Institut für Höhere Studien (IHS), Wien
Institute for Advanced Studies, Vienna

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Abstract

This study examines the role of foreign direct investment (FDI) in enabling Russia to grow and prosper economically. The study focuses on Russia's policy towards FDI, assessing how well it has worked through analysis of the data, and how it may be strengthened. The paper considers the roles and functions of FDI in a comparative perspective with other emerging economies, in Russian/Soviet history, and in the Russian Federation. The strategic factors affecting the level of FDI are then discussed, including Russia's policy toward FDI, the policy's operational problems, and the steps being taken to overcome those problems.
The study concludes by recommending actions that could increase the flow of FDI to Russia.

Keywords
Foreign investment, foreign direct investment, trade, Russia, capital flows

JEL-Classifications
F21, F36

Comments

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I. Introduction

Scope of Study

This study examines the role of foreign direct investment in enabling Russia to grow and prosper economically. The study focuses on Russia's policy towards FDI, how well it has worked, and how it can be strengthened.

The study considers the roles and functions of FDI in comparative perspective with other emerging economies, in Russian/Soviet history, and in the Russia Federation. The strategic factors affecting the level of FDI are then discussed, including Russia's policy toward FDI, the policy's operational problems, and steps being taken to overcome those problems. The study concludes by recommending actions that could increase the flow of FDI to Russia.

Why Focus on FDI?

Foreign direct investment is a form of foreign private investment. Most foreign private investment involves the purchase of stocks or bonds and hence is called portfolio investment. Foreign direct investment, in contrast, involves the purchase of an equity stake--stocks or full or partial ownership--with the expectation of active participation in firm management. In practice, FDI is usually defined as a 10% or more equity stake.

FDI's distinction and importance comes from its combination of capital and management, i.e., through its joint provision of investment funds and managerial authority and expertise. To the foreign direct investor, this combination provides not only the reassurance of having some control over a firm's investment, product, process, and marketing decisions, but also a means of influencing those decisions in ways that incorporate the investor's experience, knowledge, and perception of market opportunities. Through these decisions, the investor becomes a gateway to other resources from abroad--skilled workers, accountants, engineers, marketers, production line managers, techniques, equipment, materials, research findings, and access to professional networks--all to be enlisted, initially, in the service of the firm, and subsequently, as on-the-job learning occurs, as workers change jobs, and as knowledge travels by word of mouth, in the service of the economy at large. Thus, to the country receiving FDI, the potential value to the economy can be far greater than the dollar amount of the investment.

Policy Perspective

Russia is in the midst of enormous economic restructuring. Economic reforms began modestly in the late 1980s with steps aimed at strengthening managerial incentives at the enterprise level and improving the efficiency of the distribution system. The pace and depth of restructuring changed markedly in January 1992, however, with the introduction of a program to shift Russia from a centrally planned economy to a market economy. The program's objectives were to control inflation, permit ruble exchange in foreign currency markets, decontrol prices, privatize state enterprises except those vital to national security, and maintain a social safety net. The pursuit of these objectives set in motion a host of other actions necessary for the establishment of a market economy: the creation of banking and financial services, the reduction and privatization of state monopolies, the creation of opportunities for the entry of new firms, the development of a commercial code, the clarification of terms for the long term lease of land, and changes in trade policy. In large part, Russia's economic history of the past four years is the history of devising and implementing the specific actions necessary to implement and reinforce the market economy program.

Progress toward a market economy has inevitably brought upheaval. Industrial production has been halved since 1992 in most sectors, the real value of pensions has eroded, the education, training, health and social service systems are in disarray, and crime and suicides are up while incomes and fertility are down. But restructuring has also brought opportunity. Now enterprises have strong incentives to produce the quality and quantity of goods their customers demand, entrepreneurs have incentives to create new firms and to bring new products to the market, and many workers have greater opportunity to see their own effort, skills and creativity rewarded. A consumer sector is developing, and with it a host of opportunities for producers, distributors, and retailers in apparel, food, home appliances, housing, entertainment, information, recreation, and so forth. Also, defense expenditures have declined significantly, allowing resources to be reallocated to other parts of the economy, and banking, financial services, securities markets, telecommunications, residential and commercial office space, and computers, for example, have grown rapidly. Yet these are first steps and many challenges remain.

Like other emerging economies, the pace of Russia's development depends on the level of investment, the transmission of skills and technologies into and within the Russian economy, and the establishment of laws and policy conducive to trade, investment in physical and human capital, and production. In particular, FDI can be a significant source of investment, skills, and technologies for Russia. At the same time, Russia's public policy can affect the flow of FDI. A climate attractive to FDI, moreover, could increase the flow of foreign portfolio investment (and vice versa).

These are not idle concerns. In 1994, out of an estimated US $180 billion of FDI flows worldwide, roughly one third went to emerging economies. Of that $60 billion, less than $1 billion flowed into Russia. Yet studies (Rodrik and Collins, 1991; Gros and Steinherr, 1991; Ochel, 1991; Korolev and Luschin, 1992) estimate that Russia needs upwards of $100 billion/year investment to achieve a 3-4% annual Gross Domestic Product growth rate, and nearly $600 billion/year for a 7% annual growth rate. In other words, more rapid growth requires *more* investment, and even "slow" growth requires a *large* amount of investment. Even though domestic savings are growing steadily as Russia's banking system and financial markets evolve, savings are not large enough to meet these investment requirements. Nor is it likely that firms will be able to make up the difference through self-finance. That is, if firms seek to finance their investments from net revenue, they will often not have sufficient capital for major expansions. In addition, for possible new firms that do not yet have product sales, self-finance is not an option. Additional investment funds can come from abroad, however. And to the extent that Russia's public policy toward foreign investment, and FDI in particular, holds the potential to increase the flow of funds, skills, and technology, the formulation and implementation of that policy is a matter of considerable significance to Russia.

The purpose of this paper is to study the current role FDI plays and the future role FDI could play in the development of the Russian economy. To assess the current role of FDI into Russia, we first present and analyze a set of summary statistics about the scope and scale of FDI. The third section follows with an analysis of the structural problems facing FDI into Russia and then the specific problems of the existing policy environment. The fourth section focuses on the future of FDI into Russia and begins with a discussion of the costs and benefits FDI can generate. The final section concentrates on recommendations for increasing the flow of FDI and the prospects for the future. Appended to the end of the paper is a presentation of international experience with FDI, paying particular attention to countries which are relevant to Russia's experience. Following the international comparisons is a brief history of FDI into Russia since the Czarist period. Finally, a schematic diagram of FDI programs in other transition economies compared to Russia is presented.

II. The State of FDI into Russian Federation

This section briefly presents the state of FDI into the Russian Federation as of Fall, 1995.

1. The Russian Government's Policy Stance Towards FDI

The Russian Government's official pro-FDI stance masks the ambivalence the policy makers and the Russian people feel toward FDI. On one hand, since 1993 the Government has enacted a series of laws designed to improve the domestic investment climate and send a signal to investors that Russia is moving toward an active policy of attracting FDI.[1] On the other hand, the Russian Government has been less willing to enact secondary, support legislation that would facilitate FDI and allow foreign firms to actually operate within the Russian economic environment. In particular, adequate legislation to facilitate imports, exports, and clarification of foreign land ownership rights has yet to be implemented. On the import side, there has been a steady increase in protectionist legislation ranging from oil and gas equipment to agriculture. The result is that although FDI is officially sanctioned by the government, investors know that the policy environment does not match the policy statements. On a practical level, the sectoral distribution of FDI reflects the economic conditions: FDI levels remain low in every sector except in consumer goods and services.

At the sub-federal level, the ambivalence towards FDI and ambiguity in the way implementation of federal laws are applied further complicate the ability to operationalize a foreign investment. That is, there is regional and even city-by-city differences in receptivity to FDI. [need example here].

Finally, the current laws on FDI suggest that the Russian Government's official stance is biased heavily towards large-scale investors. There are few if any provisions or incentives targeted at attracting small and medium-sized investors.

2. The State of FDI into Russia[2]

Data from the Russian Ministry of Economy reveals that as of 1 July, 1995, cumulative FDI into Russia amounted to US$ 2.9 billion. According to data from the UN-ECE, the stock of FDI into Russia grew by only 12% from December, 1992 to July, 1994. When Russia's results are compared with those of Central and East European countries, some of which (such as the Czech Republic and Hungary) have been growing at rates of 50% per year, it is

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[1] Some of these key legislative acts include: 27 September, 1993 law "On Perfection of Work with Foreign Investment", 23 May, 1994 law on tax policy clarification for FDI, and the 25 January 1995 law "On Additional Measures toward Attractive Foreign Investment to Implement Large-Scale Projects in Material Production Industries". See Astapovitch (1995), *Foreign Investment In Russia: Salient Features and Trends*. Second Report. Moscow: Imperial Bank, p.10.

[2] Unless stated otherwise, data in this section was reported by the Ministry of Economy of the Russian Federations' data base.

clear that FDI flows into Russia have been small both absolutely (in relation to the size of the country) and relative to other transition economies.

Sectoral Distribution

Tables 1 and 2 present the sectoral distribution of FDI from the time Russia declared independence to the first quarter of 1995.

Table 1: Sectoral Distribution of FDI into Russia as of December, 1992[3]
(in thousands of U.S. dollars)

Sector	Cumulative by value	Percent of Total Value
Total Industry[4]	725000	25.53
Fuel Oil	423952	14.93
Domestic Trade	100657	3.54
Social Services	66718	2.35
Construction	62769	2.21
Communications	50224	1.77
Chemicals	13007	0.46
Agriculture	4022	0.14
Consumer Services	3116	0.11
Wood and Paper	2470	0.09
Financial Services	588	0.02

source: Author's calculations from UN-ECE (1993,1994).

[3] The data in this table is was aggregated from ruble figures, converted to U.S. dollars at the December, 1992 official exchange rate, 415 rubles/dollar. The sectoral data was taken from the UN-ECE (1993) and total used to calculate the percentage was taken from the UN-ECE 1994 update and should only be used as a rough guide.
[4] This number may be misleading. It represents *all* industry, light and heavy, as well as consumer and producer sectors.

Table 2: Sectoral Distribution of FDI into Russia as of April, 1995,
(in thousands of U.S. dollars)

Sector	Cumulative by Value	Cumulative Percent of Total Value	First Quarter 1995 Percent of Total Number	First Quarter 1995 by Value	First Quarter 1995 Percent of Total Value
Domestic Trade	501523	17.66	28.25	23988	12.60
Fuel Oil	500000	17.61	2.43	5000	2.63
Consumer Services	230159	8.11	4.69	1829	0.96
Wood and Paper	197965	6.97	7.06	29581	15.53
Machine Building	110762	3.90	8.90	11188	5.87
Communications	99580	3.51	4.63	12763	6.70
Agroindustry	77941	2.74	3.88	20519	10.77
Foreign Trade	77661	2.73	4.50	7217	3.79
Social Services	46905	1.65	1.17	10	0.01
Financial Services	39073	1.38	2.27	6706	3.52
Other Industry	31922	1.12	2.04	1482	0.78
Agriculture	22833	0.80	0.71	185	0.10
Metallurgy	22000	0.77	0.65	623	0.33
Building	21549	0.76	2.65	14066	7.39
Light Manufacture	20889	0.74	2.52	409	0.21
Medical Industry	20663	0.73	0.84	570	0.30
Chemicals	13007	0.46	1.33	576	0.30
Info Services	7647	0.27	0.52	67	0.04
Tourism	6944	0.24	0.60	15	0.01
TOTAL	2839624	72.16	83.24	190438	71.83

source: Author's calculations from Russian Federation Ministry of Economy data base

The top two sectors receiving FDI in Russia are domestic trade and oil. It is interesting to note that FDI into the domestic trade sector has grown 500% since 1992. Though this result is not surprising in itself, relative to the extremely slow growth in other sectors in the economy, its increase appears disproportionately high. The oil and gas sector has stagnated in growth terms, due to the fact that the most crucial piece of legislation, on production-sharing agreements (PSA) which essentially break the State-controlled oil sector's monopoly and safeguards investments into the energy sector, has yet to be passed.

