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Abstract

While the European Union and Russia are actively working to strengthen their relations, the challenge of effective cooperation can only be called problematic given the pressures faced by an expanding EU and the dynamics of present-day Russia. Nevertheless, the arguments for improving relations for both parties are overwhelming as closer ties ultimately promote the economic prosperity and political stability of the entire region.

EU-Russian cooperation is presently based on the Partnership and Cooperation Agreement (PCA). The EU and Russia have also agreed to start discussions on creation of a free trade area.

While the framework of cooperation is already in place, implementation of the PCA will demand greater resources than current capacity allows. Russia will bear the heaviest burden as it will have to develop functions long-established in the EU. To ease this transition, the EU provides technical assistance to Russia through its Tacis programme and similar programmes. These constitute a good-faith commitment on the part of the EU to a functioning market economy, political democracy as well as a working system of education and social welfare in Russia.

Both parties acknowledge the other's importance as a trading partner currently, trade mainly consists of oil, natural gas and refined metals exported by Russia and machinery and vehicles exported by the EU. The asymmetry of this relationship complicates competition and trade policy. Russia's competitive weaknesses in certain sectors make it very tempting to revert to protectionist pressures which will hinder liberalization of trade and potentially jeopardize the implementation of the PCA.

Although critics have called attention to the excessive optimism and impracticalities of the PCA and Tacis, they nevertheless concede that their spirit embodies a willingness by both parties to promote better relations. And despite obvious areas of contention between the EU and Russia (especially in trade policies), there has been a consistent willingness to discuss positions and seek mutually acceptable solutions. Given the general complexity of EU-Russia relations, this willingness to sort things out will be fundamental to all future progress.

Keywords: Russia, EU, integration, foreign trade, partnership and cooperation agreement

Summary

Efforts by the European Union and Russia towards systematic engagement are a rather recent phenomenon. Indeed, even the notion of what an EU-Russia axis is supposed to be or could be is hard to pin down as the economic and political situation in Russia changes and the EU struggles with its own growing pains.

In this article, the relations between the EU

and Russia are analyzed in terms of cooperation, aid and trade. Particular attention will be drawn to the Partnership and Cooperation Agreement (PCA) and its prospects for implementation, the Tacis programme, current trade relations and existing trade policy differences as well as the potential role of Finland in EU-Russia relations.

In section one, the motives and goals of mutual cooperation are discussed. From the EU's standpoint, the ultimate goal is to support economic and democratic transition in Russia, thereby

promoting security in Europe generally. In addition, Russia's vast natural resources, to some extent antiquated industry, inefficient approaches to agriculture and infant private sector all offer major profit opportunities to EU investors and Russian entrepreneurs. Thus, the EU provides aid which helps Russia overcome the financial and technical burdens of transition. From Russia's standpoint, the EU is already its largest trading partner. Moreover, assuming that Russia also wants to have some influence on the world scene, so it has little course but to build proper relations with the EU.

Section two describes the three spheres of EU-Russia relations: cooperation, aid and trade. First the contents and the main provisions of the PCA are reviewed. Although widely criticized, the agreement does set forth mutually agreed fundamentals on which a relationship between the EU and Russia can be built. The PCA's most striking feature (particularly when compared to the 1989 Agreement between the EC and Russia) is its consideration of establishment of a free trade area between the EU and Russia. The PCA further calls for improvements in political dialogue, trade relations, trade in goods, the business environment, investment, capital movements, payment systems, financial services, cross-border supply of services, employment conditions and competition as well as better means to secure intellectual, industrial and commercial property rights. As ratification of the PCA is a long process, the EU and Russia ratified an Interim Agreement, which brought the trade provisions of the PCA into force at the beginning of February 1996.

Also in section two, the EU's technical assistance programme for Newly Independent States the Tacis and a so called Joint programme are discussed in the context of EU aid to Russia. Recent Tacis statistics show that since 1991 approximately a third of Tacis funds have gone to Russia with the aim of supporting Russian initiatives to develop a market economy and democratic society. While the importance of the Tacis has been generally acknowledged, doubts about the effectiveness of programme and how its resources have been allocated have been raised. Such criticism generally misses the point: Tacis was set up as a vehicle for transfer of know-how and the success of the transfer is largely dependent on the quality of cooperation among governments and their degree of commitment to economic and

political reform. Tacis is there simply to assist in the promotion of certain behaviours and skills – it has no power to oblige parties to actually adopt them.

The EU and the Council of Europe have also set up the Joint Cooperation Programme with Russia. Joint is intended to help strengthen Russian federal structures, introduce human rights protection mechanisms and give guidance in legal reform.

Section two ends with a discussion of trade relations. While Russia is a mid-size trading partner for the EU, the EU is the most important trading partner for Russia. The current pattern of trade is based on lower-information content products such as oil, gas and other raw materials exported by Russia, and higher-information content goods such as machinery, vehicles and other manufactured products exported by the EU. While the EU is satisfied with the current trade pattern, Russia is increasingly interested in intra-industry trade. This imbalance in trade, and more particularly, the lack of competitiveness on the part of Russian manufacturers and service providers, gives Russia strong motives to impose protectionist measures. In the short-run, it is probably best if the Russians seek to promote trade through liberalization of their trade policies and reductions in tariffs, and in the longer run make efforts to bring global-class efficiency and productivity to their manufacturing and agricultural sectors.

