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# Russian Federation

PROGRESS AND REFORM CHALLENGES



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

# ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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## Foreword

**R**ussia and the OECD have been co-operating in a wide range of policy fields that are critical for economic development. Investment policies are among the most fundamental, and our co-operation has allowed the Russian Government to draw on the OECD investment instruments and the experience of OECD member countries as it formulates these policies.

In 2001, the OECD published *The Investment Environment in the Russian Federation: Laws, Policies and Institutions*, which described the legal and regulatory framework for foreign investment and analysed the key issues and options for building in Russia an attractive enabling environment for investment. Since then the Russian Government has made important changes in many policies that affect foreign investment, including taxation, foreign exchange regulation, corporate governance and reporting standards, land law, and customs procedures. This study documents this progress and Russia's efforts to meet international standards, including those of the OECD investment instruments.

Russia continues to need more investment and further improvements in the investment environment are possible. The Review examines, for example, the scope for relaxing remaining restrictions on FDI in sectors such as financial services and energy, rules on foreign participation in privatisation of corporations and measures to ensure greater local compliance with federal laws and regulations.

I am happy to note that the study has benefited from numerous contributions and comments from senior government officials and experts in the Russian Federation. The Review has given us a unique opportunity to learn about the fascinating process of Russia's transition to a functioning market economy. I would also like to thank OECD member country experts and members of the business community in Russia for their contributions which ensured that this Review is well grounded in their experience of policy-making and doing business.

The OECD looks forward to building on the 2004 Investment Policy Review to continue its close co-operation with the Russian Federation.



Donald J. Johnston  
Secretary-General

On behalf of the Ministry of Economic Development and Trade of the Russian Federation, I should like to greet all those who will be using the Russian Investment Policy Review prepared by the Organisation for Economic Co-operation and Development.

In the past two years the Russian Federation has managed to make considerable progress in its institutional reform in terms of both creating a favourable environment for entrepreneurship and improving the quality of existing market institutions. Positive dynamics of the key macroeconomic indicators are yet more proof of that.

The Government of the Russian Federation has been pursuing a policy of improving conditions for foreign investment, creating economic incentives to attract investment resources from abroad and strengthening enforcement. Efforts to improve the transport infrastructure, to open up markets consistently for foreign participants and to liberalise the currency legislation are integral components of this policy.

Also worth mentioning is a more active policy of the regional authorities aimed at attracting foreign investment.

The Russian economy and, primarily, its manufacturing sector, have a great investment potential due to a number of Russia's competitive advantages *vis-à-vis* other countries that are recipients of foreign investment. The current policy of the Government of the Russian Federation to improve the investment climate for both foreign and domestic investors is aimed at the efficient utilisation of such opportunities.

Let me express my gratitude to the Organisation for Economic Co-operation and Development and the authors of the Review of the Russian Investment Policy for the work they have done and express my hope for further co-operation.



German O. Gref  
Minister of Economic Development and Trade  
Russian Federation

## *Note by the Editor*

**T**his report was prepared in support of an Investment Policy Review of the Russian Federation by the OECD's Investment Committee held in Paris on 14 June 2004. The Russian delegation to the Review was led by Deputy Minister of Economic Development and Trade Saveliev, accompanied by Central Bank First Vice-Chairman Kozlov and high level officials of other agencies.

The material for this report was assembled by Eva Thiel and Kenneth Davies in the Investment Division of the OECD Directorate for Financial and Enterprise Affairs, with input from its Corporate Affairs, Anti-Corruption, Financial Affairs and Competition Divisions and from the Centre for Tax Policy and Administration, the Economics Department and the Directorate for Food, Agriculture and Fisheries. The cut-off point for information in this report is 16 August 2004 and, in relation to foreign exchange regulations, 14 June 2004.

The preparation of the report and the Review are the result of active co-operation and close consultations with the Ministry of Economic Development and Trade, the Central Bank and other agencies of the Russian Federation. They also benefited from comments by delegates to the OECD's Investment Committee and input from representatives of the private sector, in both Russia and in OECD Member countries, including the law firm Salans, Ernst & Young and the Foreign Investment Advisory Council.

This report was prepared as part of the OECD Investment Committee's work programme and co-operation with non-members. It is published under the authority of the Secretary-General.

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# *Chapter 1*

## **Progress and Prospects**

## 1. Russia needs more foreign direct investment

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

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

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

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

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

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

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

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

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

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

FDI has so far not greatly helped solve the problem, since its sectoral distribution remains highly skewed towards oil extraction, which accounts for well over half of all non-financial FDI in Russia and therefore far exceeds FDI in all manufacturing and services sectors combined. FDI is therefore not yet playing a fully effective role in contributing to the government's attempt to

diversify the economy away from over-reliance on hydrocarbon extraction, and is to some extent adding to the problem. Russia therefore needs to attract more FDI in other sectors. As well as being low by international standards, FDI inflows to the Russian Federation are highly unevenly geographically distributed, with one of the six federal districts absorbing more than half the total and many regions receiving negligible amounts. As in the case of sectoral FDI distribution, this skewed regional distribution is almost certainly exacerbating uneven geographical development rather than mitigating it. Excessive concentration of FDI in a small area of Russia's huge land mass, which contains widely dispersed resources capable of exploitation, may also not be the most effective or efficient means of promoting sustainable economic growth.

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

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

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

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

## 2. Recommendations in the 2001 OECD study

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

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

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

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

*Increasing tax policy transparency.* With regard to tax policy, the OECD proposed a range of improvements designed to increase transparency, consistency, fairness and effectiveness.<sup>9</sup>

*Eliminating discrimination against foreign investors in privatisations.* The 2001 study noted that foreign investors were not really protected against discriminatory and unfair treatment as a result of changing requirements, legislation and procedures at different stages of investment projects. It recommended that the Russian government's priorities for the completion of privatisation should be: the use of direct and competitive sales to strategic investors for the more marketable stakes; appropriate organisational and administrative procedures for the full privatisation of minor shareholdings

and state assets requiring extensive restructuring; the introduction of sound management structures for property remaining in state ownership to eliminate malpractices; and the resolution of remaining disputes relating to past privatisations.

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

### **3. Recent progress and remaining challenges**

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

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

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

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

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

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

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

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

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

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

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

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

Despite many recent improvements in laws and regulations protecting property and the contractual rights of investors, uncertainty of proper administration and enforcement of justice by the court system and the continuing reported prevalence of corruption throughout the public sector

undermine confidence in the legal and regulatory framework. A related problem is incoherence between federal, regional and local regulations regarding investment and their implementation in such areas as procedures governing applications for and granting of permits, licences and other authorisations.

#### **4. Policy options for further reform**

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

##### **4.1. Relaxing remaining formal restrictions on foreign direct investment**

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

##### **Banking**

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

##### **Insurance**

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



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

### ***Transport, telecommunications, energy and agriculture***

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

### ***4.2. Foreign exchange liberalisation and persevering with financial sector reform***

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

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

### ***4.3. Improving corporate governance***

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

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

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

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

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

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

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

#### **4.6. The legal system and taxation**

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

#### **4.7. The fight against corruption**

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

### **Notes**

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

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

## *Chapter 2*

### **The Pattern of Russia's FDI Inflows**

Official FDI statistics indicate that Russia has continued to under perform in both the quantity and the composition of FDI in comparison with other industrialised economies, including transition economies in Central and Eastern Europe.

### **1. FDI inflows fluctuate at a fairly low level**

According to CBR statistics, FDI inflows are officially reported as having increased from USD 690 million in 1994 to a peak value of USD 4 864 million in 1997 before plunging to USD 2 761 during the economic crisis year of 1998. From then until 2002 total inflows remained roughly stable before rising to USD 3 442 million in 2002 and falling sharply to USD 1 144 in 2003 (FSSS/Goskomstat estimates differ markedly, especially for 2003, see below). When considering these figures, however, it should be borne in mind that a) at such low levels of FDI inflow the figure for a particular year is likely to be heavily influenced by one or two large investment projects and b) there are large differences between the CBR and FSSS/Goskomstat figures, which may occasionally indicate entirely different outcomes.

The Central Bank figure for the whole of 2003 is of an FDI inflow on a balance-of-payments basis of USD 1 144 million,<sup>1</sup> a figure that has been reported to result from heightened fears of foreign investors regarding the business climate in Russia following the targeting for investigation on charges of tax evasion of the oil firm, Yukos, and the arrest of its CEO and largest shareholder. As the Central Bank recorded a USD 3.4 billion FDI inflow in 2002, the 2003 estimate indicates a plunge in Russia's net inward FDI. However, this fall in the net figure probably represents a sharp increase in outward capital flows in the second half of 2003 rather than a collapse in inflows. In the first three quarters of 2003, the Central Bank reports an FDI inflow of USD 2 billion, a mere 16.7 per cent fall from the USD 2.4 billion recorded a year earlier, demonstrating that the outflow occurred in the final quarter.

Official figures from the country's statistical service, FSSS/Goskomstat, paint a starkly different picture from that of the Central Bank, with USD 6 781 million arriving in 2003, 69.4 per cent higher than in 2002. One major reason for the difference in FDI inflow totals – and in trend direction – is probably the conclusion of a joint venture deal between a foreign oil major and a Russian oil company that is resulting in a flow of funds into a Russian entity in Cyprus, producing an addition to FDI stock in FSSS/Goskomstat terms

### Box 2.1. Sources of Russian FDI data

FDI statistics of Russia are basically in accordance with international standards. The Central Bank of Russia (CBR) provides annual and quarterly statistics on foreign direct investment in its balance of payments reports. The Federal Service of State Statistics (FSSS), formerly the State Committee for Statistics (Goskomstat), publishes annual statistics on foreign direct investment broken down into countries of origin and receiving sectors. The FSSS/Goskomstat figure for total inward FDI is usually higher than the CBR figure (see box table). The difference results from differences in data collection methods and ultimately from fundamental differences in purpose. FSSS/Goskomstat relies on customs statistics and special questionnaires, while the CBR, while taking into account FSSS/Goskomstat data, and also relies on its own system of monitoring the capital account operations of banks, based on compulsory reporting for foreign exchange purposes. The difference between FSSS/Goskomstat and Central bank data is also explained by the fact that, in accordance with IMF methodology, FSSS/Goskomstat includes "secondary investment" (i.e. investment made on Russian soil by Russian entities with more than 50 per cent foreign equity) in total FDI volume. The generally larger figure reported by FSSS/Goskomstat includes under the heading of foreign direct investment projects whose financing involves payments to Russian entities based abroad, which are excluded from the balance of payments statistics issued by the CBR.

Opinions in Russia differ regarding which figure is more indicative of FDI trends. FSSS/Goskomstat statistics provide more information on the detailed composition of FDI and include major projects involving foreign enterprises which might not appear if unaccompanied by a flow of funds into Russia. On the other hand, CBR figures may be seen as giving a clearer indication of the impact of FDI on Russia's international financial position.

#### Central Bank and FSSS/Goskomstat figures for national FDI inflows in selected years

USD million

	1995	1998	1999	2000	2001	2002	2003
Central Bank of Russia	2 066	2 761	3 309	2 714	2 748	3 442	1 144
FSSS/Goskomstat	2 020	3 361	4 260	4 429	3 980	4 002	6 781
Difference <sup>1</sup>	-2.2%	21.7%	28.7%	63.2%	44.8%	16.3%	492.7%

1. Difference between FSSS/Goskomstat and Central Bank figures expressed as a percentage of Central Bank figure.

Source: Central Bank of Russia; FSSS/Goskomstat.

**Box 2.1. Sources of Russian FDI data (cont.)**

It should be borne in mind that FDI constitutes a minority of foreign investment as defined in the Russian Federation, since a high proportion of foreign investment is classified as “other investment”, i.e. trade credit and other forms of credit. The official Russian definition of FDI is in some respects more restrictive than that applied in other countries. Portfolio investment, on the other hand, is generally a far smaller component of foreign investment than FDI.

that is not accompanied by a flow of funds into the Russian Federation and so was not recorded by the CBR in 2003.

## 2. Main sources of FDI inflows to the Russian Federation: OECD countries and Cyprus

Cumulative FDI inflows up to the end of 2003 are officially reported by FSSS/Goskomstat as totalling USD 26.1 billion. The bulk of this, 80 per cent, was recorded as having originated from 10 countries (see Table 2.1). The largest contributor is listed as Cyprus, providing 19.3 per cent of the total, much of which is almost certainly returning flight capital or round-tripping investment from within Russia itself; the remainder probably includes FDI indirectly routed from other countries. The US, is the world's largest economy and a major provider of global FDI, is recorded as being in second place, accounting for 16.4 per cent of inward FDI flows to Russia. Investment from

Table 2.1. **Cumulative foreign direct investment flows into the Russian Federation up to end-2003**

	Foreign direct investment inflow (USD million)	Proportion of total FDI inflow (%)
<b>Total foreign direct investment</b>	<b>26 131</b>	<b>100.0</b>
Cyprus	5 037	19.3
USA	4 297	16.4
UK	2 828	10.8
Netherlands	2 796	10.7
Germany	2 542	9.7
Japan	1 353	5.2
Switzerland	822	3.1
British Virgin Islands	718	2.7
France	331	1.3
Luxembourg	222	0.8

Source: FSSS/Goskomstat.

the British Virgin Islands, which is reported as constituting 2.7 per cent of cumulative FDI is, like that from Cyprus, mostly re-routed from elsewhere. An unknown, probably significant, proportion of FDI from other sources, such as the Netherlands, Switzerland and Luxembourg, is likely also to originate from Russia. One indication of this may be the size of cumulative FDI outflows from Russia to the Netherlands during the same period (Table 2.2), which amounted to 17.7 per cent of Russia's total FDI outflows.

Table 2.2. **Cumulative foreign direct investment flows from the Russian Federation up to end-2003**

	Foreign direct investment outflow (USD million)	Proportion of total FDI outflow (%)
<b>Total foreign direct investment</b>	<b>2 760</b>	<b>100.0</b>
FDI to principal receiving countries	2 271	82.3
Belarus	707	25.6
Iran	512	18.6
Netherlands	488	17.7
Liberia	227	8.2
Moldova	145	5.3
Armenia	138	5.0
Cyprus	47	1.7
Virgin Islands	0.3	0.0

Source: FSSS/Goskomstat.

FDI inflows to Russia from the Commonwealth of Independent States (CIS) countries are negligible. On the other hand, The CIS countries account for 36 per cent of Russia's cumulated FDI outflow to the end of September 2003.<sup>2</sup> Distribution of this outflow within the CIS has been highly uneven: Belarus absorbed 25.6 per cent of Russia's cumulated outward FDI flow up to the end of 2003, while the second largest recipient, at 5.3 per cent, is Moldova. The other countries of the CIS appear to have received relatively small FDI inflows from Russia.

### 3. Uneven geographical distribution of FDI in Russia

FDI is distributed unevenly across the territory of the Russian Federation (see Annex A, Table A.1). The Central Federal District (which includes Moscow, a major magnet for FDI) attracted 55.6 per cent of the national FDI inflow in 2002.<sup>3</sup> The second largest recipient was the Far East Federal District (where the bulk of FDI goes to Sakhalin), with 18.1 per cent. At the bottom of the range, the huge Siberian Federal District received only one per cent of Russia's FDI.



Table 2.3. **FDI by Federal District, 2002**

	Total FDI (USD thousand)	% of total	FDI per capita (USD)
Central Federal District	2 223 851	55.6	58.54
North-Western Federal District	332 687	8.3	23.79
Southern Federal District	213 695	5.3	9.33
Volga Federal District	197 473	4.9	6.34
Urals Federal District	269 379	6.7	21.76
Siberian Federal District	41 293	1.0	2.06
Far East Federal District	724 181	18.1	108.30
<b>Russian Federation</b>	<b>4 002 559</b>	<b>100.0</b>	<b>27.57</b>

Source: FSSS/Goskomstat.

Among the 89 subjects of the Russian Federation there is also a highly unequal dispersion of FDI (see Table A.1). In 2002 the capital, Moscow, together with neighbouring Moscow oblast, received 55.4 per cent of the national total (the other 16 subjects in the Central Federal District recorded 0.2 per cent between them), while Sakhalin oblast, a major centre for the oil and gas industry, recorded 17 per cent. Two major oil and gas producing centres, Tyumen oblast and the Yamal-Nenets autonomous okrug came next, with 4.2 per cent and 3.3 per cent respectively.

Although a few metropolitan areas attract disproportionately large amounts of foreign investment, FDI is not perfectly correlated with population concentrations. This is clear from a comparison between FDI and population in the seven Federal Districts into which the Federation is divided (see Table 2.6). In 2002, the Far East Federal District, which contains 4.9 per cent of the population of the Russian Federation, received 18.1 per cent of the country's FDI, so that FDI per capita reached USD 108.3. This high figure is due entirely to one region, Sakhalin oblast, which had per capita FDI of USD 1 245; the other regions of the Far East averaged less than USD 4. The Central Federal District, home to 25.3 per cent of the total population, absorbed 55.6 per cent of inward FDI, giving it per capita FDI of USD 58.54, held up by Moscow, where per capita GDP was USD 145.65, Moscow oblast, where it reached USD 88.9, and Kaluga oblast, at USD 34.02; the other regions in the Central Federal District averaged USD 5.04. The lowest per capita FDI figure for any Federal District, USD 2.06, was recorded by Siberia.

#### 4. Sectoral composition of FDI: prominence of extractive industries

The classification used by FSSS/Goskomstat to describe the sectoral composition of inward FDI differs from those in use in other countries, so it is not possible to make precise comparisons with the structure of FDI in other recipient countries. However, the broad categories used in official figures

clearly demonstrate that FDI in the Russian Federation is heavily skewed towards oil extraction, which was reported as comprising over a quarter of the total in 2003, and food distribution, which was simultaneously reported as comprising one-fifth of the total (see Table 2.4). Although “industry” is reported as receiving nearly half of all FDI during this period, the largest component of this category is fuel, over 98 per cent of which is usually accounted for by oil extraction, which comprised 56.1 per cent of total industrial FDI in 2003, with key manufacturing sectors absorbing a smaller share of FDI, for example machine-building and metal-processing (9.4 per cent) and chemicals and petrochemicals (2.8 per cent). Other major sectors of the economy receive relatively small proportions of inward FDI, including financial services<sup>4</sup> (5.4 per cent), construction (4.2 per cent), transport (4.8 per cent) and communications (2.8 per cent). The distribution of inward FDI reflects, among other factors, the degree of openness of each sector: gas extraction, for instance, attracts far less foreign investment than oil extraction because it is dominated by the Gazprom monopoly. This distribution is also reflected in individual projects, the largest of which are in oil and gas extraction and in retail operations such as hypermarket chains.

**Table 2.4. Composition of FDI inflows into the Russian Federation, January-September 2003**

	FDI by sector (USD million)	Proportion of total non-financial FDI (%)
All industries	3 420	100.0
Energy	9	0.3
Fuel	1 917	56.1
Ferrous metals	84	2.5
Non-ferrous metals	47	1.4
Chemicals and petrochemicals	96	2.8
Machine-building and metal-processing	323	9.4
Wood and paper processing	315	9.2
Food processing	345	10.1
Construction	142	4.2
Agriculture	56	1.6
Transport	165	4.8
Communications	96	2.8
Trade and catering	1 513	44.2
<i>of which:</i>		
<i>External trade</i>	27	0.8
Trade in capital goods and machinery	104	3.0
Other commercial activity	441	12.9
Housing and public utilities	6	0.2
Finance, credit, insurance, pension finance	186	5.4

Source: FSSS/Goskomstat.

## 5. Low level of Russia's FDI inflows in comparative perspective

Russia's FDI performance remains poor compared to that of OECD countries. In 2003, Russia's total FDI inflow of USD 1 144 million was below that of all but six of the smaller OECD member economies<sup>5</sup> and its per capita FDI inflow of USD 27.6 in 2002 (Central Bank figure) was below that of all member countries. The composition of FDI flows between OECD countries also differs markedly from the composition of Russia's FDI inflows in that the sectoral distribution is wider and more balanced. It is also worth noting that the cross-border merger and acquisition deals involving "new economy" service sectors that have been a major feature of FDI flows between OECD countries in recent years are far less important in Russia, even though the Russian government has adopted policies which it claims are aimed at raising the investment appeal of those sectors.

A meaningful comparison is with the Central and East European transition economies, which commenced their transformation from centrally planned to market economy at approximately the same time as Russia and which, as former members of the Warsaw Pact and Comecon, came from a more closely comparable political and economic institutional background to that of the Russian Federation.

