ATTRACTING FOREIGN DIRECT INVESTMENT FOR RUSSIA'S MODERNIZATION

BATTLING AGAINST THE ODDS

Mehmet Ögütçü
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Overview

At the opening of this new millennium, Russia looms on the horizon as an immense opportunity for investors, domestic and foreign alike - but for actual investments to flow and capital flight to be reversed, much will have to change. There are increasingly positive signals in this direction. Russia is a vast country stretching across Europe and Asia, possessing spectacular wealth in the form of exploitable natural resources, technology, a large, skilled workforce, and nearly 150 million consumers whose needs are endless. It is a country whose goals are to move towards a market system based on private capital investment and enterprise and to integrate rapidly into the world economy. Indeed, it has rapidly privatised the bulk of the assets of former state enterprises (although in many cases with a lack of transparency and fairness that has created an unfortunate legacy). It has also spawned hundreds of thousands of new small and medium-sized private enterprises, which have formed the backbone of its economy.

There is an increased interest from foreign investors in the Russian economy, which has seen a continuous growth over the past three years – a turnaround after a decade of declines in the 1990s. It has been quite a shock for many to see how quickly the Russian economy has rebounded from the 1998 financial crisis. On the back of strong oil prices, real GDP growth in 2002 is expected to reach 4 percent1. The governmental interim scenarios currently suggest growth in the range 3.4 to 5.6 percent for 2003-05. President Putin instructed the government to step up efforts to further increase the annual growth rate so that Russia could catch up Portugal over the next 10 to 15 years. In all the scenarios, the world oil price assumption plays an important role in view of the fact that Russia is the world's second largest oil exporter2. Otherwise, growth is only expected to accelerate if reforms are implemented, and there would also be a lag before the effects of reforms would materialise.

President Putin brought political stability, a welcome change for investors after the rotating governments in the final years of Boris Yeltsin's presidency. The state is consolidating its control functions, and political and macroeconomic risk factors have

[1] Deutsche Bank Risk Monitor, 21 June 2002.
[2] In 2001 Russia produced 7.34 million barrels a day while Saudi Arabia pumped 7.4 million barrels a day. OPEC production quota system has been seriously affected by non-OPEC Russia's decisions.

been significantly reduced. The consolidation of the Federal Government's authority in the regions (via the Presidential Representatives in the Federal Districts) has regional legislation into line with federal law on most issues, thereby overcoming the fragmentation of the national economic territory while reducing administrative barriers and risks. President Putin called on the Russian elite to bring money abroad back to Russia at low tax rates offered, warning that offshore accounts would become increasingly difficult to use as the international community tightens rules governing their use3.

A recent positive development for Russia has been the recognition of Russia by the EU and the USA as the 'market economy'. This should serve it well on several fronts, including providing a boost to Russian exports, relieving the country's anti-dumping duties (particularly on steel), and paving a way for its entry to the World Trade Organisation (WTO). Russia's new status will also improve general investor sentiment toward the country.

However, what has been achieved to date is not in itself enough to guarantee an improvement in the investment climate and a long-term revival of the economy. Despite a general economic recovery, problems of a strategic nature remain. Until Russia sees stable growth in the output of competitive products, it will be too early to speak of a stable economic growth pattern. That applies not only to the raw materials sectors, but also to secondary industries and services, and it will require massive investment into industrial plants and equipment, the widespread deployment of new technologies, and an improvement in economic management in practically all sectors of the economy. That is the real essence of the Government's task of modernising the economy, as laid out in the Gref Programme for 2000-20104.

FDI for modernisation

Modernisation of the Russian economy will result first and foremost in stable growth in domestic demand, thereby reducing Russia's dependence on the international raw material and oil markets. However, there is still a long way to go before the country reaches that stage. To that end, Russia must create conditions conducive towards generating revenue and increasing in-bound investment, and make more effective decisions on how it uses resources and promote goods on the market. Over the past three years, investment growth has outstripped GDP growth in relative terms; but it is difficult to say that Russia is making full use of its investment potential. Its mechanisms for transforming savings into investments are ineffective, resulting in a situation where total savings in Russia significantly exceed total capital. Sector-to-sector capital flow is also at a very low level. In terms of investment resources, there is a clear misbalance in supply and demand between the export-oriented raw materials sectors and the rest of the economy, which is in dire need of capital.

