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Sectoral Distortions and Service Protection in Russia. A Comparison with Benchmark Emerging Markets and EU Accession Candidates

by

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Abstract

Recent empirical research on efficiency gains for Russia from WTO membership concludes that service trade liberalization especially through allowing foreign suppliers to invest in Russian service industries promises the largest gains. This points to sizable efficiency deficits in the Russian service sector. This paper departs from the question whether both the Russian sectoral protection structure and the effective rates of protection (ERPs) differ from structures and rates in benchmark countries if tax equivalents for intermediate services are taken into account. The result is that almost all Russian service industries get effectively taxed and not protected once not only tax equivalents of intermediate goods but also those of intermediate services are included in ERP calculation. Variance among industries and peak taxes in service industries are significantly higher than in a median emerging country taken as benchmark. These findings support the key role of intermediate services liberalization for the expansion of a viable Russian service sector. Results from comparing Russian effective rates of protection with those of the EU accession countries Bulgaria and Romania are not inclusive. Tax levels of the two accession countries are also high and variant and thus cannot serve as a proxy for the "economic distance of Russia to Brussels". Lessons for European Neighborhood Policy point to the requirement for the EU to liberalize bilateral service trade (through mode 3 supply: commercial presence) on a *quid pro quo* base: without opening EU markets for Russian companies in specific services (i.e., energy distribution), Russia will probably not open its service sector for EU suppliers more than is required in order to comply with minimum WTO accession prerequisites.

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I.   Introduction

Today's Commonwealth of Independent States (CIS) economies are known to have inherited a widely distorted economic structure from their socialist past. While industrial activities under socialism were given numerous privileges and were released from hard budget constraints, service sectors were stigmatized as unproductive and did not play any significant role. That changed when market reforms were initiated. Budget constraints for the manufacturing sector were hardened gradually as well as shockwise from two sides. Trade liberalization exposed domestic output to international competition and domestic prices for inputs like energy have gradually approached world market level. As a result, many industrial activities collapsed. Extent and speed of market exit were accelerated by lack of a competitive supply of services. Such supply of intermediate services like banking and insurance, transport infrastructure and telecom could have helped to support reallocation of idle resources and to mobilize additional ones. New downstream manufacturing industries would have benefited from competitive intermediate services. So would have been the expanding service sector itself by absorbing relatively skilled labor and by giving incentives to skill formation. Yet, these services were neither in place nor on the way of being rapidly established in former socialist markets. One reason was that the political support for a service economy was almost entirely lacking in CIS economies, another one that governments in the post-socialist era feared to lose control over an emerging service sector and thus were less prepared to open domestic service sectors to foreign supply than to open the manufacturing sector. What contributed to the resistance of opening domestic service sectors to foreign supply was the fact that expanding foreign service supply would have required to dismantle restrictions against market access via allowing commercial presence (foreign direct investment) of service suppliers.

As a result, service industries in CIS economies like finance, utilities and infrastructure have remained lagers in policy reforms and structural change relative to the service industries in Central Eastern Europe and the Baltic countries (CEB) (EBRD, 2005: 8-9) but possibly also relative to manufacturing industries. The CEB countries benefited from a clear reform agenda thanks to the policy benchmarks set by the EU as a prerequisite for full EU membership (the *acquis communautaire* in general and the Copenhagen criteria in particular). Rules for market opening and sector-specific regulations affected the service sector as much as the other sectors and allowed foreign supply to operate in CEB service markets. In contrast, the institutional lock-in of CIS economies to the EU was and still is far less clear. Trade preferences combined

with technical, financial and economic co-operation in the context of partnership agreements and neighborhood policies comprise a vast gray area. It ranges between non-preferential most-favored nation treatment (MFN) on the one hand to be handled in principle by multilateral agreements such as the WTO accession and special benefits open to members of European Economic Area on the other hand. This gray area includes a blend of free trade area ingredients, factor mobility elements and policy co-operation projects.

