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Foreign Direct Investment in Russia: Unfavorable Investment Climate, Uneven Distribution

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ABSTRACT

Foreign direct investment may be an important source of economic development for nations. Acceleration of mobility of capital with globalization has increased foreign direct investment flows around the world. Although being one of the largest economies in the world, Russia has not been getting expected amount of foreign direct investment. Furthermore, foreign direct investment to Russia has been concentrating in a limited number of regions, amplifying regional inequalities. Inadequate foreign direct investment performance of Russia is a result of structural imbalances and legal background. In this study, importance and development of foreign direct investment in the Russian economy are investigated. In this context, benefits and negative impacts of foreign direct investment to the Russian economy and its negative impacts on it were discussed. Factors which make the country attractive to the foreign direct investment and impede foreign investment were examined as well as the sources of and solutions to the problem of uneven regional distribution of foreign direct investment. In order for Russia to attract more foreign direct investment, a favorable investment climate must be formed with modifications at the state policy level. Strategic participatory regional planning approach must be adopted to increase FDI flows to the Russian regions.

Keywords: *Foreign Direct Investment, Russia, Investment Climate, Regional Inequalities, Regulations.*
JEL Classification: G28, O52, P26, R58

1. INTRODUCTION

The World economy today is defined by integration of national economies to the global economy, improving international relations and an increased flow of capital for various objectives and in differentiated forms. In the modern era, foreign direct investment (FDI) has become increasingly important for the development of nations (Kuzub, 2009). The pivotal role of FDI in the development can particularly be observed in such transition economies as Russia.

Active influx of FDI into the Russian economy has started in 1870s. At the beginning of the Twentieth Century, Germany, France, England and Belgium were the countries which had the highest amount of investments in the Russian economy. In this period foreign investors particularly interested in energy, mechanical engineering and railroad construction sectors.

FDI has almost lost its importance in the development of the Russian economy after 1917. However, with concessions policy in 1920s, some increases, although minimal, were recorded in the total amount of FDI. This policy, which generally aimed at increasing FDI, has not attained expected improvements and has been rarely used through the end of 1920s. Major developments in Russia's relations with foreign investors were observed in 1990s when a new policy approach of attracting foreign investment for economic development began to be pursued. However, the level of FDI into the country was still significantly low in this period due to socio-economic crisis and hardships. Due to improving economic conditions, structural reforms and development of business environment within the next decade, significant increases in FDI into Russia were recorded. Improvements in tax applications and regulations modified according to international practices were also effective in attracting foreign investors to Russia (Zimenkov, 2009).

A rapidly developing economy, appreciation of ruble and improvements in working conditions were the most important reasons attracting more and more foreign investors into Russia at the beginning of 2000s (Mitchek & Mitchek, 2008). However, the negative environment caused by international crisis of 2008-2009 have significantly set back the entry of FDI to the country; while the annual rate of increase in foreign investment was 42, 2% prior to the crisis, it fell to 10, 5% due to the crisis. As of 2012, FDI in the Russian economy is on the rise again and the country has been regaining its pre-crisis attractiveness to foreign investors (Babitch, 2013). However, the amount of FDI to Russia is still not as high as desired.

In the light of changes in geopolitical status of the country, Russia has been aiming at increasing attractiveness of its regions to FDI within the last 20 years (Rats & Tadevosian, 2012). The policy of transition to a market economy and liberalization of external economic affairs have entailed giving individual regions the rights to access international markets independently and to receive FDI for the aim of modernizing national economy. This policy, however, benefits only a few regions and causes an asymmetrical distribution of foreign investment among Russian regions (Valiullin & Shakirova, 2004). Thus, the imbalance in distribution of FDI within the country remains to be a problem for Russia.

This study investigates dimensions of FDI in Russia and ways of increasing FDI, with an emphasis on regional inequality in the distribution of FDI. The paper is organized as follows: The second section briefly summarizes the role of FDI in the Russian economy and its positive and negative consequences. The third section includes an overview of factors attracting foreign investors to Russia while factors impeding influx of FDI to Russia are discussed in the fourth section. Investment climate in Russia and efforts for creating a favorable investment climate are discussed in the fifth section. The sixth section focuses on uneven regional distribution of FDI in the Russian regions. Some recommendations for increasing FDI and solving the regional problem are provided in the seventh and concluding section.