Anticipated WTO Accession: Pros and Cons

[3] "Russians Invest Money at Home", 26 June 2002, International Herald Tribune.

[4] In 2000, under President Putin, the Government published a Social & Economic Policy Program 2000-2010 (the Gref Program) that demonstrates an understanding of the threats currently facing the country and which offers a development strategy based on a series of social and economic reforms intended to create a liberal market economy, governed by a democratic political system. The Program was widely endorsed by the business community in Russia, and refers to the task of improving the investment climate as one of the most important issues facing Russia today.

Russia's accession to WTO would complement its internal economic reforms by promoting rule of law, fair competition, transparency and predictability in business and investment. While reiterating his optimistic belief that Russia would be granted membership by the end of 2003, WTO General Director Mike Moore said that the biggest obstacle Russia has to overcome was reforming its agricultural sector. In addition to resistance abroad, there are some concerns domestically about the ramifications of Russia's joining WTO. President Putin and Prime Minister Kasyanov stressed that integrating into the world economy was "the main current economic priority of Russia," the largest economy still outside the WTO. However, it does not seem that the government has made a thorough analysis of the implications for domestic industries and regions of Russia's accession to WTO. Nor is it clear what the government's goal is in its current negotiations with the WTO. While there is little doubt among the vast majority of producers that Russia should join the WTO, several items remain unclear including the incompleteness of legislative reforms required for membership, such as passing a new Customs Code, law on external trade policy and other5.

Many sectors remained unexposed to competition and growth of total factor productivity was slow in such sectors. Exposure to international competition may be detrimental in the short run to some sectors of the Russian economy such as the food and machine-building industries, but the long-term consequences of not joining and not restructuring are even more harmful to Russia. The international experience of countries (i.e. China) that have joined the WTO demonstrates that WTO accession attracts FDI; not only do WTO membership brings more FDI, but also the accession process itself is accompanied by growth in FDI. To be successful in the global economy Russia needs greater factor mobility. Export-oriented Russian producers will become more attractive for FDI after WTO accession.

Opportunities for Investment

The opportunities for investment are immense. Yet, the existing level of FDI in the Russian economy remains far short of the huge needs. The low levels are not due to the lack of opportunities or potential, but mainly to its difficult climate for private business and investment. The cumulative figure for FDI in Russia from 1991 through the end of 2001 represents $18.2 billion, or only 5 percent of domestic fixed capital formation. This performance may be compared with FDI in China of $46 billion in 2000 alone, more than $200 billion in the United States in 2001, and a global total of $1,270 billion in 2000. The level of FDI in Russia is very low relative to other transition countries in the region as well, adjusted for population size: on a per capita basis, cumulative FDI in Russia is $15, compared to $84 for Poland, $118 for the Czech Republic and $221 for Hungary. In cumulative terms, the largest investors in Russia by the end of 2000 were Germany (17.1 percent), the United States (15.6

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[5] Deputy Prime Minister and Finance Minister Alexei Kudrin reiterated in June 2002 that an extensive plan for more reforms was under way. He said that in 2002 the government would pass the laws on investment, which would reduce the number of required approvals for the right to build, to take over construction site. It would also pass a new Customs Code, which will conform to international regulations and standards. There will be a law on standardisation and certification, which will substantially reduce the scope of mandatory standardisation, and certification of products. The government also plans to pass laws on the regulation of foreign trade, on special protective anti-dumping and compensation measures as applied to imports, on government support in connection with Russia's accession to the WTO.

percent), and Cyprus (14.9 percent). Most of the FDI went to the fuel, food, trade, catering, and transport sectors.

