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A REGIONAL PERSPECTIVE**

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**INVESTMENT AND BUSINESS CLIMATE
IN THE REPUBLIC OF BASHKORTOSTAN¹**

Introduction

1. The purposes of this study are to examine recent foreign direct investment (FDI) developments in Bashkortostan, its efforts to attract FDI and suggest options to enhance attractiveness of the region for foreign investors. The study evaluates various aspects, which play in favor or, on the contrary, in disadvantage Bashkortostan within the Russian Federation and compares them to the situation in other 14 sub-regions of the Pre-Volga Federal Region. These comparisons are based on the 2000-2004 data provided by the Federal Service of Service Statistics (FSSS) and statistics reported by the territorial statistical office in Bashkortostan (Bashkortostanstat). The study also relies on available information of international and Russian rating agencies, legislative and normative legal acts of the Russian Federation and Bashkortostan as well as interviews, media and electronic materials.

2. The Republic of Bashkortostan is one of strategically most important regions of the Russian Federation. Its area is 143 600 km² with population of more than 4 million people. Its capital Ufa situated in the western foothills of Urals is 1500 km east of Moscow. Republic of Bashkortostan is among the most economically developed regions of the Russian Federation and a major centre of oil and petrochemical industry, machine-building and engineering industries as well as timber production and nonferrous metallurgy. The Republic belongs to the first 15 Russian regions in terms of gross industrial output and is the second major agricultural producer in Russia. From the budgetary perspective, Bashkortostan is one of a few Russian donor regions as its contributions to the federal budget are higher than its allocations from the federal budget.

1. Position of Bashkortostan in the Russian Federation and in the Pre-Volga Region

1.1. Infrastructure

3. Bashkortostan is situated at the junction of Europe and Asia and has a well-developed transport network with an easy access to the major centers of Russia and CIS states. Local air routes connect Ufa, the capital of Bashkortostan, with towns and district centers of the Republic; there is also an international

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Ufa's airport. Bashkortostan's transport infrastructures represent 1.7% of railways, 3.3% of roads and 1% of airlines of Russia, 1.1% of inland navigable waterways and 8.3% of long-distance pipelines. The Republic is crossed by three Russia's five main train lines between the West and the East.

4. Major pipelines and highways pass through the territory of Bashkortostan connecting the European part of Russia with Urals and Siberia. The Republic is at the 10th position in Russia and the 3rd in Pre-Volga Federal Region as regards motor transport cargo turnover and at the 4th position in Pre-Volga Federal Region and the 13th position in Russia in railway transported cargo tonnage. The Belaya River, the part of the common deep-water transportation system of Russia, provides the Republic with access to the ports of the Caspian Sea, the Baltic Sea, the Black Sea and the Sea of Azov basins. However, the depreciation of transport infrastructures is higher in Bashkortostan than the average depreciation level in Russia and is also worse than the average level in the Pre-Volga Federal Region.

5. The Republic is less well equipped in fixed-line telephone installations for urban and rural population than the majority of Russian regions and within the Pre-Volga Federal Region. At the same time, Bashkortostan has a high density in cellular communication and transmission service use and the level of computerization of the companies in Bashkortostan is at the 6th position in the Russian Federation and the 1st in Pre-Volga Federal Region.

1.2. Institutional support

6. The support and promotion of economic and business activities is managed by the following institutions in Bashkortostan:

- *Agency of the Republic of Bashkortostan for Foreign Investments* is a state entity supervised by the Ministry for Foreign Economic Relations and Trade of the Republic of Bashkortostan. The Agency has the following main tasks: selection and promotion of investment projects of regional enterprises; support of foreign investors in realization of their projects on the territory of Bashkortostan; promotion of the Republic of Bashkortostan as a favorable location for foreign investment. Currently, the Agency focuses on organizing and controlling promotion of foreign investor projects in the Republic. Following agreements between the Agency and investing companies, the Agency is also responsible for obtaining required permits prior the implementation of the projects.
- *Fund for Business Development and Support of Bashkortostan* has 29 offices in towns and districts of the Republic. The Fund provides legal and information support to the enterprisers and participates in realization of projects undertaken within the program of governmental support to small and middle-size business, including through projects financing. The Fund also provides micro-credits to small firms.
- *Chamber of Commerce and Industry (CCI)* of Bashkortostan is non-commercial non-governmental organization. The Chamber represents more than 700 companies and organizations of all types of ownership. More than 75% of companies are corporate enterprises and the remaining are individual businessmen. Members of the CCI of Bashkortostan are at the same time the members of the Russian Chamber of Commerce and the members of the International Community of CCI. The CCI of Bashkortostan participates in preparation of documents on economic policy issues and foreign economic relations, analyses business activity, develops and implements the Republic's Target Comprehensive Programs of economic restructuring and foreign economic activity developments. The most important activity of the CCI is its information service, which is supported by the CCI Unified Information System of the Russian Federation, covering 89 regions, CIS states and about

30 representations abroad. The system comprises more than 100 data-bases and some 88 electronic publications available through the computer network.