It is expected that once the PSAs have been adopted, the energy sector will receive the largest share of FDI in value terms. The growth of FDI into financial services is also consistent with other countries in transition which are trying to build financial widening and deepening as quickly as possible.

FDI into light manufactured goods and other tradeables remains a small proportion of inward FDI into Russia. Thus, the main motivation for FDI into Russia remains to capture shares of the domestic market. This result can be explained by various factors. First, Russia remains at the early stages of FDI development and its greatest attraction is its vast market and rich natural and human resources. Given the large gaps especially in the consumer market, firms undertake lower risk by investing into a market where there is demand. Second, the administrative and procedural difficulties in importing and exporting, many firms see that domestic production for domestic consumption is a much more certain and easy way of making money. Third, as will be discussed more thoroughly in subsequent sections, the current structure of Russian firms is still biased toward large conglomerates, few of which could be used for manufactured exports. Thus these investments would most likely be greenfield investments, which are a lot more difficult to undertake if the firm/investment size is small.

Regional Distribution

The regional distribution of FDI into Russia (table 3) is indicative of both the type and scale of inward investments undertaken. For example, the Central (Moscow) region and Western Siberia are the largest recipients of FDI, hosting roughly 40% and 17% of the total share, respectively, by value. At the same time, the Moscow region represents 45% of the total number of investments, while Western Siberia represents only 5% of the total number. These figures suggest that the level of capitalization of Moscow projects is much lower than that of Western Siberia. FDI into consumer and service sectors tend to be low capital investments, while FDI into energy and natural resources tend to be high capital investment. Given that Moscow is the largest population center in Russia and the Western Siberia is the energy and resource abundant, the results are consistent with sectoral patterns. The low levels of investment into the Urals (industrial region) and the Far East (which has the potential to become a major port on the Pacific Rim) indicate that there are regional problems inhibiting FDI outside of the major cities and energy/resource producing regions. Again, we return to this issue below.

Table 3: Regional Distribution of FDI into Russia as of 1 July, 1995
(in thousands of U.S. dollars)

Region	1992-1995 Dollar Value	1992-1995 %Total Value	1992-1995 % Total Number	1st Half 1995 Dollar Value	1st Half 1995 % Total Value
Northern	555147	18.67	6.22	12922	2.81
of which:					
Komi Republic	490216	16.49	1.27	3023	0.66
Karelia Republic	17900	0.60	3.28	6955	1.51
Arkhangelsk	44120	1.48	0.58	35	0.01
North-West	216291	7.28	13.58	26853	5.83
St. Petersburg	212345	7.14	12.76	16727	3.63
Central	1205254	40.54	45.47	258202	56.09
Moscow City	1135948	38.21	40.21	244221	53.05
Moscow region	48511	1.63	1.22	9166	1.99
Volga Region	30256	1.02	1.65	10236	2.22
Black Earth	17047	0.57	1.03	995	0.22
Tatarstan	39223	1.32	1.61	39223	8.52
Volgograd	23522	0.79	0.98	7812	1.70
North Caucacus	81382	2.74	3.04	15946	3.46
Urals Region	77102	2.59	5.35	20740	4.51
Perm Oblast'	38694	1.30	1.03	8919	1.94
Chelyabinsk	26516	0.89	1.30	9535	2.07
Western Siberia	517262	17.40	5.29	33395	7.25
Altai Krai	35758	1.20	0.29	17162	3.73
Tomsk	38046	1.28	0.69	593	0.13
Tyumen	427204	14.37	1.38	14448	3.14
Khanti-Man	213687	7.19	0.56	9077	1.97
Eastern Siberia	64866	2.18	1.38	6048	1.31
Krasnoyarsk	25546	0.86	0.40	362	0.08
Irkutsk	35574	1.20	0.61	5071	1.10
Far East	107826	3.63	8.95	13339	2.90
Primorsky	26115	0.88	1.51	711	0.15
Khabarovsk	50921	1.71	3.71	4608	1.00
Kalingrad	13909	0.47	2.78	2621	0.57
TOTAL	2918831	98.18	96.08	438096	95.17

source: Author's own calculations from Russian Federation Ministry of Economy data base

Distribution of Source Countries

According to the Ministry of Economy's data base, the UK is Russia's largest source of foreign investment by cumulative value, though the U.S. does not lag behind by much, as shown in table 4. In fact, the United States has been the largest single investor country since early 1994. The European Union contributes over 53% of FDI into Russia. It is interesting to note that other countries in transition, notably China, are investing (albeit small amounts) in Russia.

Table 4: FDI into Russia by Country of Origin
(in thousands of U.S. dollars)

Country	Cumulative Capital	Percent of Total	First Quarter 1995	Percent of Total
UK	569818	20.07	12582	6.61
USA	532247	18.74	33787	17.74
France	457016	16.09	1988	1.04
Germany	153746	5.41	22143	11.63
Sweden	106764	3.76	5453	2.86
Japan	93539	3.29	4245	2.23
Italy	83124	2.93	1625	0.85
Finland	81297	2.86	2550	1.34
Austria	68038	2.40	25823	13.56
Switzerland	63827	2.25	16590	8.71
China	50851	1.79	53	0.03
Poland	3378	0.12	171	0.09
Bulgaria	1643	0.06	191	0.10
TOTAL	2265288	79.77	127201	66.79

source: Russian Federation Ministry of Economy data base

Conclusions

The above data reveal the following conclusions:

1. The rate of growth of FDI into Russia is slowing down, perhaps due to the perception that the risk premium in Russia is not being reduced by macroeconomic economic developments (price and exchange rate stabilization) , by local economic developments (privatization) or through official support of FDI programs.

2. FDI into Russia is concentrating in domestic trade, suggesting that the main motivation for FDI into Russia at present is to capture shares of the domestic market. FDI into export-oriented sectors is neither significant nor growing.

3. FDI in 1995 tends to be concentrated in the main European cities and their surrounding areas--especially in the Moscow region. The existence of a history of FDI into specific regions might have eased the entry of new investments into local markets through network externalities.

4. FDI into non-European Russia areas tends to be stagnant at best. Some of the most promising regions (such as the Urals and the Far East) have not succeeded in attracting foreign capital. This failure might be due to local political and economic situations and the lack of supporting infrastructure (both legal--such as the ability to export freely--and physical--such as roads or rail links).

5. Levels of new investment capitalization are low and falling, as revealed by the relatively large *number* of new investments against the small increase in the stock of incremental capital. This result could be indicative of two phenomena. First, investors perceive the risk of investment in Russia growing (or at least not declining) and thus the willingness to sink money into Russia is declining. Second, investments which have high and rapid payoffs tend to be in the consumer and service sectors, which require low levels of initial capital and concentrate in large cities.

6. FDI into oil producing sectors has declined rapidly and is not expected to rise until the production sharing agreements are signed.

7. Perhaps due to locational reasons, over one-half of all FDI comes from the EU. The U.S.'s share is approximately 19% currently, but appears to be rising.

8. FDI from Japan is still negligible due to political differences with Russia and Japanese perception of a high level of risk.

9. FDI from other countries in transition to Russia is beginning to take off, with China leading the trend.

III. Strategic Problems Impeding FDI into Russia

Impediments to FDI into Russia go beyond the governmental/institutional environment created by policy makers and architects of economic reform.[5] This section looks at the structural and systemic problems facing potential foreign investors into the Russian market. To put these issues into a tractable framework, we divide the issues into the following categories: systemic, microeconomic, cultural/domestic perception, operational (individual policy), and bureaucratic barriers. The problems arising in these areas affect the entire economy and have a negative impact on FDI.

A. Systemic Problems

Systemic problems refer to impediments which result from the current economic reform process or from the economic decisions made during Soviet period. These conditions deter foreign investment by adding uncertainty (risk) to projected returns or by increasing the financial cost of making the investment operational. The most immediate problems include:

- Declining production
- Weak domestic demand
- Inadequate infrastructure

Declining Production. The decline in production can be attributed to the general economic slowdown, restructuring at the firm level, and privatization--each of which has contributed to the rapid down-sizing or elimination of firms. The macroeconomic impact of the firm and industry level has been a persistent decrease of domestic output from 1991 to the present and it is expected to continue at least into 1996.[6]

Weak Domestic Demand. The direct impact on foreign investment is that production for the domestic market is uncertain in both the short and medium terms due to weak demand especially for industrial sector goods and services. In addition, uncertainty in *the level of industrial output decline* makes an accurate projection of future market demand difficult. The inability to make even medium term estimates of demand adds additional risk to the investment and could be the deciding factor in the decision making process. Second, many foreign investments require not only a growth in demand for output but also growth in input sources. With declining production, some local supply channels may also be insecure, necessitating the investors to create of alternative suppliers. This uncertainty surrounding input supply also raises the cost of production.

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[5] See the following section for the "canonical list" of institutional problems inhibiting FDI into Russia.

[6] Industrial production has declined by 45% from Russia's independence in December, 1991 to the first quarter of 1995. Data from *Russian Economic Trends*, various issues.

The Inadequacy of Infrastructure. The inadequacy of infrastructure, i.e., roads, rail links, telecommunications, transportation, distribution centers, and storage facilities is a major impediment for FDI at any scale. Poor infrastructure makes the entire production to distribution process more expensive. The lack of sufficient transportation links outside of European Russia makes market expansion (once an initial investment is made) more costly, which might deter potential investors. Inadequate infrastructure (transportation, distribution systems, and storage) also discourages FDI for export. That is, goods produced in one area which must be stored or shipped to another area to be exported will incur high transportation costs if the link is either insufficient or non-existent. This additional cost might reduce the good's cost competitiveness in the world market.

Microeconomic Problems

Structural problems in Russia that affect FDI are largely found at the firm and worker level. This section identifies and analyzes the following areas:

- Debate over the level of worker productivity
- Problems in information flows
- Lack of a dynamic set of small and medium-sized enterprises (SMEs)
- Lack of an entrepreneurial class

Debate Over Worker Productivity. The question of worker productivity in Russia has not been resolved. Briefly, the issue revolves around the question: is Russia a low-wage country or are nominal wages commensurate with productivity levels, making production expensive? Nominally, wages in Russia are low relative to other emerging market economies in transition (such as the Czech Republic and Hungary). But the crux of the question lies in evaluating worker productivity. That is, how do worker wages compare to level of output per worker. Though no definitive answers have been agreed upon, it is clear that investors fear that worker productivity in Russia is low and that the real cost of producing is higher than nominal wages suggest. Simply the perception that Russia's labor productivity is low is in itself a deterrent to FDI.

