DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS

THE INVESTMENT ENVIRONMENT IN THE RUSSIAN FEDERATION

LAWS, POLICIES AND INSTITUTIONS

The Institutional and Policy Environment for Investment: Summary and Recommendations

May 2001

This Summary and Recommendations forms part of an OECD publication entitled "The Investment Environment in the Russian Federation: Laws, Policies and Institutions" which was published in May 2001. The study was carried out under the auspices of Centre for Co-operation with Non-Members of the OECD as part of its programme of co-operation with the Russian Federation. This work is published under the responsibility of the Secretary-General of the OECD.

TABLE OF CONTENTS

The Institutional and Policy Environment for Investment: Summary and Recommendations

1. Introduction

Russia moved quickly with initial economic reforms, in particular mass privatisation and price liberalisation (despite some temporary re-imposition of price controls, mainly at regional level, following the 1998 financial crisis). Many structural reforms were, however, either incomplete or delayed, frustrating hopes for a surge in restructuring and new investment within the enterprise sector. A genuine competitive environment for business development failed to emerge, and there was no large-scale entry of new firms to absorb productive resources freed from older, non-viable enterprises.

This low investment, low restructuring trap is well described by data on economic growth and productivity developments. Despite recent growth, GDP has fallen by over 40% since 1992. Although fixed capital formation began to show positive growth in 1999 it still remains at a level of less than a quarter of the corresponding figure for 1990. Average productivity levels are estimated to be around 24% of the United States average. Soviet era assets, accounting for 70% of the present industrial capital stock, were 30% as productive as US assets in 1992 and are now estimated to be only 15% as productive. Roughly 25% of industrial capacity is in sub-scale or obsolete assets. On a per capita level both Foreign Direct Investment (FDI) inflows and spending on research and development rank very low in international comparisons. In short, levels of both domestic and foreign investment remain low.

In these circumstances there is no doubt that the factors responsible for the comparatively low level of FDI inflows are on the whole the same as those depressing domestic investment. Offering special incentives or privileges to foreign investors is not likely to fundamentally increase the share Russia is capturing of the growing flows of direct investment into developing and transition countries. Seeking remedies in revisions to the legal and regulatory framework for foreign investment – as advocated in some studies – also represents an incomplete approach, as deficiencies in this respect only form a minor part of the picture. The lags in structural reform and the policy

deficiencies which have combined to produce an unfavourable climate for domestic as well as foreign investment need to be analysed as a whole.

Furthermore, studies of the performance of the domestic enterprise sectors across transition countries show evidence that the competitive pressures from foreign firms, via trade and investment, are key factors in promoting product innovation and the overall diffusion of new technology, investment in new plant and sales growth. In the case of Russia, such competitive pressures from foreign firms have generally been weak, not only because of isolation due to the geographical distances from markets, but also because of the relatively low level of FDI. It is quite clear that increased levels of FDI could play a crucial role in transforming the industrial configuration still remaining from the period of central planning into a product of competitive forces, reducing the current excessive levels of horizontal and vertical consolidation as well as regional market segmentation. 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.

Recent data on macroeconomic developments indicate a strong acceleration of growth, which is being reflected in concomitant growth in capital formation, and this trend is expected to continue at least into the year 2001, according to most forecasts. (In 1999 GDP growth was 3.2%, while the government currently estimates GDP growth of 7% in 2000, declining to 5-6% in 2001).

In addition, the new administration has demonstrated a strong intent to speed up structural reforms and places heavy emphasis on measures to stimulate investment activity across the board.

With this seemingly large window of opportunity for improving the investment climate in the Russian Federation, it is important to have a clear idea of where the most significant obstacles encountered by investors lie, as well as the most effective ways to alleviate their impact in the short term.

One fundamental minimum condition for the existence of an attractive investment climate is certainly present in the form of an adequate endowment, both with respect to natural resources and highly educated manpower. Political and economic stability is also a *sine qua non*, and here the record has of course been variable during the past ten years of transition. However, as mentioned in the preceding paragraphs, vigorous economic growth is being registered and a prospect for medium-term stability is clearly present.

In addition to providing a stable political environment and striving to ensure favourable macro-economic fundamentals, the government must also facilitate business development at the micro level. This includes providing an adequate physical and institutional infrastructure as well as the policies which aim to promote profitable investment activity. In this study we have tried to identify major weaknesses in the institutional framework for, and the policies towards, business activity in general, including FDI.

A multitude of impediments to the development of a healthy business climate exists in Russia, and these are often linked in their origin and nature. The fundamental questions we are posing can be simply stated as follows:

- Is there an adequate, rules-based legal and regulatory environment for investment?

- Does it apply consistently, for all, across the territory of the Russian Federation – or are there inconsistencies and regional variations?

- Are the rules being properly implemented and enforced, or being thwarted through corrupt behaviour and rent-seeking by economic agents?

The first question can be answered affirmatively, with some caveats as to a few areas where the legislative basis itself needs to be strengthened in order to adequately protect investor rights and interests. However, the other two questions require a negative answer. There is no unified economic space, no "level playing field" for businesses in Russia, because of the multitude of administrative barriers and obstacles encountered by investors, particularly at regional level, often in contravention of federal legislation and regulation. As specific examples of unpredictable hurdles to be surmounted by investors at federal level could be mentioned sudden withdrawal of frequencies from telecommunication companies, or sudden unavailability of previously posted railway freight tariffs, which served as a basis for feasibility calculations. At the regional level, examples abound in the form of unforeseen licensing or permission requirements, license fees in excess of what is legally required, tax payments that are negotiable rather than statutory, "voluntary" contributions to extra-budgetary funds, etc. In addition, the general burden of licensing and other policy-induced start-up difficulties at regional level is so onerous that firms specialising in helping new businesses to manage this process are becoming a new growth industry.

As to uniform implementation of the law, the uncertainty of proper administration and enforcement of justice by the court system and the degree of

corruption throughout the economy further undermine the confidence in the existing legal and regulatory framework. There is no security of private property rights, contracts are difficult to verify and enforce and most businesses expect to pay bribes of varying levels to be able to execute claims awarded in dispute resolution.

These issues are discussed in more depth in Part II, Chapter I, "Protection of Property Rights" and Chapter II, "The Regional Dimension: Investment Policies at Sub-Federal Level", while the related policy recommendations are summarised below.