Increased FDI activity is set to continue particularly in sectors such as oil, gas, power generation, distribution, and food6. In the past, many Russian companies had already teamed up with foreign partners. Cellular companies are one example, Ruhrgas and Gazprom another. Other examples abound. Over the last several months there have been renewed strategic investment in traded Russian companies: Danone purchased 4 percent of Wimm-Bill-Dann; Heineken is paying up to $400 mn for Bravo International; and S&N has offered $1.5 bn for Hartwall; whose main asset is its 24.3 percent stake in the Russian brewery “Baltika”.

Russia is most actively encouraging the participation of foreign companies in the oil and gas sector, not only for their capital contribution, but also for their advanced technology and experience. Nearly all the major international oil companies and many smaller ones have expressed interest in participating in the exploration and development of Russia's oil and gas reserves and willingness to commit modern technology and billions of dollars of capital on a long-term basis, provided Russia creates investment conditions compatible with international practice and which take account of the long-term character of investments in this sector. Such conditions include an opportunity to share in the production generated by the investment, a clear and reasonable tax regime which allows an equitable return on investment, a stable set of rules, and an equal opportunity to obtain and exercise rights to the oil and gas fields.

Four Russian companies, included on The Financial Times’s list of the world's 500 largest corporations, all are active in the fuel and energy sector. Yukos, Russia's second largest oil producer, made it to 227th place on the list, with market capitalisation of $ 18.7 bn. Next came Gazprom, the Russian gas monopoly, in 250th place. Surgutneftegaz, Russia's third largest oil producer, was in 344th place and LUKoil, Russia's largest oil producer, was in 362nd place. The total overall value of these four companies amounts to $ 61.7 bn7. There are around 15 international oil majors that consider a sizeable stake in Russian companies. Several Russian companies, notably Sibneft and TNK, have stated that they would welcome a foreign strategic buyer. British Petroleum, despite having burnt fingers before, may be interested in acquiring Sidanco. Mol has agreed to invest approximately $350 mn in a joint venture with a major Russian oil company to develop the West Malonalykskoye field.

In the power sector, the proposed reforms include breaking up the current vertically integrated regional companies into generation, distribution and supply and envisage concluding management contracts for several of the enlarged generation companies that are to emerge from the restructuring. While current uncertainty over future tariffs, regulation and the resulting sector structure prevents most foreign strategic buyers from taking aggressive steps, in the longer term many European power companies may be attracted by the cheapness of Russian assets and the chance to gain exposure to a promising market. UES is actively searching for bidders and already by the end of

[6] “Foreign Strategic Buyers”, Denis Rodionov, AmCham News, May-June 2002, p.14

[7] “Four Russian companies included on FT 500 list”, Alexander’s Gas and Oil Connections, Volume 7, issue #12 - Thursday, June 13, 2002

2003 several foreign participants are expected to emerge. EDF is planning to create a joint venture with Mosenergo and EON has recently signed a letter of intent with UES to participate in modernising the Russian power sector.

Improving Policy Environment for Foreign Direct Investment

With this seemingly large window of opportunity for improving the investment climate and attracting greater inflows of FDI from OECD-based multinationals, it is important to have a clear idea of where the most significant obstacles encountered in Russia by investors lie, as well as the most effective ways to alleviate their impact in the short term. Russia can and should take full advantage of benefits associated with inflows of FDI, but it lacks a clear strategic vision of how FDI could fuel its growth and modernise some of its antiquated industries.

It needs to have an integrated approach towards investment across the often-disconnected central government departments, the regions, and the municipalities in order to ensure that investors would operate in an enabling environment without arbitrary government hindrance and on the basis of market-based incentives. Significant benefits would flow from exposure to new entrants with advanced organisational and managerial skills, particularly in the infrastructure monopoly sectors, where deregulation is now being considered. The dominance of many large industrial firms, hitherto fairly immune from robust competitive pressures, would also be seriously challenged.