Section three focuses on existing trade policy differences and prospects for implementation of the PCA, noting the various threats to both the PCA and the Interim Agreement. Should these agreements fail to be implemented, there is a potential that foreign investment will be discouraged and free trade negotiations between the EU and Russia will be broken off.

The final section of this paper deals with the role that Finland might play in formation of EU-Russia policy. Indeed, assuming Finland's Russian expertise is credible and applicable, one must ask to what extent does the EU intend to exploit this resource in strategy planning, Tacis projects, and the widening of business and cultural links. Certain groups in Finland support the idea of Finland as the EU's "East-West Gateway". Certainly the possibility of assuming a gateway role is there, but whether Finland succeeds in capitalizing on its geographical position and special familiarity with

certain parts of the Russian market depends, to a large extent, on whether Finns themselves are committed to the idea. Gateway proponents can be found throughout the public and private sector, yet all their efforts to date appear quite ineffectual given the scale of the envisioned EU-Russia relationship. On the other hand, any workable scheme starts with the acts of individuals who believe in their goal.

1 The arguments for EU-Russia cooperation

It is rather new phenomenon that the EU and Russia are systematically and actively forming mutual relations and strategies towards one another. In this respect, the EU, for example, has prepared strategy-papers defining motives and goals for mutual cooperation. The following chapter summarises some of the thoughts presented in these papers.¹

After a half decade of transition in Russia, no sustainable equilibrium has been achieved. Democratic institutions are still quite fragile and the rule of law is often uncertain. Recent developments such as the communists' good showing in the parliamentary and presidential elections as well as personnel changes in the Russian government indicate that nationalism and Russia's authoritarian traditions still appeal to many. Further, the Russian government's actions in Chechnya constitute a serious setback to the development of a democratic Federation.

And yet, political life in Russia is more open and lively than it has ever been in the past. An independent press freely criticizes government policies, and public opinion, now more informed and expressive, exerts a strong influence on the course of Russian politics.

Economically, Russia still suffers from its Soviet legacy – an industrial base that wastes valuable resources and damages the environment as well as a heavily subsidized, and inefficient agricultural system. Certain structural reforms have been achieved including price liberalization,

sustained currency convertibility and privatization. Macroeconomic stabilization, however, has proven very difficult, and inflation has remained high, fuelled by excessive budget deficits. Compounding this situation are the collapse in tax revenues, strong spending pressures, and massive capital flight indicating that even Russian economic operators do not feel confident about the economic reform. Finally, a fragmented and divided policy-making environment with many competing sectoral and regional lobbies has proven to be an additional obstacle for stabilization. Given all this, no definite predictions about the directions of political and economic reform can be made. Russia might turn inwards, or it could take its place in the world economy in full and responsible partnership with other leading industrial nations.

In the face of such uncertainty, the EU has decided to provide all possible support to promote pro-market democratic reforms in Russia. From the EU's point of view, good relations with a healthy Russia are essential to stability in Europe. The better are relations between the EU and Russia and the more intensive is the cooperation, the better the EU's ability to follow and be part of developments in Russia. If the EU has even a minor possibility to influence Russian development, it can also influence pro-market democratic development, which in turn will increase security and promote a better political climate throughout Europe. For the EU, a good relationship with Russia has long-term significance because of Russia's considerable economic, commercial and scientific potential. Russia is a mid-size trading partner, a permanent member of the UN Security Council and a member of the Council of Europe. With Finland's accession to the EU, Russia is now also an immediate neighbour.

For Russia, good relations with the EU are important. The EU is Russia's main trading partner, so gains in trade should be extended by increasing trade liberalization. The EU has resources to help Russia with its transition process. Also, in order for Russia to reestablish its presence in the setting of international policy, it must intensify relations not only with the EU, but also with other

¹ See more European Commission ^{a)} COM(95) 223 final and ^{b)} IP/95/533, ^{c)} MEMO/95/85, ^{d)} Union's Strategy for the future EU/Russia relations 1995.

western institutions.²

Under the Partnership and Cooperation Agreement, The EU aims to promote the economic and democratic reform process in Russia, to enhance respect for human rights and maintain stability and security in Europe. Russia is to be gradually integrated into the Western community of free and democratic nations.

In order to promote the ongoing democratic reforms in Russia, the EU is committed to support the further development of the rule of law, promote a solid and independent judicial system and reinforce the freedom of media. These goals are to be achieved through regular consultations and technical assistance provided by the EU. The EU also wants to intensify people-to-people contacts as well as regional cooperation.

In the area of economic reform, the EU's main goal is to encourage market-based economic growth and a steady rise in living standards. Further, the EU aims to promote the integration of Russia into the international economy according to market economy principles along with Russia's admission to the WTO and other international economic institutions. The EU aims to encourage the development of trade, investment and economic relations between the parties, and will help to improve environmental protection and safety at nuclear installations in Russia. Finally, the EU wants to encourage the development of the legal framework as well as promote the necessary conditions for the future establishment of a free trade area.

The goals in the area of economic cooperation require, most of all, prompt ratification of the PCA. In the meantime, trade links can be intensified and special consideration can be given to improving market access to such sectors as financial services, textiles, coal and steel. The EU should improve dialogue on commerce and investment through the existing channels and continue Tacis assistance.

