

# **Barriers and obstacles to foreign direct investment (FDI) into Russia**



Master Thesis  
in MSc in International Fisheries Management

by

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May 2006



*Dedication*

**I dedicate this work to my dearest parents –  
Elena Shevtsova and  
Grigoriy Shevtsov (passed away on 7.10.1992).**

( 7.10.1992).

## *Acknowledgements*

It is a great pleasure for me to acknowledge the guidance, assistance and help I have received from my supervisor – professor Terje Vassdal, whose valuable comments during the writing this paper was instrumental in making this project a reality.

I have many people to thank for their assistance and contribution to my research. I am particularly pleased to mention Knut J. Borch (NORUM) for sharing and supporting my ideas in Tromsø mass media, providing me with materials as well as with precious information regarding his positive experience of setting up business in Russia in spite of being an extremely busy person.

A huge thank you goes to Anton Voskoboynikov (Gigante Pechenga) for sharing his experience of working in fishery business in Russia.

I would also like to mention all those who devoted some of their valuable time for answering my questionnaire and commenting on it during the interviews that were arranged: Anatoli Bourmistrov (University of Bodø), Peter Arbo (Norwegian College of Fisheries Science, UiTø), Nils Petter Beck (Den Norske Bank), Hans Henrik Gundersen (SpareBank 1, NN), Odd-Helge Skog (Weibull Nord AS), Jan Erik Angelsen (Nordnorsk Vekst AS), Stein Ivar Antonsen (Nordnorsk Vekst AS), Einar Frafjord (SpareBank 1 NN), Svein Ruud (Troika Seafood), Roger Håkon Mikkelsen (Bedriftskompetanse AS), Kjell-Otto Sebergesen (IMES AS).

I am also very grateful to all my classmates and friends at the Norwegian College of Fishery Science and University of Tromsø who brought so many new colors in my life and made my time that I spent in Tromsø really unforgettable. Guys, you rocked my world!

I would like to say many thanks for everyday support to my dearest classmate – Arina Sidoryuk, who shared with me the long days in the fish laboratories, cruises and went with me the whole way just from the beginning of the Master programme shoulder to shoulder.

For never-ending faith in me I would like to thank my dearest mother – Elena Shevtsova. Everything I achieved in my life I owe her.

There is one more person, who surely deserves the special huge thank you – Yulia Lichutina, who was always there for me no matter what.

I want to express my appreciation to every person (Bjørn Arve Fossum in particular) who contributed with either inspirational or actual work to this paper.

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*May, 2006*

### *Abstract*

The transition from socialism to capitalism in Russia is both a political and an economic process. An important aspect of the latter is the possibility of integration into the world economy (through trade and capital flows) is a crucial and related element of the former. Foreign direct investment (FDI) is a particularly important element of the transition process itself and economic integration, because it opens not only possibilities for accelerated growth, technical innovation and enterprise restructuring, but also for capital account relief (Bevan and Estrin, 2000). There is growing evidence that enterprise productivity, R&D expenditure, innovation and company performance are higher in foreign owned firms – both in the transition economies and in the West.

However, the inflows of foreign direct investment to Russia up until now were at the low level in comparison with the FDI to other country with transitional economies such as, for example, Poland or Hungary.

Thus, the paper focuses on answering the following questions:

- ✓ what are the reasons for the lack of interest and enthusiasm on the part of foreign direct investors?
- ✓ what are the most important problems foreign direct investors come across with?
- ✓ are there any changes and improvements in investment climate in Russia happened nowadays comparing with the situation in the beginning and mid 1990s?

**KEY WORDS: FOREIGN DIRECT INVESTMENT, TRANSITION ECONOMY, FOREIGN INVESTOR, INVESTMENT CLIMATE.**

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## ***Chapter 1. Introduction: the nature of the problem***

### ***1.1. Background of the problem***

The inflows of foreign direct investment to Russia in the mid 1990s were at the low level in comparison with the FDI to other country with transitional economies such as, for example, Poland or Hungary. The figures clearly demonstrate that the annual inflow of FDI per capita in Russia calculated for the period of time from 1994 to 1999 on average was not more than \$20, which is hardly compared with the same indexes calculated for Hungary (\$220) and for Czech Republic (\$134) (Ahrend, 2000). However, there are at least two facts that should be taken into consideration. Firstly, the value of FDI calculated per capita is usually higher in countries with smaller population. Secondly, these countries are located closely to Europe and have closer relations and easier access to EU. Despite these, figures presented above confront greatly with Russian abundant natural resources, highly skilled labor force, etc.

Thus, this lack of interest and enthusiasm on the part of foreign direct investors were quite often explained by both instability of political situation and poor business climate and investment environment in Russia in the beginning and mid 1990s. In addition to these, Western media get used to paint the picture and present Russia as a lawless (if not completely bankrupt) country, mostly controlled by criminal and mafia-type organizations, riddled by corruption and violence.

In the beginning of the XXI century the question is – did the situation with FDI inflows into Russia remain the same or did Russia made a good step forward in the direction of improving the overall investment climate and adopting the necessary changes to make her record on FDI considerably better since the time of 1990s?

### ***1.2. Problem statement***

The opportunities and obstacles of placing foreign direct investment (FDI) to the countries with transitional economy have received considerable attention in the academic literature nowadays. Recent studies (for example, Dunning, 1994) suggest that inter-country competition to attract FDI is becoming more and more intensive, because host country governments began to realize the potential advantages which FDI could bring in the light of the modern globalizing economy. An increasing number of governments now adopt and make a welcome step towards FDI, considering these investments as means of improving the competitiveness of their countries' resources and capabilities, and as necessary impulses for

speeding up the market processes in countries with transition economy. However, their ability to attract FDI and to help it to flourish once established depends on the existence of an accommodating business environment, together with supportive government economic policies (Jones, Fallon and Golov, 2000).

So I suggest, as a research problem of my Master Thesis project, that one of the problems of Russia's disability to attract sufficient amount of FDI is insufficient development of companies' governance. By insufficient development of companies' governance I mean the cases when, for example, the executive board of the company established in collaboration with FDI pursues interests of the particular group of shareholders and infringes the interests of other shareholders.

Thus, to my point of view, this problem originates from the existence of the particular obstacles, which in its turn help to explain the insufficient amount of FDI inflows into modern Russia. So what are these obstacles?

### ***1.3. Relevance of the problem***

A brief look at the present situation with FDI inflows to Russia makes it clear to see that Russia has been relatively unsuccessful during the 1990s in attracting FDI, as compared with her fellow transitional economies in Central and Eastern Europe. Both the volume of FDI inflows and the net benefits derived from FDI entering Russia have been at quite low level. What is more, the debates about Russia's prospects for improving on her poor FDI record in the near future are very disputable today: some economists are convinced that Russia's perspectives in this regard do not appear encouraging, whereas others have the opposite point of view.

It is also important to consider the regional distribution of FDI among the federal districts. It is easy to notice the clear polarization between a very small number of regions that have received large amounts of FDI and the majority of the other federal districts. The North-Western (N-W) federal district<sup>1</sup> (which is of the particular interest in this paper) has been keeping the fourth place among all the other regions during last years. There were many joint-ventures established in N-W Russia (mostly with Norwegian partners), but in spite of generally considered as favorable investment climate, many companies have not become successful. So why did that happen? What are the most important problems foreign direct investors came across with? Are

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<sup>1</sup> North-Western federal district (N-W Russia) one out of 7 Russia's federal districts. N-W Russia comprises 11 territories: Kaliningradskaya oblast', Pskovskaya oblast', Leningradskaya oblast', Novgorodskaya oblast', Kareliya republic, Nenetskiy autonomous area, Komi republic, Vologodskaya oblast', Arkhangel'sk oblast' and Murmansk oblast'. N-W Russia covers the territory of 1 676,4 thousand sq km; population (2004) – 14 282,9 thousand people. St. Petersburg is the regional centre (OAO North-West Telecom, 2004).

there any changes and improvements in investment climate in Russia happened nowadays comparing with the situation in the beginning and mid 1990s?

#### ***1.4. Research objectives***

In order to consider barriers and obstacles to foreign direct investments into Russia, the following research objectives will be taken into consideration:

- 1) To provide the understanding of the nature, background and relevance of the problem of foreign direct investments (FDI) to Russia;
- 2) To show the importance of FDI to the transitional economy of Russia;
- 3) To provide an overview of the investment climate in Russia in mid-1990s and in the beginning of 2000s;
- 4) To provide clear understanding of the typical barriers and obstacles to FDI into Russia;
- 5) To present the results of the survey which was worked out by R. Ahrend and carried out with the assistance of the European Business Club in Moscow in 2000;
- 6) On the basis of the survey mentioned above, to carry out the research among the Norwegian companies most of which have been/are involved or are planning to be involved in investing (both into fishery business and other businesses) into Russia.
- 7) To study and compare the results of the two surveys mentioned above.

#### ***1.5. Hypothesis***

John H. Dunning (1994) suggests that some countries may be more successful in attracting FDI than others, because of the historical and geographical circumstances. Their abilities to attract FDI and to explore their economic benefits are closely correlated with national political, economic and legal cultures, traditions and infrastructures, as well as with the economic objectives and policies pursued by host governments.

Thus, the hypothesis of present paper states that Russia's abilities in attracting FDI are limited by the national ambivalence towards the benefits of FDI and constrained by:

- ✓ the country's taxation and legal infrastructure;
- ✓ the presence of the oligarchy, and the prevalence of crime and corruption;
- ✓ Russia's political and economic culture, and its impact on government reform policies;
- ✓ the failure of domestic enterprises and managers to adapt to competitive market conditions;

The suggested hypothesis is based on the review of papers, studies; researches made by Russian and foreign economists as well as on the feedback and comments of the arranged interviews.

### ***1.6. Methods and materials utilized***

Data for the research is mainly obtained from the documentary sources both in Russia and in Norway.

In order to provide a substantial scientific research and to collect important data and information needed, two groups of scientific methods of study were utilized:

- quantitative methods;
- qualitative methods.

Quantitative methods, which are based on the secondary data sources, include mainly register data analysis such as:

- economic surveys;
- research databases;
- national statistics.

From the variety of qualitative methods for the purposes of the paper mostly two sub-methods were used:

- document studies:
  - ✓ formal documents, e.g. laws, decrees, orders, etc.;
  - ✓ newspaper articles;
- specific cases, process analysis:
  - ✓ individual interviews.

It is also important to point out that such a variety of methods was used because of the complex and contradictory nature of the research problem. The paper can not be based on, for example, interviews only, because it is important not only to escape the subjective opinions but it is also essential to view the research problem from the variety of different angles and points of view.

The research will be started with the definition of investments, types of investments and the analysis of the present investment climate in Russia. An overview of the relevance of the research problem on the macro (state) level and micro (regional) level will be provided. Russia's successes in the investment attraction will be compared with the experience of her fellow transitional economies in Central and Eastern Europe.

As a part of theoretical analysis the theoretical findings regarding the definition of investments, classification of the types of investments and the importance of foreign direct

investments for the countries with transitional economy will be viewed. Moreover, the special attention in the paper will be paid to regional distribution of foreign direct investments along the territory of Russia.

In order to meet the research objectives of the paper and verify the hypothesis stated, the analysis of the investment barriers which existed in the beginning and mid-1990s with comparison to modern situation will be carried out. A part from that, in order to find out the nature of changes and improvements (if any) occurred to the investment climate in Russia within last 10 years, it was decided to carry out the survey (appendix 1).

Thus the objectives of the survey mentioned are as follow:

to find out Norwegian businessmen' as well as theorists' point of view about the reasons of Norwegian companies for establishing business and/or direct investments in Russia;

to indicate the problems which they could face in this regard;

to identify changes which occurred to investment climate in Russia (in North-Western region in particularly);

to compare the obtained results with those findings which were described according to the results of the survey which was carried out by R. Ahrend with the help of the European Business Club in Moscow in 2000.

Following this, the survey which is supplementing this paper was based on the questionnaire which was worked out by R. Ahrend and contains 7 questions. Each question contains many possible alternatives which in its turn are supposed to be graded on the scale from 1 (the least important factor) to 5 (the most important factor). The possible answer Do not know was also included. In the end of the questionnaire the space for comments was provided.

Just from the beginning the interviewees were divided into two major groups: theorists (who have solid theoretical knowledge of the issue) and business experts (who have practical experience of issue). The complete list of those questioned is presented in the table below.

Table 1. The complete list of persons interviewed

	<b>Theorists</b>		<b>Business experts</b>	
	<i>Name</i>	<i>Position</i>	<i>Name</i>	<i>Position</i>
1.	Terje Vassdal	Professor, Department of Economics and Management, NFH	Knut J. Borch	Managing director, NORUM Ltd, EBRD North West and West Russia Regional Venture Fund
2.	Anatoli Bourmistrov	Associate professor, University of Bodø	Anton Voskoboinikov	Manager, Gigan te Pechenga (Murmansk, Russia)

Table 1. The complete list of persons interviewed (continuation)

	<b>Theorists</b>		<b>Business experts</b>	
	<i>Name</i>	<i>Position</i>	<i>Name</i>	<i>Position</i>
3.	Peter Arbo	Associate professor, Department of social and marketing studies, Norwegian college of fishery science, UiTø	Nils Petter Beck	Regional director, Den Norske Bank (DnB)
4.			Hans Henrik Gundersen	General manager, Sparebank 1, NN
5.			Odd-Helge Skog	Managing director, Weibull Nord AS
6.			Jan Erik Angelsen	Aministrative director, Nordnorsk Vekst AS
7..			Stein Ivar Antonsen	Special Adviser in aquaculture, Nordnorsk Vekst AS
8.			Svein Ruud	Director, Troika Seafood (Kirkenes)
9.			Einar Frafjord	Special advisor, Sparebank 1, NN
10.			Roger Håkon Mikkelsen	Project Director Eastern Europe, Bedriftskompetanse AS
11.			Kjell-Otto Sebergesen	Director, IMES

All those interviewed are involved in doing business and either had/still have investments in Russia or planning to make them in future. It is also worth to mention that the majority of interviewers have their business related to the fishery industry.

In order to get the closer look at the business of Norwegian companies which took part in the survey and more thoroughly investigate the nature of the problems that they faced entering Russia, the interviews with representatives of top-management were arranged. As far as there are two types of interviews exist – structured and unstructured – in this paper the unstructured interviews in the form of discussion were chosen as the most suitable ones.

In the chapter 7 the primarily data of the survey will be utilized in order to draw conclusions about the contemporary barriers to foreign direct investments from the Norwegian businessmen's point of view. What is more, for better and more thorough analysis of the survey's primarily data, the standard deviation will be calculated.

The results of the survey will be discussed and presented with the help of graphs and diagrams. The comparison of the results obtained with those of the European Business Club survey (2000) will be made and conclusions will be drawn.

In the discussion the decision on rejection or acceptance of the hypothesis of the paper will be made and the research limitations will be mentioned.

In the conclusion the major ideas will be summed up and the recommendations for research will be pointed out.

## *Chapter 2. Theory of foreign direct investment (FDI)*

### *2.1. Definitions*

International equity flows and loans are the main feature of the recent globalization of capital markets both in developing and in developed economies. These flows take two major forms: Foreign Direct Investments (FDI) and Foreign Portfolio Investments (FPI).

The two main definitions of FDI are given in the Balance of Payments Manual: Fifth Edition (BPM5) (Washington, D.C., International Monetary Fund, 1993) and the Detailed Benchmark Definition of Foreign Direct Investment: Third Edition (BD3) (Paris, Organisation for Economic Co-operation and Development, 1996).

In accordance with the BPM5, FDI refers to an investment, which is made to acquire lasting interest in enterprises operating outside of the economy of the investor. In other words, the basic distinguish between the FDI and FPI is that in cases of FDI, the investor's purpose is to gain an effective voice in the management of the enterprise. Thus, the foreign entity or group of associated entities that makes the investment is termed the "direct investor".

The unincorporated or incorporated enterprise - a branch or subsidiary, respectively, in which direct investment is made - is referred to as a "direct investment enterprise". Some degree of equity ownership is almost always considered to be associated with an effective voice in the management of an enterprise; the BPM5 suggests a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor.

In case of Russia, the definition of foreign direct investment is presented in the article II Law on Foreign Investment in the Russian Federation (9 July, 1999) and says the foreign direct investment is (a) a 10 % or higher investment by a foreign investor in share capital, (b) fixed capital investment in an affiliate of a foreign company established in Russia, and (c) a lease by a foreign investor of an article classified in the list of external transaction goods between CIS states, which exceeds 100 million rubles .

Once a direct investment enterprise has been identified, it is necessary to define which capital flows between the enterprise and entities in other economies should be classified as FDI. As far as the main feature of FDI is taken to be the gaining of the lasting interest of a direct investor in an enterprise, only capital that is provided by the direct investor either directly or through other enterprises related to the investor should be classified as FDI. Taking these into account, it is possible to conclude that the forms of investment by the direct investor (which are classified as FDI) are:

- ✓ equity capital,

- ✓ the reinvestment of earnings,
- ✓ the provision of long-term and short-term intra-company loans (between parent and affiliate enterprises)<sup>1</sup>.

Defining these three main forms of FDI (which are associated with having an equity stake in an enterprise) does not necessarily mean that there are no other controlling interest forms of FDI. There are many other ways in which foreign investors may acquire an effective voice in company's management. Those include:

- ✓ subcontracting,
- ✓ management contracts,
- ✓ turnkey arrangements,
- ✓ franchising,
- ✓ leasing,
- ✓ licensing,
- ✓ production-sharing.

A franchise (a firm to which business is subcontracted) or a company which sells most of its production to a foreign firm through means other than an equity stake are not usually collected, some countries have begun to contemplate doing so. For example, the OECD treats financial leases between direct investors and their branches, subsidiaries or associates as if they were conventional loans; such relationships will therefore be included in its revised definition of FDI (United Nations Conference on Trade and Development, <http://www.unctad.org/Templates/Page.asp?intItemID=3147&lang=1>).

Following the definition of the FDI which is given in the BD3 of the OECD, a direct investment enterprise is an incorporated or unincorporated enterprise in which a single foreign investor either owns 10 per cent or more of the ordinary shares or voting power of an enterprise (unless it can be proven that the 10 per cent ownership does not allow the investor an effective voice in the management) or owns less than 10 per cent of the ordinary shares or voting power of an enterprise, yet still maintains an effective voice in management. An effective voice in management only implies that direct investors are able to influence the management of an enterprise and does not imply that they have absolute control.

It is also worth to say that different countries have different threshold values for foreign equity ownership which they accept as the evidence of a direct investment relationship. We can say that

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<sup>1</sup> It is interesting to point out that countries do not always collect and report data for each of those three components of FDI. Thus, reported data on FDI can not be totally comparable across countries. In particular, data on reinvested earnings, the collection of which depends on company surveys, are often unreported by many countries.

the direct investment relationship is defined by the level of participation at or above which the direct investor is normally regarded as having an effective voice in the management of the enterprise involved. In common practice the threshold value for foreign direct investment is usually considered to be 10 per cent; when it comes to TNCs operations – the ranges are between 10 and 50 per cent. However, if we take Malaysia as an example, the foreign controlled companies are those in which non-residents hold more than 50 percent of the equity capital (Bajpai and Dasgupta, 2004). Another example is New Zealand – the percentage of shares or voting rights, which are classified to be the FDI, is 25% (Clarke, 1998).

Another peculiarity which differs from country to country is that some countries do not specify a threshold point at all – they just rely entirely on other evidence, including companies' own assessments as to whether the investing company has an effective voice in the foreign firm in which it has an equity stake. The quantitative impact of differences in the threshold value used is relatively small, owing to the large proportion of FDI which is directed to majority-owned foreign affiliates.

To conclude, the most important characteristic of FDI, which distinguishes it from foreign portfolio investment, is that it is undertaken with the intention of exercising control over an enterprise (United Nations Conference on Trade and Development, 2005).

## ***2.2. The importance and potential economic benefits of FDI***

Foreign direct investment (FDI) has the potential to generate employment, raise productivity, transfer skills and technology, enhance exports and contribute to the long-term economic development of the world's developing countries. More than ever, countries at all levels of development seek to leverage FDI for development.

There are just some facts which clearly show that the importance of the FDI on the global scale is really difficult to overestimate:

- ✓ foreign affiliates of some 64,000 transnational corporations (TNCs) generate 53 million jobs.
- ✓ FDI is the largest source of external finance for developing countries.
- ✓ one-third of global trade is intra-firm trade.

Talking about the countries with transitional economic, one can say that the range of economic benefits can arise from the exploitation of FDI inflows, such as:

- ✓ restructuring countries economic activities in line with dynamic comparative advantage;
- ✓ reducing their costs of structural adjustment;

- ✓ fostering more demanding purchasing standards by firms and consumers;
- ✓ raising the productivity of national resources and capabilities as well as contributing to the modernization of the industrial structure;
- ✓ improving quality standards and strengthening of product competitiveness on the international market;
- ✓ stimulating economic growth (adapted by Jones, Fallon and Golov from Dunning, 1994).

Taking Russia in particular, FDI could have to improve and strengthen country's economic performance in the three main ways:

- ✓ It can contribute directly to capital accumulation, helping to address shortages which arise due to low domestic savings and limited financial intermediation (Borensztein *et al*, 1995).

- ✓ It can stimulate faster progress in restructuring enterprises, so helping to boost their productivity and export performance (Hunya, 1997).

- ✓ It can provide technological and organizational benefits for domestic suppliers and competitors (EBRD, 1998).

