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**SECOND LEVEL REGIONAL
POLICIES IN THE RUSSIA
FEDERATION AND THE
MULTILATERAL TRADE RULES
AFFECTING SUCH POLICIES**

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1. Executive Summary

This paper begins by setting out the constitutional framework of the Russian Federation and demonstrates that, over time, Russia's regions are beginning to exert greater control over their internal economic and commercial relationships. In this context, the theoretical underpinnings of second level economic policies are considered. It is noted that the increasingly active role of regional authorities in determining economic policy is, particularly in times of crisis, understandable, though not particularly efficient or effective. Indeed, these policies can have serious implications for macroeconomic stabilisation. Finally, the implications such policies have for Russia's accession to the WTO are highlighted and a distinction is drawn between measures which are expressly forbidden as a consequence of multilateral trading rules and those which are subject to reduction commitments or need to be notified for transparency reasons.

2. Background

The political and administrative organisation of federalism in Russia is a unique blend of *de jure* federative organisation and *de facto* elements of confederation and of a unitary state, an organisational blend that reflects the country's size, diversity and Soviet legacy. Russia's subnational governments consist of 89 regions which have very different administrative and political status. The Federation comprises 21 republics, 50 oblasts, 6 krais and 10 autonomous okrugs, plus two metropolitan centres (Moscow and St Petersburg). This group is collectively known in the Russian Constitution as the 89 "subjects of the federation." Each of the 89 regions are further subdivided into more than 2,000 districts (municipalities and rayons). All local administrations within a region are technically responsible to the regional government and are subject to regional regulations, though each local administration has an independent budgetary and administrative status.

The Federation Treaty of 1992 provides the framework for federal-provincial relations. This defines the division of sub-federal and federal divisions of responsibility as long as these do not contravene Russia's constitution. Article 71 of the constitution reserves exclusive rights for the federal authorities including, inter alia, the authority of the central bank to issue money, financing of the court system from the federal budget, transportation and communication links across regions, the development and control of energy. The constitution also details (Article 72) joint federal and sub-federal management of issues ranging from international relations and taxation to the selection of law enforcement officials. The Government's political responsibility to the regions is also spelled out in the constitution. In effect, this is to ensure that all 89 provincial administrations are "equal in their relations" with the central Government."

While what has been outlined above appears straightforward, the situation is complicated somewhat by the fact that over 30 regions have drawn up their own constitutions and several more are in the pipeline. Most of these are believed to directly contravene the Federation's own constitution. Notwithstanding this, none have been tested in court. In addition, a further eighteen regions have signed 'bilateral' treaties with the central Government. Most of these are modelled on the 1994 treaty signed between Tatarstan and the central Government. Among other things, this provided for a special tax arrangement with the central authorities and allowed Tatarstan to develop its own 'foreign economic policy.' In effect these 'special arrangements have meant that a significant number of regional authorities have developed their own methods and mechanisms for regulating internal trade.

The separate arrangements outlined above do appear to undercut the Federal Government's claim that Russian law can be consistently enforced across the country. The Government recognised this as early as 1991, by establishing the office of Presidential Representative to be the 'eyes and ears' of the central authorities in the regions. The success of this particular policy has, however, been rather mixed as the ongoing difficulties in the Russian Far East illustrate. Indeed, the increased independence of regional administrations and the lack of central Government oversight has seen the rapid rise since 1992 of what may in economic terms be described as a regional policy administered at the sub national level. In essence, this has involved the spatial targeting of assistance/regulation in sub national areas that are perceived to be under-performing over a range of economic indicators. Sub-national measures may also be implemented in an effort to protect local living standards by, for instance, preventing the out flow of subsidised products to neighbouring regions where market prices prevail.

In common with most areas of economics, there are unresolved debates in the underlying theory,¹ but an assessment of regional economics in Russia is further burdened by the unreliability of data and the unresolved debate at the Centre as to the appropriate geographical level of application. Some economists take the view that extensive regional policies directed either by the Centre or indeed by the regional administration are unnecessary and even harmful, because they impede the operation of the market and perpetuate a culture of dependency with serious macroeconomic implications. Others argue that, for microeconomic reasons, regional policies can play a crucial role in the development of regions with or without intrinsic economic advantages and that these can be immensely successful. There are therefore essentially two main approaches: the free market/neo-classical approach and interventionist theories, both of which draw on Ricardo's principles of comparative advantage.