The most successful of these in terms of overall economic development and, as part of that development, also in terms of attracting FDI, have been the Central European countries that became members of the OECD. All of these countries have at some stage outperformed Russia in terms of total FDI inflows, despite their vastly smaller populations and territories (see Table 2.5). Poland has consistently attracted more FDI than Russia, receiving an annual average of USD 5.2 billion in 1994-2003, compared to USD 2.6 billion for Russia. During that period, the Slovak Republic absorbed less than Russia (an annual average of USD 1.1 billion), while the Czech Republic received USD 3.8 billion and Hungary USD 3.3 billion.

Table 2.5. **FDI inflows to Russia and Central European OECD members, 1994-2003**  
(USD million)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Russia	690.0	2 066.0	2 579.0	4 865.0	2 761.0	3 310.0	2 714.0	2 748.0	3 461.0	1 144.0
Czech Republic	868.3	2 561.9	1 428.2	1 301.1	3 716.4	6 326.2	4 980.2	5 644.6	8 433.5	2 591.6
Hungary	1 143.5	5 101.9	3 300.4	4 170.9	3 337.1	3 313.1	2 763.0	3 936.0	2 844.6	2 470.0
Poland	1 875.0	3 659.0	4 498.0	4 908.2	6 364.9	7 269.6	9 341.0	5 713.0	4 131.0	4 225.0
Slovak Republic	272.9	241.4	395.7	230.6	706.8	428.5	2 383.1	1 584.1	4 126.5	593.8

Source: CBR; International Investment Perspectives, OECD, 2003 edition.

Differences in population size, however, regularly ensure that FDI per capita in Russia is far lower than in all the Central European transition economies. For example, FDI per capita in Russia was only USD 27.6 in 2002, the latest year for which comparable figures from all these countries are available and a typical year, when comparable figures ranged between USD 88.6 in Hungary and USD 817.8 in the Czech Republic (see Table 2.6). Only part of this difference can be explained by the proximity of the Central European transition economies to major investing countries in Western and Central Europe (and their prospective membership of the European Union<sup>6</sup>); their attractiveness is also largely accounted for by their more developed institutional framework. Moreover, the composition of FDI inflows into the Central European transition economies is directed towards manufacturing and services and not primarily towards mineral extraction, as in Russia.

**Table 2.6. FDI inflow per head in Russia and Central European OECD members, 2002**  
(USD million)

	(USD)
Russia	27.6
Czech Republic	817.8
Hungary	88.6
Poland	106.1
Slovak Republic	743.6

Source: CBR; *International Investment Perspectives*, OECD, 2003 edition; OECD web site, Basic Structural Statistics.

Those Central European countries which have attracted more FDI as a proportion of GDP, Hungary, Poland and the Czech Republic, have recorded higher rates of economic growth. It is sometimes argued that the causal relationship between the FDI: GDP ratio and the GDP growth rate may operate in the reverse direction, i.e. that high growth may attract inward investment. However, this has not been the case in Russia, where the order of magnitude of inward FDI flows has not risen in response to the relatively rapid post-1998 economic growth.

Russia's modest record in attracting FDI has frequently been compared with that of China, which became the world's largest recipient of FDI in 2003, when it received over USD 50 billion in FDI for the second year in a row. China has consistently outperformed Russia in this regard, for instance absorbing over 13 times as much total FDI as Russia in 2002 (see Annex A, Figure A.1). However, it should be borne in mind that China's opening up to foreign investment occurred over a decade earlier than Russia's. If Russia's FDI inflows

in the mid-1990s are compared to those in China in the early 1980s, the two can be seen to be of similar magnitude (see Annex A, Table A.2). But this does not provide grounds for complacency concerning Russia's relatively low FDI inflows: there is as yet no specific reason to expect Russian FDI to rise as sharply as China's did from 1992 onward.

The comparison between FDI inflows to Russia and China is also less stark if it is made on a per capita basis. Per capita FDI inflows to Russia were on average just over half those to China in 1992-2001 and nearly reached the Chinese figure in 1997.

### Notes

1. Central Bank web site, [www.cbr.ru](http://www.cbr.ru).
2. FSSS/Goskomstat figures.
3. Regional statistics are published later than national statistics; at the time of writing, figures for 2003 were not yet available.
4. This figure, however, only includes investment in financial services by non-financial entities.
5. *International Investment Perspectives*, 2004, OECD.
6. Claessens *et al.* (1998), found prospective EU accession to be a significant determinant of FDI in an econometric evaluation of the factors determining FDI in Central and Eastern Europe and the countries of the Former Soviet Union.

## *Chapter 3*

### **Progress Since the 2001 OECD Study: Selected Areas**

## 1. Tax reform and tax incentives for foreign investment

One of the fundamental reforms that were being introduced as the 2001 study was drafted concerns the Russian tax system. Based on their experience of the system in force during the 1990s, investors complained vociferously about the tax burden created not so much by the incidence of tax rates but by the multiplicity of different taxes levied and the methods of determining the tax base. Many structural aspects of the system contained an inherent bias against business activity, and its negative impact on entrepreneurs, both domestic and foreign, was aggravated by frequent changes in rules and regulations.

Following attempts at *ad hoc* tax reform between 1993 and 1996, a complete overhaul of the system of local, regional and federal tax legislation was undertaken from the beginning of 1998, resulting in a more efficient and user-friendly system for both the taxpayer and the collecting authorities.

The centrepiece of the new system, the Tax Code, was intended gradually to incorporate the entire set of rules constituting the legislative framework for the Russian tax system, including the general rules and the rules of calculation and payment of all federal, regional and local taxes. The Tax Code takes precedence over all other tax regulations.

Part I of the Tax Code, which took effect on 1 January 1999, established the general taxation framework in terms of principles of taxation, definitions and tax administration procedures, including protection of taxpayer rights against retroactive tax legislation and liability for tax violations. Part II of the Code, establishing the rule for calculation and payment of individual taxes, came into force on 1 January 2001, initially containing four chapters dealing with VAT, excise tax, individual income tax and a new unified social tax. Under the VAT Chapter of the Tax Code, VAT remained at its previous rate of 20 per cent but the number of privileged tax payers was reduced and the recovery of VAT was permitted in full on constructed fixed assets, which reduced the cost of capital investment. Under the Individual Income Tax Chapter of the Tax Code, the rate of the tax was cut to 13 per cent for residents (individuals spending 183 or more days in Russia in a given calendar year, regardless of their citizenship) and 30 per cent for non-residents. The new unified social tax replaced several separate social charges together previously amounting to 38.5 per cent of payroll expense. The aggregate rate of the social charges (excluding the work-place injury insurance contribution, which remained

separate) was lowered: the unified social tax is levied at a regressive scale, with a top rate of 35.6 per cent and a bottom rate of 2 per cent, which is available for employers paying an average salary of over 2 500 roubles (equivalent to less than USD 100) a month. A major portion of the unified social tax is still in effect allocated to the State Pension Fund. From 1 January 2002 the chapter on corporate income tax ("profits tax"), applying also to banks and other financial institutions, came into force, setting a flat profits tax of 24 per cent for all enterprises, split among federal, regional and local authorities. It also eliminated the previously widespread use of tax concessions and special favourable tax regimes at all levels of government. Finally, it introduced a liberal withholding tax regime for Russian-source income of foreign companies.

Expense deduction rules were broadened from January 2002 to permit full deductibility of most major business expenses. Although restrictions still apply to the deductibility of certain expenses, for the most part the restrictions are similar to the expense deductibility restrictions used in many industrialised countries. This is in contrast to the situation prior to 1 January 2002, when, because of restrictions on the deductibility of some business expenses, the tax base for Russian corporate profits tax was larger than the comparable corporate tax base in other industrialised countries, thus often resulting in a higher effective profits tax rate than the nominal statutory rate would lead one to expect. Indeed, many of the expenses subject to restricted deductibility were the principal expenses incurred by businesses in the transition from a command economy to a market economy.

Part II of the Tax Code now includes chapters on individual federal tax, regional taxes and special tax regimes. The Tax Code will be further expanded by the addition of a new chapter on the regional property tax, with the new chapters on the remaining federal, regional and local taxes to follow within the next few years.

Tax incentives for FDI appear of less importance in the recent period, except at local levels. Efforts to contain them and make them available to all investors are compatible with the *OECD Checklist on Foreign Direct Incentive Policies* ([www.oecd.org/daf/investment](http://www.oecd.org/daf/investment)). It is important that measures to reduce reliance on special tax incentives be conceived as part of a broader reform effort to establish a broad-based, fair and transparent tax regime for investment, both foreign and domestic.

Two other recommendations set out in the 2001 study where further action still seem to be required are:

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



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

Although the new Tax Code significantly clarifies the roles and powers of tax inspectors and tax bodies, and grants greatly expanded rights to taxpayers,

### Box 3.1. List of Developments in the Tax Area During 2003

- Abolition of road user tax (the last turnover tax) from 1 January 2003.
- Liquidation of separate federal tax police bodies from 1 July 2003 (tax police converted into a subdivision of the Ministry of Internal Affairs, with a significant staff reduction and limitation of certain powers).
- Abolition of sales tax and some insignificant local (municipal) taxes from 1 January 2004.
- Reduction of VAT rate to 18 per cent from January 2004.
- No excise tax on natural gas from 1 January 2004 (compensated for by an increase of mineral restoration tax and change of export customs duty on gas from a fixed to an *ad valorem* 30 per cent rate).
- Pending changes to property tax (reduction of the tax base to fixed assets only and an increase of the maximum rate to 2.2 per cent) (approved by Parliament, and awaiting the President's signature).
- The effective term for regional and local investment tax incentives granted under the old rules for an unlimited period prior to 1 July 2001 has been cut off.
- A new Chapter 264 of the Tax Code "Taxation System under Production Sharing Agreements" came into effect on 10 June 2003.
- The threshold in the Tax Code for non-taxable bank interest on rouble deposits for individual taxation purposes has been raised from 75 per cent to 100 per cent of the RF Central Bank refinancing rate.
- The Constitutional Court adopted a resolution on the criminal liability for tax evasion (Article 199 of the Russian Federation Criminal Code): the vague wording "tax evasion by other means" was found to conform to the Constitution with certain reservations, *i.e.* in effect the current practice of imposition of criminal liability for tax offences has been supported.
- The High Arbitration Court Issued an information letter on the application of Part I of the Tax Code, including clarifications on the transfer pricing rules (*inter alia* supporting the position that sister companies can be found to be "interrelated" by court).
- The government is considering the introduction of special bank accounts for VAT settlements to curb VAT evasion by fly-by-night firms.

Source: Salans, Moscow.

tax enforcement remains political and often arbitrary. A practical problem in this area is that tax inspectors have a dual function: they are charged not only with enforcing tax legislation, but also with meeting budgetary targets for tax collection. While this combination of functions is not unusual, the manner in which it is applied in Russia creates an incentive for inspectors to assess additional taxes even when there is no basis for doing so, and creates a disincentive to pay out refunds of withheld or overpaid tax to taxpayers. It would be preferable for the tax authorities to concentrate their efforts on enforcing tax legislation and ensuring taxpayer compliance with its provisions. To that end, there should be more clear direction on the standards which should be applied to reviews and audits to reduce the discretion of individual inspectors in this area. Clear sanctions should be imposed on tax-collection officials when they assess additional taxes without any reasonable basis and when they fail to pay refunds in a timely fashion.<sup>1</sup>

A related source of numerous complaints by foreign investors is that of obtaining refunds of withheld or overpaid amounts. Cases are reported in which the service has either itself recognised an obligation, or has been ordered by a Russian court, to repay an amount, but has refused to do so or has protracted the process with frivolous appeals and additional claims. Where refund amounts are calculated in roubles, such delays can have a disproportionately severe impact on foreign investors because of currency fluctuation risks. In some cases, taxpayers are entitled to claim interest on delayed repayments, which may to some extent compensate for added currency risk. This problem is also relevant for exporters who are entitled to claim refunds of input VAT incurred in connection with the acquisition and/or production of exported goods. It is only in very rare cases that taxpayers are able to obtain a refund without going through lengthy and costly litigation.

In examining shortcomings in tax administration in Russia, it is important to bear in mind that the taxation system was only established in the early 1990s and there has as yet not been sufficient time for administrative approaches to mature. The absence of a taxpaying culture after more than seven decades of Soviet rule, heightened by perceptions that a few people have become disproportionately enriched by the privatisation of state assets, means that there is widespread and persistent resistance to paying tax, leading to large-scale tax evasion, particularly in the area of VAT. The requisite cultural change necessary to permit full implementation of a regular taxation system will take many years to complete. Administrators work in a complex and difficult environment and would benefit from greater exposure to modern tax practices to enable them to understand what changes are necessary to ensure effective implementation of the taxation system.

The 2001 study also recommended the establishment of a tax regime for the oil and gas sector that would encourage new investment and provide a sufficient

return to the state. The Production Sharing Agreement (PSA) chapter of the Tax Code, introduced in June 2003, effectively discourages new PSAs because it makes the special PSA tax regime available only to PSAs on low-deposit fields and establishes only very limited tax benefits under the special tax regime. The law also repeals a special VAT exemption for supplies by PSA contractors. By reducing incentives for investment by the use of PSAs, the new measure does indicate that the authorities are seeking to limit special tax treatment for specific types of investment and are moving towards a broader-based taxation system.

## **2. Reforming foreign exchange legislation**

Awaiting the entry into force of the new foreign exchange law adopted in December 2003, which has been in preparation for several years, a number of separate amendments have been made to the 1992 Foreign Exchange Law, partly in response to repeated complaints from the foreign business community.

For a number of capital account transactions, including the raising of loans abroad by resident non-financial institutions with a maturity exceeding 180 days and the opening of accounts abroad by resident legal entities to service their representative offices and branches abroad, requirements for authorisation have been replaced by a notification requirement only. The mandatory surrender requirement for foreign currency revenue was lowered from 50 per cent to 30 per cent in July 2003. Measures were also taken to liberalise the export of currency out of Russia, so that since February 2003 both Russian and foreign citizens have been allowed to export the equivalent of USD 10 000 without supporting documentation.

However, because of the capital flight problem experienced in Russia, the Russian Central Bank continues to impose restrictions on the outflow of foreign currency. Although these restrictions are intended to stem illegal outflows, legitimate repatriation by foreign investors can sometimes be problematic, as pointed out in the 2001 study.

For example, a major currency control issue is the requirement that a resident of Russia must obtain advance approval from the Ministry of Finance to convert roubles into foreign currency to make one or more related payments of more than USD 10 000 (or the equivalent in another foreign currency) to a non-resident of Russia under a contract for the provision of most services, including an inbound cross-border lease. Advance approval is not required if the Russian resident has sufficient foreign currency funds to make the payment and does not need to convert roubles into foreign currency for that purpose. However, currency conversion requirements may make it difficult for a Russian entity to amass sufficient foreign currency reserves to avoid the approval requirement. Although such approvals are generally granted, there is often a delay of several weeks.

Similarly, although currency regulations have been significantly liberalised in recent years, Central Bank approval continues to be required for certain categories of transaction involving foreign currency. For example, as a way of controlling outward and inward capital flows occurring through leads and lags in trade payments, foreign purchasers of goods exported by Russian entities must pay for such goods within 90 days unless they have authorisation from the Russian Ministry of Finance for a longer period; payment in connection with purchase otherwise of immovable property or shares on a secondary market may be made only pursuant to a prior licence of the Central Bank; and certain set-offs and other settlement arrangements require prior Central Bank approval if they involve foreign currency indebtedness. In addition, the repatriation and surrender requirements imposed for all currency proceeds obtained abroad by residents (with limited exceptions) is still regarded as onerous, even at the lower rate of 30 per cent.

Each of these requirements, while technically applicable to all entities within Russia, has a disproportionately greater impact on foreign investors and Russian entities which have significant operations with foreign countries and/or foreign shareholders or partners. Moreover, the process of seeking and obtaining Central Bank approvals is cumbersome, document-intensive and very time-consuming. Although licences are usually granted, the process can take several months for a foreign investor who follows proper application procedures.

There are also complex rules and regulations governing the use by foreign investors of domestic bank accounts. A number of regimes are currently in force. Foreign legal entities may conduct most of the operations either through "K" (convertible) or through "N" (non-convertible) accounts. Roubles deposited in a type "K" account may be freely converted into foreign currency. Amounts credited to a type "N" account may be converted into foreign currency only if they are deposited for one year. In addition, for certain settlements in connection with securities and other investment operations non-residents may open type "S" accounts, which also have usage and repatriation restrictions. Non-resident individuals may conduct settlements through type "F" accounts.

The new foreign exchange law, which will enter into force on 18 June 2004, envisages that several controls (including requirements for repatriation and obligatory conversion) will remain in effect in some form at least until end-2006, as will the new CBR discretionary power to impose deposit requirements set for a range of capital account operations deemed to have a potentially destabilising effect on the financial sector and the economy in general. In addition, controls on the opening and maintaining of bank accounts outside the Russian Federation will be retained for a further year. Detailed implementing regulations for the new law are currently being drafted.

Subject to closer scrutiny, the securities law does not restrict the issuing of domestic securities in foreign markets.

### 3. Improvements in corporate governance

The 2001 study raised several warning flags regarding corporate governance. It concluded that the investment climate was impaired by serious abuses, such as infringements of minority shareholder rights, opacity regarding trusteeship, contradictory regulations in joint stock company law, as well as outright corporate racketeering. Since then, the Russian authorities have undertaken important steps to enhance corporate governance, including some in partnership with the OECD.

The Russian Corporate Governance Roundtable was established in 1999. Several meetings have been organised since then (most recently on 11-12 November 2004), bringing together an informal network of Russian and international policy-makers and private sector decision-makers. The OECD Principles of Corporate Governance (see Box 3.2) serve as a benchmark for the Roundtable, providing a set of shared values against which to assess progress in corporate governance reform.

The Russian Corporate Governance Roundtable produced its White Paper on Corporate Governance in 2002, outlining common objectives for reform. Some of the priority areas agreed in the Paper were: i) implementation and enforcement of legal and regulatory frameworks; ii) clarity and coherence between institutions and legal and regulatory provisions; iii) the development of a corporate governance culture; iv) continuing support and review of progress; and v) the development of training programmes.

A major step forward came in April 2002 with the development of a new **Code of Corporate Governance** based on the OECD Principles of Corporate Governance. Although compliance with the Code is not a legal requirement, it provides a clear set of benchmarks for Russian business to follow. Many large companies have adopted the Code and are actively promoting it among their peers. In addition, the Code is effectively mandatory for companies seeking level-one listings in Russia, as stock exchanges have also introduced tougher disclosure requirements and have included compliance with the Code as an obligatory element of such listings. The Moscow Interbank Currency Exchange (MICEX, which operates a stock exchange), which adopted the Code of Corporate Governance in early 2003, demands that companies who want an A1-level listing adopt the Corporate Governance Code, and that those applying for an A2-level listing follow the principles of information disclosure declared in the Code. Similarly, the RTS<sup>2</sup> Stock Exchange, also in Moscow, imposes a requirement that a company seeking to obtain an A-level listing must comply with the requirements set out in the Code. The work on the Code is seen as paralleling and reinforcing the White Paper exercise.

### Box 3.2. The OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance (“the Principles”), first published in 1999, cover six main areas. They call on governments to have in place an effective institutional and legal framework to support good corporate governance practices (Chapter I). They call for a corporate governance framework that protects and facilitates the exercise of shareholders’ rights (Chapter II). They also strongly support the equal treatment of all shareholders, including minority and foreign shareholders (Chapter III). They recognise the importance of the role of stakeholders in corporate governance, while they also look at the importance of timely, accurate and transparent disclosure mechanisms (Chapter IV and V, respectively). They deal with board structures, responsibilities and procedures (Chapter VI).

The OECD Principles of Corporate Governance have been widely adopted as a benchmark both in OECD countries and elsewhere. They are used as one of 12 key standards by the Financial Stability Forum for ensuring international financial stability and by the World Bank in its work to improve corporate governance in emerging markets.

The Principles are a living document that was most recently revised in 2004. Corporate scandals in a number of countries had highlighted a need for improvements in standards of corporate governance. New provisions address a stronger role for shareholders, conflicts of interest and self-dealing, abuse of related companies, the role of stakeholders, executive and director remuneration, financial market integrity and transparency and effective enforcement.

