

# **“Foreign Investments in Russia: problems and prospects”, Moscow, 1993**

## **1. FOREIGN INVESTMENT IN RUSSIA: AN ANALYTICAL OVERVIEW<sup>1</sup>**

Like any another country embarking on a road of fundamental market reforms, Russia must formulate its strategy in respect of foreign investment. As evidenced by historical experience, the industrialized and fast-developing countries have attracted substantial foreign investment, especially over the last 40 years. Private direct investment combined with borrowings have become the key to success. It is natural that somebody else's experience is not easy to assimilate, which is why each country handles the problem its own way. For the post-communist states, currently in the process of shaping up market relations and seeking ways out of the grave economic crisis, the question of foreign investment is critical. The problem is not only and not so much the shortage of domestic savings that would allow rapid modernization of the economy. The investment climate may serve as a criterion of maturity of the market reforms, of the world community's trust in the property rights and in the situation in the country as a whole. At the same time, access of foreign investors to national economy ensures the fastest adaptation of that economy to the world market

### **1.1. Investment Strategy Aims And Peculiarities**

The world experience has proved that foreign direct investment has a number of decided advantages over other forms of economic assistance to the reforms. First, they are a source of capital investment in the production of goods and services, ensuring also transfer of technology, know-how, advanced methods of management and marketing. Second, unlike foreign loans and credits, investment are not an additional burden on the external debt. On the contrary, they help generate the means to settle it. Third, direct investment ensure a most effective integration of national economy to the world system thanks to the growing outside impacts, the diverse cooperation in the areas of production, science and technology.

The main objectives of the Russian economic policy associated with attracting foreign investment consist in the following:

- creation of efficient economic units;
- stabilizing the economic and financial position as a pre-requisite for the revival of the Russian economy;
- promotion of sectors essential for the sustenance of the country as a whole;
- expediting the structural reform, development of new high-technology advanced sectors and industries;
- shaping up a competitive market environment and effective struggle with monopolism;
- expansion of export and restriction of import through establishment of export-oriented and import-substituting production.

Foreign investment strategy must be closely tied up with the overall structural and

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<sup>1</sup> Chapter 1 in “Foreign Investment in Russia: Problems and Prospects” (edited by Alexander Z. Astapovich and Leonid M. Grigoriev). –The Agency “INFORMAT”, Moscow, 1993.

investment policy of Russia. Under the conditions of an acute investment crisis, foreign investment are likely, to a point, to make up for the shortage of domestic savings. A flexible financial policy is to play an important role. Such a policy would take into account the true requirements of Russia's sectors and regions in sources of finance, new equipment, technological modernization, as well as the interests of foreign investors proper. Besides, types of sectors must be clearly identified on the basis of potential sources of finance:

- sectors, where the government is capable of providing centralized investment;
- sectors and industries promoted primarily at the expense of national private investment;
- sectors which at this stage must be supported by credit lines;
- sectors and industries which it would be expedient to develop through active attraction of foreign investment.

During Russia's current period of transition, the following grouping of sectors, reflecting the role of foreign capital in the national economy, appears to be most clear and potentially effective:

- (a) priority sectors capable of attracting and using foreign investment;
- (b) (b) sectors where the participation of foreign investors is invariably restricted;
- (c) (c) a small number of sectors inaccessible to foreign capital from considerations of national security, protection of national interests and property, the sectors which may be crucial to country's viability.

There are sectors that require immediate increase of investments. These include oil-processing, chemical and petrochemical industry, ferrous and non-ferrous metallurgy. Investment priority in particular spheres of economy is determined by a number of serious socio-economic factors, too. A task of top priority during the transition period is saturation of the domestic market with foodstuffs. Conversion of military production is an important internal problem. Once the defense industry is devoid of state orders and has no sources of finance that would make possible re-orientation of the sector, it may, potentially, generate high social tension in the society. Within the framework of conversion, several priority tasks can and should be performed at a time: establishment of capacities for import-substituting products; expansion and diversification of export-oriented industries; setting up the material and technological base for the development of infrastructure and of the agro-industrial complex.

