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# "WHY HAS RUSSIA FAILED TO ATTRACT FDI?"

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This dissertation is the result of my own work and includes nothing that is the outcome of work done in collaboration. It is 12,698 words in lentgh.

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# Contents

## Introduction

The benefits of FDI on a country's economy are getting more and more recognized by governments and decision makers. Benefits include spillover effects, such as transfer of technology and know-how to the local economy, increase in competition among foreign and local firms which may make the latter more efficient, more tax revenues for the government, less unemployment. For those reasons, there is a general consensus on the benefits of FDI among governments. More and more countries are liberalizing their economic policies in order to attract FDI. This fact combined with the increasing global economic integration (see for example EU, NAFTA etc.) has led to an increasing competition among the countries competing on which will attract more FDI. This has made the position of the MNEs stronger, since now if a country does not offer a good environment for investors, the latter will invest in another country where the environment will be considered as more secure and more likely to be profitable.[1]

The above reality leads us to the question on what determines FDI. Which factors may make an MNE to decide to invest in a country and which may prevent such a decision? Answering this question will enable us to realize why a country may succeed in attracting FDI flows or fail. The purpose of this essay is to examine why Russia, a country which recently liberalized its economy, failed to attract FDI. One would expect that a country with a very big market size of more than 140 million people, and a well-educated labour force would have attracted large flows of FDI once its socialist economic system had collapsed. However, this was not the case in Russia. To understand why Russia has failed to attract FDI we need to see, in the first

[1] Nunnenkamp, Peter, "Determinants of FDI in developing countries: Has Globalization Changed the Rules of the Game?", *Kiel Working Papers,* No.1122, July 2002 , p.4

part of the essay, which factors determine FDI in general and how We will see how factors such as macroeconomic stability, political risk, performance of the state administration, rule of law, open and fair competition among local and foreigners, the system of corporate governance in a country, and issues such as taxation and protection of property and intellectual property rights play in attracting FDI.[2] In the second part we will see what went wrong with Russia regarding these factors, resulting in its failure to attract FDI.

We will notice that despite the obvious advantage of being a country with a big market size, Russia's performance in all the factors mentioned above is poor. The situation seems to be changing since Vladimir Putin took office in 2000. Russia now attracts huge capital flows compared to the 1990s. However, it is still lagging behind other countries of the former socialist block even if the collapse of their socialist economic systems took place almost at the same period of time. The situation during the 1990s seems to be having a strong effect still. Moreover, some decisions of Putin's administration have raised concerns towards Russia's policy. The hostile governmental policies towards foreigners in strategic sectors of the economy such as energy, and the increasing governmental intervention to businesses in order to achieve political goals (see the Khodorkovskyi case) are the most important reasons for such concerns.

In order to attract more FDI, Russia, apart from refraining from such policies, must deepen its structural reforms since despite the improvement in the situation towards attracting FDI Russia's structural weaknesses are still evident.

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[2] This is not to say that other factors do not matter. Such factors include the banking system, infrastructure, trade policies (especially for efficiency-seeking FDI which wants to export its products from the host country to other countries), labour costs, existence of natural resources (especially for resource-seeking FDI). For the purposes of our essay we will not mention much about those factors, with a possible exception for natural resources, since Russia is a country abundant in natural resources which may potentially be a major source of attracting FDI.

## Part I Determinants of FDI

As mentioned above, a number of factors determine how attractive a country may be regarding FDI. In the first part of the essay, we will see how the factors that we mentioned above affect the decision of a firm to invest abroad. In order for a firm to invest abroad three types of advantages must be present. According to Resmini these include, "Ownership-specific advantages (i.e. proprietary technology), locational advantages in both the home and the host country, and superior commercial benefits in exploiting the two previous type advantages internally and directly rather than in exchanging them on the market through licensing or co-operation agreements with an independent foreign firm".[3] From these, only locational advantages are country-specific, since the other two are firm specific. That is, a country must offer a good business environment so as to attract FDI. In other words, it must offer strong locational advantages in order to be chosen by a foreign firm. In this section we examine some of the factors which determine how attractive will a country be for an MNE to invest.

### Macroeconomic stability

According to Neuhaus, "by macroeconomic stability we primarily understand sustainable growth, a low degree of inflation and exchange rate risk, a small amount of unemployment, as well as fiscal discipline and enough reserve coverage".[4] According to this definition, the effects of macroeconomic stability on attracting FDI are obvious. In an economy with sustainable growth, people will be richer, which means that they will have more available money to spend for investment products.

[3] Resmini, Laura, "The determinants of foreign direct investment in the CEECs. New evidence from social partners", *Economics of Transition,* Vol.8, No.3, 2000, p. 668

[4] Neuhaus, Marco, *The Impact of FDI on economic growth: an analysis for the transition countries of Central and Eastern Europe,* Heidelberg, Physica-Verlag, 2006 , p.147

This increase in the consumer power of people potentially means more profits for investment projects. This gives an incentive for investment and the opposite happens when there is either economic decline or low growth. Similarly, a depreciation of the country's currency increases the risk because depreciation reduces the profits denominated in the donor country's currency.[5] An economy with low inflation, prudent fiscal activity and low external debt (which show macroeconomic stability) is also a good signal to investors and show that a government is credible towards implementing an efficient macroeconomic policy.[6]

From these it is obvious that a country with a good macroeconomic performance is more attractive regarding FDI compared to a country with macroeconomic instability as it is clear that lack of macroeconomic stability increases the uncertainty and the risk of any investment.

**Political risk**

According to Kobrin, by political risk we mean "the potentially significant managerial contingencies generated by political processes and events".[7] Moreover, according to the investorwords website (http://www.investorwords.com), political risk is "the risk of loss when investing in a given country caused by changes in a country's political structure or policies."[8] From those definitions we conclude that political risk includes the risk faced by unexpected and frequent changes in the political decisions

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[5] Ibid

[6] Campos, Nauro F. and Kinoshita, Yuko, "Why does FDI goes where it goes? New Evidence from the Transition Economies", *IMF Working Paper,* November 2003 , p.11

[7] Kobrin 1982:29 here found in Berg, David M. and Young, Stephen, "Capital Flows, Capital Controls, and International Business Risk", in Rugman, Alan M. and Brewer, Thomas L., *The Oxford Handbook of International Business,* Oxford, Oxford University Press, 2001 p.269.

[8] Investorwords website, available as http://www.investorwords.com/3733/political_risk.html

and policies of the leadership as well as the risk due to a an unstable political environment in a country, either due to possible often changes in the leadership of the country or due to political disputes, weak governmental power, or conflicts (including violent ones). Obviously, an unstable political environment will result in more often changes in governmental policies and decisions. This does not mean however, that frequent policy changes may not occur in a country with a stable political environment. It may be the result of the absence of clear ideological and policy orientations from the part of the government, the vulnerability of the latter to the pressure of interest groups or lobbies etc.

Such often and unexpected changes in the political decisions and orientations refer to issues such as possible nationalizations of key industries or resources where foreigners have already invested or intend to invest, decisions to expropriate assets of the companies by the authorities, governmental interventions to in order businesses to achieve political goals, governmental commitment or non-commitment to fulfill its obligations towards foreign investors (for instance, by braking contracts, not implementing the terms of a contract, or renegotiating the terms of a contract signed with a foreign company), or even hostile takeovers of enterprises.

Political risk may also be the result of a politically unstable environment in a country.[9] As we mentioned above, often changes in the leadership of the country also mean often changes in all policies that affect FDI (macroeconomic, institutional etc). But often changes in the leadership may not be the only source of political risk. This may be the result of a government holding a weak parliamentary majority, forming a weak governmental coalition, or a government whose power is challenged by other power centers within the country, even of this government stays on power for the

[9] Ibid., p. 269-272

whole term. Political risk may also be the result of political disputes and social opposition to the governmental decisions, or even an internal or external violent conflict. In case of political instability, the ability of governments towards implementing efficient macroeconomic or institutional policies decreases. It is more difficult for a weak government under threat from various events and circumstances to implement effective strategies. A weak government is thus more likely to change its decisions and policies frequently. In general, foreign investors will prefer a country with a stable political environment since this reduces the uncertainty and the cost of their investment. Predictability of the rules and the decisions is very important, but also very unlikely to occur in a politically unstable country.[10]

**Administrative performance**

Dealing with an effective and favourable to business environment administration is very important. Problems related to administration include corruption from the part of the state employees and officials, high bureaucracy, and administrative interventions to businesses which may put obstacles to their proper functioning.

Corruption increases the uncertainty and the cost of an investment. A corrupt state administration is an unpredictable one. Investors can not be sure that formal rules will be implemented, since this may be subject to the desire of any corrupt administrative employee or official who may ask to be bribed or receive other private benefits in order to enforce the rule. That is, apart from the uncertainty, corruption also increases the cost since paying bribes require extra money which will be added to the money of the investment. Thus, the cost of investment consists of not only economic costs, but also noneconomic.[11]

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[10] Fitzgerald, Valpy, "Regulatory Investment Incentives", *OECD-Directorate for Financial, Fiscal and Enterprise Affairs,* 20 November 2001 , p.3

Bureaucracy is another important obstacle. There are many cases, especially in the developing countries, where establishing an investment and acquiring all the necessary licenses (such as registration licenses, construction permits etc) needs much time. Investors may have to wait for months or even years to get all these licenses increasing the time needed for the investment. This may prevent an enterprise from investing. Moreover, bureaucratic procedures are a reason for the increase in corruption themselves. When so many licenses and time to get them is needed, an administrative employee or official may ask for bribes or other favours in order to help the investor finish with this procedure earlier. Such bureaucratic procedures may reflect a general fear of the government towards FDI. Governments often use licensing as a mean to restrict FDI.[12]

Administrative intervention to businesses may be another serious threat. Public administration beyond governmental control may often intervene creating serious problems to the enterprises. Many companies, for instance, face problems with tax authorities, which may threaten them with fines or various actions against them either they have really done something illegal or not. It is very difficult for a company to survive under the permanent threat of tax authorities. Bribes may be needed again to deal with them. Administrative intervention may also take other forms such as expropriations of assets, withdrawing of licenses, non enforcement of signed contracts with a firm etc.