- ✓ FDI can also have positive effect in terms of contribution to market-oriented institution formation and behavior in Russia. This can be achieved by creating a positive spill-over effect for local firms, through the stimulus of greater competition, and by means of both backward and forward linkages (adapted by Jones, Fallon and Golov from Hunya, 1997; Mayhew and Oriowski, 1998). To this point it could be worth to add that the local suppliers can have higher standards of product quality and supply reliability forced on them, while higher standards may also spread to other suppliers through demonstration effects (EBRD, 1998; Matouschek and Venables, 1998).

### *Chapter 3. Investment climate in Russia: the main problems and barriers*

#### *3.1. Overview of FDI in Russia in mid 1990s*

It is well-known fact that Russia possesses some clear advantages which could make her investment climate look more favorable for attracting FDI, for example:

- ✓ abundant natural resources;
- ✓ clear strength in science and technology;
- ✓ high average level of population education, etc.

However, in spite of all these Russia has not been successful enough in attracting FDI in the mid- and end of 1990s comparing to some of her fellow transition economies countries. Following the economic reforms and the beginning of process of privatization, the FDI flow entering Russia increased more than twice in 1997 (US \$ 3,75 billion) comparing to those in 1996 (US \$ 1,7 billion) (EBRD, 1998). Nevertheless, the data taken in cumulative terms did not look encouraging. During the period between 1989 and 1998, the cumulative DFI inflows into Russia reached only US \$ 9,2 billion. For example, in Hungary this figure was around twice higher - US \$ 16,9 billion and one quarter higher of that recorded in Poland (US \$ 12,4 billion) (EBRD, 1998) . FDI in Russia comparing to some other post-Soviet countries are presented in the table below (Table 2).

Table 2. Foreign direct investment in Russia (net flows of equity capital recorded in the balance of payments)

	FDI inflows in 1996 (US \$ millions)	FDI inflows in 1997 (US \$ millions)	FDI inflows per capita 1997 (US \$)	Cumulative FDI inflows 1989-98 (US \$ millions)	Cumulative FDI inflows per capita 1989-97 (US \$)
Russia	1,700	3,752	25	9,201	63
Hungary	1,986	2,100	207	16,903	1,667
Poland	2,741	3,044	79	12,442	321
Czech Republic	1,388	1,275	124	8,473	823
FSU (1) and CEECs (2) overall	12,439	17,101	43	74,471	187

Source: Adapted from EBRD Transition report 1998, p. 81

Notes: (1) Former Soviet Union excluding the Baltic States; (2) Central and Eastern Europe and Baltic States.

Analyzing the figures presented in the table 1, it is clearly seen that Russia's FDI per capita does not look impressive (however, it is worth to keep in mind that the population of Russia is much bigger than in any of the countries compared). In 1997 Russia took only the 14<sup>th</sup> position out of 25 CEEC and FSU countries in the ranking based on the amount of FDI per capita (US \$ 25). Nevertheless, cumulative FDI inflows per capita taken for the period of time from 1989 till 1997 indicate that during that time Russia managed to attract US \$ 63 per capita. It goes without saying that this figure contrasts greatly comparing to the amount of FDI inflow per capita in the case of Hungary (US \$ 1, 667) and to the US \$ 823 in the case of Czech Republic. On the whole, in terms of FDI per capita Russia was ranked number 20 out of 25 countries in the region (EBRD, 1998).

Another peculiar feature of which characterize FDI inflow to Russia is the clear polarized distribution of FDI along the territory of Russia. It is easy to notice that FDI are mainly concentrated in relatively few regions of the country (fig.1).

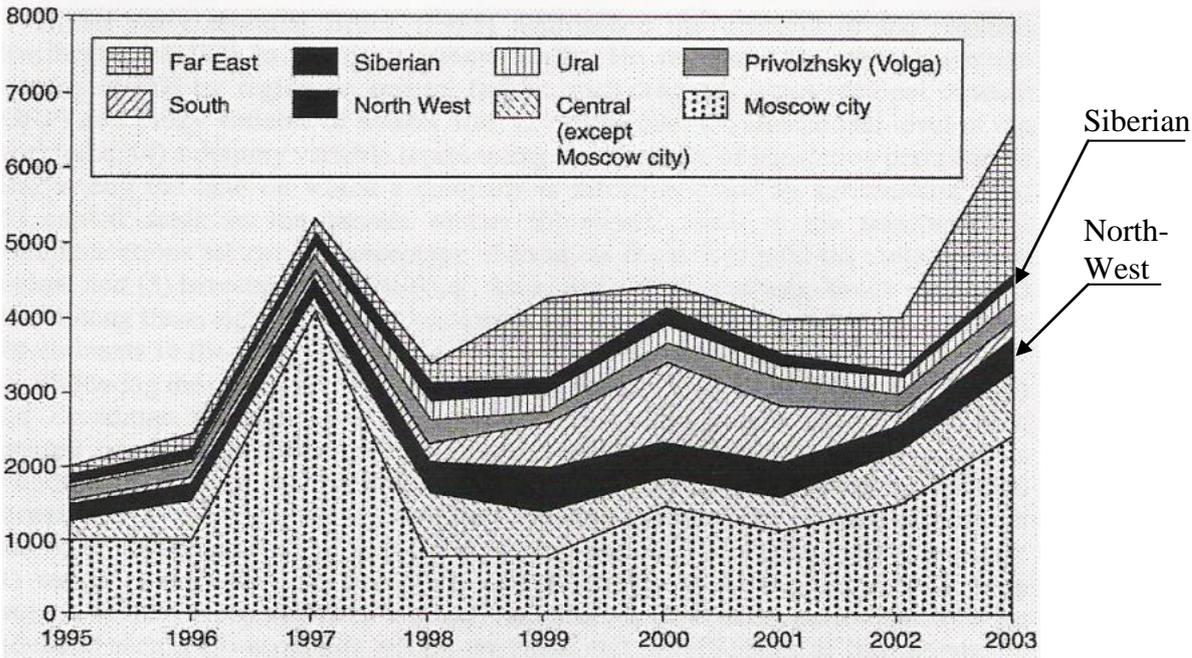


Figure 1. Development of FDI inflow by Russia's federal districts during 1995-2003 (million USD)

Source: Iwasaki & Sukanuma, 2005

There are probably two main conclusions which can be drawn from figure 1. Firstly, such polarized FDI distribution supports the fact of resource oriented strategies of the foreign direct investors. In other words, investors prefer to invest to such industries as oil, gas, metal industries which are mostly concentrated on the Far East of Russia. Secondly, concentration of FDI inflows in Central part of Russia and in the Moscow city indicates the territorial differentiation of

business conditions between the Russia's regions. It is obvious that large regions with a highly developed market infrastructure, high per capita incomes and abundant resources attract the largest shares of FDI. What is more, according to the data from Institute for the Economy in Transition (1999), in 1997 there were 5 regions with the population of 49 per cent of the total Russia's population, which managed to attract about 90 per cent of total FDI of that year. Among those regions are Moscow, St. Petersburg and Nizhny Novgorod, which have received around 75 per cent of total FDI entering Russia in 1996. In addition, FDI in Moscow during 1996 accounted for 66 per cent total foreign investments in Russia (that was almost ten times the national average share in FDI (Jego, 1997)). In spite of the fact that FDI to Moscow fell down to the level of 66 per cent in 1997, Russia's capital city, St. Petersburg and other Moscow regions continued to accumulate approximately 70 per cent of the total amount of Russia's FDI steadily (Institute for the Economy in Transition, 1999).

Apart from FDI inflows polarization along the territory of Russia, another specific feature of FDI into Russia in the late 1990s was the fact that the investment projects itself were quite small comparing to the scale of the companies which launched or participated in them. For example, General Motors's share in the investment project of the production of the Chevrolet Blazer (in Tatarstan) was \$250 mil. The rest of the total investment was provided by the local government of Tatarstan and the Russian government. Taking into account that General Motors's turnover is about \$170 billions, such a small share of participation looks more like launching a pilot investment or just making a tentative commitment.

Dunning (1994) has distinguished the four major types of advantages which foreign investors are aiming to achieve when they make their decision about entering the market. They are:

- ✓ access to natural resources – physical and human (resource-seeking FDI);
- ✓ access to markets – local or adjacent (market-seeking FDI);
- ✓ product or process rationalization/specialization – across or along the value chain (efficiency-seeking FDI);
- ✓ the acquisition or linkage into foreign assets including technology, organizational efficiency, or markets (strategic asset-seeking FDI).

Thus, according to Dunning (1994) the majority of FDI inflows to Russia (as well as to other countries with transitional economies) in the period of time from 1980s till 1990s were mostly oriented for search for natural resources or market access. These resource- and market-seeking FDI were particularly concentrated in food industry, automobiles and natural resources, including the oil production (EBRD, 1998; Institute for the Economy in Transition, 1999). However, there were some traces of strategic asset-oriented FDI in the aerospace industry in late 1990s, but the scales of those FDI were not that large (Ostrovsky, 1997).

### ***3.2. Contemporary legal framework for FDI in Russia***

In spite of the fact that the Russian Government does realize the advantages which Russia possesses in order to improve her investment record and takes into account the positive potential which FDI can contribute to Russia's economic growth with, there are still shortcomings in contemporary Russian investment climate, which have to be improved.

Overall the relations regarding the investment business in Russia are regulated by 2 major documents, which are supplemented by the variety of other legislations:

- ✓ the investment code (1991);
- ✓ the law on foreign investment (1999).

What is more, there are four characteristics which can be considered as the main features of Russia's FDI regime nowadays. These are defined by the law and are worth viewed:

- ✓ FDI establishment;
- ✓ operational conditions;
- ✓ control and ownership;
- ✓ foreign exchange controls.

#### ***3.2.1. FDI establishment***

Foreign investors have a legal right to invest in various industries of the Russian economy. However, the investment is constrained when it comes to some fields of economy such as:

- ✓ natural resources;
- ✓ banking;
- ✓ communication;
- ✓ insurance;
- ✓ aerospace
- ✓ electric power;
- ✓ defense related industries;
- ✓ large scale construction projects
- ✓ transportation.

What is more, according to the Russian legislation foreign investors will need a prior approval in case of investing:

- ✓ to ventures with more than 50 percent of the total share capital (foreign direct investing);

✓ the amount of money which is more than 50 million Russian roubles (in case the amount of investment exceeds 100 million Russian roubles – there is an additional registration is required);

✓ to projects related to the Russian defense industry (however, in some cases this investment could be prohibited by legislation);

✓ to natural resource exploitation;

✓ on the purpose of setting up companies with the use of the assets which belongs to existing Russian enterprise;

✓ to take over incomplete construction (housing) project.

All the initial investment in Russian companies which is made by non-residents is registered in the Central Bank. However, in case of further follow-on investment or if the investment is made in foreign currency, the registration is not required.

### ***3.2.2. Operational conditions***

Generally speaking performance requirements do not exist in Russia. Nevertheless, when it comes to the product sharing legislation, the 70 percent of the project's content must be local. For example, there are tariff breaks which could be granted in case of large investment in the Russian auto industry providing that such investment reaches 50 per cent domestic content levels within the period of time which is five years.

### ***3.2.3. Control and ownership***

Foreign investors are allowed to own Russian business in two ways:

✓ incorporation;

✓ purchase of the business which is already exist.

As far as there are some fields of the Russian economy which are restricted for foreign investors (see chapter 3.2.1.), there are some constrains regarding foreign control and ownership of the companies in these restricted industries:

✓ in the aerospace enterprise foreign ownership can not exceed 25 per cent of the total capital;

✓ in the enterprise which business lies in the field on natural gas, the foreign ownership can not be more than 11 per cent of the total capital;

✓ foreign participation in the insurance sector can not exceed 15 per cent;

- ✓ foreign participation is restricted in the Russian electric power industry to not more than 25 per cent;
- ✓ foreign investor can not own more than 12 per cent of total banking capital.

#### ***3.2.4. Foreign exchange controls***

The remittance of investment returns is permitted by the Russian legislation. Licenses are required when it comes to foreign exchange transactions and lease payments which are in the foreign currency; however in case both lessee and lessor are non-residents of Russia, the license is not needed.

The currency controls are imposed on the transaction of both export and import type (these include transaction of capital).

There are restrictions regarding the amount of foreign currency which could be kept on the bank account of the residents.

Russian rouble is the national currency which is the only legal currency in the territory of Russia.

### ***3.3. Overview of foreign investments and foreign direct investments in Russia in the beginning of 2000s till nowadays***

#### ***3.3.1. Foreign investments***

The facts and data about foreign investors' performance in the Russian economy during last six years prove the statement that foreign capital is going to play a remarkable role in further Russian economy and in particularly in future Russia's GDP growth. According to the results of the years 2004 and 2005 the foreign-owned companies were involved in 6-7% of the total fixed investments. What is more, the companies with joint domestic and foreign ownership made another 10-13% of the total fixed investments during the time period mentioned.

In addition, the attention should be paid to the structure of the investments made: 45% of total investments in 2004 were directed to the trade sector. Speaking about the key branches of manufacturing, the data shows that in 2004 fully and partly foreign-owned companies had shares, which were equal to:

- ✓ one fourth in the machine and metal processing industry;
- ✓ one third in the chemical industry;
- ✓ about half in the food industry.

### 3.3.2. Foreign direct investments

The statistic data on FDI development trend during the year 2005 is quite difficult to analyze due to the fact that different sources of information present data that vary considerably. This could be explained by the different components which are included to the value of total FDI to Russia as well as by the different interpretation of these components itself. However, that the types of FDI within the total FDI inflow (FDI structure) demonstrate significant variations (fig. 2).

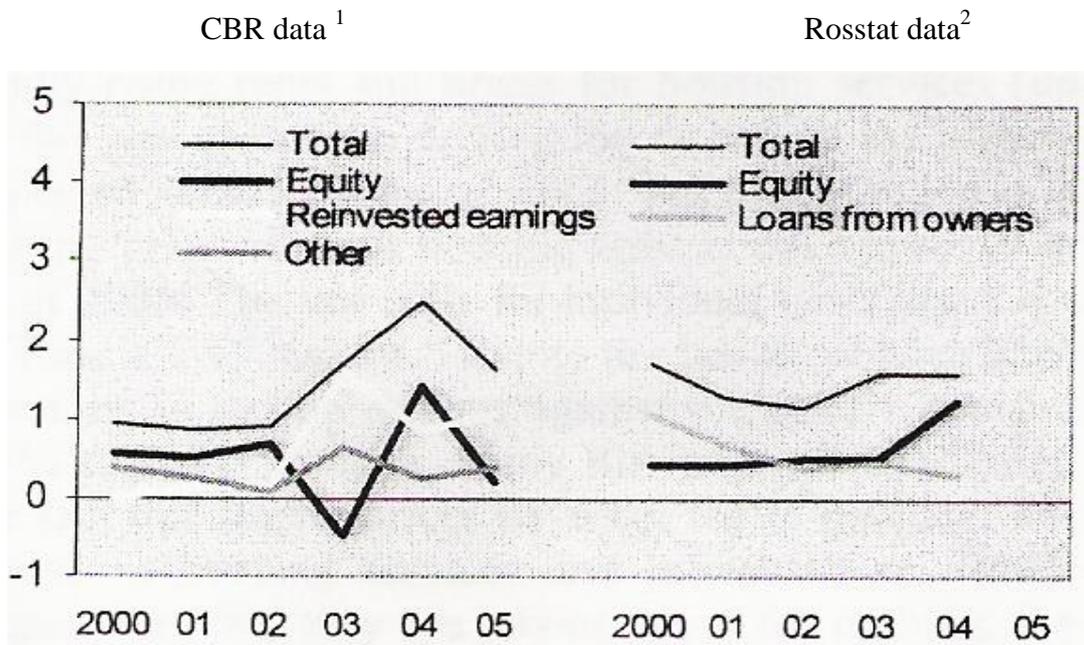


Figure 2. Foreign direct investment inflows into Russia, % of GDP

Source: Bank of Finland, 2006

On the figure 2 (CBR data) it is clearly seen that those companies which has already been established in Russia with the collaboration of foreign direct investors, showed notable increase in reinvesting their earnings to the further production expansion (\$8 billion USD in 2005). In spite of the fact that the amount of loans from foreign owners has been declining during the year 2004, this value was equal to \$2 billion USD in 2005. This fact can also be viewed as a sign of companies' expansion.

Talking about FDI into equity, the figure 2 demonstrates that information about this value is quite contradictable – according to balance-of-payments (CBR data) FDI into equity decreased

<sup>1</sup> Central Bank of Russia (CBR)

<sup>2</sup> Federal Bureau of State Statistics (Rosstat)

sharply during the last year, however reference to Rosstat data indicates that the amount of FDI into equity has gone up considerably. Nevertheless, both graphs show that the equity value was subject to dramatic fluctuations. The explanation for this observation could be the fact that the transactions such as acquisition or selling companies by foreign direct investors to Russian investors influence greatly the relatively small volume of FDI into equity in total (BOFIT Russia Review, Bank of Finland, 2006).

If we look at the absolute values of FDI to Russia, (according to Rosstat) they subject to fluctuations to since 1999 (table 3).

Table 3. Dynamic of absolute values of FDI to Russia, 1999 - 2004

	Years					
Foreign direct investment (mln. USD)	1999	2000	2001	2002	2003	2004
	4 260	4 429	3 980	4 002	6 781	9 420

Source: Rosstat, 2005

## ***Chapter 4. Distribution of foreign direct investment in Russia among regions***

The significant infusion of FDI to the country has a great influence not only on the country's economy on the whole, but first of all, FDI brings along considerable changes in regional economies as well. The instances of these changes on the regional level can be observed on the examples of China, Hungary and some other countries in the Central Europe.

The major concern in this regard is that the opportunities of each region in Russia to attract foreign direct investment vary greatly. Some regions are obviously more successful, whereas the others are much less. For example, the regions such as Moscow city, St. Petersburg, Krasnodar krai, Sakhalin oblast' have been experiencing the positive effects of FDI due to the fact that they managed to attract the significant amounts of FDI during last years in comparison with the other regions.

However, it is worth to point out that this obvious inequality in FDI distribution leads to substantially increasing economic differentiation between the Russian regions. As potential outcomes of this situation, the high income diversification between the regions and social dissatisfaction could be named. Thus, it is obvious that all these mentioned above make the local authorities as well as researches in Russia and abroad to be pretty much interested in the issue of regional FDI distribution and, what is more important, its implications.

### ***4.1. Study on regional FDI distribution – 2005***

In the year 2005 Japanese economists – Ichiro Iwasaki and Keiko Suganuma (2005) – made a study with the aim of testing the two major hypotheses: to confirm the findings that point out on the clear differences between the regional distribution of FDI in Russia and to test if there is a clear geographical pattern which can explain the allocation of FDI among the Russian regions. Moreover, the searches have developed the econometric models aiming to test the hypothesis which suggest that the changes in the regional FDI distribution could have happened after the financial crisis in Russia in 1998.

The major figures and statistical data that the study is based on are displayed in the appendix 2. However, as a serious limitation of this study could be named the fact that only 64 Russian regions were taken into consideration. The major conclusion that can be drawn judging from the data in the table 2 is that the variation of the amount of FDI that reached each region in particular during the period of time from 1995 till 2003 is extremely high. This is based on the following facts:

✓ each year the difference between maximum and minimum values of FDI is extremely large (the difference between the maximum cumulative value of FDI and the minimum cumulative value of FDI accounts 14,4 billion USD);

✓ the value of standard deviation is quite large (1,9 billion USD);

✓ the dispersion of individual data in each region from the mean value is significant.

Talking about the geographical FDI distribution, the interesting conclusions can be drawn as well. If we consider the case of China, the clear geographical pattern of FDI distribution along the country can be observed: the majority of multinational corporations are located along the country's coastal line. The main features of FDI distribution in Central and Eastern Europe countries are:

- 1) the major FDI flows are concentrated along the border with EU;
- 2) the density of FDI flows are also high in the capital cities and the adjacent areas.

None of these patterns suits to regional FDI distribution in Russia. It is not necessary at all that the major FDI stocks are located in the border- or coastal zones. The regions which attract the major amounts of FDI are not always situated in proximity to the capital city – Moscow.

#### ***4.2. Main conclusions of the study – 2005***

The major conclusion the Japanese researchers came to is that FDI in Russia forms a mosaic in which the concentrations of FDI are scattered throughout the federation (Ichiro Iwasaki and Keiko Sukanuma, 2005).

Moreover, one should also keep in mind that the clear polarization with regard to FDI does exist between the Russian regions (see chapter 3.1). The data shows that cumulative FDI value during 1995-2003 was above 1 billion USD only in six regions in Russia (fig. 3), whereas in the other 50 regions this value has never reached the amount of 1 billion USD (fig. 4, 5).

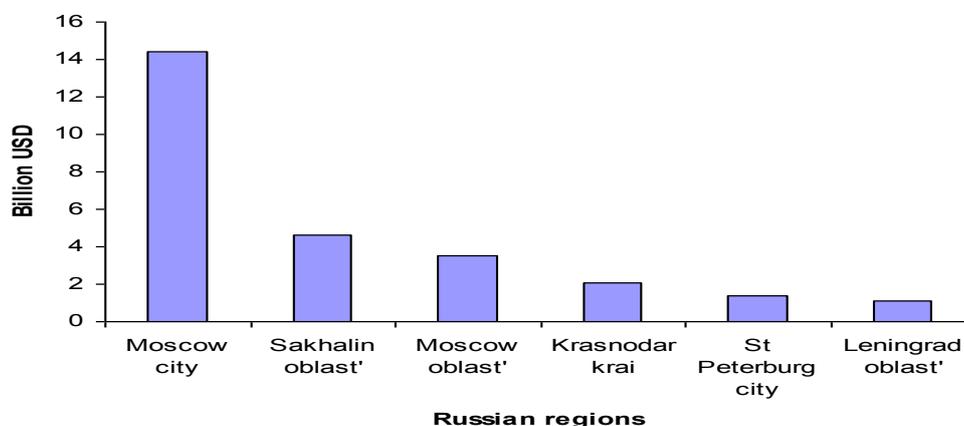


Figure 3. The most successful Russian regions in attracting FDI during 1995-2003

Source: Iwasaki and Sukanuma, 2005.