Obviously, the preferential treatment cannot compensate the unfavorable investment climate which is due to internal instability. The incentives, alongside the stable legal guarantees, must be aimed, above all, at minimizing the risk of the loss of capital and must be fairly efficient, considering the growing competition for investment. Very important here is a clear understanding of what specific kind of investor's activity or behavior can be stimulated by introduction of particular incentives and of how these can be skillfully combined, depending on the nature of the investment project

The process of Russia's integration to the world economy must inevitably take into consideration the interests of structural policy. It is this policy that determines the choice of priority sectors for import substitution and expansion of export as well as for the attraction of foreign investment Enterprises in such sectors are likely to require the introduction of sufficiently high barriers to protect them from foreign competition. The world experience has proved dramatically that this kind of policy is a powerful impetus for foreign

companies which, through investment, manage to get into the markets normally inaccessible to goods and services from abroad. At the same time, the "opening" of the Russian economy without the support of priority sectors may lead to the liquidation of basic sectors and industries. As a result, the commodity-raw materials orientation of Russia's export will persist for years which is in glaring conflict with the structural reform.

The problems of regional policy under the conditions of Russia are more often than not dealt with from the standpoint of establishing and promoting free economic zones (FEZ) which must be based on a clear legal regulation of economic activity carried out by foreign investors and enterprises using foreign investment. In the course of their analysis, Vjacheslav Morgachev and Oleg Morgachev came to the conclusion that decisions of 1990 - 1991 to establish in Russia 12 FEZ simultaneously in different territories and regions had been made without a close examination of the likely effects, with no regard for economic capabilities of the state and of the regions. As evidenced by the world experience, a positive result can only be achieved by concentrating the efforts and resources on the establishment of compact export-oriented zones. Legal issues of FEZ activity call for an early drafting and adoption of the free economic zones law of the Russian Federation.

As the economy is revived, finances stabilized and the investment crisis in Russia overcome, it will be possible to switch to stimulating capital investments into particular sectors and industries. In such cases, it will be expedient to provide equal conditions for all the investors. Moreover, easy terms of investment may, alongside the specific sectors, also apply to the regions. The experience of countries where the wise regional policy is conducive to structural reform of the economy as a whole is of special importance for Russia.

## **1.2. Foreign Investment Pre-requisites And Terms**

The reputation of Russia as a recipient country has been twice seriously undermined in the course of this century. The 1917 October overthrow resulted in the confiscation and nationalization of private, including foreign, property without any compensation whatsoever. In the late 1920s - early 1930s, the curtailing of NEP predetermined the liquidation of foreign concessions. At present, to regain the trust of foreign investors, there must be stable legislation, a clear legal base for foreign investors in the area of financial, tax, trade and tariff regulation. Besides, the question of succession in the field of governmental agreements entered into by the former USSR is a special issue for Russia.

Integration into the world economic system is impossible unless normal legal conditions for foreign investment are created. As far as business is concerned, it is keenly interested in state guarantees, including those provided in the form of intergovernmental and international agreements. To investors, however, there can be no proper substitute for guarantees of property rights. From this standpoint, the inflow of foreign capital will be provided, above all, by the fast progress of market reforms. Foreign capital can and must play an important role in economic revival of Russia. A fundamentally new business climate based on principles familiar to investors is to evolve, combined with an absolutely predictable long-term policy. It is in this case that natural advantages of Russia, including its natural resources and a potentially capacious market, the enormous research and technological potential, and educated population, will become the most important condition of Russia's competitiveness in the struggle for attracting private capital. It is obvious that the current state of the Russian economy and society has no direct analogs in history. It looks like Russia continues performing experiments on itself, hopefully, in the interests of the mankind. However, no matter how specific the country is, it seems

preferable to follow the standard investors' pattern of behavior abroad to produce a favorable climate for them, thereby ensuring more investments. The hope for the attractiveness of Russia's vast expanses associated with no adequate legal security is pure illusion. It cannot provide massive investments.