**Rule of Law**

Among developing countries there are many weak states lacking the necessary capacity to enforce the rule of law. One reason is the inability to control state

[11] Campos, Nauro F. and Kinoshita, Yuko, "Why does FDI goes where it goes? New Evidence from the Transition Economies", *IMF Working Paper,* November 2003, p.11.

[12] Foreign Direct Investment Restrictions in OECD countries, *OECD,* available as http://www.oecd.org/dataoecd/24/35/2956455.pdf, p. 2

administration effectively. This may be the result of the state lacking both the necessary control mechanisms to monitor the action of the state administration and the necessary financial resources to fund the administrative branches throughout the whole country. This lack of efficient control makes the enforcement of formal institutions and rules uncertain. State administration becomes vulnerable to the influence of various interest groups or powerful individuals who may use many legal or illegal ways (such as bribes) to influence administrative decisions according to their interest, even if these decisions are against the formal rules. Employees and officials may realize their power and abuse it to receive personal gains. Such informal practices are a widespread phenomenon in many developing countries. The combination of weak control mechanisms and inadequate funding can thus create serious problems regarding the enforcement of the rule of law since state administration may act independently of the government.

Moreover, the inability of the government to enforce the rule of law can be the consequence of the existence of other strong power centers within the country. Decentralized systems in weak and lacking in democracy states often results in the central authorities being unable to enforce the rule of law due to their weakness combined with the increase in the power of the periphery. Governmental decisions may face hostility from other political authorities in the country (regional, local, municipal). Inconsistencies between decisions of the central authorities and those of the local authorities may be created and governmental decisions may not be implemented. This increases the uncertainty and the risk that a foreign company faces. Such phenomena also strengthen the positions of administrative employees and officials of the local branches who may look to take advantage of such legal gaps and interpret laws in whatever way favours their private interests.

Lawlessness often expands to other sectors. Informal practices may cover the operation of the businesses in the absence of effective state control mechanisms combined with a poor institutional framework. Equally important is the possibility that the judicial system (which is supposed to be responsible for the implementation of the law) in a country works under ineffective control by the state, is corrupt and vulnerable to influence by powerful groups, individuals or politicians. Obviously, a foreign firm will have to deal with some legal disputes during its presence in the host country. That is, a fair and effective judicial system is necessary for a company to invest abroad.

Under such circumstances, where the whole functioning of the state is weak, and where there is inconsistency between formal rules and reality, a foreign firm is very unlikely to invest. That is, rule of law is a necessary condition for FDI.

**Open and fair competition**

Open and fair competition are very important for FDI. By open competition we mean that all sectors of the economy are open to foreign investment. That is, they are not protected from international competition. Sectors either closed or highly restricted to FDI may be the result of the actions of powerful economic lobby groups who are interested in protecting their sectors from foreign competition. It may also be the result of specific governmental policy orientations considering that specific sectors of the economy should be under state control and, that is, highly protected. By fair competition we mean that in sectors where foreign investment is not severely restricted or forbidden there will be still no discriminatory decisions or implementation of the rules from the part of either the governmental or the administrative authorities against the foreign investors. Rules have to be implemented fairly to all enterprises (foreign and domestic). Open competition does not necessarily mean fair competition.

As we mentioned, the role of lobby groups in decision making regarding open and fair competition may be very important. They can influence decisions in favour of their interests and violate the rules of open competition. Lobby groups may press for regulations that set restrictions to foreigners' participation in a sector by either forbidding it or severely restricting it (for instance, by restricting the percentage of stakes that a foreign company investing in a specific sector can hold). There may be industries where such restrictive rules do not exist nor are strong and others where such regulations really restrict or forbid foreign participation.[13] As we also mentioned, protectionist and restrictive to FDI regulations may not only be the result of pressure from interest groups but also the result of governmental decisions stemming from a specific policy orientation or ideology. Governments may consider several sectors as strategic and thus restrict or forbid FDI flows.

As mentioned above, open competition, however, does not mean fair competition. Even in open sectors, domestic interest groups may still use their power to get a preferential and discriminatory treatment from authorities at the expense of foreigners. Preferential treatment means discriminatory decisions regarding issues such as state subsidies to the domestic enterprises, discriminatory enforcement of the law in cases of tax evasion, credit issues, direct or indirect support for the locals in case of legal disputes with foreigners etc. In general, in key sectors (such as energy or defense) lobby groups obviously have more power to influence such governmental decisions. That is, such sectors are less likely to be open to FDI. Weak states, where

[13] Spar, Debora L, "National Policies and Domestic Politics" in Rugman, Alan M. and Brewer, Thomas L., *The Oxford Handbook of International Business,* Oxford, Oxford University Press, 2001, p. 220.

central authorities are not strong, are even more vulnerable to pressure from interest groups.[14]

**<u>The system of corporate governance in the host country</u>**

There are two main ways of investing abroad. The first is Greenfield investment meaning the direct investment in new facilities or the expansion of existing facilities. The second is mergers or acquisitions of already existing local firms whose assets will be transferred to the foreign firm. The latter method of FDI is preferred many times since investing in an already existing local SME  instead of making a Greenfield investment may reduce the cost and the risk of the investment, especially if this enterprise is well functioning.[15] The attractiveness of an already existing firm is determined firstly by whether and to what extent it is open to foreign participation (severely determined by the type of ownership of the firm), and secondly by the performance of the firm (whether it is working in an efficient and market-oriented way or not). Apart from buying shares of a local firm, foreigners very often participate in partnerships with local firms in an investment project. That is, the local firms must be a reliable partner.

In transition countries privatisations of state enterprises are in general a good way of attracting FDI since foreign investors may be interested in acquiring a percentage of shares of such enterprises or even buy the majority of them. Foreign firms may invest in newly privatized enterprises of the host country since they may see it as a good and potentially profitable investment. Obviously, the methods of privatizations of the former state enterprises severely determine how attractive firms will be in the future. One of the issues that the methods of privatizations of former state firms

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[14] Ibid, p.222

[15] Cho-Joong-Wan, "Foreign Direct Investmen: Determinants, Trends in flows and promotion policies", *Investment Promotion and Enterprise Development Bulletin for Asia and the Pacific* , p.109.

determine is how open they will be to foreign capital. The chosen methods will show whether privatizations are targeting foreign participation regarding the new ownership or not, and to what extent. In transition countries insider privatisations (managers and employees acquiring the shares and the control of the newly privatized firm) are likely to be chosen from the governments since this will reduce the social cost from firms being privatized (managers could lose their positions and many employees their jobs). However, privatizations of enterprises finally leading to insiders acquiring the majority of the shares and the control of the enterprise also result in foreigners being severely restricted to participate. They are directly excluded from buying shares which are given almost exclusively to insiders.

Another issue that the methods of privatizations determine is the functioning and the efficiency of the firm. In order for foreign investors to invest in either state or private companies, they must be working under a framework that will make them attractive. As Kuznetsov, Kuznetsova and Kapelyusnikov state, "in modern society the system of corporate governance is responsible for reassuring individual investors that the money they invest in a public company will be handled in with due care by the management of the company, so that the interests of investors are protected".[16] In order for this to happen, companies should be working in an effective way allowing them to be competitive and potentially profitable. In case of insider privatizations, nobody prevents the new owners from selling shares to foreigners, even if this is obviously difficult to happen. FDI is not fully restricted. In such cases, however, other severe obstacles exist. Newly privatized firms controlled by insiders usually operate in a way that makes them less market-oriented and potentially profitable, and thus less

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[16] Kuznetsov, Andrei, Kuznetsova, Olga and Kapelyusnikov, Rotislav, "Ownership Structure and Corporate Governance in Russian Firms" in Mickiewicz, Tomasz, Corporate *Governance and Finance in Poland and Russia*, Studies in Economic Transition, New York, Palgrave McMillan, 2006 p. 179

attractive. Such firms' performance is usually poor also making them unreliable partners for partnerships in investment projects. Foreign investors intending to invest are very likely to face a strong resistance by either the managers (whose interests and positions may be threatened) or the employees (who may be afraid of foreign participation or ownership). For these reasons, the chosen methods of privatizations may open or limit access to FDI.[17]

**Taxation and protection of property and intellectual property rights**

A good institutional framework is necessary in order to create a good business environment and attract FDI. A foreign firm will establish its presence into a country which is under the rule of a specific government which imposes the regulatory framework for the functioning of all the aspects of the society. That is, FDI is impossible to act independently of these rules. Thus, the institutional framework under which FDI will work is a very important determinant of FDI.

Among others, some of the most important issues that institutional framework determines are the protection of property rights (protection of land, assets, contract agreements etc) and the protection of intellectual property rights of a firm. Taxation is also a very important issue for attracting FDI.

Regarding property rights, FDI is less likely to go to a country where the protection of property rights is poor. Phenomena of non protection of the assets of a firm (real estate, office equipment, securities or other properties) that a firm holds are widespread especially in developing countries. Firms also often face expropriations of their properties and various interventions from the governmental or the administrative authorities.

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[17] Neuhaus, Marco, *The Impact of FDI on economic growth: an analysis for the transition countries of Central and Eastern Europe,* Heidelberg, Physica-Verlag, 2006.

Protection of intellectual property rights (trademarks, copyrights, etc) is equally important. When economic agents (individuals or firms) sell products using the trademarks of another firm (the one which is the legal owner of the trademark) without permission, people may get easily confused and cheated and may buy goods that are not products of the firm they thought they are. This will directly reduce the profits of the firm which legally uses the trademarks. Intellectual property rights are less likely to be protected in countries with a large underground economy.

