A GREATER EUROPEAN FTA: ECONOMIC GAINS YET SOCIO-POLITICAL PAINS FOR MOSCOW?

By Michael Martin Richter[19]

Abstract
Despite the significant worsening of relations between the EU and Russia, the vision of a 'Greater European' economic space from Lisbon to Vladivostok still exists. However, how far are repeated statements by Russian policymakers speaking in favour of this idea simple rhetoric and how far is a 'Greater Europe' FTA actually a rational interest? This work analyses the impact of a common "Greater European" economic space on Russia. By using the most-developed gravity model on the effects of an FTA between EU and the EAEU, the political and economic key stakeholders affected by this hypothetical agreement are detected and their potential gains and losses together with their influence on political decision making assessed. At the same time, crucial socio-economic constraints in the short and long-term, influencing the current political economy system of Russia, are incorporated. Hence, the work provides valuable insight into the feasibility of such an agreement. Not only allows it to estimate the probability of the formation of such an agreement, but it also sheds light on the necessary political and economic adjustments that would have to take place in order to make the creation of such an arrangement likely. The political economy approach in the given context is novel and fills therefore a central research gap on this topic.

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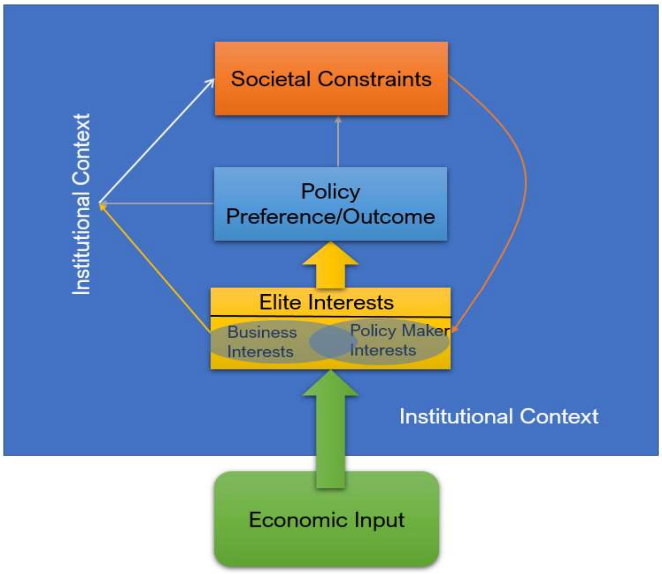
Introduction

Back in 2010, Vladimir Putin envisioned the formation of a free trade area from Lisbon to Vladivostok, which was to be accomplished in a strategic perspective, within the next 20-50 years (Donahue, 2010). What seems almost utopian from today's perspective was considered a serious policy option by some analysts as late as the beginning of 2014 (Tkachenko, 2014). However, is a "Greater European" free trade area (hereafter: FTA) truly in the rational interest of the Russian Federation? Can the repeated declarative support for such a project from the Russian authorities really be a desired policy preference or is it a mere symbolic gesture? Analysing the impact such an agreement would have on key stakeholders in Russia within the corresponding political economy frame sheds light on these questions. A review of the available literature shows convincingly that both the preferences of key interest groups as well as the institutional framework, that is the way these interests are channelled, is necessary in order to predict the overall trade policy preference of a certain nation (see Rodrik (1995) and Millner (1999)).

To retrieve a comprehensive picture, it is therefore important to incorporate the distinctive nature of the political economy system of Russia into this analysis. The behaviour of political and economic agents in the Russian system, hence also their preferences towards an FTA, can be predicted through one specificity: the subordination of the economic effects of decisions to their potential impact on regime stability and regime survival (Libman and Vinokurov, 2018). Unlike in states with strong rule of law, where property rights are ensured and seen as means in themselves, systems characterised by a strong reliance on informal relations among actors put any form of property rights under the conditionality of the goodwill of the ultimate ruler. In the Russian system, property rights are granted and withdrawn by the Kremlin (Sakwa, 2010). The wealth of ruling elites depends to a large extent on their position within the political system. Any change in this constellation, like a change of power, might lead to a reshuffling of economic property rights. This way, political and economic power go hand in hand.