Olga Ivanova, Andrei Chemyavsky and Olga Koziyova reveal the extent and pattern of investment requirements of the Russian economy. During the current century Russia practically stands no chance of meeting the investment requirements from domestic sources of finance. Besides, in addition to sectors that are likely to be financed from private investments, there are vital sectors with a long period of capital investment repayment. Development of these during the transition period must be the responsibility of the state. Finally, sectors with most backward technologies are in dire need of investment for fundamental modernization of the production facilities.

However, the resources of the world capital market are rather limited. More over average inflows of foreign direct investment to the developing countries reached of USD 26 billion in 1988 – 1990 compared with USD 13 billion in 1980 -1985. The global recession cut the investment opportunities, restricting considerably the freedom of governments as far as the aid to other countries was concerned. Igor Doronin's analysis makes one think seriously of the need to participate in the capital market competition as well as of the new opportunities and new responsibility stemming from membership in international financial organizations.

Countries that managed to make the best of the outside sources of finance, to rely on them in the process of modernizing their economies and producing normal conditions to encourage the growth of domestic savings and accumulation of funds laid down the conditions for a steady economic growth. Such an option presupposes a very dear and well-coordinated long-term strategy of attracting foreign investors, which is an integral part of both the structural policy and the program of privatization. Yet, most surveys conducted in different years and in different countries contain a conclusion of the most important role of macroeconomic variables for investment-related solutions. Special attention of analysts is engaged by variables in respect of which opinions differ. These usually include the scale of economy (total GNP; per capita GNP), that determines the size of potential market; the rating of a political risk; currency rate, its predictable variations.

On a practical level, regardless of the achieved standard of development, and this equally applies to Russia, the capital inflow from abroad is not so much dependent on the government policy but on the size of the market. As for the rating of a political risk, it is taken into account mainly when making investments in the developing countries, Russia grouped with such countries from the standpoint of its internal situation. The currency aspect has a dual meaning. In case of inconvertibility of the currency, it is an extra element of risk and a constraint on investments, which was amply illustrated in the process of setting up joint ventures in the USSR. However, if the currency is convertible, but its exchange rate is low, this may indeed stimulate the inflow of capital, an option quite likely for Russia in the nearest future, providing that foreign capital has a free access to property. Still, macroeconomic consequences of capital inflow at the exchange rate of Rbls 600 - 800 per dollar in early 1993 cannot be serious. The initial ruble rate is too low to have an effect on the dynamics of the rate.

The factors that determine the real access of foreign direct investment to Russia can be subdivided into several groups:

- the country's need to modernize and develop;
- general conditions of resources accumulation: taxes and tariffs, their stability, contracts legislation, export and import regulation, nature of the banking system and banking services, mechanism of exchange control;
- national legislation as a whole and special laws laying down the conditions for the activity of foreign investors;
- psychological, political and especially general legal terms that shape up and mature as the society develops and which cannot be decreed or imposed by a government decision.

The search for ways of transition to a market economy, transformation of property relations take place under the conditions of a complicated political struggle, without a clear public consensus on the key issues of economic and social fundamentals of the future society. In this respect the state and dynamics of the public opinion constitute an important factor that determines the investment climate in Russia. Sergei Shpilko showed that, having lost in many ways the traits of an ideological enemy, robber who is after a country's national wealth, the foreign entrepreneur acquires, in the eyes of the public opinion, the features of a real economic competitor on the markets of goods and services, real estate, capital. Hence, there is a different, contradictory attitude of the different strata of the population, new businessmen and officials to the new emerging foreign enterprises, to the participation of foreign investors in privatization of the land, extraction of natural wealth. The impact of this factor can be felt not only in the drafting of new laws, but also in practical decisions regarding the specific investment projects.

Of special significance are the policy of privatization and the administrative regime for investors. While privatization creates many opportunities to the investor it is not a process independent of the general capital formation. The administrative regime includes different problems like sharing the liability between the government agencies and local authorities, access to reliable information on the legal framework, on the specific projects, methods and objects of privatization. Given the huge country and fairly decentralized management, these factors are rather important.