Problems in Information Flows. Second, problems in information flows plague both domestic and foreign investors in Russia. This issue is both mechanical and cultural. On the mechanical side, the lack of adequate telecommunication networks, computer access (for example internet connections), and a reliable mail service adds to the cost of doing business in Russia both in terms of employee time and figuring out alternative routes to transmit information. Again, these hidden costs raise the price of producing in Russia, perhaps compromising Russia's international competitiveness in the market for FDI.

On the cultural side, Russia still appears to be a culture where information is guarded as a precious commodity whose use is restricted. It is difficult to change this mentality, and thus a large part of the dearth of information flows is due to the general unwillingness to pass information along at all, albeit for free.

Lack of SMEs. The lack of SMEs is a problem for foreign as well as domestic investors. The structure of the economy inherited from the Soviet period was heavily dominated by large enterprises. Most emerging market investment goes into existing SMEs as joint ventures or into SME greenfield investments. In general, it is clear that the lack of SMEs in Russia limits the number of small and medium-sized joint ventures. But in addition, the dearth of SMEs domestically points to a lack of experience in setting up and managing SMEs as well as a lack of SME culture. Since most developed and emerging market economies are dependent on SMEs for the bulk of production, Russia is extremely behind in this necessary structural feature of the economy.

On the foreign investment side, the current impediments (see the "canonical list" in the next section) are biased more heavily against SMEs than large enterprises, due to the fact that SMEs have fewer resources to surmount political, institutional, and economic obstacles. That is, SMEs do not have the political clout to affect rapid policy changes that would facilitate FDI and they do not have to financial resources to spend a long time waiting for changes in the investment climate. Further, without an SME culture, investors into SMEs have few if any successful models of SMEs that have survived the hostile business environment. Finally, there are no special incentives set up by the Russian Government to facilitate the creation and operationalization of SMEs either foreign-owned or wholly domestically owned.

Lack of an SME Culture. The lack of SME culture is clearly a result of the dearth of SMEs in general. Addressing this problem is extremely important for Russia's economic future.[7] An SME culture is synonymous with a middle or entrepreneurial class which is interested in creating new firms to fill a specific hole in the market. These firms are fiercely competitive and thus exist in a culture of cost minimization and profit maximization. These sectors are usually characterized by relatively easy market entry and exit, which forces competition. Thus what is sorely lacking in Russia is both the physical SMEs and the culture which promotes their creation.

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[7] One way to address the problem is for the Government to set up incentives such as a development bank for small investors or to provide tax incentives to stimulate the creation of new SMEs.

Cultural Impediments

Cultural impediments to FDI are the most difficult both to identify and remove. This study limits the discussion of cultural impediments to the following three areas relating to FDI:

- Negative image of FDI
- Distrust and lack of understanding/experience of the West
- Distrust of the role of the market

Negative Image of FDI. Many Russians have a strong distrust of FDI. FDI is perceived as a threat both to the budding Russian economy and to Russian culture in general. These fears are based on the belief that foreign investors are robbing and exploiting the Russian economy of its natural resources (especially skilled labor and technological expertise) with very little benefit to Russians in general. They fear that FDI will create unemployment and it will facilitate the "Westernization" (and hence "de-Russification") of the Russian economy, and eventually, Russian culture. Though these perceptions are not totally unwarranted, they ignore the benefits of FDI.[8]

Distrust of the West. Distrust of FDI is symptomatic of the general distrust of any influence from the West. During the Soviet period, Russians were told that any influence from the West would harm the economy. Though this quasi-official stance has been eliminated, distrust of the West, mostly due to lack of understanding or experience, continues to shape public opinion of FDI. The distrust of the West translates into an impediment to FDI through obstruction of investor plans at the local, regional, and sometimes federal level. Despite official sanction of FDI in general in Russia (via policy decrees and official statements), and despite agreements at the top governmental level, many FDI projects are either impeded or terminated at the local level. Many of these obstructions are a result of the wariness to entrust a foreigner to take the place of a local producer.

Distrust of the Market. Finally, the fears of Western influence are coupled with a broad skepticism of market-based economic systems in general. Most Russians see that the large gaps in income distribution in Western countries are a result of the "free" market. They attribute the growing split between the "haves" and the "have nots" in Russia to the movement to the market system. Thus, it is not surprising that Russians are not convinced that they are resistant to market-oriented changes, some of which are facilitated by FDI.

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[8] For a detailed discussion of the costs and benefits of FDI, see section XX in this report.

Deterrence and Reputation Effects

In conclusion, the strategic and perceptual problems faced by Russia have contributed to the low levels of FDI flows since 1991. The difficulties and uncertainties faced by investors have deterred many investors from operationalizing programs and have forced some investors to reduce the scope and scale of investment. The failure or reduction of FDI projects due to the issues presented above has caused reputation problems for both the Russian Government and for the Russian economy as a place to invest. Stories of insurmountable systemic barriers to FDI spread through the foreign investment community. Some of the deterrence and reputation effects can be mitigated through image enhancement programs, but they will not be removed until the problems are resolved through further development of institutions and market structures or until the government takes a more active role in attracting FDI through changes in policy.

B. Shortcomings in Existing Governmental Policy

This section presents and analyzes operational impediments frequently cited by Foreign investors. These barriers can be divided into two categories: those which can be remedied through appropriate legislation and those which can only be remedied through a change in the "culture" of government or through the process of education. The first part of this section looks at the policy aspect of the operational problems which face investors; these issues are frequently cited as the obvious impediments to increasing FDI. The problems, in combination with the strategic impediments discussed above form a formidable barrier to FDI for all types of foreign investment. All of these issues point to an immediate need for an interim measures to mitigate the problems. Foreign investors suggest that the most obvious solution is to implement incentives (for example in the tax and tariff systems) targeted directly at foreign investment. Thus the first part of this section ends with a discussion of incentives. The second part of the section concentrates on those problems which are more systemic in nature and thus cannot be resolved directly through changes in policy.

Operational Problems Most Frequently Cited by Foreign Investors

1. Domestic Economy Barriers

The operational barriers described below are the policy-related impediments to FDI most frequently cited by foreign investors. One of the first set of criteria investors use to weigh potential foreign investment opportunities tax burdens, economic and political security of the investment and thus the existence of institutional and legal safeguards in place for investments, and the ability to conduct both production and distribution of goods in the foreign country. The extent to which these issues (especially taxation) is an impediment is well understood and documented.[9] Thus this highlights the most important operational problems and analyzes them in the context of Russia.

a. Tax Problems: High Rates, Lack of Transparency, and Lack of Consistency

Tax rates in Russia are deemed excessively high compared to other countries in transition. For example, corporate income tax rates in particular are at the upper range the rates listed for most other transition economies (especially for banks and insurance companies). But perhaps worse for foreign investors is the lack of transparency, standardization, and general logic behind tax levies. For example, the current VAT requirements are biased against making capital expenditures and investment because the rate is seen as excessively high. The following list details the aspects of the tax system which investors believe deters or curtails investment:

- VAT in general
- VAT on inter-enterprise loans was seen as a way to prevent Russian companies from tax avoidance
- VAT on capital expenditures seen as excessive and prohibits technology transfer
- Excess wages tax, though scheduled to be eliminated, has inhibited the incentive to hire Russians
- Lack of clarity on schedule of deductions (includes deductions on currency conversion losses)
- Excessive profit tax rates
- Income tax problems and lack of transparency
- Excessive restrictions on foreign currency restrictions and high surrender requirements

These tax issues can be attributed to problems of transparency and consistency of the existing tax codes and they effectively put Russia at a serious disadvantage in the world-wide competition for FDI. The barriers primarily deter FDI by making the cost of doing business in Russia higher than in other countries in transition, as well as emerging markets. In addition, these impediments send a signal to potential investors that despite the laws encouraging FDI into Russia, the Government does not encourage FDI because it is not willing to make its policy environment more hospitable to FDI. This "reputation" effect is extremely powerful, if evidence from countries such as China and the Czech republic serve as a guide.[10] At the same time, these policy-generated barriers to FDI can be removed

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[9] See, for example, the report of the Working Group Meetings to the Consultative Council on Foreign Investment in Russia 3-4 April, 1995, the EBRD's 1993 and 1994 *Transition Reports*, or The American Chamber of Commerce in Russia's *Key Issues Spring/Summer 1995*.

[10] China has spent considerable resources to show foreign investors that it is both committed to attracting FDI and willing to make fiscal sacrifices to get it (as evidenced by the establishment of free enterprise zones and the implementation of a substantial tax incentives policy). The Czech Republic has developed its reputation of being a hospitable environment for FDI by enacting supporting legislation (rapid privatization with foreign partners, a relatively stable currency, low inflation, a streamlined legal code based on West European models, and a liberalized trade sector).

most easily, relative to the other impediments discussed below, through clarifying or codifying legislation and through other government actions (such as adoption and operationalization of official decrees).

b. Lack of Clarity in Legal System

One aspect of investor security (i.e., risk) is determined by the legal and institutional frameworks that have been adopted, the precision (transparency) of the systems, and the ability to implement them. The Russian system is weak in all three areas. Thus along with problems in both the transparency and general logic of the tax system, investors cite the following set of problems affecting the legal system:

- Definitional problems: how to categorize certain goods for tax purposes
- Lack of adequate legislation and protections governing leasing arrangements
- Lack of adequate legislation and protections governing production sharing agreements[11]
- Lack of adequate legislation and protections governing licensing requirements
- Lack of clarity on which royalties are subject to taxation and at what rate
- Lack of a transparent civil code which addresses problems arising in a market economy and lack of harmonization with Western codes and standards

Like the tax code the lack of clarity and transparency in the legal code has allowed the government to make ad hoc decisions based on interpretation of an obtuse set of laws. In addition, it allows different levels of the bureaucracy to contradict each other, raising the level of uncertainty of existing investors and potentially inhibiting potential future investors.

c. Foreign Investors have Fewer Rights and Protections than Domestic Investors

It is clear that another component of investment security is the scope of privileges a foreign investor enjoys. In Russia, foreign investors are at a disadvantage to domestic investors, in that they enjoy fewer rights than domestic residents and have no special incentives (see below). The following is a list of some of the privileges that foreign investors do not have, which are impediments to investment:

- Lack of ability for foreigners to purchase land
- Uncertainty about the ability to arbitrate disputes
- Lack of adequate safeguards for intellectual property

All three of these shortcomings deter investment because it adds to the risk premium. The inability to purchase land makes greenfield investors nervous that their buildings, though technically owned by the foreign firm, could be nationalized if the lease on the land is

[11] Production sharing agreement (PSA) legislation was passed by both houses of the parliament in December, 1995, however the potential impact of the agreement have yet to be determined.

revoked. Some surveys of foreign investors (Collins and Rodrick) suggest that the inability to own land in Russia is a deterrent because it does not remove the possibility of nationalization and thus adds to the uncertainty.

Second, the Russian Government's refusal to submit to international arbitration on disputes (for example, in production sharing agreements) prevents investors from seeking international adjudication. This problem in combination with the lack of clarity of legal codes and lack of sufficient investor safeguards raises the level of uncertainty about the viability and sustainability of a foreign investment in Russia. If the Russian Government were to agree to an unbiased source of arbitration in disputes, it would send a signal to investors that it stands by its commitment to protecting foreign investment.