How would in this regard the current political system in Russia be affected by economic changes brought up by an FTA between the EU and EAEU? To evaluate this question, the article is divided in two principle parts: first, based on the most pronounced work in this context, the sectors benefiting and losing from such an agreement will be identified and contextualised within the elaborated political economy framework. Secondly, the long-term socio-economic constraints stemming from the current development model of Russia will be identified, shedding light on potential ways to overcome them while incorporating a Greater European FTA at its core. As such, the research approach does carry along a double advantage: not only incorporates it the necessary assessment of both the institutional context and influential interest groups within it, but also sheds light on its long-term dimension. The overall research design can be systematised as follows:



Graph 1. Research design. Own presentation

Sectoral winners of an FTA and their corresponding leverage in the system

The most sophisticated study on the consequences of an FTA between the EU and the EAEU (Russia) was published in 2016 by Felbermayr et al. and gives the possibility of a sectoral assessment of economic effects. As its results show, only a "deep" FTA (hereafter "DCFTA"), that is one abolishing most non-tariff barriers, would have a significant wealth-enhancing effect on the Russian economy, with GDP increasing by 0.69% and incomes of average citizens by 3.09% (Felbermayr et al. 2016). However, academia has shown that there is little evidence that policymakers pursue overall welfare interests, but rather focus on narrower interest groups (Brenton et al. 1997). What is true for democracies is even truer for the Russian political economy system with its elaborate specificities.

Thus, evaluating the sector-specific effect, the biggest beneficiaries of an FTA are found in the extractive sector. The extraction of resources in Russia is very concentrated and highly dominated by the state directly, as in the case of the oil, gas and diamond sectors (Henderson and Ferguson, 2014), or by state-close oligarchs and interest groups, as in the case of practically all other extractive resources. It should be mentioned that oil and gas are already traded almost without any tariffs, and positive effects would therefore mostly stem from increased cooperation and technology transfers from the EU (Felbermayr et al. 2016, p.80). In this context, a DCFTA between Russia and the EU would spur the adjustment of standards and pave the way for necessary technology transfers. This is especially important with regard to a projected decline in extraction from existing oil deposits and the necessity to drill in new territories, mostly "offshore deep-water, Arctic and tight oil deposits," which rely to a substantial level on Western technologies (Connolly, 2013, p.756).

Hence, an FTA would secure the rents coming from oil. This sector forms the backbone of Russia's political economy system, which is additionally characterised by the redistribution of internationally competitive national resource rents to the state, its elites, and, to some degree, to society as well (Connolly, 2013). These rents constitute around a third of the Federation's budget and form a substantial part of the income level of ordinary citizens (Kluge, 2019, p.43). Subsidies, which stem from over 750 different federal laws alone, account for approximately 20% of the average Russian's income (Aven, 2015). In this regard, a logic becomes visible – the state captures those rents to divert some of them to its citizens in order to stabilise the system and decrease the likelihood of discontent. An FTA would, at first glance, allow these rents to increase and these subsidies thereafter.

Sectoral losers of an FTA and potential drawbacks

On the other side of the equation, however, are subsidized industries,which the government helps through tariffs and other forms of support. These can be found in sectors linked to manufacturing, that is, sectors focused on processing extracted resources. These industries would experience a decline in their output, already due to a "normal" FTA since protective tariffs would break away. This shows well the direction in which an FTA would influence the balance between Russia and the EU – the former would increase its role as a raw resource supplier, whilst the former would increase its share in manufactured goods vis-à-vis Russia. This is exemplified with the case of metal. Whilst the extraction of this resource would get a boost from an agreement, the manufacturing of metal products in Russia would, however, experience a decline (Felbermayr et al. 2016). Thus, the changes following an FTA in Russia's production structure have an asymmetrical nature in terms of their potential countermeasures: whilst the production process of a certain good can, cost-issues put aside, theoretically be placed in almost any place of the country, resources can only be extracted where they are physically located.