¹ The literature on regional policy is extensive. Minford and Stoney (1991), however, offer arguably the most useful outline of the key issues.

According to the theory of comparative advantage, regions should specialise in those areas of production in which they have a natural advantage over other areas. In this case, Krasnodar should focus on its comparative advantage in agricultural production, while Kamchatka should focus on natural resource utilisation. The comparative success of some regions is often explained therefore by differential resource endowments, though this approach may only take one so far. Indeed, Russia's regions provide a useful case in point. The differences in real incomes between the regions of Russia is not determined by the difference in resource endowments, but by what Kaldor² has called the "unequal incidence of development in industrial activities." The major flaw in comparative advantage theory is that manufacturing capacity and services are not in fact natural endowments.

Mainstream economic theory relies heavily on freely functioning markets for its policy prescriptions. Where these do not exist, it is contended that they should be created. Wage flexibility and labour mobility are believed to be the key to solving regional problems. The argument runs that capital will be attracted to areas where it can enjoy a greater share of the rewards. This means that labour must be prepared to take less so that wage 'flexibility' is a question of reducing the reward to labour in the production process. One way of avoiding the market which is commonly utilised in the Russian context is for regional administrators to provide subsidies or other incentives for production to ensure that capital does not shift to other regions, or indeed close down altogether. The free market approach also suggests that labour should be encouraged to seek work outside its own region. Regional policy in so far as there is one should be directed only at removing obstacles to the free movement of labour. It is immediately apparent that this model does not tell us much that is useful about the approach regional Governments in Russia have adopted to local economic conditions.

The second approach is a more interventionist one and better explains the manner in which Russia's regional authorities have become involved in regulating internal economic relations. The model has its foundations in the work of Myrdal (1957) and of Kaldor (1970) and may be characterised as the school of 'cumulative causation.' The argument is that a region possessing an initial advantage in a particular area will be able to sustain this and even increase its lead through increasing returns to scale. These are not just the economies of large scale production commonly considered, but the cumulative advantages accruing from the growth of industry itself - the development of skill and know-how; the opportunities for the easy communication of ideas and experience; and the opportunity of ever increasing differentiation of processes and specialisation in human activities. This perspective is consistent with Verdoorn's law which states that the rate of productivity and the rate of growth of output are positively related. This suggests that growth is a circular and self-sustaining process, meaning that initial disparities in growth become exaggerated over time:

² Kaldor (1970, p. 339).

success breeds further success, while failure breeds further failure. If a region like Saratov establishes an advantage in a processing activity, then the gap between it and its rivals can widen and the gains may become cumulative. There is therefore a virtuous spiral of growth and a vicious spiral of decline. The argument suggests that, in the absence of an active regional authority, unsuccessful regions will sink, while successful regions with activist Governments will swim. In the case of Russia, regions like Novgorod, Moscow, St Petersburg etc, already have various advantages over the regions in the Russian Far East or the far North in terms of manufacturing and processing. One could argue that the active support of local authorities would tend to maintain or enhance this advantage at the expense of poorer regions. This is an opposite conclusion to that of the free market approach and, not surprisingly, is used to justify a different more interventionist approach to regional development.

The problems with this approach are numerous. The international evidence is mounting that regional policies, particularly those which distort market signals (ie protectionist measures) can substantively hinder macroeconomic development by restricting efficiency and effectiveness. In effect, the international evidence, both theoretical and empirical suggests that activist regional policies may in the short run improve a region's level of economic development, but in the medium to long term not only will the region's overall development slow down, but more importantly, the efforts at the Centre at macroeconomic stability and improving efficiency and effectiveness will be significantly hampered.³

In the context of a changing political system and the financial crisis in August 1998, the evolution of inter-governmental economic and trading relations in Russia has been a rapid and somewhat chaotic decentralisation of economic and commercial responsibilities. This has had serious implications for commercial activity at the sub-national level.

3. Multilateral Trade Rules Affecting Sub-National Entities

In the trade technician's jargon, sub national measures are known as second level obligations. These are the expectations under the various WTO Agreements of central governments in respect of provinces or regions constituting their jurisdiction.