² See more on the topic Baranovsky 1995, Fedotova Sutyryn 1994, Jopp 1994, Kissinger & Lukin 1994 and Standke 1994.

2 The current state of EU-Russia cooperation, aid and trade

2.1 The Partnership and Cooperation Agreement – An asymmetric deal

The 1989 Trade and Cooperation Agreement with the former Soviet Union offered Most Favoured Nation (MFN) status for tariffs and duties and dialogue through a Joint Committee. Technically, the 1989 agreement still constitutes the formal framework for EU-Russia relations. The Partnership and Cooperation Agreement, signed on Corfu in June 1994 is far more ambitious. It is the product of more than two years of negotiations that included exploratory talks, eight official rounds, two reconsiderations of the negotiating directives and many informal meetings. These efforts resulted in the broadest and most far-reaching agreement ever concluded between Russia and any Western country or organization. Although faulted for its excessive optimism and asymmetry, the agreement sets out the mutually agreed fundamentals on which the relationship between the EU and Russia will be built. The PCA presumes neither the establishment of an association between Russia and the EU, nor future membership in the EU. It simply aims at achieving a new quality of relations, ie "partnership". The most notable feature of the agreement in comparison to the 1989 agreement is the establishment of a free trade area between the EU and Russia. Since ratification of the PCA by the European parliament and the national parliaments of the member states is a long process, the EU and Russia have agreed and ratified an Interim Agreement,³ which brings the trade provisions of the PCA into force. The Interim Agreement came into a force at the beginning of February 1996.

The following summary of the original agreement text⁴ includes some of the main contents and

³ European Union, Interim Agreement (1994).

⁴ European Commission, Agreement on Partnership and Cooperation, Full text signed on Corfu on 24 June 1994 by the EU and the Russian Federation, Moscow &

provisions of the agreement.⁵

The PCA recognizes seven main aims and principles. These are:

- intensification of political relationships between the EU and Russia
- intensification of cultural relationships between the EU and Russia
- development of closer political relations through regular dialogue
- support for the reform process in Russia
- promotion of trade and investment links
- reinforcement of non-discriminatory treatment in all trade relations
- targeting of long-range goals such as gradual integration of Russia into a wider European economic area and establishment of a free trade area between the EU and Russia.

The agreement also follows a number of guiding principles which were agreed during the negotiations such as democratic principles, respect for human rights and an evolutionary character of the economic integration process between Russia and the EU.

In the area of political dialogue, the President of Russia, the President of the European Commission and the President of the Council of the European Union will meet twice a year to discuss issues of mutual interest. In addition, political dialogue will be intensified through annual meeting at ministerial level as well regular meetings of senior civil servants and parliamentary representatives.

In the area of trade relations, the PCA aims at gradually integrating Russia into European economic cooperation. Both parties have agreed to grant each other MFN status with regard to tariffs. Further, while Russian goods shall be imported free of quantitative restrictions to the Community, with exceptions concerning agricultural products in particular, the same principles do not apply to goods originating in the Community and imported to Russia. Russia can apply quantitative restrictions on imports from the EU in exceptional circumstances. Thus, if a sector or industry is undergoing reconstruction, if free competition

would result in dire social difficulties, if an industry is still in its infancy, or if domestic producers face a total or dramatic loss of market share,⁶ protectionist measures may be applied. Any such restrictions imposed by the Russians must be temporary (eg until Russia's accession to GATT/WTO) and quantified (expressed in terms of a proportion of total value of goods imported). Both parties agree to consultations before imposing any quantitative restrictions or increasing tariffs.

In goods trade, both parties agree not to discriminate against imported goods by imposing internal taxes or additional taxes. All goods should be granted free transit between borders, and the same regulations governing the sale, purchase, transportation, distribution and use of domestic products should be applied to imported goods. Such provisions exclude, however, textiles and coal and steel products, which are considered as sensitive by the EU. Trade for sensitive sectors is dealt with under separate agreements (eg the PCA does not affect the 1993 agreement on trade in textiles). Trade in coal and steel products are subject to the general provisions of the PCA, but are exempt from the conditions of quantitative restrictions.

Trade in nuclear materials is covered only partly by the PCA. In spite of the Russian request, the provisions on quantitative restrictions and the safeguard clause are excluded. Regarding to the safeguard clause, the PCA refers to the 1989 agreement with the USSR according to which trade and other cooperation between the parties shall be conducted in accordance with their respective regulations. Nuclear materials should remain subject to a price clause since goods must be treated at market prices. Finally, each party shall accord the highest possible degree of liberalization to imports of other's products. The mixed application of PCA rules as well as rules of the 1989 agreement, however, will be valid only during the transitional period. This means that a specific

Brussels 1994.

⁵ ^{a)}See also more on the topic: Borko (1996) and ^{b)}European Commission, A Short Guide to the PCA (1994).