The Principles are useful not only for discussing the quality of corporate governance in OECD member countries. The Organisation works closely with a large number of developing and emerging market countries. In particular, the OECD is organising Regional Corporate Governance Roundtables in Asia, Latin America, Eurasia, Southeast Europe and, notably, Russia. These Roundtables have used the OECD Principles to formulate regional reform priorities and are now actively engaged in implementing these recommendations.

On the basis of the discussions at the Roundtables, national or regional “White Papers” are produced, identifying common policy objectives and reform priorities with a view to concrete steps that can be taken to improve corporate governance. A White Paper is a non-binding, consultative document, developed on a consensual basis by an informal, but highly influential group of policy makers, regulators, market participants and other experts.

Consistent with the recent revision of the OECD Principles, a revised version of the Code has been proposed, but not yet approved. It includes new provisions addressing issues involving institutional investors, shareholder rights, conflicts of interest and auditor responsibility, stakeholder rights and whistle-blower protection, and board duties and responsibilities.

The Roundtable has now moved into a second phase of implementation and enforcement. Policy-makers and business practitioners from Russia and OECD countries launched on 2-3 October 2003 in Moscow two Task Forces for this. One of these ("Task Force I") will assess the experience in introducing international financial reporting standards (IFRS) in Russia. The second ("Task Force II") will assess the present legal, regulatory and institutional framework for related party transactions and beneficial ownership and control.

On the specifics of the task of Task Force I, the Russian White Paper on Corporate Governance recommends a full and quick adoption of international financial reporting standards (IFRS) for listed and widely held non-listed companies as a critical ingredient for improving transparency. Recent efforts to speed up the transition to IFRS are an encouraging signal to investors. In 2002, the government announced its plan to speed up the transition process for consolidated reporting of listed companies and financial statements of banks starting in 2004. Difficulties in forming a consolidated and coordinated action plan, as well as the lack of an appropriate legal framework, have resulted in delays. Current efforts by the government to draft a law "On Consolidated Reporting" could provide some leverage to develop further a mechanism for implementing standards and determining priorities. Using IFRS would significantly improve the ability of investors and managers to monitor a company by providing increased reliability and comparability of reporting, as well as improved insight into company performance.

Task Force I last met on 30 June-1 July 2004. A summary of the discussions is available on the OECD internet site. The final results will address policy aspects that could assist current efforts to form a consensus on the way forward and will be presented at the end of 2004. The European Union's experience with transition to IFRS will be valuable. This initiative is part of the Russian Corporate Governance Roundtable's second phase of work, focused on implementation and enforcement. It is also a response to a request by the Federal Service for the Financial Markets (FSFM<sup>3</sup>) and the Ministry of Economic Development and Trade for the OECD to support the transition to IFRS, which it considers a priority for improving the transparency of financial markets.

The adoption of high quality financial reporting standards is also essential for Russian companies who want to lower the cost of financing, both nationally and internationally, as well as for the sound corporate governance of enterprises. To the immediate costs relating to the need for parallel reporting by both the financial and real sectors as long as RAS remain closely linked to tax

reporting requirements should be added costs of a longer-term nature for hiring specialised staff, retraining accountants and auditors as well as costs inherent in the enforcement mechanism to be instituted. See discussion papers produced for the Consultative Meeting of the Russian Corporate Governance Roundtable held at OECD on 25 March 2004 (“Implementation of International Financial Reporting Standards”, Task Force I).

The **Law on Joint Stock Companies** was significantly amended in 2001 and became effective on 1 January 2002, except for two provisions on general shareholders meetings that went into effect on 9 August 2001. While the law does enhance legal protection of shareholder rights, criticisms have been voiced regarding the “watering down” of initial provisions between the law’s first reading in April 1999 and its final enactment. Further amendments to the Law on Joint Stock Companies were introduced on 31 October 2002 and became effective on 1 January 2003.

The amendments to the Law on Joint Stock Companies now provide for stronger protection of shareholder rights upon the distribution of issued securities. All shareholders of the company are given a preferential right to acquire additional shares and issued securities convertible into shares which are distributed in an open subscription. Shareholders of the company who voted against or did not take part in a vote on a distribution by a closed subscription of securities still have a preferential right to acquire those shares and securities convertible into shares.<sup>4</sup>

#### 4. Regulatory reform

The central goal of the de-bureaucratisation programme is to reduce state intervention in economic activity by shifting the role of government away from direct control over assets and markets and towards greater reliance on law and regulation.

The “Law on Protection of Legal Persons and Individual Entrepreneurs in the Process of Exercising State Control (Supervision)” was enacted in 2001, with the purpose of reducing the number of inspections to which businesses are subjected. It defines procedures for government inspections and assigns responsibility to government agencies carrying out the inspections. The law stipulates the procedures for unplanned inspections but does not limit their frequency. It also prescribes the duration of an inspection, which should not exceed one month, or, in special cases, two months.

The Law “On Licensing of Certain Activities” came into effect in February 2002. It strictly limits the number of activities subject to licensing and reduces the fee for obtaining a licence to 1 000 roubles, plus 300 roubles for application, and stipulates that the licence should be valid for not less than five years.



### Box 3.3. Main features of amended legislation on corporate governance

The amendments also provide for stricter rules concerning the increase of registered capital by placement of additional shares, open subscription of additional shares and reorganisation of joint stock companies. A decision to increase the registered capital by placing additional shares through a closed placement, or through an open placement of shares in an amount exceeding 25 per cent of already-placed shares may, depending upon the wording of the company's charter, be approved either by unanimous board decision or by simple majority shareholder vote.<sup>1</sup> However, the increase of a company's authorised capital by the issuance of additional shares in case of existence of a block of shares representing over 25 per cent of the votes at the general shareholders' meeting and fixed in accordance with the Russian Federation legal acts on privatisation of state or municipal property, may be carried out during the stipulated period only if the share of the state or a municipal entity remains unchanged as a result of such increase.<sup>2</sup> The decision to amend the Articles of Association concerning an increase of registered capital must be adopted by no less than a two-thirds majority vote of the Board of Directors. Previously, such decisions had to be approved by a simple majority vote of the Board of Directors.

Preferred shares remain limited to a maximum of 25 per cent of the chartered capital.<sup>3</sup> Holders of preferred shares have no ordinary voting rights except in cases provided for in the law, such as reorganisation or liquidation of the company.<sup>4</sup> The law also eliminated a pre-existing clause that allowed for granting the right to vote at an ordinary shareholders' meeting to the holders of preferred shares in the Articles of Association.

The amendments to the law also stipulate that in the event of the reorganisation of the joint-stock company by split-up or split-off the shareholders who were not present or voted against the reorganisation have a right to acquire shares in each company in proportion to their current holdings.<sup>5</sup>

In order to minimise violations of the governance of companies that have previously led to important corporate changes without the consent of the shareholders, amendments to the law also provide more detailed rules on the procedures for calling and conducting a General Meeting of Shareholders, covering such matters as notification periods, which were previously the basis for serious shareholder abuse.<sup>6</sup>

Another provision elaborated in the amendments concerns the register of the shareholders of the company. While the original law required all joint stock companies to maintain a register of its shareholders, the 2001 amendments make it mandatory for companies with more than 50 shareholders to transfer their registries to a professional registrar licensed by the FSFM.<sup>7</sup>

### Box 3.3. Main features of amended legislation on corporate governance (cont.)

Concerning **large transactions**, the 2002 amendments **broaden approval rules to apply also to loans, credits, pledges and warranties**, which is a positive development as regards related party transactions. Concerning **specifically related party transactions**, the law now includes as related parties those who issue instructions, which implicitly includes local authorities.

With respect to the role of the board, amendments passed in 2003 **require election of boards of directors by cumulative voting** regardless of the number of shareholders. Previously, this provision was restricted to companies with 1,000 shareholders. This means that minority shareholders may now be better able to make their voices heard.

The 2002 amendments to the Joint Stock Law and the Labour Code now allow **shareholders to terminate the authority of management and the boards of directors at any time**, thus significantly increasing their monitoring ability.

However, some of the amendments introduced in the new laws actually seem to limit the rights of shareholders. In the case of a violation of shareholder rights, the amendments entitle a shareholder to appeal to the court within 6 months from the day on which the shareholder became aware of the decision adopted by the General Shareholders meeting.<sup>8</sup> In the previous legislation, the shareholders had (implicitly) a limitation period of three years, as established in the Civil Code.

Concerning **the disclosure of information**, regulations have developed over time which require disclosure in various contexts of such documents as accounting documents, minutes of General Shareholders' meetings, minutes of the meetings of the Board of Directors and of the internal auditors, as well as the reports of independent valuers and lists of affiliates of companies. These requirements have been reflected also in the JSC Law,<sup>9</sup> as have provisions relating to compulsory disclosure of information by a company and information concerning the affiliated entities of a company.<sup>10</sup> The FSFM is responsible for monitoring and enforcing the disclosure rules. In 1999, the Federal Law "Concerning Investor Protection" gave the then-FCSM authority to fine joint stock companies and their managers for violating information disclosure rules.

The Federal Law "Concerning the Securities Market"<sup>11</sup> and numerous regulations by the Ministry of Finance and the FSFM require additional disclosure about publicly-listed companies and the securities they issue. The Federal Law "Concerning the Securities Market" states that issues must be registered with the FSFM (or with the CBR, for banks). The requirements for the prospectus include the issuer's financial statements, information on its activities and managers, description of the issue, investment goals, and the

### Box 3.3. Main features of amended legislation on corporate governance (cont.)

list of exchanges where the issue can be traded. New requirements introduced by the 2002 amendments to the Law on the Securities Market include much broader disclosure requirements for closed subscriptions, and much more detailed requirements regarding the prospectus, as well as an obligation to provide interested parties with unrestricted access to information included in the prospectus. A new amendment requires issuers to provide financial statements for the preceding five, instead of three, years.

The amended law also introduces **the concept of financial consultant**.<sup>12</sup> For public placement and circulation of securities, issuers must hire financial consultants who then are required to sign the prospectus and are liable for the accuracy of the information in that prospectus. Financial consultants must be FSFM-licensed brokers or dealers in the securities markets. They must not be affiliated with the issuing company and must abide by the FSFM rules regarding the conflict of interest and the use of information obtained as a result of their activity as financial consultants. A detailed list of requirements for financial consultants is available in the FCSM-issued regulation No.03-30, "Concerning the Standards of Securities Issuance and the Registration of Securities Prospectus", dated 18 June 2003.

1. Article 28, Para. 2.
2. Article 28, Para. 6.
3. Article 25, Para. 2.
4. Article 32, Para. 4.
5. Article 19, Para. 3.
6. Articles 52 and 53.
7. Article 44.
8. Article 49, Para. 7.
9. See, e.g., Article 89, Para. 1 and Article 91.
10. See, e.g., Articles 92 and 93.
11. Federal Law No. 39-FZ, "Concerning the Securities Market" (April 22, 1996) as amended by Federal Law No. 195-FZ (December 28, 2002).
12. Financial consultants must be FSFM-licensed brokers or dealers in the securities markets. According to FSFM, in early 2004 there were ten licenced financial consultants in Russia.

The Law "On State Registration of Legal Persons" (July 2002) limits the charge for registration to 2 000 roubles and the time limit for approving or rejecting registration applications to no more than a month after submission. The law also establishes the goal of having a single office complete the registrations process. According to the Russian Foreign Investment Law, registration should take place with the "bodies of justice", but the State Registration Chamber, attached to the Ministry of Justice, only provides guidelines as to which types of enterprises need to be registered, leaving the registration process largely to be administered by regional authorities.

A new law “On Technical Regulation” introduced in December 2002 provides for a seven-year period of transition to completely new procedures of standardisation and certification and requires the adoption of a number of new sectoral sublaws in order to be fully implemented. An important innovation is that Article 9 of this law provides for public consultation through publication, also in electronic form, so that all interested parties should thus be given access to draft technical regulations and a possibility of providing comments before finalisation and introduction of new regulations.

Regular monitoring of administrative barriers to business development in Russia is carried out by the Russian Centre for Economic and Financial Research (CEFIR).<sup>5</sup> Survey results available to date indicate some improvement in the sense that the number of inspections declined considerably during 2002 and at a slower rate in 2003. However, in some cases illegal inspections increased in the second round, and respondents continued to complain in the third round of frequent unplanned inspections, particularly by the police.

A positive note is that the second round of business surveys gave evidence of improved perceptions of the business climate overall, although 44 per cent of the population surveyed still reported significant problems with either business registration, licensing and permits, price control, certification or documentation requirements. The improvements noted in the second round endured into the third round, but without significant further progress. In summary, the administrative burden on the enterprise sector in terms of filings required and the number of state organs exercising some measure of control, often duplicating each other, has not been significantly reduced. The removal of unnecessary barriers at Federal level has not yet been completed, nor has there been across the board implementation of the de-bureaucratisation reforms at regional level.

A major reform step in 2002 was **the adoption of a new version of the Bankruptcy Law**, eliminating the deficiencies in the old law which made it a vehicle for fraudulent asset transfers and predatory take-overs rather than an instrument for promoting the orderly restructuring of distressed enterprises. The previous bias in favour of creditors, which made these abuses possible, has been removed by making it more difficult to initiate a bankruptcy process and by providing the debtor with better possibilities of settling or restructuring overdue obligations. The new law also curtails the status of arbitration managers, who were previously subject to inadequate accountability, transferring their regulation to self-regulating organisations, in turn regulated by the Federal Bankruptcy Service.

Other improvements brought by the new law reflecting recommendations in the 2001 study are the removal of the state’s priority claim in the hierarchy of creditors and the strengthening of the rights of secured creditors, thus moving the ordering of different categories of creditor claims into line with international practice.

Finally, the law has been extended to cover other sectors of the economy, such as agriculture, the defence industry, one company towns, securities market activities and insurance, which were excluded from the coverage of the old law. While these are major improvements, there is still scope for misuse of court injunctions in corporate conflicts. By bringing in greater reliance on rehabilitation as opposed to liquidation, the new version of the Bankruptcy Law unwisely transfers too many powers in this area to courts rather than temporary administrators, in view of the courts' poor record of competence and ability to withstand pressure from local and regional administrations.

In calling for improved protection of property rights, the 2001 study also recommended **strengthening of law enforcement** through increased independence of the judiciary and the creation of more effective enforcement mechanisms. This reform agenda has been addressed through a major overhaul of the judiciary completed in 2002 consisting of laws and amendment to laws relating to court procedures, the status of judges and the status of attorneys. It also included significant salary increases for judges and a strengthening of the court infrastructure.

In this package, major immediate benefits for investors were brought through the enactment of the **RF Code of Arbitrazh Procedure** in September 2002 and the **RF Code of Civil Procedure** in February 2003. These Codes at last brought all disputes concerning corporate relationships under the jurisdiction of a single body, the arbitrazh courts, with the aim of ending previous abuse by physical persons (shareholders) of their right to take commercial disputes to courts of general jurisdiction. Corporations previously found it difficult to protect themselves against frivolous lawsuits brought in a parallel court system to disrupt or delay justice. The procedural code for the arbitrazh courts is designed to encourage amicable dispute resolution, including out-of court conciliation. A final recommendation relating to the judiciary in the 2001 study, which has been addressed, is the redirection of responsibility to the arbitrazh courts for recognition and enforcement of international arbitration awards.

However, judicial recognition and enforcement of foreign arbitral awards remains problematic, at best, with Russian judges frequently relying on the "public policy" exception under the New York Convention to refuse recognition and enforcement. Also troublesome is the significantly expanded list, under the new Code of Arbitrazh Procedure, of subject areas which are within the exclusive competence of the arbitrazh courts and thus arguably unarbitrable.

These recent legislative changes are of real benefit to investors, but their implementation and enforcement cannot be fully ensured. The judiciary and its enforcement mechanisms remain weak and suffer from resource

constraints, lack of competence, favouritism and corruption, as mentioned in the 2001 study. For foreign investors to feel confident that their rights will be protected, the competence, independence, and probity of judges and enforcement officers need to be further increased. Even if a number of common abuses are now either clearly designated as illegal or have become more complex to perform, legislation *ex post* can not anticipate and close loopholes for other forms of abuse which have not yet become common practice. To do this requires both an efficient system of administration and enforcement of the law and respect by economic agents for the spirit of the law and the basic safeguards that the law is intended to provide.

The issue of **administrative reform** is a pressing one in the current economic context in Russia, and a major programme has been under way for the past two years to reform both the operations and powers of government agencies and municipal self-governing bodies.<sup>6</sup> The capacity constraints and inefficiency under which the national government operates due to its competing and overlapping structures with unclear accountability make it unable to promote and implement effective policies conducive to economic growth.<sup>7</sup> For investors, the most immediate negative aspect of the Russian business environment originates from an overly complex administrative system, which has resulted from the merger of an ever-growing body of new, modernised laws and regulations with remnants of Soviet administrative practices. In addition, the combination of inadequate training and low salaries of the officials at all levels of government set to administer this framework of laws and regulations has generated corruption and rent seeking on a scale that usually amazes new entrants to the Russian markets. Administrative barriers and direct “corruption taxes” levied by the officials in charge of licensing, inspections and other authorisations have severely curtailed entrepreneurial activity especially at SME level where the means of protection can easily become unaffordable. It was suggested in the 2001 study that foreign investors were frequently singled out as targets of harassment via arbitrary additional licensing and product certification requirements, usually at the level of sub-federal administrations.

The Russian authorities are well aware of these shortcomings, and recent reforms aiming to reduce administrative barriers and rent-seeking opportunities should be considered very important steps in the process of ridding the business environment of one of its most negative aspects. A federal government programme of de-bureaucratisation was launched in 2001. A central goal of this reform is to reduce drastically the multitude of registration, licensing and inspection procedures. New legislation related to these procedures as well as to certification has been welcomed by foreign as well as domestic investors. There are already three new laws enacted during 2001 and 2002 and a fourth law on certification that came into force on

1 July 2003. However, as further argued below, achieving significant progress in the area of administrative reform at all levels of government remains one of the most pressing issues facing the Russian authorities in the interest of furthering sustainable economic growth.

In connection with the administrative barriers facing investors, the 2001 study noted that these obstacles to investment activity are encountered most frequently at the level of sub-federal administrations, often in direct contradiction to federal legislation. There are numerous reports of instances where local or regional governments have imposed unforeseen licensing or permit requirements, or imposed licensing fees in excess of those legally permitted. Regional licensing procedures may differ from federal requirements, and/or may be used to favour local enterprises to the detriment of outside investors.<sup>8</sup> Conversely, grants of federal licences may be hampered by existing disputes between federal authorities and a given region – concrete examples may be found in the field of subsoil licences issued to companies within a particular region which were revoked to “punish” a region for taking a stand against the federal authorities (subsoil licence issuance requires joint approval by federal and regional authorities). Arbitrariness of this kind sends a strong negative signal to potential foreign investors. Moreover, it is difficult to challenge, since the conditions for approval or denial of a licence are often opaque.

Recommendations were set out in the 2001 study for the **harmonisation of diverging legislation and conflicting regulation among federal, regional and local agencies**, while at the same time encouraging the development of region-specific programmes for investment attraction. Progress on the former count has been significant. During the past two years, the central government has been conducting a campaign to assert and strengthen its powers and reinforce the foundations of a single economic and legal space throughout the Russian Federation. Important cornerstones for this campaign are measures taken by the Putin government in the summer of 2000, already mentioned in the 2001 study, namely the restructuring of the Federal Council (the Upper Chamber of the Federal Assembly) to remove direct representation by regional governors, and the reassignment of regional presidential representatives to seven major supra-regional districts (okrugs).<sup>9</sup> These new presidential representatives were given the general task of co-ordinating federal relations with the 89 subjects and ensuring that central government policies are implemented consistently, with the specific initial assignment of weeding out acts by the executive authorities of the regions that contradict the Constitution, Federal laws, and international obligations of the Federation or violate citizens’ rights and freedoms. While the latter task has met with considerable success and has been largely completed,<sup>10</sup> much of the coordinating functions envisaged for the presidential representatives could be further developed and would seem of

particular importance in the harmonisation of trade and investment policies in line with national objectives. They may also be usefully extended to deal with the prevalence of informal arrangements at regional level which sometimes work at cross-purposes with efforts to achieve standard-setting regulation at national level.