The factors responsible for the comparatively low level of FDI inflows in Russia are on the whole not different from those depressing domestic investment. Why has there been so little foreign investment and what needs to be done to change this in the coming decade? One, perhaps cynical, explanation is that Russia may not really want foreign investment, and has only paid lip-service to the principle in order to gain the backing of foreign governments and international financial institutions8. Russia's history, not just in the Soviet period but going back centuries, has been one of isolation from the West and distrust of the outside world9. It takes time for attitudes to change. Many members of today's Duma distrust foreigners per se and believe their only purpose in investing in Russia is to rob the country of its riches by making quick profits and shifting them abroad. However, there is an enlightened segment of leadership in Russia, which does not share this view, but to the contrary, recognises that there are enormous benefits Russia can and should derive from FDI.

Over the past decade, private sector has been overwhelmed by the absence of framework conditions for investment and business operation and a number of barriers, but today the reduced political and macroeconomic risks, together with ongoing changes in the policy environment and legislative reform (especially the introduction of an Income Tax set at 13 per cent and Profits Tax of 24 percent), give hope for tangible improvements in the investment climate. One of the key remaining obstacles

[8] See http://www.iccwbo.org/home/conferences/reports/budapest/book_articles/hertzfeld.asp

[9] Peter the Great sought to open a "window to the west" by building Saint Petersburg, where we meet today. But the German, Dutch and Italian specialists who were invited to Russia to assist in this venture were kept segregated from Russian society and, when their task was done, few were encouraged to stay on. During the communist period, foreign companies sold plants to the Soviet trading monopoly, but once the plants were built and commissioned the foreign specialists who built them were no longer welcome.

to FDI inflow in the country and investment of domestic capital is the poor implementation of improved rules. In most cases the new laws need the underpinning of another set of laws and regulations to become operational. There is a serious concern as to the coherence of new legislation and co-ordination of government (federal, regional and local) policies to attract investment.

Banking Sector Reform is Critical

Legislative reforms in banking sector and oil, gas and rail monopolies have been the weakest element in the reform program so far. The Russian banks are still not fully playing the role of financial intermediaries and do not serve as a major source of enterprise financing. Banking regulations have been tightened, but structural weaknesses remain. The banking system, insurance industry and pension funds are highly protected from foreign competition. The key points of the government's three-year programme in banking sector reform include: (i) a mandatory deposit insurance system starting in 2004; (ii) capital requirements for newly created banks to be increased to Euros 5 million; (iii) international standards for accounting and reporting to be adopted by 2004; (iv) the government to disinvest its stakes in a number of banks (there was a disagreement on the matter between the government and the former Central Bank governor Victor Geraschenko, who was replaced); and (v) equal conditions for resident and non-resident banks.

The reform programme would allow the Central Bank of Russia to withdraw licenses from bad banks. Many of the more than 1,200 banks in Russia are substantially undercapitalised and technically insolvent. Over the next two years Russia plans to restructure or close half these banks. A federal guarantee of retail deposits is a key step with regard to restoring confidence in the banking system and ensuring fair competition with Sberbank, which has a state guarantee for deposit. A functioning process of financial intermediation (particularly retail banking) is vital for strengthening SMEs (and middle class) in Russia and thus for a more diversified economic structure.

Regarding the natural monopolies, the restructuring of the Ministry of Railway Transportation has already been adopted by the government and is slowly being implemented. Other objectives in restructuring infrastructure monopolies include de-monopolisation of electricity generation, gas and telecoms, significant reduction in lists of consumers whose energy supply may not be cut off, reduction of cross-subsidies between categories of consumers and development of production sharing agreement legislation.

Public and private sector governance issues

The combination of complex laws, government control over key assets, low level of remuneration of government agents, along with weak enforcement and control mechanisms, provides a breeding ground for corrupt practices. Furthermore, given the sheer number of sometimes-conflicting regulations in tax and other areas, most businesses are in violation of some regulation or other and can thus be free game for pressures for bribes by officials.

Corrupt practices in the private sector can also represent the other side of the coin to the corruption of public sector officials, in situations where business firms or other private sector parties exercise direct pressure, including threats of outright violence or sanctions putting the official at personal risk. The existence of racketeering and organised crime is unfortunately a fact in the Russian economic environment, and many business firms pay a significant percentage of profits in “protection money”.