The crucial question therefore is whether the increased rents would outweigh the loses, in both political terms and potential consequences on the system itself. This needs to be put into a broader perspective. Whilst the noisy protests in 2011/2012 were mostly associated with Moscow and St. Petersburg, it has been shown that in so-called "monotowns" inhabitants possess a similar tendency to loudly express their discontent (Crowley, 2015). As often in the case of assessing Russia, geography is an aspect that cannot be ignored. Monotowns are cities relying to a large extent on a single industry and were set up during Soviet times, not due to economic factors, like proximity to markets, but mostly due to security considerations. That is why they can often be found in remote areas. The most well-known example is Tolyatti with its big Avtovaz car-manufacturing factory that employs roughly one in seven of the city's inhabitants (Crowley, 2015, p.5).

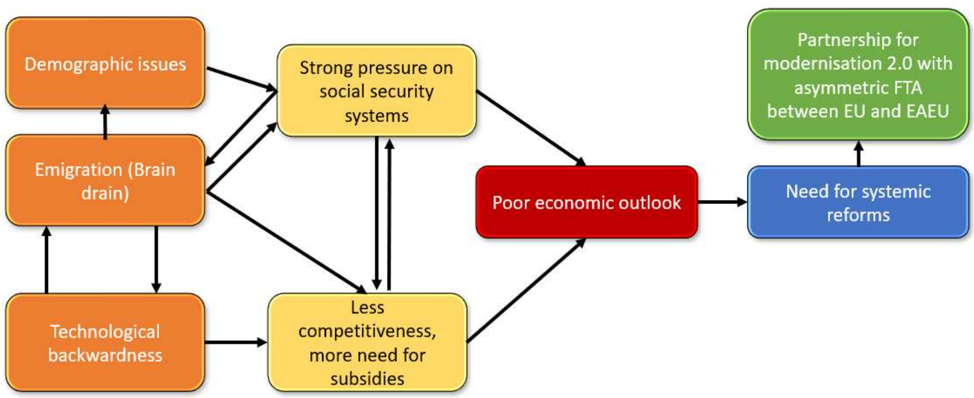
And it is the car industry that would be the biggest loser of a DCFTA, losing almost half of its pre-FTA output, since it is today an industry protected by some of the highest tariffs in Russia (Gucci, 2018). Car tariffs are a good example of that previously mentioned focus of policymakers on narrow interest groups. Not only are they introduced for the sake of those groups, but also for the benefit of political stability itself, not sacrificing it for necessary, but painful, economic adjustment processes. Potentially negative socio-political effects in monotowns are only increased by the low labour mobility of the Russian workforce (Bell et al. 2015). This might lead to a potential bottling of social discontent in these places, rather than alleviating those problems through labour movements. This situation highlights the lack of competitiveness of value-added processes in Russia vis-à-vis the EU and is an important aspect in the feasibility of an FTA: some, often remote, towns in the resource extracting sector would substantially benefit from these changes, whilst other, equally remote towns would lose, of which some to a significant extent. The problem in modern day Russia is that those cities benefiting from such a constellation, like Surgut, are already among the wealthiest cities of the country (Ria Novosti, 2019). However, the low intra-Russian labour mobility shows that laid-off workers in Tolyatti would not necessarily move to Surgut, not balancing this change in the production pattern of the country, but rather leading to additional needs for subsidies and potential grievances among the population of Tolyatti.

Long-term socio-economic constraints

Stability and economic growth seem, at least in the short term and given the current structure of the Russian economy and institutional features, not complementary but substitutes. The Russian economy lacks diversification, which is a direct consequence of the lack of investment (Dabrowski and Collin, 2019). This lack of investment, however, is a direct consequence of systemic corruption (McMillan, Woodruff, 2002; Zakharov, 2017). Hence, many analysts argue that the system in Russia in its current form can neither diversify in economic terms nor provide long-term growth (Dabrowski and Collin, 2019). Given therefore the level of institutional performance, it seems unlikely that thriving and internationally competitive companies would replace companies of hard-hit sectors by a Greater Europe FTA (Polischuk, 2013). This way, the political system, and the desire to keep the status quo, is the core obstacle for a full-scale FTA itself.