A further question deriving from the inventory of minimum conditions for a positive investment environment in Russia is:

> Are there particular areas where policies could be improved either to remove disincentives for investment (whether foreign or domestic in origin) or generally to put in place missing elements of institutional infrastructure to support investment?

In this context, we have chosen to focus on the following three issues as areas of priority:

Developments in tax reform: in particular what should be done to address remaining negative incentives for investment;

The manner in which privatisation is being pursued and the policies towards participation by foreign investors;

The situation in the financial sector and its impact on the availability of finance for investment.

Part II, Chapter III, "Tax System and Policies" gives a more detailed overview of the tax environment relevant to business activities, while Chapter IV, "Privatisation Policies" describes how the evolution and successive changes in privatisation policies has affected the conditions on which investors have been able to participate in this process. Chapter V, "Financial Infrastructure and Intermediation" is primarily intended to describe the financial sector environment and available range of opportunities for investors to raise external finance. Policy conclusions deriving from the analysis in these chapters are likewise presented below.

2. Legal Framework, Protection and Enforcement of Property Rights

Framework Laws

The legal framework for trade and investment in Russia is established by the 1994 Constitution, the first two parts of the Civil Code adopted in 1995 and 1996 and by somewhat more recent legislation on joint-stock and limited liability companies and insolvency. These laws are in turn supplemented by other sector- or activity-specific laws on property, natural resources, banking, insurance, and other specialised areas. Some provisions regulating investment are also included in the laws on competition and environment protection. Two recently enacted laws, *On general investment activity* and *On foreign investment* neither enhance security for nor add restrictions on investors as compared to those already foreseen in other legislative acts. (See further Part I, section 1, *General Legislation on Investment Activities*). Thus, while the existence of separate legislation on foreign investment activity had some practical significance in the beginning of transition, before the full legal basis for commercial activity was firmly embodied in other major legislative acts, it is now more declarative in nature. Beyond the specific introduction of a grandfather clause with protection against changes in legislation detrimental to investment projects (see Part I, Box 1), both laws serve more to reflect the government's commitment to existing investor rights and full national treatment for foreign investors.

Although legislation at times has proceeded at very rapid pace, with little co-ordination of reforms affecting the same or related areas of economic activity, commercial legal rules are at present sufficiently clear, coherent and operational to support business activity in general. Unresolved legislative issues of major importance for investors remain:

- The adoption of a universal Land Code;
- The creation of adequate registry procedures for non-possessory pledges in line with the provisions of the Civil Code;
- Harmonisation of the Tax and Customs Codes with the provisions in investment legislation, in particular as relates to grandfather clause provisions and production-sharing agreements.

Certain other factors impacting negatively on the legislative framework have not been discussed in depth in this document. These include mutually exclusive provisions resulting from poor co-ordination of legislative acts, and a certain degree of devaluation or undermining of legislation due to the frequency

of amendments to laws. In addition there is the general problem of unclear balance of jurisdiction at federal and regional levels, preventing uniform implementation. Another deficiency is the ineffectiveness or even absence of penalties for violation of laws. In addressing these problems, it is of paramount importance that attention be given to safeguarding the stability of laws, particularly by avoiding successive amendments to laws unless absolutely unavoidable to eliminate inconsistencies.

For foreign investors, part of the general legal and regulatory framework described in Part I below deserves to be singled out for immediate reform or rapid advancement of improvements already on the drawing board. This relates in particular to the foreign exchange regulations currently in force and to the area of production sharing agreements (PSAs) for extraction of mineral resources.

Foreign exchange regulation in Russia provides the basic guarantees for investors as concerns repatriation of profits and dividends, and Russia has accepted the obligations of Article VIII of the IMF Articles of Agreement, formally since June 1996. However, current legislation requires the prior authorisation of the Central Bank of Russia (CBR) for most capital account transfers, and the licensing system for such operations is both cumbersome to operate for the authorities and onerous and non-transparent for private sector participants. Priorities for reform are:

- As an immediate measure, the system of licensing capital account operations should be made more transparent by the issuing of guidelines (including for internal use by the control authorities) which would clarify on what grounds a license would be refused;

- The rules for the present elaborate system for non-resident rouble accounts should be rendered clearer, more systematic and user-friendly;

- The exchange control system for both current and capital account operations should be amended to permit market participants to make freely those payments and transfers which are required under contracts that have been legally entered into. This means that firms should not find themselves unable to perform under legally binding commercial agreements because of the foreign exchange regulatory regime or its discretionary implementation by currency control authorities;

- The 1992 Foreign Exchange Law and its implementing regulations should be revised to simplify the regime and bring it into line with international practice, in particular by introducing a negative list principle for capital account operations, leaving all but a specified number of items completely free of licensing requirements.

As to the legislation and regulatory regime providing the basis for production-sharing agreements, urgent improvements are needed if the full potential of this crucial area for attracting long-term foreign capital and expertise is to be realised. Beyond the already mentioned need for reconciliation with other legislation, (in particular harmonisation with *Part Two of the Tax Code* where a draft proposal is already being considered by the Duma) the following measures are called for:

- The elimination of local content requirements, in particular the stipulated minimum share of Russian equipment (70%);

- Establishing a clearer and more transparent distribution of powers among different ministries and government agencies with respect to regulating and negotiating PSAs.

Protection of property, shareholder and contractual rights

In practice, one of the major problems encountered by investors relates to the protection and enforcement of property rights, as discussed in more depth in Part II, Chapter I below.

The insecurity of property rights in Russia perceived by investors relates in particular to the protection of shareholder/investor rights, protection of secured and unsecured creditors rights and to the balance between debtor/creditor interests in bankruptcy proceedings.

As to *shareholder rights*, the many well-publicised corporate scandals during the period 1997 – 2000 illustrate that it is in the reorganisation of legal entitites that the infringements of ownership rights of shareholders and portfolio investors in general have been most widespread. Above all, attempts have been directed towards pushing out individual minority shareholders into new companies in a less favourable financial situation or transferring valuable assets to other entities leaving only impaired assets in the original shareholding structure. The need to strengthen regulation and oversight by the authorities in the domain of corporate governance to prevent these and other infringements of shareholder rights is widely debated in Russia today. The appropriate response

from the regulatory and supervisory powers is currently being designed, with a significant role to be played by the self-regulatory organisations and private business through the development of codes of conduct for securities market participants.[1] However, unless the legal basis covering reorganisations is amended, such abuses are likely to continue.