Moreover, a taxation system that will boost and not prevent investment is also necessary. A system of taxation which increases the tax burdens of a company may be a reason for less investment. It is also very important that tax rules do not change frequently, are clear and easy to interpret, and make taxes easy to calculate. Enterprises do not want to pay many taxes, but it is equally important for them to know and to be able to calculate easily how much tax they have to pay. This will make their investment more predictable. Transparency is vital for the functioning of the economy.[18] When an investor knows the exact rules under which the investment will be made, this will reduce the uncertainty and the risk of the investment. On the other hand, a non-transparent legal framework (for instance, by changing the rules regarding a specific institutional issue very frequently and without providing information to the business world about these changes) is an obstacle to foreign investment.

[18] Ibid

## Part II The case of Russia

As we mentioned in the introduction despite Russia being a large market of 145 million population and a country with a well-educated labour force, which should make it more attractive to foreign investment, it is lagging behind many other transition countries of the region. Especially during the 1990s the FDI flows were particularly low. However, the situation has severely changed after Putin took office in 2000. In the first six months of 2003 FDI was $23 billion, while the first six months of 2002 it was just $8 billion. In 2006 FDI reached $30 billion, showing the severely rising trend in FDI flows to Russia.[19] In table I (appendix) we can see an indicator of the increase in FDI flows, as shown by the large increase of the number of the European FDI projects in Russia just within a very short period of time (2002-2003).[20] However, Russia is still far behind other transition countries of the region and far behind its investment potential. In this chapter we will examine the reasons why Russia failed to attract FDI and what may be the reasons for the recent change in FDI flows during Putin's administration. As we will see, the reason for this failure is Russia's poor performance towards the above mentioned determinants of FDI.

### Macroeconomic performance

The collapse of the Soviet Union resulted in a dramatic increase in the macroeconomic instability of Russia. Despite the many negative aspects of the former socialist system, it had still managed to provide a minimum standard of living and social welfare. Two important aspects of this were the percentages of the inflation and unemployment rates which were close to zero. The collapse of the Soviet state meant

[19] Pryde, Ian, "FDI in Russia: rewards justify the risk", *Ria Novosti,* 18/4/2007, available as http://www.cere.gr/shownew.asp?news_id=645.

[20] Rogacheva Elena and Mikerova Julia, "European FDI in Russia: Corporate Strategy and the effectiveness of Government promotion and facilitation, *OCO Consulting,* September 2003, p. 22

that the already poor Russian residents would now have to deal with two more severe problems, the high unemployment and inflation rates. To give some representative examples, from the almost 0% percent in the late Soviet era, unemployment reached 8.6% in 1996 and 10.5% in 2000. Inflation reached 14.6% in 1997, 27.8% in 1998, and 85.7% in 1999. External debt also increased dramatically. The estimated Russian external debt was $163 billion estimated in the year 2000. Moreover, during the period 1990-2005, Russia's GDP growth was -0.1 reflecting mostly the decline in production in all sectors during the 1990s. Wages also severely dropped (and in some cases the state did not even have enough resources to pay the state employees at all). This entire situation resulted in the financial crisis of 1998 when rouble was depreciated. A country with such an unfavourable and unstable macroeconomic environment is very unlikely to attract FDI. The consuming power of the population dropped since people could hardly make ends meet. Depreciation of rouble in 1998 also showed the risk of doing any kind of business caused by macroeconomic instability. The fact that a government performed so badly in terms of macroeconomic policies gave the impression of a non-credible reformer to foreign investors. Governmental policies resulted in transition to market economy failing. Macroeconomic instability is a thus a major reason that Russia failed to attract FDI since the collapse of Communism.

**Political risk**

As we mentioned in the theoretical part, political risk may be the result of frequent changes in the leadership of the country as well as frequent and unexpected changes regarding governmental decisions. Russia is a country where both types of political risk exist.

Regarding political instability, it has to be mentioned that the leadership of the country has only changed once during the period 1993-2007. This change took place in 2000 when Vladimir Putin replaced Boris Yeltsin in the Presidency. Despite the fact that this should indicate a low political risk, we should not forget that Russia was a communist country until 1993. Obviously this caused fear among the foreign investors regarding a possible restoration of the old regime, especially during the first years of transition. Political and social forces supporting either the restoration of the old regime (or being ideologically close to the ideology of the old regime), or at least opposing the reforms that Yeltsin suggested were very strong and Boris Yeltsin acquired power only after a conflict with a strong political opposition in the Supreme Soviet and the Congress of People's Deputies opposing his radical reforms during the first two years of his Presidency. The conflict resulted in Yeltsin calling up the tanks to shell the building of the Russian Parliament (Duma), which was surrounded by his opponents supporting the opposition. Even if Yeltsin managed to establish his position, the violent way that this was done, as well the existence of a very strong opposition both in the Duma and among the population increased fears that political instability in the future could be caused. Indeed, in the 1996 elections the fact that neo-communists were likely to come to power proved that such fears were right. Gennady Zyuganov, the candidate of the Communist Party, won the 40% of the votes in the second round. Yeltsin finally won by getting a 53% but Zyuganov's popularity showed again that the risk of a political setback was serious. Political instability was thus a major obstacle to FDI during the 1990s.

As we mentioned in the first part, political instability is also a result of government's power being challenged by other strong power centers within the country. Following the collapse of the Soviet Union, which was a strongly centralized state, Yeltsin's orientation towards increasing the federal character of the state combined with the weaknesses of the central state, severely increased the power of the regional governments.[21] The center's control over the decisions of local governments was ineffective. In Russia, many of the autonomous republics became disloyal to the central authorities. Some of them were in conflict with the centre making separatist claims (especially republics in Russia whose population is ethnic-based, such as Chechnya), while some others were in political conflict with the center (the example of the Central-Black Earth Regions, where the majority of people supports the Communist Party). Federal government's power was severely challenged (especially during the 1990s) and governmental decisions opposed and even not implemented by regional governments. Russian state was sometimes considered to be under collapse. Presidential representatives were supposed to control the local governors but in general they acquired strong ties and relations with them and finally became members of the regional elites.[22] This situation obviously increased uncertainty.

Besides the risk of political instability, firms doing business with Russia also face the risk of often and unexpected changes in the decision-makers' policies and preferences towards important issues. Such changes in rules and regulations increase the degree of uncertainty of an investment. One of the most important issues related to frequent changes in rules is the frequent changes in the tax regulations.[23] Especially during the 1990s tax rules had been changing very often, and it was difficult for businesses to count how much tax they had to pay and according to what tax rules

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[21] Petrov, Nikolai, "Federalism-Russian Style and the Evolution of Center-Region Relations", *Carnegie Moscow Center,* 17 March, 2002, p. 3

[22] Ross C., "Putin's federal reforms and the consolidation of federalism in Russia: one step forward, two steps back!", *Communist and Post-Communist Studies,* Vol.36 (2003), p.33

[23] Ogutcu Mehmet, "Attracting Foreign Direct Investment for Russia's Modernization. Battling against the odds", *OECD-Russia Investment Roundtable,* St. Petersburg, Russia, June 2002, p.7.

they had to operate. Such practices also created uncertainty about often changes in tax regulations in the future. Government information provided to enterprises about such changes was also poor.[24] In a survey conducted by the European Business Club in Moscow among 46 European Enterprises (see table II) the majority of the respondents answered that unexpected changes in tax law is considered to be the most important problem that they face. In the same survey, the risk of political change is also considered as an important problem by the respondents.[25]

The importance of political risk is also indicated in another survey conducted by the Economist Intelligence Unit the year 2007, in which 455 executives around the world were interviewed. Political risk is mentioned as the second most important problem for investing in Russia (mentioned by the 44% of respondents).[26] Here, it is very important to mention that the Russian political system is a system with strong personalization of power. President is very powerful and institutions that should be able to control presidential decisions (such as the Duma and the judiciary system) are particularly weak.[27] Since Russia lacks such a system of checks and balances, President can change regulations, laws and policies frequently without any serious obstacles. This increases the political risk faced by investors.

**Administration mechanisms**

One of the major problems that a foreign enterprise may face when investing in Russia is the inefficient administration. As we mentioned in the first part this may

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[24] Rogacheva Elena and Mikerova Julia, "European FDI in Russia: Corporate Strategy and the effectiveness of Government promotion and facilitation, *OCO Consulting,* September 2003, p. 22

[25] Ahrend, Rudiger, "Foreign Direct Investment into Russia-Pain without Gain? A Survey for Foreign Direct Investors", *Russian Economic Trends,* Moscow, June 2000 p.7

[26] Economist Intelligence Unit, "Hidden Gem? Perceptions of business opportunity and Risk in Russia", *Economist Intelligence Unit*, April 2007, p.4 (see also table IV, appendix)

[27] Petrov, Nikolai, "Federalism-Russian Style and the Evolution of Center-Region Relations", *Carnegie Moscow Center,* 17 March, 2002, p.5

include corrupt practices from the part of the state employees and officials, time-consuming bureaucratic processes for the registration and the establishment of an enterprise, as well as administrative interventions to businesses (expropriations, withdrawing of licenses, braking contracts with companies, interventions from tax authorities etc). This later issue could be linked with the political risk we mentioned above. Such administrative practices may reflect the will of the government to restrict FDI. However, it may be the result of an administration being beyond the control of the state and acting mainly on its own interests.