⁶ European Commission, Agreement on Partnership and Cooperation, Full text signed in Corfu on 24 June 1994 by the European Union and the Russian Federation, Moscow & Brussels 1994.

agreement has to be concluded by 1 January 1997.⁷

The PCA also contains provisions which aim to improve Russia's business environment by creating a better climate for direct investment, easier movement of capital, payments, trade in services and conditions for employees. The principles of MFN treatment regarding the establishment and operation of companies in the other party's territory make a clear distinction between establishment and operation. MFN status only applies to establishment, while national status, if better, may be granted to operation of subsidiaries of the other party's companies. Branches of Russian and EU companies are granted MFN status for operation. In cases where MFN treatment is believed to be unfairly restrictive, the parties have agreed to hold consultations to find a solution.

To stimulate investment, Russia and EU member states have agreed to conclude further agreements governing investment protection and promotion, and the avoidance of double taxation. They agree to regularly exchange information on laws, regulations and administrative practices in the investment field as well as broaden general knowledgeability of investment opportunities through trade fairs, exhibitions, theme weeks and similar publicity events.

MFN status is applied to capital movements. Direct investment is freely allowed, as is repatriation of investments and any profits generated. However, as Russia is currently besieged by capital flight, monetary and reserve problems, it has kept the option to impose restrictions where appropriate after it notifies the EU. Any restriction Russia does impose must remain within MFN guidelines. Neither party will introduce new restrictions or extend existing restrictions after the PCA has been in force five years. The one exception is that restrictions may be applied after the five-year period for up to six months in crisis situations in the foreign exchange or money markets.

Under the PCA, Russia and the EU also grant each other MFN status for payments and payment methods. All current payments connected with the movement of goods, services or persons can be made in freely convertible currency. This is backed

by other provisions which guarantee that trade in goods and services will not be hindered by exchange restrictions.

In the area of financial services, the agreement sets provisions in the area of banking and other financial services as well as insurance and insurance-related services. Under the Agreement, Russian banks are able to set up subsidiaries in the EU. Russia, in turn, will start to open up its market, which has been closed since the Presidential Decree of November 1993. Parties have agreed that Russia guarantees a national treatment to banks from EU member states. The numerous exceptions to national treatment will either lapse or be subject to review after a 3-5 year transition period. Most exceptions apply to higher minimum capital requirements for EU subsidiaries and a ceiling of 12% on the overall share of foreign capital in Russian banks. Russia can set a minimum level for balances on accounts of each physical person (not more than 55,000 ECU) and prohibit transactions with Russian residents. Most of these exceptions will not apply after five years at which time Russia will consider lifting the remaining exceptions. Finally, MFN status is applied to insurance services that are connected with such activities as direct insurance, reinsurance and retrocession. Licenses will be given to EU companies according to legislation applicable in Russia. The present maximum foreign shareholding limit of 49% must be abolished no later than five years after the ratification of the PCA.

MFN status applies to cross-border supply of services, and the PCA aims at further liberalization of the service sector. Although the PCA does not allow freedom of movement of people in a general way, representatives of companies selling services will be permitted temporary entry into the EU or Russia. The specific service sectors listed are adult education, correspondence services, advertising, computer and related services, database services, engineering, franchising, management consulting, market research, publishing, technical testing and analysis, certain telecommunications services and wholesale trade services.

Conditions for employment require that once legally employed, employees will not be discriminated against on the grounds of nationality. This applies to working conditions, remuneration or dismissal. Further, although access to labour markets will continue to be regulated by each

⁷European Commission, Agreement on Partnership and Cooperation, Full text signed in Corfu on 24 June 1994 by the European Union and the Russian Federation, Moscow, Brussels 1994.

member state of the European Union, temporary intra-corporate transfers of personnel is possible, providing that these are key employees, generally with senior positions.

In the areas of taxation, competition and intellectual property rights, the PCA provisions provide MFN treatment in the establishment of companies and trade in services (business, investment, payments and capital), but do not apply to the tax advantages which parties are currently providing or will provide. Tax advantages include eg agreements to avoid double taxation. Both Russia and the EU are free to adopt measures which will prevent tax avoidance or evasion.

Trade between Russia and the EU should be free from unfair competition, so both parties are committed to removing restrictions placed on competition between enterprises by competition laws or government intervention. Furthermore, export supports are strictly prohibited and other assistance is subject to strict regulation or elimination after the PCA has been in force for three years (certain exceptions are given five years). Russia is thus allowed to take measures to support emerging industries and enterprises undergoing restructuring or facing serious difficulties.

In respect of intellectual, industrial and commercial property rights, Russia will treat EU nationals and companies most favourably in respecting and recognising these rights. By the end of the fifth year of the PCA, Russia should provide for a level of protection similar to that of EU member states.

Some PCA provisions do not apply to specific service sectors. These sectors are transport, space launch services and mobile satellite communications.

The EU and Russia have also agreed to increase cooperation in the areas of mutual interest and to foster economic cooperation as a means of expanding the economies of both parties. This will create a supportive international economic environment, integrate Russia into a wider area of economic cooperation, and strengthen economic links. Areas of cooperation include industry, customs, the prevention of unlawful activity, education and training, science and technology and telecommunications. In the major areas of cooperation outlined in the Agreement, the EU will provide support through its Tacis Programme.

It is rather obvious that the PCA is not only

ambitious but also partly asymmetric. With regard to ambition, it is enough to observe that workability discussions will probably come to a head in the course of the ratification process, which has been estimated to end sometime around the end of this year or at the beginning 1997. This assumes, of course, that neither party decides to violate the basic principles of the PCA. All it would take is a second Chechen war.