- *Association of Business Organizations of Bashkortostan* is a major consultation forum between the business community and the state. The main task of the Association is professional intermediation between members of the Association and the authorities.
- Within the government, the following structures are involved in the support of business activities: Interagency Council for Business Support in the Cabinet of Ministers of Bashkortostan; Department of Investment Cooperation of the Ministry for Foreign Economic Relations and Trade of Bashkortostan, Department of Business Development and Department of Investment Policy of the Ministry of Economic Development and Industries of Bashkortostan.

1.3. Human Potential

7. Development of human potential, especially its scientific and educational aspects is a key factor that determines economic growth of the countries and regions. The education system of Bashkortostan comprises 3 227 full-time public facilities of general education (1st position in the Pre-Volga Federal Region), 122 facilities of basic professional education (1st position in the Pre-Volga Federal Region), 77 state technical secondary educational establishments (2nd position in the Pre-Volga Federal Region) and 16 higher educational establishments (4th position in the Pre-Volga Federal Region).

8. The Republic also has a leading position within the Pre-Volga Federal Region regarding the indicator of the number of qualified graduate workers to 1000 employees in the industry and is well placed for the number of students in technical secondary educational establishments. In contrast, the number of university graduates is considerably lower and Bashkortostan occupies only the 32nd position in Russian Federation and 7th in the Pre-Volga Federal Region. The education system thus appears not to cover adequately the needs for highly skilled workers and highly qualified personnel in industrial profession group.

1.4. Demography, employment and unemployment

9. Demographic indicators for 2004 confirm maintaining of recent trends in Bashkortostan, i.e. the decline of population and continuing decrease in migration flows. Regional demographic situation reflects similar developments in Russia, marked by low birth rates, insufficient to ensure reproduction of the population, and high mortality, in particular among men in active age. Nevertheless, the demographic situation in Bashkortostan is relatively more favorable than in other Pre-Volga sub-regions.

10. In the past ten years the size and directions of migration flows have changed. In the 1990s, the inflows were larger than outflows with a positive impact on the population level, but the inflows have gradually decreased. Starting 1999, external migration is insufficient to compensate the natural decline. Given that neighboring countries have been the main source of immigration to the Republic, further expected decline in this immigration source will continue to negatively influence the population levels in the Republic. Similarly to generally observed trends, the share of young generation in non-active age will decrease while the share of aged population will grow in Bashkortostan. The number of persons in active age will decline starting 2007-2008.

11. People with higher, incomplete higher and secondary technical education represent 48.1% of the total number of the employed population in Bashkortostan (compared to 56.4% in the Russian Federation). In the recent years, there has been a certain decline in the number of workers in production and some increase in active population employed in services, infrastructures and social activities. The number of

vacancies offered by regional enterprises to the Federal Employment Service has considerably expanded between 2004 and 2005, which allowed reducing the number of officially registered unemployed persons.

12. There is an important disparity between demand and supply in regional labor market. Demand is high for blue collars, whereas most unemployed are specialists and white collars with higher and secondary education, of which the 70% are women. According to available forecasts, the optimistic scenario envisages the unemployment rate maintained at the present level (2% of active population), which represent some 30 000 people. However, if hidden unemployment comes out to open labor market, the number of unemployed may reach more than three hundred thousand persons (Table 1).

Table 1. Unemployment in Bashkortostan (2004 and forecasts)

Thousand persons				
Scenarios	2004	2005	2010	2015
Optimistic	35.7	32.9	33.3	31.9
Moderate	35.7	177	178	170
Pessimistic	35.7	350.5	344	344

13. Average monthly nominal gross payroll by worker in Bashkortostan was USD 192.5 in 2004 (i.e. an increase of 23% compared to 2003). Real earnings, taking into account consumer price index increased by almost 9% in 2004 against the previous year. Both indicators are close to the average observed in the Pre-Volga Federal Region but below the Russian average. In USD terms, the average salary of Bashkortostan's workers in manufacturing, agriculture and timber industry was in 2004 in the range of 100-120 USD in agriculture and between 500-600 USD in banking, insurance and fuel industry².

2. Investment climate in the Republic of Bashkortostan

2.1. Credit ratings

14. International credit ratings of the Republic of Bashkortostan is one of the preconditions enabling the region to attract investment and boost interest of investors in regional projects. Obtaining credit ratings from leading international rating agencies also facilitates the access to international capital markets and allows the region to negotiate more favorable terms for loans. For these reasons, Bashkortostan turned in July 1998 to Moody's and Standard & Poor's Agencies with a request to get credit ratings. However, due to the August 1998 financial crisis in Russia, the whole process was delayed. In April 2001 Standard & Poor's and Moody's conferred credit ratings to the Republic of Bashkortostan on 'B-' and 'B3' levels respectively. These were the first new ratings from the leading international rating agencies to Russian regional government after the 1998 crisis. The rating level of the Republic of Bashkortostan corresponded to the sovereign rating of the Russian Federation and was equal to the rating of the leading Russian regions of Moscow and St.Petersburg .