In the domain of corporate law, attention should be given to:

- Widening the monitoring capabilities exercised by the board of directors and minority shareholders of the executive organs of companies and majority shareholders;
- Developing more effective legislation prohibiting insider dealing;
- Defining deals among affiliated entities, widening the concept of an affiliated party and strengthening the power of regulatory authorities to prohibit such deals when required;
- Extending disclosure requirements as well as the responsibility for the content of such information disclosure;
- Regulating the dilution of share capital;
- Limiting cross-ownership of share capital;
- Strengthening the requirements for independent audits;
- Protecting good faith shareholders from effects of invalid share transactions;
- Introducing personal liability and responsibility for officers, directors and controlling shareholders for the damages inflicted on their company, or on its shareholders (with outright dismissal for breaking corporate governance norms and imprisonment in graver cases).

There are pressing needs for amendment to the law on joint stock companies on the following points: (1) the introduction of pre-emptive rights for all shareholders to participate in new issues of shares irrespective of any stipulations regarding such a right in the company's articles of association; (2) decisions regarding issuance of additional shares or obligations convertible into shares through closed subscription should be the exclusive prerogative of the general shareholders'meeting; (3) prohibiting the conversion of an open

underwriting into an effectively closed one through a requirement that the shares should be paid for with specified property; (4) strengthening the powers of the board of directors to control the executive organs of the company; (5) clarifying of the procedures for calling a general meeting of shareholders. A draft law introducing these amendments was adopted by the Duma in the third reading on 2 June 2000, but afterwards blocked by the Federal Council, reportedly due to pressure from certain major companies.

Such amendments are not intended to signify exclusive concern with legal protection of minority shareholders' rights from infringements by major shareholders. From the legal standpoint it is necessary to find a sensible balance or compromise between (1) the necessity to provide minority shareholders and foreign investors the protection they require from infringements of property rights and (2) at the same time avoid blocking up the legal system with unfounded claims made by minority shareholders on the basis of private agendas.

Lack of compliance with disclosure requirements must be addressed both in the joint stock company law, in the law on protection of rights and legal interests of investors, the law on securities and also through the introduction of international accounting standards and criminal liability for non-compliance.

An important task for supervisory authorities is the introduction of a system for monitoring who participates in the share capital of companies and the establishment of clear rules concerning mergers and acquisitions. This is extremely important for preventing insider dealing. A mechanical extension of the concept of affiliated party is not enough, since the establishment of transparency of ownership relations in a company or a bank requires penetration into the dynamics of real owners/decision makers. The incompleteness of disclosure requirements in Russia has resulted in widespread expropriation by controlling agents. Improvements are required in the disclosure of ownership structures, voting rights, the identity of management and the board of directors. Significant progress is required in the frequency and timing of disclosure in order to enable investors to properly assess a company's governance and most importantly, to provide an opportunity to catch illicit transactions early on.

In order to provide outsiders with real information about who the major principals of a corporation are and to bring the latter to take responsibility for any infringements or direct damage inflicted on shareholders it is necessary to expose flows of funds between entities to identify group holding relationships. Within the framework of corporate law it is necessary to prevent the establishment of the type of "overnight" shell companies without proper capitalisation, which are used in operations diluting the authorised share capital

of another company, in order to protect creditors and assist them in the recovery of losses incurred through this route.

There is by now fairly broad consensus among Russian policy-makers, regulators and the international investor community that financial reporting standards and disclosure requirements need to be substantially improved and tightened in the Russian enterprise sector. An important tool in this context, strongly advocated by foreign investor associations as well as the European Bank for Reconstruction and Development (EBRD) and other international bodies active in the Russian corporate environment is the introduction of international accounting standards (IAS). It is proposed that the government adopt as a medium term goal (ideally over a three to a maximum five-year period) the replacement of Russian Accounting Standards (RAS) with full IAS for financial reporting in all joint-stock companies. This could be accomplished through a phased process whereby different enterprise sectors be permitted and in some cases required to adopt full IAS (in place of RAS) in a sequence and according to a definite timetable. It is argued that the current accounting reform programme envisaging gradual adoption of individual parts of IAS will produce misleading results and prove unnecessarily costly for enterprises.

While the application of IAS financial statements is an important means to communicate financial information, it will not in itself eradicate fraud or prevent illicit transactions for personal gain by insiders. However, it will assist in their timely detection and also act as an important deterrent. To improve the application of accounting standards, it is important that the public and private sectors clearly understand their complementary responsibilities. Following the determination of accounting standards by national standard setting bodies, the accounting profession and companies must apply them appropriately when putting together financial statements. In addition, there must be proper incentives to ensure high quality reporting. One of the key incentives is the existence of a large and sophisticated investor community.

Concretely, the recommendations put forth by the foreign investor community are:

- Immediate IAS adoption by banks and listed companies and optionally by others;[2]

- Whenever state shareholdings of significant value are being sold, audited IAS financials should be prepared for incorporation in the sales prospectus;

- Unitary enterprises (i.e. 100% state owned) subject to audit should prepare IAS financial statements;

- The Russian accounting standards being prepared under the Government's current accounting reform programme should focus on the needs of private companies and small companies;[3]

- A professional association of accountants should be developed and empowered to take the lead on IAS training and IAS certification.

The protection of creditor rights is of crucial importance for the further development of investment activity in Russia. Deficiencies in the present situation have to be addressed via a balancing of protection and enforcement of contractual rights, corporate law, bankruptcy procedure, tax legislation and execution of court judgements.

The new law on bankruptcy which entered into force on 1 March 1998 attempts to strike a correct balance of incentives to encourage debtors to honour their contractual obligations and to discourage creditors from abusing the institution of bankruptcy. It includes detailed provisions for both reorganisation and liquidation but could benefit from further refinement and clarification. There is still a pressing need to shield debtor companies from attempts to seize their assets through unjustified or invalid petitions for bankruptcy. The trigger mechanism needs to be refined so that it is not pulled too early on still solvent companies and also to improve the rights of certain interest groups, including the state. It is necessary to increase the ability of court institutions to refuse the use of bankruptcy procedures as a standard means to extinguish debt (possibly by referral to bad faith use of the rights established in Article10 of the Civil Code). In order to initiate bankruptcy proceedings, creditors should be forced to establish clearly that no other means exist to pay off the debt in question. Another major problem remains in the placing of all federal, state and local tax claims above those of secured as well as unsecured creditors in liquidation. Another frequent complaint in Russia has been that minority shareholders are not heard or not even able to vote in negotiations concerning reorganisation plans proposed as alternatives to liquidation. Further strengthening of certification and training requirements imposed on external administrators is also needed.