As the anchor country for all other CIS countries, Russia deserves most attention. The emergence of a competitive service sector in Russia is essential not only for narrowing the income gap between CIS, the CEB and the EU but also for skill formation. Jensen et al. (2006, 2007) estimate that the largest welfare gains to Russia from WTO membership will derive from liberalization of barriers against multinational service providers. Markusen et al. (2005) complement such macroeconomic effects of opening the Russian service sector to foreign suppliers by pointing to real wage increases for skilled domestic labor due to the presence of foreign firms in the service sector. Hence, any service trade liberalization in CIS economies can also be expected to provide strong incentives for skill formation.

To begin with, this paper briefly introduces the importance of services for the extent and the direction of the protection structure (Section II). It then stylizes major facts on the effective rates of protection (ERP) in Russia (Section III) before comparing this structure with that of a median emerging market and the two most recent EU accession countries Bulgaria and Romania, always by highlighting the changes in the comparative setting if service intermediates are included (Section IV). Both emerging markets represented by the median country and Bulgaria and Romania serve as benchmarks or "normal patterns" for Russia. Section V is devoted to the issue whether the specific mode of supply 3 (commercial presence) can be identified as the cornerstone of Russian service restrictions as suggested in the Jensen et al. analyses. Again, mode 3 restrictions in Russia are compared to those in the benchmarks. In Section VI, some implications for European Neighborhood Policy (ENP) are discussed. Section VII concludes.

II. The Importance of Services in Determining Extent and Direction of the Protection Structure

To assess the effects of incorporating services as inputs for downstream manufacturing and services output, the effective rate of protection concept (ERP) in which differences between nominal and effective protection are determined by the difference between input and output protection can be helpful. With nominal protection rates (NRPs) rising with the stage of

processing (escalation effect), ERPs exceed NRPs and show to which extent domestic value added is subsidized. This is the well-known departure point for developing countries' critics against developed countries and their trade policies which protect their relatively labor-intensive industries by opening the wedge between high nominal protection of output and low nominal input protection. Alternatively, with input taxation higher than output taxation, ERPs turn negative so that downstream value added is taxed. After excessive import substitution strategies in the manufacturing sector of developing countries in the past, the agricultural sector in many developing countries has been a victim of effective taxation because of purchasing highly protected industrial products as inputs.

Until recently, services both as input and output were not considered in the ERP concept due to the lack of sufficiently reliable data on tariff equivalents for service protection. This has visibly improved thanks to in-depth data collection and the assessment of such equivalents at a disaggregated level in order to account for the heterogeneity of services[1]. Heterogeneity is not only due to the fact that because of different modes of supply protection can mean taxation of goods and services (modes 1 and 2) or taxation of factors of production like capital (mode 3) or labor (mode 4). What is equally important is that in many countries it is typical that barriers to services are non-discriminatory treating domestic and foreign suppliers the same way. Dismantling such non-discriminatory measures would give an impulse for the service sector itself rather than to downstream manufacturing only. The former would attract resources from the latter while the ERP concept would – under the assumption of service barriers equal to barriers against foreign service supply – indicate downstream industries to receive higher protection and thus attract resources. If downstream industries are service sectors benefiting from cheaper intermediate services, the two conclusions may reconcile: service sectors expand.

Empirically, there is the major critic that the limits inherent in a partial equilibrium analysis of the ERP like the zero elasticity of substitution assumption between inputs and primary factors prevent the analysis to be relevant for general equilibrium implications concerning the allocation of resources between sectors after changing the ERP structure due to liberalizing service trade. The concept is argued to be more appropriate for indicating the influence of protecting service inputs for downstream industries. It seems that in many developing countries service inputs enjoy higher protection than manufactured inputs (Langhammer 2007). That implies that once service inputs are included in the calculation of ERPs for

service and manufactured industries, ERPs for these industries either turn from positive to negative or negative ERPs rise. In short, to include services generally implies taxation rather than protection for those industries buying service inputs. This suggests a sizable competitive disadvantage for developing countries trying to penetrate into world markets with downstream labor-intensive goods on the one hand and to accelerate sectoral structural change beyond the manufacturing and agricultural sector on the other hand. Yet, the data also indicate that the level of barriers incurred by service protection varies significantly between countries and sectors.