15. Press releases of the credit-rating agencies noted a relatively low (by Russian standards) debt load of the Republic, high liquidity of its regional budget and capital financing through equity financing that offers additional financial flexibility. They also stressed resuming regional economic growth, resulting mainly from increasing industrial output and expected growth of gross regional product by 3% in 2001-2003 as well as adequate budget performance and good financial management.

² The exchange rate used is: 1USD=28,5 rubles

16. In conformity with the agreements signed with the rating agencies, the analysts monitor regularly and in cooperation with the Republic's executive bodies regional socio-economic developments and financial and political conditions. During the monitoring period, Bashkortostan's rating levels increased. In March 2004, Standard & Poor's raised long-term credit rating of Bashkortostan from 'B+' level (forecast stable) to 'BB-' level (forecast stable). Among other subjects of the Russian Federation, only Moscow and St.Petersburg obtained higher credit ratings. In November 2004, Moody's agency raised credit rating of the Republic of Bashkortostan from 'Ba3' level (forecast stable) to 'Ba1' level (forecast stable). It is worth mentioning that credit ratings dynamics of the Republic of Bashkortostan by international rating agencies is stable (Table 2).

Table 2. Credit rating dynamics of the Republic of Bashkortostan according to international rating agencies

Standard & Poor's		Moody's	
<i>Year</i>	<i>Rating</i>	<i>Year</i>	<i>Rating</i>
2001	B-, forecast stable	2001	B1, forecast stable
2002	B, forecast stable	2002	Ba3, forecast stable
2003	B+, forecast stable	2003	Ba3, forecast stable
2004	BB-, forecast stable	2004	Ba1, forecast stable

17. In views of credit rating analysts, the increase of Bashkortostan's credit rating reflects effective governmental policy in state fund management, low debt burden and stable economic growth during recent years. Another positive sign is that the board of directors of the Central Bank of Russia decided to include government (domestic) bonds of the Republic of Bashkortostan issued in 2004 of total nominal value of USD17.5 million to the Bank of Russia mortgage list. On September 16, 2004 the whole bond issue was placed in one day at the Moscow Interbank Foreign Currency Exchange. The mortgage list of the Bank of Russia includes in addition to Bashkortostan bonds only the bonds of two subjects of Russian Federation, i.e. the city of Moscow and Samara Region.

Table 3. Investment Potential and Investment Risk Ratings Dynamics of the Republic of Bashkortostan, according to 'Expert' Rating Agency'

Years	Investment potential rating	Ratings of investment potential components							
		Consumer	Labor	Production	Infra-structure	Financial	Innovation	Institutions	Nature & raw materials
1999-2000	11	7	8	9	40	8	12	13	25
2000-2001	12	4	9	8	39	7	11	18	25
2001-2002	15	9	17	9	40	8	14	18	25
2002-2003	15	8	13	8	41	9	14	15	25
2003-2004	15	8	12	10	47	6	14	18	25

Years	Risk rank	Ratings of investment risk components						
		Legislative	Political	Economic	Financial	Social	Criminal	Ecological
1999-2000	8	43	13	4	45	23	12	55
2000-2001	21	36	15	3	51	76	12	55
2001-2002	17	16	14	7	49	59	17	47
2002-2003	11	5	21	6	37	61	10	45
2003-2004	10	4	7	3	35	38	63	42

18. As for investment ratings by domestic agencies, Bashkortostan has obtained an annual rating of investment attractiveness by 'Expert-RA' Agency. Since the financial 1998 crisis year, the Republic has received a 'moderate potential-moderate risk' type of investment climate. Recent political and economic

changes, in particular in budgetary relations between federal and regional authorities and legislative changes related to administrative and social reforms, have to a certain extent increased uncertainties and therefore investment risks within the regions. However, Bashkortostan succeeded to improve its investment risk index in 2004 and occupies the 10th position among 89 Russia regions. Table 3 shows recent developments in ‘investment potential and investment risk ratings’ of the Republic of Bashkortostan (see Table C in Appendix for ranking of Russian regions).

19. The evaluation of investment potential and risks presented in Table 3 is based on several components covering both quantitative and qualitative aspects, which are assessed through an expert survey. Legislative aspects, political risks and infrastructure are considered as the most important aspects and receive therefore the highest coefficients. The main contribution to Bashkortostan’s improved rating is due to development of new legislation and weakening of social tensions. During the last three years, the rank of Bashkortostan regarding the legislative aspects passed from the 36th position to the 4th position among Russian regions. Presence (or absence) of ‘investment active’ management also influences the attraction of foreign investments into the region (see Table D and Figure in Appendix).