Initially, **privatisation policy** in the Russian Federation was geared to giving certain categories of potential domestic shareholders – employees, management and certain Russian banks and financial groups – clear preference in the privatisation process, and foreign investors were effectively excluded from most large sales. More recently, however, the government has moved to a system of auctions and tenders in which all participants are supposed to have an equal chance of securing the asset up for sale. The 2001 study noted that although Russian legislation now enshrines free access and national treatment for foreign investors, there have nevertheless been many reported instances of discriminatory or unfair treatment of foreign investors in the course of implementation of privatisation projects. The unresolved status of some past, controversial privatisations, at intervals raising the spectre of re-nationalisation, remains a deterrent for foreign investors. They have in the main resorted to joint ventures, direct acquisition from management or stock market purchases to establish an investment base in Russia. The study called for a clear strategy statement from the government, including its long-term intentions for foreign participation in natural monopolies as well as oil, energy and aerospace industries. Improved management of property remaining in state ownership was also recommended, in the interest of combating frequent malpractice.

Since 2001, policies toward state property have evolved towards greater reliance on renewable sources of income as opposed to one-off sales motivated by budgetary requirements. This has in turn allowed more room for strategic considerations to prevail in privatisation policy and also increased motivation for sound management of state assets.

A new privatisation law came into force in July 2002 which aimed to resolve long-standing conflicts between the executive and the legislative branches of government in matters of disposal of state property. The new law allocates responsibility to the President for designation of strategic enterprises and categories of state assets excluded from privatisation. Responsibility for privatisation of large natural monopolies such as Gazprom, UES and the railways was assigned to the Federation Council, requiring the enactment of separate laws, while jurisdiction for all other federal property was given to the government. The privatisation policies for municipal and regional property were left to the corresponding levels of sub-federal authorities. The new law also introduces a variety of new privatisation methods intended to assist the government in cost reduction and elimination of illiquid assets.



The new law does not, however, lay out a comprehensive strategic vision for how the privatisation process should be pursued, nor does it address the lack of transparency and equity in the implementation of privatisation tenders, which routinely produce seemingly prearranged outcomes. Foreign-owned bidders complain about the opaqueness of selection processes and that privatisation requirements are often structured in such a way that certain bidders are favoured in practice. While the new law no longer allows the exclusion of bidders unable to submit, as part of the purchase price, a specified asset (since cash contributions must now be considered in lieu of in kind requirements), problems of discrimination are reported to remain.

Even if the foreign investor does win a bid, there may be an increased risk that the privatisation becomes subject to challenge. Because of inconsistencies and contradictions within existing privatisation legislation, it is almost certain that any privatisation will have been conducted in violation of some provision of law. As a result, every privatisation is in theory subject to challenge. Well-publicised privatisations in which a foreign entity (or an entity with foreign investment) prevails may be a more attractive target for such challenge than other, better-connected domestic entities.

After a lengthy period of redrafting and compromises among the interests of several ministries and representatives of carriers and traders, a **new Customs Code** entered into force on 1 January 2004. The new Code brought in greatly simplified customs clearance procedures which will increase handling speed, cut down on storage and transport costs and have a positive impact on the financial performance of investment projects. In addition to being tailored to generally accepted international norms and practices it provides an adequate legal basis for qualitative improvements in the Russian customs administration, changing its priorities from focusing on its fiscal function to that of promoting foreign trade.

It also addresses problem areas noted by foreign investors, such as the variable application of customs regulations between regions, requiring potential importers to seek clarification at each stage to ensure compliance. In many regions, regional and local authorities have considerable influence over classifications of goods for import duty purposes, and have been known to exercise this authority to the detriment of foreign investors. While authority over customs regulation generally falls to the federal government, regional authorities have had responsibility for classifying goods, estimating their values and defining their country of origin, allowing considerable latitude for abuse.

In 2002, following an examination conducted in June 2000, Russia was removed from the blacklist of the Financial Action Task Force (FATF), indicating that the country is recognised as taking serious measures to deal

with financial abuses such as money laundering. The Russian Federation is now a full member of FATF and also of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL).

## 5. Land reform

Russia's new Land Code was passed into law on 31 October 2001.<sup>11</sup> The Land Code represents significant reform because it establishes under law and sanctions land ownership, providing domestic and foreign investors alike with new rights and opportunities. Full provisions of the Land Code apply primarily to urban areas, with procedures concerning the circulation of agricultural land regulated by a separate law passed in mid-2002 (see Box 3.5). The Land Code endows the Russian State, municipalities, private individuals and legal entities with full rights to land ownership. Although the law stipulates that perpetual or indefinite use of land<sup>12</sup> is to be granted only to the State and municipal enterprises and authorities, individuals and legal entities enjoy all other forms of land rights covered by the law, including free fixed-term use, leasing, and lifelong heritable possession.

The provisions of the Land Code define the land rights of private individuals, legal entities and municipalities, endowing them, as well as the Russian state, with full rights to land ownership. Perpetual or indefinite use of land is to be granted only to the state, municipalities and municipal institutions, federal-treasury-owned enterprises, and local authorities. All other legal entities that previously enjoyed the right to perpetual or indefinite use of land were allowed until 1 January 2004 to convert and re-register their status to that of owner or leaseholder. This period was further extended to 1 January 2006 by an amendment passed in December 2003. Other forms of land rights covered by the law include free fixed-term use, leasing, and lifelong heritable possession. Land Code provisions state that private individuals are allowed to maintain and transfer their existing rights of lifelong heritable possession and perpetual use, but no new such rights may be created. The Land Code also mandates that other existing rights to land plots that are not provided for in the new Land Code must be re-registered within the permitted categories.

Owners of existing facilities and structures located on land owned by third parties are given the pre-emptive right by the Land Code to purchase or lease the land plot beneath their buildings. The Land Code establishes a formula to calculate the price at which the owners of existing buildings or structures may purchase the land the building stands on. The formula is based on the size of the plot, the land tax rate, the purpose for which the buildings and the land are used, and two other coefficients. The resulting price is normally rather

### Box 3.4. Federal regional policy coherence for acquisition of real estate

In March 2004, the OECD conducted a survey of federal-regional policy coherence in North-West Russia in co-ordination with the North-West Investment (Development) Agency in St Petersburg. Experiences and opinions were canvassed from a variety of respondents to a questionnaire and thereafter in a follow-up workshop in St Petersburg, where participants included officials from the federal government and from the governments of St Petersburg, Kaliningrad oblast, Leningrad oblast and the Republic of Karelia; representatives from local consulates of several OECD member governments; representatives from chambers of commerce in North-West Russia; representatives of Russian enterprises; and academics specialising in relevant fields of study.

The findings of this survey (summarised in Annex D) indicated that, although there has been much progress, problems of lack of coherence between federal government policy and the policies implemented at regional level and below are still in evidence.

A major problem for foreign investors that was reported by a number of respondents is that of acquiring real estate for business purposes. It was reported that purchasing land on the secondary market in St Petersburg, for example, was easier than buying or leasing land owned by the state, but that most land was state-owned (87 per cent of city land in St Petersburg belonged to the state at the beginning of 2004). Moreover, it was difficult to find a vacant site on the small secondary market.

Procedures for obtaining land are inconsistent and cumbersome.

Allocation of land plots is regulated by the Land Code, the Town-planning Code and by regional and municipal legislation and therefore differs according to region and even between different municipalities in the same region. Allocation procedures also differ according to the prospective purpose of land use. Nevertheless, there are some common features.

Approval must be sought from as many as 25 territorial bodies (depending on factors such as location and land category), including such committees as those for land, architecture and town planning, together with the Ministry of Natural Resources, the Ministry of Civil Defence and Emergency and the State Sanitary-Epidemiological Inspectorate.

In some regions applicants must deal with all services directly while in others they simply submit an application and the decision whether or not to allot land to them is taken without their participation. The next stage of the procedure is the formation of the land plot, including land surveying and making an entry in the land cadastre. These procedures are provided by different services.

### Box 3.4. **Federal regional policy coherence for acquisition of real estate** (cont.)

There is a need to get so-called technical conditions for connection to public utilities before design work begins. All technical conditions have to be approved by the corresponding supplying organisation. The final decision and signing of a contract between land owner and investor occurs only after approval of the project documentation.

The procedure described above applies to purchases of land plots for construction when preliminary approval has been given for the location of the proposed building. Land plots for construction without preliminary approval of allocation of building can be purchased only by competitive tender or at auction. In the latter cases, the local authorities are in charge of all preparatory procedures. The protocol on results of trading (auction) constitutes grounds for the conclusion of a purchase agreement and state registration of the purchaser's title to a land plot.

Owners of buildings enjoy the exclusive right to privatise the land plots on which their buildings are located. Privatisation is performed on the basis of the application of the owner of the building. The "cadastre card" (land registry plan) of the land plot must be attached to the application. If a cadastre card is not available the owner of the land plot must request that the authorised municipal body issues such a card. The authorised body is obliged to prepare a cadastre card within one month and determine the borders of the land plot based on the previous cadastre card containing data of the location of the land plot and construction documentation.

Upon the applicant's submission of all required documents, the administration must decide on the transfer of the title to the land plot within two weeks. If the decision is positive, the authorised body then prepares a draft purchase agreement.

attractive, and serves as an encouragement for building owners to establish widespread private ownership of land. In the case of privatisation of buildings and structures by the State or municipal authorities, the law requires that those facilities are privatised together with the land they are on.

The new Land Code also elaborates on two different procedures for land allocation for construction purposes. In urban areas, the right to purchase or lease land is granted on the basis of public tenders organised by state or municipal authorities. In rural areas, investors wishing to purchase or lease land to be used for the construction of industrial facilities must i) make a specific request for the land rights to the State or municipal authority; and ii) consent to a thorough study of ecological, sanitation, architectural and other issues.

While the legislative base for the privatisation of urban land has been set, few tenders have so far taken place. One of the impediments to the development of a healthy real-estate market in Russia is the absence of a comprehensive registration framework. There are now in Russia multiple registers of land plots, technical records of buildings, installations and structures. Procedures for recording and identifying various types of real estate are fragmented.<sup>13</sup> There is no unified register of real estate rights, which greatly complicates both the “primary market”, i.e. the privatisation of State- and municipal-owned lands, and the “secondary market” – the commercial turnover of already privately-held real estate.

Agricultural land is the subject of a law passed in 2002, whose main provisions are listed in Box 3.5.

### Box 3.5. Agricultural land rights

The Land Code stipulated that procedures concerning the circulation and turnover of agricultural lands would be elaborated in future legislation. The passage of the law “On the Circulation of Agricultural Lands” in mid-2002 was an important step in the government’s efforts to reform the land laws. This law elaborates the procedures on the possession, use of, and disposal of land designated for agricultural use, as well as the conditions for the release of such lands from state and municipal ownership and its return to state or municipal ownership. According to the Russian Federal Land Register Service, in 2002 a total of 427.8 million hectares of land in the Russian Federation was designated for agricultural use, of which about 70 per cent is in state ownership and is leased to legal entities or private individuals. The new law affects a large part of this surface.

Not all agricultural land is covered by the law. Individual land plots for the construction of homes and small-scale or dacha gardening, certain plots of agricultural land with buildings, structures or facilities on them, and urban land zoned off for agricultural use is outside the scope of the law “On Circulation of Agricultural Lands” and is covered by the Land Code.

Certain provisions in the law concerning land rights are similar to those in the Land Code. For example, individuals and legal entities (excluding federal and municipal entities) who held permanent land rights (perpetual or indefinite use of land) must transform those rights to lease or ownership in accordance with the Land Code. The sale of agricultural land plots occurs through a tender process described in Article 38 of the Land Code. The law also stipulates that when an agricultural land plot is claimed by two or more potential lessees, that plot should be allocated by an auction.

### Box 3.5. **Agricultural land rights (Cont.)**

The law stipulates that local authorities can set the limit on the maximum amount of land held by a single title holder (or related entities and persons), but that the actual percentage may not be below 10 per cent of the total agricultural land in a particular administrative unit. No such limit is set for the size and number of land plots held by a single lessee.

The law provides additional legal clarity in specifying that land may be used as collateral for loans or leases. The law also allows the pledge of ownership rights to agricultural land as a mortgage of real property rights. An owner of shared property is also entitled by the law to transfer or mortgage his or her property share, contribute this share to authorised capital of a company or to entrust it to a trustee as a part of shared property.

Foreign nationals, foreign legal entities, and stateless persons are forbidden by law from owning agricultural land. This restriction also extends to Russian legal entities with majority foreign capital participation. Non-residents and foreign legal entities can hold agricultural land on lease, for periods up to 49 years. This provision is understood to apply to all lessees.

\* Federal Law No.101-FZ "On Circulation of Agricultural Lands", dated July 10 2002.

While this law is generally seen as a positive reform, laying the legal basis for land transfer and signalling government support for the development of private agricultural land ownership, it does not address all legal inconsistencies and clarify all procedures regarding land transfer. For example, the 1998 law "Concerning Mortgages (Pledges of Immovable Property)" imposes a ban on pledges of land used by agricultural organisations, farming enterprises and private farmlands that may be held in state or municipal ownership or by private individuals and legal entities.<sup>14</sup> The provisions regarding the transfer of land shares that resulted from the restructuring and privatisation of collective and state farms in the early 1990s and that represent nearly two thirds of total farmland in Russia also needs to be clarified.

## Notes

1. There has been some recent movement in this area, as the tax service has only recently become liable for a taxpayer's legal costs in the event that the taxpayer prevails in a court challenge against the service.
2. Russian Trading System.
3. President Putin announced on March 10, 2004 the creation of a new Federal Service for Financial Markets (FSFM) which will assume all the existing functions

of the former Federal Commission for the Securities Market (FCSM), in addition to monitoring the asset allocation of private-sector pension funds, and regulation of Russia's commodity markets.

4. Article 40, Federal Law No. 208-FZ (December 26, 1995) "Concerning the Introduction of Amendments to the Law on Joint Stock Companies", as amended by Federal Laws No. 120-FZ (August 7, 2001) and No. 134-FZ (October 31, 2002).
5. See the Results of three rounds of *Monitoring of administrative barriers to small business development in Russia* on the CEFIR site [www.cefir.ru](http://www.cefir.ru). The latest report was published in November 2003.
6. A presidential decree outlining the objectives of civil service reform during 2003-2005 was issued in November 2002. Work is already well under way in a few priority areas including the drafting of a new law on the civil service, streamlining the division of labour within and between ministries and federal agencies, the preparing of pilot projects in several regions and the drafting of ethical norms for civil servants. This programme is engaging several different groups working in parallel: the government is directly in charge of the streamlining of the functions of federal executive agencies; a commission headed (until the presidential elections in March 2004) by D.N. Kozak under the presidential administration is in charge of the segregation of powers between federal authorities and constituent entities of the Federation and municipal authorities; an inter-agency commission chaired by the Prime Minister is in charge of civil service reform; finally, deregulation issues are the responsibility of the Ministry of Economic Development and Trade. It is expected that these reforms will be given further political impetus by the new government during the spring of 2004.
7. These issues are the subject of a horizontal review of regulatory reform in Russia initiated in 2003 under the OECD Regulatory Reform Review Programme. This Programme is based on multidisciplinary country studies and relies on the OECD peer review mechanism. Russia's regulatory reform review follows the approach of the previous reviews of the OECD Member countries, emphasising the active involvement of the Russian authorities during the whole review process. The purpose of this review is to assist the Russian government in improving its regulatory framework, thus contributing to important policy objectives, such as economic growth, competition and innovation. The review addresses the economic context of the reform, the capacity of the government to assure quality regulations, the role of competition policy and its enforcement, and the contribution of trade policy to market openness. Russia's review will contain a focus on the regulatory framework for selected sectors, and will analyse specific regulatory challenges faced by Russian authorities, especially the issue of federalism.
8. For example, Moscow City's list of activities requiring a licence includes activities which do not require licensing under federal law, and the documentation requirements and fee structure imposed by Moscow there under differ from federal law. See, e.g. Instruction of the Moscow Mayor No. 242-RM "On developing the licensing system in the City of Moscow", dated March 18, 1998 (as amended).
9. Presidential Decree 849 "On Plenipotentiary Representatives of the Russian Federation President in the Federal Districts". The districts and their capitals covered by the decree are as follows: Central Federal District (with Moscow as its capital); North-Western Federal District (St. Petersburg); Southern Federal District (Rostov on Don); Volga Federal District (Nizhniy Novgorod); Urals Federal District (Yekaterinburg); Siberian Federal District (Novosibirsk); and Far Eastern Federal District (Khabarovsk).

10. Progress has been made in removing inconsistencies between federal and regional laws. It has been estimated that in 2000, when the 2001 study was drafted, about 30 per cent of all regional laws and regulations conflicted with federal laws, and that of those, most had been adopted in spheres such as regulation of state administration, the constitutional system and financial and business activities. Over 4,000 existing subfederal regulations have since been brought into line with federal laws. The Ministry of Justice, through its 86 territorial agencies, maintains a register which now encompasses 116,000 laws and regulations effective in subjects of the Federation.
11. The Land Code of the Russian Federation No. 136-FZ, adopted by the State Duma on 28 September 2001, and approved by the Council of Federation on 10 October 2001.
12. Rights to perpetual or indefinite use were originally granted under a Soviet law of 1921. While most of the grants were to villages and municipalities, some legal entities also held these rights.
13. Cf. Box 3.1 for confirmation that this is the case in several localities examined in early 2004.
14. Federal Law No.102-FZ, "Concerning Mortgages (Pledges of Immovable Property)", dated July 16, 1998 (as amended), Art. 63.



## *Chapter 4*

# **Addressing Remaining Non-discriminatory Barriers to Investment**

The progress reviewed in Chapter 3 above presents an impressive number of concrete reform steps, supported by a large body of new or amended legislation. The resulting improvements in the overall investment environment should be evaluated against these criteria:

- Is there an adequate, rules-based legal and regulatory environment for investment?
- Does it apply consistently, for all, across the territory of the Russian Federation, or are there inconsistencies and regional variations?
- Are the rules being properly implemented and enforced, or are they being thwarted through corrupt behaviour and rent-seeking by economic agents?

### **1. Enforcement and coherence in implementation**

There are no longer any major gaps in the legal framework when it comes to laws protecting property or contractual rights of investors. The process of harmonising and unifying investment policies and practices at different levels of government is still continuing. Nevertheless, the more flagrant contradictions in the legislation have been weeded out. The positive effects to be expected from competition among regions for foreign investment and the emphasis on realising to the full the region-specific comparative advantages of investment locations can probably be relied upon to complete this task in the medium term.

But despite the many recent improvements, the uncertainty of proper administration and enforcement of justice by the court system and corruption throughout the public sector undermine confidence in the legal and regulatory framework. Without confidence in impartial and unimpeded implementation of existing rules and regulations, businesses as well as individuals continue to rely on informal networks, contacts and special arrangements to obtain results that otherwise should be achievable or even guaranteed under the formal regulatory system.<sup>1</sup> This means that there is not yet adequate security of private property rights, contracts are difficult to verify and enforce and most businesses expect to pay bribes of varying levels to be able to execute claims awarded in dispute resolution. A quote from a paper on administrative reform recently presented by the Russian Union of Industrialists and Entrepreneurs (RSPP) serves to describe the current situation confronting investors as well as call for better dialogue between business and government authorities at various levels.

*“Absence of state feedback mechanisms seriously impedes business activity in Russia and actually becomes the major obstacle to the attraction of foreign investment to the country. ...The corruption pressure on small and medium-sized enterprises is not simply burdensome but devastating. Small business cannot come out of the shadow (economy) not only because of the tax burden but also because of administrative barriers and unofficial exactions, the level of which, paradoxically, is higher for lawful business than for shadowy operations. A citizen is helpless against the administrative machine in general and against any single public officer. Foreign companies are getting lost in our administrative tangle as they do not know whom to apply to, how to ensure the adoption of a desired decision, (according to) which rules to play.”<sup>2</sup>*

A related challenge is that of how to **achieve sufficient coherence between federal, regional and local regulations and their implementation**, without stifling the beneficial effects of regional diversity in investment attraction. As a federal system of government, Russia clearly has an interest in delineating authority and responsibility between federal and regional governmental bodies. However, on a practical level, the presence in many regions of a few very large and very powerful enterprises may make it difficult for regional authorities to exercise autonomy and encourage foreign investment and competition, particularly if such actions are seen as a challenge to strong domestic companies within the region. The regions vary greatly in their supportiveness of foreign direct investment. Some regions have pursued a policy of relatively equal treatment, with limited subsidies for local businesses and limited use of tax, licensing and other regulatory authority to favour local enterprises; others have taken the opposite approach and used their regulatory authority to protect local vested interests. As a result, there can be considerable variations in approach among regions as well as inconsistency between central and regional/local level governments in procedures governing applications for and granting of permits, licences and other authorisations, as exemplified in Annex D.