Finally, the lack of safeguards on intellectual property scare off a large range of investors from consumer goods (records, films, videos) to high tech firms. Though the intellectual property problem is not unique to Russia (the issue complicates U.S. economic relations with China), it is one which must be dealt with. Lack of safeguards for intellectual property will deter firms from transferring technology and human capital.

d. Corruption

Though corruption exists to some extent in most countries, it is perceived by investors to be a non-trivial inhibitor of FDI into Russia due to the fact that it is both widespread and unpredictable. Investors complain that the price tag on navigating through official corruption is so high that it is deterring SME investment as well as some large investors. These payments raise the cost of investment, raise the level of uncertainty (not knowing where will the payoffs end), and lowers Russia's attractiveness as a place to invest. Analysts attribute the level of official corruption to the Byzantine system of bureaucracy in Russia and the numbers of official approvals and signatures required to become operational.

2. The Debate Over Incentives

Russia accords foreign investors no special incentives (such as tax holidays) over domestic investors; i.e., foreign investors are subject to national treatment. Incentives to foreign investors are granted based on the belief that foreign investment has advantages that domestic investment cannot generate, such as technology transfer and spillover effects. In addition, in countries such as Russia where the risk to investment is high due to the combination of operational and structural problems (see below), incentives are seen as ways of mitigating the uncertainty and also as a sign of governmental commitment to bringing in foreign investment. Foreign investors argue that given the operational and strategic impediments (see below), the lack of incentives is a strong impediment to investing in Russia.

Opponents to according incentives only to foreign investors argue that the policy may have political consequences as well as the fiscal effects (giving away one source of government revenue). These people believe that the bias against domestic investment will further hamper the development of the domestic capital market.

A third side of this debate argues for a "level playing field" for all investors, such that if there are incentives for foreign investors, domestic investors should enjoy them as well. The main counter-argument to this view is that the fiscal loss might be substantial, due to the fact that investors would face a reduce tax burden which, at the macroeconomic level, could mean that government budget receipts drop substantially. Second, if the capital market develops with incentives in place, it might be politically and economically difficult (or at least a shock) to remove them.

Examples of other countries in transition (namely the Visegrad-4--Poland, Hungary, the Czech and Slovak Republics) which began the transition process with substantial tax holidays for foreign investors and then removed them when the level of risk dropped (when the perception of governmental stability and commitment to economic reform was formed, when the first positive signs of transition--stabilization, privatization, and positive growth of GDP) suggest that a combined approach may work. All of these countries removed their tax incentives by December 1993 and all of these countries' rates of accumulation has increased substantially since then.

3. Foreign Sector Barriers

Foreign sector barriers affect foreign investors through making imported inputs unavailable or expensive and through lessening or removing the ability to export. The high cost of importing goods may make investment into Russia prohibitively expensive, and the inability to export effectively deters the more than 60% of emerging market foreign investment that is export oriented. The issues focus mainly but not exclusively on export restrictions which effectively eliminates a large class of potential foreign investments (those investments into the tradable sector):

- excessive government licensing requirements
- commodity passports allowing ad hoc implementation of exports
- quotas
- Import restrictions high, though negotiable
- Need for quality certification as a signal for international competitiveness

The EBRD's 1994 *Transition Report* attributes part of the relative success of the Visegrad-4 countries of Eastern Europe in attracting FDI to these economies' rapid liberalization of the trade sector. Trade liberalization has facilitated the rapid increase of FDI into the export-oriented industries, the fastest growing sectors receiving FDI. The sudden introduction of new tariff restrictions on agricultural goods in the Fall, 1995, highlights the fact that the Russian government is not committed to trade liberalization. The rationale given for the tariff was to protect the ailing agricultural section and was implemented without regard for the effects on the rest of the economy, including foreign investment. This example show that the Russian Government still uses trade policy as the Soviets did, as a means of complementing domestic policy. That is, a trade restriction is placed to protect a domestic industry without regard for its effect on the other aspects of the economy such as on foreign investors. Relatively successful economies in transition, such as the Czech Republic and Poland have specifically liberalized their trade sector and thus have not relied on trade policy to bring about a change in the domestic economy. Thus, foreign investors are more confident that the governments of these economies will not use trade policy indiscriminately, which in turn reduces uncertainty. That is, periodic implementation and removal of tariff barriers again demonstrates the ad hoc nature (and hence unreliability) of Russian Government policy.

4. Bureaucratic Problems

Though the problems enumerated in the above list are formidable barriers to FDI, they can be removed through appropriate changes in policy. Through interviews of large investors, we have identified a group of more subtle but perhaps more virulent problems inhibiting FDI. These critical problems are as difficult to quantify as they are to eliminate and thus pose the greatest threat to increasing FDI. In addition, they are inter-related and thus it is sometimes difficult to separate them out. Some of these problems include:

- Lack of follow-through among official channels
- Lack of discipline
- Lack of practical hierarchy
- Lack of real will
- Lack of transparency

a. Lack of follow-through

Lack of follow-through of orders given by government officials appears to be a consistent problem facing foreign investors. Briefly, the investors typically receive support from high level officials (even from the Prime Minister) for a proposed investment and then a lower-level official either fails to carry out the request from above to operationalize the investment or he/she stops the investment by his/her own initiative. Examples foreign investors cite include a customs official who disagrees with the law or decree made by the President and thus does not implement it. Given the problems of communication within the government, this impediment to FDI is also an impediment to the normal implementation of law.

The preceding discussion focuses on Russia's Federal Government. This problems, however, are multidimensional because not only do they exist *within* the Federal Government, but they also exist between the federal government and regional/local governments as well as within regional/local governments. Thus, it is unclear where authority lies. That is, if a project given approval at the Federal level, it might be effectively overturned at the regional or local level, as is often the case. Regional or local officials may impose additional "requirements" in order for the project to become operational or they may openly object to it. In the reported cases of regional or local blocking of potential FDI projects, the Federal government has either been unwilling or unable to rectify the situation.

b. Lack of discipline

The lack of discipline is symptomatic of the lack of follow-through. That is, if a low-level government official has the ability to thwart a decree or law coming from above, then an investor cannot rely on a senior government official's ability to obtain all of the necessary approvals to make a proposed project work. The ability of a low-level bureaucrat to foreign investors have complained that senior officials have been unwilling either to stop the low-level bureaucratic interference or to over-ride the blocks imposed at the bottom of the administrative ladder.

c. Lack of practical hierarchy

The lack of follow-through and discipline all point to the fact that despite the stated hierarchy in the governmental structures, in practice it does not work well, if a low-level administrator can block a high-level decree from being implemented. The lack of practical hierarchy has far-reaching implications. First, confidence in the Government's ability to implement laws is severely impaired. Second, the Government's ability to carryout economic reform is threatened by the possibility that a low-ranking official might personally hold the Government program hostage. Finally, from an investor standpoint, the lack of practical hierarchy means that there is grave uncertainty about the validity and viability of the Government's approval of an investment and about the government's commitment to see the investment become operational.

d. Lack of real will

The lack of real will refers the idea that Russians who are involved in the process of clearing the way for FDI (mainly government officials) appear to have no interest or desire to see the investment operationalized. This lack of interest is manifested in slow work or documents getting lost or shelved. The general impression of foreign investors is that there are few government officials who are willing to take the steps which will move the process of investment approval along. To do so, officials might need to push others as well to make the process work. The result is that approvals get lost in the sea of bureaucracy and simultaneously, investors become frustrated.

One explanation for this behavior is that Russians welcome the foreign capital but not the loss of firm control which accompanies most foreign investment. That is, Russians want the physical capital and not the managerial and human capital that comes with FDI. Effectively, Russian firms would prefer portfolio investment rather than FDI. This behavior is manifested in the lack of desire by local officials to try to attract FDI. A mayor of a town which is host to a large consumer sector investment said that they don't need to go out and solicit FDI, that given the large number of interested parties, they can sit and wait for foreign investors to come to them. Foreign investors see this attitude as symptomatic of the general feeling that local officials are more apt to obstruct FDI projects rather than facilitate them.

The seriousness of the lack of will impediment to FDI should not be underestimated. Stories of this sort of treatment of investors spread quickly. The lack of real will hurts small and medium-sized investors the most, as they tend to have less time and money to wait. The other difficulty with this impediment is that it is basically a cultural problem and cannot necessarily be removed simply through a stated policy change.

e. Lack of transparency

The lack of transparency affects all aspects of economic reform in Russia, not just FDI. But for FDI, lack of transparency is the main source of investor uncertainty. That is, it is unclear to investors 1) whether a governmental decision is being made about their investment will actually be carried through and 2) whether the laws, institutional structure, and minimum requirements will remain or whether they will change during the process. Without transparency of both the legal framework and the decision making process, investors do not know whether their plans will become operational. Thus investors have a difficult time making medium term investment decisions (scope and scale of investment) and cost estimates.

Lack of transparency is associated with the lack of will, as without commitment in every level of Government bureaucracy, the is little incentive to make the laws transparent. In fact, investors perceive that the lack of transparency allows officials to hide their objections to FDI behind the obtuse set of laws.

Observations

The critical problems, which mainly stem from the problems in the Russian government's decision making process, are the most difficult to remove because they cannot be legislated away. Their removal requires a strong government with a well-defined, well-disciplined hierarchy, a change in culture, and perhaps system of checks on the progress (through a sherpa) of getting investments approved to avoid the costly waiting periods between proposal and investment operationalization. The waiting period is costly both to the investor (because there is an opportunity cost to investing in Russia, which increases as the waiting period increases) and to the Russian government (as the longer it takes to operationalizing an investment, the longer the wait to reap the benefits of that investment and the greater the possibility that the investor will take the investment elsewhere).

IV. Prospects for the Future of FDI into Russia

The power of FDI to generate economic growth and the depends both on the quantity (flow) and direction. This section begins by analyzing the costs and benefits of FDI into Russia. Each item is evaluated both in terms of its applicability to Russia and in terms of evidence from the rest of the world. The section ends with

A. Potential Benefits

FDI has traditionally been viewed as an external source of capital which can be used to augment domestic savings. Especially in countries where savings rates or levels of capital accumulation do not meet the requirements for investment leading to sustained growth, FDI offers a potential remedy to domestic capital shortfalls. In Russia, the capital requirements for FDI making a strong contribution to economic growth at the macro level is wholly unrealistic. It is clear that Russia will not receive the large sums of capital required to fill the savings and investment gap. Thus, this direct macroeconomic benefit is not available to Russia.

At the same time, however, FDI can more realistically be viewed as having a strong impact at the firm and industry level. The micro level effects can be summarized as:

- Transfer of Physical and Human Capital
- Spillover Effects
- Enhancement of Competition (price effects)
- Effects on Employment
- Trade Balance Effects
- A Catalyst for Economic Transformation

1. Transfer of Physical and Human Capital

FDI is a channel through which much needed technology, technical expertise, and new production methods are transferred. Human and physical capital transfers can indirectly affect economic growth by diffusion of new managerial techniques and adoption of new production processes, which aids in firm restructuring, which can raise sectoral quality, and which can ultimately stimulate competition.[12] The transfer of human capital is essential to the development of Russia's economy, and in certain sectors which need human capital from abroad, FDI (which provides the "software" needed to run the hardware or goods) is more crucial than the importation of goods.

