Foreign Direct Investment in Russia

Investment Climate in Russia

U.S. Commercial Service Russia

Russia presents many promising investment opportunities with the potential for dynamic growth in sales and profits. However, investors face several significant challenges, including a complex regulatory and legal system that requires professional help to navigate, widespread corruption, a lack of respect for the rule of law, and immature banking and financial markets. In addition, state-owned entities have a major presence in many economic sectors, and hence may be potential competitors of new investors.

Russia’s economy is still developing, not diversified, and is largely focused on natural resource extraction. GDP sharply contracted in the last two months of 2008. Although it posted a 7.3 percent growth rate for the first nine months of 2008, the final figure for 2008 is expected to be 6.8 to 7.0 percent, as compared to 8.1 percent in 2007. The numbers for 2009 are expected to be even lower, ranging from 0 percent growth to 2.5 percent. Fixed capital investment saw an increase of 13.1 percent January-September, which was lower than the 21.3 percent increase during the same period in 2007. Most of the capital investment in the first nine months of 2008 went to energy, manufacturing, real estate, and transportation.

According to the Central Bank of Russia, foreign direct investment (FDI) inflows exceeded $50 billion in the first 9 months of 2008, as compared to $38 billion during the same period in 2007. End of year estimates place FDI at $55 billion. At 4% of GDP, this level of FDI inflow is on par with other emerging markets. The United Kingdom and the Netherlands continued to be the top source countries for investment inflows during the year, reflecting these two countries’ heavy investments in Russia’s energy sector.

Capital account liberalization, which took effect on July 1, 2006, helped increase net inflows to Russia in 2006 ($40 billion) and 2007 ($82 billion). The general economic slowdown stemming from the economic crisis and shocks to investor confidence, however, have produced a marked shift for 2008, increasing capital outflow and putting additional pressure on the ruble. As of October 1, 2008 (latest available data at this writing), capital outflows were equal to capital inflows. BNP Paribas has estimated that investors withdrew about $140 billion from August – October 2008. According to the Central Bank of Russia, net private capital outflow reached $50 billion in October 2008 alone.
A sense that the Russian investment climate had generally strengthened in recent years has been undermined by recent Russian government actions, such as the apparently politically-motivated investigations into businesses (e.g., the TNK-BP oil and gas joint venture and the Mechel coal company) and the military conflict with Georgia. The global economic downturn also exposed Russia’s weaknesses. Many structural improvements remain necessary, such as: judicial reform to establish an independent and effective judicial system; banking reform to improve the capacity of the financial sector; accounting reform to promote greater transparency and integration with the international business community; a legal and regulatory framework for preventing insider trading; and improvements in corporate governance.

Reducing government bureaucracy and corruption has long been high on the agenda of businesses large and small, Russian and foreign, operating in Russia. While President Medvedev has committed his government to fighting corruption, his only progress to date has been the enactment of new anti-corruption legislation.

Openness to Foreign Investment

The global economic slump during the latter part of 2008 dampened foreign investor enthusiasm, which had been stoked by Russia’s economic growth and rising incomes in recent years. The Russian Federal State Statistics Service estimates that since 2000, the economy has demonstrated real growth of 72%, where real disposable incomes have grown 209% in the same period. Recent real income growth deceleration, however, combined with citizens’ fears about the future of the Russian economy, raise concerns about future growth, particularly in the retail and consumer sectors. While many U.S. firms reported that their return on investments in Russia was among the highest in their international operations, the global economic crisis and recent Russian government actions may retard their Russian investment plans.

The Russian government has repeatedly emphasized foreign investment’s critical role in Russia's economic development, but has been reluctant to allow unfettered access in practice. The 1991 Investment Code guarantees foreign investors rights equal to those of Russian investors (although some industries have limits on foreign ownership – see below). The 1999 Law on Foreign Investment also affirms this principle of national treatment.