A survey was conducted by the North-West Investment (Development) Agency in St Petersburg on behalf of the OECD in February 2004 to ascertain conditions for foreign investors in North-West regions of the Russian Federation. The questions were based on obstacles reported in the World Bank's Foreign Investment Advisory Service (FIAS) report on administrative barriers to investment in several subjects of the Russian Federation,<sup>3</sup> which described conditions in 2000-2001. The object of the survey was to ascertain the degree of progress in overcoming specific obstacles reported to FIAS in a number of locations. In the matrix in Annex D, the original obstacles reported by FIAS are in the first column and responses for each locality (St Petersburg city and the oblasts of Leningrad, Novgorod and Kaliningrad) in the other four columns. The responses indicate that while the situation has improved with

regard to the removal of some of these obstacles, significant administrative barriers still need to be overcome. Caution may be needed in interpreting these results, as respondents may include representatives of the administrations concerned.

## **2. The challenge of corruption**

Eradicating corruption would greatly improve the investment climate. Some laws and draft regulations have been developed to fight corruption from the perspective of recipients of illicit payments, but further efforts need to be made to ensure good public governance and prevent, detect and punish corruption. The Russian authorities need to ensure the effective adoption and enforcement of draft laws and regulations aimed at simplifying the administrative process, reducing the scope for administrative discretion and limiting rent-seeking opportunities. Laws should also be further developed to increase public-sector integrity. To live up to its various international commitments<sup>4</sup> and ensure a level playing field in the conduct of business, Russia still needs to adopt rules and regulations in line with international standards to criminalise bribe-giving to domestic and foreign public officials. Another major challenge is to ensure effective investigation and enforcement of anti-corruption laws and regulations. The widespread perception of a high level of corruption in the judiciary and the enforcement agencies undermines the credibility and effectiveness of the enforcement effort. The Russian authorities might also consider encouraging the private sector to introduce integrity measures, such as corporate codes of conduct and compliance policies, and adopting whistle-blower protection measures to ensure that employees in both the public and private sectors can report suspected bribery without fear of reprisal.

## **3. Corporate disclosure**

### ***3.1. Disclosure of ownership and control of companies***

The 2001 study pointed to the urgent need for strengthening the requirements for disclosure of ownership and control structures and the establishment of clear rules concerning mergers and acquisitions. Despite progress highlighted in Chapter 3, this necessity remains a significant challenge for the authorities. As Russian companies often use complex cross-holding schemes, including some that operate via one or several “mailbox” offshore companies, the structures of property and control are far from transparent. The lack of ownership transparency makes it difficult for regulators, supervisors and tax assessors to enforce regulatory requirements properly in their respective areas of competence. It also prevents outsider shareholders and potential investors from forming a clear picture of the way

control is exercised in order to assess their own position and interest in providing finance to a particular company.

The use of various screening devices to hide beneficial ownership is not unique to Russia. However, the lack of clarity in the disclosure of ownership and control structures in the general model of corporate governance that has evolved in Russia in the past decade is so pervasive that it has serious implications for many of the checks and balances recently instituted which rely on standards of fair and equal treatment and transparency (antimonopoly legislation, privatisation and other tenders, licensing of financial market participants, etc.).

Attempts to improve ownership disclosure have been made recently, notably with the introduction of the new Code of Corporate Conduct in early 2002. However, a high level of ownership concentration, the closed, non-transparent nature of many companies, amalgamation of functions of management and ownership, the practice of in-house financing and co-opted boards of directors still combine to facilitate disregard of minority shareholder rights in Russia.

The schemes or mechanisms abused by open joint-stock companies and their major shareholders in Russia to conceal and convolute real ownership structures vary greatly. They include cross-holding schemes involving financial institutions (a practice particularly prevalent among but not limited to large financial-industrial groups), acquisition of shares via offshore companies, use of nominee shareholders and entering into shareholder agreements.

The motives for concealing information of the real owners can include the shielding of specific assets from judicial, political and criminal investigation, from the danger of having methods of acquisition in past privatisation processes declared null and void, from the danger of confiscation and redistribution of property. Various vehicles aimed at the concealment of true ownership are often used for optimising taxation, for asset transfers, for conducting insider deals on exchanges. Further motives include the circumvention of related party transactions rules and of the anti-monopoly regulations, as well as to facilitate acquisitions of major equity blocks and hostile takeovers.

While, since 2000, a few leading Russian companies have embraced internationally recognised standards for information disclosure and transparency of asset structures, this is still reported to be the exception rather than the norm. Such efforts were often undertaken prior to the launching of major share or bond offerings on international markets, to reassure potential investors and increase the attractiveness of the company. As is observed in Russia, a certain evolutionary process seems to be required

from the time of a company's or holding's reorganisation, following privatisation and subsequent takeovers, and the creation of transparent and fully lawful asset and ownership structures, when entry to international markets or preparation for a major cross-border transaction become powerful incentives for greater transparency.<sup>5</sup>

One of the most prevalent practices employed to conceal beneficial ownership is the use of nominee shareholders to avoid disclosing offshore companies and trusts as the true holders of a company's capital. However, there are some legal safeguards against such practices. While Russian law does not have a definition of *beneficial ownership* applicable to the stock market, it does make a distinction between the notions of a *nominee shareholder* and the *owner of securities*. In accordance with Article 8 of the Federal Law "On the Stock Market", a nominee shareholder is a person registered with the register keeping system of the company who is not an owner of the stock. However, while the shareholder register contains information on the nominee shareholders, the list of persons entitled to participate in a general shareholder meeting must reflect information on the owners of the stock. The nominee shareholders can thus be required to divulge the information on persons or entities in whose interest they hold the stock.

Federal legislation and FSFM regulations should be streamlined to establish common norms of information disclosure and strengthen the enforcement of those norms. Powerful incentives for the disclosure of information at company level now exist, both through mandatory compliance with the Corporate Governance Code enforced by stock exchanges and professional organisations and through the alignment with international standards by those companies that approach international capital markets.

### **3.2. Related party transactions**

In Russia, as in other countries, related party transactions may be on market terms and conducted at arms-length but the fact that they are related involves control which may lead to abuse. In most countries, the definition of related party and related party transaction, as specified in the law, listing requirements, or accounting standards, varies considerably. In Russia, there has been considerable abuse of minority and other shareholder rights through related party transactions and many suggestions have been made from the international investor community to curb such abuse through stricter regulation including clearer, more inclusive and coherent definitions in the legal and regulatory framework of what constitutes related parties.<sup>6</sup> Recent amendments to the law "On Joint Stock Companies" aim to impose stricter limits by defining as related party transactions those that imply an interest to a company shareholder who jointly with affiliated persons owns 20 per cent or more of the voting shares of the joint stock

company. The shares of these shareholders will be recognised as non-voting during the relevant ballot. However, in practice, such restrictions are often not enforced at shareholder meetings (or evaded through transfers of shares amongst family members) and numerous transfers of assets from subsidiaries to mother companies and *vice versa* have occurred, often to the detriment of minority shareholders.

### **3.3. Anti-monopoly measures**

In the sphere of antimonopoly measures and control of economic concentration, all significant mergers and acquisitions are formally subject to notification from the earliest stages of the transaction. According to article 18 of the Federal Law “On Competition and Restriction of Monopolistic Activity on Product Markets” an acquisition by a legal or a natural person of more than 20 per cent of the voting shares in the charter capital of a legal entity requires preliminary consent of the antimonopoly authority. In reality, often a number of legal entities are set up to conceal the identity of the true purchasers. The anti-monopoly authority is then contacted *post factum*, after the stake has been purchased by formally independent legal entities, for the purpose of legalisation of the new ownership structure.

After the recent re-organisation of the government, these functions are performed by the new Federal Antimonopoly Service, which replaces the now-eliminated Anti-Monopoly Ministry. The jurisdiction of the new body will be more closely focused on competition issues, because consumer and utility matters will be done elsewhere.

The changes, which still require new laws and regulations for implementation, are positive steps toward more effective competition policy oversight, which is an important element of a healthy investment climate. They are consistent with the recommendations made in the peer review of Russia’s competition law and policy which was held in the OECD’s Global Forum on Competition in February 2004.<sup>7</sup> That report described the efforts of the anti-monopoly agency, through advocacy as well as enforcement, to support reforms and to correct official actions that interfere with trade and competition. It proposed several measures to make the enforcement of the rules of competition more efficient and effective. Some further suggestions for improving anti-monopoly oversight that are directly related to the problem of beneficial ownership include harmonisation of anti-monopoly law and corporate practice, the elaboration of the concept of beneficial ownership and the regulation of activities related to “affiliated parties and persons”.

## Notes

1. Especially when the regulatory system is particularly complex. Cf. Annex D.
2. Position of the Russian Union of Industrialist and Entrepreneurs (RSSP) on Administrative Reform, FIAC September 2003 Session
3. FIAS (2001).
4. Russia formally applied to accede to the OECD Convention and to become a full participant in the OECD Working Group on Bribery in 2000. Russia has since engaged in a dialogue with experts from the Working Group on Bribery and adopted the regional “Anti-Corruption Action Plan” established in the framework of the OECD’s Anti-Corruption Network for Transition Economies (ACN). Russia also signed the United Nations Convention against Corruption in December 2003 and the Council of Europe Criminal Law Convention on corruption in 1999.
5. See Radygin, A. (2003) “Beneficial Ownership Information Disclosure”, presented at the Russian Corporate Governance Roundtable Workshop on Implementation and Enforcement of Disclosure Rules, Moscow 2-3 October, 2003.
6. The existence of abusive related party transactions is often the result of weaknesses in the corporate governance system and related areas, including the disclosure and access to information about ultimate beneficial ownership and control structures. The Russian Ministry of Economic Development and Trade and the FSFM requested the OECD to help develop possible policy options – learning from some OECD member country experiences – focused on implementation and enforcement of the policy framework in these areas. The final results will address policy aspects that could assist current efforts and will be presented to the Russian Corporate Governance Roundtable at the end of 2004.
7. OECD 2004a.



## *Chapter 5*

# **Relaxing Discriminatory Restrictions on Foreign Direct Investment**

A number of measures in several sectors of industry and services discriminate directly against foreign investors and are thus not consistent with the principle of non-discrimination embodied in international instruments such as the OECD Codes of Liberalisation or the National Treatment Instrument. Ownership quotas and other restrictions on foreign investment apply in agricultural land, banking and insurance as well as in the mass media, aviation and domestic transport sectors. In addition, reciprocity conditions apply to foreign participation in telecommunications, and the regulatory framework for the natural monopolies in the gas and electricity sectors sets limits on direct and indirect foreign ownership. Details of these restrictive measures are reproduced below. Regulations governing foreign investment in legal and other professional services are not covered in the present report due to insufficient information.

## 1. Restrictions on Land Ownership

The 2001 Land Code allows for foreign ownership of non-agricultural land but places a number of restrictions on non-resident foreign owners. Non-residents may not purchase land in border areas and other specially designated areas; this restriction appears to be related to legitimate national defence requirements, as are similar restrictions in some OECD countries. Foreign investors have a priority right, as do Russian purchasers, to acquire rights to land underlying buildings, construction projects and structures, but under the Land Code the President of Russia has the right to specify a list of such buildings, construction projects and structures to which this right does not apply. The right to acquire the land under existing buildings also cannot be granted to foreigners without the requirement of payment, as it can be for Russians that hold certain categories of rights.<sup>1</sup> Local governments can also establish base payment rates which vary according to the category of land and the category of lessee; as a result, many local authorities have established a separate category of lessee for foreigners, subject to higher rates.<sup>2</sup>

Foreign nationals, foreign legal entities, and stateless persons are forbidden by law from owning agricultural land. This restriction also extends to Russian legal entities with majority foreign capital participation. Non-residents and foreign legal entities can hold agricultural land on lease for periods up to 49 years. Prior to the enactment of the Land Code and the Law “On Circulation of Agricultural Lands”, some regional land codes allowed foreign ownership of agricultural land. This category of owners was mandated

by the new law either to apply for the re-designation of the use of their land plots (such as the re-designation of agricultural land near urban areas for industrial use) or to sell their plots by 26 January 2003 (the day the law took effect).

## 2. Financial services

### 2.1. Recent developments

The 2001 study identified lagging development of the financial sector as a significant negative factor in the Russian investment environment, curtailing the availability of finance for investment and limiting the range of risk management options for investors. A number of policy recommendations were formulated, aiming towards further institution-building in the financial sector. Among these were: opening the banking sector to foreign competition by actively promoting the entry of foreign banks as important agents of innovation and prudent practices; consolidating the banking system through the application of firm exit policies for non-viable institutions: the establishment of a universal deposit insurance scheme with compulsory participation; and, as a linked issue, resolving the future role of Sberbank in view of its special dominant position in the banking market, based on the explicit State guarantee of its liabilities. The fact that legislation on a deposit insurance scheme was finally adopted in December 2003, after ten years of deliberations, is an encouraging sign in this context,<sup>3</sup> while the degree of openness of the banking sector to be opted for by the Russian authorities is still a subject of discussion in the continuing GATS negotiations.

Russia's financial markets have undergone more than ten years of development, reaching a point where, in an operational sense, some segments are approaching technical and functional characteristics of mature markets in OECD countries. However, Russia is still characterised by relatively low overall penetration of the financial sector in the economy, both compared to the main industrialised countries and Central and Eastern European transition economies. The banking sector is small and fragmented by international standards,<sup>4</sup> and although stock market capitalisation has by now reached nearly 50 per cent of GDP, which can be considered high in an emerging market context, liquidity and depth indicators are still poor. Most trading on the two major stock exchanges occurs in the equity of 7-10 major companies in the oil and gas sector, and this sector accounts for over 80 per cent of Russia's total stock market capitalisation. Financial intermediation by institutional investors and venture funds is still insignificant.<sup>5</sup>

Several major setbacks have been experienced in the process of financial market development, most recently through the serious financial crisis which followed the sharp devaluation of the rouble and the government's *de facto*

default on its domestic debt in August 1998. This crisis brought sharply into focus the underlying weakness in banking supervision and in the legal environment in which banks and other financial institutions were operating. As discussed above, cross-ownership relations producing a “captive” status of many banks within industrial holding groups, weak security for investors’ rights, disclosure deficiencies and lack of market transparency as well as generally low standards of corporate governance all contribute to reducing investor confidence, thus slowing down the development of fully efficient markets and institutions.<sup>6</sup>

The Russian authorities are now confronted with a number of very important policy challenges relating to further development of financial sector infrastructure and regulation: full liberalisation of capital account operations foreseen at least for the medium-term, the development of a funded pension system, the liberalisation of financial services within the framework of GATS negotiations (notably in the banking and insurance sectors) and the introduction of the newly established deposit insurance system requiring the eventual inclusion of the dominant state-owned Sberbank and the elimination of weak and undercapitalised institutions.

The authorities are well aware of the need to adopt an integrated approach in addressing the challenges of achieving efficient economy-wide financial intermediation. Over the past ten-year period, laws and regulations for the development of different segments of the financial sector have been allotted to different departments and agencies, with limited opportunities for co-ordination. This has at times led to parallelism of functions and contradictions in regulation – as well as excess red tape and associated costs for market participants. Since end-2003, there has been a better co-ordinated and integrated approach. A concrete sign of this new strategy is the recently announced creation of a Federal Service for the Financial Markets (FSFM), which may eventually assume all the function of the former Federal Commission for Securities Markets (FCSM), in addition to monitoring the asset allocation of private-sector pension funds, formerly controlled by Russia’s Ministry of Finance. The new service will also assume responsibility for regulating Russia’s commodity markets from the now-defunct Anti-Monopoly Ministry.<sup>7</sup> This goes part of the way to resolving the previous conflicts among different regulatory authorities which have bedevilled attempts to develop the non-bank financial sector.

Against this background, the maintenance of ceilings on the participation by foreign investors in the banking and insurance sectors detailed below do not seem appropriate and in the interest of the development of a robust financial sector. The authorities maintain that the limits imposed have not represented any binding constraint as foreign interest in the sector has so far not materialised to the extent of filling any quota.<sup>8</sup> However, the persistence of these restrictive measures discourages the inflow of foreign capital and

expertise into a sector where further development should be an urgent priority. Statements by senior Russian officials in the context of GATS negotiations indicate preparedness on the part of the authorities to impose a limit of 25 per cent on foreign participation in the banking sector. In addition, amendments to the *Law on Organisation of Insurance Activity*<sup>9</sup> adopted by the Duma in December 2003 which took effect on 17 January 2004<sup>10</sup> raise the maximum stake of foreign insurers in the total equity capital of Russian insurers from 15 to 25 per cent.<sup>11</sup> In addition, restrictions on foreign firms' operations in the spheres of compulsory insurance and life insurance are lifted for insurers originating from EU member states. It is still not clear how this will affect non-EU based insurers.

## **2.2. Banking**

### ***The ceiling on total foreign ownership in the banking sector***

Pursuant to Article 18(14) of the RF Law on the Central Bank, the Central Bank has the power to "determine in accordance with federal law the conditions of access by foreign capital to the Russian banking system".<sup>12</sup> Similarly, Article 18 of the RF Law on Banks and Banking Activity<sup>13</sup> (the "Banking Law") establishes several special provisions and restrictions concerning the participation of foreign capital in the banking sector.

The Banking Law specifies that a quota on foreign participation in the sector is to be established in a federal law by agreement of the government and the Central Bank. No such law has been enacted to date, although in 1993 a *de facto* quota of 12 per cent was established by a resolution of the Central Bank Board of Directors.<sup>14</sup> Until recently, application of that number was validated by a Regulation of the Central Bank dated April 23, 1997.<sup>15</sup> However, at least as from November 2002 the direct validation of reliance on the Board resolution has been removed.<sup>16</sup> The general perception is that at least as from that date no quota is applied, although the possibility of imposing one continues to exist under the law.

There have been recent suggestions within government circles that the quota be established at 25 per cent, the figure proposed by the Russian side in preparing its GATS negotiating position. If and when a quota were to be established and filled, the Central Bank would be authorised by the Banking Law to cease granting licences to Russian banks with foreign investment and to branches of foreign banks.

### ***Prior approval for capital increases and equity participation by individual foreign investors***

As an extension of the quota requirement, the Banking Law requires every Russian bank to obtain the prior consent of the Central Bank for any

increase in charter capital paid for with foreign investment. Therefore, to the extent that any foreign investor wishes to contribute to the charter capital of a Russian bank or wishes to participate in a charter capital increase, that contribution or participation must first be approved by the Central Bank. Based on OECD best practices, it would be advisable to subject foreign investors to the same percentage thresholds for ownership by individual domestic investors which require the authorities' prior approval.

In addition, under current legislation both a shareholder holding shares in a Russian bank, and the Russian bank in which such shares are held, are required to obtain the prior approval of the Central Bank for any "sale (resale) of already issued shares (existing participation shares of capital) by resident shareholders (participants) for the benefit of non-residents".<sup>17</sup> Thus, where shares are sold by a resident shareholder to or for the benefit of a non-resident, such selling shareholder must obtain the prior consent of the Central Bank. The Central Bank has a two-month review period; if it does not respond during that period, or responds affirmatively, the sale is deemed approved. However, any alienation of shares for the benefit of a non-resident that has not been sanctioned by the Central Bank (and with respect to which the Central Bank's two month review period has not expired without action by the Central Bank) is null and void. The phrase "for the benefit of a non-resident" is not currently defined in applicable legislation.

### ***Reciprocity condition***

The Banking Law gives the Central Bank the right, in co-ordination with the government of the Russian Federation, to establish limits on the conduct of banking activities by credit organisations with foreign capital, if the government of the foreign country in which such investors are domiciled establishes in that country limits on the creation or operations of banks with Russian investment and/or branches of Russian banks.<sup>18</sup> In other words, the possibility of the Central Bank to adopt, in co-ordination with the Russian government, reciprocal treatment based on the treatment of Russian banks by foreign governments is codified in the Banking Law. If applied, reciprocity requirements are discriminatory restrictions by OECD standards.