Policy direction in this area should be:

- Refining the criteria for triggering the commencement of insolvency procedure in order to avoid invalid petitions for

bankruptcy of actually solvent companies, and introducing liability for intentional misuse of the insolvency process through fictitious bankruptcy petitions;

- Developing clear criteria for choosing between liquidation and reorganisation and establishing the conditions for rejecting competitive execution in favour of prolonging the period of external management;

- Strengthening the certification requirements for external administrators and introducing some form of control of their activity and liability for action taken in the exclusive interest of certain groups of creditors;

- Encouraging the formation of professional management companies involving trained professionals (liquidators, trustees, accountants, lawyers) specialising in the insolvency process.

With respect to pledge law, creditors are able to take non-possessory pledges on most types of movable assets, but the mechanisms for registration of security interests are not fully developed. The order of priority of satisfaction of creditor claims in bankruptcy proceedings is also of importance to the use of pledges. Credits secured by pledged assets in fact only rank in third place, after full satisfaction of claims of higher priority, with the result that there is no unconditional priority for secured creditors. This together with other unregulated aspects of property rights undermines confidence in security as a means of accessing external finance. Thus, to widen the use of pledged security as an instrument for smaller and medium-sized companies to raise finance from banks and other creditors confident of their rights in claiming on the collateral offered, the authorities should:

- Develop a dependable and effective centralised system for taking and enforcing security interests;

- Widen the scope for enforcement of pledges via simplified court procedures or without court assistance;

- Develop consensus on the basis for a resolution of widespread lingering tax arrears in the enterprise sector of such magnitude that creditors are dissuaded from lending against collateral, given the existing order of priority of satisfaction of claims against a debtor.

In the area of trust management the incomplete and contradictory status of legislation relating to trusteeships (including the lack of definition of the concept of trust) has led to the widespread use of trust schemes to hide true ownership control, withdrawal and export of assets and tax evasion. For the further development of trust management in Russia it is necessary to:

- Create legally effective, clearly formulated, non-contradictory trust mechanisms so as to eliminate the wide range for criminal use of the trust concept within the present institutional framework;

- Address the directly contradictory regulations in joint stock company law (e.g., the prohibition of voting by prior agreement) in the tax code, in the insolvency legislation, etc.

As mentioned above the protection and transfer of land and real estate ownership, requires the resolution of the long-standing problems regarding transfer of agricultural land which have for many years blocked the introduction of a Federal Land Code. A further, related element needed to underpin the real estate market would be the strengthening of property rights of privatised companies to the land on which they stand. Such rights would give them the possibility to devise more effective management schemes for the land in question and bring into existence the principle of "one company/one unified property complex". Other areas where policy direction would be important are:

- Development of a state system for registering real estate property and transactions therewith and to strengthen rights to land plots occupied by buildings;

- Development of a system for real estate valuation, including for assessment of tax liability;

- Development of a legal basis for insurance of property rights to real estate, including titles;

- Raising standards and licensing requirement for real estate operators.

As concerns transfer of securities, the weaknesses in the registry dating from the initial development of the securities markets have become well known through flagrant cases of manipulation and fraud in company registries. Despite improvements in legislation and regulation governing the activities of registrars, infringements are still common, especially in the regions.

The providers of depository services in the Russian securities markets have also been placed under stricter regulation in recent years, but long-standing investor concerns regarding irregular and inaccurate information remain. Although various proposals for the creation of a centralised depository have come forward in recent years, they have invariably failed due to a lack of support from the government. The Federal Commission for the Securities Markets has recently presented an elaborate and detailed plan for such a central depository, which seems to present a more solid basis for progress in this area. There are also a number of other infringements or lack of proper observance of regulations relating to the issuance, information disclosure, registration and distribution of securities which put investors at risk of having a purchase or sale invalidated. Similar concerns can arise in connection with clearing and settlement activities, for the finalisation of property transfers, and proposals have been raised for developing better regulation of such activities.

These remaining problems should be addressed through the following measures:

- Enforcing stricter procedures, and making top managers personally liable for their company registrar's mistakes;

- Improving the monitoring by the self-regulatory organisations responsible for professional registrars and depositories and its supervisory body, the FCSM, of the functions of registrars and depositories by strengthening oversight and providing a code of conduct as well as introducing requirements to improve professional standards;

- Introducing electronic means for the transfer and registration of securities to reduce delays and provide a uniform procedure for settlements of securities transactions. This could facilitate an efficient ownership registration process and improve market liquidity.

Law Enforcement and the Judiciary

Weak enforcement of laws is partly a consequence of the failure of the existing Russian judicial system to keep pace with change. Courts still need to develop expertise to deal with complex issues of the application of economic legislation. Investors are in fact often deterred from taking cases to court by the long delays due to court workloads as well as by the mistrust regarding fairness and independence of the judicial system and the likelihood of being able to obtain enforcement of a judgement. Judges, bailiffs and other court officials

tend to be inadequately remunerated to ensure their commitment to protecting the rights and interests of plaintiffs or enforcing court rulings (See further Part II, Chapter I).

The existing institutional barriers to effective implementation of legislation are connected to the lack of independence of the judiciary and serious deficiencies in Russia's law enforcement system, in turn related to past and present inadequacy of resource provision for the judicial system. Funds are at times lacking even for such fundamental tasks as calling of witnesses, paying statutory fees to jury members and meeting postal charges. Many problems for investors arise from the limited approach of the courts with regard to the interpretation of legal norms. This is directly related to the few opportunities of Russian judges to become fully trained in the law, and to familiarise themselves with new economic concepts embodied in legislation. Staffing in general is a serious problem in the judicial branch of power, again due to under-funding. There are numerous cases where court decisions have not been executed, because of undue influence on enforcement officers or the absence of effective enforcement mechanisms. As the receipt of a court decision containing a judgement is usually not sufficient for execution, the plaintiff has to take additional action to ensure that the decision in his favour is executed. The award of a sum of money or a performance or the transfer of property by a court decision requires an accompanying execution order from the court, valid for a specified time period. The lack of institutions and markets developed to a level where execution of court orders can be facilitated is a general problem, which is not easy to address in the short term. Such mechanisms and supporting information disclosure are rarely created specially for legal enforcement purposes. Most often, they are only gradually being built up, in line with growing requirements of business transactions and relationships.