It is from this level of empirical evidence where one starts when comparing the Russian protection structure with that of benchmark countries.

III. The Russian Protection Structure including Services: Where does the Country stand?

Over a couple of years, the OECD Trade Directorate has continuously collected data on the service intensity of production and tariff rates on output and input in the agricultural and manufacturing sector using the most recent version of the GTAP database version 6.2.[2] Service barriers are quantified by estimating tax equivalents for barriers in specific service sectors as taxes on output and exports. A first set of tax equivalents treats barriers as output tax equivalents for several service sectors and as output tax equivalents and export tax equivalents for other service sectors. A more recent second dataset distinguishes between barriers by modes of supply (the total of all modes being the aggregate) and explicitly estimates taxes on output for mode 3 (commercial presence) and the aggregate while mode 1 barriers against cross-border trade are portrayed as taxes on exports. ERPs are computed based on input-output-tables in the CGE framework and calculated in the usual way as the difference between the protected value added on the one hand (the difference between protected output and protected input) and unprotected value added relative to unprotected valued added. This difference mirrors the wedge between domestic and world market prices.
Table 1 reports the share of services in total inputs in agriculture, manufacturing and services for Russia and the three benchmark countries. To account for the variance of input shares within the three sectors, lowest, median and highest shares are displayed. Two findings are striking.

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[1] See for the various empirical approaches Findlay et. al 2000, Dihel, Dee 2006; Dee 2007 and OECD 2006. A major contribution to data collection stems from the GTAP database and recent updates (Dihel, 2005).
[2] For details see OECD (2006:9) and the previous OECD publications cited there. The G.2 version of GTAP database reports data for 2001.

Table 1   Share of Services in Total Input in Agriculture, Manufacturing and Services[1] in Russia, Emerging Markets[2] and EU 2007 Accession Countries, in percent

	Subsectors	Median Emerging Market	Russia	Bulgaria	Romania
	ranked by share of services	*share of services in total input*	*share of services in total input*	*share of services in total input*	*share of services in total input*
Agricultural Sector	lowest	13	17	9	14
	median	23	26	16	21
	highest	35	31	29	33
Manufacturing Sector	lowest	21	19	7	11
	median	27	38	15	21
	highest	41	63	25	42
Services Sector	lowest	44	15	25	31
	median	66	61	43	45
	highest	85	91	65	66

[1] Median from seven agricultural products (cereals, vegetables & fruit, oil seeds & plants, meat & fish, milk & diary, vegetable oils & fat, sugar), fifteen manufacturing industries (beverages& tobacco, food products nec, forestry & wood product, paper products, publishing, mineral products, textiles, leather products, chemical, rubber, plastic) and nine service industries (electricity, trade, sea transport, air transport, communication, financial services nec, business services, insurance, other services).

[2] Median emerging market from a sample comprising Argentina, Chile, Venezuela, Brazil, China, India, Malaysia, Thailand, Zambia, Egypt, Morocco and Tunisia

First, for Russia it is both the level and the variance of input shares within sectors which distinguishes the country from the benchmark countries. In manufacturing, the median industry absorbs 38 per cent of total inputs from service sectors with the industry with the highest share absorbing almost two thirds. These are the highest figures among the countries and by far the highest share of services in inputs emerges in the service sector itself. While this is true for all four countries, again the upper outlier is in Russia with more than 90 per cent (insurance).

Second, service input shares in the Russian median service industry in each of the three sectors are much closer to the benchmark of the median developing country than to either Bulgaria or Romania where the shares are generally lower. Assuming that by 2001 the two new EU members had already widely transformed their economies towards relatively undistorted structures prior to their membership, such high shares of services in total input as

in Russia and the lower shares in the accession countries indicate prices for services in Russia decoupled from world market prices due to lack of competition and closed markets.

Such discrepancies between Russia and the accession countries in particular should find their impact in the comparison between ERPs with and without intermediate services. We would expect that by including intermediate services in ERP calculation, the ERPs would move more strongly toward negative protection in Russia than in the other countries because of the expectedly larger gap between intermediate goods protection and intermediate service protection in Russia than in the other countries.[3]

In Table 2, ERPs with and without intermediate services are shown for Russia and the other countries again, as in Table 1, for the three sectors and for the median, highest and lowest industries within a sector.