One of the most important objectives of the economic reform currently underway in Russia is the attraction and use of foreign investment for development. However, the complexity of the task is far from being fully appreciated, the requirements of investors being frequently ignored. Apparently, when the policy is formulated, the politicians fail to consider the fact that in the opinion of western companies the high potential profitability of investments in Russia is at the moment offset by the political and commercial risk associated with the overall internal political and economic instability, insufficient legal and administrative procedures. As a result, for the time being, ambitions to invest in the Russian economy amount virtually to rather small investments. Besides, the peculiarities of the project preparation cycle in corporations, which in itself lasts around one year, are also of importance. In 1991, relatively few projects were initiated for purely political reasons. Therefore, in 1992, the projects launched in 1988 - 1990 were completed, while new ones were sought. Subject to generally favorable conditions, heavy investments may, presumably, be expected not before 1994, as the western companies embarked on a large-scale search for projects in 1992. There is a long and complicated road ahead to cover before the foreign investor becomes an integral part of our economic system.

### **1.3. Macroeconomic Stabilization: Impact On Foreign Investment**

it must be admitted that policies in the field of macro-stabilization in Russia in 1992

were carried out against an extremely unfavorable backdrop of the existing economic ties both between enterprises and regions being disrupted, of the aggravated internal political and ethnic conflicts. This resulted in a sharp degradation of the investment climate in the country, affecting a fair portion of foreign investment. From the standpoint of foreign investors, the degradation occurred in two closely related areas.

First, the general economic crisis, significant decline of production, decrease of export occur under the conditions of a desperate struggle between the government and the parliament, a consolidating position to the government as regards methods of carrying out the reform. The policy of the government itself proved to be not effective enough. The measures to prevent inflation failed to bring about a major drop in the budget deficit, they did not check the growth of the wages fund as a tangible factor of inflation. The rigid taxation policy and expensive credit did not encourage manufactures to invest more. For this reason, the disruption of the capital accumulation process was anything but a structural economic reform. The measures to stabilize the ruble, including currency interventions of the Central Bank, practically were futile.

The legal insecurity of the macro-reform must be particularly emphasized. This was especially disconcerting in the fields of taxation, privatization, export-import regulation. As foreign investors saw it, the major drawback of the reform was that the conditions of operation changed practically every month. The frequent change of rules of the game on the market found its reflection in the negative evaluation of the situation in Russia by the banks, consulting and legal firms since in the generally accepted methods of risk calculation legal stability plays the key role.

Second, in 1992, the foreign investment treatment proper toughened. In the government policy, the position of those advocating immediate equalizing of the conditions for the Russian and foreign investors prevailed. Such a stand ignores the existing enormous legal, informational, transportation and, of course, language barriers. The actual stake in a fast provision of favorable conditions for investments was unduly optimistic and "theoretical". In our view, the difficulties of coordinating the legal, administrative and tax-exchange controls became the key problem. Measures taken in any of these areas failed to be consolidated by respective steps in the other spheres. At best, this occurred with a big delay.

The policies in the investment, tax and customs-tariffs fields taken in 1992 were not conducive to attracting and using more foreign investment, thereby undermining the trust to the long-term stability of the investment regime. In future, the formation of a favorable climate for foreign investment will inevitably call for the return to the privileges that had existed prior to 1992 for enterprises with foreign participation. Besides, a system of incentives for investments in priority sectors of economy will have to be developed. During the current transition period for Russia, mechanical application of measures for currency allocation, export-import licensing and foreign exchange earnings sale to joint ventures and foreign enterprises leads to an abrupt reduction of the inflow of foreign investment. That was exactly what happened in 1992, following the adoption of a number of decisions that violated the rights of foreign investors and contradicted the Law "On Foreign Investment in the RSFSR" dated July 4, 1991. The greatest concern among foreign investors was caused by the cancellation of tax exemptions for enterprises in the sphere of material production. In this connection, Michael Braginsky and Raphael Nagapetyantz specifically stress the clause of the law whereby the norms restricting the rights of the subjects of the investment activity cannot be enforced until after one year has expired from the moment of their publication. It was only in July 1992 that the Supreme Soviet of the

Russian Federation restored the two-year tax holidays in respect of enterprises with foreign participation registered before January 1, 1992, failing, however, to apply this amendments to the newly set up enterprises. The idea of the "grandfather's clause" (making legitimate the conditions of taxation under long-term agreements as of the date of signing thereof) has been applied to an extent, yet on quite a few points the terms of old contracts underwent fundamental changes in 1992.