The proper enforcement of existing criminal law sanctions on outright corruption, extortion and blackmail and other economic crime is of course of fundamental importance for a secure investment climate. Further action by the authorities in encouraging the development of ethical standards in the corporate sector such as currently contemplated for corporate governance practices should be explored. It is also important that the many corrupt practices which are now taken for granted be explicitly recognised and disclosed whenever possible in the interest of furthering ethics in everyday business life.

Tax policy

Complaints from foreign investors about the excessive tax burden imposed on their operations in the Russian Federation are, in the main, due to the multitude of different taxes levied and, importantly, from the methods of determination of the actual tax base. Many studies and reports have pointed to the fact that the Russian tax system consistently discourages investment, both through its structure and the manner in which it has been implemented. This fact remains true for domestic as well as foreign investors, whether we discuss start-ups of new businesses or the restructuring of existing firms. The frequent changes in rules and regulations have created a degree of uncertainty that impacts negatively on business development in general.

For many years, reform initiatives have been mired in political controversy, both at federal and regional level, often becoming hostage to other political bargains. The comprehensive tax reform now being implemented in Russia has two main objectives: it addresses both the lack of an efficient system for inter-budgetary allocations of revenues and expenditures (fiscal federalism) and the need for improving the structure and calculation of taxes to enhance neutrality, fairness and thus the degree of compliance.

An excessive tax burden on oil and gas production has curtailed new investment in the energy sector. In particular, the oil and gas tax regime has relied primarily on revenue-based and production taxes, such as excises, royalties, and export duties. Two reform efforts to rationalise oil and gas taxation are under way. One effort is to provide for a more profit-based tax regime through production-sharing agreements. The other effort is to amend the existing tax legislation to replace the production-based excise tax with surtax on profits.

The fairness and effectiveness of the tax enforcement function are limited for a number of reasons. For example, there is a lack of modern facilities (such as computers) for the effective monitoring of taxpayers’ accounts. In addition, some tax inspectors are not adequately trained. Finally, some judges who hear tax cases lack sufficient knowledge about tax issues.

The many unresolved issues in the field of inter-budgetary relations and arrangements for revenue sharing between the federal and regional governments have brought added uncertainty and changeability to the tax environment faced by investors through multiplication of seemingly irrational and incoherent taxes.

Although the current policies aim to reclaim and reaffirm federal authority, relying on closed lists of taxes allowed at the different budgetary levels, many regions and local governments continue to introduce taxes that are not provided for in the federal legislation. Thus, while strong federal presence seems likely to remain necessary in the near future, it should not simply take the form of increasingly rigid federal regulation, which could risk backfiring as sub-national authorities continue to seek loopholes for every restriction. A workable revenue-sharing system clearly requires consensus about its fairness in order to be genuinely effective.

Federal vs Regional Governments: Implications for Investment

The business in Russia suffers from the absence of a unified economic space and the frequent regulatory changes, contradictory interpretation and discriminatory implementation of existing legislation resulting from unclear and contested separation of powers. There is still a sense of uncertainty in the relations between different levels of power. What Russia needs is a clear-cut definition of state functions, transparency of official actions and the determination of what every level can and cannot do.

Among the most important reforms aimed at creating, not in word but in deed, a democratic rule-of-law state with a modern market economy is the re-engineering of federated relations in Russia and reform of local government, as it is virtually impossible to rule the 89 regions from Moscow. Depending on the region investors encounter different conditions for business, different degrees on interference by the authorities. This is due on the one hand to the existing level of lawlessness that was rampant in the country when, in violation of the Constitution and the federal laws, the political leanings and agendas of the heads of regions and municipalities introduced various restrictions.