The first result is common for all countries. Everywhere intermediates services are more highly protected than intermediate goods. Thus, ERPs shrink and often become negative once intermediate services are taken into account. Shifts from positive to negative effective protection after considering intermediate services can be observed in the median manufacturing industry of emerging markets and in Romania. In the Russian median manufacturing industry, ERPs shrink to zero.

Second, in the manufacturing sector, the largest disparity between industries is in Russia. With or without intermediate services, ERPs range from more than 30 per cent protection to – 40 per cent taxation. This suggests a very high intra-manufacturing degree of discrimination between the sub-sectors. Interestingly, Bulgaria and Romania show similar levels of sub-sector disparities though this does not seem compatible with EU policies aiming at a uniform protection structure.

Third, as can be expected from the importance of services as inputs for other services, the service sector itself suffers most from service protection. Its level of implicit taxation due to taking the protection rates of service inputs into account is the highest. This sectoral distortion benefiting the manufacturing sector which has already existed before considering service inputs gets larger with service inputs. Again this holds for all countries not only for Russia.

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[3] That assumes that intermediate goods protection in Russia is by and large at the level of intermediate goods protection in the other countries.

Table 2   Estimates on Effective Rates of Protection (ERP) in Agriculture, Manufacturing and Services[1] in Russia. Emerging Markets[2] and EU 2007 Accession Countries with and without Service Intermediates, in percent

		Russia		Median Emerging Market		Bulgaria		Romania	
		Without intermediate services	With intermediate services	Without intermediate services	With intermediate services	Without intermediate services	With intermediate services	Without intermediate services	With intermediate services
Agricultural Sector	Lowest	-3	-7	-5	-11	-13	-15	-10	-15
	Highest	+24	+19	0	-5	+2	-2	+8	+6
	Median	+3	+1	-4	-8	-3	-8	+2	-5
	CV[3]	1.3	3.2	-1.1	-1.0	-1.3	-0.4	4.7	-1.3
Manufacturing Sector	Lowest	-40	-41	-17	-21	-7	-12	-17	-20
	Highest	+35	+33	+6	+6	+17	+15	+34	+28
	Median	+3	0	+3	-2	-3	-6	+1	-4
	CV[3]	11.8	29.4	1.7	-1.8	-4.3	-1.8	8.9	-3.9
Service Sector	Lowest	-2	-36	-6	-28	-7	-92	-5	-29
	Highest	+1	+11	-1	-3	-1	-13	+1	-5
	Median	-1	-11	-3	-13	-3	-53	0	-12
	CV[3]	-0.8	-1.0	-0.8	-0.8	-0.5	-0.5	-1.8	-0.6

[1] Median from seven agricultural products (cereals, vegetables & fruit, oil seeds & plants, meat & fish, milk & diary, vegetable oils & fat, sugar), fifteen manufacturing industries (beverages& tobacco, food products nec, forestry & wood product, paper products, publishing, mineral products, textiles, leather products, chemical, rubber, plastic) and nine service industries (electricity, trade, sea transport, air transport, communication, financial services nec, business services, insurance, other services).

[2] Median emerging market from a sample comprising Argentina, Chile, Venezuela, Brazil, China, India, Malaysia, Thailand, Zambia, Egypt, Morocco and Tunisia

[3] Coefficient of variation

Source: OECD (2006). Own calculations

Fourth, while the traditional pattern of distorted internal terms of trade to the detriment of agriculture and to the benefit of the manufacturing sector shows up for the median emerging market, protection rates for the agricultural sector are moderate relative to the manufacturing sector. Surprisingly, on average for Russia, internal terms of trade do not seem to be distorted against the agricultural sector. In total, compared to the manufacturing and service sector, the agricultural sector seems to be least affected by high protection of service activities.

As intermediate findings from these stylized facts one can conclude that it is the Russian service sector which appears to collect the largest gains from lowering protection rates for intermediate services. This would be specific Russian result.