2. Spillover Effects

Perhaps the important long run benefit of FDI is the possibility of spillover effects. That is, the transfer of technology and human capital that comes from FDI should increase the productivity per worker within the firm. As experienced workers leave firms, they carry new knowledge to other firms either within the industry or not and this transfer of knowledge will increase the productivity of the new firm. The spillover effect is characterized by many domestic firms reaping the productivity benefits of the initial injection of foreign physical and human capital. Aitkin and Harrison (1993) argue that these spillover effects substantially contribute to economic growth and thus a prudent policy would be to try to attract FDI into those industries which are likely to generate the largest spillover effects. The magnitude of the effect depends upon the extent, type, and mutability of the technology and skill factors transferred in the initial investment. The more generalizable the skill or technology, the stronger the repercussion effects. Thus, the effect of such FDI is first a positive spillover into the host sector (again, forcing competition and greater efficiency firms not receiving FDI to compete with the FDI recipients) and ultimately generating greater efficiency in the other industries which have adopted the new technology. Depending upon the size of the "ripple effect", there could be a measurable impact at the macroeconomic level if the spillover generates growth and increased efficiency in many sectors.

3. Employment Effects

FDI can have strong effects on employment. As Dunning (1988) points out, FDI can increase employment by providing new jobs not only in the target firm but also in support sectors as well. At the same time, as capital is replaced for labor, there could be a net outflow of jobs from the sector which receives FDI (see next section). This cost of FDI could be viewed as a short run cost. As sectors become more efficient due to FDI, net employment might drop; but in the long run, the spillover effects of FDI might generate the growth of new sectors which could provide new employment opportunities.

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[12] See Stern (1995a) for an analysis of the microeconomic impact of FDI in transition economies.

4. Trade Balance Effects

FDI can have an impact on industries engaged in foreign trade. Specifically, FDI can either substitute for or act as a complement to trade. When FDI is a *substitute* for trade, it is usually undertaken to fill existing holes (and/or failures) in the host country market. Typical foreign investments of this nature are found in the consumer market, low-tech (labor intensive) manufactured goods sector, and the financial system (especially when the financial system is still at a fledgling level). These investments tend to characterized by low levels of capitalization, with high levels of return. The motivations for investment on the home country side include taking advantage of holes in the host country market, especially where there is no competition from domestic sources or to secure a foothold in the domestic market. That foothold could result in strategic market power for the investor, either created by the lack of viable alternatives or through government intervention protecting creating the monopolistic or oligopolistic market structure.[13]

Alternatively, FDI can be a *complement* to trade or trade augmenting especially if it is targeted directly toward the export sector. That is, a foreign investor might have a better sense of what products would sell in foreign countries, how to market those products, and how to raise quality standards to conform to foreign demand. Thus, in addition to transferring in new technology, physical capital, and know-how, the effects FDI could change the composition of a country's export basket, significantly altering the country's comparative advantage, direction, and terms-of-trade. FDI into the foreign trade sector could also facilitate the internalization of foreign marketing strategies, ease entrée into new markets (for example via brand name recognition) and gain access to foreign distribution channels. These potential results are extremely important, as foreign (especially developed country) market entry is difficult--even in the absence of formal trade restrictions.[14]

In addition to the primary connection between FDI and exports, there can also be a secondary effect: the enhancement of host country credibility and subsequent trade creation. That is, by exporting goods a firm and eventually a country will build up a reputation as being a reliable exporter of goods demanded in world markets. At a minimum, the establishment of credibility in foreign markets via FDI-induced trade will speed up the process of opening those markets and most likely will result in the creation of new trade flows that might not have been possible without the market entrée via FDI. After a firm or set of firms gain credibility in especially developed country markets, they might be able to establish a foothold for new products produced either with or without foreign capital. As this

[13] For example, the Austrian Bank, Creditanstalt has been successful in setting up operations in most central and east European capitals, and thus establishing itself as the leader in international banking in the region. Due to its speed of entry into each domestic market, it has now become the most popular choice of banks for international transactions.

[14] It is clear from the experience of the central and east European countries that reduction of formal trade restrictions (tariffs and quotas) does not necessarily guarantee market access. In fact, intangible barriers to market entry such as lack of access to distribution agents, lack of appropriate marketing skills, and the difficulty in new product introduction make market entry a formidable task.

process continues, and as more firms engage in foreign trade, demand for goods from the exporting country will grow, which will generate export revenues and growth in export and corresponding support sectors. If the growth of the exporting sectors is sufficiently large, there could be measurable (positive) effects on the trade balance and on economic growth at the economy-wide level.

Finally, it is clear that firms which receive FDI are more likely to import inputs from the home country. The tendency to import can be offset by the locational advantage of setting up production in an area which is endowed with low cost inputs. Additionally, firms which receive FDI have a higher tendency to export than similar wholly domestically owned firms in the same sector.[15] Thus the combined effects of FDI into the tradable sector could be a short run worsening of the trade balance (when FDI is substituting for trade) and a long run improvement in the trade balance (when FDI complements trade).

5. Catalyst for Economic Transformation

FDI plays a non-obvious but crucial role in the Russian economy (or any economy in transition) by being a catalyst for economic transformation. It is clear that the Russian economy is moving toward becoming an fully marketized economy. However, the process is long and arduous. The most difficult (and slowest) part of economic transformation is firm restructuring. The faster firms restructure, the more efficient and competitive sectors will become and FDI is one important means of speeding up the firm and sector restructuring process. Again, the reason for FDI's effectiveness lie in its ability to generate spillover effects. In particular, if one firm in a sector receives FDI, domestic competitors will be forced to become more efficient and perhaps change their production techniques, managerial structures, and the composition of their capital stock and labor force in order to compete with the firm receiving FDI. If successful, all firms in the sector will be forced to undergo restructuring quickly in order to remain competitive. If a firm cannot or will not restructure, it is more likely to go out of business. The net result is that the industry will become more efficient and productive.

Thus FDI has the potential power of speeding up the process of transition. That power is non-trivial, from both an economic and political standpoint. On the economic side, the faster the restructuring, the faster the establishment of competitive markets, the faster economic recovery and future growth. The political ramification is that if the economy is growing (and hence creating jobs), there will be greater satisfaction with the government which is in power during the period of economic turnaround and might contribute to greater political stability.

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[15] See UN-ECE (1994a), "The Impact of Foreign Direct Investment on the Trade of Countries in Transition: Results of a Preliminary Survey", p. 7.

B. Potential Costs

The perceived costs of FDI into Russia mirror the concerns of any host country of the world and thus are not uniquely "Russian" in character. Under the assumption that the potential costs of FDI into Russia are the same as they are in other areas of the world, the experiences of FDI into the rest of the world should provide some insights into how realistic these costs.

The main perceived costs of FDI are associated with a loss of Russian control at the firm level aggregated to the macroeconomic level. Though these fears may be borne out by individual firms, evidence from other countries receiving FDI suggests that the following list of costs do not show up at the economy-wide level:

- Economic Vulnerability
- Domestic and International Competition Effects
- Employment Effects
- Fiscal Effects
- Foreign Sector Effects
- Reverse Technology Transfer
- National Security
- Loss of National Character

1. Economic Vulnerability

One of the first questions host country residents ask about foreign investment is whether the introduction of foreign ownership will make the domestic economy more vulnerable should a foreign supplier choose to shut down or limit production, and/or manipulate the price of the output? The risk is two fold. First, if a foreign supplier is the sole source of inputs and it decides either to limit or stop shipments, then the domestic producer is vulnerable to both price and quantity restrictions. Thus foreign control could threaten the ability to produce in a given firm or sector. Second, dependence on foreign suppliers could result in the use of economic levers used for political means. The Russians feel particularly sensitive on this issue, given their experience during the U.S. embargo of grain in 1980.

Though these fears of FDI and dependence are not unwarranted, the likelihood of them bearing out in practice are small. First, in order for Russia's economic security to be threatened, foreign participation would have to be great enough such that entire sectors which are vital to the economy would have to be dominated by a single foreign investor. This scenario is unlikely because given the size of Russia's market, such an investment would have to be larger than most companies are willing to make. Second, FDI into those sectors which are vital to economic (and national) security, such as banking and the military industries, is restricted by the government (as they are in all other countries of the world).

2. Domestic and International Competition Effects

The long term effects of FDI on the economy as a whole depend upon whether or not FDI promotes economic efficiency and hence improve welfare. Translated into practice, the question becomes whether or not FDI into the Russia will enhance or inhibit the development of competitive markets. FDI enhances domestic market competition if entry by foreign firms forced domestic firms to produce more efficiently and/or to cut costs. If the entry of a foreign firm undercuts the market by too much (either through legitimate technological or production expertise which significantly cuts costs, or through subsidies or strategic price setting which undercuts the market--analogous to dumping) then the result could be the oligopolization or monopolization of markets which limits competition and effectively reduces welfare. The question of FDI's effects on domestic competition is central to the economic security of the Russia. That is, if FDI resulted in the monopolization of markets, then in addition to making the Russian market subject to strategic price setting, but it would also make it more economically vulnerable as described in section one above.

Tyson (1992) argues that whether FDI strengthens or undermines local economies depends on a number of factors, first and foremost, the level of technological capability. Tyson's argument is an extension of Dunning's (1988,1990) conclusion that when a country has a relatively high level of indigenous technological capacity in a particular industry and a work force able to utilize that technology, FDI is most likely to enhance local economies by utilizing resources to their fullest extent and thus fostering competition. Tyson argues that in contrast, if the host country has limited technological capabilities, then FDI is more likely to be competition detracting by forcing local competitors out, thus further weakening the locally generated technological resources.

The effects of FDI into Russia on the international market raises the following issues: FDI's impact on the growth of the Russia trade sector and its impact on Russian competitiveness world-wide. The effects of FDI on domestic competitiveness is determined by whether FDI enhances or detracts from Russia's competitiveness internationally. Specifically, if FDI is promoting lower cost, more competitive exports (via implementing more efficient production techniques or technology) then FDI is enhancing Russian competitiveness throughout the world. Alternatively, if a foreign investor eliminates competition by capturing either the domestic market or a specific export industry in each country through FDI, then it is monopolizing the global market which reduces both domestic and international competitiveness; that is welfare reducing for the Russia and the rest of the world.

Part of the answer to this question lies in the motivations for FDI into Russia. At present, the majority of FDI by value is in the production of energy. Obviously, the motivation of these investments is the profits from exports into the world market. The majority of FDI by number of ventures is concentrated on capturing the domestic market, as this FDI is directed at domestic trade, consulting, tourism, and construction.

3. Employment Effects

As noted earlier, the impact of FDI on employment is ambiguous. At the individual firm level, FDI is likely to result in a reduction in labor, due to the need for firm restructuring; however, it is equally possible that these jobs would be phased out once the firm was subject to market forces (which would most likely take longer with wholly domestic-based investment). At the same time, FDI has employment creating effects. Once a firm has been restructured, its input, support service, and distribution needs may necessitate the creation of new jobs. Thus at the economy-wide level it is difficult to say what effect FDI has on employment.

4. Fiscal Effects

A common perception is that FDI will not add physical capital to the economy in the long run since profits can be repatriated abroad. This is not necessarily the case because foreign owners must still pay Russian profit/income taxes (even if there are tax incentives and tax holidays) which contributes to the local, regional, and federal budgets. It is also suspected that the internalization of markets with FDI creates opportunities for multinationals to engage in transfer pricing, thus minimizing tax liabilities in the host countries. To the extent this is possible, the loss of tax revenues to the host country might be non-trivial. But to date, there is little empirical evidence supporting this claim.[16]

5. Impact on the Foreign Sector: Exchange Rate and Trade Balance Effects

Many concerns over the impact of FDI center on the exchange rate and trade balance.[17] For FDI to have a significant impact on the exchange rate, the flows would have to be at high levels, for a sustained period of time. Given the size of Russia's monetary base, the level of existing foreign capital does not come close to approaching levels that would affect the exchange rate. As an aside, most of the effects of foreign investment on the exchange

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[16] *European Economy* (1993), *op. cit.*, pp. 113-114.