In practice, the Government of Russia (GOR) tends to favor joint ventures with local entities, especially state-owned entities, or direct cash injections, particularly in Russia’s “strategic sectors.” This has been most obvious in the energy sector, in which the GOR continues to tighten its grip and typically limits foreign companies to minority stakes (often 20 to 25 percent) in larger projects. In the area of consumer products, however, international companies have been able to set up and expand their operations with relatively few restrictions.
At the federal level, Russia is establishing special economic zones, high-technology parks, and special tourist regions to encourage foreign investment. At the regional level, many local governments have developed laws and programs to attract FDI, which include techno-parks near universities and export zones near ports and borders. Although federal tax reform aimed to create a level playing field for all investors and limit the scope of incentives regions can offer, large foreign investors continue to receive incentives from local authorities in practice. In addition, many local administrations view foreign investors as sources of cash for support of municipal services, which can range from topping up teachers' salaries or provision of carpentry and plumbing services to maintenance of a municipal park or supply of heat to a village from a processing plant's boiler.

While FDI inflows had picked up substantially since 2004, the slow pace of structural reforms and the ever increasing role of the state in some sectors of the economy continue to restrain foreign investment. In response to the global economic crisis, the GOR is preparing to support various sectors of the economy in return for control of assets and revenue flow, and the role of government and quasi-government entities could become even more opaque. The lack of clarity in Russian tax law and administration, inconsistent government regulation and enforcement, unreliability of the legal system, underinvestment in infrastructure, difficulty in conducting due diligence, and high levels of corruption can dissuade investors.

Rule of law, corporate governance, transparency, and respect for property rights, including intellectual property rights, although improved over the years, remain key concerns for foreign investors. As a result, while there is increased interest, many U.S. companies remain cautious about investing in Russia. Concerns about possible liabilities associated with existing operations (especially environmental cleanup) and inadequate bankruptcy procedures are also factors.

In recognition of widespread corporate governance problems, the Federal Service for Financial Markets has had a corporate governance code in place since 2002 and has endorsed an OECD White Paper on ways to improve practices in Russia. Some large Russian companies have developed their own policies, although implementation is not always robust. International business associations such as the American Chamber of Commerce in Russia, the Association of European Businesses in Russia, and the International Business Leaders Forum, as well as Russian business associations such as OPORA, the Russian Managers Association, the National Council on Corporate Governance, and the Russian Directors’ Institute stress corporate governance as an important priority for their members and for Russian businesses overall.

Roughly three-quarters of the Russian economy has been privatized, although the GOR continues to hold significant blocks of shares in many privatized enterprises. The privatization of remaining state holdings is scheduled to continue, but could be delayed as a result of the current economic slowdown. Furthermore, the GOR may ultimately acquire/re-acquire additional shareholdings in Russian companies if GOR-financed loans, collateralized by shares, are not repaid.
Often foreign investors participating in Russian privatization sales are confined to limited positions and face problems with minority shareholder rights and corporate governance. Moreover, the treatment of foreign investment in new privatizations is likely to remain inconsistent. Potential foreign investors are advised to work directly and closely with appropriate local, regional, and federal ministries and agencies that exercise ownership and other authority over companies whose shares they may want to acquire.

The GOR approved a new “Strategic Sectors” law in May 2008. The law restricts new foreign investment in 42 sectors deemed “strategic.” Investors wishing to exceed set ownership limits must seek approval from a special commission, chaired by the prime minister. There are concerns that the approval process may prove to be non-transparent and burdensome. Concurrent amendments to legislation governing subsoil resources restrict foreign investment to 10 percent in entities controlling large oil and gas deposits, which are defined as “strategic.” Potential investors in such entities must seek the approval of the special commission.

The government has reasserted control over the oil and gas sector in recent years. Foreign investors who want to do business in the Russian oil and gas sector should keep in mind the key roles played by the state companies Rosneft (oil) and Gazprom (gas). Particularly in oil and gas investments, Russian officials at both the federal and local levels frequently raise environmental concerns as considerations in the approval process for investments. In some instances, it is difficult to say whether such concerns are genuine.