In summary, to create the "larger role and greater authority for the judiciary" advocated by President Putin already in a December 1999 statement, it is necessary to:

- Increase the prestige of judicial power, attract qualified specialists, train currently working staff;
- Guarantee real independence of the judges via substantial salary increases and via heightened risk of exposure of undue influences;
- Pay special attention to the system of execution of legal rulings and other decisions so as to offer alternatives to plaintiffs faced by non-existent or inadequate market-based enforcement mechanisms.

The lack of independence of the territorial courts from the political authorities in the different subjects (subdivisions) of the Federation is a feature of the system that many foreign investors have experience of. As a shareholder or investor plaintiff can only bring a suit against a legal entity - a company having infringed his rights - in that company's own geographical locality, foreign investors are particularly exposed to the potential interference of authorities in support of local entrepreneurs. Current reform plans include measures to prevent influencing by regional and local governments and to increase financing and provision for court officials while at the same time making them independent of the sources of support at local or regional level.

A related problem which at times has received attention in the international press concerns the poor record with respect to execution of the decisions of international arbitration courts. It is important to note that execution orders can only be issued by a Russian court, which means that all arbitral awards and decisions of foreign courts must be recognised by a Russian court and an execution order issued by this court on the basis of the foreign award or decision.

As Russia is a signatory of the New York Convention regarding recognition and implementation of international arbitration awards, Russian courts should rightly only be concerned with the possible contraventions of procedure for the administration of the decisions in question (which could contain infringements of the rights of either party) and not examine their content. The actual situation here is complex , since lack of due procedure for administration of justice is often invoked by the local courts while Russian companies frequently claim to have been unaware of the procedures and regulations they come into contact with as a result of accepting international arbitration. However, the fact remains that there are numerous cases of local courts failing to execute international arbitration awards on spurious or trumped-up grounds. If inclusion of clauses regarding international arbitration in commercial contracts are to be meaningful for investors, the authorities should develop means to raise the awareness within the Russian judiciary of the jurisdiction and process of international arbitration.

3. Public and Private Sector Governance Issues

Public Sector Governance

Corruption of public officials is not a phenomenon unique to the authorities at federal, regional and local level in the Russian Federation, as it is a common social and political problem in both developing and economically advanced countries around the world. In a transition environment such as

Russia's, the massive undertakings of wealth redistribution in combination with a fragile institutional framework, recently erected or still under construction and fragmented social cohesion, all contribute to provide a fertile ground for corruption.

Although there has been additional legislation as well as concerted campaigns to combat this form of corruption, the resort to mere policing is made difficult by the scale of potential remuneration compared to average salaries in the public administration. A presidential address dating a few years back regretfully stated that "the risk of being persecuted is totally out of proportion to the profits to be gained from criminal activity".

The combination of complex laws, government control over key assets and low level of remuneration of government agents, 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. Key steps for reducing corruption opportunities in the medium term are:

- Regulatory reform and simplification of procedures, reducing the scope for discretionary decisions;

- Increase in salary levels;

- Introduction of laws against conflicts of interest, creation of strong independent controls and credible enforcement and penalties;

- Development of an administrative procedure act or code which at the same time would establish standards and limits for discretionary power and promote uniformity of practice across regions.

Although the present government has included among its objectives the transformation of the public administration into a merit-based, transparent and accountable civil service, it is a long process given the scale of the problems and the resources required. Nevertheless, the fundamental goals of improving service delivery, strengthening accountability and developing a performance driven culture with a focus on cost-effectiveness are clearly incorporated in the government's reform programme. For the immediate future it would seem that significant results could already be obtained by:

- Raising wages and salaries throughout the civil service to the level needed for weakening the motivation for corruption, while at the same time liberalising and eliminating discretionary procedures through the removal wherever possible of quotas, ceilings, permits, licences etc. Clarification and transparency should be established for those areas where discretionary decisions need to be maintained, with publicised guidelines and statutory time limits for the granting of permits and licenses. These measures should be accompanied by swift imposition of penalties as well as rewards for conduct, as appropriate. Greater resort to competitive selection and appointment procedures of officials at regional and local level is another feasible short-term measure that could bring substantial benefits.

Private Sector Governance

As to private sector governance issues, we have already touched upon the serious abuses in the corporate sector, in particular, infringements of minority shareholder rights, as discussed in Part II, Chapter 1 below.

Also, the incomplete and contradictory status of legislation relating to trusteeships (including the lack of definition of the concept of trust) has led to the widespread use of trust schemes to hide true ownership control, withdrawal and export of assets and tax evasion.

The scheme by which directors or real principals of a Russian joint stock company transfer this company into management by an affiliated or dummy entity created for this purpose is well known. Similarly widespread is the establishment of an "impersonal" trust company abroad -- offshore, either directly or via a chain of dummy trustees -- through which a Russian joint-stock company or blocks of its shares and other assets are managed. The real beneficiaries or principals, be they the actual owners, the founders of the trust or the trust managers, can thus evade responsibility and control by the authorities.

To address these forms of economic crime, it is necessary to amend a number of directly contradictory regulations in joint stock company law (e.g., the prohibition of voting by prior agreement), in the tax code, and in the insolvency legislation, etc. It is also necessary to stop the use of trusts for avoidance of antimonopoly legislation, for creating sham transactions and for fraudulent property transfers.

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.

4. Regional Policies

The Russian Federation is a federal republic encompassing 89 regional administrative units. The Federal Constitution defines the areas and scope of jurisdiction of federal and regional authorities, with shared competencies in some areas.