[17] Note that if balance-of-payments are to be equal to zero under a flexible exchange rate system, a trade deficit is offset by capital inflows and exchange rate deprecations.

rate come from portfolio investment or so called "hot money" which flows in and out quickly and in large magnitudes, potentially having an impact on the exchange rate.[18]

The major effects that FDI should have on the trade balance are: an increase in foreign imports (due to foreign investors favoring foreign inputs) with an increase in exports of domestically produced goods and services. Evidence from Central and Eastern Europe of the effects of FDI on the trade balance are inconclusive. It is clear that firms which receive FDI are more likely to import inputs from the home country. The greater tendency to import can be offset by the locational advantage of setting up production in an area which is endowed with low cost inputs. Additionally, firms which receive FDI have a higher export rate than similar wholly domestically owned firms in the same sector.[19]

6. Reverse Technology Transfer

Technology is traditionally transferred from country to country via international trade or through foreign investment. Technology transfer through international trade works by importing critical high-tech basic and intermediate inputs as well as finished products. Technology transfer through foreign direct investment is potentially most beneficial because they involve the transfer of both human and physical capital. FDI, because it can take the form of establishment of foreign subsidiaries, joint ventures, counter trade, buyback agreements, and loans, is the most common form of technology transfer. But technology transfer can occur in two directions: from the source country to the host country or from the host country to the source country. One of the major concerns surrounding FDI into Russia is the idea that a foreign firm might tap into the wealth of Russia technological expertise through a takeover of a Russian firm and costlessly transfer the technology back to the investor country. In addition, if the technology is restricted in use due to patents or national security reasons, then FDI provides a channel through which embargoed technology can leave the country.

Outward technology transfer could be potentially harmful to the Russian economy because it can blunt Russia's leading edge in the development of new technology--ultimately translating into a decline in competitiveness. Fears of outward technology transfer began to be expressed immediately after Russian independence in 1991.

The studies that have tried to test the hypothesis that FDI was leading to technology transfers out of other countries such as the US determined that such a technology drain was not occurring. Young and Steigerwald (1990) determined that FDI into the Russia has not

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[18] Currently, Slovenia is having a problem with the influx of "hot money", as it has caused a dramatic real appreciation of the exchange rate, rendering Slovene goods less competitive on the world market.

[19] See UN-ECE (1994a), "The Impact of Foreign Direct Investment on the Trade of Countries in Transition: Results of a Preliminary Survey", p. 7.

been motivated by technology acquisition. Their results were based on evidence that the majority of high tech industries that received FDI had was comparatively lower than the service sector, and thus the main motivation was profit related, not technology related.

7. National Security

The issue concerning the effects of FDI on national security are whether or not FDI does or can pose a threat to the defense of the Russia. First, the answer to this question depends in part on the motivation behind the investment. The surveys studying the underlying motivations for FDI all over the world suggest that FDI is carried out solely for strategic economic reasons. Most of these include locational advantages, lower labor costs, ability to exploit increasing returns to scale via market access, deployment of new technology, and access to technology. All of these studies suggest that access to defense related industries for the purpose of gaining a security advantage is an unlikely primary motivation unless there is some economic incentive as well. Indeed due to COCOM restrictions, investment into Russia's defense or defense-related sectors has been prohibited investment supply side (by the NATO prohibition) as well as on the host side.

8. Loss of National Character

Finally, a non-trivial concern over FDI into Russia is that the internationalization of Russian markets will lead to the destruction of the market for Russian goods and for the dilution of the indigenous culture. The argument that FDI will be a channel for cultural imperialism has been evoked in both Western Europe and Japan since World War II especially with the arrival of U.S. investment into the consumer sector in both areas. At the enterprise/industry level it is possible that firms which receive FDI could completely replace wholly-domestic production, as happens in most countries of the world. This potential cost to FDI is unlikely to occur at the macro level because at a minimum it would require massive amounts of FDI into many sectors, which is not likely to happen even under the most optimal scenarios.

V. Conclusions and Policy Recommendations Policy Recommendations

A. Why FDI is Good for Russia

FDI into Russia faces formidable hurdles, stemming from conflicting government policies, from the political and economic environment during reform, and from the Russian skepticism about what FDI can contribute to the growth of the country. Overcoming these obstacles is essential to accelerate the transformation process and to solidify Russia's links with the world economy. The discussion of costs and benefits of FDI in section X reveals that most of FDI's costs are speculative and need not be incurred. In fact, empirical evidence from other countries (the U.S. as well as emerging market countries) that the hypothetically most damaging effects of FDI (economic vulnerability, employment effects, reverse technology transfer) never materialize. Though Russia faces these same costs, it seems likely that the benefits will overwhelmingly outweigh the costs.

Given that Russia is a country in transition, foreign intervention into domestic markets should provide three essential results. First, studies of the rates of technology transfer reveal that FDI is the fastest and most efficient channel through which high tech machines and know-how moves into countries trying to modernize quickly.[20] Second, firms and sectors which do not or cannot attract domestic capital for restructuring can be transformed quickly through FDI. Thus FDI can speed up the process of firm restructuring and hence will hasten Russia's economic revival. Finally, even if FDI does not effect all sectors, its ability to stimulate competition and diffusion of new technology will eventually affect every sector.

An additional effect of FDI is that it can stimulate the domestic credit market as well. That is, FDI can free up domestic capital, thereby alleviating some of the excess demand for credit. Domestic creditors will also begin to compete with foreign financing, which should make the domestic credit market more efficient.

Having reiterated the benefits of FDI into Russia, it must be stated that without the elimination of economic, political, and perception barriers to FDI through appropriate policy changes and public education, Russia stands to lose a vehicle for economic transformation and an engine of economic growth. It is clear that FDI can generate benefits even at its existing low levels. But for these benefits to be felt by the entire economy and population, FDI must increase substantially. Though no analyst believes that FDI will approximate the estimated level of needed capital inflows (ranging from US$ 100-500 billion *per annum*)[21] to

[20] See Stern (1995), "Putting Foreign Direct Investment in Eastern Europe into Perspective: Turning a Macroeconomic failure into a Microeconomic Success Story" in Rumen Dobrinsky and Michael Landesmann eds. *Transforming Economies and European Integration*. London: Edward Elgar Publishers, pp. 297-311.

[21] See EBRD (1993), *Transition Report*.

finance Russia's development directly, the realistic potential FDI flows (approximately US$ 5-10 billion) have not been realized.

In order to attract FDI, we recommend the following policy changes:

- Coordination of FDI legal framework into one cohesive set of regulations (as was done in the Czech republic through the commercial code) to improve transparency of the legislation.
- Implementation of a legal framework in sectors that have an impact on FDI. In particular, emphasis should be placed on facilitating exports by eliminating (or reducing) export tariffs, quotas, licensing requirements, and other non-tariff barriers.
- Stimulation of the creation of SMEs through tax incentives or through preferential financial facilities (such as a guarantee bank) is essential to broaden the scope of FDI to include small and medium-sized enterprises.
- Perhaps set up FDI incentives programs in critical areas such as infrastructure, conversion sectors, and small and medium sized enterprise manufacturing, as is done in many .
- --Industrial Policy? Should Russia target some industries for rapid development, giving tax/tariff incentives to both domestic and foreign investors within these sectors? Do we want to broach this?
- Implementation of a "sherpa" system to coordinate navigation through government bureaucracy and to provide a central resource (point person) for foreign investors.
- Institute a public education program about the realistic costs and benefits of FDI. This may be difficult to do, but it's worth a shot.

B. What if Russia Doesn't Attract a Substantially Larger Level of FDI?

FDI is an essential ingredient to expediting economic reform and transformation. If Russia's ability to attract FDI does not improve dramatically, FDI's impact on the Russian economy will remain marginal. The danger lies in the fact that without FDI, Russia's urgent demand for physical and human capital will most likely be unsatisfied. It is clear that FDI will bridge the savings-investment gap because the level of capital required (from US$ 100-500 billion) is not feasible. But without FDI, the rapid implementation of high technology goods and production processes will take place at a much slower rate (perhaps through trade, which will facilitate the importation of goods but not human capital) if at all.

The effects on the economy of *not* receiving could include:

at the micro level:

- a dramatic slowdown of firm restructuring (or at least no dramatic increase)
- slow sectoral reorientation to the market
- the continual use of outmoded machinery and production techniques
- the continual loss of competitiveness on the world market
- the perpetuation of certain industries that are not competitive

and at the macro level:

- the failure to reverse the economic slow down or retardation of new growth
- the perpetuation of unemployment due to the lack of development of new, dynamic sectors
- the perpetuation of Russia's economic "backwardness" vis-à-vis the West and failure of Russia's ability to compete in the 21st century

Russia needs FDI and it needs to improve the *conditions that facilitate FDI* in order to use the resources of the world market to improve its economic situation. Though Russia can secure international loans based on energy exports as collateral, it is unlikely that Russia will be able to borrow the capital it needs to fill the savings-investment gap nor to import the human capital and machinery it needs to modernize because the amount is too large (again, we cite the figure US$ 100-500 billion per year). In addition, though portfolio investment is another viable source of foreign financing, the effects of it can be radically different than FDI, and thus it might not be a viable substitute for FDI.[22] At the same time, the conditions necessary to attract FDI are similar to those necessary to attract portfolio investment and to earn a high international borrowing credit rating, and they include political and economic stability, the existence of legal infrastructure, etc. (see above). Thus, by setting up the "correct" environment for FDI would also facilitate both foreign borrowing and portfolio investment.

[22] Portfolio investment could facilitate restructuring in theory, though in practice it is unlikely. Portfolio investors by definition own less than 10% of equity stakes in a firm. Most portfolio investors have short term horizons, which means that they do not wait for complete restructuring to occur before selling. Also, a large proportion of portfolio investment traditionally goes into government debt, which can impact the exchange rate but not individual sectors of firms. A fuller treatment of this subject is left for another paper.

Appendix 1: International Comparisons

This section examines representative experiences of FDI development in "emerging markets". Since Russia is perceived to be an emerging market, the experiences of Russia's potential competitors might provide some insights into Russia's path of FDI development. Following an overview of Indonesia, India, China, and Eastern Europe, this section concludes with a distillation of the emerging market characteristics and the comparability of these experiences to Russia.

Indonesia[23]

Relevance to Russian case

The first emerging market case is that of Indonesia, which like Russia, is a large country in both geographical and population terms (190 million inhabitants, of which approximately 7 percent is considered middle class and 15 percent live below the poverty line). Per capita income is estimated at $1000 in 1995.[24] Like Russia, the economy is still highly regulated and state-controlled: approximately 26 percent of non-oil manufacturing sector value-added contributed by state-controlled ventures in 1975 (fell to 1 percent by 1985).

Structurally, the Indonesian economy highly dependent on oil: on average oil accounted for 60 percent of government revenues and 70 percent of total exports between 1973 and 1982. In the late 1980s, after substantial decline in world oil prices, oil-related sectors (mining and quarrying, refinery oil, and liquefied natural gas) still accounted for over one-fifth of GDP and almost half of total exports. Although manufactured exports grew from 2 percent to 30 percent of total exports between 1980 and 1988, exports still dependent on resource-intensive manufactured goods (biggest manufacturing export category is processed wood products like plywood), which accounted for almost half of the total.