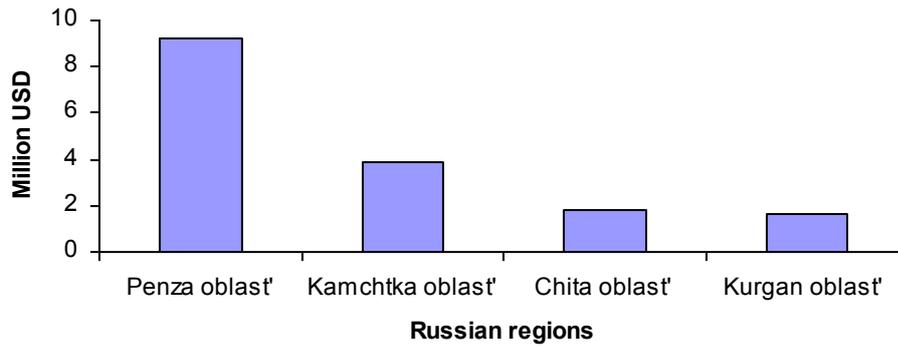


Figure 4. The least successful Russian regions in attracting FDI during 1995-2003

Source: Iwasaki and Suganuma, 2005.

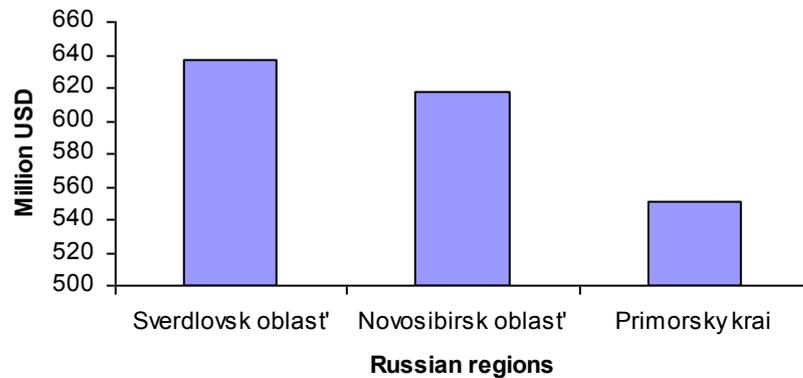


Figure 5. Close to the average Russian regions in attracting FDI during 1995-2003

Source: Iwasaki and Suganuma, 2005.

Thus, taking all the facts mentioned into account, the major conclusion regarding the regional FDI distribution in Russia is that there are other factors rather than geography, which could explain the scatter distribution of FDI along the Russian territory.

Since the mid 1990s there were a lot of studies carried out aiming to investigate the factors which could determine the mosaic distribution of FDI along the Russian territory. One of the first papers devoted to this topic was written by Bradshaw (1997). His major conclusion was that in spite of the fact that at the beginning and mid 1990s the Russia's endowment with natural resources and their exploration were the major factors for attracting FDI to Russia, the situation had changed in the late 1990s: manufacturing for the domestic Russian market had become the focus-activity for foreign investors. All the following studies and researches on the determinates of FDI distribution in Russia were mainly concentrated on testing the influence of the particular investment factors which could be arranged in the three large groups:

- ✓ size of market;
- ✓ the level of urbanization and industrialization;
- ✓ environmental factors.

However, for the econometric model developed by Iwasaki and Suganuma in their study on determinants for FDI allocation in Russia, the following four investment factors were taken into consideration:

- ✓ market;
- ✓ investment policy;
- ✓ socio-economic development;
- ✓ environmental factor.

The econometric analysis based on these factors has shown, firstly, that within the period from late 1990s till 2003 the prevailing investment factors were the abundance of natural resources in Russia, large capacity of Russian market as well as factors of social-economic development. Secondary, the hypothesis that the changes in the regional FDI distribution could have happened after the financial crisis in Russia in 1998 – was not supported.

The structure of the FDI in the period 1995-2003 (see appendix 3) also suggests that the main FDI inflows were directed to trade and catering, fuel industry, food industry, transport and general business activity. Here it is worth to mention that the prevalence of the investments to fuel industry and to other domestic-oriented sectors corresponds very well with the first finding of Japanese economists. Moreover, Japanese researches also claim that this industrial structure of FDI could be used as the other evidence which proves the idea of the mosaic-like geographical distribution of the foreign capital. What is more, the scientists suggest that in spite of the fact that Russian economy development sometimes displays some of the features which are similar to those called Dutch diseases<sup>1</sup>, the development of the sectors other than energy does take place. The argument regarding the Dutch disease is mainly based on the fact that Russian receives the large revenues from exporting oil and gas resources, however in light of current increase of the prices for this resources Russia could enjoy the extra revenues, but the further development of the country's economy will be determined by the government's abilities to utilize the financial resources gained for balancing the Russia's production sector. This could be an auxiliary factor which could assist in developing those sectors of economy which do not enjoy the sufficient

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<sup>1</sup> Dutch disease is an economic concept that tries to explain the seeming relationship between the exploitation of natural resources and a decline in the manufacturing sector. The theory is that an increase in revenues from natural resources will deindustrialise a nation's economy by raising the exchange rate, which makes the manufacturing sector less competitive. However, it is extremely difficult to definitively say that Dutch disease is the cause of the decreasing manufacturing sector, since there are many other factors at play in the economy. While it most often refers to natural resource discovery, it can also refer to "any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance, and foreign direct investment. "Finance & Development. A quarterly magazine of the IMF", 2003.

amount of FDI. Thus, Iwasaki and Suganuma believe that in case such relatively balanced development continue, Russia has chances to become one of the worlds centers for production being more integrated into the worlds economy. Under these circumstances and due to the logistics efficiency under international specialization, Japanese researches conclude that FDI inflows to Russia's economy could be possibly geographically concentrated in future mostly along the borders and coastal regions. This guess is mostly based on the similar situation which is currently going on in China and Central and Eastern Europe.

Thus, the overall conclusion of all stated above is that the contemporary mosaic-pattern of FDI distribution along the territory of Russia could possible change in future and a new geographical pattern has high chances to appear.

## *Chapter 5. Main barriers and obstacles to FDI to Russia*

Generally speaking the economic situation in the sphere of foreign direct investments to Russia can be characterized as a mismatch between the hopes and expectations of potential inward investors and the perceptions of Russian recipients. There is a point of view shared by many economists, which states that the obstacles such as contributions to restriction of opportunities for potential investors, existence of unhelpful infrastructural conditions and, on top of all that, the lack of governmental support likely originate from the wide misunderstanding of the potential advantages that FDI could bring to economy and society. So, these particular misunderstandings reflect tensions and conflicts between outward declaration and popular acceptance of the market economy, the particular expectations of positive economical changes, and the persistence of the values and practices of the former Soviet Union order.

Describing the current state of Russian economy, many western economists (for example, Dunning, 1994) come to the conclusion that Russian's particular historical, cultural and political circumstances determine country's inability to attract the substantial amounts of FDI to a great extend. These circumstances mentioned led to the failure of the market system to develop, the failure of the economic reform process. They have also contributed negatively to the establishment of appropriate conditions under which local business and trans-national corporations can operate freely and at their own discretion.

Thus, it makes it possible to conclude that these circumstances, which mainly derive from the Soviet Union time experience, lead to the misunderstanding of those economic and social relationships which build the basis of modern capitalism contributed to such major barriers which help to explain insufficient DFI inflows to modern Russia:

- ✓ the country's taxation and legal infrastructure;
- ✓ the presence of the oligarchy, and the prevalence of crime and corruption;
- ✓ Russia's political and economic culture, and its impact on government reform policies;
- ✓ privatization and the failure of domestic enterprises and managers to adapt to competitive market conditions (Jones, Fallon and Golov, 2000).

### *5.1. The country's taxation and legal infrastructure*

In spite of the fact that according to some economic surveys Russia's environment for development of FDI looks quite encouraging the country's taxation and legal infrastructure seem to be one of the major constraining features. To my point of view, it is obvious that the process of transformation from the former administrative economy to the market economy requires not only

the institutional change which would positively contribute to creation of encouraging and well-functioning taxation and legal framework, but also sufficient period of time which would be enough to adapt to these changes, to realize and understand them thoroughly. I personally think that these changes are taking place in Russian economy nowadays; however there is a main reason which slows down the process of changes and does not allow it to go on in more rapid rates – this is the preoccupation of the Russian state with its own affairs and matter rather than with the promotion of business. However, it is also true that we can not expect rapid changes because relatively short period of time passed since 70-years long communism system had collapsed.

The wide range of obstacles for foreign direct investors associated with the modern Russia's taxation system were mentioned by Chmelyev (1998) in his report which contained recommendations to investors and was issued on behalf of the American Chamber of Commerce in Moscow. These are the following:

- ✓ instability and frequent changes to the tax system;
- ✓ overstated penalties in case of tax underpayments. These penalties can significantly exceed the amount of tax itself.
- ✓ incompleteness of the tax decrees which gives opportunity to tax inspectors interpret them in the most favorable way for their personal interests;
- ✓ existence of too many taxes imposed on federal, regional and local levels;
- ✓ the confusion caused by presidential decrees and amendments which modify the existing tax laws.

Thus, it goes without saying that both meeting the tax requirements and keeping eye on all changes and amendments make it difficult to carry on any business activity both for foreign direct investor and for local ones.

Even through Russian government impose quite a lot of taxes the business sector, it is found to be difficult to collect the tax revenue in the full measure and in the proper amount. Some western economists (for example, Thornhill, 1996b) suppose that the main source of difficulty in this regard originates from so-called covert tax arrangements of the government with many very large domestic companies. According to Thornhill, the tax authority estimated that around 60% of the companies' tax debt is shared by the 1 000 large companies. The explanation of this fact is that these larger companies possess the political lobbying power, which gives them opportunity to get government tax breaks or even forgiveness for the accumulated debt. As a result much of the private business sector goes without contributing to the government tax revenues. Taking this fact into account, Thornhill believes that this situation is extremely unfavorable for foreign investors who get used to writing comprehensive and transparent

accounts and paying taxes conscientiously, because it makes them to be an attractive target for tax inspectors.

It is also well known that quite a lot of difficulties arise from the principal differences between Western and Russian tax rules. For example, some economic costs which are considered to be the true business costs according to Western tax legislation (such as interest expenses, advertising expenses, expenses for business trips) are not recognized as deductible according to the Russian tax rules. In addition to this, some foreign companies (for example, French company *Le Monde*) pointed out that the company was required to report their financial accounts not less than three times a year. What is more, the company's accounts could become a subject for seizing by the tax police (without recourse to appeal) on the slightest pretext (Jego, 1997).

There is also a common opinion that obstacles to FDI which emerge from the legal infrastructure go hand in hand with taxation barriers. Many foreign investors blame mostly incompleteness and unclearness of the property law and laws associated with ownership of shares and the rights attached to them. Here are the quite picturesque examples of problems encountered with the malfunctioning of legal and bureaucratic processes in the Russian industrial sector:

1) Assi Domain which is the Swedish paper group was the owner of 57 per cent of stake of Karelian Segezhabumprom paper mill at the cost of \$45 million. Assi Domain was the guarantor for the loans taken by Karelian Segezhabumprom paper mill. However, due to the difficulties which originated from the disputes over the taxation, the Swedish paper group had to withdraw its support for the loans and the disputes ended up when Karelian regional government declared the fact that Assi Domain's share ownership was illegal (Burt, 1998).

2) IBM was compelled to close the assembly plant that could not compete with its own machines which were imported duty free by a favored importer (Thornhill, 1997).

3) Both Radisson and Marriot (the American Hotel companies) experienced difficulties establishing who owns the hotels which they manage in Moscow and the status of their holding in joint venture arrangements (Boulton, 1994).

To conclude, the difficulties created for the FDI by the Russian taxation and legal systems are likely to reflect the tensions within the country's political and economic process.

## ***5.2. The presence of the oligarchy, and the prevalence of crime and corruption***

The presence of so-called oligarchy in modern Russia is considered to become an additional feature of the contemporary Russian economy. The significance of oligarchy is reflected in its ability to exercise the state power in its own behalf and to take personal advantage of it. The existence of special relationships between the state authorities and oligarchs, oligarchs' ability to influence over the disposition of state property, as well as the fact they possess the

particular power over the mass media and business – all these facts obviously place oligarchs in a strong position to decide the conditions and directions in which the processes of economic reforms will take place in Russia.

It is interesting to point out that some specialists in the history of economy compare contemporary political development of modern Russia with Western European feudalism in the middle ages (Shlapentokh, 1996). They say that as in feudal society, the power of institutions in modern Russia arbitrary while many operate in some particular narrow private interest. In this situation public authority is co-opted to private interest and use, and this problem does not a distinctive character of some regions in Russia, but it extends across Russian society involving in most cases crime and corruption. What is more, the entire concept of *Krysha* or roof appeared out of it. The concept is quite broad and has variety of manifestations. At one end this concept demonstrates itself as special type of protection which is given to private vendors and street sellers usually by street criminals (or sometimes even by the police in exchange of good payment). At the other end it refers to a higher level sponsorship, which means exercising the power or favors being available to those who are employed by the state for high positions or those who were delegated political power that derives from the authority of their office. For example, former Russia's Prime Minister Chernomyrdin (who used to be a chairman of large gas monopoly GAZPROM) was suspected in providing special support to his former organization by allowing its survival in spite of earlier government plans for its break up as a logical step of a general deregulation concept of Russia's oil and gas industries (Shlapentokh, 1996).

There were also quite a lot of disputes in the period of president election in June, 1996 regarding Yeltsin's financial support and media power which, they said, he was provided by several oligarchs who controlled about 50 per cent of that days Russian economy. Western mass media accused those oligarchs (who called themselves reformers) of being hostile to deregulation of Russian economy and to foreign access to Russian investment opportunities. As major beneficiaries of the privatization process, they were perceived to take advantage of special arrangements to acquire important Russian assets at knock-down prices (Naudet, 1996). There were rumors that in return for providing Yeltsin their support in 1996, two of these oligarchs were given high government posts. Later, President Yeltsin's was accused of the utilization of state power in his own favor by providing special privileges and rights to import goods to Russia to his personal friends.

However, some reformist Russian politicians, as for example, Chubais (who is currently the Chairman of the Unified Energy System of Russia) have defended the oligarchs claiming that they are the only ones who can offer the best possible prospects for the future of Russian capitalism and oligarchs will inevitably seek to secure legitimacy as the best way of securing their own gains (Freeland, et al., 1997). On the other hand, it is worth to point out that flourishing

of oligarchy is not necessarily a positive factor for attracting FDI to Russia, because oligarchy in essence represents a barrier to establishment of the rule of the law in Russia due to the fact that much of its affairs are conducted in a very questionable manner (Service, 1997). Nevertheless, we can not deny the fact that there were some trans-national corporations (TNC) which did participated in co-operation with some oligarchs in connection with FDI in Russia. But the truth is that these relationships are extremely fraught with difficulties, because those outsiders could be drawn into compromising themselves through being involved in illegal activities and/or tax evasion (Jones, Fallon and Golov, 2000).

Many Russian and foreign economists agree that corruption and criminality obviously create further barriers for foreign direct investors to overcome. The definition for corruption states that this is an opportunity available only to those in authority, thus unless the corruption exist at the highest levels of Russian politics and society there is almost no chances to achieve competitive advantage.

Another aspect of this problem is extension of corruption into the relations between the federal authorities and regional governments. The regional powerful governors and senior politicians are also sometimes got involved in corrupt processes. This fact demonstrates the existence of regional oligarchy. For example, according to Jones, Fallon and Golov, 2000 in Primorskii Krai (Primorskii region) the governor – Y. Nazdratenko – has set up a company including 213 local bosses of the 36 main enterprises in the region called PAKT. Though its links to regional government it controlled export licenses and the distribution of local quotas, while it has also acquired shares in local privatizes companies at knock-down prices in non-public auctions. It has also been accused in the major embezzlement from the regional budget, while its companies and members have been accused of large-scale tax evasion.

To sum up, it goes with out saying that existence of criminal and corrupt practice, especially in the spheres where they have direct influence on business and/or competition, do prevent foreign direct investors from starting their business in Russia.

### *5.3. Russia's political and economic culture, and its impact on government reform policies*

The time period from 1922 till 1991 is known as the time during which the Union of Soviet Socialist Republics was established. During 69 years one of the world's superpower country was under the communist regime. Thus, it is no wonder that the common experience of all Russians, especially those who are in management or government is communism. This fact clearly demonstrates that the ideas of democracy and market economy have to be learned and acquired from scratch. Even nowadays, in the era of economic transformation and reforms the traces of Soviet Russia and organizational institutions inherent to communist era are still quite

visible in contemporary Russia. For these reasons the on-going reforms and transformations in post-Soviet Russia should be probably seen in the broad terms – namely, as a rejection of communism. In addition to this, one should keep in mind that the experience of communism in Russia is longer and deeper than anywhere else in the former communist bloc. It should be not surprising then, that whatever the enthusiasm of the reformers for capitalism, the institutions and culture of communism have persisted, contributing to negative reactions towards FDI (Jones, Fallon and Golov, 2000). Trans-national corporations, for example, that have invested and started their business in Russia complained of the hostility of local Soviet-era bureaucrats, whose poor understanding of how a market economy works can derail deals agreed at the federal level (Thornhill, 1996a).

In other words, foreign investors should first of all understand that both the political and economic culture of Russia has originated out of communism, and even the rapidly imported ideas of market economy, have to take account of that inheritance.

In 1992 the reformation process began in Russia. The four major aspects of this process were (Kuznetsov and Kuznetzova, 1996):

- ✓ liberalization of all prices in the framework of light monetary and budget policy;
- ✓ providing total freedom to all forms of business activities;
- ✓ to start the process of privatization and remove the monopolies of state enterprises;
- ✓ to introduce social policy in order to compensate the impact of the creation of free market.

These reforms which are well-known as the shock therapy reforms were implemented by Russian government with the aim of achieving a quick transformation from command to market economy. However, the majority of Russian economists share the common opinion that these reforms were held with great incompleteness, imperfection and glaring mistakes. They also established confrontation and disputes between the reformers and the gradualists (those who oppose and resist the process of reformation and those who tried to push it through reckoning on taking personal advantage (for example, oligarchs). These drawbacks of the reformation process, which are also blamed to be the significant obstacles to attract large volumes of FDI, contributed to creation in the mid- and late 1990s in Russia a phenomenon called *faux capitalism*, which can be defined as maintaining the ingrained inefficiencies of communism while depriving market participants of protections from the rule of law or the advantages of competition. (This type of fake capitalism was also observed in post-communist China (Lingle, 2002). The existence of this phenomenon demonstrated that some of the elements of the Russia's reform process were obstructive in the creation of proper conditions for growth, while institutional and infrastructural reforms that could create beneficial conditions in which both domestic and foreign investment might be combined effectively, have been neglected and opposed. It is a well-known fact the

Western-style market economy (and the idea of capitalism itself) bases on the supportive institutional arrangements, taxation and legal framework. In addition to these, an approving culture and ethics are required to make private companies to function within the acceptable risk range. All these factors did not just appeared or were imported to the West; all these were clearly outcome of a historical process. What is more, the spread of global market economy is also relatively recent phenomenon, which is based on the slow and gradual acceptance of the values of free trade and FDI. Thus, in this form market economy is much younger than the communism. For this reason it should not be surprising that the institutional framework for global market economy which is supposed to replace the communist's one in Russia has not simply appeared yet (Jones, Fallon and Golov, 2000).

All these mentioned above makes it also easier to understand that Russia's cultural inheritance has also created, to a certain degree, conditions in which FDI is often viewed with suspicion. This could be especially relevant to the Western investment to the industries which deal with the exploitation and development of natural resources (such as oil, gas, fish resources as well, etc.) This foreign participation is often seen with a degree of suspicious and sometimes even regarded as colonization (Jones, Fallon and Golov, 2000).

#### ***5.4. Privatization and the failure of domestic enterprises and managers to adapt to competitive market conditions***

The process of privatization was an integral part of the reforms which have begun in all Post-Soviet countries. However the results of privatization varied from country to country greatly. Comparing Russia's privatization experience with similar experience of other former Soviet Union countries, economists and analytics point out that the nature of privatization has become, to some degree, another obstacle to the development of FDI, preserving pre-competitive forms of management and operation (Hughes and Helinska-Hughes, 1998). In theory privatization should place the key role driving economic change within an economy in the process of transformation. It should stimulate microeconomic response to price and trade liberalization, which are seen as central driving forces to the transmission mechanism of the process of transformation from the communist and market economy. The process of privatization is also supposed to offer specific opportunities and stimuli to foreign investors to participate in FDI mainly by taking control of, or sharing control of, and investing in already existing production. It is considered that in case these circumstances are achieved, the opportunities for effective joint ventures in which technology transfer, and the other advantages and benefits listed above can occur, should be favorable (Jones, Fallon and Golov, 2000).

However, according to the results of the privatization process, which took place in Russia in the mid 1990s, the levels of foreign participation through share ownership in former Russian state-owned companies still remained low. Thus economists usually mention two main reasons for this:

- ✓ natural distrust to risky market and business;
- ✓ outcomes of Russian privatization.