2.2. Investment Policy

Legislative Acts

20. Foreign investment activity in Bashkortostan is regulated by the following legislative acts of the Republic of Bashkortostan:

- “On Principles of Foreign Economic Activity of the Republic of Bashkortostan”
- “International Agreements of the Republic of Bashkortostan
- “Foreign Investment Activity in the Republic of Bashkortostan”
- the Regulation “On Procedures of Signing and Implementation of Investment Agreements and with Government Guarantee concluded on behalf of the Government of the Republic of Bashkortostan”.

21. In general, the current legislation of the Republic of Bashkortostan is in compliance with corresponding federal legislation. However, a few contentious points remain. First, there is no reference in the laws of the Republic of Bashkortostan to the federal laws when establishing the legal basis for regulation of investment activity despite the provision of the Federal Law “On foreign investment in the Russian Federation”, which clearly determines the priority of federal legislation over the legislation of the subjects of the Russian Federation. The law of the Republic of Bashkortostan also indicates the possibility to restrain investment projects by other legislative acts although such restrictions may be imposed only by a federal law. The Federal Law stipulates that such restrictions could be only justified by protection of constitutional system and moral, health, defense and state security reasons.

22. In accordance with the current legislation in the Republic of Bashkortostan, foreign investors and newly established commercial companies with foreign participation engaged in production activities can benefit from various incentives schemes.

- a) Commercial organizations with foreign participation in which the foreign share in authorized capital amounts to not less than 25% and their production activity profit exceed 70 % of the total income from the sold products (work, services) have access to the following incentives:

- in the first two years after their registration, these firms are exempted from paying the share of the profit tax, which is normally allocated to the budget of the Republic of Bashkortostan; in the 3rd and the 4th years after their registration, these firms should pay 25% and 50% respectively of the basic rate of the profit tax that is normally allocated to the budget of the Republic. It is necessary to specify that the proportions of sharing between the federal and sub-national budgets are not fixed and vary annually. In 2005, the shares in profit tax were fixed as follows: 6.5% go to the federal budget and 17.5% to regional budgets.
- during the first three years after their registration, these companies are exempted from paying the share of enterprise assets tax that goes normally to the budget of the Republic of Bashkortostan. The property tax amounts to 2% and is shared between the budget of the Republic of Bashkortostan and local budgets. The proportions of sharing vary according to different municipal levels.

23. Specified commercial organizations with foreign investment included in the list of priority projects of the Republic of Bashkortostan³ benefit from the following incentives:

- in the first three years after their registration, they are exempted from paying the share of the profit tax that goes normally to the budget of the Republic of Bashkortostan;
- in the 4th and the 5th years after their registration, these firms pay 25% and 50% respectively of the share of the profit tax that is normally allocated to the budget of the Republic of Bashkortostan.

24. Foreign investors and commercial organizations with foreign investments have the following rights:

- they can participate in privatization of state and municipal property on the conditions and under procedure established by the legislation of the Republic of Bashkortostan;
- they can develop and use natural resources in line with product sharing agreement of the Republic of Bashkortostan and use state property of the Republic of Bashkortostan on the basis of concession agreements. According to these agreements, investors in mineral resources can be exempted during the validity of the agreement from taxation, excise duties and other compulsory payments in exchange of sharing extracted mineral resources as established by a corresponding agreement.

25. Foreign investors dispose of the following legal guarantees on the territory of the Republic of Bashkortostan:

- Nationalization, requisition, confiscation or other forced seizure of foreign investor property by the Republic of Bashkortostan is not allowed, except the cases, stipulated by the civil legislation and international agreements of the Russian Federation.
- Government bodies of the Republic of Bashkortostan and their officials can not interfere with foreign investors activity, except the cases when this interference is allowed by the legislation and is exercised within official competence; compensation for losses suffered by foreign

³ Investments directed to natural resources development, creation of new high technology production, incompleated construction, environmental protection measures, infrastructure development are considered priority by the Government of the Republic of Bashkortostan.

investors as a result of illegal actions, is carried out by the responsible body financed through budgetary funds of the Republic of Bashkortostan.

- In the case any alterations or amendments restricting foreign investors rights are introduced to the Law or other normative legal acts of the Republic of Bashkortostan, these alterations and amendments may be applied to foreign investors and commercial organizations with foreign investment (if its share is at least 25% or 100 million Rubles of authorized capital and if these firms are active at that time in Bashkortostan) only after 3 years after the entry into force of these alterations and amendments. However, this clause does not apply to alterations of the normative legal acts of the Republic of Bashkortostan concerning national security and public order, environmental protection, moral and health protection.

26. After paying relevant taxes and charges and provided they observe the current Currency and Customs Laws, foreign investors are free to manage their income from foreign investments including reinvestment in the Republic of Bashkortostan or outside its limits and can transfer funds outside the Russian Federation. The Cabinet of Ministers of the Republic of Bashkortostan provides state guarantee to foreign investors that belong to the list of priority projects.