As per the Decree of the RF President of June 4, 1992, all enterprises with foreign investments must sell 50% of their export earnings in foreign exchange. However, pursuant to the Foreign Investment Law, foreign exchange earnings generated by export of own products should remain entirely at the disposal of enterprises fully owned by foreign investors and of joint ventures, if the share of foreign participants in their equity capital is more than 30%. In fact, enterprises with foreign participation lose up to 10% of the profit in the form of commission payable to commercial banks authorized by the Central Bank of Russia.

The Decree of the RF President of June 14, 1992 stipulates that an import customs duty shall be paid by all importers, while the earlier granted exemptions are cancelled except those that are established by the laws of the Russian Federation and international agreements, in fact, the regulations specifying the procedure of applying the Provisional import tariff, coupled with the current practice, have deprived the joint ventures of the right to import goods duty-free regarding these as a contribution of foreign investors in the equity capital of a joint venture, which was envisaged by the Foreign investment. Law In practice, application of the RF Government resolution of December 30, 1991 also ignores the right of foreign enterprises to export, even without licenses, the goods of own manufacture and import products to meet their own requirements.

The cancellation of tax exemptions for joint ventures was a vivid illustration of how imperfect the Russian legislation is and especially the failure to follow the existing laws, which is traditional for this country. The legal guarantees of tax controls stability in respect of enterprises with foreign investment would prevent the negative consequences of raising the tax rates. In particular, the absence of the "grandfather's clause" led to a situation where joint ventures in oil industry were forced either to insist on granting them tax exemptions as an exception, or to wind up operations due to unprofitability. The said guarantees currently absent in the laws could be made applicable for 5 to 7 years, up to the moment of actual reduction of political and commercial risks of making investments in the Russian economy.

Yelena Dyachkova, taking oil industry as an example, shows convincingly the way particular measures of government policy obstruct the inflow of foreign capital, and, ultimately, come into conflict with the objectives of the macro-reform. For example, the export duty introduced concurrently with the raising of the profit tax rate (from 25 to 32%) proved to be a heavier burden for investors compared with the super-profit tax canceled in 1992. Foreign companies are also seriously concerned about the fact that methods of calculation and the size of duty are changing all the time. In these conditions, it would be expedient, on the strength of the positive experience of many countries, to replace the duty by sliding scales of royalty in the contracts with foreign investors.

The results of the first year of reforms indicate that by now all attempts to devise the mechanism of attracting foreign investment that would be adequate to the requirements and objectives of market transformation of the economy have been futile. This applies to both the economic conditions and the legal and administrative regime. Moreover, the

deepening economic crisis is accompanied by the growing instability, frequent changes in the legislation. In the present situation, it would be helpful to elaborate, as early as possible, an adequate tax and tariff system that would meet the requirements of foreign investors and ensure the protection of national interests.

#### **1.4. The Problem Of National Treatment**

The reform has revealed an insufficient understanding of the Western practice, of the existing general investment trends. In particular, the government approach to the national treatment for investors has been the cause for a number of unexpected steps in the field of tax controls, tariffs, etc. in our view, the idea of national treatment is closely related to relaxed protectionism, meaning, first of all, a "nondiscriminatory regime" for foreign investors, covering a wide range of parameters. The latter include not only tariffs, taxes, export regulation, but also pricing, deliveries of products, subsidies, access to particular sectors of economy. In the present-day Russia, however, "national treatment" is viewed by many as a "pure national treatment", as the end of any motivation for the investor. This, in fact, is in conflict with the practice of most developing countries during the initial period of transformation.