IV. The Sectoral Protection Structure with and without Intermediate Services: Comparing Russia with Benchmark Countries

The above summary statistics in Table 2 points to large industry-specific variances in Russian rates of protection especially when intermediate services are taken into account. Figure 1 disaggregates this information by industries in the manufacturing and service sector for Russia and the two benchmarks with and without taking service intermediates into account. Distortions are understood as deviations of ERPs from neutrality (ERP=zero).

The following results deserve attention:

- Russian manufacturing industries face strong distortionary treatment regardless of whether service intermediates are taken into account or not. The highest inter-industry differences arise in manufacturing with leather products enjoying effective protection above 30 percent while electronic equipment is discriminated against by 40 percent.

- Given large inter-industry variation of ERPs between the manufacturing industries in both directions (protection and taxation), the ERP for the median Russian manufacturing industry mirrors a leveling effect. Its rate of 3 per cent is not far above the neutral level.

- The median emerging economy shows a much more undistortionary structure of protection than the two accession countries. This is somewhat unexpected viewed against the high degree of heterogeneity among the emerging economies.

- The Russian service sector seems a case sui generis. Excluding service intermediates, expectedly, most Russian service industries are discriminated against. However, this implicit tax is found surprisingly low, not far from neutrality. Yet, once intermediate services are taken into account, changes in ERPs become very notable in all industries and most notable for Russian the services. This is not only due to the fact that the median Russian service industry spends much more for purchases of services than the manufacturing sector (and agricultural sector) and also much more than service industries in the benchmark countries. What matters more is that Russian intermediate services are seemingly so much more highly protected (and thus so much more inefficient) than final downstream services so that all ERPs for the latter (except for business services) become strongly negative indicating a high implicit taxation of final service industries[4].

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[4] The 2006 OECD publication (ibid) notes that for a number of service industries tax equivalents are unavailable. For the Russian median service industry, estimates on such equivalents have only been available for two thirds
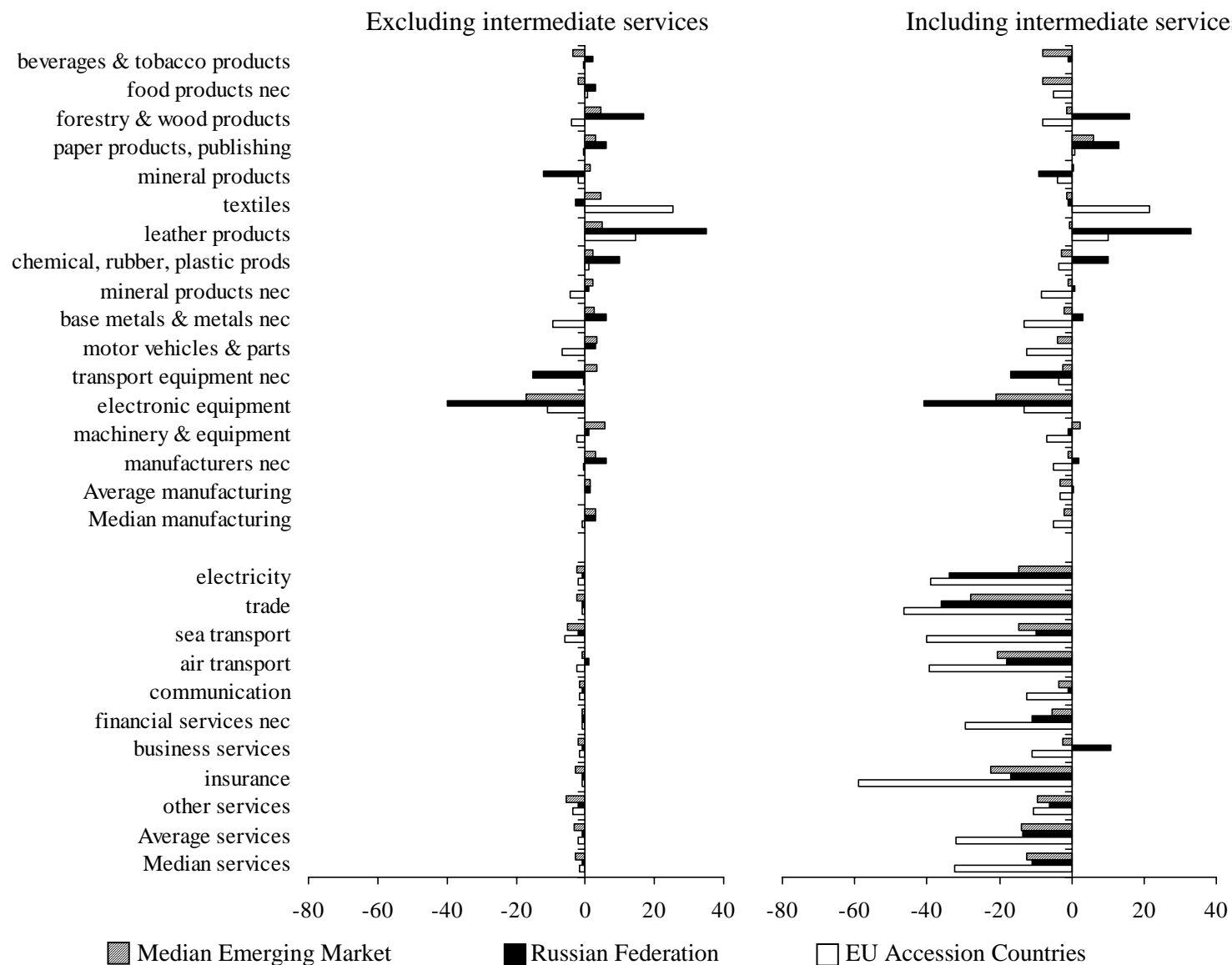
- In addition to the high level of implicit taxation of Russian service activities due to high protection of service intermediates, intra-services variance in protection increases strongly after taking account of intermediate services. This is a further support for arguing that the main source of intra-sectoral policy discrimination in Russia is rooted in the protection of service activities in general and the variance in particular.