27. It is nevertheless important to stress that there are some uncertainties regarding the legal framework for foreign investment in Russia in general. In particular, in his annual address to the Russian Parliament in April 2005, President Putin asked the government to submit a new legislation to the State Duma by November 2005 on strategic sectors, in which foreign participation will be limited.⁴ Another important legislative initiative prepared by the Ministry of Natural Resources intends to restrict the possibility for non-residents to participate in auctions for exploitation of some major raw material deposits. According to this planned measure, non-residents can participate in natural resources development only after their registration in Russia. Participation in auctions for strategic deposits will be allowed only to companies with foreign shares not exceeding 49.9%.

28. The Republic of Bashkortostan intends to apply for the status of special economic zone in accordance with the recently adopted Federal Law “On Special Economic Zones”.

State program for enhancing investment attractiveness of the Republic of Bashkortostan

29. The program aims at creating and improving the legal framework to attract investment, developing conditions and legal guarantees for improving protection of foreign investors in the financial area as well as concerning real estate and intellectual property. It also seeks to increase available funds for strategic and high technology industries in view to enhance competitiveness of the region.

30. In accordance with this program, the government of Bashkortostan can offer to companies with foreign ownership various privileges such as the possibility of accelerated amortization, tax incentives, soft loans, guarantees and securities and facilitate their access to infrastructure and government contracts on preferential terms. The program includes a number of measures to enhance investment attractiveness, for instance the use of mortgages to attract foreign and domestic investments, including securities at the account of the Republic; insurance protection system for investing companies; stimulation system to attract investment also from natural persons; pension reserve. It also foresees the simplification of registration procedures for new joint enterprises with foreign capital participation. However, this programme has not been applied due to the lack of budget resources.

⁴ According to ITAR-TASS, in his instructions the President mentions industries “ensuring country security, infrastructure objects, organizations, executing defence order, natural monopolies, development of the resource of strategic significance”

3. Assessment of the present situation in the sphere of direct foreign investment

3.1. Level and structure of foreign direct investment in Bashkortostan

31. Foreign investment stock in the Republic of Bashkortostan amounts to some USD 430 million. Table 4 shows developments in different categories of foreign investment inflows since 1998.

Table 4: Level and composition of foreign investment to Bashkortostan (USD, thousand)

	1998	1999	2000	2001	2002	2003	2004
Total foreign investment	67318,9	27458,4	10447,2	29643,0	20547,9	40187,7	91073,2
Of which							
a) Direct investment including	5633,8	14009,5	1236,7	19360,1	8995,0	766,0	89004,5
• Contribution to the capital	3764,5	558,5	1181,3	18528,6	7382,9	765,2	28948,2
• Credits obtained from foreign co-owners	726,5	13451,0	52,1	782,9	1591,9	-	18233,5
• Other direct investment	1142,8	-	3,3	48,6	20,2	0,8	41822,8
b) Portfolio investments	324,4	388,9	-	-	451,7	1,7	1528,5
c) Other investments	61360,7	13060,0	9210,5	10282,9	11101,2	39420,0	540,2

32. In 2004, the amount of foreign investment inflows doubled in comparison with the previous year, reflecting the increase in foreign direct investment and portfolio investment. In both cases, it corresponds to the best performance achieved in the last 10 years. In 2004, the highest amount of foreign investment was directed to trading companies and catering facilities, transport, construction materials production, machine building and chemical industry (Figure 1). In terms of foreign investment stocks, the leading investor countries in Bashkortostan are: Belgium, Federal Republic of Germany, China, the Netherlands and Canada (Figure 2). Figure 3 shows the breakdown of foreign investment according to main sectors.

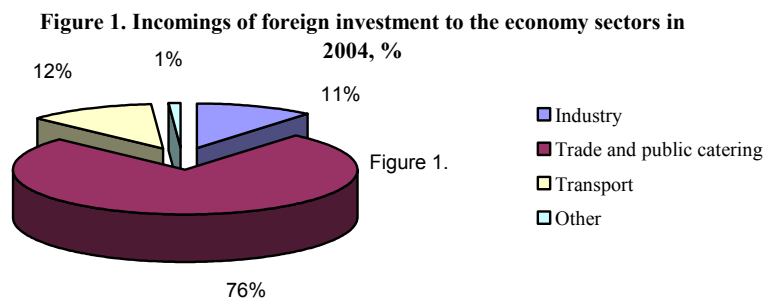


Figure 2. Composition of foreign investment by countries, %

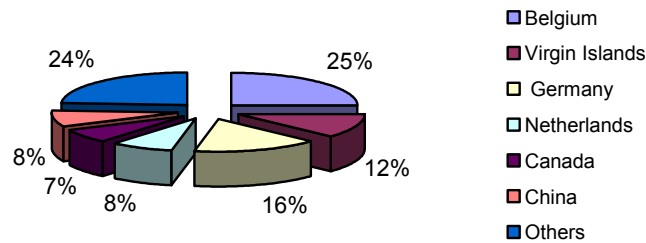
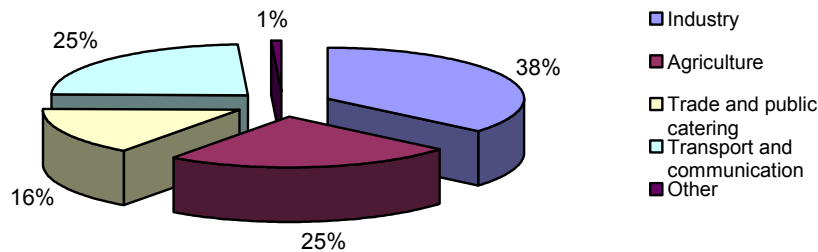