### ***Other special requirements for banks with foreign investment***

The Banking Law reserves the right of the Central Bank to establish additional requirements for credit organisations with foreign investments and branches of foreign banks, including as regards mandatory norms, financial and statistical reporting requirements, approval of management, the list of permitted banking operations, and minimal charter capital requirements.<sup>19</sup>

In this connection, the Central Bank has established special rules pursuant to which it scrutinises, *inter alia*, the financial situation and business reputation of foreign investors in connection with review of an application for creation of a credit organisation with foreign investment.<sup>20</sup> Foreign physical persons must submit “first-class” proof of creditworthiness in accordance with international banking practice.<sup>21</sup> While provisions on reputation and financial situation are common practices in OECD countries provided the criteria are clear and fair, the Central Bank also reserves for itself the right, in reviewing the application, to take into account the “character of the two-sided relations between the Russian Federation and the governments of each jurisdiction in which the proposed founders are located”.<sup>22</sup> This latter provision remains to be clarified.

A Central Bank approval concerning founding of a credit organisation with foreign capital is valid only for one year.<sup>23</sup> If, as a result of practical delays, the foreign investor fails to complete the registration process for establishment of the bank within such one-year period, he or she must start again and obtain and resubmit all of the supporting documentation.

In the application for Central Bank approval the proposed foreign founder must also submit a copy of a “written approval of the corresponding controlling organ of the country in which it is located, of participation by such entity in the charter capital of a credit organisation on the territory of the Russian Federation, or a conclusion of such organ concerning the absence of a requirement for such approval”. This requirement does not appear inconsistent with OECD country practices.

Since January 1996, foreign-owned banks have been allowed to establish full service subsidiaries that provide retail and wholesale commercial banking services to Russian clients. (A presidential decree of 1993 had previously restricted these services.) As a matter of policy towards the establishment of foreign banks, the CBR has so far wished to encourage the establishment of fully capitalised subsidiaries rather than branches, setting the capitalisation requirements equal for both. The official justification has been that the CBR wishes to exercise supervision of all resident banks rather than have foreign branches supervised by home country authorities. It remains to be determined whether the authorities’ expressed preference for subsidiaries over branches influences licensing decisions in practice. The OECD Codes do not favour one form of establishment over another, but stipulate that non-residents shall have the right to choose their form of establishment, *e.g.* by a branch, an agency or a subsidiary.

The minimum charter capital requirement is currently set in euros for foreign banks<sup>24</sup> as compared to roubles for Russian banks;<sup>25</sup> however, the amounts are quite similar.<sup>26</sup> Subsidiaries of foreign banks have the right to open other branches within Russia in accordance with applicable law and

regulations, but only with the prior approval of the Central Bank.<sup>27</sup> It remains to be determined whether the same requirement applies to domestic banks.

Also, the Regulation specifies that in order for a foreign citizen or stateless person to serve as the “single executive body” (general director/president) of a Russian credit organisation, the management of such credit organisation must consist of not less than 50 per cent Russian citizens.<sup>28</sup> There are also certain requirements concerning knowledge of the Russian language if multiple foreign citizens or stateless persons hold management positions within a Russian credit organisation;<sup>29</sup> and of the total number of employees of the credit organisation, at least 75 per cent must be Russian citizens.<sup>30</sup> Nationality restrictions on company board composition are covered by the OECD Declaration on International Investment and Multinational Enterprises. Performance requirements such as achieving a minimum proportion of local employees can act as *de facto* discouragement to the establishment of an investment, and can be challenged under the OECD Codes<sup>31</sup> and other international disciplines.

### **2.3. Insurance**

#### ***Mandatory restrictions and special requirements affecting foreign participation***

Until end-1999, Russian legislation established an absolute 49 per cent threshold for participation of foreign capital in individual Russian insurance companies that were to be set up either as joint stock companies or limited partnerships.<sup>32</sup> The threshold was relaxed in November 1999<sup>33</sup> by virtue of the entry into force of the Partnership and Co-operation Agreement (PCA) signed with the European Union in 1994.

Since 17 January 2004, when the amendments to the law regulating insurance activity in the Russian Federation took effect, subsidiaries of European insurers (originating from countries participating in the PCA) are admitted to provide all types of insurance, including life insurance and motor liability insurance.<sup>34</sup> It is understood that the countries which joined the EU in May 2004 and were not party to the PCA at the time of its signature are to enjoy similar treatment.

On the other hand, insurance companies which are subsidiaries of non-EU foreign entities, or in which non-EU foreign ownership exceeds 49 per cent of charter capital, are prohibited from engaging in the following types of insurance: i) life insurance; ii) compulsory insurance;<sup>35</sup> iii) compulsory state insurance;<sup>36</sup> iv) property insurance relating to the performance of deliveries or of work under a contract for state needs; and v) insurance of property interests of state and municipal organisations.<sup>37</sup> There is a “grandfathering” exception to this restriction for those insurance companies with foreign investment exceeding



the applicable threshold which were in existence and licensed for the respective activity on the day the Insurance Law Amendment came into effect.<sup>38</sup>

Non-EU based foreign insurers wishing to exercise a greater than 49 per cent control of an insurance company are required to i) have engaged in insurance industry in the country of origin for not less than 15 years, and ii) have participated in the activities of the Russian insurance companies for not less than 2 years.<sup>39</sup>

The requirement that the individual executive body (general director) and the chief accountant of any Russian insurance company in which there is foreign investment must be Russian citizens continues to apply to non-EU based insurers.<sup>40</sup> Moreover, Russian subsidiaries of non-EU foreign entities, and Russian entities in which there is more than 49 per cent non-EU foreign capital, must obtain the prior approval of the Ministry of Finance to open branches.<sup>41</sup>

The intermediary activities of insurance brokers remain restricted. National legislation allows foreign brokers to provide services on the territory of the Russian Federation, but limits their intermediary activity by distributing insurance risks only with Russian insurers.

### ***Ceiling on total foreign investment***

Pursuant to the amendments introduced to the Law on Organisation of Insurance Activity in late 2003, the absolute quota on total participation of foreign capital in the charter capital of insurance companies in the Russian Federation has been raised from 15 per cent to 25 per cent. If foreign investment exceeds this proportion, the Russian Ministry of Finance must stop issuing insurance licences to such companies (and their subsidiaries).<sup>42</sup> The Ministry of Finance has been instructed to establish and periodically publish the level of foreign investment in the insurance sector and the corresponding level of “remaining investment” available to foreign entities. The Ministry of Finance reported in early 2004 that companies from 28 countries<sup>43</sup> were participating in the Russian insurance market. On 1 January 2004 the share of foreign capital in the total charter capital of the insurance industry was 2.1 billion roubles, approximately 2.7 per cent of the total.<sup>44</sup>

### ***Other prior consent requirements***

As a mechanism for ensuring government control over compliance with this quota, the prior approval of the Russian Ministry of Finance is required in connection with the following acquisitions and transfers of shares in Russian insurance companies:

- An increase in the charter capital of the insurance company to be paid for out of funds of foreign investors and/or the (Russian) subsidiaries of such foreign investors.

- The sale by the insurance company of its shares to foreign investors.
- The sale by Russian shareholders of their shares in the insurance company to foreign investors and/or the (Russian) subsidiaries of such foreign investors.
- The participation by insurance companies which are subsidiaries of foreign investors in their own subsidiary insurance companies.
- This prior approval can not be denied to the insurance companies which are subsidiaries of EU-based investors or in which charter capital belongs to EU-based companies if the absolute quota of 25 per cent on total participation of foreign capital in the charter capital of insurance companies in the Russian Federation is not exceeded.

Payment by non-EU-based foreign investors for shares in insurance companies may be made only in monetary form, and only in roubles.<sup>45</sup>

### ***Capital requirements for establishment***

The amended version of the law also upgrades the requirements for the financial stability of insurers and eliminates the differences between the minimum amount of paid-in charter capital required of Russian insurance companies and that required of the subsidiaries of foreign insurance companies or companies in which foreign ownership exceeds 49 per cent of charter capital. Previously, the requirements for the subsidiaries of foreign companies and majority foreign-owned Russian companies were ten times the amount their Russian counterparts had to pay.

The changes introduce the requirement of the minimum charter capital, with the lowest amount set at 30 million roubles, adjusted for each type of activity the insurance company is engaged in. The highest minimum amount of paid-in charter capital is for re-insurers: 120 million roubles. Companies providing life insurance must have 60 million roubles of minimum paid-in charter capital, requirements for those companies that provide property, medical or other non-life forms of insurance are set at 30 million roubles.<sup>46</sup> All insurers had until 1 July 2004 to form at least a third of their required capital; by 1 July 2006, two-thirds of the total amount must be raised, and the formation of paid-in charter capital must be completed by 1 July 2007.

### **2.4. Other financial services**

There are no reported restrictions on foreign participation in securities business and the licensing requirements for foreign-owned and for domestically owned firms are the same. Any discrimination against foreign-owned firms in the issuing and underwriting business that occurs appears to be caused by informal practices on the part of Russian competitors (which may or may not be sanctioned by the authorities). For instance, there is only

one foreign firm (Raiffeisen) which has led a domestic corporate bond issue. No restrictions are reported for foreign ownership of shares of stock exchange organisations.

It remains to be determined whether or not foreign-owned pension funds will be allowed to compete for the management of pension assets in the new framework being developed for private-sector management of the funded part of the pension system. Foreign-owned asset management funds were allowed to compete with Russian asset management firms when a list of such firms approved for handling pension assets was established in late 2003.

### **3. Foreign ownership restrictions in other sectors**

#### **3.1. Mass media**

According to the 1991 Law of The Russian Federation on Mass Media, the dissemination of mass communication in the Russian Federation is guaranteed without unlawful restriction, including both mass media founded in the Russian Federation and those set up beyond its borders.<sup>47</sup> The law also explicitly states that citizens of the Russian Federation shall be guaranteed unimpeded access to reports and materials of foreign mass media.<sup>48</sup> Foreign printed periodicals not registered in the Russian Federation may disseminate their products there, but must first receive a permit from the Federal Agency of Press and Mass Media (formerly the Ministry of Press and Information), unless the procedure for dissemination is established by an interstate agreement.<sup>49</sup> Foreigners may not establish a mass media enterprise unless they are domiciled in the Russian Federation.<sup>50</sup> According to amendments to the Law on Mass Media adopted in 2001, foreign-owned companies and companies with 50 per cent or more foreign participation may not establish mass media enterprises which produce television or radio programmes, nor may they, or foreign individuals, set up radio or television broadcasting companies if more than half of the prospective listeners/viewers are Russian citizens.<sup>51</sup> Shares in mass media enterprises may not be transferred to foreign purchasers if the result would be 50 per cent or higher foreign ownership.<sup>52</sup> It is not clear whether, or to what extent, the definition of “mass medium” in the 1991 Law on Mass Media includes Internet sites.

#### **3.2. Aviation**

The aviation sector is subject to various foreign ownership restrictions. The 1997 Aviation Code<sup>53</sup> stipulates that aviation entities involving foreign capital may be established in the territory of the Russian Federation provided the share of foreign capital is not greater than 49 per cent of the entity’s issued capital, that its manager is a citizen of the Russian Federation and that the number of foreign citizens on the management body is not more than one

third of the management body. This restriction applies to enterprises involved in cargo, baggage, passenger and mail transport by air. While similar restrictions are common in OECD countries in relation to international air transport pursuant to the Chicago convention, restrictions on foreign participation in cabotage only activities have less justification. Furthermore, the 1998 Aviation Law<sup>54</sup> applies a foreign ownership limit of 25 per cent on aviation organisations engaged in aircraft development, manufacture, testing, operation, repair and/or salvage. Domestic aircraft production is protected by a 20 per cent tariff on imported aircraft, but this tariff also applies to aircraft components, raising costs for local aircraft manufacturers, whether wholly-domestically-owned or partly foreign-owned. Restrictions apply to the operation of air services by foreign-owned aviation enterprises, international operations agencies and foreign sole proprietors, but not to Russian entities with foreign investment.

### **3.3. Land transport**

Strict controls that limit the use of foreign-owned means of transport apply to road transport into, across and within the territory of the Russian Federation. According to the 1998 Law on Automotive Transport Control,<sup>55</sup> the use of foreign-owned trucks, buses and other forms of land transport to transport goods or passengers between points within the Russian Federation is prohibited, even when such means of transport have been imported under a temporary import customs regime, so preventing their leasing to Russian operators. Truck and bus transport of goods and passengers into or in transit across the Russian Federation is allowed only on presentation of a special permit from the Russian authorities and a special international permit. This permit requirement may be waived by international agreement on the basis of reciprocity.

## **4. Reciprocity condition for foreign participation in telecommunications**

Since the 2001 study was published, the 1995 Law on Communications has been superseded by a new Communications Law approved by the State Duma on 18 June 2003 and by the Federation Council on 25 June 2003. Unlike the earlier law, the new law does not explicitly state that foreign ownership of telecommunications facilities is permitted in the Russian Federation,<sup>56</sup> but it does imply this by stating that individually-owned and legal-person-ownership is permitted in the sector.<sup>57</sup> It further states that any foreign investor may take part in privatisations of state-run and municipal enterprises' property on terms specified by the Russian Federation laws.<sup>58</sup> However, a reciprocity condition applies for participation by foreign investors: the new Communications Law stipulates that foreign organisations and

citizens shall enjoy a regime established for Russian Federation citizens and institutions to the extent that such a regime is provided by the corresponding country to citizens and organisations of the Russian Federation, unless otherwise stipulated by international treaties or Federal laws of the Russian Federation.<sup>59</sup>

Although there have in recent years been attempts to impose a 49 per cent limit on foreign investment in telecommunications enterprises, no such limit has so far been imposed. The Ministry of Information Technology and Communications (formerly the Ministry of Communications and Informatisation) has stated that it does not intend to impose any limit on foreign ownership of mobile telecommunications enterprises.

Long-distance and international telecommunications are routed via lines owned by Rostelecom. The Russian government intends to maintain the monopoly enjoyed by Rostelecom of such services for six years after WTO accession to enable it to cross-subsidise the modernisation and expansion of basic telecommunications infrastructure. In the long term, the government envisages that the lowering of operating costs resulting from the introduction of new technology will allow it to end this practice.

The authorities are considering further privatisation of the federal holding company Svyazinvest which owns seven consolidated regional telecommunications companies that together currently control approximately 80 per cent of the industry (and also 50.7 per cent of the voting shares of Rostelecom), but will only do so when they have found ways of meeting national security concerns without having to introduce restrictions on foreign ownership.

The licensing process for telecommunications operators is characterised by a lack of transparency and predictability which has not been ameliorated by the amendments to the Communications Law in 2003. The Ministry of Information Technology and Communications (referred to in the Communications Law of 2003 as “the Federal executive authority body in the field of Communications”) has substantial discretion to grant licences to telecommunications operators,<sup>60</sup> allowing it to establish different licensing conditions for different operators and to amend or modify licences after they have been granted. However, licences may only be revoked by the Ministry after a court decision confirming transgression of the operating conditions. Although the new law specifies the very wide powers of the Ministry in establishing licensing terms and in issuing, denying, suspending, annulling and reforming licences,<sup>61</sup> and also lays down detailed requirements in terms of licence application procedures,<sup>62</sup> it does not make clear the criteria upon which the decision to issue or deny a licence is based. Allocation of radio frequencies is similarly opaque,<sup>63</sup> and the right to use a particular radio

frequency band may not be assigned by one radio frequency spectrum user to another without a decision by the Radio Frequencies Governmental Commission,<sup>64</sup> limiting market allocation of this resource.

The authorities are considering privatisation of state-owned telecommunications companies and in this context, ways of meeting national security concerns while allowing foreign participation in the privatisation process (see above). Lack of transparency of procedures has a *de facto* discouraging effect on foreign participation in current privatisation programmes.

## **5. Energy sector**

### **5.1. Recent developments**

As the main driver of economic growth in the Russian economy, the energy sector remains a major focus of both foreign direct and portfolio investment. However, relatively little progress has been made on the energy sector reform since the 2001 study, and foreign investors are still hampered by Russia's inefficient regulatory approvals process that involves multiple major and minor approvals from federal, regional and local agencies. Additionally, there still exist a number of important inconsistencies in pricing in the gas sector that impedes foreign investment in both the gas and electricity sectors.

Mineral resource extraction in Russia is governed by the 1992 Law on the Subsoil.<sup>65</sup> A major revision of this law is currently being prepared, with adoption envisaged towards the end of 2004. The revised law is expected to bring more clarity and consistency to property rights affecting mineral resources and their extraction and will also reduce the discretionary power of officials at various levels of government in the implementation and audit of concessionary conditions in licensing awards. To this latter end, licences will be transformed from mere administrative decrees subject to withdrawal on vague and non-transparent grounds to more transparent contractual licensing agreements between the state and the licence-holder. This does not represent a complete move from administrative law to civil law, since procedures for state waiver of immunity will have to be worked out in any potential commercial disputes regarding these contracts. However, the elimination of administrative discretion and rent-seeking opportunities for government officials will be a major positive development, removing a major source of corruption while at the same time making the licence awarded more "bankable" for fund-raising to cover exploration costs.

A number of proposals for radical restrictions on direct (large and long-term) foreign investment projects in the exploration and development of mineral resources appeared in different versions of the draft law. One such version imposed restrictions at several levels, consisting of general

prohibitions on foreign subsoil users as well as specific restrictions relating to participation in new field development, transfer of existing licences, temporary subsoil use and purchase of a stake in existing licences. These provisions would have effectively barred foreign investors from participation in the oil and gas sector in Russia unless they would have accepted minority positions in Russian oil and gas companies or received specific approval for larger stakes from the government and the Duma.

The Russian authorities may wish to consider whether or not it is necessary, in the interests of competition, to de-link exploration and development rights in connection with tendering for development of reserves once identified. Foreign oil firms consider it legitimate that exploration risk be balanced by automatic development rights. The Russian authorities argue that once substantial resources have been identified, the subsequent tender for development will give the successful explorer the same opportunity and chances to win as everyone else participating in the tender. Should the explorer fail, he or she is free to seek compensation for the exploration costs from the successful competitor, through the commercial courts if need be. However, there is nothing in Russian law that requires the winner of a development bid to compensate the explorer for such costs. A change in these procedures might help attract the more substantial foreign participation in the development of reserves not yet fully explored.

A revised structure of taxation of natural resource use is currently being developed and may be adopted during 2004, although the fact that this reform requires revision of the Tax Code as well as of the Law on Subsoil Resources may delay its introduction. The current proposal envisages a move from the present system of a uniform rate applied to all subsoil reserve users, calculated by volume of lifted product, to a system of differentiated rates. The criteria for differentiation are still being worked out and are likely to include productivity, complexity of access, availability of processing plants and transport costs (as in US legislation). This reform may be seen as a logical move to a more modern tax regime enabling the authorities to extract resource rent from the sector. However, it is possible that it will involve introducing more qualifications rather than standardisation in tax assessments, thus giving officials room for further administrative discretion and potential abuse.

Production-sharing agreements (PSAs) have hitherto provided a special legal framework for foreign investors in mineral resource extraction requiring substantial long-term investment in accordance with the 1995 Federal Law on Production-Sharing Agreements.<sup>66</sup> However, recent developments indicate that the government now intends to cease using PSAs, except in the case of a small number of large-scale projects in difficult locations and with small projected returns and for which there are no bidders at auctions for subsoil

rights. Existing grandfathered PSA projects will be allowed to continue; however, recent amendments to the Tax Code have affected these negatively. It must be noted that despite some reforms in the hydrocarbons sector since 2001, foreign investors must in practice enter into extensive co-operation agreements or joint ventures with well-connected Russian partners in order to realise their investments.

There has been little progress on gas sector reform. Following the preparation of several competing proposals for gas sector restructuring which appeared at the end of 2002, there has been a disappointing vacuum with no decisions taken. In addition, the plans to liberalise trade in Gazprom's shares by removing the strict separation between the domestic and American Depositary Receipt (ADR) markets have not yet been implemented. In the sense that Gazprom has been engaging in buy-back of its own shares during 2003, the government has consolidated its direct (38 per cent) and indirect shares into a majority stake. So far, Gazprom is also resisting efforts to move toward a more market-oriented pricing system and reduce the difference between export prices and far lower domestic prices, a practice which is impeding foreign investment in both the gas and electricity sectors.

The ability of the electricity sector to attract foreign investment for new electricity generation capacity is highly dependent on the current regulatory reform process in this sphere, where some progress was made in 2003. However, the electricity tariff levels are still set too low by the government to make the sector attractive foreign investment. Additionally, current government policy affecting both the electricity and gas sectors do not give foreign investors the assurance of secure and stable gas supply at predictable prices which would enable them to conclude long-term, enforceable contracts. Separately, foreign ownership ceilings remain in force regarding portfolio investment in Gazprom, and in Unified Energy Systems of Russia (UES), the national electricity monopoly.