Corruption is a very serious problem. Officials and employees of state agencies often see their offices and positions as private fiefdoms which they could use in order to enrich themselves. Private benefit very often prevails over the public one.[28] Among all surveys making international comparisons of corruption, Russia is placed among the worst performing countries in the world. To give some examples, in the probably most widely quoted source, the Transparency International (IT), Russia is placed 82nd out of 99 countries in 1999, with a score of 2.4 on a scale of 0 (highly corrupt) to 10 (highly clean).[29] Moreover, an aggregate indicator of graft compiled from numerous sources by Kaufmann et al (1999a), places Russia 113th out of 155 countries.[30] As also shown in the data of the World Economic Forum (see appendix, table III), Russia is one of the worst performing transition countries regarding corruption. Corruption increases the cost of the investment. Paying bribes must be added to the money spent for the investment itself. It also increases uncertainty since corrupt authorities are

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[28] Ellman, Michael, "The Russian Economy under El'tsin", *Europe-Asia Studies,* Vo.52, No.8, Dec.2000, p.1418

[29] Roaf, James, "Corruption in Russia", IMF, Conference on Post-Election Strategy, Moscow, April 5 July 2000 p.1

[30] Kaufmann et al (1999a) found in Roaf, James, "Corruption in Russia", IMF, Conference on Post-Election Strategy, Moscow, April 5 July 2000, p.1.

unpredictable authorities as they may favour whoever bribes them or finds the most effective ways to approach them, and not always the one who is legally right. Besides such problems, corruption also creates a disadvantage for foreigners compared to local competitors since the latter know better how to deal with such issues and practices, and have stronger networks that may help them.[31] According to the survey conducted by the Economist Intelligence Unit, the 53% of the respondents answered that corruption is the major problem that Russia was and continues being a difficult place to do business.[32]

Another very important issue regarding administrative mechanisms is bureaucracy. Russia is a country where bureaucratic procedures may be a serious reason preventing foreign enterprises from investing. According to Andrei Goltsblat, in order to operate a business in Russia, "1 month is needed to establish a Russian legal entity, 1-4 months to select a land plot, 5-7 months to acquire it, 5-11 months to develop the necessary pre-project documentation, 6-10 months for construction, 2-5 to import or purchase and install the production machinery (simultaneously with construction), 1 month for final official acceptance of erected facility by state accepting commission, 1-3 months to register the title to facilities, buildings, constructions, which means a total of 20-30 months". [33] Moreover, in order to register a trade mark with the Patent Office, the application for foreign entities or individuals must be submitted only through trade mark attorneys registered with the Patent Office. It is a very tine-consuming process, which may take from 18 to 24 months to

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[31] Economist Intelligence Unit, "Hidden Gem? Perceptions of business opportunity and Risk in Russia", *Economist Intelligence Unit*, April 2007, p.3  p. 4

[32] Ibid. p.3

[33] Goltsblat, Andrei, "An Investment Project in Russia: Applicable Laws" in Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005  p.317-321 (*)

complete.[34] To mention another example which shows the problem, as Adrian Marley, the Country Director of Russia for DHL says, "I am providing 75-80 signatures a day on documents for the tax authorities".[35] Obviously, bureaucracy is not only a problem for registering a business but a permanent problem for all the period that a business runs. Such time-consuming and complex bureaucratic procedures set important obstacles to FDI. According to the 28% of the responses in the Economist Intelligence Unit survey, inefficient bureaucracy indicates a major problem to foreign investments.[36]

Finally, Russia is a country where administration often intervenes to business. As already mentioned such interventions include expropriations of assets, contract-braking, intervention from tax authorities, withdrawing of licenses of companies etc. It is important to mention that during the Soviet times, the local enterprises (especially the big ones) apart from their functioning were also responsible for the overall social welfare of nearby towns and villages. In these terms they were responsible for building schools, hospitals and generally for providing some social service independently of their operation. This legacy was transferred to the post-Soviet era. Local administrative authorities, which still have strong power, often pose severe obstacles to the functioning of firms (often in cooperation with the local political authorities) since many of those firms (especially foreign ones) refuse to take such responsibilities.[37] They also act against firms in order to favour other firms which are

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[34] McKenna, Cameron, "Intellectual Property Rights and E-Commerce"in Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005 p.295

[35] Economist Intelligence Unit, "Hidden Gem? Perceptions of business opportunity and Risk in Russia", *Economist Intelligence Unit*, April 2007. p.4

[36] Ibid. p.3

controlled by people having stronger links with them or bribing them with more money. It is obvious here that corruption is directly linked with such administrative interventions. The fact that for the one fifth of the respondents of the Economist Intelligence Unit survey, contract non-enforcement is the major problem for doing business shows how important a problem such administrative practices constitute. However this may be a matter of non-enforcement of contracts from the part of a Russian private partner (a Russian company) it also reflects the case that it may be from the part of local administrative authorities which for the reasons mentioned above may change their preferences and decisions regarding an investment project.[38]

**Rule of law**

The above mentioned problem of corruption is part of a wider and very serious problem of Russia, the absence of rule of law. As we explained in the first part of the essay, absence of rule of law means that a state lacks the capacity to enforce the laws and the regulations it introduces. This results in all the activities of the society (the economic not excluded) becoming a fight on who will prevail in the absence of a strong general framework whose role would be to set rules that would be respected, as well as produce stability and clarity in all the forms of social activity. Russia is a country where absence of rule of law is a major problem. Obviously, this has a negative influence to FDI.

Corruption is an important part of it. As we have already mentioned, corrupt officials and employees often discriminate against firms or individuals implementing the rules in favour of people or groups of interests which bribe them or offer them various private benefits. Moreover, as we mentioned above, following the collapse of

[37] Nilsson, Mats and Soderholm, Patrik, "Foreign Direct Investment and Institutional Obstacles", *Natural Resources Forum,* Vol.26 (2002), p.309-310

[38] Ibid. p.4

the Soviet Union, the fact that regions' power over the centre severely increased during the 1990s, and the economic bankruptcy of the state, resulted in the latter becoming unable to control effectively the administrative branches within the whole country. In turn, the administrative branches often take advantage of this state incapacity and act not according to the law but according to the personal interests of their officials or employees.[39] The decentralization of the state further increased posed another serious threat to the rule of law. Regional laws very often collide with the federal ones since both levels (federal and regional) share powers in many issues. This was the consequence of the transfer of power from the centre to the periphery taking place in such a way that it was very often unclear which level of governance was responsible for what. As we have already mentioned, such phenomena increase uncertainty for investors since they do not know under which laws they should work.

Lawlessness also exists in business activity. The uncertain environment under which businesses operate and the challenges from the institutional distortions resulted in the economic agents reacting rationally to this situation by attempting to by-pass the "legal" market economy.[40] Making themselves part of the game was seen as a way of surviving in a general environment of lawlessness. As Goorha states for Russia, "Symbiotic functioning of lex scripta and lex non-scripta are essential components of the institutional setting under which the economic exchange takes place".[41] Criminalization of the economy is a consequence of this. Many examples have been

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[39] Petrov, Nikolai, "Federalism-Russian Style and the Evolution of Center-Region Relations", *Carnegie Moscow Center,* 17 March, 2002. p.3

[40] Kuznetsov, Andrei and Kuznetsova, Olga, "Institutions, Business and the State in Russia", *Europe-Asia Studies,* Vol.55, No.6, Sep. 2003, p.908

[41] Goorha P., "Opening the black box: an analysis of the Russian Economy", *Communist and Post-Communist Studies,* Vol.34 (2001), p.407

reported of paying protection money and even killing a rival.[42] Criminal, political and business worlds retain strong links, allowing the informal practices to prevail over the formal. What matters is who has the stronger connections and who can influence decision-making more. Obviously, this creates a disadvantage for foreign companies, since local competitors know better how to deal and participate in such practices, while they also have stronger ties with politicians and officials.

Another very important reason causing lawlessness is that the judicial system (whose role supposedly is to enforce the law) is very ineffective and a victim of the lawlessness on its own. Networking and bribing occupy judicial system too and judges are part of the system of the informal practices. Independence of the judiciary does not exist. Moreover, judges often lack the necessary knowledge about important issues (for instance, tax issues) and do not know how to deal with them. They lack knowledge on how issues which occur under market economy must be legally solved since for more than 70 years Russia's economic system was completely different. Apart from making them more likely to take wrong decisions, it also makes them even more vulnerable to influence from groups or individuals.[43]

There is a widespread view that Russian society is a society where informal practices are embedded. According to this view rule evasion had always been a characteristic of the Russian society no matter what type of regime ruled the country. This fact combined with the distrust of the state created from the autocratic and unaccountable to the people communist regime are often considered as important reasons making Russians often unwilling to obey the law. However exaggerating this

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[42] Ellman, Michael, "The Russian Economy under El'tsin", *Europe-Asia Studies,* Vo.52, No.8, Dec.2000, p.1419

[43] Ogutcu Mehmet, "Attracting Foreign Direct Investment for Russia's Modernization. Battling against the odds", *OECD-Russia Investment Roundtable,* St. Petersburg, Russia, June 2002, p.7.

view may be, it should not be completely underestimated. The legacy of the past is an important reason for the phenomenon of lawlessness in the Russian society.[44]

**Open and fair competition**

One of the major problems that foreign investors face when doing business in Russia is the violation of open and fair competition. Open competition is violated in some sectors where foreign participation is restricted officially as a result of governmental decisions or policies. Such sectors include energy, automotive, aviation, and metals, which are considered strategic. However, open competition in other sectors, does not necessarily mean fair competition. “Illegal” or “informal” indirect preferential treatments to local firms from the governmental or the administrative authorities (including governmental and administrative decisions, subsidies, or non enforcement of the law in cases of tax evasion) are very often the case. In both cases what plays a decisive role is the strong power that some economic groups may have, using it either to influence the government to pass laws which protect their sectors, or to find ways and surpass the legal regulations by using networking or other ways to achieve preferential treatment.

Russia is a country where a very strong economic group (called the “oligarchs”) emerged, following the rapid privatizations of the early 1990s.[45] This group concentrated strong powers over the state. Regarding the concentration of power from vested interests, Russia acquires the 4th place among 21 countries, showing the extent of the phenomenon.[46] To mention some more examples that prove this, 10 families

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[44] Hedlund, Stefan, “Path Dependence in Russian Policy Making: Constraints on Putin’s Economic Choice”, *Post-Communist Economies,* Vol.12, No.4, 2000, p.400.

[45] The purpose of this section is not to analyze how this group emerged through the way that government privatized the state enterprises, but rather to examine the influence of this group’s actions to FDI.

control the 60.2% of the share of stock market capitalization, they export the 30-90% percent of their output, and they control sectors that account for half of the total Russian exports.[47] This overconcentration of power from powerful economic interests had as a result the emergence of the phenomenon of what is called state capture, meaning the systematic activity of powerful groups or individuals to influence the decision-making to their own advantage, by using legal means.[48] In Russia, and especially during the 1990s, such vested interests have indeed captured the state.