It would be, no doubt, more preferable to create equal conditions for all, right from the start. But even then, different investors will use different opportunities. Investors having a greater capital, capable of reviving the economy and raising its efficiency, must be offered acceptable conditions for getting integrated into the economy. It is most important to attract not just money but "strategic" investors with practical experience in particular sectors, with knowledge of the market, considerable financial resources and experience of managing enterprises in different countries worldwide, in Russia, a country of a high political and commercial risk, there will inevitably be the question of how to equalize this risk for the investor at the early stages of the reform. Special conditions for foreign firms at the first stage are no alternative to a consistent shaping up of a market economy, creation of normal conditions of capital accumulation for all investors. These processes should run side by side, ultimately merging as a stable investment climate gets ripe. This, in fact, has been a routine practice in a number of developing countries.

The alternative to the pragmatic policy is embodied in slogans like "equal conditions for all" that are immediately picked up by the national snobbery: from "ours is better!" to "why do we have to". The answer to the latter question for Russia, going through a fundamental structural reform, is very simple: because we need investment for economic recovery, to revive export and raise the living standards. In the long term, investments constitute the real source of funds that will make it possible to resolve our domestic problems. Every step toward laying down the conditions for major private investments from abroad means the shortening of the period of crisis, economy in transition and structural reform. One cannot stay indifferent as regards the rejection of the need for foreign investment, because such policy delays the process of integrating the leading Russian enterprises into the world economy. Unless there is a definite success of the first investment, it is hard to expect a wider wave of investment to follow: lack of wide experience of interaction between managers, officials and businessmen, on the one hand, and "strategic" investors, on the other, impedes the formation of the groundwork of a market economy. Although the degree of risk will gradually be reduced, the time for investments in the first half of the 1990s may be wasted.

The most important question of encouraging foreign investment is the efficiency of incentives. Different point of view on the matter are known to exist, and many experts,

especially those working for international organizations, are against offering any incentives to foreign investors. Basically, their arguments consist in the following. First, the privileges provided are far less important compared with the size of the market and costs of production. Second, the competitors may offer more attractive incentives, which in general gives rise to an unduly fierce competition for the attraction of investments (this is a question of realities of our time). Third, the system of incentives and preferences in respect of foreign capital is unfair to home business.

It is obvious that under the current conditions of Russia's development the question of incentives and privileges cannot be regarded separately from the other aspects of economic policy. Indeed, the world practice shows that financial and fiscal incentives do not play a crucial role in deciding whether or not to embark on a particular investment project. Yet, the experience of many countries has proved that national treatment devoid of any special privileges for foreign investors yields a real effect only when there is political and economic stability. Apparently, it will take a rather protracted period of consistent macroeconomic policy, enjoying the trust of foreign investors (including wide-scale privatization, assertion of the institute of private property, stability of the rights of different proprietors) before the domestic investment regime attains the quality suitable for foreign companies. Only then the transition to national treatment will be really feasible. At the moment, the task is two-fold: to create normal regime for Russian investors and to do away with actual discrimination of foreign investors by offering them specific privileges in particular areas.

There is a global competition on the capital market. For this reason, when investors have a choice of investment opportunities in countries with similar natural resources, geographical position, human capital, they pay attention on the risk factors and economic motivation. Naturally, the Russian diamond – or gold-extractive industries have a limited number of competitors. The situation with oil industry is more complicated. Finally, if we take manufacturing industry and the services, the situation here changes dramatically for the size of potential market, the skills of labor, given the relatively low price, are no longer decided advantages.

The quality of labor force, systems of transportation in Eastern Europe are comparable with those in Russia. Therefore, it is important that Russia should not confine itself to investment provided for the development of raw materials sectors and protection of high technologies in a situation where consumer sector enterprises will be set up in East European countries by foreign investors. Sometimes, the deployment of an industry in Russia closes a network in a global structure of large multinational corporations or is used to maintain the competitive edge. The time factor is extremely important. Strategic investors may come now or in a few years that does not put their long-term interests in jeopardy, but narrows down sharply the possibilities of a positive effect on the Russian economy. As a result, the western regions of Russia will, in the foreseeable future, have to compete with the Baltic republics, Poland, Czechia, Slovakia and Hungary.