## **5.2. Limitations on foreign ownership in Gazprom and United Energy Systems**

A Presidential Decree<sup>67</sup> issued in 1999 set a 20 per cent cap on the foreign shareholders' stake in the natural gas monopoly Gazprom and its affiliates and raised the government's minimum stake to 35 per cent. Foreigners may buy Gazprom's ADRs, but another regulation issued in 1997<sup>68</sup> states that Gazprom's domestic shares cannot be freely converted into ADRs. Recently, Gazprom's management has been discussing the removal of the convertibility restriction, but so far no such measure has been put into effect.

Legally, foreign ownership in the national power utility UES is limited to 25 per cent and state ownership is set at 51 per cent.<sup>69</sup> However, the real



extent of both state and foreign ownership is difficult to calculate as UES shares are freely convertible into ADRs and *vice versa*, and the State is widely reputed to hold over 51 per cent of the company. There has been a push by UES management to eliminate foreign ownership caps as a part of its restructuring program, but no conclusive decision has been reached yet.

## Notes

1. Land Code, Art. 28.
2. Federal Law No. 1938-1 "On Payment of Land", dated October 11, 1991 (as amended), Art. 21.
3. The Federal Law "On Insurance of Deposits of Physical Persons in Banks of the Russian Federation" of 23 December 2003 provides for full insurance of deposits up to 100 000 roubles (about USD 3 500). While Sberbank will be part of the system from the outset, government guarantees for all Sberbank deposits opened before as well as after the passage of the Bill (although there are now discussions regarding amending the legislation to exclude new deposits) will be retained until its share of total deposits has fallen from current 65 per cent to 50 percent or until 1 January 2007, whichever comes first. A key provision of the law allows the CBR to review banks wishing to participate in the insurance scheme and exclude those found wanting in various respects, thus in practice barring them from the retail market. See OECD 2004 Economic Survey of the Russian Federation for further details on the scheme now in the process of being introduced.
4. As of April 1, 2004, there were 1 330 operating credit institutions in Russia with total assets of over 5,600 billion roubles (about USD 195 billion), or over 40 per cent of the GDP. Besides being small and fragmented the sector is top heavy, with the five largest banks accounting for over 40 per cent of all banking sector assets. Russia's largest bank, the state-owned Sberbank continues to dwarf rivals, accounting for nearly a quarter of all assets in the banking sector, and for more than two thirds of all retail deposits. Only a third of banking institutions have a capitalisation exceeding USD 6 million. For a detailed review of recent developments in the Russian banking sector, see OECD 2004 Economic Survey of the Russian Federation.
5. The Russian insurance sector is extremely small, with some 1 200 companies (of which 48 with foreign direct participation) having an aggregate charter capital estimated at slightly over 76 billion roubles (USD 2.7 billion) in early 2004. Only thirty of Russian insurance companies had capitalisation of over USD 10 million, and it is estimated that at least ten per cent of all licenced companies do not reach minimum capital levels, currently set at the equivalent of 30 million roubles (USD 1 million). Many of the largest companies are owned by Russia's financial-industrial conglomerates and remain "captive" in terms of business orientation to their founders. The largest 100 companies account for over 80 per cent of all premiums collected, and the largest 10 companies, for over 30 per cent of premiums collected, with the penetration ratio of premiums representing just under 3 per cent of the GDP. As to pension funds, there are about 250 active non-state funds operating in Russia with about USD 2.6 billion under management. Over 50 per cent of assets are concentrated in the top five funds, most of them belonging to large natural resources monopolies such as Gazprom and RAO UES, or to large financial-industrial groups. Recent pension reform is expected to contribute to funds flowing to financial markets, but the impact of the pension money is expected to be minimal in the short to medium term.

6. To some extent it can be argued that Russia is on the same side as most of the CIS countries of the “financial divide” between transition economies experiencing rapid financial sector growth and those with poor results in this sphere. Furthermore, it finds itself in this category for many of the same reasons as the CIS countries essentially a combination of low depositor trust and high credit risk originating from the weakness of its institutions and of the implementation of the legal and regulatory framework. See Berglof, Eric and Bolton, Patrick 2002 “The Great Divide and Beyond: Financial Architecture in Transition”, *Journal of Economic Perspectives* (Winter, pp. 77-100).
7. The creation of a new Federal Service for Financial Markets (FSFM) to replace the existing FCSM was announced by President Putin on 10 March 2004. The new service is expected to be an independent agency, and it is still unclear whether it will be subordinated to the Prime Minister or directly to the President. Oleg Vyugin, the newly appointed head of the FSFM is advocating that the service should be under the direct control of the President and accountable to the Duma, in order to ensure that the service can pursue long-term goals without interference from short-term government needs. Mr. Vyugin has also recently expressed a view that the regulation of audit and insurance companies, and eventually the banking sector, could also come under the functions of FSFM, once there is a higher degree of intermediation in the Russian financial sector.
8. As of 31 March 2003, there were 29 wholly foreign-owned banks holding full operating licences and a further 9 institutions with majority foreign ownership. Although exact data are not available, most commentators estimate that foreign investment in the banking sector accounts for 4 per cent of total capital.
9. RF Law No. 4015-1, “On Organisation of Insurance Activity” dated 27 November 1992, amended by No. 204-FZ, dated 20 November 1999.
10. Federal law No. 172-FL “On modification and additions to the Law of the Russian Federation” On organisation of insurance business in the Russian Federation, dated 10 December, 2003.
11. The current share of foreign investment of the equity capital of Russian insurance companies is estimated to be between 3 and 5 per cent.
12. RF Law No. 86-FZ “On the Central Bank of the Russian Federation”, dated July 10, 2002 (as amended).
13. RF Law No. 17-FZ “On Introduction of Amendments and Additions to RFSFR Law ‘On Banks and Banking Activity in the RSFSR’”, dated February 3, 1996 (as amended).
14. Minutes No. 13 of the Meeting of the Board of Directors of the Central Bank of the Russian Federation (Bank of Russia), dated March 29, 1993 (not officially published).
15. Central Bank Regulation No. 437, dated April 23, 1997 “On particularities of registration of credit organisations with foreign investment and on the procedure for receipt of prior approval of the Bank of Russia for increase in charter capital of credit organisations on account of resources of non-residents”, which specified, in Art. 3, that “until adoption of the corresponding federal law, the quota on participation of foreign capital in the banking system of the Russian Federation established by the Board of Directors of the Bank of Russia is to be applied”.
16. RF Central Bank Directive No. 1204-U, dated November 4, 2002, “On the losing of force of point 3 of RF Central Bank Resolution ‘On particularities of registration of credit organisations with foreign investment and on the procedure for receipt of prior approval of the Central Bank of Russia for increase in the charter capital of registered credit organisations on account of resources of non-residents’ dated April 23, 1997 No. 437”.

17. Banking Law, Art. 18.
18. Banking Law, Art. 18.
19. Banking Law, Art. 18.
20. Central Bank Order No. 02-195, dated April 23, 1997 (as amended), approving Central Bank Regulation No. 437 “*On particularities of registration of credit organisations with foreign investment and on the procedure for receipt of prior approval of the Central Bank of Russia for increase in the charter capital of registered credit organisations on account of resources of non-residents*” dated 23 April 1997 (as amended).
21. *Id.*, par. 8.
22. *Id.*, par. 5.
23. *Id.*, par. 11.
24. *Id.*, par. 12.
25. For requirements current as of February 15, 2003, see Central Bank Telegram No. 186-T dated December 31, 2002.
26. As of February 15, 2003, the current levels are 5 million euros for a bank with foreign participation, and 165 549 000 roubles, or approximately 4 900 000 euros at current exchange rates, for purely domestic banks.
27. *Id.*, par. 28.
28. *Id.*, par. 29.
29. *Id.*, par. 30.
30. *Id.*, par. 31.
31. An examination of the intentions and the specific effects of such measures as nationality and residency requirements of directors, management or employees is needed to determine whether they should be considered to fall within the liberalisation obligations of Item I/A of the Capital Movements Code.
32. Resolution of the Supreme Council of the Russian Federation No. 4016-1 “*On Introduction into Effect of Law of the Russian Federation ‘On Insurance’*”, dated November 27, 1992.
33. See Federal Law No. 204-FZ “*On introduction of changes and amendments to the Law of the Russian Federation ‘On Organisation of Insurance Business in the Russian Federation’*”, dated 20 November, 1999 (the “*Insurance Law Amendment*”).
34. Amended Insurance Law, Art. 6.5.
35. The category of compulsory insurance covers insurance for damage or injury to the life, health and/or property of third parties caused by actions of the insured, as well as for civil liability arising in connection with the same.
36. The category of compulsory state insurance covers insurance for damage or injury to the life, health and/or property of government servants of various categories.
37. Amended Insurance Law, Art. 6.3.
38. Insurance Law Amendment, Art. 3.
39. Amended Insurance Law, Art. 6.3.
40. Amended Insurance Law, Art. 6.3.
41. Amended Insurance Law, Art. 6.3.
42. Amended Insurance Law, Art. 6.3.

43. Including companies from the Baltic States, CIS countries, USA (12 companies), Germany (8 companies), and a number of other European nations.
44. Ministry of Finance of the Russia Federation, [www.minfin.ru](http://www.minfin.ru).
45. Amended Insurance Law, Arts. 6.3 and 6.5.
46. Amended Insurance Law, Art. 25.3.
47. Law of the Russian Federation No. 2124-1 of 27 December 1991 on Mass Media, Article 1 on Freedom of Mass Communication, Article 3 on Inadmissibility of Censorship, Article 6 on the Application of the Law.
48. Law on Mass Media, Article 54, The Dissemination of Foreign Information.
49. Law on Mass Media, Article 54.
50. Law on Mass Media, Article 7, Founders.
51. Law of the Russian Federation No. 107-FZ of 4 August 2001 on Introduction of Additions to the Law of the Russian Federation on Mass Media: amended Law on Mass Media Article 19.1 on Limitations Regarding Founding of Television, Video Programs, as well as of Organisations (Legal Entities) that Carry on Television Broadcasting.
52. Amended Law on Mass Media Article 19.1.
53. Aviation Code of the Russian Federation, Adopted by the State Duma on 19 February 1997 and approved by the Council of the Federation on 5 March 1997.
54. Law of the Russian Federation No. 10-FZ of 8 January 1998 on State Control over Aviation Development.
55. Law of the Russian Federation No. 127-FZ of 24 July 1998 on State Control over International Automotive Transportation and Liability for Violating the Rules Thereof.
56. The Law of the Russian Federation No. 15-FZ of 16 February 1995 on Communications did this in Article 8.
57. Law on Communications of 2003, Article 5 paragraph 1.
58. Law on Communications of 2003, Article 5, paragraph 1.
59. Law on Communications of 2003, Article 69, paragraph 2.
60. Law on Communications, Article 15.
61. Law on Communications of 2003, Article 29, paragraph 2.
62. Law on Communications of 2003, Article 30, paragraph 1.
63. Law on Communications of 2003, Article 23.
64. Law on Communications of 2003, Article 24, paragraph 2.
65. Law of the Russian Federation No. 2395-1 of 21 February 1992 on the Subsoil.
66. Law of the Russian Federation No. 225-FZ of 30 December 1995 on Production Sharing Agreements.
67. Presidential Decree No. 1020 "On consolidating Gazprom Stock in Federal Property", dated August 9, 1999.
68. Presidential Decree No. 529 "On Terms of Trading Gazprom Stock within the Period it is Retained in Federal Property", dated May 28, 1997.
69. Federal Law No. 74-FZ "Regarding the Disposing of Shares of RAO UES and other State-Owned Energy Companies", dated May 7, 1998.

## ANNEX A

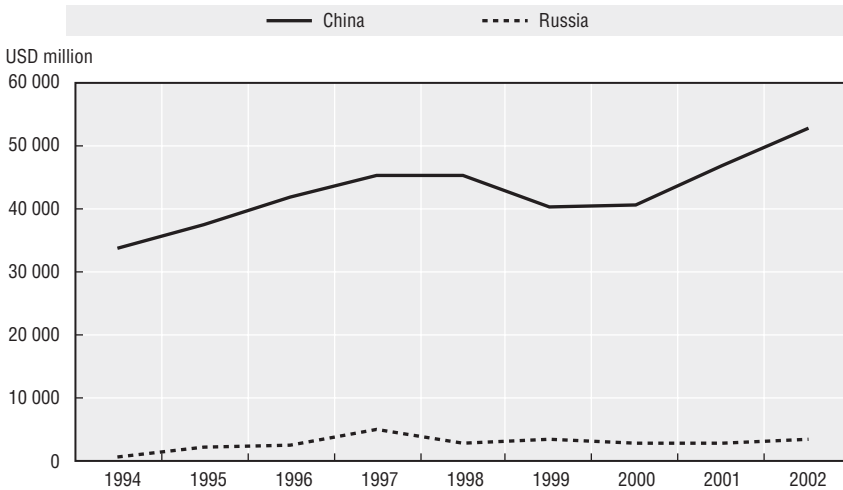
### *Statistical Tables and Figures*

Table A.1. **Top 12 recipients of FDI among subjects of the Russian Federation, 2002**

	FDI inflow (USD million)	% of national total
City of Moscow	1 508 680	37.7
Sakhalin oblast	679 771	17.0
Moscow oblast	589 146	14.7
Tyumen oblast	168 773	4.2
Yamal-Nenets autonomous okrug	133 850	3.3
Leningrad oblast	115 352	2.9
Sverdlov oblast	99 719	2.5
Samara oblast	97 721	2.4
Arkhangel oblast	96 452	2.4
Krasnodar krai	90 003	2.2
St Petersburg	84 082	2.1
Rostov-on-Don oblast	52 650	1.3

Source: FSSS/Goskomstat.

Figure A.1. **FDI inflows into Russia and China, 1994-2002**  
(USD million)



Source: OECD International Investment Statistics.

Table A.2. **FDI inflows to Russia and China in the early years of opening to foreign investment**  
(USD million)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
China	916	1 419	1 956	2 244	2 314	3 194	3 393	3 487	4 366
Russia	690	2 066	2 579	4 865	2 761	3 309	2 714	2 748	3 442

Source: OECD International Investment Statistics.

FSSS/Goskomstat figures for FDI inflows to Russia from OECD countries differ markedly, but not consistently, from figures recorded by the source countries. For the United States, the United Kingdom and Japan, the FSSS/Goskomstat figure for cumulative FDI inflows during the period 1994-2003 exceeds that of the source country figure by an average of 602 per cent, while that for the Netherlands, Germany, Switzerland and France is on average 32 per cent below that provided by the source countries. The FSSS/Goskomstat figure was on average 40 per cent higher than source country figures for the seven OECD member countries listed in FSSS/Goskomstat statistics.

Table A.3. **Cumulative FDI inflows to the Russian Federation from selected OECD countries, 1994-2003**  
(USD million)

	Source country figure	FSSS/Goskomstat figure
United States	518	4 297
United Kingdom <sup>1</sup>	1 553	2 828
Netherlands	3 548	2 796
Germany	2 666	2 542
Japan	124	1 353
Switzerland <sup>1</sup>	1 305	822
France	990	331
<b>Total</b>	<b>10 703</b>	<b>14 969</b>

1. 1994-2002 (2003 figure not yet available).

Source: OECD Investment Statistics; FSSS/Goskomstat.

## ANNEX B

## *Measuring Capital Flight from Russia*

Estimates of capital flight from Russia vary widely because of definitional differences<sup>1</sup> and also because of variations in estimates of the amount of capital outflow that is illegal and undetected.

One definition of capital flight is the so-called “hot money” definition,<sup>2</sup> measured as net errors and omissions in the balance of payments plus net flows of non-FDI, non-portfolio investment assets and liabilities held by entities other than the monetary authorities, general government and banks. On this definition, during the period for which IMF figures are currently available, 1994-2002, capital flight averaged USD 19.1 billion a year and totalled USD 171.5,<sup>3</sup> comfortably exceeding Russia’s total long-term external indebtedness of USD 144.9 billion at the end of 2003.<sup>4</sup>

Using a broader definition of “hot money” (i.e. “hot money” as defined in the preceding paragraph plus net flows of non-FDI, non-portfolio investment assets and liabilities held by banks) plus net flows of portfolio investment assets and liabilities in the form of debt securities, the period average is reduced to USD 16.7 billion and the total to USD 149.3 billion.

The inclusion of net errors and omissions is based on the assumption that this figure largely represents illegitimate capital flows, not just random statistical fluctuations. One indication that this assumption is reasonable is that Russia’s net errors and omissions are large, negative and stable, for example moving within or slightly outside the USD 8-9 billion range in 1995-2001. However, even if this large amount is deducted from the total, this still leaves just under USD 9 billion a year and a cumulative total of USD 80.3 billion in net capital outflow in 1994-2002.<sup>5</sup>

Elements of the business environment which discourage domestic investment and encourage capital flight may include:<sup>6</sup>

- Macroeconomic instability, especially in the late 1990s.



- A tax system perceived as arbitrary and confiscatory, especially preceding the implementation of the new Tax Code.
- Lack of confidence in the banking system.
- Weakness in the institutions for protecting private property rights.
- The privatisation process has in some cases resulted in opportunities for managers to hollow out the assets they control and hide the proceeds abroad.

The channels of capital flight include:<sup>7</sup>

- Misrepresentation of export earnings, particularly in the energy sector.
  - Under-invoicing of exports.
  - Export smuggling, with the proceeds deposited in foreign companies or accounts.
  - Exports via an offshore subsidiary, recorded at a low transfer price, with the margin between transfer and market prices deposited offshore.
- Overstatement of import payments, including through fake import contracts for goods and services.
- Fake advance import payments.
- A variety of capital account transactions evading the regulations often effected through the correspondent accounts of non-resident banks with Russian banks.

Some commentators, asserting that balance-of-payments data may be incomplete, have proffered widely varying estimates of capital flight.<sup>8</sup> These are frequently at or above the upper end of the range of balance-of-payments-based estimates quoted in preceding paragraphs.

Russia is unique among transition economies in that it has been a net exporter of capital in recent years. The main Central and East European transition economies and the Baltic country economies experienced a far smaller per capita export of capital in the early years of transition, and the flow was soon reversed into substantial capital inflows.<sup>9</sup>

## Notes

1. Cf. Schneider (2003) for details of the general problems of defining capital flight and measuring capital flows.
2. Summarised in Loungani *et al.* (2000).
3. International Monetary Fund (IMF), *International Financial Statistics*, April 2004.
4. Central Bank of Russia web site.
5. International Monetary Fund (IMF), *International Financial Statistics*, April 2004.

6. Loungani *et al.* (2000).
7. Loungani *et al.* (2000).
8. Wintrobe (1998) quoted a range of USD 30 billion to USD 300 billion.
9. Loungani *et al.* (2000) and Garibaldi *et al.* (2001).

## ANNEX C

## *Russia's Bilateral Investment Treaties and Double Taxation Agreements*

### **Bilateral investment treaties (BITs)**

Russia has signed bilateral investment treaties (BITs) with 56 countries. BITs with 14 OECD member countries were signed by the former Soviet Union in 1989-1990, together with a BIT with China. BITs with several other OECD members and a number of other countries were signed by the Russian Federation in the 1990s. Since the 2001 study was published, two more countries, Thailand and Yemen, have signed BITs with Russia. The Russia-United States BIT was signed in 1992, but has not yet entered into force pending Russian ratification. Russia developed a model BIT in 1992 which it used as the starting point for negotiations; this was replaced by a new model in 2001 that retained provisions on compensation for expropriation and on guarantees for monetary transfers but removed the principles of non-discrimination, national treatment, MFN treatment and "fair and equitable treatment".

Table C.1. **Russia's Bilateral Investment Treaties (BITs)**

Partner	Year concluded	Partner	Year concluded
Albania	1995	Laos	1996
Argentina	1998	Lebanon	1997
Armenia	2001	Lithuania	1999
Austria	1990	Macedonia	1997
Belgium-Luxemburg	1989	Moldova	1998
Bulgaria	1993	Mongolia	1995
Canada	1989	Netherlands	1989
China	1990	Norway	1995
Czech Republic	1994	Philippines	1997
Croatia	1996	Poland	1992
Cuba	1993	Portugal	1994
Cyprus	1997	Romania	1993
Denmark	1993	Slovakia	1993
Ecuador	1996	Slovenia	2000
Egypt	1997	South Africa	1998
Ethiopia	2000	Spain	1990
Finland	1989	Sweden	1995
France	1989	Switzerland	1990
Germany	1989	Tajikistan	1999
Greece	1993	Thailand	2002
Hungary	1995	Turkey	1997
India	1994	Ukraine	1998
Italy	1996	United Kingdom	1989
Japan	1998	United States	1992
Kazakhstan	1998	Uzbekistan	1997
Korea, Republic of	1990	Vietnam	1994
Kuwait	1994	Yemen	2002
North Korea	1996	Yugoslavia (former)	1995

Source: UNCTAD, BIT/DTT database.