- With respect to the direction of changes, Russia is not an outlier when compared to the two other benchmarks. The direction of changes in ERPs after introducing service intermediates is the same in the emerging economies and Bulgaria/Romania and – as far as the service sector is concerned – even more distinct in the accession countries.

In brief, relatively little is changed in the structure and the magnitude of protection in Russian manufacturing industries once service inputs are included. Effective protection of these industries basically stems from the gap between final goods protection and intermediate goods protection. But much is changed for the protection of Russian service industries if ERPs are calculated including intermediate services. Especially the electricity, trade, transport and insurance industries get strongly taxed once they purchase intermediate services. Except for electricity where the share of services in total inputs in Russia is moderate (15%), all other service industries are heavily dependent on service inputs These sectors incur major efficiency losses which are carried over to the Russian consumers as well as industries which demand services as inputs.

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of all intermediate services sold to final services. Thus, following the OECD, it is likely that the existing data underrate the true extent of the taxation effect arising from including intermediate services and their tariff equivalents.

Figure 1 — Distortions of the Effective Rate of Protection in the Manufacturing and Services Sector of the Median Emerging Market, Russia, and EU Accession Countries, Excluding and Including Intermediate Services

Excluding intermediate services   Including intermediate services

beverages & tobacco products
food products nec
forestry & wood products
paper products, publishing
mineral products
textiles
leather products
chemical, rubber, plastic prods
mineral products nec
base metals & metals nec
motor vehicles & parts
transport equipment nec
electronic equipment
machinery & equipment
manufacturers nec
Average manufacturing
Median manufacturing

electricity
trade
sea transport
air transport
communication
financial services nec
business services
insurance
other services
Average services
Median services

-80 -60 -40 -20   0   20   40   -80 -60 -40 -20   0   20   40

▨ Median Emerging Market   ■ Russian Federation   □ EU Accession Countries

Source: See Table 1. Own calculations.

This leads to the preliminary conclusion that any lowering of service protection are likely to trigger larger effects on resource allocation in the Russian service sector in terms of expanding this sector than on downstream manufacturing industries.