With regard to asymmetry, the PCA allows Russia the options of protectionist measures or adjustment periods of 3-5 years based on structural problems. This asymmetry does not mean that Russia would have reached an easier deal in terms of provisions and requirements of the PCA, rather it obliges Russia to improve in many areas to EU levels. Thus legal reform in particular is crucial. Russia must have an efficiently functioning legal system that permits prompt adjudication of matters as well as effective means to inform people about changes in the legal system. This implies systematic reform in the economic and political arena. Given these great challenges faced by Russia, the EU has committed to help and assist Russia in various ways. The main instruments in this field are the EU's Tacis Programme and the Joint Programme together with the Council of Europe.

2.2 Tacis Programme, the EU and Russia

The Tacis Programme, established in 1991, is the EU's technical assistance programme for the Newly Independent States. It aims to support partner initiatives to develop towards market economies and democratic societies.

Between 1991 and 1994 the total value of Tacis financing amounted to ECU 1,757 million of which Russia received more than ECU 630 million (USD 846 million) to launch more than 420 projects. In 1994, the total value of Tacis funding was about ECU 470 million, of which Russia's share was 150 ECU million. The Tacis budget in 1995 amounted to ECU 506 million.

Tacis ensures funding to a number of projects that are relevant to the Russian reform process. As can be seen from Table 2., the latest priority sectors for Tacis funding in Russia have been state enterprise restructuring and private sector development, public administration reform, social services

Table 1 **Tacis Funds Allocated by Sector, 1991-1994** (ECU million)

Sector	Total	Share %
Nuclear safety and environment	321.00	18.3
Restructuring state enterprises and private sector development	288.64	16.4
Public administration reform, social services and education	280.74	16.0
Agriculture	214.20	12.2
Energy	185.66	10.6
Transport	141.24	8.0
Policy advice	94.88	5.4
Telecommunications	16.51	1.0
Other sectors	213.97	12.1
Total	1756.80	100.0

Source: Europe Information Service, A year of change for Tacis, Euro-East, No 37, October 1995.

Table 2 **Tacis Funds Allocated by Sector in Russia, 1994** (ECU million)

Sector	Total	Share %
Enterprise restructuring and private sector development	43.30	28.9
Energy	19.50	13.0
Policy advice	18.95	12.6
Public administration reform	18.85	12.6
Agriculture	16.30	10.8
Transport	13.90	9.2
Telecommunications	4.10	2.7
Other sectors	15.00	10.0
Total	150.00	100.0

Source: European Information Service, A year of change for Tacis, Euro-East, No 37, October 1995.

and education, agriculture, energy, transport and telecommunications.

In respect of enterprise support, actions have been taken to support privatization as well as small and medium size enterprises. In particular, efforts have focused on the reinforcement and better implementation of privatization policies and legislation. In addition, support has been provided to improve trade and company legislation, competition rules, taxation, and protection of investor and

shareholder rights.

In the area of public administration reform and education, support has mainly concentrated on legal training, training in economics and management, and policy advice. Social sector development, in turn, has focused on the improvement of labour conditions, the health sector and the pension system.

One of the Tacis priority sectors in Russia has been agriculture, where actions have been taken to

promote farm enterprise restructuring. Efforts have aimed at getting better access to finance both for farms as well as for dealer and wholesale networks.

Tacis assistance in the energy sector has focused on the improvement of the legal system and regulatory framework. In particular, actions have been taken to improve the implementation of existing laws and regulate natural monopolies. Support has concentrated on the promotion of competitiveness by reinforcing management capacity and energy savings.

In the area of transport, the main emphasis has focused on the improvement of roads and railways. In telecommunications, Tacis has aimed to develop efficient information services.

Each year, the Tacis programme identifies two new geographical areas or regions for their strategic importance in the development of the economy. Support to these areas is provided at a local level.⁸

In 1991, the Moscow and St. Petersburg regions received Tacis priority. The Moscow region is a major industrial area and has, naturally, a strategic importance as the capital of Russia. St. Petersburg region, in turn, represents the main access to the sea for Russia in the west. In 1992, Samara and Tyumen, were added to strategically important key areas. Tyumen's region is one of the world's most important reserves of oil and natural gas, while Samara is an important agricultural region as well as a centre for Russian food production and distribution. In 1993, the Urals and Western Siberia were chosen to increase the coverage of the programme. Both regions are rich in natural resources and have highly skilled labour forces. The areas are also characterized by a high concentration of large enterprises and heavy industry. Other common features include acute social problems associated with the closure of industrial plants. In 1994, Tacis priority went to Kaliningrad and Southwest Russia. In the case of Kaliningrad, Tacis programme aims to support the development of the region as a free economic zone and exploitation of its potential role as a commercial gateway between Russia and the West. Southwest Russia, in turn, is a region with a concentration of large enterprises. The area plays a key role in the pro-

duction and distribution of food within Russia. Through its strategic location, the region also offers links with important external markets. In 1995, the new focus areas were Lake Baikal and Northwest Russia. Lake Baikal faces serious pollution problems and ecological damage due to the activities of heavy industry. The lake also has strategic importance because it represents 20% the world's fresh water reserves. Finally, Northwest Russia has the potential to develop cross-border cooperation with Finland. Potential cooperation areas include development of infrastructure, trade and tourism.