Production Sharing Agreement (PSAs), which were used to attract foreign investors into oil and gas production are out of favor with the Russian government, and are not likely to re-emerge as a tool for attracting investment. Only two major PSA projects, Kharyaga and Sakhalin 1, with majority foreign ownership remain in Russia. Under pressure, one PSA, Sakhalin 2, sold its majority stake to Gazprom. Sakhalin 1 has recently come under some pressure as well to sell its gas production to Gazprom. In 2007-8, BP and its Russian partners in oil major TNK-BP were engaged in a public battle for management control of the company. Following a string of official actions by Russian state bodies affecting TNK-BP operations and expatriate personnel, the two sides reached an agreement in late 2008 that many observers saw as resulting in a dilution of BP’s influence over its investment. The dispute dealt a major blow to investor confidence in Russia, and raised questions about the GOR’s respect for the rule of the law and the independence of state administrative bodies.

In 2003, Russia enacted several amendments to the insurance law that effectively liberalized the market, allowing majority-owned Russian subsidiaries of insurers from the European Union to sell life and mandatory forms of insurance in Russia. Although the law only permits those companies with offices in the European Union to open subsidiaries in Russia, the regulator has interpreted the
legislation as allowing any foreign insurer to set up life insurance operations in Russia as long as the company has an office in the EU via which the investment is made. As a result of bilateral WTO negotiations with the United States, Russia agreed to allow foreign insurance companies to operate through subsidiaries, including 100% foreign-owned non-life insurance companies, and branching after a transition period.

In July 2008, RAO UES, the electricity holding company that controlled all of Russia’s power assets with the exception of those connected to nuclear energy, completed its corporate reorganization and ceased to exist. Although the unbundling and privatization of RAO UES was initially hailed as a huge success, concerns are growing as investors’ plans to modernize and expand electricity infrastructure make less economic sense under current market conditions.

The Russian automotive industry has been booming and has been the fastest growing automotive market in Europe. Foreign brands account for over 75% of car sales. In 2005-2007, Russian legislation offered reduced customs tariff rates on automotive parts imported by companies assembling vehicles in Russia. Many foreign auto manufacturers took advantage of the reductions and set up assembly operations in Russia, including GM, Ford, Toyota, Peugeot, Isuzu, Kia, Nissan, Volkswagen, and Renault. The GOR is now offering similar investment incentives to foreign producers of car parts and components who agree to set up domestic production operations in Russia.

In December 2008, PM Putin signed a GOR Resolution that increased the duty on most imported automobiles from the current 25% to a new rate of 30% (and raise the minimum Euro-specific duty that is based on the engine volume by a corresponding amount), and imposed a prohibitive duty on cars older than five years (current law applies a prohibitive duty to cars older than seven years). The move is seen as a measure to help local auto manufacturers, such as Avtovaz, weather the global economic crisis. The new duties became effective on January 12, 2009 for a period of nine months.

Thanks to active government intervention, the agricultural and agribusiness investment climate has improved in recent years. However, future growth is likely to be tempered by a reduction of financing in the agricultural sector brought on by the global economic crisis, lingering uncertainty regarding land tenure in Russia, and restrictions on foreign ownership of agricultural land.

Despite supportive statements by GOR officials regarding investment in agricultural processing facilities located on land previously designated for production agriculture, some projects have been thwarted through exploitation of legal ambiguities about land purchase and control, due to
entrenched interests which want to reduce competition. There have also been blatant, though ultimately unsuccessful, attempts to raid foreign enterprises and to take over their processing facilities through illegal means.

**Visas for Businessmen and Investors**

The GOR requires visas and residence permits for businessmen and investors. Work and residence permits must be renewed periodically -- a cumbersome process.

**Conversion and Transfer Policies**

While the ruble is the only legal tender in Russia, companies and individuals generally face no significant difficulty in obtaining foreign exchange. Finding a bank licensed to conduct foreign currency transactions is relatively easy. While the following discussion represents a "snapshot" of current requirements, investors would be well advised to seek expert advice on the controls in effect at the time of an investment.