Are differences in the protection *level* between Russia and the two benchmark groups large enough to reject the hypothesis of equality of median protection rates with and without intermediate services? In other words, is the Russia level of protection special? Using the Wilcoxon/Mann-Whitney Test for equality, differences in the median protection rates in manufacturing between Russia on the one hand and the median emerging market and the accession countries, respectively, are found not high enough to accept the equality hypothesis regardless of whether intermediate services are included or not. Here, Russia by and large seems to have similar levels of ERP rates. Yet, this only holds for manufacturing industries. In the service industries, Russia' protection level in fact is special. The equality hypothesis has to be rejected if ERPs without service intermediates are compared between Russia and the median emerging market and if ERPs including service intermediates are compared between Russia and the accession countries.

Apart from the sectoral protection *level*, the comparison of Russian ERPs to those of the benchmark countries invites the question whether also the sectoral *structure* of ERPs in Russia is special. Are those industries which are highly protected in Russia the same as those protected in the benchmark countries and does a possible similarity of protection change if intermediate services are taken into account? Spearman rank correlation suggests that across all sectors (agriculture, manufacturing and services), the Russian protection structure is in fact significantly (5 per cent level) similar to that of the median emerging market but not to Romania/Bulgaria. Similarities increase when intermediate services are taken into account and then also similarities between the protection structure of Russia and the accession countries turn significant.[5] Interestingly, however, this result is not driven by similarities of the sectoral protection structures in manufactures but in services. It is this sector in which similarities are the largest and most significant between the protection structure of Russia on one hand and those of the median emerging market and Romania/Bulgaria on the other hand.

In short, while Russia's level of service trade protection (including service intermediates) is not found to be equal to that of the median emerging country and Romania/Bulgaria but higher, it is similar to the two benchmarks with respect to the sectoral structure. Those service

industries such as electricity, trade and air transport which are most highly discriminated against in Russia are also those which face the highest implicit taxation in the benchmarks. This can be explained by their over proportionate dependence on other also highly protected services as inputs.

V. Discriminating against Commercial Presence. Russian Restrictions against Mode 3-Supply

For long, Russia has been known for applying a restrictive stance against so-called mode 3 supply of services via commercial presence of foreign companies. Especially foreign companies supplying business services face sizable restrictions in both market access and national treatment. A recent estimate of aggregate restrictiveness indices in banking and insurance, for instance, positions Russia in third and fourth place among twenty-nine emerging countries and former socialist transition countries (Dihel, Shepherd, 2007: Table 5). The study lists Russia as the most restrictive among the transition countries in the sample. This is equivalent for Russia discriminating against foreign direct investment over domestic investment. The OECD data set used here provides special estimates for tax equivalents of combined mode 1 supply (cross-border trade) and mode 3 supply (commercial presence). Given that many business services can only be applied through commercial presence while the scope for cross-border trade supply, for instance via internet, is limited, the magnitude for tax equivalents is likely to be determined by restrictions against commercial presence[6]. Hence, the questions arise how much of total protection against all modes of service supply is accounted for by specific mode 3-measures in Russia, the benchmark emerging market and Romania/Bulgaria and whether both in terms of level and structure Russia deviates from the two benchmarks.

The results do not reveal much difference between tax equivalents for all modes and mode-3 supply in agriculture and manufacturing. This holds for Russia, the emerging market benchmark country and Romania[7]. Yet, for services, again Russia is special for two reasons. First, the level of the explicit taxation of a median service industry due to discrimination against commercial presence of foreigners is the largest: (-15 per cent), and second, the difference between this level of taxation through restrictions against mode-3 supply and the level of taxation due to restrictions against all modes of supply (-11 per cent) is the highest

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[5] Test tables on both the equality of protection level and the similarity of the protection structure are available upon request.

[6] See Dihel and Shepherd (2007: tables 11-15) which support this view for banking and fixed telecom while other service industries show mixed results with larger importance of mode 1 supply barriers.

