ISBN 92-64-01849-2
Russian Federation
Progress and Reform Challenges

Chapter 1

Progress and Prospects

1. Russia needs more foreign direct investment

The Russian Federation, the world's largest country, with a land area of 17 million square kilometres and a population of 144 million, has attracted relatively little foreign direct investment (FDI).

This modest performance of Russia in attracting FDI is particularly evident in comparison with other transition economies in Europe, which have received far more FDI, adjusted for population, and have also exhibited a positive correlation between FDI inputs and GDP growth rates. By the end of 2003 Russia had recorded a cumulative inflow of USD 26.1 billion, less than half China's annual inflow for 2003 alone, and far below comparable absolute figures for the Czech Republic and Poland. Divided by population, the resulting figure is much lower than the per capita FDI inflows recorded during that time by all four Central European OECD member countries, which were, like Russia, transition economies.

Low FDI inflows are a problem in Russia because the country suffers from a low rate of capital investment which restricts its economic growth potential. Gross fixed capital formation fell from a third of GDP in 1989 to 14.4 per cent in 1999 and has since recovered to 17.9 per cent in 2002. This figure is not far behind those in more developed countries, such as OECD member countries (21 per cent in 2002), but is much lower than those in countries at a comparable stage of economic development which are enjoying robust growth, such as China (42.2 per cent in 2002) or Malaysia (43 per cent in the years preceding the 1998 Asian economic crisis).[1]

At the same time, the saving rate has fallen steadily from 35 per cent in 1989 to 21 per cent in 2002.[2] However, since capital formation has fallen faster than savings, the savings: investment ratio has remained above 100 per cent during the transition to market economy, matching continued current-account surpluses. The problem has been not merely a lack of domestic savings to fund investment as a lack of confidence of Russian investors in the Russian business environment, as indicated by the substantial capital flight that has occurred during most of the period.

This outflow suggests that a range of domestic investors prefer to operate in the business environment in other countries, indicating that the Russian investment environment may also not be sufficiently competitive to attract adequate inflows from abroad. This judgment needs to be tempered by the

 RUSSIAN FEDERATION – ISBN 92-64-01849-2 – © OECD 2004

observation that an unknown and perhaps significant proportion of outward investment from Russia is destined to return as inward investment. Empirical studies have found that foreign investment in Russia was not driven primarily by demand but was highly responsive to indicators of reform and liberalisation, including those measuring enterprise reform, competition policy and the volume of foreign exchange and tax collection.[3]

Russia's failure to attract large quantities of both domestic and foreign investment does not reflect a lack of investment opportunities. Real GDP growth has averaged over 6 per cent a year during the five years following the 1998 crisis, a period during which household consumption rose by an average of nearly 36 per cent a year. FDI inflows into Russia have, unlike those in Central European transition economies, not been greatly stimulated by this increasing prosperity.

Foreign direct investment is needed to improve the productivity of Russian industry. The low productivity by international standards characteristic of the former planned economy persists in many sectors, especially those which have little or no foreign ownership, no comparative advantage and a low proportion of exports to total output. Industrial sectors which have received a high degree of foreign investment, such as tobacco and brewing, are among those with the highest productivity growth. Labour productivity in the tobacco industry rose 74.8 per cent and that in brewing by 119.7 per cent in 1997-2002, contrasting with almost wholly-domestically-owned sectors such as electric power, gas and grain processing, where productivity fell during that period by 12.5 per cent, 27 per cent and 10.3 per cent respectively.[4]

Recent research suggests that productivity of foreign firms is higher than that of Russian firms and that there is some spill over from foreign-owned to domestic enterprises.[5] Regional spill overs have been found to be increased by higher education.[6]

Increasing productivity is particularly important in Russia because the country relies heavily on earnings from fuel exports that push up the exchange rate (as a result of current-account surpluses averaging USD 33.7 billion in 1999-2002,[7] helped by favourable terms of trade), rendering non-tradable sectors internationally uncompetitive. As pointed out in the *2004 OECD Economic Survey of Russia*,[8] "The non-resource tradable sector must increase productivity and restrain unit labour costs sufficiently to stay competitive in order either to export or at least to withstand imports".

FDI has so far not greatly helped solve the problem, since its sectoral distribution remains highly skewed towards oil extraction, which accounts for well over half of all non-financial FDI in Russia and therefore far exceeds FDI in all manufacturing and services sectors combined. FDI is therefore not yet playing a fully effective role in contributing to the government's attempt to diversify the economy away from over-reliance on hydrocarbon extraction, and is to some extent adding to the problem. Russia therefore needs to attract more FDI in other sectors. As well as being low by international standards, FDI inflows to the Russian Federation are highly unevenly geographically distributed, with one of the six federal districts absorbing more than half the total and many regions receiving negligible amounts. As in the case of sectoral FDI distribution, this skewed regional distribution is almost certainly exacerbating uneven geographical development rather than mitigating it. Excessive concentration of FDI in a small area of Russia's huge land mass, which contains widely dispersed resources capable of exploitation, may also not be the most effective or efficient means of promoting sustainable economic growth.