2. THE ROLE OF FDI IN THE RUSSIAN ECONOMY

FDI, which possesses an important place at both micro and macro levels, is among the principal sources of the development of the Russian economy (Trofimenko, 2011). Resources generated by FDI are particularly important for the Russian Federation in cases where allocations from the state budget are inadequate (Vasilyevskaya, 2010). FDI may also contribute to the solution of important socioeconomic development problems such as (Fedotova, 2011);

- Enhancement of Russia's scientific-technical potential,
- Access of Russian products and technology to foreign markets,
- Increasing export potential and diversity, and improvement of production in various industries to cut down on imports,
- Starting-up of new businesses and development of productive businesses,
- Providing flow of resources to those regions which have abundant natural resources in order to facilitate their rapid development.

2.1. Benefits of FDI for Russia

The most important characteristic of FDI is that it facilitates integration of national economies to the world economy (Nariskin, 2008). In addition to generating financial resources, FDI brings about such important benefits as technology transfer to national economies, acquisition of modern management techniques by domestic businesses and development of work ethics (Levin, Borisyuk, and Tyapuhin, 2012). In particular, some benefits of FDI to the Russian economy can be listed as follows (Yunusov, 2009):

- FDI enables a more productive use of production factors through decreasing unproductive production by increasing total capital stock, overall employment and competition in the market.
- Foreign capital firms are relatively more productive than domestic businesses and their profitability are much higher due to relatively lower production costs. Therefore, their contribution to the Russian economy is more than that of the domestic firms.
- FDI increases gross income through developing new markets and lowering labor, raw material and energy costs.
- As a contribution to economic transformation, FDI establishes a new institutional structure and facilitate development of economic relations between different bodies (Gorshkov, 2006).

2.2. Disadvantages of FDI for Russia

FDI does not always bring about benefits to the economy and may sometimes hamper the development of a nation’s economy. In order to get rid of competition, foreign investors in the Russian market usually buy over domestic businesses competing with themselves, a practice which may have harmful consequences for the structure of the economy. Moreover, relatively more relaxed environmental policy of Russia makes way for easy transfer of production methods, which are harmful to human health and environment, into the country.

Sometimes, FDI may be used as a tool for international policy by other countries, aiming at security objectives or for influencing domestic policies of targeted countries. Because of this, many countries have a skeptical or prejudiced approach towards capital imports. Russia has been given up a certain extent of its sovereignty in developing and implementing its economic policies in order to pay its debt to IMF. This situation altered decision making to the degree that Russia had to seek the approval of IMF for future credits since it has been implementing economic policies formulated according to IMF recommendations (Volodina, 2007).

An important disadvantage for Russia is that revenues from FDI are not re-invested into the economy; rather they are transferred out of the country. Foreign investors view Russia as a high-return market which is rich in natural resources and choose to invest revenues obtained in Russia in other markets abroad. This situation negatively affects Russia’s balance of payments (Kalinina & Miroshnichenko, 2014: 26).

Although FDI results in start-up of new businesses in the country, it also has adverse effects on employment in small-scale businesses. Demands of increasing qualifications of labor also result in increased subsidies in education and training in all developing countries. Qualified labor is demanded by domestic companies who have access to advanced technologies as well. In the globalized world, states may seek to develop human resources in order to increase investments in sectors which have relatively higher value added than the traditional sectors. Otherwise, income created by the labor will be redistributed to the capital and this will result in a decrease in the welfare of the country (Rud, 2007).

In sum, integrative and productivity effects of FDI are more important for development of transition economies as Russia. Russia offers many advantages to foreign investors as a geographically- large country with diverse opportunities.

3. FACTORS ATTRACTING FOREIGN INVESTORS TO RUSSIA

Although some developing economies are competing with Russia for FDI, Russia has some significant advantages in attracting FDI. Russia’s geographical proximity both to the west and to the east makes the country attractive to FDI (Ashvanyan, 2003).