Patterns of Foreign Direct Investment.

From 1967-1972, FDI accounted on average for 24 percent of long-term capital inflows; this level fell to 14 percent in 1973-1981 and 10 percent in 1982-88. The major source of foreign capital has been government borrowing, not FDI.

It should be noted that data sources for FDI into Indonesia are unreliable due to under-reporting. For example, data on FDI entering Indonesia through overseas Chinese business

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[23] Source for most of Indonesia section is Mari Pangestu, "Foreign Firms and Structural Change in the Indonesian Manufacturing Sector," in Eric Ramstetter, ed., *Direct Foreign Investment in Asia's Developing Economies*, Boulder, CO: Westview Press, 1991. Other sources as marked in references.

[24] *Far Eastern Economic Review*, "Trade and Investment: Indonesia," 18 May 1995, pp. 48-72.

networks is reported as domestic investment. This component is believed to be quite large. In addition, FDI data sources (including IMF as well as Indonesian sources) routinely understate FDI in oil and finance sectors because of sector-specific reporting requirements.

Import-substitution and heavily interventionist economic policies discouraged development of healthy manufacturing export sector, especially during the 1973-1982 oil boom period. Foreign investment in non-oil manufacturing followed phases of import substitution: From 1970-1979, the majority of FDI went into the consumer goods sector (especially textiles and food processing); from 1980-1984 FDI flows moved into intermediate goods such as chemicals, paper products, metal products, and petrochemicals. Only recently has FDI concentrated into export-oriented sectors.

Japan is the largest source of non-oil sector related FDI in Indonesia, accounting for 41 percent of realized projects between 1967 and 1988, but Asian newly industrializing countries (NICs: Hong Kong, South Korea, Singapore, Taiwan) rapidly catching up. U.S. share of realized non-oil FDI only 3 percent.[25]

Tax policy

Preferential treatment of FDI was introduced as part of the "open door" policy at outset of Suharto regime (1967-72). The 1967 Foreign Investment Law offered tax holidays, exemptions on import duties and sales taxes for imports of machinery and equipment, accelerated depreciation, guaranteed repatriation of capital and profits, provisions for carrying forward losses for FDI projects that meet necessary requirements. During the oil boom period (1973-82), tax incentives for FDI were reduced. From 1983-89, customs system overhauled and import tariffs reformed to promote exports. Simultaneously, tax holidays for foreign investors were eliminated as the attractiveness of Indonesia (based on its stability and rates of return) improved.

Policies affecting sectoral distribution of FDI

From 1967-1972, 100 percent foreign ownership allowed but foreign investors not authorized to distribute products in domestic market. Certain sectors (with the exception of retail) were also closed to foreign investment. From 1973-1982, Indonesian equity shares in foreign-invested enterprises had a floor of 51 percent within 10 years of investment. In addition, the list of sectors closed to foreigners expanded. High level of import-protection discourages exports, thus discouraging FDI in export sectors.

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[25] *Ibid.*

Then during the period 1983-1989, the list of sectors closed to FDI was shortened and simplified. Export-production ratio required of export-oriented undertakings (EOUs) were reduced from 85 percent to 65 percent. Through establishment of joint ventures with minimum 75 percent Indonesian equity, foreign investors were allowed to participate in distribution of products, access state bank credit. All sectors were opened to export-oriented joint ventures; export-oriented joint ventures were allowed to have up to 95 percent foreign ownership and eligible for government-subsidized export credit schemes. The June, 1994 deregulation package was designed to increase FDI by Japanese suppliers and other EOUs.[26] 100 percent foreign-owned EOUs was allowed outside bonded zones and entrepots if capitalization was greater than or equal to U.S. $50 million. If capitalization was greater than or equal to $2 million, foreign investments were allowed outside zones for export-destined production of raw materials, semi-finished goods, and components to supply other factories. Despite the liberalization policies, the 51 percent domestic ownership requirements remained in force.

Bureaucratic structure / legislative environment

From 1973-1982, the Bureau of Investment was established as one-stop center for processing of land use, environmental, and labor licenses. Previously, all prospective investors had to approach each responsible government ministry for approvals. By 1993, domestic and foreign investors were allowed to circumvent regional agencies and go directly to local governments (e.g., mayors) when applying for investment licenses. Land reservation permits issued by regional governor were abolished. In addition, procedures for obtaining construction permits for industrial construction from local public works offices simplified. Procedures for obtaining disturbance permits were also relaxed. However, the ownership of land continues to be restricted to Indonesian nationals.

India[27]

Relevance to Russian case

India is an emerging market and a likely competitor for international investment capital.

Like Russia, India is a large country geographically and in terms of its population; it is ethnically diverse. Its population is estimated between 850-950 million, with an estimated

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[26] *Economic and Business Review Indonesia* No. 82, "Deregulation: Keeping the Wheels Turning," 6 November 1983, pp.-9.

[27] Sources for most of India section is United Nations, *Foreign Direct Investment and Technology Transfer in India*, New York: United Nations, 1992. Other sources as marked in references.

middle class of 250 million. In 1994, India's per capita income was \$310-\$330.[28] Until 1991, India was a highly planned economy, largely modeled after Soviet Union.

Patterns of Foreign Direct Investment

FDI has been heavily concentrated in Western India; centered at Bombay and state of Maharashtra. By 1988, FDI stocks were estimated at approximately \$170 million[29] and roughly \$1.1 billion in FY 1993-4.[30] In the past, the domestic market has been the major attraction for foreign investors, primarily due to projectionist policies. For example, exports-sales ratio for foreign-invested firms rarely above 5-7 percent prior to 1980s. Thus, FDI in India is seen as vehicle for technology transfer, not source of capital.

Manufacturing accounted for 25 percent of FDI stock in 1948, 40 percent in 1964, 87 percent in 1980, and 89 percent in 1986. As of 1989, Germany was the largest foreign investor, followed by U.S., UK, Denmark, the USSR, and Japan.

From 1968-1979, Indian policies towards FDI became more restrictive. In 1973 the Foreign Exchange Regulation Act (FERA) was implemented to regulate all business activities which affected India's foreign exchange reserves. Foreigners were restricted to 40 percent participation unless involved in transfer of sophisticated technology or in EOU. (IBM and Coca Cola divested during this period) In 1980s, India switched to export-promotion strategy, begins to reduce licensing requirements.

Tax policy

A five year tax holiday is given to EOUs in export processing zones applies to new foreign or domestic investors. Such EOUs were allowed to sell 25 percent of production domestically after paying customs duties. Partial tax holidays were offered to new investors producing commodities other than on specified list. Income from exports qualifies for tax exemptions; EOUs were eligible for duty drawbacks & export credits.

As of 1989-1990, dividends were taxed at a rate of 25 percent; know-how fees were taxed at 30 percent; royalty fees at 30 percent; and corporate tax rates were 50 percent.

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[28] John F. Burns, "India Economic Reforms Yield a Measure of Hope," *New York Times*, 15 January 1995 and *The Economist*, "Survey: India," 21 January 1995.
[29] *Ibid.*
[30] United Nations, *Foreign Direct Investment and Technology Transfer in India*, New York: United Nations, 1992 and Walter K. Andersen, "India in 1994: Economics to the Fore," in *Asian Survey* Vol. 35, No. 2, February 1995.

Bureaucratic structure / legislative environment

Investment projects with capitalization over Rs. 1 million or having at least 25 percent market share must get clearance under Monopolies and Restrictive Trade Practices Act (MRTP). This requirement creates long delays and replicates measures under Consumer Protection Act. Processing of applications under FERA or MRTP range from 6 to 24 months; capital goods clearances take 6 to 15 months; environmental clearances from 3 to 18 months; overall delays of 1 to 3 years just for clearing letter of intent. Approvals from multiple government ministries necessary. India considering one-stop approval process as of 1989-90.

China[31]

Relevance to Russian case

China is an economy in transition and a recent convert to "market socialism." Along with India, China is seen as a strong competitor for international investment capital. China is a large country in geographic and population terms. The current population is approximately 1.2 billion.

Patterns of Foreign Direct Investment

China officially opened its doors to foreign investment in 1979. Between 1979 and 1994, 220,000 foreign-funded ventures were approved with cumulative pledged contracts reaching $305 billion by 1994. Actual outlays have been estimated at $95 billion. FDI is the major source of foreign capital for China. It is important to note that FDI didn't really take off until 1992, more than ten years after first opening.[32]

In 1994, China accounted for approximately half of all FDI flows to developing countries, and ranked second only to the United States as a destination for all foreign capital.[33]

75 percent of China's direct investment originated in countries where Chinese diasporas dominate business. Hong Kong contributed 60 percent of the 1994 total, with Taiwan at 10 percent and Singapore at 4 percent. The U.S. and Japan, China's third and fourth largest investors in 1994, contributed 7 percent and 6 percent respectively.[34]

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[31] See tables in 3 October 1995 draft for more details on Chinese experience.

[32] Chengsan Ma, "Issues in Fine-Tuning Foreign Investment Policies," in Japan External Trade Organization (JETRO) *China Newsletter* No. 116, May-June 1995 and Nicholas Lardy, *China in the World Economy*, Washington, D.C.: Institute for International Economics, April 1994.

[33] Richard Brecher, "Considering the Options," in *The China Business Review*, May-June 1995.

[34] Bob, pp. 10-19 Hagerty, "Tangled Up," in *The Asian Wall Street Journal*, 13 May 1995, p.11.

FDI in China is highly concentrated in export industries. Special export-oriented investment zones all located in coastal areas; coastal areas accounted for 86 percent of total FDI in 1993.[35]

Tax policy

As of 1989-90, joint ventures investing in export zones with planned operation of ten years or more are eligible for a two year full tax holiday, then a 50 percent reduction in income tax for next 3 years, and finally a preferential income tax rate of 15 percent thereafter. If the investment is not located in a special zone, but it meets other sectoral & capitalization criteria, it may be eligible for the 15 percent rate as well. Other joint ventures taxed on net profits at 33 percent.

As of 1989, income tax on fully-owned foreign enterprises are levied at a progressive rate, with a floor at 20 percent and ceiling at 40 percent. Exemptions from export duties and export licenses on unrestricted exports were added. In 1994, foreign firms received national treatment in taxation. However, domestic firms still not eligible for tax holidays, exemption from import duties on capital equipment.[36]

Policies affecting sectoral/regional distribution of FDI

Special Economic Zones (SEZs) were set up in 1980 on southern coast, followed by 14 "open coastal cities," 3 "open coastal economic areas," and 13 "free trade zones." Tax incentives, low land-use fees offered to foreign investors. Initially, targeted Overseas Chinese as main investor groups.[37]

Central and Eastern Europe[38]

Relevance to Russian case

Central and East European economies (CEECs) were roughly replicas of the Soviet system and thus are currently undergoing a similar process of economic transformation. Having said that, most of these countries are small in terms of geography and population, and they do not share the ethnic diversity that is found in Russia. The Visegrad-4 (Poland, The Czech and Slovak Republics, and Hungary) plus Slovenia are closer ethnically and culturally to Central Europe then to their Eastern neighbors. At the same time, like Russia,

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[35] Chengsan Ma, *op. cit.*

[36] *Ibid.*

[37] Lawrence Reardon, "The SEZs Come Of Age," in *The China Business Review*, November-December 1991, p.14-20.