Much of the latent contention between different nationalities and repressed aspirations for self-determination in the former Soviet Union found an outlet during the so-called "parade of sovereignties" between 1988 and 1991 when over 40 former Soviet Republics declared themselves sovereign. While several of these became independent states, over 20 ethnically based republics still remain within the Russian Federation. They were able to avail themselves of considerable power in the Yeltsin era through the "parade of bilateral treaties" with the federal government. Other regions than the ethnically based also benefited from significant devolution of power from the centre during this period.

The business climate in Russia has suffered accordingly 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.

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. A programme of administrative reform has been adopted which redefines the powers of the regional authorities. Special presidential representatives in seven newly created federal (supra-regional) districts encompassing varying numbers of subjects of the Federation are to

oversee compliance with federal law. 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. It remains a fact that a significant share of the administrative barriers and other obstacles to investment and business activity in general faced by investors are found at regional level. If, as has been suggested, the main task of the new presidential representatives in the supra-regional districts is to remove local implantations of federal organs from the direct influences of regional authorities and other local interest groups, this would of course be a positive step in the direction of greater uniformity of policies.

While it is no doubt beneficial to encourage some spontaneous innovation and new ideas and approaches stemming from the degree of regional diversity, policy direction should ensure:

- Harmonisation of legislation and implementation practices affecting investors at regional and federal level, including a full review of diverging legislation contravening federal law as well as of existing bilateral treaties and agreements in separate areas;

- Transparency of regional administrative structures for remaining region-specific competencies;

- Transparency in the role and evolution of powers of the newly created supra-regional districts;

- Formulation of region-specific investment policy and development plans to ensure best use of regional and federal programmes and resources, including budgetary transparency of incentive packages and full elimination of extra-budgetary contributions.

5. 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. Statutory tax rates in Russia prevailing

during the transition period have in fact not been very high by world standards, except in the case of payroll taxes.

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.

During most of the 1990's approximately 50 federal, regional and local taxes and social fund payments have applied in Russia. Through the stage of tax reform in effect in 2001, the number of taxes will be approximately halved. However, the bulk of the total tax liability of a typical business has generally been attributable to 6 categories of taxes: VAT, turnover taxes, profits tax, labour taxes, property taxes and customs duties. The major changes in the tax burden for business firms via the parts of the reform package already introduced will come from simplifying and lowering labour taxes and eliminating virtually all turnover taxes. Another part of the reforms, perhaps the most important change -- which is still to be approved by the Federal Assembly -- for stimulating investment activity is the widened possibility for enterprises to deduct their business expenditure for purposes of profit tax calculations.

Due to substantial restrictions on the deductibility of many business expenses, the tax base for the Russian profits tax has been and still is larger than the comparable corporate tax base in other industrialised countries, often resulting in a higher -- sometimes much higher -- effective profits tax rate than the nominal statutory rate. As many of the major expenses subject to restricted deductibility are those incurred by businesses in a market economy (such as advertising, interest payments, training and insurance), this has had a significant negative effect on investment. It is clear that the manner of determination of the profits tax base has consistently provided investors with the wrong incentive from the point of view of transforming productive resources in ways to unleash economic growth.

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 a 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.

A somewhat similar problem still remains with respect to VAT, as businesses in Russia are faced with restricted ability to credit fully VAT on all purchases. The result is that the effective VAT rate is usually greater than the statutory VAT rate and becomes a cost to the business. Thus, even though value added tax is intended to be a tax on final consumers rather than on businesses, the Russian VAT more often than not is also a tax on production.

The high tax cost of labour prevailing during the transition period in Russia, which results from the combination of many taxes and charges imposed on employers' payrolls added to the personal income taxes, has discouraged the hiring of additional labour and given rise to tax evasion schemes. The latest tax reform package, in effect from 1 January 2001, introduces a unified tax on wages at a highly regressive rate in order to reduce the incentives for businesses to understate the size of their payrolls and thus bring more employees out of the shadow economy.

It is also relevant that local officials enjoy a number of tools other than formal fiscal authority which can be used in their relations with investors to circumvent restricted tax autonomy. The regional and local authorities control

licensing of various forms of activity and are often partners in local commercial enterprises and financial institutions. Their leverage is substantial and every investor in Russia has become keenly aware of the need to maintain good relations with the local administration. In addition, there exist funds at regional and local level, to which local businesses are often encouraged to make "voluntary" contributions.

As a general criticism of the system it has been argued that the combination of strict limits on tax authority at lower levels of government, mandatory expenditure obligations and a plethora of regulations and other instructions make orderly budgetary execution extremely difficult for regional and local officials. These conditions do not provide incentives for responsible budgetary execution policies, but can serve as partial explanation for the rent-seeking activities by these officials, when coupled with the low pay available to civil servants. Sanctions for such irresponsible activities are in addition not easily imposed, given the size of the Federation and the information and other advantages enjoyed at local level.

Thus, while strong federal presence seems likely to remain necessary in 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.

In summary, efforts should be focused on the following:

- Accelerating as much as possible the recognition of deductibility of business expenses in the calculation of the profit tax base and the introduction of accounting rules which reflect the economic reality of commercial transactions, prepared in accordance with international accounting standards;

- Establishing a tax regime for the oil and gas sector that will encourage new investment and provide a sufficient return to the State;

- Improving the administrative mechanisms for implementing transfer pricing rules and double taxation treaties;

- Providing clearer definition of taxpayers' rights and duties with possibilities for judicial and non-judicial dispute resolution;

- Improving the fairness and effectiveness of the tax enforcement function by modernising tax administration facilities, training tax inspectors and educating judges in handling tax disputes.

- Providing a higher degree of autonomy for each level of government within a clearly delineated set of revenue sources and expenditure assignments (current policy of reversing previous *de facto* decentralisation could backfire through reliance on increasingly rigid federal regulation and mandates, leading to accelerated search for loopholes);

- Eliminating the conditions presently conferring substantial rent-seeking opportunities on officials subject to very limited liability.

6. Privatisation Policy

The Russian Federation completed its small-scale and mass privatisation programme by 1994, succeeding in transferring ownership of 40% of state-owned enterprises to some 40 million citizens largely by voucher distribution, either directly or via the intermediation of investment funds. Over 75% of Russian employment is now estimated to be accounted for by privately owned companies.