Currency controls exist on all transactions that require customs clearance, which in Russia applies to both import and export transactions. The procedures involved have been greatly simplified in recent years. The importer or exporter presents the "deal passport" documents to a bank licensed to provide foreign currency transaction services. The bank bears the responsibility of ensuring that the flow of funds related to the import or export complies with CBR regulations.

A "deal passport" is a set of documents that importers and exporters provide to banks authorized to review whether the transaction meets currency control regulations. Once an authorized bank signs the deal passport, it monitors the entire transaction for compliance with currency regulations, and the importer/exporter must use that bank for all parts of the transaction. The importer/exporter then presents the signed passport to clear shipments through customs. The Federal Customs Service notifies the bank once the shipment has been cleared. The authorized bank then monitors compliance with payment regulations.

Only authorized banks may carry out the sale or purchase of foreign currency transactions. According to currency control laws, the Central Bank retains the right to impose restrictions on the purchase of foreign currency, including the requirement that the transaction be completed through a special account. The Central Bank has eliminated security deposit requirements on foreign exchange purchases.
Expropriation and Compensation

The 1991 Investment Code prohibits the nationalization of foreign investments, except following legislative action and where deemed to be in the national interest. Such nationalizations may be appealed to the courts of the Russian Federation, and the investor must be adequately and promptly compensated.

At the sub-federal level, expropriation has occasionally been a problem, as has local government interference and a lack of enforcement of court rulings protecting investors. The embassy is tracking a small number of cases in which U.S. companies are seeking compensation for the loss of their investment or property due to regional government action or inaction.

Dispute Settlement

Russia has a body of conflicting, overlapping and rapidly changing laws, decrees and regulations, which has resulted in an ad hoc and unpredictable approach to doing business. Independent dispute resolution in Russia can be difficult to obtain since the judicial system is still developing. Courts are sometimes subject to political pressure. According to numerous reports, corruption in the judicial system is widespread and takes many forms, ranging from bribes of judges and prosecutors to fabrication of evidence. In addition, court decisions are at times not executed. The bailiffs, who are charged with enforcing court judgments, report to the Ministry of Justice rather than the courts. They sometimes fail to enforce those judgments due inter alia to legal restrictions and limited trained personnel.

Many attorneys refer their Western clients who have investment or trade disputes in Russia to international arbitration in Stockholm or to courts abroad. A 1997 Russian law allows foreign arbitration awards to be enforced in Russia, even if there is no reciprocal treaty between Russia and the country where the order was issued. Russia is a member of the International Center for the Settlement of Investment Disputes and accepts binding international arbitration. Russia is also a signatory to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. However, enforcement of international arbitral awards still requires action from Russian courts and follow-up by bailiffs, which have yet to become consistently effective enforcers of court judgments.

Commercial disputes between business entities are heard in the Arbitrage Court system. That court system has special procedures for the seizure of property before trial so that it cannot be disposed of before the court has heard the claim, as well as for the enforcement of financial awards through the banks. Additionally, the International Commercial Arbitration Court at the Russian Chamber of Commerce and Industry will hear claims if both parties agree to refer disputes there. A similar arbitration court has been established in St. Petersburg. As with international arbitral procedures, the weakness in the Russian arbitration system lies in the enforcement of decisions.
**Performance Requirements and Incentives**

Performance requirements are not generally imposed by Russian law and are not widely included as part of private contracts in Russia. However, they have appeared in the agreements of large multinational companies investing in natural resources and in production sharing legislation. There are no formal requirements for offsets in foreign investments. Since approval for investments in Russia frequently depends on relationships with government officials and on a firm's demonstration of its commitment to the Russian market, this may result in offsets in practice.

**Right to Private Ownership and Establishment**

Both foreign and domestic legal entities may establish, purchase, and dispose of businesses in Russia. As mentioned in other sections of this report, investment in some sectors that are regarded as affecting national security, such as natural resources, energy, power, communication, transportation, and defense-related industries, may be limited.