Russian economists Kuznetsov and Kuznetzova (1996) carried out the survey with the aim of tracing the changes in the structure of ownership of Russian organizations between 1991 and 1995. The main results of this survey showed the major features, which are:

- ✓ the dominance of insider shareholders, both managerial and non managerial;
- ✓ a slow growth in the shareholding of small share holders from outside of organizations;
- ✓ the relatively small growth of large outsider shareholders;
- ✓ the failure of market infrastructure and dynamics to re-distribute shares in ways that might enforce organizational change from the outside.

As it is seen from the results of the survey, the insider owners were dominant. This fact, in its turn, led to the formation of so-called *Nomenklatura Management* kept some aspects of communist system (Kuznetsov and Kuznetzova, 1998). The problem is that the feature that reflect the routine work in pre-privatization Russian organizations were kept almost unchanged even after actual privatization. This happened not least because up to actual privatization managers and directors were able to assume many of the rights of ownership even before the Russian privatization programme began (McFaul, 1996).

In addition to this, it is difficult to deny that privatization's the most strong influence was mainly internal to the companies. This happened due to the fact that the principal method of privatization was to allow managers and company's workers to buy up to 51 per cent of the total amount of company's shares. Probably for this reason it was very difficult to make a distance between ownership itself and control in the companies. However, this particular distance is one of the most important characteristics of capitalist economies and the discipline that implies out of this distance is typical for the Western private companies.

They say that privatization in Russia have helped to emerge companies mainly of the three types:

- ✓ those organizations that preserve or reproduce aspects of the old order;
- ✓ those that serve the short run interests of new managers;
- ✓ those that accepted the ideas of capitalism (Baglione and Clark, 1997).

It is interesting to mention that all three types of organizations manage to survive, however this happened due to different factors. Some companies became successful because they

developed new attitudes to the demand of the market. However, other organizations survived even keeping a large element of the traditional ideology and hierarchy unchanged. Such organizations mainly relied upon the privileged access to state demand, or special rights like, for example, export licenses (negotiated with the use of old private relationships). Some organizations have suffered from the debts and severe financial difficulties caused by their own management.

To conclude, these circumstances demonstrate difficulties for potential foreign investors in Russia in a sense that even if it was easy to obtain the ownership of the companies, there still remained the risk of inheriting the responsibility of paying, for example, considerable debts. Thus, the major turn off for foreign investors was the idea of participating in the economy whose business practice was based substantially on the fulfilling the needs of, and acting within the limits of the demand of state, even after privatization (Jones, Fallon and Golov, 2000).

## ***Chapter 6. A survey-study of foreign direct investors by European Business Club and its conclusions***

In the chapter 4 the main obstacles and barriers for foreign direct investment typical for the beginning and mid 1990s in Russia were listed and thoroughly characterized. However, it would be interesting to find out if the situation changed anyhow in the beginning of 2000s. The purpose of this chapter is to look at how foreign direct investors rank those investment barriers they face in Russia, to look at the reasons why do they still invest in Russia and what are the reasons which are stand behind the companies' presence on the Russian's market, what is their view of Russia's perspectives with regard to FDI.

In order to answer the questions mentioned above, the present chapter will be mostly based on the survey which was conducted by Rudiger Ahrend in the tight cooperation with the European Business Club in Moscow in the year 2000.

### ***6.1. Description of the survey***

There were 50 European companies, which had been developing their business in Russia, took part in the survey. In order to be more specific about the results and outcomes of the survey, all participating companies were split into two groups:

- ✓ those companies which are mainly interested in distribution and selling on the Russian market their goods and services that they produced outside Russia;
- ✓ those enterprises that invest into production of goods on the territory of Russia and then sell their products either on the Russian local market or export.

This distinguish between two groups of companies also serves the purpose which is to see if both groups face the same barriers and obstacles regarding FDI. It is a well-known fact that distribution-oriented companies which have a foreign market as their target market for distribution do not necessary need to establish their presence there. There are many different ways to distribute goods on foreign market, for example, licensing for the production or know-how which gives owner an opportunity to benefit from collecting royalty payments or various forms of subcontracting. Having such questions in mind the authors of the survey asked both groups of the companies about the reasons and incentives which influenced their decisions about entering the Russian market.

As far as the survey also aimed to find out the main difficulties faced by investors with regard to the industry they conduct their business in, for this reason all 50 companies was divided into five industry groups:

- ✓ those which produce industrial goods in Russia;

- ✓ those which are involved in transport activities;
- ✓ those that have only sales and distribution networks on the Russian market;
- ✓ those that provide consultancy services;
- ✓ banks.

During the research the interviewed companies were questioned if the presence of other foreign direct investors on the Russian market influenced the surveyed companies' decision about entering the Russian market; there was also important to find out the ownership structure of the companies, to look at the level of technology utilized by the companies, to analyze factors which determined the company's geographical location decision on the Russia's territory. The identification of the overall level of company's satisfaction with its business results and future plans were also of interest.

### *6.2. Survey's characteristics and limitations*

The survey was carried out by the European Business Club which is located in Moscow during the spring of 2000. All the surveyed companies were members of the European Business Club, however names of the companies were not announced due to confidentiality reasons. The total number of employees working for the interviewed companies varies from 2 to 2 500 (the mean is about 200 employees). The size of the parent companies was also taken into consideration and it varies from 15 to 400 000 employees (the mean value is about 44 000). It was also know that around 33 per cent of those enterprises interviewed were the producers of the industrial goods in Russia, another 33 per cent of the companies surveyed were involved in sales and distribution business, roughly 10 per cent of companies were in banking, another 10 percent – in consulting business and the last 10 per cent were companies that provide transport services.

As an input data it was also known that 46 out of 50 companies involved in the survey were European ones, although those 4 enterprises were not pure European, but they at least had a good deal of presence on the Western European market. Thus, this focusing and taking into consideration mainly European direct investors constrains the authors of the survey to speak about mostly European FDI. Nevertheless, it could be expected that the foreign direct investors from other countries would probably face the similar barriers and obstacles and would be forced to solve mostly the same range of problems making FDI to Russia as the ones that European countries came across with.

Another data limitation is the fact that all of the countries which took part in the survey were represented on the Moscow market. This characteristic feature of the data sample could demonstrate the bias towards the Moscow market. However, I share the opinion that this

limitation is acceptable due to the fact that the great share of FDI goes to the Russian capital market first of all.

Despite the survey described does have some serious limitations, its findings can provide insights into the FDI in Russia.

### ***6.3. The incentives of investing to Russia***

For the purpose of better analysis the survey was split into several sets. The first set contained questions regarding the incentives and factors which influenced the foreign direct investor's decision of launching investment projects in Russia. The criteria which were evaluated by the interviews were as the following:

- ✓ overcoming trade barriers;
- ✓ lower unit labour costs;
- ✓ avoid exchange rate risk;
- ✓ existing cash flow in Russia;
- ✓ lower environmental standards;
- ✓ enter Russian market;
- ✓ qualified labour force;
- ✓ lower general production costs;
- ✓ avoid transport costs;
- ✓ tax breaks;
- ✓ availability of raw materials;
- ✓ enter the 3<sup>d</sup> market from Russia;
- ✓ proximity of the market;
- ✓ size of the market.

Those questioned were asked to evaluate these criteria on the scales from the least important to the most important ones (fig. 2). The results of the research have shown that the large size of Russian market criterion dominated clearly. The enterprises which were involved in industrial production and transport industry pointed out that nearness to their home country played an important role. However, for other industries this factor was much less important. The next important reason for placing FDI in Russia is overcoming trade barriers. It was clearly seen from the results of the survey that this factor was equally important for companies in industrial sector and for those companies which conduct their business in distribution and sales, and transport activities. In addition, those interviewed reported that they also considered well-

qualified labor force in Russia and low labor costs which was fairly significant for making their investment decision.

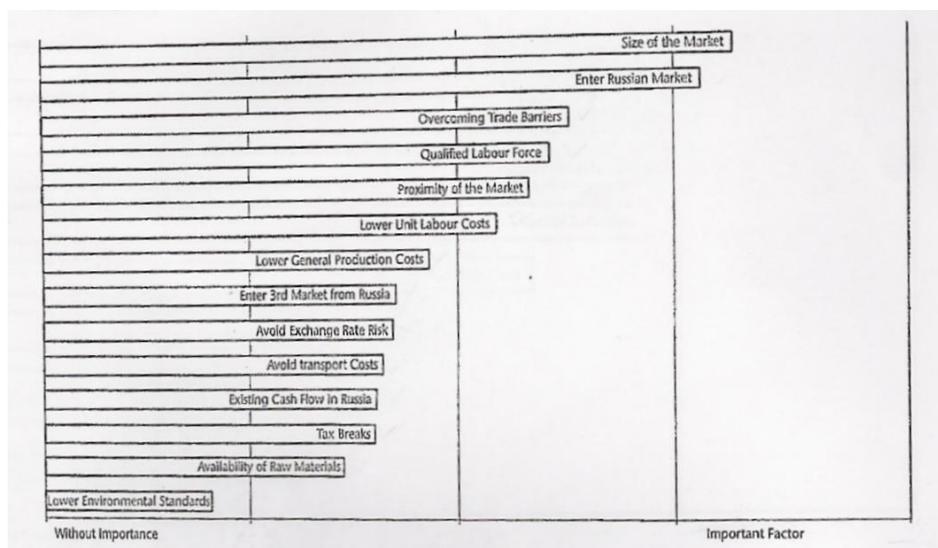


Figure 6. Importance of factors which motivate companies to place FDI to Russia

Source: Ahrend, R. (2000).

It was also the interesting finding that the main aim of the companies which were established in Russia with FDI is serving the local market, but not exporting. This was proved by the fact that Russian subsidiaries on average have a low share of export (12% of the output<sup>1</sup>), and the actual companies established in Russia export even less – about 7 % of their output.

The criterion of the avoiding transport costs was ranked lowly with the exception of companies in distribution and sales business. All the rest factors, such as entering 3d market from Russia, avoiding exchange rate risk, existing cash flow in Russia, tax breaks, availability of raw resources – were listed as those with the minor importance. However, the reason of placing the availability of raw resources on the one of last places could be explained by the suggestion that other countries, such as USA, are more interested in placing their FDI there than European ones.

Eventually, lower environment standards are of almost no relevance for FDI companies' decisions (Ahrend, 2000).

<sup>1</sup> According to Ahrend (2000) the largest share of the exported goods goes to EU countries. Some goods exported to the Commonwealth of Independent States (CIS) and CEEC countries (Central and Eastern Europe and Baltic States).

#### 6.4. What is more preferable – production or licensing?

During the survey it was also investigated why foreign investors prefer to produce in Russia instead of working through the licensing or by means of other forms of subcontracting. The following criteria were suggested to be ranked by the participants of the survey:

- ✓ to keep control over profits;
- ✓ to keep control over marketing;
- ✓ to control product quality;
- ✓ protection of know-how;
- ✓ to control cash flows;
- ✓ access to market know-how;
- ✓ state requirements;
- ✓ access to buildings and production know-how.

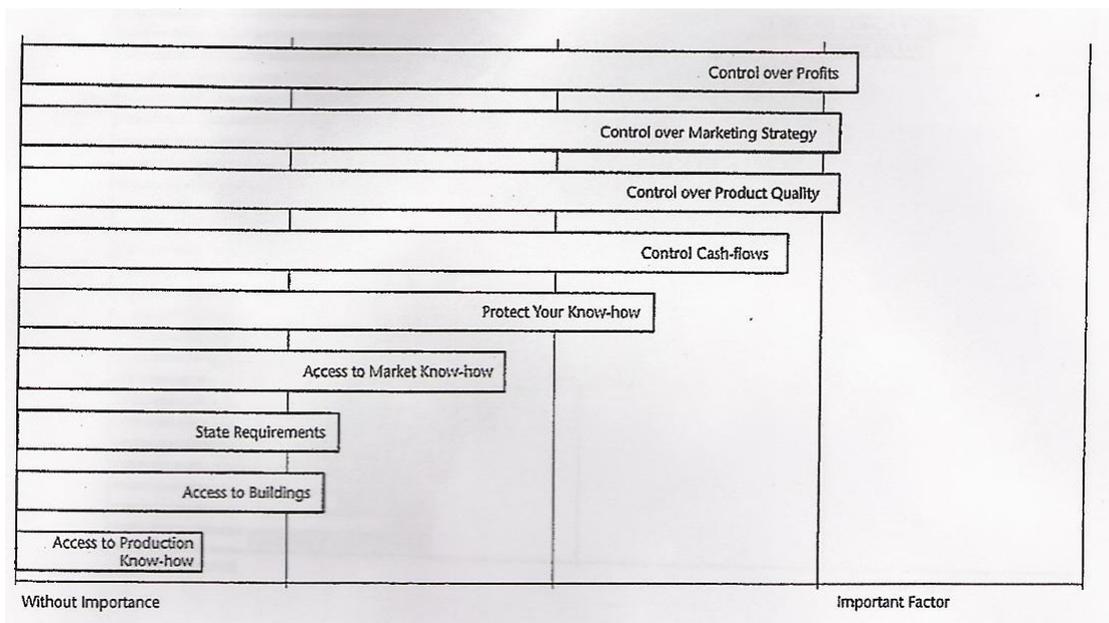


Figure 7. Motives for establishing production in Russia instead of using licensing systems  
Source: Ahrend, R. (2000).

The obtained results (fig. 7) indicated that the priority was clearly given to the first three factors. Keeping control over the cash flows was slightly less important. Two factors such as know-how protection and access to market know-how are of next priority and of very limited significance and relevance to interviewed companies. Only two factors – state requirements and access to buildings and production know-how - were named of having no influence on the

enterprises' decisions to produce using their own facilities rather than utilizing subcontracting or licensing arrangements (Ahrend, 2000).

**6.5. The major obstacles and problems mentioned by foreign direct investors in Russia**

For the purpose of identifying the main problems which foreign direct investors could potentially face with the organizers of the survey worked out a questioner which contained 25 criteria and asked the investors to rate these factors starting from those which according to their point of view were the most important and ending up with those which were least important (fig. 8).

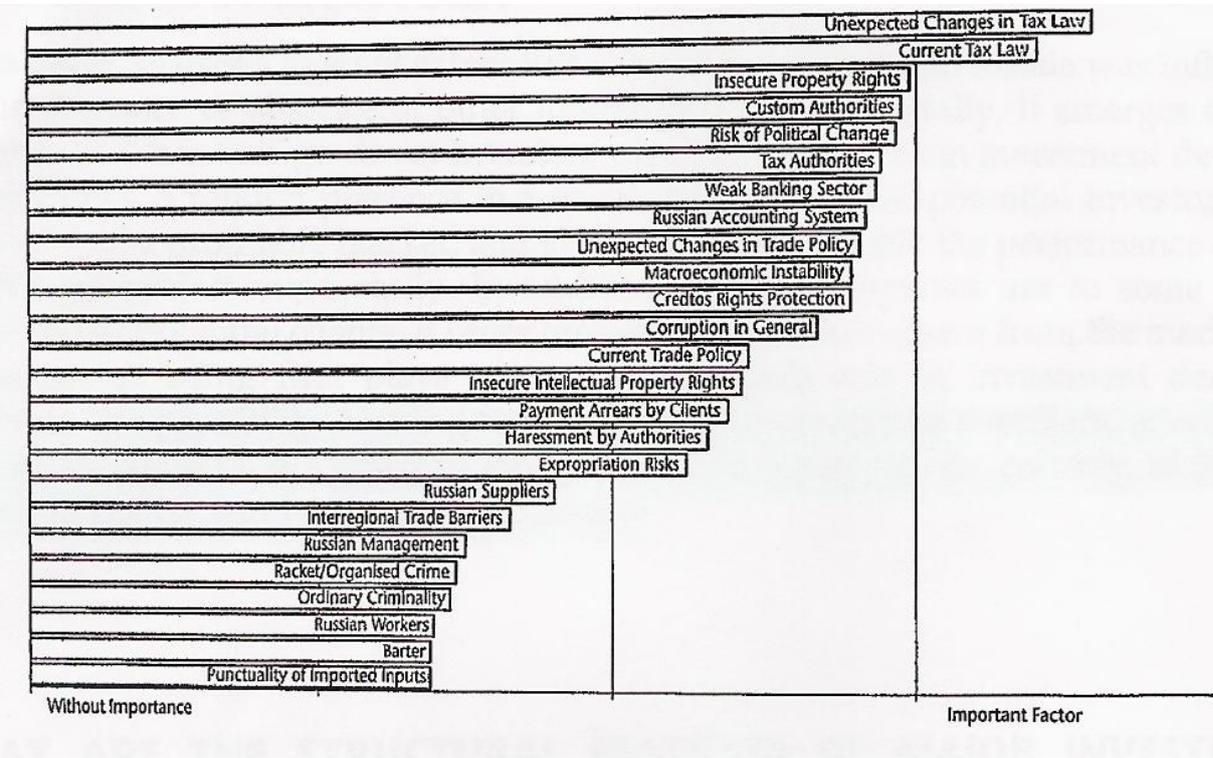


Figure 8. Problems faced by foreign direct investors in Russia  
 Source: Ahrend, R. (2000)

As it could be expected, the most important problem mentioned is unstable and inadequate tax legislation. The fact that this problem was appointed as a problem number one, fully corresponds with the conclusions drawn in the chapter 4.1. and supports the idea that the problem of incomplete and ever-changing tax legislation existed in Russia in the mid- 1990s and is still present up until the beginning of 2000s. Despite any attempts, the Russian Government can not manage and sort it out.

The fact that the insecure property rights factor has also been highly ranked prove the hypothesis that legal infrastructure still deserves a lot of improvement (chapter 4.1).

Next in the order were listed problems with custom and tax authorities, the risk of political changes, weak banking sector, complicated Russian accounting system and macroeconomic instability in general. It was also a very interesting finding that foreign direct investors prioritize problems with tax legislation much higher than difficulties that they face dealing with the tax authorities, which are suppose to work on enforcing the tax legislation in Russia. It is even more interesting that the reverse is true when it comes to rating customs authorities and Russia's trade policy. As it is well seen in the figure 8, those interviewed consider problems with customs and changes in international trade policy as bigger problems than the Russian trade policy itself.

Rating expropriation risks and harassment by authorities as the factors which have moderate importance could probably be viewed as a positive trend in improving Russia's investment climate in a sense that this could be regarded as gaining more trust to Russian authorities on both federal and local levels. Insecure intellectual property rights and payment arrears by clients are put at almost the same temperate level. However, talking about intellectual property right, it is worth to point out that that this criterion was rated lower than the property rights in general. This quite often stands even for those companies which utilize more advanced technologies in Russia – they still prioritize problems related to property rights in general higher than the intellectual property rights (Ahrend, 2000).

Another positive finding of the survey is that foreign direct investors are quite satisfied with the way Russian suppliers work, their punctual delivery as well as with qualifications and skills of Russian managers and workers, whose professionalism is at a pretty high level and do not cause any major difficulties to the companies owners. It is also could be regarded as a proof that Russian workforce is able to meet Western labor standards. However, in case the latter is true and the average wages ratio in Russia comparing to the Western countries is about 1:10, why foreign direct investors still prefer to set up their business in Baltic countries and Poland and Hungary? The possible answer could be that

*“The Baltic states have a dichotomous character owing to the fact that while they are small states that were part of the Soviet Union from 1939-91, their traditions, languages and institutions are linked to the Baltic basin, primarily Scandinavia. Thus, though they are geographically distant from most potential investors, they are psychologically much closer, and this greatly reduces the cost of undertaking operations” (Bevan and Estrin, 2000).*

Other factors such as barter, which is used to be one of the major peculiarities of Russian economy in the beginning and mid- 1990s (after 1998 the barter is not a problem anymore, because Russian currency has stabilized), and organized crime and racket are almost of no importance at least for foreign direct investors. The last point contrasts greatly to the perception that is widely spread in the West.

In spite of the fact that survey demonstrated that the problem ranking is fairly the same across the different industries the surveyed companies belong to, the affiliation to different sectors should also be taken into account. Thus, industrial companies particularly stressed the problems with relation to banking sector, whereas foreign banks rated higher poor protection of the creditors' rights, complicated accounting system and debts caused by clients. Companies which conduct their business in the sector of distribution and sales as well as transport companies suffer more from customs and, probably as a result of this, point out the high level of corruption in modern Russia (Ahrend, 2000).

#### ***6.6. Production or distribution – any difference for foreign direct investors?***

Assuming the distinguish that was made in the chapter 5.1. (the interviewed companies were split into two groups: those which belongs to so-called real sector, i. e. the industrial enterprises which produce goods, and those companies which business is in distribution and sales), the survey aimed to investigate whether there are any difference between these two groups. The research has shown that the difference does exist – the producing companies in Russia appeared to face more problems related to the current tax law, weak banking sector and current trade policy (fig. 9). On the other hand, companies in distribution and sales consider problems with tax and customs authorities' behavior and Russian customer payment debts as those which are of higher importance.

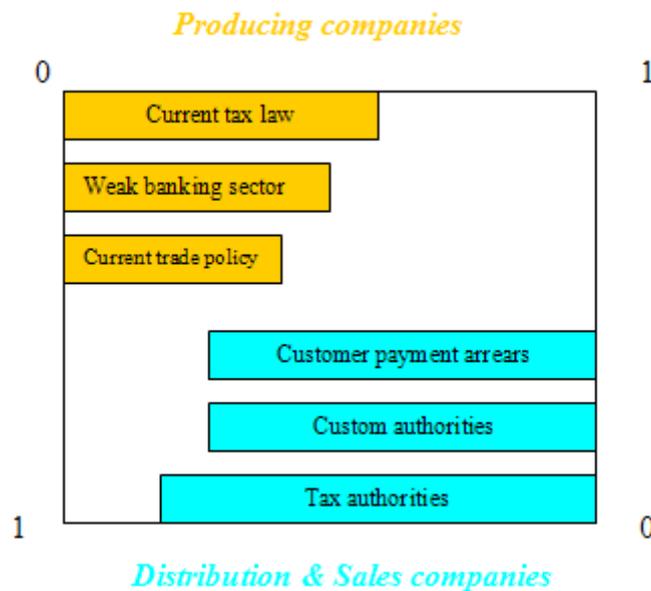


Figure 9. Difference in perception of the investment problems between companies in production & distribution and sales.