The low level of FDI in Russia has resulted less from direct formal restrictions – Russian regulations have since the early 1990s been increasingly open to foreign investment – and more from institutional factors which also affect domestic businesses. High entry barriers in many sectors have discouraged not only foreign investors but also the formation of small and medium-sized Russian enterprises, resulting in high levels of industrial concentration and the survival of Soviet-era monopolies (albeit privatised).

Russia has nevertheless made great strides in opening its economy to foreign investment. The economic structure inherited by the post-Soviet regime was one that had been largely closed to the outside world for seventy years, with foreign trade playing a marginal role and foreign investment insignificant. Opening Russia's economy to foreign investment formed part of a strategy of rapid switch from plan to market. As a result, many formal obstacles to foreign investment were speedily eliminated, allowing FDI inflows to rise sharply in the mid-1990s, peaking at USD 4.9 billion in 1997, the year before the economic crisis. They have since fluctuated around USD 3 billion.

In 1994 the Russian Federation adopted a new constitution which explicitly protected the property and other economic rights of foreign investors. This was followed by the adoption of a Civil Code in 1995 and 1996 and by the enactment of legislation on joint-stock and limited liability companies and insolvency. A law governing fixed capital investment, passed in 1998 and amended in 2000, included an article underlining, but not adding to, the rights of foreign investors already laid out in the Civil Code and other business legislation. A law specifically governing foreign investment in Russia was passed in 1999 and amended in 2002 and 2003. This law stipulates national treatment for foreign investors and gives them the right to engage in investment activity in any form authorised by law. It guarantees compensation for expropriation, authorised repatriation of profits and capital and contains a grandfather clause providing protection against increases in mandatory payments to some large foreign-invested projects.

RUSSIAN FEDERATION – ISBN 92-64-01849-2 – © OECD 2004

Russia has signed bilateral investment treaties and double taxation treaties with many OECD members and other countries, and has signed (though not yet ratified) the Energy Charter Treaty (see Annex C).

2. Recommendations in the 2001 OECD study

The OECD made proposals for building on the legislative foundation laid by the Russian authorities in the 1990s by further developing policies towards foreign investment in *The Investment Environment in the Russian Federation: Laws, Policies and Institutions* (OECD, 2001).

Improvements in the legal and regulatory framework for foreign investment. In the 2001 study, the OECD first of all recommended improvements in the legal and regulatory framework for foreign investment. These included the relaxation of restrictions on foreign investors in specific sectors and clarification of regulations relating to mineral resource extraction. Recommendations were also made on simplifying the exchange control regime and bringing it into line with international practice. The OECD also urged stronger protection of property, shareholder and contractual rights.

The 2001 study also made recommendations to address insufficient independence of the judiciary and inadequate resource provision for judicial and enforcement systems, and the prevalence of corruption among public officials.

Harmonisation of federal and regional legislation and implementation. The OECD noted in 2001 that as Russia lacked a unified economic space for investment and suffered from frequent regulatory changes, contradictory interpretation and discriminatory implementation of existing legislation resulting from unclear and contested separation of powers between different levels of government. It therefore recommended harmonisation of legislation and implementation practices affecting investors between federal and regional levels of government and transparency of regional administrative structures and of the new supra-regional district authorities.

Increasing tax policy transparency. With regard to tax policy, the OECD proposed a range of improvements designed to increase transparency, consistency, fairness and effectiveness.[9]

Eliminating discrimination against foreign investors in privatisations. The 2001 study noted that foreign investors were not really protected against discriminatory and unfair treatment as a result of changing requirements, legislation and procedures at different stages of investment projects. It recommended that the Russian government's priorities for the completion of privatisation should be: the use of 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 malpractices; and the resolution of remaining disputes relating to past privatisations.

Opening the banking sector to foreign investment. In order to meet the needs of productive firms the 2001 study recommended *inter alia* that competitive pressures be increased on banks, in particular by opening the banking sector to foreign competition and actively promoting the entry of foreign banks as agents of innovation and prudent practices, allowing the establishment of branches without a capitalisation requirement and removing quotas for Russian employees and similar forms of discrimination.

3. Recent progress and remaining challenges

The Russian government has made marked progress in formulating and enacting legislation governing foreign investment since the publication of the 2001 OECD study and has in varying degrees implemented some of the recommendations in the study. Details of progress since the 2001 study are in Chapter 3.