**Protection of Property Rights**

The Constitution and a 1993 presidential decree give Russian citizens general rights to own, inherit, lease, mortgage, and sell real property. The rights of Russian citizens to own and sell residential, recreational, and garden plots are clearly established, with over 40 million properties of this type under private ownership. Mortgage legislation enacted in 2004 facilitates the process for lenders to evict homeowners who do not stay current in their mortgage payments, which in theory should make mortgage lending (and the housing market) more attractive to lenders and developers. However, foreclosures and evictions by lenders are rarely tested within Russia’s legal system. Complicating this picture further is a GOR plan, not formally codified at this writing, to provide relief in the form of an extended grace period to homeowners affected by the economic crisis. Mortgage lending is in its initial stages, but its growth, up from an estimated US $ 5.5 billion of the total amount of outstanding mortgage loans in 2006 to US $ 27 billion as of October 1, 2008, has been stymied by the domestic credit freeze. Land ownership rights and limitations for foreign investors are discussed in other sections of this report. While Russia has made significant advances in improving its intellectual property rights (IPR) protection regime, many challenges remain, including the need for reform of Russia’s IPR legal and regulatory framework, a court system with greater expertise in IPR cases, and greater enforcement and investigative efforts from law enforcement and prosecutorial agencies.

Copyright violations (films, videos, sound recordings, and computer software) remain rampant. Legitimate DVD sales are on the rise, however, thanks in part to cheaper legitimate products, a growing consumer preference for high quality goods, and increased law enforcement action against
pirates. The local business and entertainment software industries have also reported declining levels of piracy. Russia’s IPR regime lacks an explicit protection for pharmaceutical test data. An amendment to address this concern is pending Russian government interagency approval.

Russia has acceded to the Universal Copyright Convention, the Paris Convention, the Berne Convention, the Patent Cooperation Treaty, the Geneva Phonogram Convention, and the Madrid Agreement. Russian law on topology of integrated microcircuits protects computer programs and semiconductor topologies for 10 years from the date of registration. As part of its WTO accession process, the Russian government is working to ensure that Part IV of the Civil Code, its new comprehensive IPR legislation that went into effect on January 1, 2008, is consistent with the requirements of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). In 2008, Russia applied to join the World Intellectual Property Rights Organization (WIPO) Copyright Treaty and the Performance and Phonograms Treaty.

**Transparency of Regulatory System**

The legal system in Russia remains in a state of flux, with various parts of the government continuing to create new laws and regulations on a broad array of topics. In this environment, negotiations and contracts for commercial transactions, as well as due diligence processes, are often complex and protracted. Investors must do careful research to ensure that each contract fully conforms to Russian law and embodies the basic provisions of the new and, where still valid, old codes. Contracts must likewise seek to protect the foreign partner against contingencies that often arise. Keeping up with legislative changes, presidential decrees, and government resolutions is a challenging task. Uneven implementation of laws creates further complications; various officials, branches of government, and jurisdictions interpret and apply regulations with little consistency and the decisions of one may be overruled or contested by another. As a consequence, reaching final agreement with local political and economic authorities can be quite a long and burdensome process. Companies should be prepared to spend a good bit of money on local legal counsel to set up their commercial operations in Russia.

**Tax Considerations**

Russia has a flat individual income tax rate of 13 percent for residents and 30 percent for non-residents, one of the lowest rates in the world. Deductions are allowed for, inter alia, home purchase or construction and exclusion of earnings on the sale of real property held for more than five years. The Unified Social Tax (UST), which is paid by employers and covers pensions, healthcare, and social security, is currently set at a top rate of 26 percent on salaries up to 280,000 rubles (about $10,000) per year. The GOR has discussed introducing legislation on raising the rate to 34 percent, a change that could enter into force in 2010.
Excise duties are levied only on alcoholic beverages, tobacco products, cars, motor fuel, and oil. Oil production is subject to two main taxes -- the Mineral Extraction Tax (MET) and an export duty, which are tied to the level of Urals export prices. The approximate marginal tax rate on a barrel of exported oil is 90 percent when the oil price is above $25/bbl. Despite some recent modest improvements to the oil tax regime, the onerous tax structure is still considered to be a major hindrance to the major, multi-billion dollar investments needed to develop new production areas.