Source: Ahrend, R. (2000).

### ***6.7. The presence of other foreign direct investors on Russian market – does it influence investment decisions?***

Sometimes foreign direct investors weight up their decisions whether to invest into particular country or not on the basis of presence or absence of other foreign companies on the market of the host country. This happens, firstly, because the presence of foreign companies on the host country's market could be perceived as a sign of host country's profitable market. Secondly, watching the performance of other foreign companies makes it easier to evaluate and estimate foreign direct investor's own projects. Thirdly, it could also be true that very often some foreign companies could become potential suppliers, distributors or clients for other foreign companies. On the other hand, foreign companies could gain quite high profits being the first ones accessing host country's market.

For this reason the interviewed companies were asked whether their decision to invest into Russia was to any extend based on the fact that other foreign companies had already established their presence on the Russian's market. The results of the interviews showed that the presence of other foreign companies almost does not influence the decision of foreign direct investors to launch their projects in Russia.

### *6.8. Structural characteristics of the investment projects*

The first structural feature of the investment projects which was investigated is the ownership structure of those companies which took part in the survey. It is appeared that the way foreign direct investors structure their business is highly determined by the industry companies belong to. For example, among the companies which are in banking, distribution and sales, and consulting business, none of the companies were established as a joint venture. Vice versa, all of them were fully owned by foreign direct investors. This fact leads to the conclusion that in these sectors of economy foreign direct investors highly prefer 100% ownership. Considering foreign direct investors who established their business in production or transportation – more then 75 % of surveyed companies had shared ownership, such as joint ventures or other joint forms.

It was also interesting to look at the way partners contributed in the joint ventures. Figures showed that in almost 90 % of all cases foreign partners invested the major share of:

- ✓ finance;
- ✓ brand names;
- ✓ management;
- ✓ production facilities.

However, in about 50% of joint projects Russian partners contributed the largest part of marketing know-how as well as building facilities.

Another side of investigating the structural peculiarities of foreign investment projects is to view the competition structure on the Russian market. The hypothesis that the majority of foreign companies coming to the Russian market were looking for the opportunities of establishing the monopolies or oligopolies had not been confirmed. The fact was that only one fifth of the surveyed companies had less than five competitors on their market segment. Thus seeking for establishing monopolies is not the defining stimuli to enter Russian market.

The next problem which deserved investigation was the level and structure of facilities and technology utilized by the foreign direct investors. Taking the whole sample of foreign companies into consideration, the results indicated that about 40 % of them used relatively new technologies and facilities for their projects. In order to talk more precisely about industrial technologies, the researchers have restricted the sample size to industrial enterprises only and found out that the proportion of those enterprises which used fairly new, updated or non-established facilities to those which used well-known and conventional technologies was 30:70. There were no enterprises that reported the use of old and outdated technologies.

The last question which was asked in this section of survey was related to companies' location within the Russian territory. In other words, it was interesting to know why some companies make their decisions to be located in the centre (Moscow city and Moscow region),

whereas other foreign companies prefer to be situated in the regions? Here the following factors matter:

- ✓ tax breaks;
- ✓ large market;
- ✓ location of the partner company;
- ✓ recommended by business climate survey;
- ✓ existing investment;
- ✓ special production factors;
- ✓ recommended by other companies.

Thus, location in the centre was prioritized mainly by those companies which consider the large market as the major factor which determinate their location. As it goes from the results of the survey, for those companies which are located in the regions the decisive factors were location of the partner company and/or special production factor. One of the main incentives for companies located in the regions was existence and further improvement of favorable investment climate in the regions. Among the factors which were the least important for companies' decision of location were tax breaks and recommendations both from business surveys and other companies.

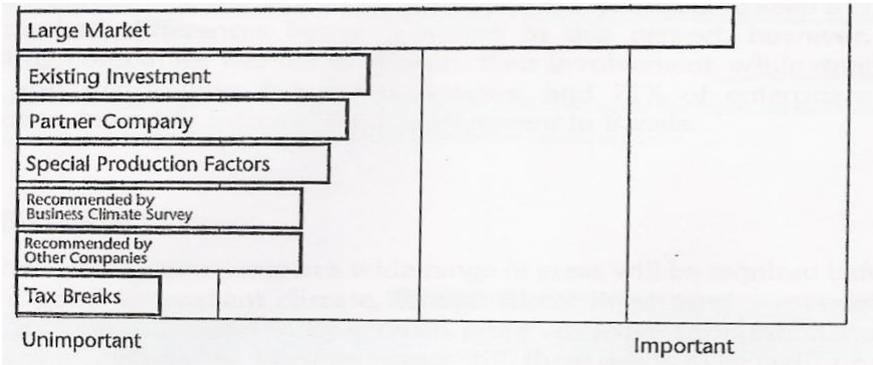


Figure 10. Factors determining location choice for FDI in Russia (companies in Moscow)  
Source: Ahrend, R. (2000).

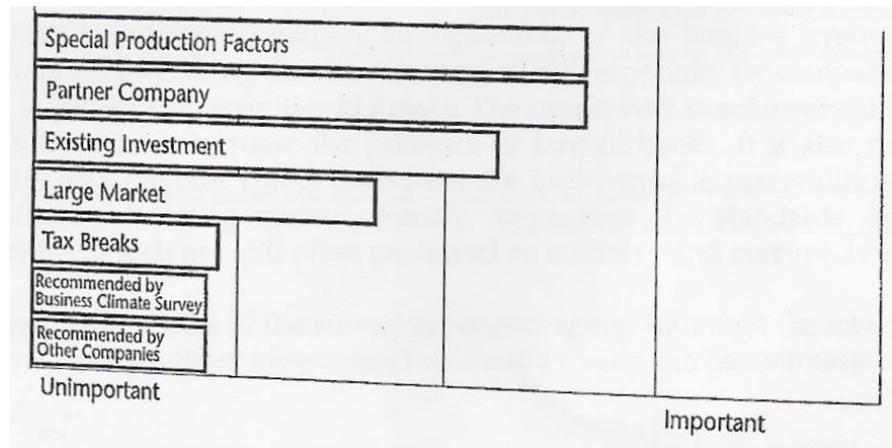


Figure 11. Factors determining location choice for FDI in Russia (companies outside Moscow)

Source: Ahrend, R. (2000).

### *6.9. Perception of the same problems by companies of different size*

While carrying out the survey, it is always interesting to view the situation from the different views. In case of this survey, researches aimed also to look whether small foreign companies and big ones view the situation with foreign direct investments in Russia in the more or less same way.

However, it was found out that there were no striking differences between small and large companies' perceptions of the problems in the sphere of foreign direct investments in Russia. Taking into consideration the size of the parent company and the size of the foreign company's subsidiary located in Russia – it seemed that these two factors does not correlated with either companies' level of satisfaction with investments made or with the nature of the problems which companies came across with here in Russia.

Nevertheless, some large companies reported that they had had problems with representatives of tax authorities and Russian suppliers, whereas small companies claimed to have less problems with those mentioned. Moreover, for large companies are tend to rate difficulties faced with tax authorities higher than those with suppliers.

### *6.10. Prognoses and future expectations*

In order to judge about foreign direct investors' general level of satisfaction as well as to find out prognoses for the future, the authors of the survey asked companies to answer the question: Suppose you did not currently have any investment in Russia. Would you invest in Russia given the experience you have acquired? (Ahrend, 2000). In general (taking the whole survey's sample size into consideration) about 75% of companies answered positively. Across the sectors this percentage remains steady with the exception of banks and industrial production companies. Among the former only 60%, whereas among the latter around 80% would invest into Russia again. What is more, there were no companies at all among those interviewed that intended to decrease their shares on the Russian market. By contrast, more than half (56%) of the companies that took part in the survey responded that they would like to increase their presence on the Russian market in future perspective, while the rest of the companies (44%) admitted that they are planning to keep their involvement at the constant level. Being more precise about the data across the sectors – 71% of the production companies wanted to extend their production; the same is true for about 50% of banks and distribution and sales companies. None of consulting companies and agencies intended to extend their business in Russia in future.

### *6.11. Survey's main conclusions and recommendations*

The main survey's conclusion is that in spite of the fact that the investment climate in general in Russia does deserve improvement, the positions and perspectives of foreign direct investors in Russia appeared to be significantly better than those painted and presented in the Western press and publications.

Among the improvements that have to be made in order to allow the foreign direct investments to thrive in Russia, the first priority has to be given to amelioration of the tax legislation. The foreign companies general requirement is that the tax system to become transparent, reasonable and more predictable. Among other foreign direct investors' requirements are:

- ✓ strengthening of the banking system;
- ✓ better protection of property and creditor rights;
- ✓ improved standards of the customs authorities.

However, the issue of company's governance improvement was not mentioned as a factor which seeks improvement in this European Business club survey (2000).

Overall, the results of the survey are encouraging. Although the total volume is still very low, foreign direct investment into Russia clearly can be a successful undertaking (Ahrend, 2000).

*Chapter 7. Survey results - Norwegian present and potential investors' perception of the possibilities and barriers to their investments into Russia (with particular emphasis on the North-Western Russia)*

*7.1. The survey structure*

First of all, I would like to point out that my impressions from all the interviews and meetings regarding filling in the questionnaire, which supplements this paper, are only positive. No matter whom I made an appointment with, people were always positive and obliging when it came to answering both general questions and sharing personal experiences and opinions. All those interviewed also mentioned that they would be glad to provide me with extra information if it was required.

The survey (see questionnaire in appendix 1) can be roughly divided into four main parts:

the first part - questions 1 and 2 - aims to find out the main incentives and way of investing to Russia;

the second part includes only one question which is supposed to point out the main difficulties foreign investors come across with;

the third part focuses on the answering questions of *what is the target market* for goods produced in Russia and *where* to allocate the production facilities on the territory of Russia;

the fourth set of questions basically looks on the future plans and perspectives of present or potential investors.

The main idea of this chapter is to analysis the results of the present survey and to compare them with those findings of the similar study made by European Business Club in 2000 (this study is described in details in chapter 6). In addition to this, the conclusions drawn in this chapter will be supplemented by the results of the study *The determinants of foreign direct investment in transition economies* made by A. A. Bevan and S. Estrin in 2000.

It is worth to mention that some of the findings in this chapter could be surprising and not easy to interpret, whereas other ones looked quite predictable.

*7.2. The main incentives to Norwegian FDI into Russia and their entry modes*

Looking at the results of the first part of the survey (fig. 12), it is clearly seen that the major incentive for investing to Russia is entering the large scale market. Companies interviewed pointed out that their interest in entering Russian market is mainly due to its constantly growing

nature and development as well as increasing consumer power of Russian population and relatively stable level of unemployment (table 4).

Table 4. Dynamic of average wage and unemployment in Russia since 2003 until 2006

	2003	2004	2005 (expected)	2006 (expected)
Average wage, USD	180	237	301	329
Unemployment, %	8,7	7,6	7,7	7,7

Source: Bank of Finland Russia Review 3/2006

In addition to this, it could be interesting to mention that Bevan and Estrin (2000) in their research on the determinants of foreign direct investment in transition economies have confirmed the so-called market size hypothesis that larger host countries are associated with greater FDI owing to greater market opportunities for investors .

Those companies which have their production facilities in Russia such as, for example, Gigante Pechenga AS (fish farming in Pechenga region, N-W Russia), NORUM (the largest fish processing factory in St. Petersburg, NW Russia) and AgroNord (agriculture production in Murmansk and Arkhangelsk, N-W Russia) rated equally high lower unit labor costs as well as lower general costs of production.

It is also important to point out that the standard deviations<sup>1</sup> calculated for each of these four factors (size of the market, entering Russian market, lower unit labor costs and lower general production costs) mentioned are allocated within the range from 0,66 to 1,14. These quite low values of standard deviations indicate the fact that the replies of those questioned did not vary greatly from its mean value, which in its turn shows that both Norwegian business experts and theorists were highly in agreement upon the importance of these four motivating factors.

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<sup>1</sup> The standard deviation measures the spread of the data about the mean value; in other words it shows how different (from 1 to 5) the replies of those questioned were.

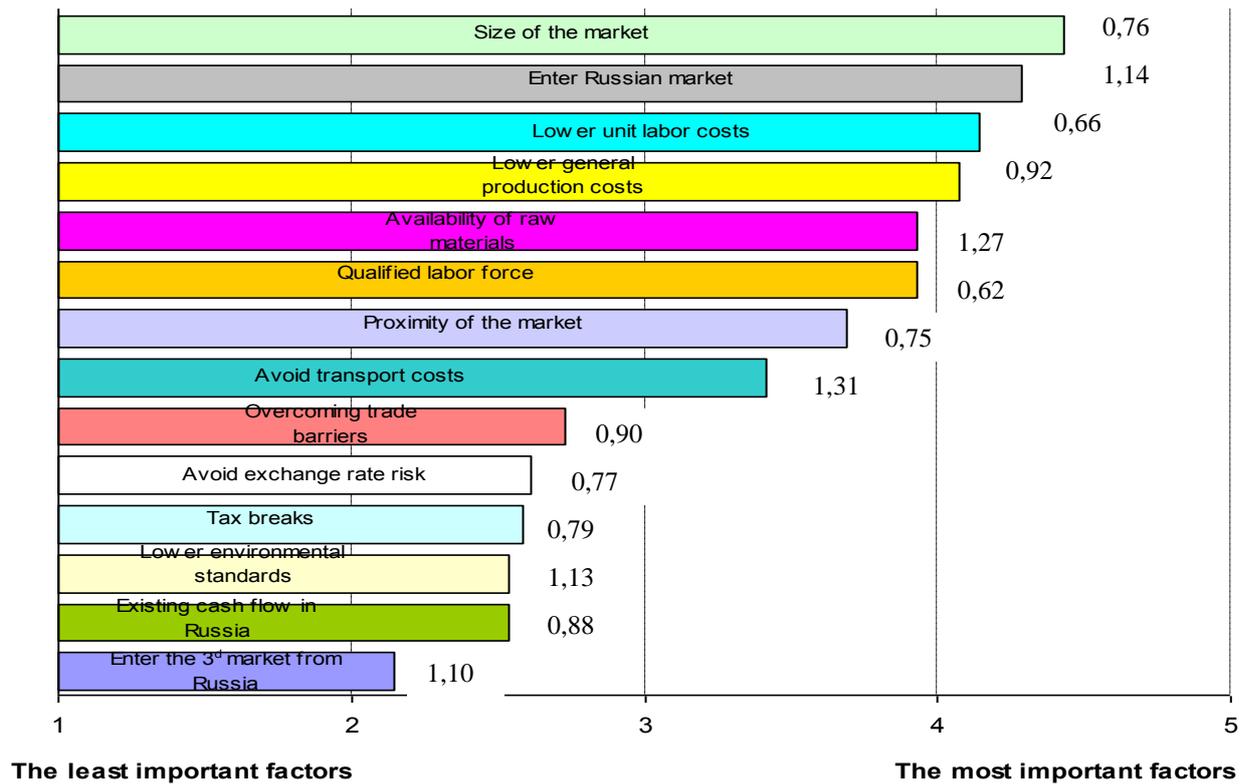


Figure 12. The most and the least important factors which motivate foreign companies to direct investments into Russia (business experts and theorists)

It could also be useful to have a look at the similar data excluding the influence of theorists' replies. In figure 13, we can see that in spite of the different order, the priority of the main motivating factors has been kept almost the same. Again, the standard deviations for each of these four leading factors were low – from 0,52 to 0,74.

However, if one compares the results of the present survey and the European Business Club survey-2000, one can notice that today the low unit labor costs and general production costs clearly replaced the factor overcoming trade barriers (fig. 6). This finding could prove the fact that the improvements in Russian trade legislation took place, and though in the beginning of 2000s foreign direct investors made direct investments to Russia mainly in order to overcome existing trade barriers, which caused difficulties for exporting goods to Russia, nowadays the decision to set up business with direct investments in Russia is mainly due to competitive advantage of local production factors.

What is more, speaking of the highly graded factor the low unit labor costs, the attention should be paid to the fact that Bevan and Estrin (2000) in their study on the determinants of foreign direct investment in transition economies proved (with the use of economical models) that unit labor costs are negatively correlated with FDI. This finding

supports even better the opinion that foreign investors are attracted to Russia by low labor costs. It is interesting that this observation was not noticed in previous studies of Bevan and Estrin when the average manufacturing wage rather than unit labor costs was utilized. Thus, this confirms the conviction that the attraction lies in labor that is relatively inexpensive *and* productive in Russia. To support this fact even better, qualified labor force factor got the mean value = 3,93 and standard deviation = 0,62 (in case of business experts only - excluding theorists – the values were even better: mean value = 4,10 and standard deviation = 0,57). This fact proves that Norwegian business experts are pleased with the professionalism of Russian workers.

The next set of factors which could be grouped as the ones which are also important and highly relevant when it comes to companies' investment decisions are the availability of raw materials, avoiding transport costs and proximity of the market. These factors, to my opinion, were highly graded by those questioned due to the geographic specific factors: northern Norway and N-W Russia are sharing a common border; in addition, the abundance of natural resources in N-W Russia is also stimulating. It is a well-known fact that N-W Russia has always been rich in natural resources. Moreover, the prospective development of oil and gas activities on the Barents Sea shelf attracts more and more attention among Norwegian investors (such as Norsk Hydro, Statoil). This fact provides to a certain degree stimuli to investors from other sectors to take measures regarding entering N-W Russian market, for example, Den Norske Bank (DNB) and SpareBank 1 Nord-Norge, which are considering following their customs and assisting them on the markets they are going to. In case of DNB, this approach to enter the Russian market was clearly seen when they made a decision to acquire one of the commercial banks in Murmansk region – Monchebank. However, in the European Business Club survey-2000, European investors did not seem to pay much attention to availability of raw materials (graded as the second least important factor), which is not the case according to the results of the present survey. Thus, one can say that Norwegian investors are paying much more attention to this factor (especially when it comes to oil and gas).

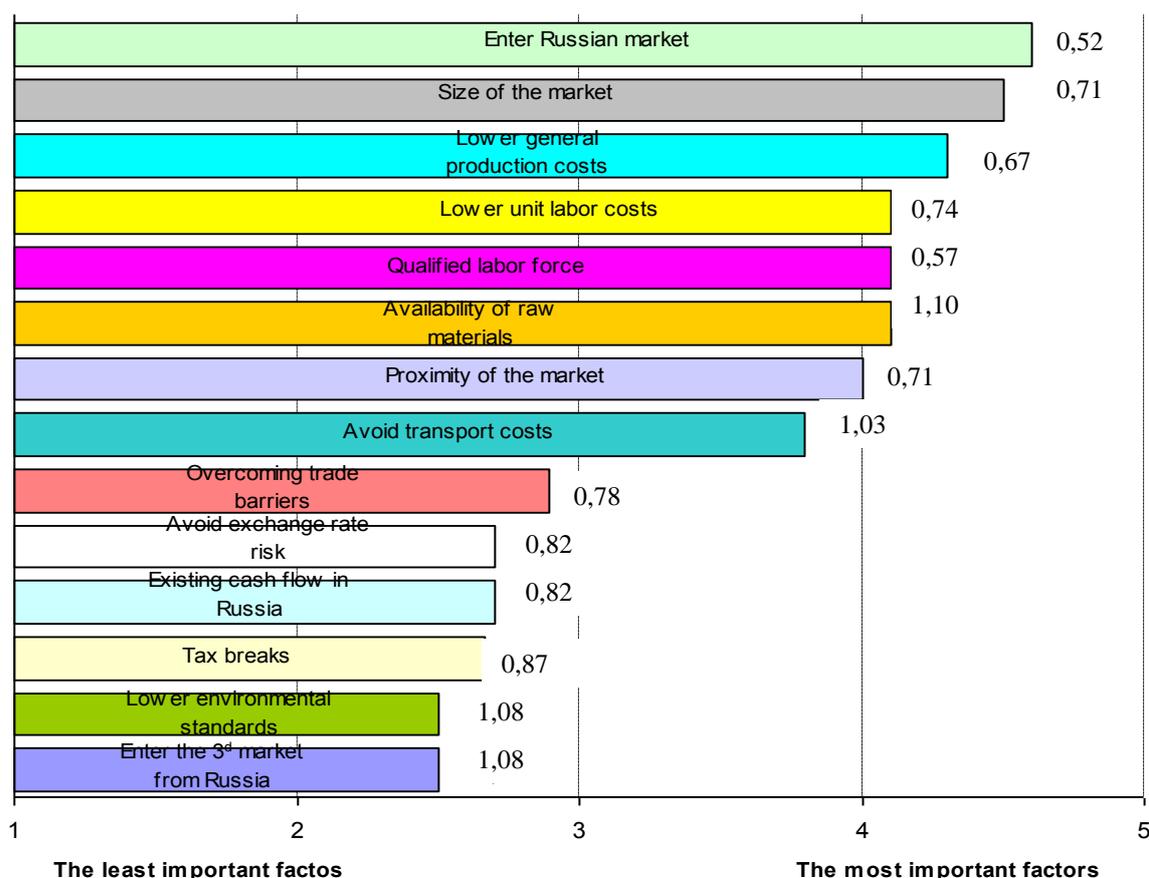


Figure 13. The most and the least important factors which motivate foreign companies to direct investments to Russia (business experts only)

However, if we have a look at the values of standard deviation, they are quite variable from factor to factor. The highest variations of opinions (1,27 and 1,31) were noticed in case of two factors – availability of raw materials and avoiding transport costs respectively (fig.12). Such variations of replies can be explained by the peculiarities of each industry, representative of which was interviewed. Yet the proximity of the market deserves more detailed comment to my opinion. In spite of the fact that Norwegian business experts and theorists paid this motive quite high attention, could be considered ambiguously. Obviously, the proximity of the Russian market to Norwegian partners is, first of all, treated as geographical closeness (another examples, proximity of St.Petersburg and Leningradskaya oblast' to Finnish companies, Kalinigrad oblast' to German companies, eastern Russian regions to Chinese companies) and is usually positively correlated with FDI. Nevertheless, it should also be kept in mind that in this case FDI could be substituted by trade (especially if to take into account the fact that the overcoming trade barriers factor was rated relatively low – see fig. 13). At this point it is worth mentioning that Bevan and Estril (2000) in their research of FDI in transitional economies argued that there could

be a negative correlation between distance and FDI. The explanation for this, at the first glance surprising statement, might be culture, language and/or distance of mentality in host country, which could greatly increase the costs of undertaking business, communication and co-ordination for direct investors. For this reason it is no wonder that the majority of those questioned in their interviews emphasized that in order to do business in Russia, one has to understand Russian culture, the manner of doing business there, etc.