The key clause of relevance to this discussion is contained in GATT Article XXIV: 12 which defines second level obligations thus:

³ The literature on this subject is extensive. The theoretical and empirical justification for opposing second level economic policies because of their impact on overall macroeconomic conditions is well covered by, inter alia, Gudgin (1995, 18-63) and Swales (1997, 73-85).

"Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories."

This, however, is not the only reference to sub national obligations in the WTO agreements. Such commitments are contained in Article 3.1 of the TBT, Point 14 of the Understanding on the Interpretation of the GATT 1994 related to paragraph 12 of Article XXIV, Article 1 of GATS, Annex 3, section 3 of the Agreement on Agriculture, Article 13 of the SPS Agreement and Article 6 of TRIMS.

This is an obligation which WTO member states take extremely seriously. It is an issue which Russian negotiators have only recently begun to focus on in any substantive fashion. It is important in this context to understand precisely the obligations the various WTO Agreements impose on the membership. The Agreements provide for a number of permissible measures which are subject to reduction commitments over a specified period. They also prohibit a number of activities, while others are allowed but must be registered with the WTO for transparency reasons. This is an important distinction.

Additionally, according to the terms of the Agriculture Agreement, all non tariff barriers (NTBs) on agricultural products, such as quotas and import restrictions⁴ must be converted into tariff equivalents (ie customs duties) and bound accordingly in members' schedules. Members are not allowed to introduce or re-introduce any measures of the type subject to tariffication. Conversion to a tariff-based system must reflect the difference between the average internal prices and representative average world prices.

The WTO Working Party in Geneva which is considering Russia's accession has received considerable evidence of the kinds of restrictions faced by companies operating at the sub federal level in Russia. These range from price controls, additional standards and certification requirements, re-establishment of monopoly purchasing, uneven enforcement of customs regulations and so on. In addition, there has been a gradual increase over the past three years in sub national support for both the industrial and agricultural sector. In this context, regional officials in the Russian Federation will be expected to re-examine their internal trading regime. There is evidence in a number of OECD papers on the subject that Russia's regions have in place measures which are expressly forbidden under WTO rules. Detailed work undertaken on the subject suggests that regional price controls are in place in some regions. Khabarovsk Kray for instance, has a Regional Pricing Policy Committee which last year issued Decree Number 234-I specifying the maximum wholesale and retail prices for

⁴ A number of the OECD papers on Russia's regions, as well as a New Zealand paper on sub federal restrictions list a number of quantitative restrictions which will need to be eliminated by the regions before Russia joins the WTO. The most obvious example of difficulties in this area is Bashkortostan which has in place no fewer than eleven quotas on agricultural goods (OECD 1999, p. 9).

agricultural products. For instance, prices for a kilogram of butter may not exceed US\$0.90 (regardless of currency fluctuations).⁵ In the same region, Governor Ishaev issued a resolution imposing an effective 'export ban' on "strategic products." This included a blanket prohibition on the movement of food stuffs (meat, cooking oil, flour and dairy products), fuel and oil out of the region. The Head of the Regional Interior Affairs Directorate in Khabarovsk, Anatoly Zolotaryov has been charged with reporting directly to the Governor on a monthly basis with a list of the number of vehicles detained. On 7 September last year, the Regional Administration of Nizhny Novgorod announced price limitations on agricultural goods, including poultry, dairy products, meat, grain etc. The new prices would be set "according to the ability of the local population to pay, not according to world prices" was how one local politician, First Deputy Governor Batyrev, described the new policy.⁶ Even St Petersburg, long a model for a liberal trading regime in Russia, has instituted a range of additional barriers prohibited under the SPS Agreement and the Agriculture Agreement.