A study by Ruslan Grinberg and Victor Durnev proves that Eastern European countries in the early 1990s headed for a rapid opening of their national economies. Such a policy envisaged the creation of most favorable conditions for the attraction of foreign investments. Russia could use the experience of Eastern European countries as far as tax exemptions, foreign exchange controls and preferential treatment in respect of joint ventures and foreign enterprises are concerned. Yet, this experience once again proves that the state policy toward foreign investment, however liberal it may be in itself, can only be successful when foreign investment are confident of the consistency and irreversibility of

systems transformations, of the recipient country's stability.

A typical example here would be Hungary which conducts privatization, following the classical patterns of Great Britain and New Zealand, and seeks to come closer to the 25% share of foreign capital, a standard rate for West Europe. The process is time-and labor-consuming, requires a lot of administrative effort and yet is a definite, worldwide proven guarantee there will eventually be truly efficient market agents in Hungary. The conditions for foreign investors in Hungary include a wide-ranging and quite pragmatic set of motivation measures. As a result, the country received \$ 600 million in 1990, and \$ 1.4 billion in 1991 in the form of foreign investments. During the first half of 1992, the capital inflow to the country was at the rate of \$ 150 million a month. Hungary's share in all direct investments in the East European countries, including the former USSR, is estimated at 60%. Having built the basis for massive influx of foreign investments, Hungary gradually began to cancel tax incentives which are no longer required.

At the first stage of the reform, Russia actually chose the alternative way. The trend toward equalizing the conditions for the activity of Russian and foreign investors resulted in an unjustified withdrawal, from the early 1992, of all privileges granted to enterprises with foreign participation the taxation, foreign exchange and customs-tariffs areas, which was in marked contrast with an intensive political campaign calculated to lure major businessmen. Yevgenia Yakovleva and Yelena Dyachkova provide a detailed analysis of the aftermath of such measures. In particular, raising of the taxation level, introduction of high export duties preconditioned the losses of most medium-size and minor foreign investment projects, including those in the oil and gas industry which remains the key source of foreign exchange earnings. This policy resulted in a situation where the volume of foreign investments (converted at the Ruble rate for respective months) was barely beyond \$ 150 mln for the first nine months of 1992. On top of that, the latest reports of Western experts say that of all the post-communist countries of Eastern Europe and the former USSR, the climate for foreign investments in Russia is the least favorable.

### **1.5. Administrative Framework**

National strategy in foreign investment may incorporate different elements. The world practice indicates that most countries stimulate foreign investors, but to a different extent, in the process, depending on the significance of a particular element, the focus of the strategy as a whole is determined. As for the attraction of foreign investments to Russia, the priority factors are stability, transparency and clear administrative organization.

It is not only clear formulation of policy, including its main objectives and tools, which is of greatest importance. The policy must be understood by and favorable for foreign investors. It must take into consideration investors' own practice and interests. In this connection, it must be remembered that the process of the foreign investor consolidation on the Russian market usually comprises several stages: reconnaissance of investment opportunities, making a decision to enter the market, negotiations with Russian partners, including the government, entering into contracts, investment of capital proper. Considering this, 'it is most important that the investment regime be clear and consistent. Frequent changes in the legislation still common in Russia, coupled with confusion and uncertainty of the legal base, increase the risk, cut the rate of profit acceptable for the investor or even force him to give up original plans.

The existing uncertainty of different government institutions as far as the attraction and utilization of foreign investment are concerned confuses and scares away foreign partners.