The last set of factors which were chosen to be the least important ones remained almost the same as those which are listed in the European Business Club survey (2000): both tax breaks and existing cash flows are of very low importance for direct investors. The lower environmental standards in Russia seem to be of minor importance for Norwegian companies' investment decisions, however the replies varied noticeably (standard deviation = 1,13) (fig. 12). Nevertheless, according to Roger Håkon Mikkelsen (Project manager, AgroNord): Even though the environmental standards in Russia are generally lower than, for example, here in Norway, we are doing business in Murmansk and Arkhangelsk with accordance to the Norwegian standards. We do not want to acquire a bad reputation in Russian mass media .

Surprisingly, entering the third market from Russia was almost of no relevance for Norwegian companies. However, in case of China, for example, foreign direct investors prefer to enter Chinese market with a purpose of producing there, but then to export this production to the third market.

### ***7.3. The motives which still stimulate Norwegian investors to set up production in Russia***

In the world rating of countries which are considered to be attractive for carrying on business, Russia took the 79<sup>th</sup> position. This rating was made by the World Bank and International Finance Corporation. The study was oriented towards the future – the rating was made up upon the expectations of analytics for the year 2006 - and brings light on the state regulation of business in 155 countries. The main indicators this list of countries is based on, are simplicity and transparency of business registration procedures, assets, acquisition of licenses and loans as well as procedures of staff recruiting and release. The leading positions in the rating are taken by New Zealand, Singapore and United States – it is considered to be easy 1) to set up a new business; 2) to recruit and release staff there. With accordance to these two indicators, Russia is placed to the 31 and 57 positions respectively. However, specialists from the World Bank and the International Finance Corporate point out that the procedures which are the most difficult in Russia, are to acquire a license for starting up business (143<sup>rd</sup> position) and to get a loan (148<sup>th</sup> position) ( Expert , 2005b).

Thus, taking all mentioned above into account, the second question in the questionnaire aimed to find out the motives which still stimulate Norwegian investors to set up production in Russia rather than to sell know-how using licensing or other forms of sub-contracting. According to the results of the survey, with a considerably high degree of common consent, Norwegian investors clearly indicated that the major incentives for producing in Russia are control over the cash-flows and control over the profits (standard deviation - 0,66 and 0,74 respectively) (fig. 14). Keeping control over marketing of know-how was also considered to be an important factor, however opinions among business experts and theorists varied noticeably and pushed the value of standard deviation to 0,90. For this reason it is important to have a separate look at the replies from the business experts only. In this case, variation of responds was lower (0,63), which allow to conclude that the factor keeping control over marketing could be as important as the previous two. With a slightly lesser degree of importance the factors such as control of product quality, protection of know-how and access to market know-how were mentioned.

The factors such as state requirements, access to buildings and production of know-how were rated as the least important ones, which almost do not influence the companies' decision in this regard.

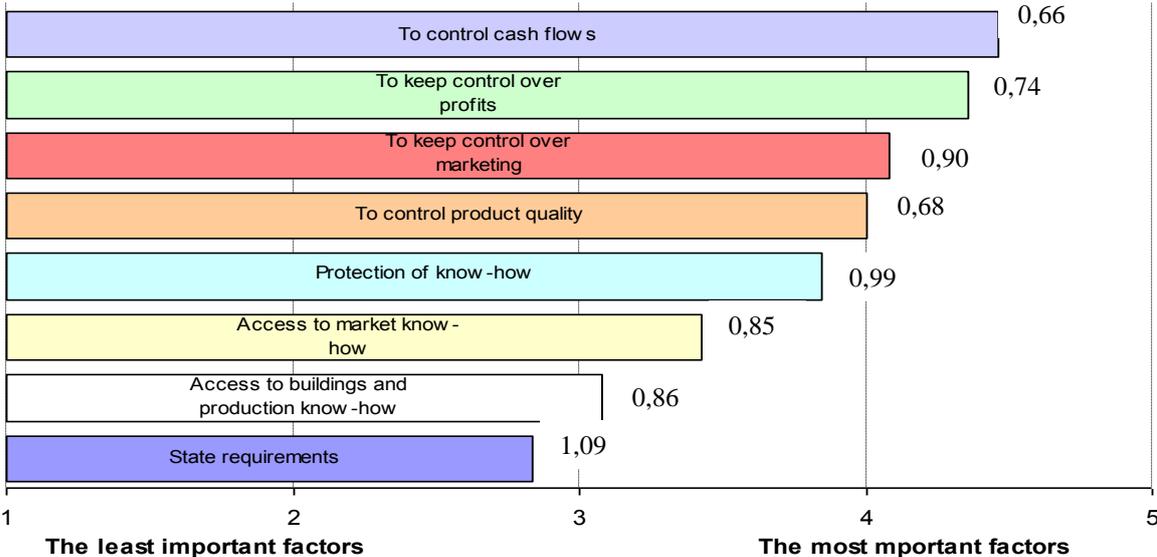


Figure 14. The Norwegian direct investors' motives for establishing production in Russia instead of using licensing systems (business experts and theorists)

To conclude, the results presented on the figure 14 follow those findings of the European Business Club survey-2000 very closely. This fact indicates that the situation in this sphere almost did not change since the year 2000.

#### 7.4. The main difficulties Norwegian investors are confronted with when entering Russian market

In order to find out the main obstacles Norwegian investors face in Russia, those surveyed were asked to rate the factors presented in the figure 15 in the same way as it was

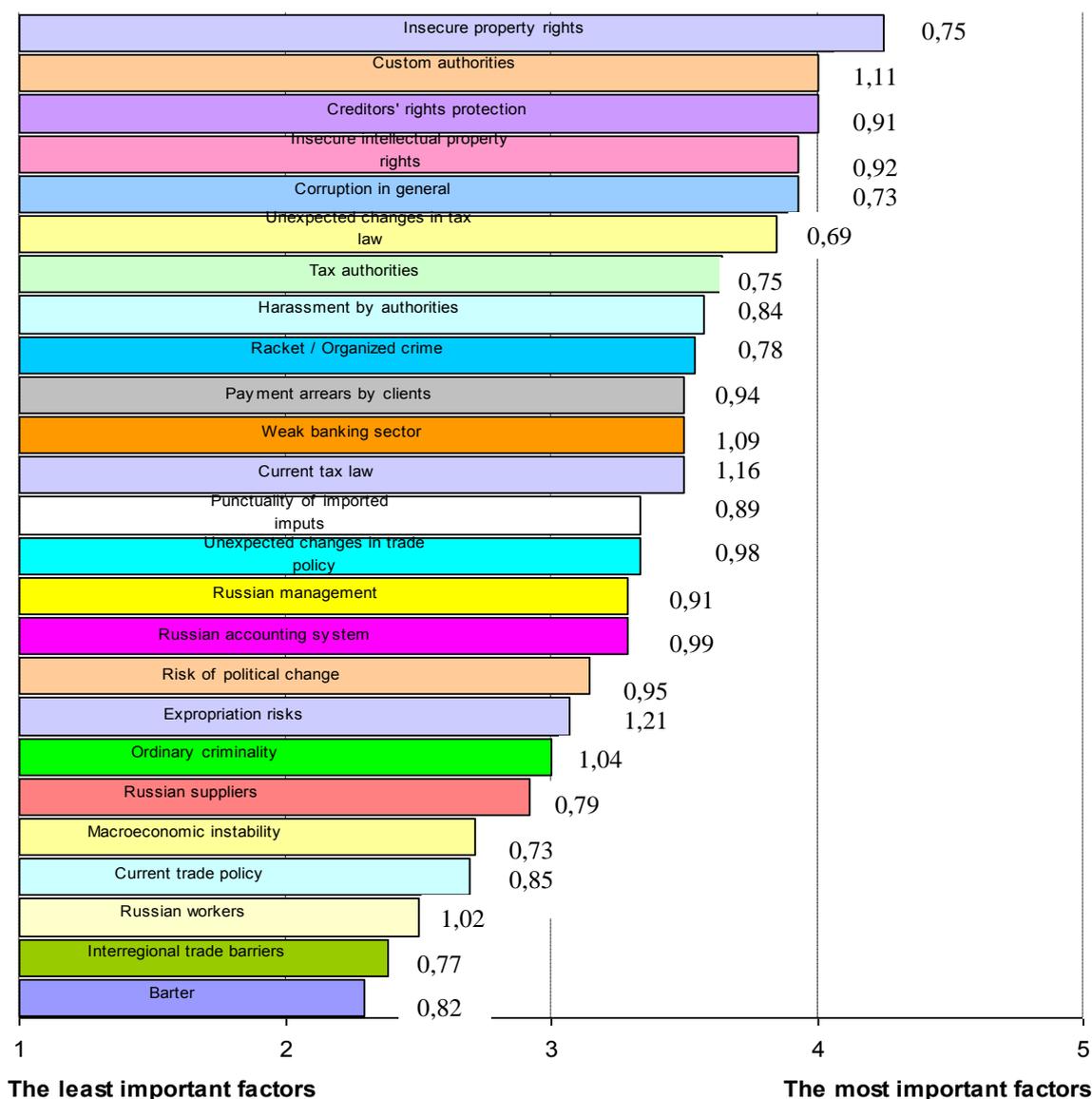


Figure 15. Rating of the major obstacles for foreign investors in Russia by (business experts and theorists)

done for the European Business Club survey-2000. The results obtained pointed out that the evaluations of the factors are quite different in case of total sample group (both business experts and theorists) and exclusive group which consist of the business experts only. For this reason it is worth to analyze both result sets (figures 15 and 16).

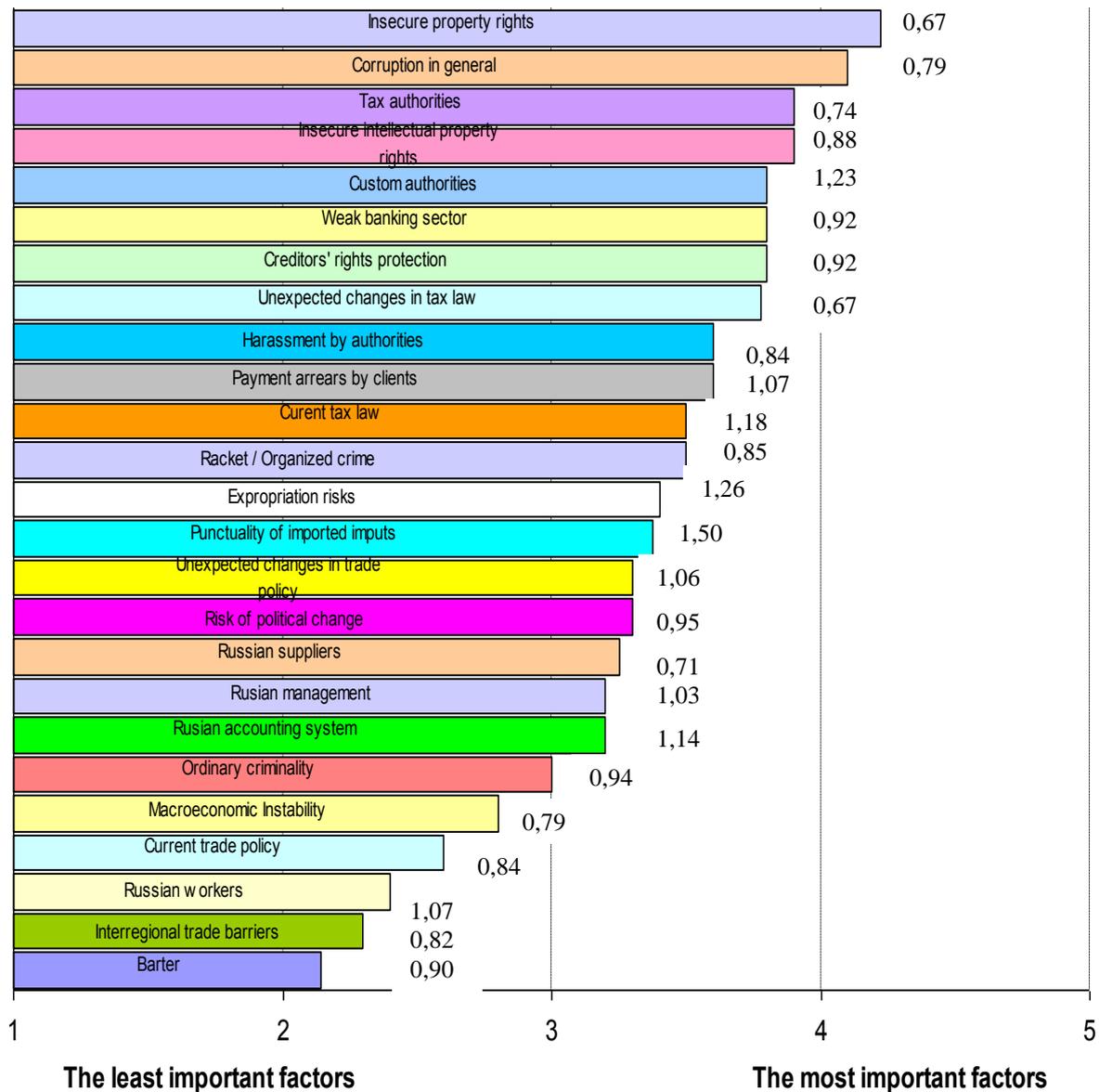


Figure 16. Rating of the major obstacles for foreign investors in Russia by Norwegian companies (business experts only)

According to both figures 15 and 16, the biggest problem for foreign investors is insecure property rights. All interviewed came to this conclusion with quite high degree of consent. This problem has a long-time existence in Russia and it was also rated as one of the most important ones in the European Business Club survey - 2000.

Many researches claim that the issue of insecure property rights in Russia could probably originate from disrespect to the institution of private property, which is reflected in relatively poor property rights protection in Russian legislation (Expert, 2005a). This fact, in its turn, to a high degree minimizes the possibility of constructing the long-term strategy of development not

only for Russian business, but for the Russian state as a whole, because as Russian government changes - the laws, the owners and attitude to property rights undergo changes as well. Thus, the issue of making property rights secure in Russia remains the issue of the day and the ability to solve it will determine the amount of FDI into Russia in future.

As a part of the problem of property rights security, it is also worth mentioning the problems of shareholders' rights, especially the minor ones. The common opinion is that Russian companies do not put enough effort to improve such important elements of the system of corporate management such as minimizing the risks of shareholders' rights violation. Researchers claim that the drawbacks of corporate management in Russian companies are:

weak dividend policy

slow formation of internal control system

lack of transparency about those real shareholders, etc.

The existence of these drawbacks could be explained by the fact that the majority of Russian joint-stock companies concentrate their efforts on attracting loans and credit resources. Thus, companies are much less concerned about minor shareholders' rights and their problems than the potential creditors' requirements. For the latter the issues mentioned above are not as important as the data about the company's balances and accounts (Bashun and Gorbvtsov, 2005).

Although the problem of insecure property rights was placed as the highest concern in the present survey (both in figure 15 and 16), the remaining ranking of obstacles varies depending on whether or not you include the opinions of theorists.

According to figure 15, the difficulties, which Norwegian companies face with, the custom authorities and the problem of creditors' rights protection are also among the most important ones and took the second and the third places respectively. Comparing to the results of the European Business Club survey-2000, harassment from customs authorities almost five years ago was placed in the lower position on the list, but still was one of the most important ones. However, the variation of answers was considerably high (standard deviation = 1,11). The highest grade this factor got from representatives of NORUM, Troika Sea food, AgroNord, the lowest - from commercial director of Gigante Pechenga. As an example of the customs related problem, Roger Mikkelsen (Project Manager, AgroNord) particularly pointed out the differentiation of customs requirements from region to region in Russia: If one look at the requirements at customs in St. Petersburg, one will notice a great difference with customs requirements in Murmansk.

It is also a quite remarkable fact to point out that dealing with custom authorities is to a high degree perceived to be much more trouble-making than the Russian current trade policy

itself. This applies for both figures 15 and 16. However, we can say that although the problem with custom authorities has remained the same during last five years, the changes and the potential for the improvements have appeared recently. On the May 11<sup>th</sup>, 2006 Russian President V. Putin signed up the decree «Issues of Federal Customs». With accordance to this decree the Federal Customs is taken out of the control of the Ministry of Economic Development and has become subject to Federal Customs Office and is directly subordinate to Prime Minister of Russian Federation – M. Fradkov. From now on, all responsibilities for working out the state policy and legal regulation of Russian customs functions are directly passed to Federal Customs Office. The president has also given an order to prepare all the changes to Russian legislation regarding this event within one month.

According to sources within the Kremlin, the Prime Minister Fradkov possesses thorough and deep knowledge in the sphere of international trade activities, and this together with the power associated with his position will allow him to sort out the existing customs' governing problems in relatively short period of time; all the measures which are going to be taken with the aim of improving Russian customs functioning will be effective (Kanaev, 2006).

In contrast to figure 15, in figure 16 where the responses of Norwegian business experts are gathered, the second place in the rating of problems was given to corruption, which was on the 12<sup>th</sup> position in the European Business Club survey-2000. The nature of this issue is well-known in Russia, because bribery is still widely spread not only in Russian economy, but it penetrates to almost all spheres of everyday life. From the pure economic point of view, bribes, paid by the companies, could be regarded as additional transactional costs of production and therefore cause the increase of production costs of goods which, in its turn, results in the increase of the price. As a result, high prices lead to the substantial decrease of company's competitiveness on the market.

However, the Russian President keeps on taking measures to fight corruption. On January 12<sup>th</sup>, 2004 Vladimir Putin decided to be a chairman on the first meeting of the Committee on fighting corruption<sup>1</sup>. This Committee was set up with accordance to the President's Decree signed up in November, 2003. The members of the Committee on fighting corruption became representatives of Government, Duma, Federation Council as well as representatives of Constitutional, Arbitration and Superior Courts (Korotetskii and Rubchenko, 2004).

Next in the order of seriousness (fig. 16) come problems with tax authorities. Standard deviation of 0,74 indicates that business experts were pretty much in agreement when rating this factor. Again, as it was mentioned in case of custom authorities, tax authorities are causing more problems than unexpected changes in tax legislation and the current tax law. However, it is

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<sup>1</sup> Комитет по борьбе с коррупцией (Committee on fighting corruption).

essential to mention that tax law related problems, which were on the two first positions according to the results of European Business Club survey-2000, appeared to be only of moderate importance nowadays. Thus, one may conclude the noticeable positive changes did occur in Russian tax legislation. Knut J. Borch has mentioned during the interview: Taxation system is considerably simplified and developing forwards the OECD<sup>1</sup> standard.

Insecure intellectual property rights issue got the same quite high mean value in the business experts' rating. Notably, insecure intellectual property rights are systematically viewed as being a less of the problem comparing to property rights on the whole in both cases - nowadays and 5 years ago.

Factors which appear to be of modest importance to the interviewees' point of view are harassment by authorities, organized crime and payment arrears by clients. However, rating the first two problems, business experts were more in agreement about their importance (standard deviations 0,84 and 0,85 respectively) than about the third one (standard deviation = 1,07) (fig. 16). Nevertheless, regarding the latter factor, Kjell-Otto Sebergsten (Director, IMES AS) mentioned in his interview that situation has improved greatly during the last years. Russian clients and partners are much more accurate and punctual nowadays when it comes to fulfilling their liabilities than they used to be.

Among the problems which usually do not cause many troubles were mentioned risk of political change, Russian management, accounting system and ordinarily criminality. It is very important to point out that according to results of the present survey the risk of political change was rated at relatively low level, whereas the opposite was true for the results of the European Business Club survey-2000. This finding suggests that political stability in Russia improved greatly since the beginning of 2000s. However, the main question that disturbs both local and foreign investors is whether political situation will remain stable after the year 2008. The great disputes in this regard were provoked by the Alfa Bank report "The investment climate in Russia: political risks and the Kremlin mysteries" which was published last year. The report was originally meant to be written for the bank's large customers therefore in the report Alfa Bank analysts provide an overview of the current economic and political situation in Russia as well as assess potential developments after the presidential election in 2008. The report quotes certain representatives of Russia's large business saying that stability for investors in Russia will be held intact only if the present political elite remain at the helm (Malinin, 2005). What is more, Pravda.Ru asked some business analysts to comment on the report mentioned – the analysts are inclined to believe that the Alfa Bank report is a conscientious and pragmatic approach to the problem (Malinin, 2005).