This massive privatisation undertaking endowed the Russian economy with a basic corporate sector, a corporate securities market and its first network of institutional investors. The use of vouchers led, however, to dispersed ownership structures and widespread insider (management) control (up to 65% on average) of privatised companies. The state retained up to 20% of many companies, with little cash investment taking place at this time. The question of enterprise reform was largely ignored on the assumption that this would be the object of a further phase of redistribution of ownership rights involving the disposal of the residual state shareholdings. Mass privatisation was regrettably not accompanied by the necessary land reform, one of the many difficult political dimensions of privatisation in the Russian Federation. Altogether, the highly politicised context contributed to unstable and inconsistent legislative practices resulting in uncertainty and discriminatory treatment for many investors, which are still perceived to be part of the Russian investment climate.

Against this background, the second, “cash,” privatisation phase failed both in its prime objective to generate revenue for the state and -- for want of a comprehensive plan based on strategic investment and enterprise reform needs-- to attract enough outside foreign or domestic investors to tackle the corporate

restructuring problems. Investors were critical of the lack of transparency of this privatisation initiative during which many shareholdings were sold below their real value to insiders and the well-connected dominant financial-industrial groups (FIGs). As the failure of "cash" privatisation rapidly became apparent, a controversial "loans for shares" scheme was introduced, whereby shares in selected important state-owned companies were auctioned to a consortium of major banks (mostly with links to the FIGs) in return for loans. These auctions were conducted without transparency, fair competition or open access for foreign investors. The scheme proved highly controversial, the loans provided were mostly not commensurate with the market value of the shares and the FIGs were able to consolidate their control of substantial shareholdings in the companies involved in the scheme. This left a legacy of disputes and unresolved issues, which dogged the privatisation process in the years that followed.

Legislative provisions were made in 1997 to complete case-by-case privatisations and compile lists of assets and shareholdings to be privatised or retained in state ownership for strategic reasons. Commercial valuation of assets and market-oriented tender procedures were announced. With the exception of a few significant sales, there was little interest in the residual state shareholdings as other unresolved issues such as land and property rights, comprehensive enterprise reform and administrative barriers increasingly preoccupied investors. In the difficult period leading up to the financial crisis in 1998, privatisation potential was further limited by conditions affecting international investment activity in the oil sector.

Further legislation and a detailed policy statement issued in late 1999 are expected to shape the future privatisation strategy of the Russian Federation during the present decade. New approaches involving more clearly defined priorities for the sale of the remaining state assets, new privatisation methods and increased emphasis on professional, commercial and transparent deal structures and procedures have been announced.

The necessary further legislative changes and clear evidence of the government's commitment to practical implementation of the new approaches are, however, still lacking as investors have been getting mixed messages from recent privatisation transactions.

All Russian privatisation legislation enshrines, in principle, free access and national treatment for foreign investors in all areas excepting those of importance for national security or where there are moral or ethical concerns. This has not, however, protected foreign investors against discriminatory and unfair treatment as a result of changing requirements, legislation and procedures at different levels of investment projects and before and after their implementation. There is still no clear indication of the Russian government's

intentions concerning non-residents' possibilities to invest in natural monopolies and some major companies in the oil, energy and aerospace industries, where privatisation and deregulation programmes are being designed. In practice foreign entrepreneurs have mostly opted for joint ventures, direct acquisition of companies from management or share purchases on the primary or secondary markets to establish an investment base in the Russian Federation.

Investors' concerns still revolve around the continuing absence of a clear long-term privatisation programme, unresolved ownership, corporate governance and legal problems dating back to the cash privatisation and "loans-for-shares" scheme, where re-nationalisation is being advocated by certain interest groups. The lack of institutional and procedural transparency for the handling of future transactions and poor management of residual state shareholdings continue to serve as disincentives for foreign investor participation.

With the transfer of ownership from public hands now largely completed in the Russian Federation, there is no call for a new privatisation model. Rather it seems clear that resources should now be devoted to restructuring and resolving ownership and governance deficiencies in privatised companies. Underlying issues such as the rule of law, the fiscal regime, administrative barriers and lack of financing resources affecting the overall business environment must also be addressed (see Part II, Chapters I-III and V). Priorities for the completion of privatisation should be:

- The resort to direct and competitive sales to strategic investors for the more marketable stakes;

- Appropriate organisational and administrative procedures for the full privatisation of minor shareholdings and state assets requiring extensive restructuring;

- The introduction of sound management structures for property remaining in state ownership to eliminate malpractice;

- Resolution of remaining disputes relating to past privatisations with the imposition of time limits for contesting past deals as well as respect of good faith investor rights in cases where expropriation may result, giving prompt, adequate and effective compensation.

7. Financial Sector Development

According to the CBR, the most important reasons for the unwillingness of banks to finance production is the lack of information about the true financial condition of borrowers, as well as the inadequate legal basis for creditor rights. Of total fixed capital formation in Russia in 1999 (659 billion roubles) only 4% was financed through bank lending, 17% from budgetary resources and as much as 53% from enterprises' own resources. Data on working capital in the enterprise sector show more than 70% financed by own resources and the remainder through supplier credits and arrears of various kinds (salaries and taxes) while bank credit plays an insignificant role.

Hence it is necessary to increase the competitive pressures on banks to meet the needs of productive firms, in particular smaller clients. The authorities can and should take a lead in demonstrating that lending to start-ups and SMEs can be profitable, through introducing special support schemes and venture capital funds where conditions for banks to participate can be made suitably attractive. That access to external financing of working capital is difficult for smaller enterprises can be attributed to limited competition among banks, which relieves banks of pressure to develop lending schemes for SMEs, and to high risks and transaction costs of such lending. In addition, there are problems of information and contract enforcement related to legal and regulatory frameworks that are still evolving (see Part II, Chapter I) and inadequate institutional capacities.

To date in Russia, government-led project co-financing schemes involving commercial banks do not exist. A number of investment credit facilities are provided by the government directly to business firms, either financed from budgetary resources, or, as in the case of SME support, indirectly via a range of different tax incentives.

The government can also play an important role in ensuring that the legal and regulatory framework provided for financial sector activities facilitates development of innovative financial instruments and the setting up of new types of financial institutions. It can even take a catalyst role in innovative financial engineering, by introducing new methods of financing. In the years immediately preceding the 1998 financial crisis, at least two new, important schemes were designed in Russia, which failed to materialise, reportedly for reasons of contentious turf issues between different regulatory authorities. One was the development of a commercial paper market in the Russian context, and the other was a scheme establishing a CBR rediscounting facility for banks of promissory notes (veksels), which could have brought orderly trading and considerably more depth to this unregulated market. These initiatives should be revived.