The corporate profits tax is set at 24 percent. Regions are allowed, at their discretion, to lower the tax rate to 20 percent. Prime Minister Putin has recently announced, however, that the profit tax rate will to drop from 24 to 20 percent. Regional governments will retain the latitude to adjust rates at the local level, a provision that many regions have made use of in the past. For dividends/interest earned by non-residents, the profit tax rate is 15 percent.

Since the Yukos affair, many companies have become more reluctant to engage in aggressive tax optimization schemes. In addition, market forces are driving businesses toward more transparent accounting practices, prompting firms to review their accounting procedures and improve their tax behavior. For example, firms with clean books have an easier time accessing local credit and foreign capital than their shadier competitors. As a result, tax compliance levels are gradually increasing.

Nonetheless, problems in the tax environment remain. Surveys have shown that many entrepreneurs complain about the complexity of the tax code and requirements of other regulatory and inspection bodies. Well-intentioned SMEs often go out of their way to follow the law but are then penalized for making mistakes in documentation. They complain that the tax police make no distinction between hard-core tax-evaders and inexperienced small-business people who do not fully understand the bookkeeping requirements. Companies often have little recourse other than the courts during tax disputes. While firms have successfully appealed to the courts, tax authorities are often slow to implement judicial decisions. Penalties for non-compliance include confiscation of property and freezing a company's bank accounts.

Efficient Capital Markets and Portfolio Investment

The Russian banking system remains relatively small, with RR 3.2 trillion ($112 billion) in aggregate capital as of October 1, 2008. While the successful implementation of the Deposit Insurance System in 2004 has proved a critical psychological boon to the banking sector, evidenced by growth in overall deposits, it remains one of the weakest parts of the Russian reform program. Despite measured progress, the Russian banking system is not yet efficiently performing its basic role of financial intermediary (i.e., taking deposits and lending to business and individuals). Approximately one third of the population still prefers to keep personal savings
"under the mattress" rather than in the banks. In the wake of the economic crisis, Russia’s banking sector is under stress and may change dramatically in the near to medium term.

Russia’s two main stock exchanges are in Moscow: (1) the Russia Trading System (RTS), and (2) the equity trading floor on the Moscow Interbank Currency Exchange (MICEX). The benchmark RTS index and the MICEX index each declined approximately 70 percent in 2008. The average daily trading volume for 2008 was $52.8 million on RTS (compared to $76.4 million in 2007) and $1.47 billion on MICEX (compared to $2.35 billion in 2007). Trading volume is largely dominated by large oil and gas companies such as Gazprom, Rosneft, and Lukoil. Trading activity at Russia’s other exchanges, such as the Moscow Stock Exchange and several regional centers, is low. The Law on the Securities Market, as amended in 2003, includes definitions of corporate bonds, mutual funds, options, futures, and forwards. Companies offering public shares are required to disclose specific information during the placement process, as well as quarterly. In addition, the law defines the responsibilities of financial consultants who assist companies with stock offerings and holds them liable for the accuracy of the data presented to shareholders.

The corporate bond market is currently the most rapidly and dynamically developing sector in Russia’s capital markets, but conditions may change rapidly in light of the global economic crisis. High and increasing demand from enterprises for funds in the absence of an effective bank lending system is the main driver of growth. It is also boosted by weaknesses in other sectors of the capital market: the absence of more attractive ruble-denominated alternative asset classes, low and even negative real interest rates on the secondary government securities market, the absence of speculative opportunities on the currency market, and a significant volume of rubles from oil export earnings. Subprime-related concerns at the beginning of the year served as a brake on issuances, but new issuances rose to RR 660 billion (face value) in 2008 compared to RR 452 billion during 2007.