President Putin is now giving priority to restoring authority to the central government and dismantling power bases and conflicting administrative and other structures at regional level. In May 2000 he announced as a primary task to restore a common legal space in Russia. Existing federal laws make it very difficult even for a skilled lawyer to determine which body of government has what power and responsibilities, and what relations it can regulate and what the scope of its interference is. If one looks at the existing federal laws, they very often use the formula whereby simultaneously three levels of government are responsible for compliance with federal laws: federal, regional and municipal. This as yet untested new layer of authority will face very specific economic and political challenges. Whether for investors this will result in elimination of some of the differences in interpretation of laws and legislative practices (land ownership and transfer, taxation, foreign investment policy) remains to be seen.10

Need for Corporate Responsibility

A degree of scepticism exists in regional administrations as to the positive effects of foreign investment at regional and local levels. Some of the oblast administrations simply lack knowledge and expertise necessary to respond to the requirement of a modern business and cannot find ways to ‘anchor’ FDI in the regional economy. In addition, while on one hand this sceptical attitude can be explained by the desire to

[10] “Inter-Governmental Relation Reform is priority”, Dmitry Kozak, Deputy Head of the Russian President’s Administration, in AmCham News, March-April 2002, p.22.

protect local producers, on the other, local administrations are more likely to give green light to investors which take social responsibility and “not only think about global profits but also take care of local matters”. In case the foreign investors are not likely to take social responsibilities the local authorities may act as they deem necessary and impede investors’ activities.

In the same time, the attitude of some regional administrations towards foreign investors could be summed up in one phrase - “trap and squeeze” as compared to long term planning and finding mutually beneficial solutions. The burden of bureaucratic procedures and poor public governance at local and regional level is considered as a “nuclear threat to business”.

Cross-border partnerships, between local and regional governments as well as between enterprises, were seen as a potentially powerful economic development tool in ensuring that local economies can benefit from the process of globalisation. With the foreseen accession of Baltic states to EU, promoting cross-border partnerships has particular application in Northwest Russia regions. There is considerable concern among Russian authorities that competition to attract FDI will intensify between Russia and neighbouring countries in the Baltics and Central/Eastern Europe, particularly after their accession to the EU in 2004.

The Way Ahead

Russia is now at a critical juncture where it could grow very rapidly, catching up with Europe in the same way that poor Europe caught up with rich Europe under the stimulus of international trade and capital flows. The strategy that it will adopt now will determine the irreversible course of events to come. It is widely believed that seeking remedies in revisions to the legal and regulatory framework for foreign investment represents an incomplete approach, as deficiencies in this respect only form a minor part of the greater picture. The lags in structural reform and the policy deficiencies that have combined to produce an unfavourable climate for domestic as well as foreign investment need to be analysed as a whole.

A rules-based FDI policy regime and its enforceability is key. It is one of the reasons why Russia’s accession to the WTO is so important. Indeed, WTO accession would be both an actual and symbolic step towards Russia’s harmonisation with international economic policy practices and bring it in line with the new paradigm of FDI. Although it could create some short-term negative results for certain uncompetitive industries, WTO accession will bring about fundamental competitive advantages to Russia in the medium to longer term.

A level playing field and a rule of law require an honest, even-handed and efficient bureaucracy and judicial system, implementing reasonable rules in a consistent and predictable manner. It also requires the evolution of a new business culture in Russia, which favours compliance, with rather than avoidance of, the rules and a system of values which encourages productivity and efficiency in the workplace. Such a change cannot be achieved overnight, but can be achieved over time. Failure to do so will certainly discourage foreign direct investment. However, even more importantly, it will carry a heavy political, social and economic price - continuing decline in the country's economic performance with still lower levels of new investment, higher rates of unemployment, and a growing percentage of the population living below the poverty level11.

The problems faced in Russia are in large part as relevant to most domestic investors as they are to foreign investors in the Russian economy. However, the basic difference between the two is that the domestic entrepreneur is condemned to cope with local conditions while the foreign investor is free to choose from among competing host countries and to decide which one offers the most attractive balance of risk and opportunity for its investment. A country's success in attracting foreign investment is therefore a measure of its domestic success as well. As and when positive change occurs, foreign direct investment will dramatically increase and such investment will indeed become a motor for economic growth and prosperity in the coming years.

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[11] See http://www.amcham.ru/external/280202.html