By capturing state institutions (such as legislative and executive bodies, where the power is concentrated), these lobbies fought against political and economic reforms which would eliminate the distortions that enabled them to receive concentrated gains.[49] The Russian Union of Industrial and Entrepreneurs was initially created by businessmen to support reforms that would help industrial sector to develop. However, after a short period of time, oligarchs captured the Union changing its orientation, and making it a tool for opposing reforms and Russia's accession to WTO, since reforming the market and opening it to international competition would eliminate their benefits from having stakes in highly protected sectors. By influencing decision-making, through manipulating politicians, controlling the media, and shaping institutions, oligarchs managed to keep most of their sectors protected erecting barriers to FDI at the expense of the social interest.

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[46] Omelyanchuk, Oleksiy, "Explaining State Capture and State Capture Modes: The cases of Russia and Ukraine", *Central European University*, *Department of International Relations and European Studies,* Budapest 2001 p.18

[47] Guriev, Sergei Guriev, S and A. Rachinsky (2004) *Ownership Concentration in Russian Industry,* July 2004 p.12

[48] Ibid. p.9

[49] Omelyanchuk, Oleksiy, "Explaining State Capture and State Capture Modes: The cases of Russia and Ukraine", *Central European University*, *Department of International Relations and European Studies,* Budapest 2001 p.13

Powerful economic groups obviously have very strong networks with state and administrative officials. Even in sectors which are not protected, domestic economic groups are still often favoured towards foreigners through indirect governmental, or administrative preferential treatment (as described above). The political and administrative corruption is a very important reason for this. Existing laws are distorted, and regulations are interpreted in the way that vested interests want.[50] In this way officials and politicians promote their own interests and not the interests of the society as a whole. That is, fair competition is violated. The over-Presidential Russian political system and the isolation of policy making from parliamentary scrutiny and political competition is an important reason for such phenomena. The character of the system allows decision making politicians to satisfy lobby groups without being effectively checked for their decisions from a weak legislative body.[51]

**<u>Privatizations and the system of corporate governance</u>**

As mentioned above, a well functioning corporate governance system is an important determinant of FDI. In transition countries where all enterprises were state until transition began, the type of privatizations of the state firms chosen by the government obviously has a very serious effect in the creation of a well-functioning system of corporate governance. As we saw, the type of privatizations is strongly related to the future status of ownership of the newly privatized firm, and whether it is targeting on attracting FDI or not and to what extent. It is also related to the effective and potentially profitable way that the firm will work. Foreigners need a method of privatization which will not exclude them from investing in firms under privatization

[50] Omelyanchuk, Oleksiy, "Explaining State Capture and State Capture Modes: The cases of Russia and Ukraine", *Central European University*, *Department of International Relations and European Studies,* Budapest 2001 p.4

[51] Robinson, Neil, "The myth of equilibrium: winner power, fiscal crisis and Russian economic", *Communist and Post-Communist Studies,* Vol.34 (2001 p.427

and which will also make the firms potentially work in an effective and market-oriented way making them more profitable and reliable to do business with. It is also important for foreign investors to operate in an environment where local competitors operate under the rule of law and not try to manipulate or surpass official decisions by using informal ways. In other words what matters is allowing equal access to foreigners when privatizing state firms, and providing the necessary framework for the newly privatized firms to operate effectively and in a market-oriented way, making them attractive for FDI to invest.

Regarding the type of privatization, many transition countries followed the method of insider privatizations and Russia was not an exception. The shares of the state firms were transferred to insiders, that is, the managers and the employees of the firms. The right to decide on the method of privatization was granted to them, and not surprisingly they became the new owners. After the privatizations started, 41 million shareholders were created within a period of only 18 months. Since insiders were the ones to decide about the future of the firms they were working on, and since they finally became the owners, foreign investors were almost excluded from this process.[52] Even if theoretically the new owners could later approach them, they had no incentive for doing so since this would put their positions at risk. Inefficient managers (as the majority was) would lose their positions. The danger of firing many workers would also increase fears among employees. Anyway, one of the reasons that this form of privatizations was chosen was the fear of the social cost that real restructuring of the firms would have. It is very important to mention here that after some period of time such insider privatizations resulted in the managers of the firms acquiring the real control of them. The main reason for this was the essentially

[52] Kuznetsov, Andrei and Kuznetsova, Olga, "Privatization, Shareholding and the Efficiency Argument: Russian Experience", *Europe-Asia Studies,* vol.48, No.7 (Nov. 1996), p.1174

paternalistic relations between the managers and the employees of the firms during the Soviet times which were transferred to the post-Soviet system also. Managers used to play the role of the representatives of workers in securing as better conditions as possible under which they would carry out production through networking with higher officials. They were also providing social services to the workers and their families. This resulted in workers being very loyal, and having very close and paternalistic relations with them, cementing together the "work collective".[53] Managers thus became the real controllers of the enterprises even if by mid-1994 they possessed only the 26% of the shares in closed-joint stock companies, and only 11.6% in open joint-stock companies.[54] Boards of directors of the newly privatized firms were mostly dominated by managers or people selected by them. The shareholders' control was thus very weak. Any possible actions against the managers were restricted by severe factors. Employees had no previous cultural background and awareness to put through a proxy fight, managers were not giving information for the firm's performance, each shareholder held only a very small percentage of the shares. Finally, it was very difficult for someone accumulating more than 50% of the shares since agents would be need to be sent from door to door convincing people to sell their shares (in Russia, and especially in remote cities such agents are considered as unwanted strangers). Managers also used various ways to prevent the other shareholders from participating actively. Anyway small and financially weak shareholders are unlikely to have a strong incentive to monitor the activities of the managers closely.[55] It is also very important that there is no effective mechanism on which shareholders can rely on exercising their rights of ownership even if someone

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[53] Ibid. p.1176

[54] Ibid.

[55] Ibid. pp.1178-1182

holds more than 50% of the shares. This lack of protection of the shareholders rights makes it very difficult to control managers.[56] This situation resulted in the latter finally acquiring more and more shares and control as the years went by. After a period of conflicts between workers and managers (since the former faced a situation where the real value of their wages fell below an acceptable level, payments were many times delayed blaming the latter for this) managers managed to prevail by having secured possession of 31% of all shares in 2003, while the participation of the insiders in total remained high during the same period (46.2% in 2003).[57]

The performance of the enterprises under the control of the insiders and mainly the managers proved in general very poor. From the very first period of time, managers' policies were opportunistic, rent-seeking and not market-oriented. Their main purpose was to secure their positions, retaining the firms closed to foreign capital. No real restructuring of the firms took place since as we explained above this would threaten their positions. Instead managers had to rely on connections with politicians and state officials to save the enterprises, conspiring outsiders.[58] They pressured for soft budget constraints policies or other favourable governmental decisions for them (regarding tax, credit or administrative issues). The majority were corrupt managers, stealing from the enterprises (by draining unregistered cash flow from the enterprises to their pockets). Moreover, the one third of the enterprises was controlled by underworld capital, and criminals very often became the owners of the enterprises.[59]

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[56] Kuznetsov, Andrei, Kuznetsova, and Kapelyusnikov, Rotislav, "Ownership Structure and Corporate Governance in Russian Firms" in Mickiewicz, Tomasz, Corporate *Governance and Finance in Poland and Russia*, Studies in Economic Transition, New York, Palgrave McMillan, 2006, p.185.

[57] Ibid. p.182

[58] Ibid p.183

In such an environment where the vast majority of shares were given (not even sold) to insiders (restricting foreigners to participate), where managers controlled the firms, where shareholders' rights were and continue being severely violated, and where the survival of the firms is dependent on networking from the part of the managers, foreign investors are very unlikely to invest in the Russian private sector and even if they do so they are likely to face serious problems with their Russian partners. One such problem is the non enforcement of contracts from the part of the Russian partners as it is often mentioned by foreign investors. Russian corporations are considered as very unreliable.

**Taxation, protection of property and intellectual property rights**

As mentioned above, taxation is an important determinant of FDI. A country with lower tax burdens and clear tax regulations is more likely to attract foreign capital. In Russia, until recently, the tax burdens for the enterprises were very high. Profit tax was at 35%, which is a relatively high percentage. The social contributions that a company had to pay were also at 35.6%. Moreover, the tax and accounting framework was very complex. Regarding profit taxes, the businesses could not offset their profit or loss against the profit or loss of other business unit within a group. In order to avoid the problems imposed by the legislation, companies chose to retain the existing structure despite being inefficient or to resort to manipulation of figures, tax arbitrage, or not registering their turnover, increasing the already existing huge problem of tax evasion.[60] Even more important were the often changes in the tax laws. Government's goal was not creating an environment that would make the businesses viable but

[59] Polonsky, Gennady and Aivazian, "Restructurin Russian Industry: Can it really be done?", *Post-Communist Economies,* Vol.12, No.2, 2000 pp. 235-236

[60] Polonsky, Gennady and Aivazian, "Restructurin Russian Industry: Can it really be done?", *Post-Communist Economies,* Vol.12, No.2, 2000, p.232

filling the gaps of the budget and adopting tax laws only according to such needs.[61] As shown in the Survey for Foreign Direct Investors conducted by the European Business Club in Moscow (see table II, appendix), the tax regulation (in the year 2000, before the final introduction of the new Tax Code) and the frequent changes in tax laws are considered as the most important problems that investors face.[62] Similarly to all issues, the inconsistencies between the federal and the regional laws were also a major problem regarding taxation, since one issue could be interpreted differently by the federal or the regional laws.

Regarding property rights, it is necessary that the assets of a firm (land, equity stakes, securities, contracts, office equipment and other properties) must be secured in order for this company to operate properly. In Russia property rights are poorly protected. Indeed, looking again in the survey conducted by the European Business Club in Moscow, the lack of protection of property rights is considered as one of the most important problems that foreign investors face (see table II).[63] Regarding land, owning commercial land was allowed for the first time just in 2001, 10 years after the transition began, through the introduction of the Land Code the 29th of October, 2001.[64] Individuals and companies (including foreign ones without legal discriminations) are now allowed to buy and sell commercial land. This was a major step towards securing of property rights. However, besides the fact that 10 years were

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[61] Ibid.