[7] Data for Bulgaria are not available for mode-3 tax equivalents.

among the three countries. This lends support to the conclusion of Jensen et al. (2004) that restrictions against foreign suppliers of services in Russia are severe and that liberalization of FDI activities in Russia would bring the largest gains from WTO membership.

VI. Implications for EU Neighborhood Policies

In terms of its protection level and structure in non-service sectors, Russia does not seem to be so far from the benchmark of other emerging markets. Given the large variance in Bulgarian/Romanian protection level , this benchmark which initially was supposed to show the distance to EU accession countries' protection structure has not been conclusive. But Russia is much further from benchmarks in service industries. These industries suffer most from being dependent on buying inefficient inputs from other domestic service industries. This suggests an answer to the question who would benefit more from dismantling service protection in Russia, the Russian manufacturing sector which gets more protected when tax equivalents of service intermediates shrink or the Russian service sector relying more on service inputs than the manufacturing sector. It seems is very likely that Russian service industries would expand more than Russian manufacturing industries even though some manufacturing industries would also gain from gaining access to a more competitive and efficient supply of service inputs and thus attract more resources. This also implies that skill formation in Russia would find large incentives.

If services in Russia can be identified as the major field of action to modernize the Russian economy and opening it up to integration with Western Europe, what lessons can then be drawn for European Neighborhood Policy? Based on the experience with Mediterranean countries, Hoekman (2007:26) identifies services and investment as important elements of such policy. Yet, he also notes that the experiences with service trade liberalization in preferential trading arrangements do not lend too much hope for the EU policy to go far beyond their multilateral commitments in the GATT, for instance, in replacing the positive list approach (only service industries which are explicitly listed are liberalized) by a negative list (all industries are liberalized except for those which are explicitly listed). The dynamics in service sectors driven by technological innovations are clearly consistent with the second approach. However, services are sensitive in EU trade policies. This includes restrictions against the labor-based mode-4 supply (temporary movement of persons) even against new member states and dissenting views among EU member states. Therefore, it is unlikely that EU would be prepared to offer an asymmetrical approach to service sector liberalization in ENP with Russia with the EU liberalizing first and Russia following later as principle. Mode-

3 supply is of particular relevance as Russia embarks upon restrictive practices against market access of foreign service suppliers beyond so-called strategic sectors. At the same time, Russian state-owned companies have expressed their interest to invest in specific EU downstream service industries (e.g. energy distribution). This access has triggered controversies among EU member states given the state-owned character of these companies and the rising dependence of the EU on energy supply from Russia. Unless the EU is prepared to take first steps in allowing Russian companies to penetrate EU markets, the EU will not successfully claim the *qui pro quo* principle to pave their companies access to Russian service markets, for instance, in public utilities. Russia will probably also urge on easier access to EU markets via mode-4 supply.

Below "grand deals", EU cooperation instruments in supporting the modernization of Russia's inefficient service industries can project-wise become a first step of entry into the service market. A way of funding energy modernization on the provision that market prices are paid by Russian energy consumers and that the additional revenues from market pricing relative to subsidized pricing are used for investing into energy-saving technologies has already been approached in some projects.

VII. Concluding remarks

Russia has been special with respect to both its level and structure of protection against new service supply. Service industries themselves suffer most from negative protection, i.e. taxation. While the difficulties of measuring protection in services call for cautiousness toward strong policy conclusions, both the evidence from detailed sector studies in Russia and from macro-analysis drive the conclusion that there are massive distortions in the Russian economy which shift the internal terms of trade against those industries which rely on service inputs. Above all, these are service industries themselves. Not only is new domestic supply hindered to provide new supply but foreign supply is hindered as well especially through restrictions against commercial presence. It is a major stumbling block against dismantling these barriers that the EU itself is far from open against Russian state-owned (or state-controlled) companies trying to operate in EU service markets, for instance, in energy distribution markets. The EU ENP toward Russia loses much of its potential impact if the EU is not prepared to take first steps and liberalize asymmetrically as it did in the Europe Agreement with Central Eastern European countries. This is why probably the ENP will have to take an important impulse from Russia's accession to the WTO instead of becoming an own engine for integrating Russia into the European division of labor.

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