[38] Source for most of Eastern Europe section is EBRD, *Transition Report*, London: EBRD, 1994 and Richard Stern, FDI, Exports, and East-West Integration: Theory and Practice. Forthcoming in *Impediments to Exports*, ed. Janos Gacs and Richard Stern, 1996. Focus here is on Czech Republic, Hungary, Poland, and Slovenia. .

these countries experienced little FDI prior to the break up of the Soviet Bloc (with the exception of Hungary and Slovenia).

Patterns of Foreign Direct Investment

As a percent of total investment, Eastern Europe has been more successful at attracting FDI than Russia, with less than 1/10 of total FDI into Central and Eastern Europe and the Former Soviet Union going to Russia.[39] The CEECs receiving the largest amounts of FDI also have strongest geographic and cultural proximity to major FDI source countries, namely the European Union. In particular, proximity promotes investment by small and medium sized foreign investors.

Although sectoral breakdowns unreliable, distribution of FDI appears to be concentrated in manufacturing. Investor surveys, however, suggest that domestic market access and not factor costs (and by implication, export markets) are most important determinants of FDI location decisions. FDI and import protection appear to be strongly linked. In Poland, for example, FDI-intensive industries have average tariffs on imports that are 66 percent higher than manufacturing as a whole. For Hungary, the differential is 10 percent (but protection in Hungary also tends to operate through quantitative restrictions).[40]

Tax policy

Tax incentives were introduced in most CEECs in 1990 and have been eliminated (foreigners are subject to national treatment) as the macroeconomic (stabilization) and microeconomic (policy environment and privatization) environments have improved. The exception is that some incentives are given to export-oriented FDI. No restrictions on profit repatriation; some restrictions on capital and salary repatriation. Corporate tax rates vary between 36 percent (Hungary) and 42 percent (Czech Republic) and are among the highest in the developed world.

Bureaucratic structure / legislative environment

As mentioned above, in the Visegrad-4 and Slovenia, the foreign investment environment is hospitable to FDI in terms of the existence and implementation of a West European style commercial codes, of laws allowing and protecting foreign ownership of land, guarantees of profit repatriation, and on the ability to exchange currency. One major variation between countries is the extent to which privatization has occurred. FDI and privatization tend to go

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[39] Economic Commission for Europe, *Statistical Survey of Recent Trends in Foreign Investment in East European Countries*. Paper number Trade/R.624, 10 November, 1994, pp. 4-5.
[40] EBRD, *op. cit.*

hand in hand, and thus countries such as the Czech Republic which have high levels of privatize enterprises also have high levels of foreign participation.

Lessons Gleaned from Emerging Market Experience

Analysis of world experiences with FDI suggest the following conclusions:

1. The development of FDI into emerging markets usually begins in the domestically oriented sectors (consumer goods, financial services, hotels and restaurants). But FDI ultimately is directed toward export oriented sectors (manufactured goods) with a continuation of foreign investment into non-tradable goods and services only if the domestic market is large enough
2. The majority of FDI into emerging market economies flows into the manufactured goods and light industrial products sectors. Investment into these industries requires relatively low levels of capitalization, hence lowering capital exposure and risk. Thus these investments tend to be in small and medium size enterprises. The main motivation behind investment into the manufactured exports seems to be the exploitation of labor cost differentials.
3. Geography or existing ties to foreign markets appear to play an important role in determining the location of foreign investment. Countries that have natural export markets (for example, the CEECs have the EU, Mexico has the U.S., Asia has Japan and the U.S.) or established trade links (China and Poland have the large diasporas which are both the source of FDI and the destination for FDI-produced exports) have attracted FDI quickly and simultaneously experienced export booms.
4. There is a strong link between privatization, the level of private ownership and FDI. That is, countries that do the best in attracting FDI have growing private sectors.
5. Incentives seem to work to reduce the risk premium at the early stages of economic development when macro and microeconomic risk is high. But after the risk is reduced through stabilization and the establishment of a strong, transparent institutional infrastructure, they make less difference. The Czech Republic is a case in point.
6. Emerging market countries that successfully receive FDI tend to have stable (though not necessarily democratically elected) governments and stable/transparent policy environments. Some of these conditions include:
    a. Consistent and prudent monetary policies which make inflation rates and exchange rate movements at least predictable
    b. Transparent taxation/incentive regimes
    c. Transparent property rights
    d. Transparent commercial codes
    e. Transparent profit repatriation laws

Appendix II: Brief History of FDI into Russia

Foreign Investment Antecedents in Imperial and Soviet Russia

Foreign direct investment has been one of the major catalysts for the development of the Russian economy from the 18th Century to the October (1917) Revolution and then again briefly during the New Economic Policy period of the early 1920s. In particular, FDI became facilitator for rapid industrialization and railroad expansion under Count Sergei Witte and to a lesser extent, Peter Stolypin, from 1891 until 1914. In addition to furnishing the finance for Russia's biggest industrialization program in the Czarist period, FDI provided the basis for railroad building, metallurgy, mining, iron and steel production, and construction.[41]

FDI during the pre-Revolutionary period demonstrated the power of foreign participation in the domestic market. Given that domestic investment during that era was both insufficient in quantity and quality (human expertise, materials, and technology), FDI provided the catalyst (and in many cases the means) for an impressive average industrial growth rate of 5% per year from 1860-1913.[42] The success of the Government's industrialization program lay in its ability to attract and channel FDI into key industrial sectors, away from consumer goods and services. The result was that per capita incomes and standards of living did not go up commensurably with the growth of investment and industrialization. It is important to note that under Finance Minister Witte, the Russian government was able to control the distribution of FDI without offering substantial incentives or tax breaks. Instead government policy was aimed at maintaining a stable currency as the basis for monetary stability, pushing for high levels of agricultural exports to offset the imports associated with FDI.[43] The prospects of high rates of return, currency stability and convertibility, and confidence in the Russian government's commitment to industrialization resulted in high inflows of foreign direct investment.

After the October Revolution, the level of FDI fell precipitously from its 1913 high (where 33% of all private capital in Russia came from foreign investment)[44], to almost negligible amounts, with the exception of the New Economic Policy (NEP) period during the 1920s. Though FDI was allowed during the NEP, it was tightly controlled both in terms of distribution and levels by Bolshevik government. FDI was limited to exploitation of natural resources, specifically to capital and technology intensive sectors such as oil extraction, timber, and mineral mining. Of the 42 concession agreements reached by 1924, only 31 of the projects became operational. These ventures concentrated mainly in timber, employing approximately 4260 workers, and accounting for less than 0.5% of industrial output.[45]

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[41] see William Blackwell (1974), *Russian Economic Development*. New York: New Viewpoint Press, p.13, pp. 199-209.
[42] *Ibid.*, p. 324.
[43] *Ibid., p. 197.*
[44] Alec Nove (1970), *An Economic History of the U.S.S.R.*, London: The Penguin Press, p. 18.
[45] *Ibid.*, p. 89.

Both before and after the NEP period, FDI into Soviet Russia was extremely small due to a hostile political and economic environment domestically, plus international antipathy toward the Communist Regime, prevented most investors from starting Russian operations. With the notable exception of Armand Hammer's Occidental Oil Company and a few other western investors, FDI flows were negligible both in quantity and impact. Thus, FDI during the Soviet period made little if any contribution to the massive industrialization campaigns after World War II.

Finally, during Perestroika, the levels of FDI began to grow (albeit slowly) with the sequential liberalization of laws on joint ventures. At the same time, greenfield investments were effectively impossible to undertake due to the legal restrictions on sole ownership of Soviet assets. The numbers of joint ventures grew from 23 in December, 1987, to 1754 in June, 1990.[46] Though the restrictions on the legal limits of maximum foreign holdings were raised continually, foreign investors were still subject to unclear laws governing currency repatriation and legal guarantees against expropriation. Most of the joint ventures went into the consumer goods and services sectors, including computers, construction, food, retail trade, restaurants, consulting and intermediary services, and light consumer goods (such as cosmetics).[47] Thus FDI in the Perestroika period was limited to satisfying basic consumer demand, with low levels of capitalization (and hence low levels of investor risk).

One of the most important and successful foreign investments of the Perestroika period was that of the Italian automobile manufacturer, Fiat. Fiat actually began operations 1970s, when it built a plant that produced Ladas and Zhigolis patterned after the Fiat 124. But 1989, Fiat added close to US$ 1 billion to its initial investment and expanded its portfolio of direct investments to include oil exploration, road building, intensive farming, and chemical manufacturing.[48] Fiat's ability to diversify its portfolio in Soviet Russia were most likely due the long and successful history Fiat had in its car joint venture. Thus the lesson Fiat offers is that having an existing operation on the ground facilities follow-on investments. Though the Fiat example an example of a successful investment, it was the exception rather than the rule. Because the economic/institutional environment during the Perestroika period did not adequately clarify the issues of property rights, private (foreign) ownership, or profit repatriation, most large investors adopted a wait-and-see attitude with respect to Russia, or they invested elsewhere. However, this period did allow many potential investors to explore future options in Russia, some of which were realized after independence in 1991.

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[46] The International Monetary Fund, World Bank, OECD, and EBRD (1991), *A Study of the Soviet Economy.* Volume 2, table IV.4.1, p. 102.

[47] *Ibid.*, table IV.4.5, p. 103.

[48] *Financial Times*, 1 December, 1989, p.8.

3. FDI Programs and Initiatives in Eastern Europe

	Primary FDI Framework		Secondary FDI Framework	
Country	Program/Incentive Structure	Still in Place?[49]	Export Liberalization	Foreign Property Ownership
Visegrad-4				
Czech Republic	Free Economic Zones Tax incentives	Yes Most eliminated in 1993 (national treatment) except for a few items such power plant equipment	Yes, duties eliminated 1992 for everything except antiques Licensing needed on less than 20% of goods	Yes, if a registered Czech company
Hungary	Free Economic Zones Tax Incentives	Yes For limited sectors until 2003	Yes, duties eliminated Only fuel, wheat, raw mats subject to licensing.	Yes, if registered Hungarian company
Poland	Free Economic Zones Tax Incentives	Yes Most eliminated in 1993 but if FDI for export or "strategic sector", 30-50% reduction possible	Controls eliminated in 1990	Yes, but permit required
Slovakia	Free Economic Zones Tax Incentives	Yes Incentives still in place for first 2 years	Yes for most products Licensing only for ag goods	Yes if registered Slovak company

[49] If not, then these are the program's dates.

	Primary FDI Framework		Secondary FDI Framework	
Country	Program/Incentive Structure	Still in Place?	Export Liberalization	Foreign Property Ownership
Bulgaria	Free Economic Zones Tax Incentives	Yes Only for select industries	Mostly, except food and primary products	Buildings OK, limited to < 50% of agricultural land
Romania	Free Economic Zones Tax Incentives	Yes Yes, for "strategic" sectors such as industrial, petroleum, R&D, and export-oriented	Mostly, with few exceptions	Yes, if registered Romanian company
Estonia	Tax Incentives	90% eliminated in 1994	Yes with few exceptions in 1991	Yes, both assets and land
Russia	Free Economic Zones Tax Incentives	Yes Federal: National treatment, special deals possible Regional: some tax incentives possible	No, exports highly controlled through "commodity passports", licensing requirements, and quotas	Yes, in theory for business, but in practice almost impossible. Ownership of land issue not yet resolved

Source: EBRD (1994), *Transition Report.*

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