Figure 3. Composition of foreign investment in economic structures, %



33. More than 300 joint ventures, 30 branches and 75 representation offices of foreign companies are registered in the Republic. Some 40 foreign companies are partners in regional joint ventures. Within the Pre-Volga region, the share of foreign direct investment in total foreign investment was in 2004 the highest in Bashkortostan as it reached almost 98% of total foreign investment inflows. In comparison, in the Nizhnyi Novgorod Region, which leads in foreign investment attraction in Russia, this share was 31.3%. On the average, FDI represents 44.5% of total foreign investment in Russia.

34. It is necessary to stress that in all sub-regions of the Pre-Volga Federal Region the major volume of foreign investment goes to the capitals of the regions. This is mainly due to more favorable conditions for conducting business in the capitals given the proximity of the government, better availability of transports and financial facilities as well as higher living standards of the population. Within the regional capitals of the Pre-Volga Federal Region, Samara has been the most successful to attract foreign investment; the capital of Bashkortostan - Ufa is at the 3rd position. In 2004, foreign investment to Ufa reached more than USD 85 million, including USD 83.2 million of direct investment, USD 1.5 million of portfolio investment and USD 0.5 million of other investments. FDI went mainly to trading companies and catering facilities, transport, construction materials production, machine building industry and chemical industry. According to some estimates, the total level of foreign investment in Ufa can amount to USD 300 million in 2005-2006.

3.2 Deterrents of investment activity

35. Despite several positive factors that influence favorably the investment climate in Bashkortostan, there are also various negative aspects which reduce attractiveness of the region for foreign investors, in particular:

- a) Low general predictability at the federal level in the area of taxation: tax rates, their categories and shares are controlled by the federal government and are frequently subject to changes. The regions have only limited prerogatives in this area.
- b) Dependence on central government transfers. Before July 2000, Bashkortostan received a relatively higher share of centrally regulated taxes than most other regions in the Russian Federation. Starting from July 2000, the share of the Republic was brought at the level applied for other regions. The amount of compensatory transfers has also been regularly reduced. The level of centralized financial resources are negotiated which creates additional uncertainty⁵.
- c) Certain political risks and uncertainty due to the unique position of the Republic of Bashkortostan in the Russian Federation and recent legal, administrative, tax and budget changes. The constitutional status of the Republic changed as it has no longer a status of a sovereign state within the Russian Federation and became a republic within the Federation. This means strengthening of federal prerogatives, which may further increase if the proposal to replace current national election of the President of the Republic by his appointment by the President of the Russian Federation would be accepted.
- d) Limited diversification of the tax basis reflecting the fact that the main taxpayers in the Republic are enterprises of the fuel industry.
- e) Delays in institutional reforms, insufficient development of market infrastructure and, as a result, slow improvement of the business climate and absence of active business undertakings. This situation reflects in particular the remnants of state oversight of formerly non-state enterprises, including indirect subsidies and management interventions. Another reason is - as in Russia in general - maintaining of a number of natural monopolies, especially in the energy sector.
- f) Underdeveloped financial sector in Russia in general and in Bashkortostan in particular.
- g) Persistence of administrative barriers and absence of effective system to inform potential investors. Results of the survey conducted in May 2005 among companies with foreign capital participation acting on the territory of Bashkortostan showed that situation in this sphere is apparently satisfactory. Nevertheless the survey results could be affected by the fact that the survey questionnaire was distributed through regional government bodies and that most respondents were Russian managers who dominate in foreign firms' management in the Republic. This is due to the fact that some companies registered as companies with foreign capital are essentially Russian owned companies registered in off-shore zones. For example, "Atec" company, a petrochemical trader, operating in Bashkortostan, has invested some USD 70 million via Virgin Islands.
- h) Lack of differentiation in the level of profitability. Enterprises of export-oriented raw materials industries of the Republic are in the most favorable conditions with oil-refining industry being the leader. Enterprises linked with export-oriented enterprises are in an interim position. The highest profitability is in pipeline transport (33%), followed by related-engineering works (15%). Firms oriented to domestic demand and facing import competition are generally in poorer conditions, in

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In 1999, the Republic of Bashkortostan transferred to the federal budget 19.1% of the total volume of its budget revenues; in 2000, this proportion reached 31%, 49.4% in 2001, 56.4% in 2002, 61.8% in 2003 and 65.8% in 2004. In 2005, the Republic should pay Rbl 44.5 billion to the federal budget compared to Rbl 35.6 billion in the previous year. These developments have inevitably an adverse impact on the resources of the Republic: in 2004 its budget revenue declined by Rbl 1.7 billion and amounted to Rbl 48.5 billion.

particular light industry, wood and woodworking industries, pulp and paper industry, building materials, cereals, medical industry whose profitability level ranges between 0.2-5.3%.