The former Tacis regulation expired on 31 December 1995. Therefore, at the beginning of 1996, the European Council approved the new regulation that will govern the Tacis programme for the four years 1996-1999, with an overall budget of ECU 2,224 million.⁹ The annual allocations are decided by the budgetary authorities on an annual basis. The new regulation is expected to guarantee a considerable improvement in the management of the programme. The regulation covers in principle technical assistance to support economic reforms in receiver countries, but individual exemptions, examined case by case, may be granted for the cofunding of small cross-border infrastructure projects for the promotion of industrial cooperation and for the funding of equity capital of small and medium-sized companies. Regarding technical assistance, the priorities of the Tacis programme during the next four years will be: the development of human resources, the restructuring and development of companies, transport and telecommunications infrastructures, energy, the agrifood industry and environmental protection.

Like the PCA, critics question the actual impact of the Tacis programme. After all, Russia's land surface alone is five times larger than the EU.

One, however, should remember that the achievements of Tacis must be seen against the background of Russian political and economic framework, which is continually changing. Moreover, the Tacis is a programme of know-how transfer, which relies largely on cooperation with

⁸ European Commission, European Union's Tacis Programme.

⁹ Europe Documents, No 6653 26 January 1996 & No 6655 30 January 1996, Europe Agence Internationale D'information Pour la Presse, Brussels.

governments and their commitment to economic and political reform. Therefore, Tacis can only assist and advise, but not oblige its partners to change policies or implement reforms faster than they wish. Further, besides the fact that transfer of know-how is a long-run process, this know-how can also be transferred in many different ways. Therefore, it is reasonable to argue that the efficiency and achievements of the Tacis programme should be criticized from a long-term perspective and with a caution.

2.3 The Joint Programme

The European Union, the Council of Europe and Russia have also agreed to implement a "Joint Cooperation Programme" designed to benefit of the Russian Federation.¹⁰ There are several factors supporting the establishment of the Joint Programme. First, Russia recently became a member of the Council of Europe. This, in turn, has brought along requirements concerning changes in the Russian legal system. Further, implementation of both the PCA and the Interim Agreement require an efficiently functioning legal system.

The programme was signed in February 1996. It covers the 1996-97 period and has an allocation of ECU 1.2 million, co-funded from the budgets of the Community and the Council of Europe.¹¹ It is aimed at strengthening Russia's federal structures, introducing human rights protection mechanisms and reforming the legal system. The programme, which was designed in close cooperation with the relevant Russian authorities, consists of six projects. These projects are centred around a) constitutional order/strengthening of institutions, and b) legal reform. Joint projects are intended to help improve the function of federal structures, facilitate the function of local authorities and train local councilors. In addition, the projects aims to support institutions responsible for protection of human rights in Russia, encourage the teaching of law and legal training and improve the function of legal institutions. Finally, Joint seeks to develop

¹⁰ Russia became the member of the Council of Europe on 8 February 1996.

¹¹ Europe Documents, No. 6665, February 12/13 1996.

internal legislation and practices in Russia to assure compatibility with the European convention on human rights and encourage prison reform and crime prevention.

2.4 EU-Russia Foreign Trade and Future Possibilities

In 1994, the EU accounted for 37% of Russia's total foreign trade as compared with 24% for trade with other CIS states, 6% for trade with China, 4% for trade with the USA and 3% for trade with Japan.¹² Russia, in turn, represents a mid-size trading partner for the European Union. In 1994, EU imports from Russia were worth ECU 18,402 million, which compares to about 3% of total EU imports.¹³ The largest individual importer was Germany, whose share accounted for 36% (ECU 6,678 million) of total EU imports from Russia. The two next largest importers were Italy (21%) and France (12%). The smallest interest towards Russian markets was shown by Ireland with the modest import share of 0.1 percent. In respect of the product composition, the main share of import from Russia, 42%, consisted of oil and gas.

EU exports to Russia in 1994 amounted to ECU 12,177 million, about 2 % of total EU exports. Again, the most active exporter was Germany, accounting for 45 % (ECU 5,592 million) of the total. Italy came second with the share of 15%; the export shares of Holland and France were each 9%. EU exports to Russia mainly consisted of machinery, manufactured goods, transport vehicles and refined foods, which export share accounted for 86% of total EU exports to Russia.

Exports of oil and gas will likely remain the main items of Russian exports to the EU, and the EU will continue to export machinery and manufactured goods. Russia, however, is increasingly interested in changing the trade mix by adding in manufactured goods and with industrial specializa-

¹² Commission of the European Communities, Communication from the Commission, The EU and Russia: the future relationship, COM(95)233 final, Brussels 1995.

¹³ Eurostat Foreign Trade, Office for Official Publications of the European Communities, Brussels, Luxembourg 1995.

tion products (even though such sophisticated products which also possess a competitive advantage are rather scarce). The EU at present believes the present trade mix will continue – at least for the immediate future. These interest differences may lead to problems in the mutual trade. In the long run, however, the EU must remember that the restructuring of imports from Russia towards more sophisticated manufactured products and services may be the only way to ensure a stable growth of its exports to Russia.