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<sup>1</sup> Organization for Economic Co-operation and Development (OECD)

The authors of the Alfa Bank report claim that scenario according to which Vladimir Putin will be able to remain in power would be an ideal scenario for the year 2008 for investors. The report also suggests that developing economies, which showed a good progress, always had a strong leader staying in power for a long period of time as one of the necessary components of success (Malinin, 2005). Following the words of Gazprombank analyst Mikhail Zak, the investors would benefit to the maximum, if there were no dramatic changes whatsoever in the political and economic situation. Mikhail Zak has also stressed that possible changes in the political situation would negatively affect the long-term stability of the political and economic situation in Russia: The general political continuity is a very important factor both to the investment climate and business elite. In other words, Zak believes investors would be quite happy to see a protege of today's leadership as a new president. They would be equally happy to see somebody brand-new provided that he carried on with the present economic course (Malinin, 2005).

As an example of pretty high level of satisfaction with Russian management, the case D en N oske B ank acquires M onchebank (M um ansk) can be considered. After the acquisition of M onchebank, the top m anagem ent of D N B m ade a decision to let the bank's m anagem ent to keep their positions.

Finally, Norwegian investors have positive attitude to Russia's m acro-economic indicators as well as they have almost no problems with Russian workers.

One can say that the reason of such positive attitude to Russia's m acro-economy stability, which is usually determined by growth, inflation, exchange rate risk, etc., is well founded indeed. For example, the country risk indicators, which comprise the macro-economy element, in terms of creditworthiness, were published by *Euromoney* (considers 185 countries) and by *Institutional investor* (considers 173 countries) and both of them are presented in the table 5, where 100 indicates the lowest country risk.

Table 5. Country-risk poll numbers and on-year change, March 2006

	<i>Euromoney</i>		<i>Institutional Investor</i>	
	3/2006	on-year change	3/2006	on-year change
Hong Kong	82,74	0,3	78,7	3,0
China	61,71	0,5	69,8	3,8
India	56,45	0,1	57,1	1,8
Russia	54,65	1,1	62,1	6,9
Bulgaria	54,31	2,2	57,0	5,0
Romania	53,22	1,3	52,8	4,4
Ukraine	45,74	3,1	46,5	9,0

Source: B O F I T W eekly, B ank of F inland, 15, 13.4.2006 (R ussia)

As it is presented in the figure 17, Russia has improved her score in both polls, especially in the Institutional Investor report (BOFIT Weekly, 2006).

In addition to this, it is very important to point out that according to Government Decree starting from July 1st, 2006 all the limitations on export and import of capital in Russia will be taken away<sup>1</sup>. According to analysts, this fact will make an extremely positive influence on the Russian investment climate as well as open up more opportunities for foreign investors.

### ***7.5. Production for the local (Russian) market vs. export to other countries***

Taking into account the conclusion made in paragraph 7.2. that today the decision to set up business with direct investments in Russia is mainly determined by the competitive advantages of local production factors, it is now interesting to look at what is the market for this production?

According to the results of the survey (fig.17), the majority of those asked (8 persons out of 11) is convinced that the production is going to be oriented and distributed at the local (Russian) market. The reason for that (as it was already mentioned above) is a steady growing, emerging market with increasing population's consumer power.

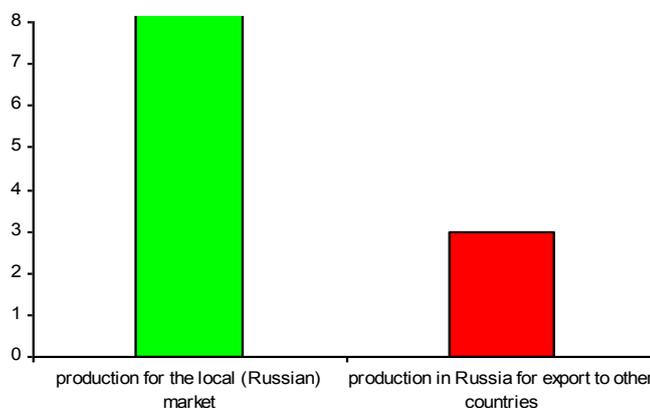


Figure 17. The main market for foreign companies' goods produced in Russia

### ***7.6. The factors that determined companies' location choice***

As it could be predicted, the two major factors, which companies pay the most attention to, are the large market in the region and location of the partner company (fig. 18). These two factors are taking the leading positions possibly due to the peculiarity of the sample size – Norwegian companies which were interviewed have their business in North-Western Russian region. This region is, firstly, characterized by the large size market and, secondly, Norwegian

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<sup>1</sup> The limitations on export and import of capital in Russia were imposed after the financial crises in 1998.

companies partners (especially those in fishery) are located there. What is more, due to the fact that the survey mostly covered those companies in fishery, the closeness to the special production factors was graded quite high as well.

Surprisingly enough, nowadays Norwegian business experts pay much more attention (when it comes to the decision of their business location) to the recommendations made by business climate surveys, than those asked in the year 2000. In addition Norwegian businessmen also take into account the existing investments in the region (which can also tell a lot about the investment climate and situation in the particular region).

However, recommendations by other companies and tax breaks in different regions in Russia still play almost no role for companies' location decision as they did around 6 years ago.

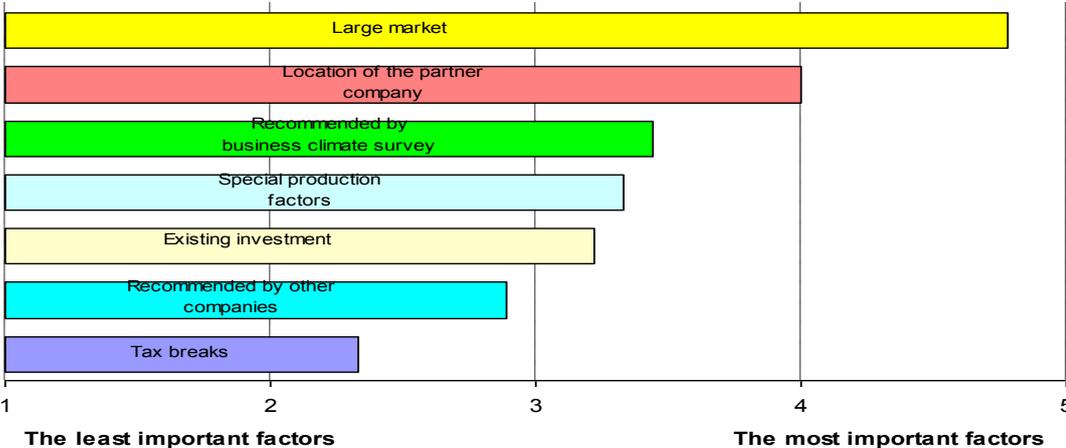


Figure 18. Rating of the factors which determine companies' location in Russia.

**7.7. Companies' attitude to their prospective investments to Russia**

The third part of the survey aimed to estimate Norwegian companies' general level of satisfaction with their business in Russia, which – according to the interviews' results – was considerably high.

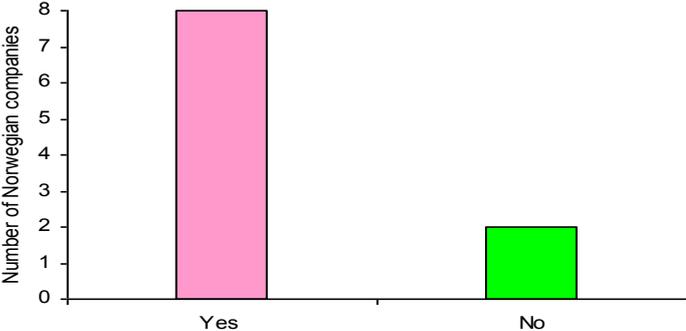


Figure 19. Companies' voting for or against investing to Russia given the experience they have acquired

Firstly, 80 % of all companies interviewed, admitted that they would definitely invest in Russia again, taking into account the experience they have already acquired (fig. 19). What is more, 60 % of respondents pointed out that in future they are even planning to increase their investments and the expand their business in Russia, whereas 30% of them claimed that they will keep their share of business in Russia at the same level and only one company reported about the possibility of decreasing its business activities in Russia (fig. 20).

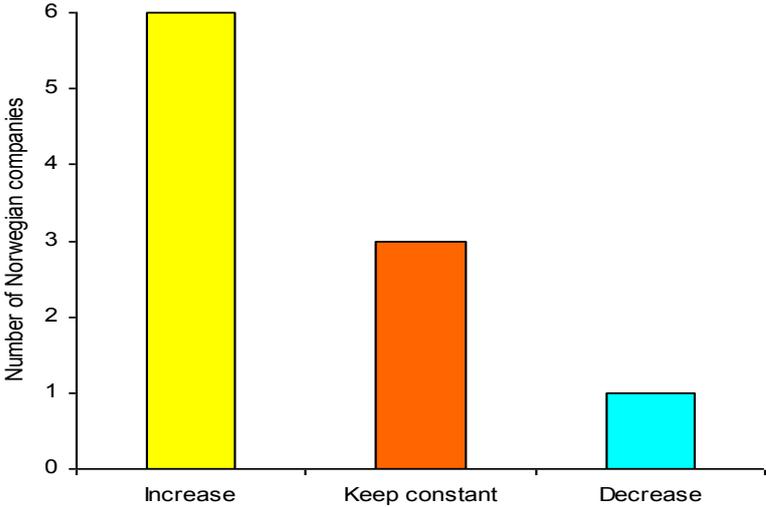


Figure 20. Norwegian companies’ voting on increase or decrease of their presence on the Russian market the nearest future?

**7.8. NORUM’s case: “Russia is not as difficult as we expected”**

As an example of very fast and successful development of the company which was established with help of foreign direct investments, the experience of NORUM’s investment in the fish processing plant called ROK-1 (St. Petersburg) can be presented.

NORUM Ltd. is a management company which is owned by Norwegian, Finish and Swedish financial institutions (DNB Nor, SITRA, Finnfund, CES Nordic); it is the northern private equity partner in Russia. NORUM was established to manage two regional investment funds on behalf of European Bank of Reconstruction and Development (EBRD) and to provide development support from Norway, Finland and Sweden.

During its 10 year presence in Russia, NORUM has considered over 3000 projects.

The main company’s goals are:

- ✓ to speed up the development and growth of medium-sized Russian companies in central part of Russia as well as in the regions;
- ✓ to prove that private equity can function as a financial instrument in Russia;
- ✓ to acquire experience and good examples which could be shown in order to attract international investment capital to Russia;
- ✓ to develop Russian management team to be qualified to establish new private investment funds with strong northern foundation;
- ✓ to provide the investors with good profit on the invested capital.

NORUM's team is an international investment team which is located in St. Petersburg, Moscow and Helsinki and is managed from Tromsø. It consists of highly qualified specialists with solid experience of international activities within finance, industry and trade. Norwegians which are taking the key positions in the company have from 10 to 15 years presence in Russia.

NORUM established a good network with EBRD, Russian and International financial institutions, suppliers and leading Russian actors. The major NORUM's figures are presented in the table 6.

Table 6. The major NORUM's figures (March, 2006)

1. Investment capital (Fund I+II)	USD 88 million
2. Committed capital	USD 80 million
3. Amount of investment projects in the portfolio	24
4. Amount of companies sold	14
5. Strong growth and promising economic development in the rest of the companies in the portfolio	10
6. Income from the companies sold	USD 72 million
7. Written-down value	1 investment (partial)
8. Expected earnings – Fund I	21% IRR
9. Expected earnings – Fund II	57% IRR

Source: NORUM, Samarbeid – Forretningsutvikling og investeringer i Russland, 2006.

NORUM provides very active follow-up of Russian companies through the participation in development projects, board representation and day-to-day support. One of those companies which NORUM's made direct investment into and currently has in its portfolio is ROK-1. The full name of the company is joint-stock company «Fish processing industrial complex 1» and it is located in St.Petersburg.

The first stage of the industrial complex's development was upgrading of out-of-date production facilities and introduction of new technology. In addition, technical support for

R O K -1 was provided by Norwegian fishery advisers and raw materials were supplied from Scandinavia waters and Kaspiyan waters. The active participation and follow-up in terms of strategy, finance and accounting were provided by NORUM team.

The key figures of R O K -1 activity are presented in the table below.

Table 7. The key figures of R O K -1 activity 1999 – 2006 (expected)

Key figures	1999	2003	2004	2005	2006 (expected)
Turnover (USD million)	8,0	58.6	91.0	123.0	160.0
EBIT <sup>1</sup> (USD million)	0.6	5.6	7.2	10.1	14.0

Source: Source: NORUM, Samarbeid – Forretningsutvikling og investeringer i Russland, 2006.

As it is indicated in the table 6, within 7 years period of time company's figures went up dramatically: turnover increased 20 times and earnings before interest & tax increased more than 23 times. This is a clear indicator of Russian economic potentials.

At present R O K -1 is the leading fish processing company in St. Petersburg. Its highly processed products are currently delivered to all large food product chains in the city. Contemporary import of raw goods from Norway in 2005 reached 22 000 tons of salmon, herring and mackerel.

Generally speaking, Knut J. Borch (Managing Director, NORUM Ltd.) has pointed out that the experience they gained in Russia is mostly positive: Russia is not so difficult as it was expected. According to him, Russia's rapid growth and considerable improvements of business climate are obvious; as a foreign direct investor (NORUM) has not experienced any problems with taking sales revenues, interests or dividends out of the country - whole Fond I capital was paid back to investors.

Mr. Borch has mentioned that the new generation of private innovators is quite ambitious and motivated, whereas the old companies' structures and management are difficult to change. Apart from that, NORUM's leader thinks that to learn to understand Russia as a market requires, first of all, presence, hard work, interest, language-/ culture understanding and close follow-up. Foreign partners are welcomed in Russia, however it requires humility and takes time to build up confidence; in order to expand business in Russia requires:

- ✓ a clear solid strategy;
- ✓ it is costly and has to have strong support from top-management.

To conclude, Knut J. Borch gave his formula of opportunities and success on Russian market:

<sup>1</sup> Earnings Before Interest & Tax (EBIT) - an indicator of a company's profitability, calculated as revenue minus expenses, excluding tax and interest.

Source: www.investopedia.com

Solid overall economic growth  
+ highly educated and hard-working people  
+ state of the art technology  
+ low level of costs  
+ market of 145 million people with rapidly growing consumer power  
= unique opportunities for creation of new economical values and profitable investments .

NORUM 's plans for future work in Russia look very optimistic – the new Russian fund NORUM Helios Equity Fund L.P. is currently under establishment. The expected fund size is about EUR 150 mil. and target groups are:

- ✓ medium size private Russian companies with:
  - good and well-qualified management;
  - considerable growth potential;
- ✓ focus on core activity and chosen branches;
- ✓ turnover of about EUR 5 to 100 mil;
- ✓ main business areas: sectors in which management team have special knowledge and long experience, such as processing/consumer sector, retail trade, service industry, media, tourism, entertainment.

## *Chapter 8. Discussion and research limitations*

### *8.1. Foreign direct investment - prospects till the year 2008*

The aim of this chapter is to draw a framework for perspectives of FDI development in the developing countries, with a specific emphasis to Russia. The chapter is primarily based on the materials of the United Nations Conference on Trade and Development (UNCTAD), which was established in 1964 and aims to promote the development-friendly integration of developing countries into the world economy. UNCTAD has progressively evolved into an authoritative knowledge-based institution whose work aims to help shape current policy debates and thinking on development, with a particular focus on ensuring that domestic policies and international action are mutually supportive in bringing about sustainable development (UNCTAD, [www.unctad.org](http://www.unctad.org)).

Every year the UNCTAD carries out a Global Investment Prospects Assessment (GIPA) which is designed to assess short- and medium-term prospects for FDI in the world. It analyses predicted future patterns of FDI flows at the global, regional, national, and industry levels from the perspectives of global investors, host countries and international FDI experts. It also analyses evolving trends in the strategies of TNCs as well as FDI policies. GIPA is designed to fill a research and policy analysis gap, equipping Governments and business alike with a critical instrument for proactive development of policies and strategies, as opposed to post facto assessment of foreign investment facts (UNCTAD, 2005).

These results of GIPA are based on the conclusions, which were drawn out of surveys carried by national investment promotion agencies (IPAs) from 158 countries (the response rate is 71%); the 325 largest transnational corporations (TNCs) from developed, developing and Central and Eastern European countries (the response rate is 21%); and 75 experts in international FDI.

On the whole, all of them are predicting that the foreign direct investment (FDI) will continue to grow over the both short- and medium-term.

The results of the researches from the year 2005 demonstrate the positive trend in the FDI development, particularly for developing countries (fig. 21). "The findings suggest that countries need to seize the investment opportunities but also to pay attention to the quality of FDI, given the fierce competition for investment", says Dr. Supachai Panitchpakdi, Secretary-General of UNCTAD.

As it is seen in the figure 21, more than half of the TNCs and expert respondents contacted, expected short-term (up to the end of the year 2006) growth in FDI flows. The same opinion is shared by around 81% of the IPAs. However, more than 40% of TNCs and experts,

and around 17% of those in IPAs, expected levels of FDI to remain steady, while only a small share of TNCs and IPAs thought that FDI would decrease in the nearest future.

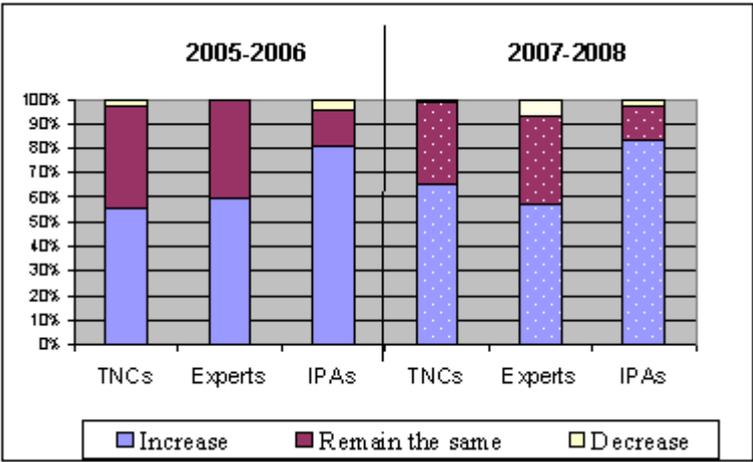


Figure 21. Global prospects for FDI, 2005-2006 and 2007-2008

Source: UNCTAD FDI Prospects, 2005-2008.

Looking on the medium-term FDI prospects, it is worth to point out that they look optimistic as well. About 57% of experts, 65% of TNCs and 83% of IPAs predicted FDI to increase during 2007-2008. Again, most of the rest of respondents expected FDI levels to remain the same (about 35% of TNCs, the same percentage of experts and only 15% of IPAs) foresaw a decline. However, in this case a small percentage of experts and IPAs foresaw the decline of the FDI level during 2007-2008.

Those responded warned about a number of facts, which should be taken into account about FDI growth prospects in the short and medium terms. They are concerned that the major threats for successful FDI development could be:

- ✓ the policy of protectionism,
- ✓ reduced growth in major industrialized countries,
- ✓ the financial instability of some world’s major economies,
- ✓ global terrorism,
- ✓ the volatility of prices for petroleum and other raw materials (UNCTAD, 2005)

Apart from these, experts also pointed out that investors’ attention is gradually shifting away from traditionally important investment locations towards other emerging markets. Asia and Eastern Europe are the two regions where the prospects for FDI look the most positively. (Talking about Latin America - its recent FDI recovery is likely to be maintained; and flows to

Africa are expected to remain at a low, but still stable level). Developed countries as a group, are expected to see some FDI recovery, but at relatively modest levels in the short run perspective. It is highly expected that the most attractive destination for FDI in the developed world will still belong to the United States, however, expectations are not so promising for the major European economies.

There were some unexpected findings in the investment locations selected as most attractive. For example, half of the top 10 countries, which were ranked by experts and TNCs, are from the developing world. Russia is considered an attractive location by 21% of experts (5<sup>th</sup> position) and 33% of TNCs (4<sup>th</sup> position) (fig. 22). Thus, Russia’s prospective looks promising since in the both ratings she is among the top five most attractive countries with China, USA, India and Brazil.

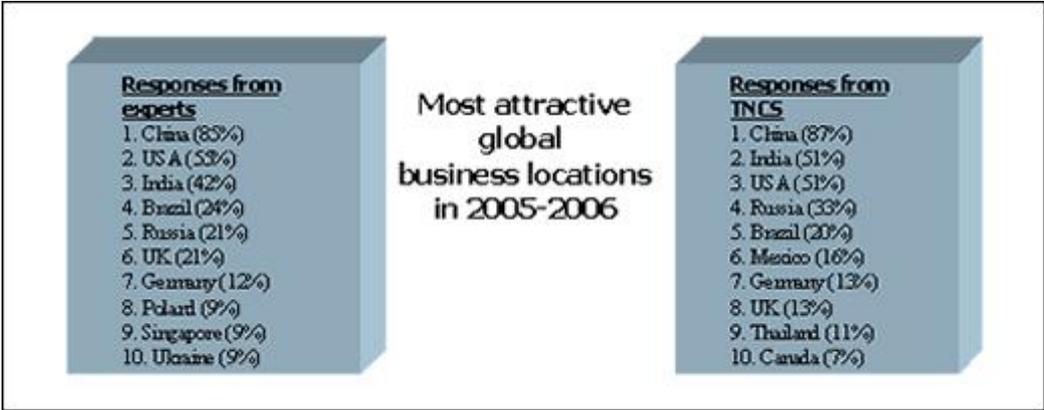


Figure 22. Most attractive business locations globally, 2005-2006 (Expert and TNC responses)

Source: UNCTAD FDI Prospects, 2005-2008.