This, above all, applies to medium-size and minor firms. The confused administrative regime necessitates complicated bureaucratic procedures and, what is worse, corrupts officials at different levels. The practice of numerous countries has revealed a number of key problems that emerge when the administrative regime for foreign investment is being shaped up. Such problems include (a) a choice between a permit-issuing system and a registration system as regards the establishment of ventures with foreign participation, (b) a correlation between the privileges and restrictions in respect of foreign investors, (c) criteria for the selection of partners for negotiations and for entering into contracts, (d) distribution of duties between the executive authorities, depending on the decision-making level - practical implementation of the one-stop shopping principle. As long as the basic legislation and the system of economic incentives are formulated within the framework of government policy and are partly made a law, the administrative support is of paramount importance. During the period of economic transformation, it appears most expedient to coordinate efforts in foreign investment area by setting up a single government body to provide necessary regulation, diverse aid and, where necessary, protection of investors' interests.

The existing administrative regime for foreign investors reflects several principal factors: current legislation, bureaucratic traditions, decentralized management in the country. Until now, the legal base does not meet the requirements ensuring the inflow of foreign investments. While declaring free access and registration procedure hinges on the need for a government decision on all investments above Rbls. 100 million. In fact, there is only one level of final decisions in Russia - the government itself. All important decisions must be signed by vice-premier, which implies a consensus of half a dozen key ministries. The traditions of bureaucracy suggest that any agency involved, either in the center or on the periphery, will seek to control every decision and will place a higher value on "self-respect" to the detriment of the cause. Finally, the disintegration of the USSR and fast, albeit frequently disorganized decentralization of management have added to the uncertainty in the decision making process. As a result of this, all levels of the same authority and all authorities insist they are "chief bodies" in a particular matter.

As a matter of fact, a foreign firm will seek a partner or a project will be proposed at any level: an enterprise, local authorities, ministries. But then, a process of coordinating project terms between the firm and the government gets underway: guarantees, taxes, export licenses, offshore accounts, barter deals, privatizations, inclusion in a credit line, project assessment, declassifying, obtaining a license for a mineral deposit, approval by local authorities. On top of this, a change of the taxation level is subject to approval by the Supreme Soviet on a case to case basis. Alexander Astapovich, while describing the existing mechanism of decision making regarding foreign investments, cites a long list of agencies taking decisions of their own practically on any major project. No wonder, then, that to an outsider the current procedure in Russia appears extremely bureaucratized.

At present, a host of ministries and agencies of the Russian Federation have special divisions to deal with foreign investments, among them the ministries for economy, foreign economic relations, fuels and energy, the State Committee for Management of State Property (OKI), the Antimonopoly Committee. In a way, they duplicated the work of the Committee for Foreign investment. The duplication of effort continues also in respect of the newly established the Russian Agency for International Cooperation and Development (RAIC&D). Similar structures exist on a regional level, too. The uncertainty of competence of various agencies misleads and scares away a foreign investor. This, first of all, applies to medium-size and minor firms. Definitely, it would be more practical to have a situation where RAIC&D would actually be in a position to coordinate the key

issues of formulation and implementation of the foreign investment policy.

### **1.6. Foreign Investment And Privatization**

The process of large-scale privatization suggests that some crucial problems will be resolved in advance - an efficient market economy or restored social justice. Then comes the question of the rate and quality of the process based on the assumption that all of these factors are impossible to maximize simultaneously. The answer to these questions will directly determine the attitude to foreign investors. In particular, one must have a clear idea of aspects like feasibility of using foreign capital prior to, during or after privatization, correlation of the responsibility of executive agencies in respect of privatization and foreign investment, preference to be given to national or foreign buyers of privatized property. Alexander Radygin and Alexander Astapovich have attempted to analyze the tremendous complexity and the nature of privatization problems in Russia to emphasize different approaches to handling these problems and associated political and inter-agency struggle.

As we see it, the practical purpose of privatization in Russia is not removal of property from the state jurisdiction but establishment of effective economic units and financing of capital investments in the Russian economy. The main thrust must be made on factors like new investments, corporate control, promotion of production on a new technological base, steady employment. Taking this into account, it is expedient to set up conditions for fast involvement of foreign investors in privatization, which would raise the efficiency of Russian enterprises and provide linkage with the world market, it would be in national interests if both major strategic investors and small/medium-size businesses took part in privatization.