However, the socio-economic consequence of the current setting is an important long-term constraint. With the Kremlin having built its legitimacy around economic stability and growth in exchange for civil rights (Sakwa, 2014), the current economic crisis and poor long-term outlook also pose a significant long-term legitimacy issue for the leadership. As some analysts argue, "that social contract [between Putin and the society] no longer works for the people who can help rebuild the economy" and this phenomenon is being described as the biggest threat for security and stability of the country (Ansley, 2017). Recent figures reveal the scale of this problem: 53% of young Russians aged 18-24 expressed in a survey the desire to move abroad *permanently* (Rodgers, 2019).

This brain drain is a direct consequence *and* an enhancer of the stagnating economy, creating therefore a negative feedback loop. This dynamic of negative consequences stemming from the uncompetitive political as well as economic system will likely just increase in the future. Whilst in 2014, the ratio of working-age population to non-working age population was 2.5, in 2050 it is expected to reach 1.5 (Aleksashenko, 2016), and the absolute population is expected to decrease by 10 million to roughly 135 million (UN, 2019). Those socio-



Graph 2. Current socio-economic problems, its consequences for the Russian economy, and a potential solution in the long run. Own representation

demographic constraints are of utmost relevance for the prediction of the further economic development of Russia and the possible paths available for policymakers. As the graph below depicts, the political economy system in its current form will face ever-increasing pressure on social security systems and a corresponding need for additional subsidies. This will only make bleaker the already poor economic outlook and stress the need for systemic reforms.

In case no institutional changes occur, there is an imminent risk of a socio-political drawback for the elites. Hence, Moscow policymakers will have to realise that, from a rational perspective, political and economic reforms are inevitable given the socio-economic and demographic constraints the Russian state, economy, and society are facing in the future. Only through institutional reforms can the process of creative destruction take place and on the ashes of uncompetitive firms, new, productive industries appear that do not require redistributive subsidies from natural resources, but constitute a strong asset of a democratised, competitive Russia of the 21st century.

On the ground of this need for reform, a "new partnership for modernization" between the EU and Russia, or EAEU in this regard, with a Lisbon-Vladivostok project could become a reality. It is not a coincidence that the previous partnership between both blocks was launched in a time when rule of law issues and the need to tackle corruption were omnipresent in Russian public discourse (EU Russia Centre, 2010). The current Ukraine-EU DCFTA serves as a good example of the trajectory that could be envisioned: in exchange for asymmetric access to the European consumer market, which means that Kyiv is granted a long transition period until it has to open its markets, the country conducts far-stretching institutional reforms that are expected to increase the GDP by 20-30% in the long-run (Shumylo-Tapiola, 2012, p.19). Such a procedure would drastically increase trans-European integration, offer Russia clear incentives to conduct much-needed institutional reforms, and have positive security-related spillovers. Even high-ranked Russian officials, like the Director General of the Russian International Affairs Council (RIAC), admit that cooperation between Moscow and the West will only be possible if the former sets sail for "serious social and economic modernization" (Kortunov and Pirsalu, 2020). Given the approaching headwinds, these reforms might be inevitable and EU-Russian cooperation, encompassing at its core an ambitious DCFTA, is the best way to approach structural problems of the future.

Conclusion

As the foregone analysis has shown, an FTA between EU and EAEU carries an economic logic for the Russian Federation. This, however, is only true under certain conditions. Only an ambitious agreement abolishing NTBs incorporates substantial welfare gains for Russia, especially for crucial sectors in this country. Moreover, only an FTA embedded into broader institutional reforms, aimed at improving the political and economic environment of the Russian Federation, can be beneficial and successful in the long run. If this condition is not met, a significant risk exists for the DCFTA, and its corresponding effects, to lead to socio-political unrest in Russia's "Rust Belt" and potentially destabilising the system itself. Nevertheless, this should not be a reason to abstain from pursuing this vision, but rather to see it as a crucial instrument on the way to bring the Russian economic and its political system to a competitive level in the world of the 21st century. Otherwise, the status quo might, due to socio-economic constraints, prove to be either economically and/or politically unsustainable in the long run.

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