[62] Survey conducted by European Business Club in Moscow in 46 European Enterprises (found in Ahrend, Rudiger, "Foreign Direct Investment into Russia-Pain without Gain? A Survey for Foreign Direct Investors", *Russian Economic Trends,* Moscow, June 2000, p.7

[63] Ibid.

[64] McKenna, Cameron, "The Property Regime in Russia" in Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005 p.283

lost without this fundamental issue being solved, even now, pre-existing ownership rights of permanent use, which are inconsistent with the provisions of the Land Code, had to be re-registered. This created problems with the corrupt and bureaucratic Russian administration combined with the fact that the land registration system was still in its infancy stage. Other problems that investors faced regarding land are the assessment of the market value of the land they want to buy or sell since there are no clearly identified market benchmarks and no objective methods for doing this, as well as the difficulty that they faced many times identifying who the owners of a land plot are, since they may be many (according to the Code, the investors need consent from all the owners of the plot for buying it).[65]

The role that authorities play in the protection of property rights is negative. Describing the situation of administrative intervention to property rights in Russia during the 1990s, Shlapentokh states that "the borders between public and private in many cases are blurred or do not exist. Just as it was 1000 years ago, property and power are closely intertwined, and it is often impossible to separate them from each other".[66] Such phenomena increase uncertainty over property rights. Expropriations, non enforcement of contracts signed between authorities and investors, and other similarly important issues often happen, unless the investors bribe the officials or manage to acquire good relations with them through networking.

Intellectual property rights, meaning the protection of the legal owners of a trademark from those trademarks being illegally used by other individuals or firms,

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[65] Goldtsblat, Andrei, "Land Relations in the Russian Federation" in Terterov, Marat*, Doing Business with Russia: A Guide to Investment Opportunities and Business Practice*, Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005 p.291

[66] Shlapentokh, 1996,pp. 393-4, found in Dyker, Davis A., "The Structural Origins of the Russian Economic Crisis", *Post-Communist Economies,* Vol.12, No.1, 2000, p.20

must also be protected. In Russia, the intellectual property rights are protected according to the law on Trade Marks which states that, "the owner of a trademark has an exclusive right to use and dispose of the trade mark and to prohibit its use by others".[67] If the rights of the trade mark owner are infringed, he may apply to the Chamber for Patent Disputes of the Patent Office or to a commercial court and has the right to ask for compensation from the illegal user.[68] Despite the fact that they are protected by law, the reality is different. Russia is a country with a big shadow and unregistered economic activity. In such countries the intellectual property rights are less likely to be effectively protected since it is easier for the unregistered economic agents (individuals or firms) to use the trade marks of well-known firms, cheating the consumers by convincing them that their products are original products of this firm. Their activities are not effectively controlled since they are not registered with the authorities. As shown in table II, taxation and non protection of property and intellectual property rights are considered as important problems by the foreign investors interviewed.

## The situation during Putin's Presidency

The situation regarding many of the above mentioned FDI determinants has improved since 2000 when Vladimir Putin took office. Russia's macroeconomic performance has much improved. Inflation dropped to 13.6% in 2003, unemployment to 7.6% in 2003 and 6.6% in 2007, and growth reached 6.4% in 2005 and it continues

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[67] McKenna, Cameron, "Intellectual Property Rights and E-Commerce" in Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005 p.294

[68] Ibid. p.296

being around 7% today.[69] This change, which severely increased the private consumption demand, mostly reflects the big increase in the oil prices during the period 2000-2007 as well as the devaluation of rouble.[70] President Putin made some positive structural changes but the increase in the energy prices is the most important reason for this recovery and a very important reason that Russia now attracts large FDI flows, especially as compared to the recent past. However, the consequences of the situation during the 1990s are still evident. Russia lost much time and for this reason it is still lagging far behind other transition countries of the region. And most importantly, in order for Russia to reach a really good and permanent stable macroeconomic performance it will need further structural reforms and less dependency on energy resources. Government's current strong commitment on using energy resources as a tool for development is likely to distract Russia's attention towards structural reforms.[71] This may make Russia a less attractive for FDI country in the future. In other words Russia is still not considered as having a fully recovered and stable economy.

Political risk has also been reduced. One of the major reasons for this is the recentralization of power by reducing the power of the regional governments. The most important changes towards this direction were the abolition of the elections of the regional governments following the crisis after the Beslan tragedy in 2003, the creation of seven new federal super-districts where the 85 federal subjects are divided (the governors of the super-districts being people loyal to Kremlin), and the

[69] All the above data has been taken from UNICEF website, available as http://www.unicef.org/infobycountry/russia_statistics.html

[70] Ellman, Michael, "The Russian Economy under El'tsin", *Europe-Asia Studies,* Vo.52, No.8, Dec.2000 p.367.

[71] In his 1997 dissertation for the Mining Institute (University), Vladimir Putin begins his article by suggesting that economic growth will have to be based on mineral resources. See Balzer, Harley, "The Putin Thesis and Russian Energy Sector", *Post-Soviet Affairs,* Vol.21, No.3, 2003.

introduction of a law which allows the President to dismiss the regional governors and dissolve the regional assemblies. Putin also managed to control the regional governors using other ways (such as the control of the media).[72] These policies resulted in the elimination of the power of the periphery towards the center. Center became stronger and more able to control regions having secessionist claims or creating political disputes. During Putin's administration, Kremlin' power is much more well-established compared to Yeltsin's era. Opposition is very weak, media are almost fully controlled by Kremlin and administration is used for strengthening of Putin's power. This obviously reduces the possibility of often changes in the government. Moreover, changes of laws and regulations regarding important issues are not as often as before. For instance, after the introduction of Tax Code in 2002, there have been no serious changes regarding the system of taxation. In general, Putin's policy seems to be more clear and stable regarding important issues.

On the other hand, the super-presidential system which has been created since 2000 increases the danger of the administration (and more specifically the president) making decisions which will not be effectively controlled by another institution, As mentioned above, parliament are very weak and Kremlin controls the media and the political game in general. Opposition parties (apart from the Communists) are also very weak. Overconcentration of power in one person increases the risk of often and unexpected changes in governmental policies and that is uncertainty among investors.

In general, however, the improvement during Putin's administration regarding political risk is remarkable. This is proven by the fact that in the already mentioned survey (conducted by the Economist Intelligence Unit), 10% of the respondents answered that Putin being out of power after the 2008 Presidential Elections (since he

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[72] Ross C., "Putin's federal reforms and the consolidation of federalism in Russia: one step forward, two steps back!", *Communist and Post-Communist Studies,* Vol.36 (2003), p.34-37

does not have the right to be a candidate for a third term) indicates a high risk, while 40% responded that it indicates a moderate risk.[73] Such fears are only compensated by the fact that his succession will be heavily managed.

The situation regarding administrative issues has not improved much. As mentioned in the Economist Intelligence Unit survey which was conducted in 2007, problems with administration are the most important ones, show that no serious improvement has been made during Putin's Presidency. Indeed, despite efforts to deal with administrative inefficiencies (by introducing the Code on Administrative violations and the Arbitration and Procedural Code in 2002), the situation has not improved much. Enforcement of such regulations is very difficult since informal practices are so deeply embedded in the activity of the Russian state administration and society reflecting the legacy of the past since that was the case not only after the transition began but also during the previous regime and even before that. Indeed, the combination of this historical reality with the fact that administration is used to being very powerful (as it was during the old regime) is a very important reason for the emergence of phenomena like the ones we analyzed.[74]

The situation regarding lawlessness has also improved but it is still far from being considered as ideal. The increase of the power of the central authorities (despite being antidemocratically done) has improved the situation regarding rule of law. The inconsistencies between federal and regional laws have been eliminated. This was indeed one of the main Putin's priorities. In a speech made in the Federal Assembly in 2000, Vladimir Putin stated that "It is scandalous thing when a fifth of the legal acts

[73] Economist Intelligence Unit, "Hidden Gem? Perceptions of business opportunity and Risk in Russia", *Economist Intelligence Unit*, April 2007, p.5

[74] Hedlund, Stefan, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice", *Post-Communist Economies,* Vol.12, No.4, 2000, p.400

adopted in the regions contradict the country's Basic Law, when republic constitutions and province charters are at odds with the Russian Constitution, and when trade barriers, or even worse, border demarcation posts are set up between Russia's territories and provinces".[75] Creating a unified economic, legal and security space in the federation was one of Putin's major tasks. By 2001 the number of normative legal acts adopted by the regions and the republics exceeded 300,000, and from these the ones contradicting the federal constitution and laws were just a quarter (70,000).[76] Moreover, according to the deputy head of the Presidential Administration, Dimitrii Kozak, "in January 2001 80% of the regional laws were checked by the administration and had either been brought into compliance with federal law, or were being considered in the courts".[77] In general, the power of the central state is now better established reducing the risk the foreign investors may face.

Moreover, Putin's establishment of a strong power allowed the government to keep effective control of the state administration which is now controlled by political authorities in a much higher degree compared to Yeltsin's period. Despite the fact that this is done mostly by antidemocratic means, as we saw before, there seems to be an approval of Putin among foreign investors. Looking at the findings of the survey conducted by the Economist Intelligence Unit, 10% of the respondents consider Putin leaving power in 2008 as a major risk, while 40% consider it as moderate risk.[78]

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[75] Putin in the Federal Assembly 2000a, p.3, found in Ross C., "Putin's federal reforms and the consolidation of federalism in Russia: one step forward, two steps back!", *Communist and Post-Communist Studies,* Vol.36 (2003), p.31

[76] Vil'chek 2001, p.20, found in Ross C., "Putin's federal reforms and the consolidation of federalism in Russia: one step forward, two steps back!", *Communist and Post-Communist Studies,* Vol.36 (2003), p.41.