According to the UNCTAD surveys findings, the prospects for FDI differ significantly by industry. The prospects for the services sector will continue to be better than for the manufacturing or primary sectors. Industries which are expected to be of the first priority of FDI growth are:

- 1) services sector:
  - ✓ computing/ICT<sup>1</sup>,
  - ✓ public utilities,
  - ✓ transportation and tourism-related services;
- 2) manufacturing sector:
  - ✓ electrical and electronic products,

<sup>1</sup> Information and communication technologies (ICT)

- ✓ machinery and metals;
- 3) primary sector:
  - ✓ mining,
  - ✓ petroleum.

It is interesting to point out that neither forestry nor fisheries industry is not mentioned among sectors which are expected to be of the priority of FDI growth.

In the short run, IPAs consider the US to be by far the most important source of world FDI flows, followed by the United Kingdom, Germany and China. The overall ranking is nonetheless very interesting because, along with China, a number of other developing countries are among the top 15 - South Africa, India, Brazil, Malaysia and the Republic of Korea. It is also true that the number of these countries is considered to be the important sources of FDI only because of their immediate neighbors. On the whole, however, "developing-country TNCs are increasingly using outward investment to become global players, which ends up benefiting other developing countries as well", states Dr. Supachai.

More than 50% of experts and TNC respondents think that the driving forces for FDI in the short run (year 2006) will be mostly mergers and acquisitions. By contrast with this, the large of IPAs -- the majority of them represent developing countries -- expected greenfield investment (new investment projects) become of the most importance. In addition to this, non-equity investment, for example FDI made through strategic alliances or licensing, is also expected to remain strong position.

Those being interviewed generally agreed that production is the corporate function most probably to be relocated. Well over 80% of those surveyed by UNCTAD came to conclusion that some production activities to be likely transferred overseas. At the same time, they predict the continuing growth of offshore outsourcing in services. Logistics and support services are the functions which are next on the list of the functions that are most likely to be relocated offshore, followed by distribution and sales.

As far as competition for FDI is increasing nowadays, countries around the world will take more proactive steps in their investment promotion efforts. The majority of IPAs are planning to continue increasing the number and range of their policy measures over the following two years. In particular, taking in to account limited resources, most IPAs intend to develop and employ a more targeted approach to investment promotion policy (fig. 23).

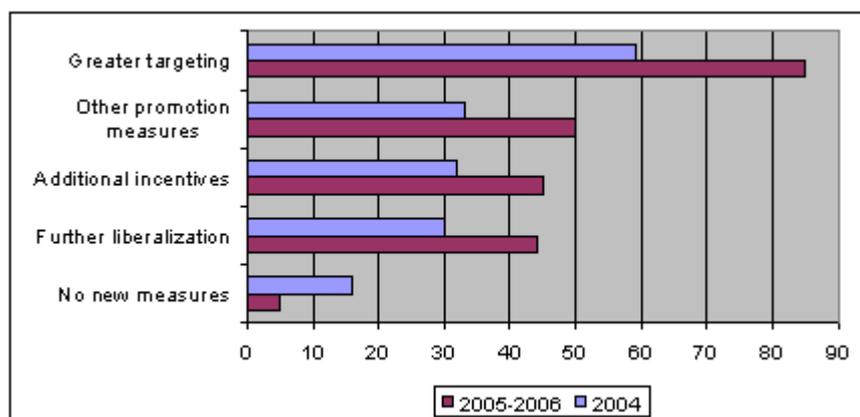


Figure 23. Policy measures to attract FDI (Percentage of response by national IPAs)

Source: UNCTAD FDI Prospects, 2005-2008.

The results of UNCTAD's global surveys of TNCs, international experts and IPAs all suggest the same direction of the FDI development: the FDI recovery will continue, although there are some threats which may weaken the momentum. The recovery is increasingly fuelled by investment in developing countries. The overall mood is one of cautious optimism (UNCTAD, 2005).

## 8.2. Foreign direct investments or national direct investments: does Russia's stabilization fund matters?

In 2004 the decision to set up a Stabilisation Fund was made.<sup>1</sup> The financial resources began to grow extremely rapidly (table 7). This rapid growth and substantial financial resources which were gathered provoked quite tough discussions in Russian society: whether to invest the financial resources and save for future or begin spending them now by investing in national economy and improving the social policy.

Table 8. Dynamic of financial resources in the Stabilisation fund of Russia

	2004	2005	2006 (as of 02/06)	2006 (as of 04/06)
Stabilisation fund, \$ bn	18,9	43,0	55,6	61

Source: BOFIT Russia Review, 4, 12.4.2006

<sup>1</sup> The Stabilisation Fund in Russia was set up with accordance to the Budget Code on the January 1, 2004. This Fund is meant to be built up of surplus revenues gained from the oil duty and tax on natural resources extraction in case the oil price exceeds \$20 per Urals barrel.

As it is shown in the table 7, in the beginning of April the volume of the Stabilisation fund reached the amount of \$61 bn, which is equal to about 8% of the national GDP. Thus, one can say that Russia's further development actually does not depend on FDI and the issue of attracting FDI is of low relevance in Russia nowadays, because the majority of investment projects can be financed with the use of financial resources from the Stabilisation fund. For example, this point of view is shared by the Moscow City Governor – Yuriy Luzhkov. He claims that money has to be invested in development of Russian industry, improvement of infrastructure, etc.

However, Minister of Finance of Russian Federation – Alexei Kudrin - has quite opposite view. He thinks that the bulk of money from the Stabilisation fund has to be invested in foreign governments' bonds and securities, which are considered to offer low risk and to be relatively liquid. The minor part of the Stabilisation fund is suggested to be invested in more profitable, but with higher risk shares of large foreign companies. A part from that, the Russian Government is considering the possibility of repaying the rest of Russia's debt to Paris club (\$12 bn) ahead of schedule. Thus, the majority of Russian Government does not support the idea to invest funds to national economy due to the fact that this measure will cause inflation acceleration no matter which sector of Russian economy these funds would be invested (BOFIT Russia Review, 2006).

To conclude, even though Russia is accumulating the large financial resources, in order to maintain macroeconomic stability and further economic development, the importance of FDI attraction is difficult to overestimate. There is growing evidence that enterprise productivity, R & D expenditure, innovation and company performance are higher in foreign owned firms – both in the transition economies and in the West (Bevan and Estrin, 2000).

### ***8.3. Research limitations***

Due to the high level of complexity of the problem of attracting foreign direct investments to Russia, it is beyond the scope of this paper to capture and describe all the angles of the issue, thus the research was mostly concentrated on Norwegian direct investments to Russia with a particular interest to North-West of Russia.

In addition to this, owing to limited timeframe which was allocated for writing the present paper and extremely business of the experts in this field of economy, it was difficult to carry out the larger-scale research and distribute the questionnaire which this study mainly based on among more than 14 people.

The research to a high degree relies on the secondary data published. Thus, the assumption that the secondary data is correct was imposed. However, during the research

difficulties with data analysis and interpretation were stipulated by the inconsistency of data which was published by different institutions which were considered the authorities.

The study is also constrained to a certain degree of the relatively short-time view of investment climate and the economic situation in Russia.

In addition to these, the present paper considers the present economic situation in the light of the policy which is carried on by the current President of Russia (Vladimir Putin) and Government of Russian Federation (until the year 2008). Obviously it seems to be difficult to predict the political and economic policy of new elected President and Government of Russian Federation after the year 2008.

## *Chapter 9. Conclusions and recommendations for future research*

The transition from socialism to capitalism in Russia is both a political and an economic process. An important aspect of the latter is the possibility of integration into the world economy (through trade and capital flows) which is a crucial and related element of the former. Foreign direct investment (FDI) is a particularly important element of economic integration, because it opens not only possibilities for accelerated growth, technical innovation and enterprise restructuring, but also for capital account relief (Bevan and Estrin, 2000).

In Russia the problem of insufficient company's governance still add up difficulties on the way of creating a favorable investment climate for FDI attraction.

The results of survey carried out among the Norwegian theorists and businessmen support the first paper's hypothesis, which states that the country's taxation and legal infrastructure can be the obstacles for FDI. Figures 15 and 16 illustrate the fact that the legal infrastructure is still not developed enough and creates problems, for example, in the field of property rights protection, creditors' rights protection and insecure intellectual property rights. Highly rated as the most important current problems for foreign direct investors, unexpected changes in tax law and the tax law itself are neither positive characteristic of legal infrastructure nor of taxation infrastructure. Moreover, the weak banking sector can be added to the infrastructure-related problems as well.

The conclusions drawn on the basis of figures 15 and 16 support the second paper's hypothesis as well by illustrating the relatively high relevance of problems connected to the presence of crime and corruption in Russia.

The third hypothesis can not be rejected as well due to the fact that, for example, the significance of payment arrears by clients is still of moderate importance, nevertheless according to the information obtained during the interviews the situation is improving steadily during last years. However, on the positive side, as a part of economic culture, survey results indicate that foreign investors presently are more pleased with Russian management, workers and suppliers than they used to be for about 5 years ago.

The relatively high degree of satisfaction with Russian management, improving situation with payment arrears by clients and near-absence of barter relations between enterprises suggest that the fourth hypothesis (regarding the failure of domestic enterprises and managers to adapt to competitive market conditions) can be rejected.

Nevertheless, the information obtained during the interviews and field work in Russia suggests that the relatively unsuccessful performance of foreign companies on the Russian market can also be explained by the obstacles which lie on the side of foreign investors. These obstacles include:

- ✓ inability to recruit highly-qualified management and staff in existing or newly established companies;
- ✓ insufficient planning of business activities (business-planning), fuzzy goal setting combined with unclear company's business perspective;
- ✓ inability to create clear organizational company's structure with clearly seen internal interactions;
- ✓ insufficient control of the results of business activities by foreign investors.

In other words, any foreign investor has to keep in mind that it is always better to make thorough preliminary work and document preparation (which is not always the case) before taking rapid measure on setting up business in Russia, rather than to blame Russian taxation and legislation systems, unfavorable investment climate and so on, in case of unsuccessful investment.

As it was stated above, all but one hypotheses of the paper were supported by the results of the survey. This fact does not characterize Russian investment climate from its best side. However, problems and obstacles of different kinds do exist in other countries as well, in case of Russia we need to take a better look at the improvements which did take place in the Russian investment climate. The fact that the improvements did happen is supported, for example, by the positive expectations for future investments to Russia by the majority of Norwegian businessmen asked. One could point out that it is a controversial question to answer: whether the improvements did really take place in Russia or if the Norwegian businessmen managed to adapt to the existing economic environment in Russia? Both could be correct. However, to support the former it is worth to mention that starting from 1999 ratings of many International agencies demonstrate the explicitly benevolent attitude of investment associations to Russia. For example, according to Euromoney rating, Russia went up in the national rating from the 133<sup>d</sup> position in March 2000 to 64<sup>th</sup> position in September 2004 (Expert magazine, 2004). What is more, the most strict International rating agency Standard & Poor's (S&P) has increased the sovereign credit rating of Russia from BB+<sup>1</sup> to BBB-<sup>2</sup> in January, 2005. This rating increase was dramatic because it represented the transition of Russia's credit rating from a speculator position to investment position. This rating means a lot due to the fact that S&P's rating first of all is based on the country's financial stability and current economic situation. This S&P's decision followed up the decisions made by the other two agencies - Moody's and Fitch, which increased Russia's

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<sup>1</sup> BB - an obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation (Standard & Poor's Ratings Definitions, 2006).

<sup>2</sup> BBB - an obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation (Standard & Poor's Ratings Definitions, 2006).

credit rating in October, 2003 and November, 2004 respectively. The fact that the country have investment ratings from these three prestige International agencies will obviously have a positive impact on Russia's investment climate.

As the first suggestion for future research the problem of investment security in Russia could be pointed out, because this issue was of concern to both business experts who are dealing with investments working for commercial banks, and to Norwegian specialist employed in the other sectors of economy.

The second research suggestion could be the further development of Russia's investment climate and the dynamic of FDI to the county in light of Russia's joining the World Trade Organization (WTO). In other words, the question is - will participation in WTO influence the FDI flows and to what degree? Nowadays Russia managed to conclude the bilateral treaties with the majority of WTO members (EU, China, New Zealand, Singapore, Taiwan, South Korea, Chili, etc.); however the attitude to joining WTO is still controversial in Russia. The bilateral treaties that Russia has to negotiate with other members require making quite serious concessions, but whether Russia benefit from the results of these concessions after joining WTO – nobody knows.

Talking about the third possible research direction, the alternative ways of using the financial resources of Russia's Stabilization fund and their implications for the Russia's policy regarding FDI could be considered.

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## Appendix I. Survey (questionnaire)



# Survey

is carried out on purpose of supplementing the Master Thesis project titled  
“Barriers and obstacles to foreign direct investment in to Russia”  
by the senior student of the programme  
MSc in International fisheries management (NFH, UiTø)  
**Julia Shevtsova**

### 1. The aims of the survey:

- ✓ the main aim of the survey is to find out interview s’ point of view about the reasons of establishing foreign direct investments in Russia and those problems which foreign direct investors could face in this regard;
- ✓ to compare the obtained results with those findings which were described after the survey which was carried out by R. Ahrend with the help of the European Business Club in Moscow in 2000.

### 2. Persons interviewed:

	Theorists		Business experts	
	Name	Position	Name	Position
1.	Terje Vassdal	Professor, Department of Economics and Management, NFH	Knut J. Borch	Managing director, NORUM Ltd, EBRD North West and West Russia Regional Venture Fund
2.	Anatoli Bourmistrov	Associate professor, University of Bodø	Anton Voskoboinikov	Manager, Gigan te Pechenga (Murmansk, Russia)
3.	Peter Arbo	Associate professor, Department of social and marketing studies, Norwegian college of fishery science, UiTø	Nils Petter Beck	Regional director, Den Norske Bank (DnB)
4.			Hans Henrik Gundersen	General manager, Sparebank 1, Nord-Norge
5.			Odd-Helge Skog	Managing director, Weibull Nord AS

*Persons interviewed (continuation):*

	<b>Theorists</b>		<b>Business experts</b>	
	<i>Name</i>	<i>Position</i>	<i>Name</i>	<i>Position</i>
6.			Jan Erik Angelsen	Aministrative director, Nordnorsk Vekst AS
7.			Stein Ivar Antonsen	Special Adviser in aquaculture, Nordnorsk Vekst AS
8.			Svein Ruud	Director, Troika Seafood (Kirkenes)
9.			Roger Håkon Mikkelsen	Project Director Eastern Europe, Bedriftskompetanse AS
10.			Einar Frafjord	Special advisor, SpareBank 1, Nord-Norge
11.			Kjell-Otto Sebergsen	Director, IMES

3. *Number of questions:* 7

4. *Evaluation of replies:* the scale from **1 (the least important)** to **5 (the most important)**.

5. *Presentation of the results:* the results of the survey will be presented in the form of graphs and diagrams.



### Questionnaire

1. Why foreign companies invest into Russia; what are the most and the least important factors which motivate foreign companies to direct investment to Russia? Please, rate the following:

✓ overcoming trade barriers	1	2	3	4	5	Do not know
✓ lower unit labor costs	1	2	3	4	5	Do not know
✓ avoid exchange rate risk	1	2	3	4	5	Do not know
✓ existing cash flow in Russia	1	2	3	4	5	Do not know
✓ lower environmental standards	1	2	3	4	5	Do not know
✓ enter Russian market	1	2	3	4	5	Do not know
✓ qualified labor force	1	2	3	4	5	Do not know
✓ lower general production costs	1	2	3	4	5	Do not know
✓ avoid transport costs	1	2	3	4	5	Do not know
✓ tax breaks	1	2	3	4	5	Do not know
✓ availability of raw materials	1	2	3	4	5	Do not know
✓ enter the 3 <sup>d</sup> market from Russia	1	2	3	4	5	Do not know
✓ proximity of the market	1	2	3	4	5	Do not know
✓ size of the market	1	2	3	4	5	Do not know

2. What are the foreign direct investors' motives for establishing production in Russia instead of using licensing systems? Please, rate the following:

✓ to keep control over marketing	1	2	3	4	5	Do not know
✓ to control product quality	1	2	3	4	5	Do not know
✓ to keep control over profits	1	2	3	4	5	Do not know
✓ protection of know-how	1	2	3	4	5	Do not know
✓ to control cash flows	1	2	3	4	5	Do not know
✓ access to market know-how	1	2	3	4	5	Do not know
✓ state requirements	1	2	3	4	5	Do not know
✓ access to buildings and production know-how	1	2	3	4	5	Do not know

3. What are the problems faced by foreign direct investors in Russia? Please, rate the following:

✓ current tax law	1	2	3	4	5	Do not know
✓ risk of political change	1	2	3	4	5	Do not know
✓ Russian accounting system	1	2	3	4	5	Do not know
✓ creditors' rights protection	1	2	3	4	5	Do not know
✓ insecure intellectual property rights	1	2	3	4	5	Do not know
✓ expropriation risks	1	2	3	4	5	Do not know
✓ Russian management	1	2	3	4	5	Do not know
✓ Russian workers	1	2	3	4	5	Do not know
✓ unexpected changes in tax law	1	2	3	4	5	Do not know
✓ custom authorities	1	2	3	4	5	Do not know
✓ weak banking sector	1	2	3	4	5	Do not know
✓ macroeconomic instability	1	2	3	4	5	Do not know
✓ current trade policy	1	2	3	4	5	Do not know
✓ harassment by authorities	1	2	3	4	5	Do not know
✓ interregional trade barriers	1	2	3	4	5	Do not know
✓ ordinary criminality	1	2	3	4	5	Do not know
✓ punctuality of imported inputs	1	2	3	4	5	Do not know
✓ insecure property rights	1	2	3	4	5	Do not know
✓ tax authorities	1	2	3	4	5	Do not know
✓ unexpected changes in trade policy	1	2	3	4	5	Do not know
✓ corruption in general	1	2	3	4	5	Do not know
✓ payment arrears by clients	1	2	3	4	5	Do not know
✓ Russian suppliers	1	2	3	4	5	Do not know
✓ Racket/Organized crime	1	2	3	4	5	Do not know
✓ Barter	1	2	3	4	5	Do not know

4. What do you think is the main aim of the foreign companies which establish foreign direct investments in Russia (Underline the correct):

- ✓ production for the local (Russian) market
- ✓ production in Russia for export to other countries

5. (**For business experts only**) What are the factors that determined location choice (in the central part of Russia or in regions) for your company? Please, rate the following:

✓ tax breaks	1	2	3	4	5	Do not know
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*Appendix 2. Descriptive statistics of regional FDI inflows, 1995 – 2003 (000 USD)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Cumulative 1995–2003
Total (64 regions)	2,010,839	2,435,960	5,317,630	3,342,441	4,006,119	4,417,035	3,957,264	3,912,161	6,670,446	36,069,895
Mean	31,419	38,062	83,088	52,226	62,596	69,016	61,832	61,128	104,226	563,592
Standard deviation	130,118	137,571	513,054	132,218	168,995	219,130	175,002	215,420	400,463	1,914,618
Maximum	1,024,173	1,031,888	4,117,916	803,255	1,022,384	1,473,807	1,154,657	1,508,680	2,482,963	14,384,929
Minimum	21	0	4	17	1	2	7	0	0	1,644
Median	4,997	6,653	9,903	6,329	8,413	9,817	9,768	6,265	11,769	100,626
Skewness	7	7	8	4	4	5	5	6	5	6
Kurtosis	56	45	64	22	21	31	27	34	28	45

Note: This table covers the 64 Russian regions for which data on FDI are available.

Source: Goskomstat RF (2001, 2003a, 2004)

*Appendix 3. FDI inflows by sector, 1995 – 2003 (million USD)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Cumulative, 1995–2003	
										Total investment	% of total
Total	2,020	2,440	5,333	3,361	4,260	4,429	3,980	4,002	6,781	36,606	100.00
Industry	915	1,321	1,274	1,991	2,603	1,844	1,753	1,932	3,420	17,053	46.59
Electric power	0	0	0	0	0	0	0	54	0	54	0.15
Fuel industry	262	196	315	307	1,189	442	430	667	1,917	5,725	15.64
Ferrous metallurgy	26	17	123	39	55	39	116	20	84	519	1.42
Non-ferrous metallurgy	35	65	68	58	18	30	21	65	47	407	1.11
Chemical and petro-chemical	69	63	54	50	19	49	88	106	96	594	1.62
Machine-building and metal cutting	102	76	118	127	126	228	316	262	323	1,678	4.58
Logging and woodworking, pulp and paper	84	184	101	112	140	141	131	133	315	1,341	3.66
Building materials	20	31	39	22	24	26	42	49	88	341	0.93
Light industry	11	44	11	5	14	8	28	14	87	222	0.61
Food	250	590	506	1,192	963	821	528	439	345	5,634	15.39
Agriculture	3	4	20	11	41	31	48	22	56	236	0.64
Construction	201	69	255	108	59	45	31	88	142	998	2.73
Transport	11	24	25	128	517	948	689	112	165	2,619	7.15
Trade and catering	469	321	455	489	597	835	757	959	1,513	6,395	17.47
Wholesaling of producers' goods	28	18	25	24	11	30	109	47	104	396	1.08
General commercial activity to promote market performance	134	136	775	253	83	148	227	299	441	2,496	6.82
Finance, credit, insurance, pensions, securities	159	295	2,265	66	31	26	39	56	186	3,123	8.53
Other industries	100	252	239	291	318	522	327	487	115	2,651	7.24

Source: Goskomstat RF (2001, 2003a, 2004)