The authorities have added new chapters to the Tax Code, clarifying the situation regarding a wide range of taxes and also clarifying the roles and powers of tax inspectors and tax bodies. Taxpayers have been granted expanded rights.

A new foreign exchange law, passed at the end of 2003, has brought Russia's foreign exchange regulation into line with international practice; under this law, currency controls will be brought more into line with modern international practice by end-2006.

The government has moved forward the timetable for the adoption of International Financial Reporting Standards. The protection of shareholder rights has been advanced by amendments to the Law on Joint Stock Companies which incorporate many of the provisions recommended in the 2001 study and a new Russian Corporate Governance Code, based on the OECD Principles of Corporate Governance, has been adopted.

The government has launched a major programme of administrative reform designed to reform both the operations and powers of government agencies and municipal self-governing bodies. At the same time, the central government has strengthened its powers and reinforced the foundations of a single economic and legal space throughout the Russian Federation.

There have been some improvements in the regulation of privatisations. A new privatisation law divides responsibility for different categories of privatisation between different levels of government. A system of auctions

 RUSSIAN FEDERATION – ISBN 92-64-01849-2 – © OECD 2004

and tenders has been set up in which all participants are supposed to have an equal chance of acquiring the asset up for sale.

A law on the circulation of agricultural land enacted in 2002 brings legal clarity to procedures governing ownership and transfer of land.

A new customs code, which came into force at the beginning of 2004, has simplified customs clearance procedures. By allowing faster handling and less spending on storage and transport, this measure is likely to enhance the profitability of investment projects.

The above measures have greatly improved the operating environment for foreign investors in Russia, but obstacles persist.

Although the legal framework for investment has been greatly enhanced since the 2001 study, formal restrictions on foreign investment have still not been completely removed. Foreign ownership quotas and other restrictions apply in banking and insurance, the mass media, aviation, land transport and agricultural land. The new Communications Law preserves a reciprocity condition which governs foreign participation in telecommunications, and the regulatory framework for the natural monopolies in the gas and electricity sectors sets limits on direct and indirect foreign ownership. While the Land Code allows foreign ownership of non-agricultural land, it also imposes some restrictions on non-resident foreign landowners. The law “On the Circulation of Agricultural Lands” excludes foreign nationals, foreign legal entities and stateless persons from owning agricultural land.

While amendments to legislation and regulations have improved shareholder rights protection and disclosure requirements, enforcement remains a severe challenge. Improvements in the quality of the rules have not been matched by improvements in the quality of the institutions that implement or enforce the legislation. Furthermore, in order to reap the full benefits of the global capital market, and to attract long-term patient capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. Adhering to international financial reporting standards (IFRS) would be an important step. This would significantly improve the ability of investors monitor the company by providing increased reliability and comparability of reporting, and improved insight into company performance. Russia has come a long way in this direction but much work remains to be done. The OECD is currently working to meet the demand by the Russian government to help it develop priorities for the transition to IFRS.

Despite many recent improvements in laws and regulations protecting property and the contractual rights of investors, uncertainty of proper administration and enforcement of justice by the court system and the continuing reported prevalence of corruption throughout the public sector undermine confidence in the legal and regulatory framework. A related problem is incoherence between federal, regional and local regulations regarding investment and their implementation in such areas as procedures governing applications for and granting of permits, licences and other authorisations.

4. Policy options for further reform

In order to overcome the remaining obstacles to foreign investment, policy options, drawing lessons where appropriate from OECD policy experience, include:

4.1. Relaxing remaining formal restrictions on foreign direct investment

The Russian authorities are encouraged to reconsider the rationale for maintaining the following formal restrictions, and, where such a rationale no longer exists, relax such restrictions:

Banking

- Any remaining *de facto* or *de jure* quota restriction on foreign participation in the banking sector.
- The requirement that Russian banks must obtain prior approval for any increase in their charter capital paid for with foreign investment or for any sale of already issued shares by resident to non-resident shareholders. Based on OECD best practices, it would be advisable to subject foreign investors to the same percentage thresholds for ownership by individual domestic investors which require prior approval by the authorities.
- The discretion of the authorities to impose reciprocal limitations on the conduct of banking activities by credit organisations with foreign capital.
- Nationality restrictions on the composition of the workforce and/or the management of a Russian credit organisation.

Insurance

- The 25 per cent ceiling on the total participation of foreign capital in the charter capital of insurance companies in the Russian Federation set by the amendments to the Law on Organisation of Insurance Activity in the Russian Federation.[10]
- Restrictions for EU insurance subsidiaries to possess not more than 49 per cent of the charter capital of the Russian insurance companies for specific insurance lines.
- Restrictions on the categories of insurance available to non-EU based foreign-controlled insurance companies.