[77] Corwin, 2001a, p.2, found in Ross C., "Putin's federal reforms and the consolidation of federalism in Russia: one step forward, two steps back!", *Communist and Post-Communist Studies,* Vol.36 (2003), p.42.

According to the same survey this fear is compensated only with the fact that his succession will be heavily managed, which shows that foreign investors are not interested in democracy as much as they are interested in the establishment of rule of law as the example of China also shows. This indicates how important problem lawlessness was and continues being for Russia's business environment.

It is also widely accepted that during Putin's administration the political influence of the oligarchs and the other powerful economic lobby groups has been reduced. Putin established a strong leadership and the role of such groups in the decision making has been diminished. This could have a positive impact on FDI, by making it easier for decision makers to make unfavourable to oligarchs reforms. However this may be true, it is also true that according to the agreement between Putin and the oligarchs (made in a meeting between the two parts the 28th of July, 2000), the President promised not to revisit privatizations if oligarchs supported his efforts to consolidate political power and pay taxes. Mikhail Khodorkovskyi, who at that time was the president of Yukos (the state oil company), violated this agreement by intending to participate in politics personally and by supporting opposition parties, and that is why Kremlin's behaviour towards him was more than hostile.[79] Moreover, lobbying during Putin has not stopped. Especially in the most strategic sectors (energy, automotive, defense, metals etc), Russian companies are lobbying in order to influence decisions to their advantage. For instance, Russian energy companies strongly reacted against the PSAs (production sharing agreements signed in the early 1990s) for the exploration and exploitation of energy resources with the participation of Russian and foreign energy companies, demanding higher participation and

[78] Economist Intelligence Unit, "Hidden Gem? Perceptions of business opportunity and Risk in Russia", *Economist Intelligence Unit*, April 2007, p.5.
[79] Guriev, Sergei Guriev, S and A. Rachinsky (2004) *Ownership Concentration in Russian Industry,* July 2004 p.23.

complaining about preferential treatment towards foreigners (apart from high participation and control of the agreements, PSAs gave stable taxes over the lifespan of the project to foreign companies).[80] To give some examples, Sakhalin I and II PSAs (for the extraction and exploitation of the natural resources in this region of Russia) were signed aiming to solve the problem of the developing fields in the region. According to the initial agreements, no Russian firms were able to take on the work. While Putin had initially accepted the agreements, he later changed his policy and supported Gazprom (the Russian state gas company who was merged with the state oil company, Rosneft) in its effort to participate with a 25% in the project.[81] This change was more obvious in the Sakhalin III project, where the Russian government annulled the Sakhalin III-tender, which had been won by a consortium led by Exxon Mobil in 1993. Government decided that Sakhalin's oil fields are "strategically important" and no foreign-controlled companies would be allowed to participate in such "strategically important" fields.[82] Apart from the important role that lobbies played in this change in policy, this latter fact also indicates the radical change in the policy orientations of the Russian government regarding specific strategic sectors of the economy towards FDI (protecting them from high foreign participation and increasing state control over them). Putin consider energy resources as the key for the development of the Russian and has thus severely increased state control over energy

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[80] Page, Bill and Redhead, Mark, "Russian Oil and Gas" in Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005, p.113

[81] Blagov, Sergei, "Russia eyes greater state control over Sakhalin hydrocarbon projects", *Eurasia Daily Monitor,* May 6 2005, available as http://www.jamestown.org/edm/article.php?article_id=2369715

[82] Ibid.

sector, restricting FDI.[83] State Gazprom's acquisition of the 51% of the shares of Rosneft was a major move towards energy sector being controlled by state. The change in government's policies over PSAs towards increasing the participation of the Russian state companies, and restricting access to information about energy reserves to foreigners are clear signs for the orientations of the Russian government regarding FDI in the energy sector. From all the above, we can see that as a result of the combination of both lobbying and strategic governmental decisions, many key sectors of the Russian economy are almost closed to foreign investment while the competition in other more open sectors may be strongly unfair and vulnerable to the action of local vested interests even less powerful than the oligarchs.

Corporate governance is another sector where the situation remains mainly unchanged. One improvement is related to the introduction of the voluntary Code of Corporate Behaviour founded on the principles of good corporate governance developed by the OECD. The large Russian companies which are more market oriented, interested in being productive and competitive, and interested in attracting foreign capital, have adapted to these principles more easily.[84] In 2003, the 20% of the large Russian companies had a corporate governance Code, 30% began to draft the Code, and 35% were planning to have one in the future.[85] Moreover, other important improvements are related to the introduction of a legislative basis for regulating relationships with shareholders in joint stock companies, the introduction of

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[83] Balzer, Harley, "The Putin Thesis and Russian Energy Sector", *Post-Soviet Affairs,* Vol.21, No.3, 2003, p.212

[84] Kuznetsov, Andrei, Kuznetsova, Olga and Kapelyusnikov, Rotislav, "Ownership Structure and Corporate Governance in Russian Firms" in Mickiewicz, Tomasz, Corporate *Governance and Finance in Poland and Russia*, Studies in Economic Transition, New York, Palgrave McMillan, 2006 p. .189

[85] Dragunov, Vladimir, "Terterov, Marat, *Doing Business with Russia: A Guide to Investment Opportunities and Business Practice,* Great Britain and the United States, Global Market Briefing (in association with the American Chamber of Commerce in Russia), 2005, p.104

procedures calling for the protection of investors in the securities market, and the consolidation of the system for registering rights to equity. This has improved the rights of the shareholders by expanding in greater detail some of the basic rights that shareholders are entitled to.[86] Despite such developments, the situation is still far from being considered as proper since insiders' role is still very important is expected to increase (insiders' percentage of shares was expected to increase to 54% in 2007 from 46.2% that it was in 2003 and 46.2% in 2005).[87]

It is widely accepted that one of Putin's major contributions to the improvement of the investment environment is government's tax policy. After the introduction of several regulations during the period 1999-2001 (which constitute the new Tax Code) the tax burdens for the enterprises were severely reduced. Profit tax was set at 24% from 35% that it was before, and social contributions at 2% from 35.6% that they were before. Moreover, the facilitation of tax levy, the improvement in the methods of calculating the taxes, and the fact that tax laws have stopped changing so often made the situation much better.[88]

However, governmental performance towards the protection of property rights is still poor. Most enterprises doing business with Russia still report that this is one of the most important problems that they face. The introduction of the Land Code is an important step. However, interventions and unreliability from the part of corrupt authorities are still a major problem. Moreover, the shadow economy in Russia is still very high, creating problems for the protection of intellectual property rights despite

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[86] Yakovlev, Andrei, "Evolution of Corporate Governance in Russia: government policy vs. real incentives of economic agents", Vol.16, No.4, December 2004, p.393

[87] Kuznetsov, Andrei, Kuznetsova, and Kapelyusnikov, Rotislav, "Ownership Structure and Corporate Governance in Russian Firms" in Mickiewicz, Tomasz, Corporate *Governance and Finance in Poland and Russia*, Studies in Economic Transition, New York, Palgrave McMillan, 2006, p.182

[88] Rogacheva Elena and Mikerova Julia, "European FDI in Russia: Corporate Strategy and the effectiveness of Government promotion and facilitation, *OCO Consulting,* September 2003, p.22

the government's effort to eliminate it mainly in order to deal with the serious problem of tax evasion.

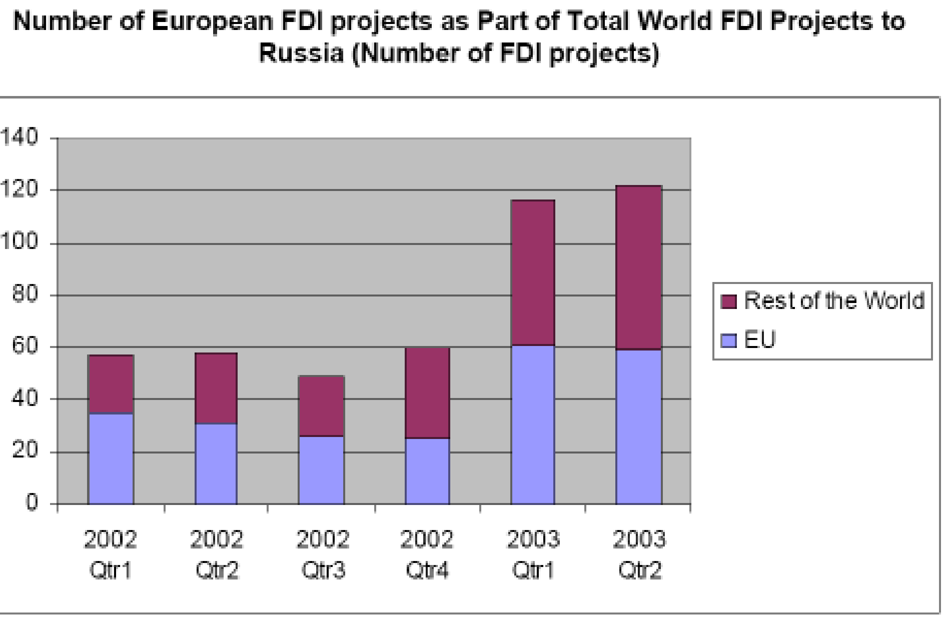
## Conclusion

The purpose of this essay was, after examining what determines FDI in general, to see why Russia, which is a country of 145 million potential consumers and a well-educated labour force, has failed to attract FDI. We stated that this was as a result of Russia' poor macroeconomic performance for many years after transition began, severely reducing the consuming power of the population and creating distrust for the ability of the government to restructure the economy among foreign investors, the high political risk faced by either the fear of unexpected and frequent changes in the government (especially during the 1990s), the risk faced by frequent changes in policies of the government, or the gap occurring from the contradicting laws and decisions made by federal and regional authorities. We also saw the negative role that an inefficient, bureaucratic and corrupt administration played, the role that the lawlessness in all levels of the society which increases uncertainty, the role that powerful lobby groups play and the implications that this have to open and fair competition, the role that the methods of privatizations of the state property played, resulting in a poorly performing system of corporate governance, and finally the role that ineffective tax policies played, as well as the poor protection of the property and the intellectual property rights.