## Energy Charter Treaty

Russia signed the Energy Charter Treaty (ECT) in 1994 but has not yet ratified it. The ECT<sup>1</sup> is a legal framework agreement on rules of international co-operation in trade in energy resources, their transit, and investment in energy. It includes commitments to: investment protection, the implementation of WTO trade rules for energy-related trade even among non-WTO members participating in the ECT; non-discrimination and freedom of transit; effectively enforced competition laws; less restricted technology transfer; free access to capital markets; environmental protection; and regulatory transparency. The ECT also includes strong dispute settlement provisions. Russian concerns about full implementation of ECT are understood to stem largely from fears that Article 7, on transit,<sup>2</sup> would require Russia to allow other members of the former Soviet Union to export oil and gas via Russian pipelines.

## Double Taxation Treaties

Russia has signed a large number of double taxation treaties (DTTs), most of them between 1995 and 2002 and many of them replacing tax treaties signed by the former Soviet Union. In those cases where no such replacement treaty has been signed by the Russian Federation, Russia abides by the treaty signed by the Soviet Union. The Russia-United States DTT, which was signed in 1992, replaced a similar agreement between the United States and the then USSR in 1973, and came into effect in 1994. They include treaties entered into directly by Russia and those USSR treaties to which Russia is a successor. Under Article 15 of the Constitution of the Russian Federation, the provisions of properly ratified international treaties to which Russia is a party prevail over provisions of domestic Russian law. This principle is reflected in Part One of the Tax Code.

Table C.2. **Russia's Double Taxation Treaties (DTTs)**

Partner	Year concluded	Partner	Year concluded
Armenia	1998 <sup>1</sup>	Macedonia	2000 <sup>1</sup>
Austria	2002	Mali	1999 <sup>1</sup>
Azerbaijan	1998 <sup>1</sup>	Malta	2000
Belarus	1997 <sup>1</sup>	Mauritius	1995
Belgium	2000 <sup>1</sup>	Moldova	1997 <sup>1</sup>
Canada	1995	Mongolia	1995
China	1997 <sup>1</sup>	Morocco	1997
Cyprus	1998	Namibia	2000 <sup>1</sup>
Czech Republic	1995	Netherlands	1996
Denmark	1996	Norway	1996 and 2002
Estonia	2002	Philippines	1995
Finland	1996 and 2002	Portugal	2000 and 2002
France	1999 <sup>1</sup>	Slovakia	1997 <sup>1</sup>
Germany	1996	Slovenia	1997 <sup>1</sup>
Hungary	1994	South Africa	2000 <sup>1</sup>
Iceland	1999	Spain	2000 <sup>1</sup>
India	1998 <sup>1</sup>	Sri Lanka	2002
Indonesia	1999 and 2002	Switzerland	1995
Iran	2002	Tajikistan	2002
Ireland	1995 <sup>1</sup>	Thailand	1999
Italy	1996	Turkey	1999 <sup>1</sup>
North Korea	1997	Turkmenistan	1998
Kazakhstan	1997 <sup>1</sup>	Ukraine	1999 <sup>1</sup>
Kyrgyzstan	2000 <sup>1</sup>	United Kingdom	1997 <sup>1</sup>
Kuwait	2002	United States	1993 <sup>1</sup>
Lebanon	1997	Uzbekistan	1995 <sup>1</sup>
Lithuania	1998 and 1999	Vietnam	2002
Luxemburg	1997 <sup>1</sup>	Yugoslavia (former)	1995
Macau	1999		

1. Year of coming into effect.

Source: UNCTAD, BIT/DTT database.

**Notes**

1. [www.encharter.org/upload/1/TreatyBook-en.pdf](http://www.encharter.org/upload/1/TreatyBook-en.pdf).
2. In particular, section (1): "Each Contracting Party shall take the necessary measures to facilitate the Transit of Energy Materials and Products consistent with the principle of freedom of transit and without distinction as to the origin, destination or ownership of such Energy Materials and Products or discrimination as to pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges." And section (3): "Each Contracting Party undertakes that its provisions relating to transport of Energy Materials and Products and the use of Energy Transport Facilities shall treat Energy Materials and Products in Transit in no less favourable a manner than its provisions treat such materials and products originating in or destined for its own Area, unless an existing international agreement provides otherwise."

ANNEX D

*Responses to Questionnaire on Investment  
Conditions in North-West Russia*

Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
<b>Obstacles relating to the acquisition and renting of land by investors</b>				
1. Lack of a secondary market for land.	A secondary market is just starting to develop.	Purchasing land on the secondary market is possible, but not easy.	Land purchase on the secondary market is possible, but only in small quantities.	It is rather hard to purchase land plot on the secondary market.
2. Inadequate co-ordination of agencies involved in land acquisition.	The main problem is a lack of co-ordination between procedures for which different agencies are responsible. There is no "one-stop shop" system.	Co-ordination of the authorities, participating in land acquisition needs to be improved.	The situation is good in the centre of the oblast, where agencies work generally in co-ordination with each other. In other areas the situation is worse. Work in this field will be continued in some municipalities in the framework of a Russo-Swedish.	To obtain land it is necessary to apply to some agencies whose activities are poorly coordinated. There is no one-stop shop system.
3. Lack of a co-ordinated database of real estate information.	There is no common informational database. Information is available from different sources, <i>e.g.</i> the official press.	Such a database is being developed by the Leningrad oblast government. Some information is available there.	Information can be obtained in the oblast administration. The regional programme entitled "The creation of an automated system of state land cadastre recording and state stock-taking real estate objects in Novgorod Oblast (2002-2007)" will promote the development of such a database.	There is no updated database. Information available in the oblast administration has not been updated for the last few months.
4. The local authority will not sell land to investors who have no properties.	As a rule, this situation does not occur.	There is no such problem, providing project documentation is available	As a rule, this situation does not occur.	The investor may purchase or rent a greenfield site, provided a concrete project is planned.
5. Long delays in land allocation. • What is the average time taken to obtain land plot for business purposes?	Delays vary from a few months to two years, depending on the purpose for which the land is obtained and upon the form of land tenure. The delay is considerably reduced for short-term land rental.	1 year on average, maximum 2 years.	Minimum 5 months.	3-5 months.



Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
<p>6. High rents</p> <ul style="list-style-type: none"> <li>• What is the average rate of land tax per 1 square meter USD?</li> <li>• What is the average rent per 1 square meter of land in USD?</li> <li>• What is the average rent per 1 square meter of office space in USD?</li> </ul>	<p>Land tax: USD 15-30 per month for 1 square meter of office premises. Maximal rent in the city centre is USD 120. Average rent per square metre of land is USD 20.</p>	<p>Rent is estimated according to the rate of land tax multiplied by land area and adjusted for usage rate, infrastructure provision and land category. The usage rate varies according to the kind of tenant, business activity and economic sector. Average rent is USD 1.5 per square metre. Average tax rate is USD 0.4 per square metre.</p>	<p>Base rent rates vary according to zone. The base rate is multiplied by land area and adjusted for usage rate and the type of construction. Average land rent is USD 0.4 per square metre. Average land tax rate is USD 0.37 per square metre (in Veliky Novgorod). Average rent for office premises is USD 2-20 per square metre.</p>	<p>Average rent is USD 0.5-3 per square metre. Average land tax rate is USD 0.15-1.5. Rent for office premises is USD 12-15 per square metre.</p>
<p>7. Long delay in obtaining building permits.</p>	<p>Delays appear in the preliminary stages when applying for resolutions. After all the resolutions have been obtained, it takes 1-2 months to obtain a building permit.</p>	<p>There are no long delays in obtaining a permit. Preparation of all required documentation is time-consuming, averaging from 5 months to 1 year.</p>	<p>There are no long delays in obtaining a permit. The process takes about 2 months. If required documentation is lacking, it takes 6 months.</p>	<p>The entire process takes about 6 months.</p>
<b>Obstacles relating to registration of enterprises with foreign investment</b>				
<p>8. Discriminatory practices in licensing of foreign economic activity.</p>	<p>There are no differences in market entry procedures between companies with foreign capital and domestic companies.</p>	<p>There are no differences in market entry procedures between companies with foreign capital and domestic companies.</p>	<p>There are no differences in market entry procedures between companies with foreign capital and domestic companies.</p>	<p>There are no differences in market entry procedures between companies with foreign capital and domestic companies.</p>
<p>9. Time-consuming and cumbersome procedures for company registration</p> <ul style="list-style-type: none"> <li>• What, if any, is the maximum time limit for company registration?</li> <li>• What are the fees for company registration?</li> <li>• For how long is the company registration licence valid?</li> </ul>	<p>To date registration of legal entities in the Russian Federation is regulated by the Federal Act on State Registration of Legal Entities and Entrepreneurs, adopted on 8 August 2001. According to this Act, the Ministry of Taxation of the Russian Federation registers legal entities. The registration procedure takes 5 working days from the moment that all required documentation is presented. The customary fee is estimated at 2 000 roubles. There is no time limit for company registration. Each legal entity must be registered as a taxpayer and must also register with all budgetary and non-budgetary foundations and state statistical agencies.</p>			

Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
<b>Problems related to customs administration and border controls</b>				
10. Poorly equipped border checkpoints.	There are no complaints from entrepreneurs about the technical equipment at border checkpoints. However, it is necessary to increase their capacity.	In recent years the situation has improved.	The oblast is not on a cross-border zone.	Last time capacity has increased by about 67%.
11. Delays and corruption within the customs administration.	These problems persist. Unnecessary documentation is often required. There are some cases of overcharging for speeding up customs clearance procedures.	Delays in goods registration occur.	Novgorod entrepreneurs do not indicate customs registration as a serious problem.	At the moment delays in customs registration of goods have decreased due to the coming into force of the new Customs Code and of the placing of all customs agencies in one hall. Time of goods registration has been reduced by 80%. Due to these measures the level of crime has been decreased.
<b>Taxation</b>				
12. Tax inspections heavily influenced by "revenue targets", including targets for fines and penalties.	Such plans exist. First of all official plans concerning tax collection have an impact on the activity of the tax authorities. Companies with foreign investments indicate that they are subject of frequent inspections because their activity is more transparent.			
13. Lack of clarity concerning tax incentives • What tax incentives are offered by the local administration?	At the moment tax incentives for investors are not provided by St. Petersburg government.	Companies having an agreement with Government may obtain the following tax incentives: 1. A reduction in the rate of profit tax by 4 percentage points. 2. An exemption from property tax. 3. Subventions from the budget to cover the 12% rate of profit tax paid.	The government provides the following incentives for investment projects: 1. A reduction in the rate of profit tax by 4 percentage points. 2. An exemption from property tax. 3. Further unspecified exemptions from tax payment. 4. Transport tax is paid at the rate of 50% of the full rate. Some municipalities grant incentives to investors for local taxes.	The Act on Free Economic Area provides customs incentives for import and export of goods, and exempts goods produced for export in Kaliningrad oblast territory from customs duty.

Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
<b>Other obstacles</b>				
14. Effectiveness of local courts <ul style="list-style-type: none"> <li>• How many disputes between foreign investors and the regional authorities have been brought to court in the past year?</li> <li>• How many such cases resulted in a judgment in favour of the foreign investor?</li> </ul>	There are no precise statistics. According to expert estimates, such disputes are infrequent. Foreign companies' lawyers consider court decisions to be fair.	No information.	No information.	No information.
15. Excessive administrative inspections <ul style="list-style-type: none"> <li>• Does extortion occur in conjunction with inspections?</li> <li>• Are inspections conducted fairly?</li> <li>• How many inspections are conducted per year?</li> </ul>	Entrepreneurs still consider the number of inspections excessive and pointless. Most problems occur in manufacturing. There were some cases of preconceived attitudes on the part of controlling agencies. The number of inspections depends on company size and kind of activity. There may be more than ten. Trading companies are inspected most.	Inspections are steady. Some companies are under inspection monthly.	Inspections are excessive. Manufacturing companies are inspected many times a year, trading companies not so often.	Inspections are excessive. Up to 10 per year for a medium-sized company. There are cases of bribe-taking during inspection.
16. Crime is a serious problem reported by foreign investors <ul style="list-style-type: none"> <li>• Include local statistics on the incidence rate of major crimes, together with the clear-up rate if available.</li> </ul>	The number of crimes recorded decreased by 17.2% (the highest rate of decrease in the Russian Federation) in 2003. At the same time, the number of crimes detected decreased by 29%. 59 849 crimes were recorded in 2003. 28 331 were detected. 27 869 serious crimes (29% fewer than in the previous year) were recorded in 2003. 11 476 (22.9% fewer) were detected. Foreign entrepreneurs do not often experience crime in Russia and consider the problem to be exaggerated in mass media.	The number of crimes recorded decreased by 5.9% in 2003. At the same time, the number of crimes detected decreased by 29.9%. 29 627 crimes were recorded in 2003. 12 351 were detected. 13 403 serious crimes (27.8% fewer than in the preceding year) were registered in 2003. 6 127 (30.8% fewer) were detected.	The number of crimes decreased in the oblast by 4.6% in 2003. The number detection fell by 3.9%. 13,069 crimes were registered in 2003. 7 662 were detected. 4 931 serious crimes (31% fewer than in 2002) were recorded in 2003. 3 134 were detected.	The number of crimes increased in the oblast by 11.1% in 2003. The number detected decreased by 1%. 22 516 crimes were registered in 2003. 13 500 were detected. 8 234 serious crimes (24.5% fewer than in 2002) were recorded in 2003. 5 213 (15.7% fewer) were detected.

Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
17. Dependence on personal contacts to overcome administrative barriers <ul style="list-style-type: none"> <li>• Include a general statement of the extent to which this is true, <i>e.g.</i> "total dependence", "moderate dependence" "minimal dependence".</li> </ul>	Some dependence on personal contacts is reported, varying according to the existence of administrative barriers to be overcome in different agencies.	Some dependence on personal contacts is reported, varying according to the existence of administrative barriers to be overcome in different agencies.	Some dependence on personal contacts is reported, varying according to the existence of administrative barriers to be overcome in different agencies.	Some dependence on personal contacts is reported, varying according to the existence of administrative barriers to be overcome in different agencies.
18. Attitude of local administration to investors <ul style="list-style-type: none"> <li>• Include a general statement typifying the attitude of foreign investors, <i>i.e.</i> the extent to which foreign investors find officials a help or a hindrance.</li> </ul>	The attitude of the city administration to investors is considered to be neutral. Russian entrepreneurs consider that the administration does not create large barriers. However, it would be desirable for the administration to be more positive. The situation is somewhat better in relation to foreign investors	Foreign investors receive support from the oblast government.	Attracting investment, particularly foreign investment, is a development priority for development of the oblast. So the administration is well-disposed to investors and provides support for them.	The attitude of the city administration to investors is considered to be neutral.
19. Long delays in connecting to public utilities <ul style="list-style-type: none"> <li>• List the average electricity, water, gas, telephone, Internet connection times.</li> </ul>	Complications occur in connecting to power and water supplies, mainly because of lack of capacity. Commercial companies offer telephone and Internet connections, which are supplied without long delays; the market for such services is well developed.	Complications occur in connecting to power and water supplies, mainly because of lack of capacity. Commercial companies offer telephone and Internet connections, which are supplied without long delays; the market for such services is well developed. The most urgent problem in industry companies is neutral gas supply.	Complications occur in connecting to power and water supplies, mainly because of lack of capacity. Commercial companies offer telephone and Internet connections, which are supplied without long delays; the market for such services is well developed.	Complications occur in connecting to power and water supplies, mainly because of lack of capacity. Such connections take at least two months. Commercial companies offer telephone and Internet connections, which are supplied without long delays; the market for such services is well developed.

Obstacle reported by FIAS	St Petersburg	Leningrad Oblast	Novgorod Oblast	Kaliningrad
<p>20. Compulsion on foreign firms to use government-linked consulting firms.</p> <ul style="list-style-type: none"> <li>• How many private-sector consulting firms are there? (Please provide a list.)</li> </ul>	<p>Agencies recommend using certain consulting companies which they consider as safe partners who will render a professional service. Some investors indicate this as positive, because it can be difficult to choose between the many consulting companies in the market.</p>	<p>Agencies recommend using certain consulting companies which they consider as safe partners who will render a professional service. Some investors indicate this as positive, because it can be difficult to choose between the many consulting companies in the market.</p>	<p>Agencies recommend using certain consulting companies which they consider as safe partners who will render a professional service. Some investors indicate this as positive, because it can be difficult to choose between the many consulting companies in the market.</p>	<p>Agencies recommend using certain consulting companies which they consider as safe partners who will render a professional service. Some investors indicate this as positive, because it can be difficult to choose between the many consulting companies in the market.</p>
<p>21. Municipal authorities demand work permits for expatriate workers on top of the permits obtained from the central government</p> <ul style="list-style-type: none"> <li>• Yes or no, plus any explanation offered.</li> </ul>	<p>At present there are no more requirements on foreign employees than those established by federal legislation. Nevertheless effective federal legislation is too complicated and provides very long and complicated procedures. Different requirements regarding the documentation needed by foreign citizens to obtain a working licence are imposed in different administrative districts of St. Petersburg.</p>	<p>At present there are no more requirements on foreign employees than those established by federal legislation. Nevertheless effective federal legislation is too complicated and provides very long and complicated procedures.</p>	<p>At present there are no more requirements on foreign employees than those established by federal legislation. Nevertheless effective federal legislation is too complicated and provides very long and complicated procedures.</p>	<p>At present there are no more requirements on foreign employees than those established by federal legislation. Nevertheless effective federal legislation is too complicated and provides very long and complicated procedures.</p>

## ANNEX E

### *Credit Ratings*

One indication of recent improvements in the business climate – in particular in macroeconomic variables – in the Russian Federation is the successive upgrading of credit ratings for sovereign debt and other instruments in the past four years, following substantial downgrades during the financial crisis of 1998. However, while overall long-term national ratings tend to be high, ratings for specific instruments remain generally just below investment grade.

#### **Moody's**

Moody's has progressively upgraded its country ceilings for foreign currency bonds and bank deposits in Russia from 2000 onward. The country ceiling was raised to Ba3 in November 2001, then to Ba2 in December 2002 and Baa3 in October 2003. The last upgrade is the most significant, as it indicates a move from a category of long-term obligation risk, Ba, judged to have speculative elements and to be subject to substantial credit risk to Baa, which is defined as subject to moderate credit risk and as potentially possessing some speculative characteristics. Russia is not on Moody's watch list of names actively under review because of developing trends or events which, in Moody's opinion, warrant a more extensive examination.

#### **Standard and Poor's**

Standard and Poor's currently allocates Russia an AA+ overall credit rating, established in February 2002. In January 2004 it raised Russia's local currency credit rating from BB+ BBB- and its foreign currency credit rating from BB to BB+, reporting the outlook for both as stable.

## **Fitch**

The Fitch National Long Term Rating for Russia established in December 2003 is AAA, the highest category of credit quality. However, this overall rating is not reflected in any of Fitch's current credit ratings for Russian banks, which are all in speculative grade categories. In May 2003 Fitch upgraded Russia's long-term sovereign debt to BB+, the top of the speculative grade category. Fitch judges the outlook for these ratings as stable.

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## Glossary

<b>ADR</b>	American Depositary Receipt
<b>BIT</b>	Bilateral investment treaty
<b>CBR</b>	Central Bank of Russia
<b>CIS</b>	Commonwealth of Independent States
<b>DTT</b>	Double taxation treaty
<b>ECT</b>	Energy Charter Treaty
<b>FCSM</b>	Federal Commission for the Securities Market [replaced by the FSFM]
<b>FSFM</b>	Federal Service for Financial Markets [formerly the FCSM]
<b>FSSS</b>	Federal Service for State Statistics [formerly Goskomstat]
<b>Goskomstat</b>	State Committee for Statistics [replaced by FSSS]
<b>IFRS</b>	International Financial Reporting Standards
<b>MICEX</b>	Moscow Interbank Currency Exchange
<b>PSA</b>	Production-sharing agreement
<b>UES</b>	Unified Energy Systems of Russia

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