As to other innovations, there are venture capital funds in the process of being created, and leasing facilities of domestic equipment are being developed for agro-business, aviation and shipbuilding, mining, metalworking and telecommunications. However, much more could be done to facilitate the growth of such financing alternatives, for the benefit of domestic as well as foreign investors. Credit unions do not exist in Russia for want of a legal framework, but experiments with credit co-operatives have been successfully carried out in several regions. Some export credit guarantee and insurance facilities are provided to exporters by the Ministry of Finance, but no fully built-out framework for export credit guarantees exists yet.

In Russia, it would seem particularly urgent to create and support mechanisms for working capital financing for the vigorous "trading company" sector, which includes many SMEs but also larger firms. During the late 1990's this sector experienced rapid growth, many large firms were established from scratch and managed to develop distribution networks for their products across the whole territory of the Russian Federation. Moreover, these firms have been operating in a very competitive environment, where transactions are settled in "real" funds and no barter or build-up of arrears are tolerated. The 1998 crisis and devaluation naturally constituted a significant set-back for this new industry, but the tendency has since been for these firms to identify cheaper domestic import substitutes. Faced with the need to ensure supplies on a reliable basis, some of these firms have begun to invest in local production, in many cases financed by funds repatriated from abroad. Facilitating access to finance for these companies would seem a good way to give impetus to a budding SME sector and could at the same time bring many of the firms in question out of a less healthy dependence on mafia-linked funding.

Policy direction should be focusing on:

- Opening of the banking sector to foreign competition, actively promoting the entry of foreign banks as important agents of innovation and prudent practices. This would include allowing the establishment of branches without a capitalisation requirement and removing quotas for Russian employees and similar forms of discrimination;

- Consolidation of the banking system through the application of firm exit policies for non-viable institutions. It is vital for the attraction of medium and longer-term deposits for sustained intermediation purposes that marginal, non-profitable institutions be eliminated from the system to enhance confidence and trust on the part of the population;

- Establishing an explicit scheme for deposit insurance with compulsory participation and covering fully the deposits of small and uninformed depositors. This would entail developing a solution for the continued role of the state-owned Sberbank, currently benefiting from a unique competitive situation in mobilising household deposits. Unless a level playing field is established for state-owned and privately-owned banks, the latter have little prospect of long-term survival.

- Reviewing government participation in specialised institutions and schemes, concentrating on supporting areas where business activity is already beginning to thrive, where additional finance could give a substantial boost;

- Developing co-financing schemes with commercial banks for project finance in general and for SME financing in particular;

- Facilitate access of small, young companies to the equity market through the creation of a special tier of the market where smaller companies could raise equity finance;

- Encourage the setting up of special credit information and rating agencies.

8. Conclusions

Much has been said above, both in general and specific terms regarding the need to deal with crime, corruption, lack of security of property rights and of enforcement of contracts and judgements in dispute resolution so as to improve the business climate for foreign and domestic investors. We have emphasised that rules-based, streamlined licensing and authorisation procedures at federal, regional and local levels need to be imposed, to remove excessive administrative hurdles and arbitrary rule. Transparent guidelines and sizeable sanctions for officials who violate this rules-based system must be put in place. The important role to be played by competition authorities in solving these problems and malpractices has also been underlined.

The urgency of further progress with tax reform has been emphasised, in particular with respect to those disincentives still affecting business investment as detailed in Part II, Chapter III. The need for a clear signal to the investor community regarding the government's intentions for privatisation of remaining government stakes in major companies, including restructured natural

monopolies, has also been expressed. Such further sales should be conducted with full institutional and procedural transparency according to best internationally accepted standards. Urgent attention should be paid to designing and implementing coherent policies for further development of financial markets, with particular attention to the financing needs of small and medium-sized enterprises.

A final word deserves to be said regarding the importance of Russia's accession to the World Trade Organisation (WTO) for its ability to attract foreign investment. In view of the complementarity of FDI and trade, co-ordination of trade and investment policies would represent a significant step forward in Russia's case. Benefits would flow from the harmonisation with international economic policy practices and full integration into the multilateral trading system. The previous separate and distinct policy approach to national trade and FDI, which has been characteristic of past administrations, has been reoriented. Preparations for WTO accession are now being handled by the restructured Ministry for Economic Development and Trade, which also is responsible for foreign investment policies.

Notes

1. Extensive co-operation with multilateral partners and numerous pressure points in the Russian private and public sectors are bringing results: a constituency for corporate governance reforms in Russia is starting to appear and gain prominence. Since its inception in 1999, the OECD/World Bank-sponsored Corporate Governance Roundtable in Russia has developed a structured dialogue between private and public sector decision-makers and experts to improve corporate governance. Recommendations for action will be presented in a Corporate Governance White Paper, an agenda for corporate governance action addressed to the regulators, the private sector and the international partners of the Roundtable. As Russian decision-makers and experts constitute the Roundtable in its majority, this provides a locally owned agenda for action firmly anchored in international principles and experience. The Paper will be submitted to Russia's government, private decision-makers as well as the international financial institutions before the end of 2001. It will also provide a major input into the process of drafting the Russian Corporate Governance Code that is being developed by the Federal Commission on the Securities Market.

2 See ICAR (International Centre for Accounting Reform, Moscow): Accounting Recommendations. The process should begin with the implementation by 31 December 2001 of full IAS financial statements in place of RAS at banks and other financial institutions, and for consolidated IAS financial statements from enterprises whose securities are publicly traded. Subsidiaries of listed companies and of banks should have the option to follow full IAS in place of RAS. All other Russian open joint stock companies, and the Russian subsidiaries of groups which prepare IAS consolidated financial statements, should at this stage also be able to elect to prepare their financial statements in full compliance with IAS, in place of RAS.

3 . It is proposed that the Russia-specific enterprise accounting system (i.e. RAS) now being developed should be streamlined and focused on the needs of small enterprises and of privately owned (for example closed joint stock) companies. It should result in those enterprises facing a simplified and much reduced accounting burden and producing financial statements consistent with a simplified version of IAS, in conformity with the IAS Framework. One example of this is the EU 4th Directive.