Additionally, New Zealand has evidence that a number of other regions have in place agricultural subsidies which will need to be included in Russia's agriculture support tables and are subject to the usual reduction commitments on accession. In the region of Vladimir, local dairy farmers receive a direct subsidy of US\$0.40 from the local administration per litre of milk produced. This system has been in place since 1996. The local Administration in the Jewish Autonomous Region is providing soy bean farmers with a direct "payment" in the form of free or sharply discounted fuel and fertilisers. This system has been in place since 1995. Grain farmers in Krasnodarsky Kray receive US\$0.10 from the local administration for every loaf of bread produced by the local (state owned) bakery. In Nizhny Novgorod agricultural subsidies comprise 10% of the regional budget. In 1998 about 80% of this was spent (this is a greater proportion than other regions manage). According to the local Administration, such subsidies contribute about 2.5 or 3% of the total value of all agricultural sales. In 1998, some 10-11% of the Republic of Tatarstan's budget is committed to agricultural subsidies (this is down from 25% in 1997). About 80-90% of these commitments are actually paid out. 50% of the agricultural support goes to fertility programmes (seeds, fertiliser, pedigree breeding); 30% to modernisation programmes (eg. long term no-interest credits); some scientific research; and some subsidies direct to farmer, especially to producers of milk and poultry. These subsidies account for 20% of the final value of milk products, and 25% in the case of poultry.⁷ The important point about all of these programmes is that none of them appear in any of the relevant documentation tabled by the Russian Delegation to the WTO. Under the terms of the Agriculture Agreement and the Secretariat's Technical Note ACC/4, all relevant information about subsidy programmes at the sub-federal level needs to be declared.

⁵ Kommersant Daily 29 September 1998

⁶ Kommersant Daily 14 September 1998

⁷ All of the examples are drawn from the New Zealand paper circulated in December 1998 at the WTO Working Party considering Russia's accession and an updated version thereof from Vitalis (1999).

Finally, a number of the regions have provisions or programmes such as Green Box measures or similar which, while not in violation of any specific Agreement, will need to be notified to the central Government and, via the Government, to the WTO Working Party in Geneva. These are not isolated incidents. Indeed, in December 1998, New Zealand circulated evidence of no fewer than forty violations of WTO Agreements to members of the Russia WTO Accession Working Party. The OECD appended this paper to its own report on trade distorting practices in the Russian Federation.⁸

Some of the key issues for consideration by the Russian federation include the following:⁹

- **How aware are regional officials of the WTO Agreement on Subsidies and Countervailing Measures when drafting policies to aid local producers?**

The Agreement on Subsidies and Countervailing Measures establishes three categories of subsidies and the procedures to be followed in dealing with them. The three categories are *prohibited subsidies* (subsidies contingent on export performance or the use of domestic rather than imported goods); *actionable subsidies* (subsidies injuring the domestic industry of another member causing nullification or impairment of benefits or causing serious prejudice to the interests of another member); and *non-actionable subsidies* (subsidies which may be maintained by members). The Agreement details an accelerated timetable for dispute settlement cases arising from the application of the Agreement. It also sets out the conditions under which countervailing duties may be imposed. It does not apply to agriculture subsidies which are covered in the Agriculture Agreement.

It is clear that most regional administrations are not aware of the Agreement on Subsidies and Countervailing Measures. This is rather worrying. Any regional subsidy which falls under the terms of the first two categories could have serious implications for both the region and the central authorities. The third category of subsidies still needs to be notified to the WTO for transparency reasons.

- **How might such aid programmes distort trade with other regions in Russia?**

It is clear that the kind of assistance provided in many of Russia's regions distort internal trading patterns. Indeed, the use of subsidies in Russia is extremely inefficient. Distortions in a local economy in the form of regional funding for particular activities causes

⁸ *ibid.*

⁹ The subsequent issues posed were originally set by the OECD to guide the 11-12 March 1999 Seminar's discussion.

capital/investment to flow into inefficient industries or sectors. Such subsidies either diminish or contribute little to a local economy's overall growth pattern.

Having said that market failure resulting in incorrect price signals could theoretically justify some form of local intervention. However, when market failure results in prices that do not reflect the true opportunity costs of an activity, international experience suggests that it is highly unlikely that a local administration would have superior information about opportunity costs or the ability to tailor a set of subsidies that result in "correct" price signals and an efficient allocation of resources.

- **How widespread are regional product testing and certification centres? What type of mutual recognition arrangements exist among regions? In what ways might regional product testing and certification become a burdensome trade barrier?**

The kinds of standards and certification procedures being worked on in the Sverdlosk oblast¹⁰ (the attempts to introduce ISO 9000 series quality controls) are a helpful illustration of how regional product testing for export may add value to a good. On the other hand, there are a number of regions which have introduced their own testing laboratories and demand that foreign products meet a local standard which is often more rigorous than the national standard. There have been other cases in the Russian Far East, for instance, where the testing of fruit and vegetables is undertaken on precisely the same terms as the national requirement. In effect, the exporter has to pay twice for the same battery of tests. Indeed, the evidence suggests that such regional product testing facilities are quite extensive and are on the increase.