The situation regarding most of these issues was much worse during the 1990s. Russia lost almost 10 years during which a lot more could have been done to make Russian economy more competitive and more attractive to FDI which is necessary for its restructuring. The situation has indeed improved during Putin's Presidency and this is the reason that Russia has attracted large FDI flows during his Presidency compared to Yeltsin's era. This is both a matter of policies but also a matter of circumstances related to the increase in oil prices which is a major reason for the macroeconomic recovery of Russia. Apart from the role of oil prices, improvements during Putin include the establishment of rule of law (even if using antidemocratic ways) through controlling the administration more effectively and through recentralizing the power reducing the inconsistencies between federal and regional laws and eliminated political disputes, the reduced political risk since Putin has managed to establish a powerful rule without facing a danger of being suddenly removed from power, the introduction of the new Tax and Land Codes, and some improvements in the corporate governance system through the introduction of the Code of Corporate Behaviour based on the general principles of the OECD. Despite such improvements, the situation is still far from being considered as ideal. Corruption and bureaucracy are still very important problems, administration continues intervening in businesses and creating problems, the majority of Russian companies are still controlled by insiders, and work in an inefficient way which makes them being considered as unreliable partners. Property rights and intellectual property rights are still poorly protected. That is, in order for Russia to attract even more flows and fully restructure its economy, further improvements need to be made regarding the issues mentioned in this essay.

## APPENDIX

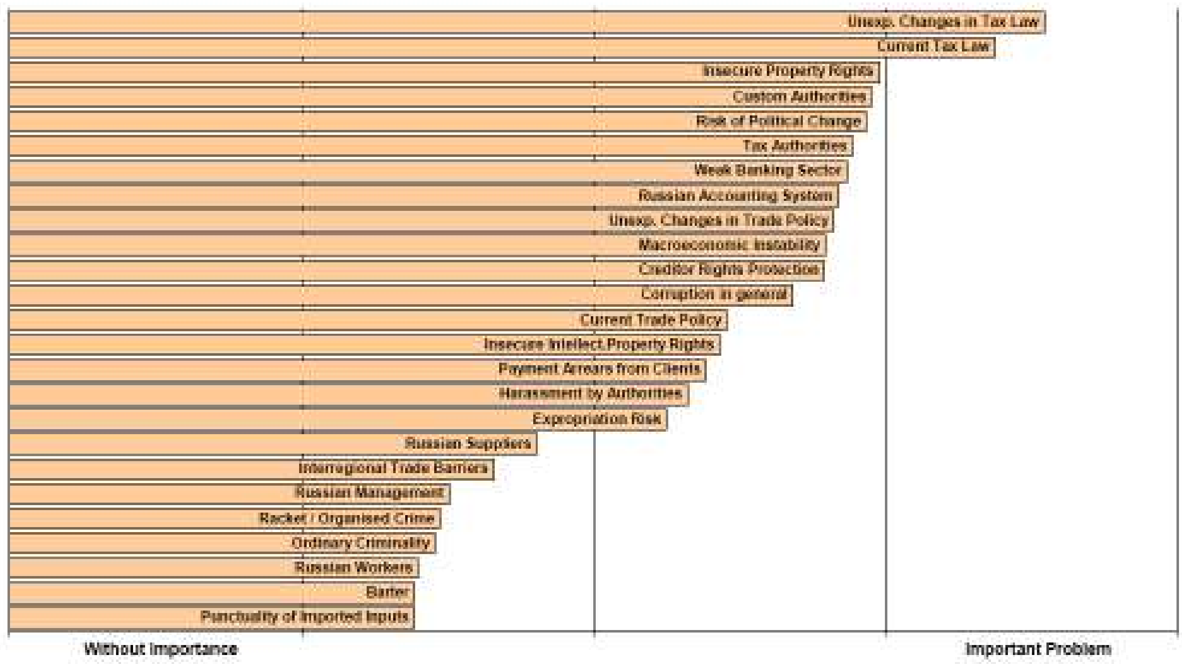
**Table I**




Source: OCO Consulting LOCOmonitor 2002-July 2003

**Table II**

**Figure 3: Problems faced by foreign direct investors in Russia**




Source: Survey conducted by European Business Club in Moscow in 46 European Enterprises (found in Ahrend, Rudiger, "Foreign Direct Investment into Russia-Pain without Gain? A Survey for Foreign Direct Investors", *Russian Economic Trends,* Moscow, June 2000, p.7

## Table III

**Table III. Comparative Analysis of Corruption Practice, Organized Crime, and Reliability of Police Services in Countries with Transition Economies**

| Country | Reliability of police services (1) | Organized crime (2) | Frequency of payments or bribes (3) | Reliability of payments or bribes (4) | Business costs of corruption (5) |
|---|---|---|---|---|---|
| Bulgaria | 2.8 | 2.8 | 4.0 | 3.6 | 3.9 |
| Czech Republic | 4.3 | 4.4 | 4.3 | 5.0 | 3.9 |
| Estonia | 4.2 | 5.3 | 5.2 | 4.6 | 5.5 |
| Hungary | 4.5 | 5.6 | 4.0 | 4.6 | 5.3 |
| Latvia | 3.7 | 4.0 | 4.6 | 4.4 | 4.7 |
| Lithuania | 2.8 | 3.8 | 4.8 | 4.1 | 4.7 |
| Poland | 3.5 | 3.8 | 3.8 | 4.3 | 4.2 |
| Romania | 3.1 | 4.2 | 2.9 | 4.1 | 4.2 |
| Russia | 2.9 | 2.9 | 3.8 | 3.7 | 4.3 |
| Slovakia | 3.1 | 3.7 | 4.3 | 4.0 | 4.6 |
| Slovenia | 4.5 | 5.7 | 4.8 | 4.6 | 5.3 |
| Ukraine | 2.7 | 2.9 | 3.4 | 3.7 | 3.5 |

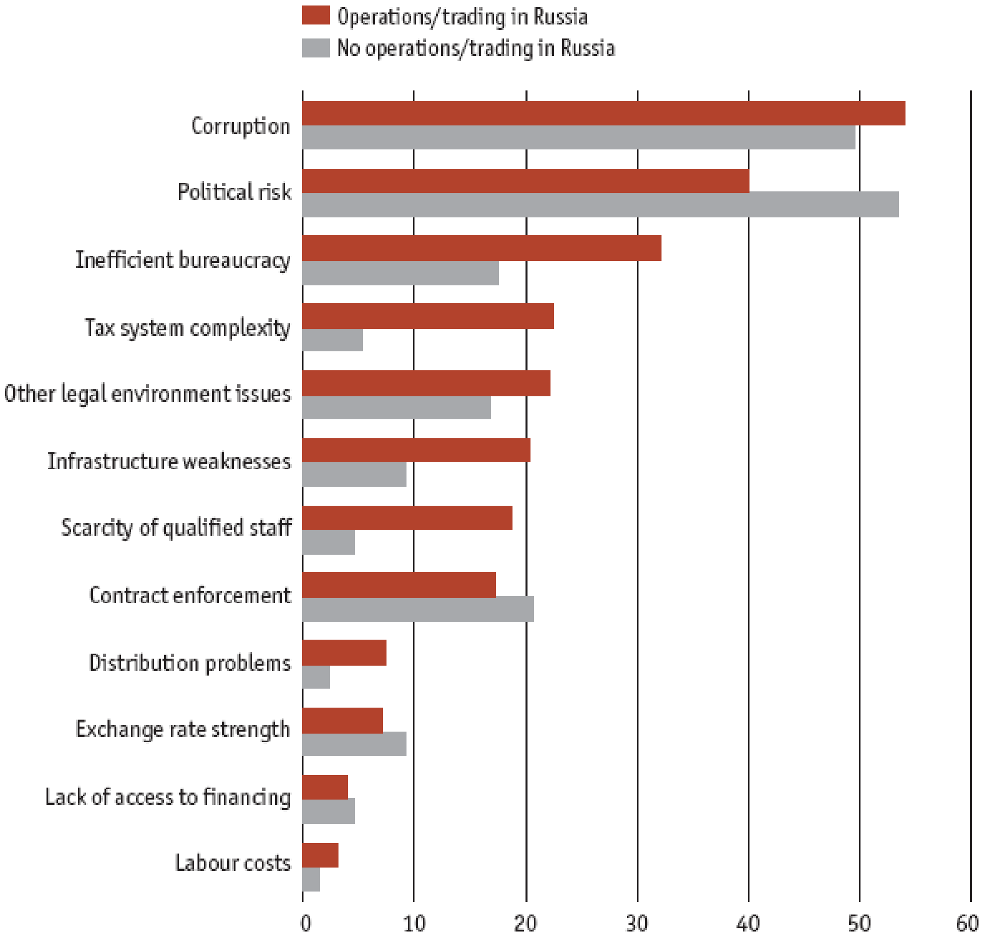
*Source: World Economic Forum, The Global Competitiveness Report 2002-2003*

Notes:

(1) Police services (1 = cannot be relied to protect business from criminals, 7 = can be relied upon to protect business from criminals)
(2) Organized crime (mafia-oriented racketeering, extortion) in your country (1 = imposes significant costs on businesses, 7 = does not impose significant costs on businesses)
(3) In the past three years, the frequency and extent of additional payments or bribes (1 = has increased significantly, 7 = has decreased significantly)
(4) When paying bribes, how confident can business people be that the service is delivered as promised? (1 = not at all confident, 7 = very confident)
(5) Do other firms' illegal payments influence government policies, laws or regulations impose costs or otherwise negatively affect your firm? (1 = impose large costs, 7 = impose no costs/not relevant)

## Table IV

Which of the following represent the most significant constraints on your firm's operations or investment plans in Russia? Select up to three.
(% respondents)




Source: Economist Intelligence Unit survey, May 2007

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