Steady development notwithstanding, the corporate bond market suffers several problems. It is still quite narrow, which makes it difficult to provide the necessary level of liquidity for relatively small issues, even if the issuer is a blue-chip company. Another problem is the expense of preparation, including development of each issue's parameters, prospectus registration, underwriting services, etc. A 0.8 percent issuance tax adds to that expense. Another barrier to the growth of the market is a provision of the federal law "On Joint Stock Companies", which requires that the volume of a bond issue not exceed a company's authorized (charter) capital.

**Political Violence**

Although the use of strong-arm tactics is not unknown in Russian commercial disputes, post is not aware of cases where foreign investments have been attacked or damaged for purely political
reasons. Russia continues to struggle with an ongoing insurgency in Chechnya, and the Chechen Republic and neighboring regions in the northern Caucasus have a high risk of violence and kidnapping.

**Corruption**

Perception of corruption in Russia slightly worsened in the last year. According to Transparency International (TI), Russia has scored 2.1 out of 10 this year, down from 2.3 in 2007 -- the lowest standing in the last eight years. Out of the 180 countries surveyed in the 2008 Corruption Perception Index (CPI), Russia was in 147th place (deteriorating from 143rd place in 2007) and is on the same level as Bangladesh, Kenya, and Syria. Denmark, New Zealand, and Sweden scored the highest (9.3), while Somalia came in last with a score of 1.

Russia’s standing was not a surprise. The high level of corruption and its pervasiveness is acknowledged both by Russia’s top officials and society at large. Russia’s INDEM foundation estimates that millions of corruption offences are committed every year in Russia at a cost of approximately $300 billion, almost equal to Russia’s federal budget. There have been few prosecutions and/or dismissals of high-level corrupt officials that would send a clear deterrent message. The Government of Russia has repeatedly designated the fight against corruption and the enforcement of law as priorities. Russia is a signatory to the UN Convention against Corruption and to the Council of Europe’s Criminal Law Convention on Corruption. In May 2008, in one of his first major steps as president, Dmitry Medvedev announced that he would head a newly-established Council for the Fight Against Corruption. On December 25, 2008 President Medvedev signed new anti-corruption legislation into law. The legislation requires government employees and their families to declare their income and assets and, absent permission from their bosses, would prevent, for a period of two years, government employees from working with businesses connected with their previous government duties. These latest measures are part of a series of anti-corruption legislation adopted earlier in the year.

In July 2008, the Prosecutor-General’s Office created a new website for citizens to report corrupt practices by public officials. The special anti-corruption department promises to study all complaints. According to the Interior Ministry, in January – October 2008, the total number of corruption investigations reached 11,492 (up 7.6% y-o-y), out of which 8,890 cases were sent to court for further prosecution. In total, 5,285 officials received criminal convictions for corruption offences, up 6.4% compared to the same period of 2007.

**Bilateral Investment Agreements**
Russia has bilateral investment treaties (BITs) with over 40 countries, though it is in the process of re-negotiating some of the agreements due to concerns existing language may not be compatible with Russia’s future WTO obligations. The United States and Russia currently do not have a bilateral investment treaty, but both sides have expressed a desire to conclude one.

**OPIC and Other Investment Insurance Programs**

In an agreement ratified in 1992, the U.S. Overseas Private Investment Corporation (OPIC) was authorized to provide loans, loan guarantees, and investment insurance against political risks to U.S. companies investing in Russia. OPIC generally insures against three political risks: expropriation; political violence; and currency inconvertibility. In 1994, to meet the demands of larger projects in Russia and worldwide, OPIC doubled the amount of insurance and quadrupled the amount of finance support - to US $200 million in each case - it can commit to an individual project (for a total of US $400 million). In the event OPIC would need to pay a currency inconvertibility claim, it would use the exchange rate in effect on the date the claim is submitted. OPIC also makes equity capital available for investments in Russia by guaranteeing long-term loans to private equity investment funds.

**Labor**

The Russian labor market remains fragmented, characterized by limited labor mobility across regions and consequent wage and employment differentials. The unemployment rate, using International Labor Organization (ILO) standards, fell slightly in the first half of 2008 but rose sharply in the wake of the economic crisis.