- **What type of mutual recognition arrangements exist among the regions?**

There are currently no mutual recognition arrangements among the regions. Indeed, certification arrangements are frequently competing ones and one region will often not accept the testing regime of another. This is the case, for instance, between the testing regimes of Primorsky Kray and Kamchatka.

- **In what ways might regional product testing and certification become a burdensome barrier?**

¹⁰ Sub-National Legislative and Administrative Policies Affecting Foreign Trade: Sverdlovsk Oblast, OECD, November 1998, p 19

Clearly Russia will have a serious problem in the WTO context when it is discovered that regional requirements in some cases are more rigorous and more expensive than the national obligations. No foreign exporter wants to have to go through two testing procedures one more expensive and protracted than the other.

- **Which regional economic measures (financial aid and subsidies, standards and certification, state orders, anti-monopoly policy, customs administration, environmental policy etc) appear to be most problematic for establishing WTO-compatible trade policy in Russia?**

During the December 1998 meeting of the Russia WTO Accession Working Party in Geneva, the Russian Delegation advised that work is under way in various Ministries to try and establish what precisely is going on at the regional level. This work is specifically aimed at identifying those practices which are actionable under WTO rules, and those which are notifiable.

- **How might the abuse of a monopoly position function as a trade barrier at a regional level?**

This is a somewhat complicated issue. In many regions the local Administration itself can act as a monopoly through the role it plays in local purchasing and supplying of product for local institutions. There is evidence that tenders for specific orders are in fact closed to foreign companies. In addition, sudden releases of local Government stock can depress local prices, an issue we are having to confront in the context of the regional distribution of food aid. This can distort local trading patterns and is obviously unacceptable. Government competition policies are now an integral part of the WTO process and this is an issue that will bear closer examination.

- **How might such abuses be corrected?**

Clearly this will be a difficult matter. The Government's Anti-Monopoly Committee is a useful mechanism in this regard, though currently its decisions have proven difficult to enforce. It is worth highlighting that trade and competition is one of the new issues now under discussion in multilateral trading forums, but already a negotiating subject at the time of the Havana Charter¹¹. This "new issue's" importance derives from increasing recognition that the benefits of trade liberalisation internationally are being negated by domestic

¹¹ The Havana Charter was the final draft of a charter for the International Trade Organisation adopted in Havana, Cuba in 1948.

measures inimical to an open competitive market environment. Such barriers may take the form of private anti-competitive behaviour, abuse of a monopoly position or dominant supplier powers and inappropriate regulatory frameworks, all of which are issues of concern in the Russian Federation. In Russia, the situation is made worse by weak competition policy and its inadequate coverage of domestic economic activity. It is obviously not desirable for Russia to be in a situation where such abuses are not corrected before accession and the Federation is taken to Dispute Settlement.

- **How are the rights to establishment managed at the regional level?**

This involves the right of a commercial entity in another country to establish itself for the purpose of producing for the local market or importing from another economy. Such establishment normally entails some form of investment, including acquisitions, mergers and takeovers. The right to establishment is an important component of GATS as well which enforces the right to a commercial presence of any type of business or professional establishment within the territory of any member of the GATS for the purpose of supplying a service. This includes juridical persons, branches and representative offices. Russia's regions have a remarkably varied and complex system of registration and establishment. Indeed, the rights to establishment outlined by the central Government are often at odds with local requirements. This often poses significant and complicated issues for foreign companies that in effect have to go through the protracted and expensive legal process twice.

4. Conclusion

Regional policy in Russia has a long and controversial history. This paper has suggested that such policies are harmful to the economy as a whole in that they distort investment and trading decisions to such an extent that they weaken efficiency and cloud decision-making. Notwithstanding this, the evidence indicates that such policies are extant in the Russian Federation. The August 1998 financial crisis in Russia has highlighted this problem with numerous regions in the country imposing their own price controls, tariff barriers, new standards and certification requirements, strengthening monopoly situations, making the right of establishment more difficult and generally restricting rather than liberalising the internal trading environment. All of these issues have grave implications for Russia's accession negotiations. The paper has placed particular emphasis on the important distinction between measures which are expressly forbidden by multilateral trading rules and those which are subject to reduction commitments or need to be notified for transparency reasons. While there are clearly problems, it is better that these are identified and resolved before Russia joins the WTO.

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