Another topical issue is competition. Fuel is the only class of goods where competition between Russia and the EU countries is not significant. Elsewhere, the problems of competition are very real. Russia's present ability to compete in Europe is generally far below that of the US, Japan and other industrialized countries. Russia suffers from poor competitiveness of its products in external markets and a very unsaturated internal market. A more complicated situation will arise as regards competition on the Russian market. The sales crisis in most branches of Russian manufacturing industry and agriculture has given rise for protectionist measures (tariffs and quantitative restrictions) on imports. This has led and will most likely lead to the government's decisions to increase customs duties on many kinds of imported goods. Thus, competition will likely remain a source of future disagreements and a topic of a more or less regular discussion within the framework of the PCA.

Referring back to the trade statistics, it seems that Russia, from foreign trade point of view, is currently more dependent on the EU than vice versa. This observation, however, must be treated with a caution as there are factors implying that perhaps Russia's trade dependency on the EU is not so obvious. First, most Russian exports to the EU consists of raw materials for which there are large markets also outside the EU. Thus, Russia can (and should) be able to seek out new markets for its raw materials. Second, Russia has run a continuous trade surplus both with the EU and with the countries outside the CIS. For example, Russian export to the countries outside the CIS increased in January-October of 1995 about 20%,

whereas imports grew only by 4%.¹⁴

Some suggestions can be made concerning the future trade and trade potential between the EU and Russia. Russia holds great economic potential for the EU: its inefficiently organized industries and resource allocation, vast environmental problems, highly subsidized and extremely inefficient agricultural sector all provide profit-making and trade increasing opportunities for EU operators. Additional economic gains are also possible as progress in structural changes, price liberalization, and privatization proceeds in Russia. Naturally, whether this long-term economic potential can be utilized depends mainly on Russia's economic recovery. Some economists see Russia's economic possibilities declining in the next 10- 20 years; other economists believe that Russia will likely join those which are fairly strong as regional powers but have limited opportunities on the global scene.¹⁵

Given the uncertainty connected with democratic and pro-market reform process in Russia, predictions are best left to the short-term and discussion should revolve around seeking concrete solutions to promote current trade between the EU and Russia. Increased trade liberalization is probably the most traditional solution. This, perhaps to some extent an old cliché, is not only based on economic theory, but it is heavily supported by the empirical evidence. One recent study made by an Australian government, for example, suggests that differences in the economic performance of industrialized countries since 1970 have been determined more by the speed at which they have cut tariffs than by the vigour with which they have tackled domestic reforms. Every 1 percentage point fall in an industrialized country's tariffs has, on average, raised their total productivity by more than 3% and gross domestic product by 2%. Finally, these increases are about 10 times greater than most economists had previously believed.¹⁶ Basically this would mean that by cutting tariffs, Russia could be able to promote economic perfor-

¹⁴ Government of the Russian Federation, Russian Economic Trends 1995, Whurr Publishers Ltd, UK 1995.

¹⁵ Zhilin 1996.

¹⁶ Financial Times 9.4. 1996.

mance despite of the slow speed of domestic reforms in some areas. If so, an improvement in economic performance would lead to increased trade and, even better, could enable Russia to switch from its current trade pattern towards more intra-industrial trade.

3 Trade policy differences and prospects for the implementation of the PCA

In 1994, Russia's share in the total trade of the EU was about 3%, while the EU's share was near 40%. Also, the EU has lower tariff protection for imports from Russia. For example, in 1995, the average tariff for Russian imports was 1%, whereas the average tariff for the products imported from the EU was 19%.¹⁷ This can partly be explained by the fact that imports from Russia are largely goods on which tariffs are not imposed eg minerals and metals. West European countries, in turn, export mainly machines, transport equipment and manufactured goods. Further, although mutual trade is generally based on MFN status, in practice, imports from Russia are mainly treated according to the General System of Preferences (GSP). In other words, the tariff is 85 %, 70 % or even 35 % of the MFN tariff. These preferential tariff margins, however, are expected to be reduced by 50% from the beginning of January 1997, and completely eliminated by January 1998.¹⁸

Although both the EU and Russia have agreed to remove quantitative restrictions in the framework of the PCA and the Interim Agreement, the issue of quantitative restrictions has proven difficult. Russia continues to complain about the EU's discriminatory practices. For example, early in 1996, Russia announced its plan to impose quotas on textile imports from the EU after accusing the EU for discrimination of Russian steel, textile and nuclear products. The EU, however, at the present is imposing quotas on 33 categories of Russian textile products, but most of these quotas are vastly underutilized (on average around 30%) with the

exception of two categories showing a quota utilization of 90%. Further, in 1994, Community textile imports to Russia were worth a total of ECU 624 million, while Russian exports to the EU were ECU 246 million.¹⁹ These figures suggest that EU quotas have had little impact on the trade flows and in no way hinder Russia's textile exports to the EU.

In addition to plans to impose textile quotas, Russian authorities have recently announced intentions to increase import duties by 20 % on a large number of products in the near future.

Clearly, a protectionist climate in Russia works against the principles and spirit of the PCA and the Interim Agreement, and ultimately, even Russia's own interests. Moreover, protectionist measures generally are seen as a danger signal to foreign investors who are already rather skittish about investments in Russia. Protectionist actions would even harm negotiations on Russia's membership in the WTO and on the preparation of discussions whether an area of free trade should be set up between the EU and Russia.