Labor mobility continues to be restricted by a lack of affordable housing, an under-developed mortgage market, and the continued existence of overly-bureaucratic procedures governing residency permits and registration. Most sectors of the economy had been suffering from a shortage of skilled labor force, but diminishing economic activity, caused by financial strains, is likely to balance the situation.

Despite a number of labor conflicts (mostly over higher wages), the general situation remained calm. From January to September 2008, official statistics registered only four enterprises where strikes took place. Experts, however, believe that these statistics underestimate the level of labor conflict.

Approximately 45% of Russia’s workforce is unionized, down from 65% three years ago. The GOR generally adheres to International Labor Organization (ILO) conventions protecting worker
rights, though enforcement is often lacking. The 2002 Labor Code governs labor standards in Russia. When adopted, it was meant to diminish the role of the government in setting and enforcing labor standards, with trade unions and a more flexible labor market playing a role in representing workers' interests. However, there are no clear enforcement mechanisms for an employer’s failure to engage in good faith collective bargaining. Revisions to the Labor Code since 2002 have included new procedures for investigating industrial accidents and the requirement that businesses employing more than 50 workers must establish a work safety division and create a position for a “work safety specialist.” The enforcement of worker safety rules continues to be a major issue, as enterprises are often unable or unwilling to invest in safer equipment or to enforce safety standards.

National Priority Projects

In the spring of 2005, President Putin announced plans for four National Priority Projects in health, education, housing, and agriculture. These projects were meant to share the benefits of the recent energy-fueled economic boom with ordinary Russians and to tackle some of Russia’s most pressing social and economic needs. While the projects have made progress in improving health and education, there have been few evident improvements arising from the housing and agriculture projects.

The National Projects provide investment opportunities, especially in medical equipment manufacturing, agricultural equipment sales, and housing construction. The 2008 budget for the projects was RR 330 billion (US $ 12.5 billion), slightly more than the 2007 budget of US $11.4 billion. In September 2007, the GOR decided to transform the National Priority Projects in health, education, and housing into mid-term (2009-2012) state programs as of 2009. The state programs will keep the priorities of the national projects, supplemented by new directions of development. In 2008 the National Priority Project on Agriculture was made part of a five year National Program for Development of Agriculture and for Market Regulation for the period from 2008 to 2012.

Foreign-Trade Zones/Free Ports

To date, six Special Economic Zones have been established pursuant to legislation passed in 2005: in Zelenograd and Dubna in the Moscow region (focused on micro-electronics and nuclear technology, respectively); St. Petersburg (information technology); Tomsk (new materials); Lipetsk (appliances and electronics); and Yelabuga (auto components and petrochemicals).

The Russian Federal Special Economic Zones Management Agency and its regional offices, a real estate management company, and a supervisory board, which includes representatives of SEZ residents, manage the zones. Enterprises operating in industrial-production zones (20 square
kilometers) pay lower unified social taxes, and those within progressive-technical zones (2 square kilometers) are allowed to write-off all R&D expenses. Both types of zones benefit from reduced land and property taxes and a waiver of customs duties on imports and finished exports.

In 2007, seven special tourist economic zones were established in the Krasnodar, Stavropol, Altai, Kaliningrad and Irkutsk regions, as well as in the constituent republics of Altai and Buryatia. In June 2008, a tender committee approved creating three port special economic zones to stimulate infrastructure development. The locations included the airports of Krasnoyarsk in East Siberia and Ulyanovsk in the Volga area, and the Sovetskaya Gavan port in the Khabarovsk Territory, in the Far East. The SEZs are developing gradually, led by the Moscow region and St. Petersburg, but poor infrastructure is hampering their growth. Transportation and logistical challenges make SEZs in more remote regions less attractive. The special tourist economic zone in Krasnodar, site of the 2014 Sochi Winter Olympics, was expected to attract significant foreign investment, but that prospect has become more uncertain in the current economic climate. The SEZ in Kaliningrad, previously established in 1996, has been able to attract some moderate investments, but those in the Russian Far East have had less success.

Read the full market research report