 RUSSIAN FEDERATION – ISBN 92-64-01849-2 – © OECD 2004

- Restrictions on intermediary activities of foreign insurance brokers, limiting their intermediary activity by distributing insurance risks only with Russian insurers.

Transport, telecommunications, energy and agriculture

- The reciprocity condition applicable to ownership of telecommunications facilities within the Russian Federation by the 2003 Communications Law.
- Ownership restrictions in the aviation industry, including the 49 per cent limit on foreign participation in cabotage air transport companies which are not called for by treaty provisions pursuant to the Chicago Convention and the foreign ownership limits of 25 per cent in other aviation organisations which are not justifiable by national security reasons.
- The prohibition of establishment of foreign-owned land transport companies to transport goods or passengers between points within the Russian Federation.
- The 20 per cent ceiling on foreign ownership of the natural gas monopoly Gazprom.
- The 25 per cent ceiling on foreign ownership of the national power utility United Energy Systems.
- The prohibition of ownership of agricultural land by foreign nationals, foreign legal entities and Russian legal entities with majority foreign capital participation.

4.2. Foreign exchange liberalisation and persevering with financial sector reform

The Russian authorities are encouraged to expedite as soon as possible the publication of implementing regulations for the new Foreign Exchange Law, including the powers for the Central Bank of Russia (CBR) to impose deposit requirements for specified capital account operations from the present time until the date of 1 January 2007 envisaged in the new law.

The Russian authorities are encouraged to persevere with the development of a strategy for reform of the financial sector taking into account the actual and potential role of the financial sector in the economy as a whole.

4.3. Improving corporate governance

In conformity with the recommendations contained in the OECD/Russia White Paper and the Corporate Governance Code, the Russian government authorities are encouraged to make further efforts to

- Ensure full disclosure of ultimate ownership of companies and structures of corporate control.

- Develop stricter regulations and more inclusive and coherent definitions of related party transactions to combat abuse.

4.4. Continuing efforts to ensure compliance at sub-federal government level with federal laws and regulations and to simplify administrative procedures.

The Russian authorities are encouraged in their current de-bureaucratisation initiative and within this context are invited further to simplify administrative procedures, ensure uniform implementation of these reforms in the regions and increase transparency in areas that are important for foreign investment, such as the issuance of licences relating to foreign-invested projects.

4.5. Developing a level playing field for the privatisation of state-owned enterprises

The Russian authorities are invited to improve the level playing field for the privatisation of state-owned enterprises by increasing transparency and maintaining non-discrimination throughout the bidding process and dispute resolution.

4.6. The legal system and taxation

The Russian authorities are also encouraged to persevere in their efforts to improve the functioning and independence of the legal system and to ensure fairness and non-discrimination in tax collection.

4.7. The fight against corruption

The Russian authorities are encouraged to develop a broadly designed anti-bribery framework which would live up to Russia's domestic and international commitments to fight corruption. The development of legal and regulatory preventive and punitive standards will help improve the investment climate and ensure fair business practices. Regulatory reform and simplification of administrative procedures would help reduce opportunities for corruption. Other anti-corruption measures may include increases in official salaries, laws against conflicts of interest, strong independent controls and credible enforcement systems and penalties.

Notes

1. See Table A1.1.3 in the *2004 OECD Economic Survey of the Russian Federation*.
2. Gross savings divided by gross domestic product, Federal Service of State Statistics (FSSS) statistics, formerly the State Committee for Statistics (Goskomstat). The figure for 1995 was 25.4 per cent.

RUSSIAN FEDERATION – ISBN 92-64-01849-2 – © OECD 2004

3. Fabry and Zeghni (2002).
4. *2004 OECD Economic Survey of Russia*, Chapter 2. Cf. tables A2.1.1 and A2.1.2.
5. Yudaeva *et al.* (2001) found that such spill overs were positive from foreign-owned to domestic firms in the same industry, but negative on domestic firms that are domestically related to foreign-owned firms.
6. Kozlov *et al.* (2001). This finding is also borne out by the 2001 Yudaeva *et al.* study.
7. International Monetary Fund (IMF), *International Financial Statistics*.
8. *Cf. 2004 OECD Economic Survey of Russia*, Chapter 1.
9. These included: the introduction of accounting rules prepared in accordance with international accounting standards; a tax regime for the oil and gas sector that will encourage new investment and provide sufficient return for the state; improving 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; modernising tax administration, training tax inspectors and educating judges in handling tax disputes; eliminating rent-seeking opportunities for officials subject to limited accountability and penalties.
10. Federal Law No. 172-FZ "On modifications and additions to the Federal Law On Organisation of the Insurance Activity in the Russian Federation' and on Declaring Individual Acts of the Russia Federation as Null and Void", dated December 10, 2003.