maximum counter-concessions in exchange for one's own concessions). As many such unilateral cuts exceed the one third tariff cut target of the Uruguay Round, the "bound" rates are higher than the actual rates charged. Thus, the Contracting Parties would have still options to raise tariffs without violating commitments or having to compensate partner countries.

For Russia and the other CIS states, "binding" a specific level of tariffs would be helpful to establish confidence and credibility in the international arena concerning the seriousness of reform commitments. Furthermore, it would facilitate and accelerate negotiations on accession to the GATT. Together with the MFN commitment, it would be an important

element in reducing the volatility of the reform process in many CIS states. Early binding could also contribute to the stability of a uniform tariff structure. It depends on the level of bound tariffs and the time when binding is announced whether there would still be scope for raising actual tariffs. If binding is announced simultaneously with the introduction of an import tariff schedule, this must not necessarily mean that CIS governments would lose the instrument of tariff increases under emergency conditions. Imposing surcharges under the appropriate balance of payments provisions of the GATT would still be legal even if tariffs are bound.

Overall, both crossroad decisions concerning the international perspective should be taken with the crucially important objective of injecting stability, credibility and predictability into the trade policy regimes of the CIS states. International commitments such as MFN treatment and tariff binding are important transmission mechanisms to achieve this target.

#### Implications for Others Republics

Economically, Russia constitutes a "large country case" for many smaller CIS states relying on access to Russian goods, services and loans. By its own behaviour, it exerts an important influence on prices and policies in neighbouring countries. Optimum tariff theory, for instance, would suggest that if Russia were a monopsonist for the countries, its trade policy could then force the countries to incur terms of trade losses if Russia raised import tariffs carried partly by export price declines in the neighbouring states. There are other transmission mechanisms of Russian policies onto neighbouring states via technology transfer, security, transit trade, and finally, monetary integration. The latter is of prime importance as has been shown by the failure of many CIS states to delink from Russian monetary policies and the Russian currency regime by introducing their own currencies to replace or compete with the Russian rouble. In spite of severe monetary imbalances in Russia, the rouble remained the main currency for transactions and resort. Rouble zone disintegration soon came to a standstill and was reversed. Major signals of this renaissance of the rouble zone have come from the monetary union recently negotiated with Belarus. This agreement is reported to be followed by other similar bilateral agreements.

It is fairly obvious that monetary integration affects real sector integration, as has been shown by the mid-1994 decision on a free trade area between Russia

<sup>19</sup> Cf. GATT: Document TD/TC/WP(91)58, Geneva, 28 October 1991.

and Belarus. Again, other former republics are expected to follow and further steps towards customs unions are within reach. Free trade areas and customs unions impose binding constraints upon the national trade policies of the former republics. Compared to the customs unions, however, free trade areas have less far-reaching implications. A free trade area offers former republics easier access to input sourcing in Russia provided that balance of payments constraints are not binding.<sup>20</sup> So does the area with respect to supply directed to the Russian market. National sovereignty in tailoring an own tariff is *de jure* maintained. Rules of origin which are usually a main element of trade intervention in free trade areas with strongly varying national tariffs will become relevant only if the former republics are able to enforce such divergence. Given the large country case, this is unlikely. Hence, trends towards policy harmonisation are expected to become powerful in a free trade area and may soon lead to the formation of customs unions. Under a customs union, two scenarios are likely. Either Russia enforces its trade policy on member states, in which case an average Russian tariff level based on intermediate and capital goods and extended to the entire customs union may sharpen adjustment pressures in those countries in which the dominance of finished goods industries would have suggested a higher average national tariff than the Russian tariff. Lobby groups in the CIS states would seek for compensation to be granted, for instance, in the form of guaranteed access to subsidised energy from Russia. Alternatively, Russian pro-protectionist lobby groups would urge the application of higher non-Russian tariffs to Russian industries. Such groups would be supported by the increasing size of trade policy jurisdiction. Compared with separate national customs territories, a customs union would offer more gains from protectionist lobbying expenditures relative to free trade expenditures and the equilibrium tariff would increase. Countervailing lobby activities could then be expected to come from downstream industries, the non-industrial sector and net importing regions.

### Conclusions

Endogenous tariff theory offers a number of useful hypotheses to explain both level and structure of Russian trade protection during a period of transition in which lobby groups contribute resources to shift the hardship of transformation partly to the trading partners and partly to other groups in the economy. Moreover, as the size of political jurisdiction also

exerts influence on the level of protection, endogenous tariff theory would also predict different levels of protection for Russia on the one hand and a customs union between Russia and other CIS states on the other hand. As concerns the tools, the theory would hypothesise strong preferences for QRs in line with the legacies of a command economy and central planning in physical units.

However, the specific conditions of transformation in Russia and other CIS states suggest that two qualifications should be made. First, the collapse of vertical hierarchies in Russia impedes enforcement of policy measures and submits any investment in lobbying to substantial amounts of uncertainty. Future gains have to be discounted significantly more than in western economies with a stable enforcement pattern. Under uncertainty, lobbying groups might contribute to both actual and potential decision-makers and/or to different regional layers, e.g. the federal government and the representatives of *oblasts* and republics. That means that although the lack of institutional order and transparency may help lobby groups to obscure their activities and to save costs, it is very likely that the lack of transparency has gone beyond the optimum level and now constitutes a barrier.

Second, rent-seeking is known to be income-elastic, i.e. rents as a share of GDP tend to be positively related to per capita income (and government size). Returns to lobbying must be paid out of the returns of the productive activities. Given this link, there is a built-in tendency to limit the levying of such "rent tax" on the productive use of factors by means of the very low tax base in Russia and the other CIS of states.

To sum up, endogenous tariff theory offers different strands of causation to explain Russian trade policies. The hypotheses derived from the theory are ambiguous and suggest that countervailing mechanisms are effective. In particular, there are effects influenced by the low level of productive activities, the legacies of central planning, and the direction of changes in the economic and institutional parameters underlying the theory.

However, even if the returns from lobbying are lower than in other economies enjoying institutional stability, the costs may be still high enough to discourage domestic investment, to fuel capital flight and to deter foreign investment.

<sup>20</sup> This is the main incentive for joining a monetary union with Russia, apart from debt relief.