- i) Slower pace of reproduction process in Bashkortostan compared to other regions of the Pre-Volga Federal Region, which have approximately the same economic potential as the Republic. In 2004, Bashkortostan was at the 3rd position in the Pre-Volga Federal Region for industrial production volume (after Samara region and the Republic of Tatarstan) and the pace of its industrial growth (3.3%) was behind the majority of sub-regions (Samara region: 7.9%; Tatarstan: 5.5%) and also behind the Russian average (6.1%).

36. Despite of the considerable increase of foreign investment in 2004 in Bashkortostan (reaching USD 91 million), foreign investment contributes still only marginally to investment activity in the region. At present, FDI represents only 4.2% of all the investments in capital goods in the region. Foreign resources cover mainly the needs for raw materials and assembly activities and are in the form of banking credits. Investment needs of enterprises in Bashkortostan continue to be mainly financed by firms' own financial resources. For example, in October 2004, the share of investment covered by internal resources amounted to 57% in Bashkortostan as against the average of 47% in Russia.

4. Policy options for enhancing direct foreign investment into Russian regions

37. Given Bashkortostan's attractive natural, human, industrial endowments, its significant economic potential and notwithstanding recent positive investment developments, the FDI level in the region remains low and insufficient in views of its modernization needs. Although some significant improvements have been recently achieved, especially with respect to political stability, dynamic economic growth and certain progress in shareholders rights, many barriers persist. Among them, foreign investors complain in particular on burdensome administrative measures, inefficient tax system, insufficient information availability on investment opportunities and business conditions in Russia.

38. To improve the situation it is necessary to modernize the legal and regulatory framework to stimulate foreign investment, including by establishing a modern and effective system of guarantees, protection and insurance of foreign investments. It is also crucial to enhance the information system and consultation support for foreign investors. While most of the proposed measures are to be undertaken at the federal level, regional authorities have also significant possibilities to intervene. The following measures should be developed in Russia and applied in Bashkortostan taking into account regional specific needs and possibilities:

- a) Developing coherent strategy of economic development and designing governmental economic policy which would clearly specify economic objectives and priorities and establish the rules for state regulation and intervention in the area of investment.
- b) Creating a general framework for investment policy with a clear orientation for the role of foreign investment.
- c) Reducing existing major distortions in the production structure by eliminating the main causes responsible for these distortions. In particular, the Republic should increase the share of final products (e.g, machine building, timber processing) and overcome its current strong orientation on fuel and raw materials, especially in its export structure.
- d) Limiting the scope of shadow economy; increasing transparency of companies' ownership structure; assisting companies in adapting international accounting and reporting standards.

- e) Evaluating natural monopolies' activities in different sectors at the regional and departmental levels.
- f) Promoting major projects and encouraging the so-called 'anchor' investors, which can attract additional units providing inputs for the main producer. This requires creating a good infrastructure basis, including communication and engineering facilities.
- g) Granting a favorable treatment in the region to stimulate investment activity in regional priority areas and providing additional state guarantees by the regional governments.
- h) Reducing administrative barriers, especially during the establishment phase, by creating for example the 'one stop shop' facility.

39. Within their prerogatives, the region and therefore the Republic of Bashkortostan should implementing additional tax incentives in the form of tax reductions of taxes which are part of their regional budgets. The reduction of 100% should apply during the period of investment and concern the following taxes:

- property tax if property was established or purchased for investment project realization;
- income tax received from realization of production (work, service), if the manufacturing capacity was produced (purchased) during the investment project realization or using technologies implemented during the realization of the project;
- tax on equipments received without payment by investor for investment project realization;
- highway tax on the manufacturing capacities produced (purchased) in during the investment project realization or using technologies implemented during the project;
- 100% reduction of property tax during two years after the completion of investment on the part of property produced or purchased for investment project realization.
- Granting additional tax incentives in relation to taxes which are paid to the budgets of local authorities on the territory of the Republic of Bashkortostan.

40. The regions should also encourage the development of companies able to provide on a competitive basis legal consultation services in the sphere of taxation, currency regulations, foreign economic activity and privatization to foreign investors. Finally, the regional government should also establish specific programs that would promote the Republic of Bashkortostan as a reliable and promising investment destination.