One area where Russia has made strong progress is in the liberalization of its fuel exports. At the beginning of 1996, as part of USD 10.2 billion loan agreement with the International Monetary Fund,²⁰ Russia agreed to scrap export tariffs on natural gas as of March 15 and oil as of 1 July 1996.

In the future, Russian authorities will most likely continue to searching for a balance between protectionism and integration with the global economy. In the short term, the trend to protectionism seems very likely to prevail. Thus, it is not at all unreasonable to expect competition on the Russian market will become an increasing source of friction between the partners.

4 Finland's role in EU-Russian relations

As both an EU member and a country with a long

¹⁷ Europe, Agence Internationale D'information Pour la Presse, No 6679, 2nd March 1996.

¹⁸ Beuter 1996.

¹⁹ Europe Documents, No 6674, Europe Agence Internationale D'information Pour la Presse, 24th February 1996.

²⁰ Moscow-Reuter 22.2.1996.

and deep relationship with Russia, Finland should be expected to make a contribution to the formulation of the EU's Russia policy. Finns have long experience in dealing with Russian politics, Russian business, trade and culture. They understand the Russian mentality.²¹

Being a close neighbour with Russia, however, does not entitle Finland to automatically set itself up as the EU's gateway to the east. Several locations offer similar geographic advantages and logistical capabilities. Nevertheless, Finland should make a strong effort to fully utilize its geographical position and experience.

Finland is presently participating in formation EU strategy towards Russia. Finns are also involved in a number of Tacis projects. Because the Commission does not publish official documents concerning each member country's participation in Tacis projects, Finland's participation in these projects is not officially quantified. According to some estimates, though, in 1995 Finland's share in Tacis projects was around FIM 100 million. Which is to say, Finland has been very active indeed.

Beyond these present forms of participation, Finns also could increase their involvement in other joint research and development programmes. Russia, for example, suffers from serious environmental problems. Finns have a great deal of knowledge about approaches to environmental protection and environmentally friendly technologies. There is a huge potential demand for such expertise. There are also various cooperation opportunities in the field of business and trade. One way to promote cooperation is an active exchange of experts and information through exchange programmes, seminars, workshops, conferences etc. For example, the EU as a whole organizes seminars in the framework of Tacis programme. These seminars should be also in the interests of Finland to participate. So far, Tacis seminars have provided opportunities to exchange information in the areas such as trade relations, political relations, free trade, customs unions, fiscal policy, taxation, banking and investment. In Finland these days, schools, universities and other Finnish institutions have in-

creased their offerings in Russia-related curricula. Efforts have also been made to promote investment and business activity in Russia. In particular, companies and trade promoting institutions offer, as an example, courses that give practical information about how to set up a business in Russia and how to do business with Russians.

All of these activities could be seen as a drop in the ocean against the vastness of EU-Russia relations. Yet, big goals are usually reached through a series of small actions. If promotion of EU-Russian relations is the "big" goal, then promotional actions taken by high officials, companies, institutions and private individuals in Finland and other EU member countries, can be seen as a set of smaller actions, which is done enough, eventually create progress to the big goal. Indeed, when individual economic and political operators stop taking the initiative to makes agreements like the PCA a reality, the agreements become essentially worthless.

5 Final remarks

The PCA, because it is ambitious and asymmetric, may ultimately be too difficult to implement. Russia is expected to make the improvements; ie liberalization of trade (goods, capital and services), competition, legal reforms, financial services and industrial property rights. No doubt, such changes are well intentioned and all for the best, but they not completely in line with existing trade policy. This can be seen in Russia's recent moves to higher tariffs and declared intentions to impose further protectionist measures.

Thus, without some softening, not only is the implementation of the PCA in jeopardy, but free trade negotiations between the EU and Russia as well. The PCA current softeners grant Russia the choice of applying temporary protectionist measures or having an adjustment period of 3-5 years for transition. Further, the EU has established Tacis programmes to provide technical assistance to Russia in the restructuring of state enterprises and development of its private sector as well as development of social services, education, agriculture, energy, transport and telecommunications. Tacis projects rely largely on cooperation of governments and their commitment to economic and political reform. They can be misused or

²¹ ^{a)}Centre for Finnish Business and Policy Studies, The European Union and Finland 1996, ^{b)}Ministry of Trade and Industry in Finland, European Integration and Finland's options 1994.

ignored.

Competition and differences concerning the imbalance in the composition of trade will also likely remain sources of contention for years to come. Nevertheless, In the long run, the best way for the EU and Russia to promote trade relations and exploit the existing economic potential is through trade liberalization.

Given Finland's long, close relationship with Russian governments, administrative bodies, business, trade and culture, it has unique value to other EU members and Russia in helping make the

relationship work.

Finally, there are no guarantees. The PCA, Tacis and Joint can all fail. And Russia may turn inwards on itself and obsess on its own problems. Yet, at the moment, the future looks rather promising. The EU and Russia have relations in the areas of cooperation, aid and trade. Despite disagreements and conflicts, there is an over-riding willingness to negotiate and overcome these problems. Given the complexity of this relationship, such an attitude is, perhaps, the best we can ask for.

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