APPENDIX

Table A. Unemployment and demography in Bashkortostan and neighboring regions in the 1st half of 2004

	Unemployed, thousand of people		Enterprises and organizations demand for manpower declared to the government employment service (July 2004)	Natural population growth (+), decline (-)
	Unemployment survey data	Registered in government employment service (July 2004)		
Russian Federation	5 799	1555,8	1042965	-5,9
Pre-Volga Federal Region	1 216	202,7	183699	-6,4
Republic of Bashkortostan	153	22,7	19005	-3,0
Republic of Marii-El	39	7,7	5299	-6,3
Republic of Mordovia	27	6,3	6302	-8,8
Republic of Tatarstan	127	22,7	16223	-3,6
The Udmurt Republic	63	11,4	14994	-3,7
The Chuvash Republic	64	11,9	8576	-4,7
Kirov Region	68	18,2	12871	-10,1
Nizhegorodskii Region	133	12,6	25051	-11,4
Orenburg Region	114	6,2	9220	-4,5
Penza Region	63	9,8	7684	-10,0
Perm Region	95	16,0	10142	-6,1
Samara Region	77	24,3	16461	-6,4
Saratov Region	121	18,8	25474	-8,1
Ulianovsk region	73	14,1	6397	-7,9

Table B: Investment climate rating in Russian regions (2003-2004)

Number in chart 4*	Region
Maximal potential – minimal risk (1A)	
Average potential – minimal risk (2A)	
Low potential – minimal risk (3A)	
High potential – moderate risk (1B)	
10	Moscow Region
18	Moscow
29	St. Petersburg
Average potential – moderate risk (2B)	
25	Leningrad Region
43	Republic of Bashkortostan
46	Republic of Tatarstan
50	Nizhniy Novgorod Region
53	Perm Region
55	Samara Region
56	Saratov Region
Lower potential – moderate risk (3B1)	
47	Udmurt Republic
48	Chuvash Republic
51	Orenburg Region
52	Penza Region
57	Ulianovsk Region
Minor potential – moderate risk (3B2)	
49	Kirov Region
Maximal potential – high risk (1C)	
Average potential – high risk (2C)	
Lower potential – high risk (3C1)	
Minor potential – high risk (3C2)	
44	Republic of Marii El
54	Komi-Permiatskii Autonomous Region
Low potential – extremal risk (3D)	
<i>*Regions numbered according to their Federal region numeration.</i>	

Table C. Investment risk of Russian regions (2003-2004)

Risk rank		Potential rank	Region(Subject of Federation)	Ranks of investment risk composition in 2003-2004							Change in risk rank	
2003-2004	2002-2003			legislative	political	economic	financial	social	criminal	ecological	2003-2004 to 2003-2002	2003-2004 to 1998-1999
3	2	2	St. Petersburg	52	76	6	2	3	40	44	-1	-1
6	5	9	Republic of Tatarstan	64	2	23	27	17	43	40	-1	-3
8	8	3	Moscow Region	9	28	8	14	40	24	43	0	-2
9	7	6	Nizhny Novgorod Region	2	72	52	16	9	29	18	-2	-1
10	11	15	Republic of Bashkortostan	4	7	3	35	38	63	42	1	14
11	45	62	Republic of Mordovia	49	1	49	47	42	14	23	34	3
14	32	11	Perm Region	10	35	26	11	11	69	67	18	-3
15	6	1	Moscow	76	34	1	1	1	85	26	-9	-14
17	26	21	Leningrad Region	11	58	10	9	50	26	72	9	0
20	21	52	Chuvash Republic	18	46	64	33	27	23	8	1	-4
21	16	8	Samara Region	28	63	36	8	18	66	60	-5	-6
23	28	20	Saratov Region	53	13	35	63	26	20	39	5	-10
28	41	49	Penza Region	15	30	74	67	36	1	29	13	15
33	24	55	Kirov Region	5	49	72	58	48	13	31	-9	8
38	51	30	Orenburg Region	22	60	42	28	55	56	57	13	0
44	25	41	Udmurt Republic	57	19	65	17	76	30	53	-19	-8
56	49	46	Ulianovsk Region	77	50	59	64	51	31	12	-7	-31
69	60	71	Republic of Marii-El	32	81	80	78	59	35	10	-9	-25
	77	87	Comi-Permiatskiy Autonomous Region	67	25	69	85	61	9	9	5	-26

Table D. Regions with the most “investment active” management

region	Risk rank in 2003-2004	Rank of investment level per 1 official for 1999-2003	Region ranks total
St. Petersburg	3	6	9
Moscow Region	8	10	18
Republic of Tatarstan	6	12	18
Moscow	15	5	20
Leningrad Region	17	7	24
Republic of Bashkortostan	10	16	26
Novgorod Region	1	26	27
Krasnodar Territory	19	8	27
Perm Region	14	13	27
Nenetskiy Autonomous Region	26	2	28
Yaroslavl Region	2	28	30
Tomsk Region	16	19	35
Vologda Region	7	31	38
Samara Region	21	17	38
Yamalo-Nenetskiy Autonomous Region	39	1	40
Belgorod Region	4	38	42
Khanti-Mansiyskiy Autonomous Region	40	3	43
Lipetsk Region	13	32	45
Nizhniy Novgorod Region	9	40	49
Rostov Region	12	39	51

Regions leading in total investment per one official