Foreign investors also look for regional comparative advantages. It was reported that regions with rich natural resource endowments and large markets attract more FDI and investment activity in such regions also pulls more FDI to service sector in these regions (Kayam, Hisarcıklılar, and Yabrukov, 2007, Gonchar & Marek, 2014). In this respect, some regions are particularly attractive to foreign investors. The reasons why foreign investors opt to invest in these regions can be listed as follows (Valiullin & Shakirova, 2004):

- Markets with possibility of high volume of sales and a population with high purchasing power,
- Sectoral structure of the regional economy,
- Active and liberal investment policies pursued by regional administrations,
- A well-developed international communications infrastructure.

As to the other macro factors which provide for the flow of FDI into the country, most significant ones are the volume of the Russian domestic market, growth rate of the economy and relatively low levels of competition (Zimin, 2013).

4. FACTORS IMPEDING FOREIGN DIRECT INVESTMENT IN RUSSIA

In recent years, it has been observed that FDI in Russia continuing at low levels. Political instability of the country is viewed as the most important reason of decreasing FDI (Ugolkov, 2007). Russia indeed lacks strong political opposition which is able to produce structural critique and formulate alternative solutions for the development of the economy (Trofimov & Kostyrya, 2013).

Another important obstacle to FDI is the high costs associated with making investments in Russia. The cost of materializing FDI in Russia is higher than the world average. High costs mainly stem from physical conditions and structure of labor. Harsh climatic conditions make production, especially construction, harder in Russia when compared to other developing countries. With an average annual temperature of – 5,5^{o}C, production and construction activities may require additional investments to continue throughout the year. The prevalence of climatic conditions on regional investment activities, as well as of natural resource endowment, market size and socioeconomic conditions, are also reported (Iwasaki & Suganuma, 2007). On the other hand, coupled with climatic conditions, low population density makes labor an expensive factor for investors. Fees demanded by the Russian labor are above international standards (Zubchenko & Shabayeva, 2001). It is also obvious that regions with low population densities have little value to foreign investors who would like to take advantage of domestic demand; as such regions have small-size markets.

Perception of Russia by the west as a technologically-backward country with high rates of corruption and crime is another reason impeding the diffusion of FDI throughout the country. Investors are especially bothered by characteristics of Russia’s commercial practices, accounting applications, lack of regulations pertaining to entrepreneurship and widespread unrecorded transactions (Kuryerov, 2003).

Low credit ratings and high risk associated with investment are other reasons discouraging the entry of FDI into the country and limiting its credits in global capital markets. This situation, coupled with low rates of return, further deters investors. In Russia, a refinancing rate of 25% is observed and this does not match up with profitability rates of most of the businesses operating in the Russian market (Polusmakova, 2013). Together, all of the conditions mentioned above reflect an unfavorable investment climate for foreign investors.

5. INVESTMENT CLIMATE IN RUSSIA AND ACTIVITIES FOR IMPROVING INVESTMENT CLIMATE

Vital parameters such as volume of domestic demand, rate of poverty, investment security, level of corruption, literacy rate and changes in bureaucracy are investigated by foreign investors before deciding any investments (Orlova, 2008). In order to attract foreign investment, an appropriate investment climate should be established by improving such parameters. Investment climate is formed as a result of the interaction of political, economic and social factors which are essential for the realization of investment activity in a country. Investment policies of the state play an important role in the establishment of a favorable investment climate. Russia plays the role of a supplier of raw materials for innovative products produced by the developed countries and an end-market for these products. Thus, it can be seen that, in the Russian economy, FDI is rather concentrated in sectors exporting raw materials and energy, while other sectors somehow lack sufficient foreign investment. In this respect, macro investment policies of the Russian government are particularly important. Fundamental objectives of Russia's investment policy cover the following topics (Alimov, 2010):

- Ensuring effective functioning of the country's economy,
- Incentives for private enterprises,
- Starting-up of new businesses,
- Development of legal base,
- Facilitating improvement of small-and-medium sized enterprises (SMEs),
- Investment incentives for different sectors,
- Implementing investment-related tax deductions, increasing productivity of tax and customs system,
- Balancing of the budget system (Vukovitch & Kravchova, 2012).

The primary target of Russia's investment policy is the establishment of a stable institutional and legal framework, which is followed by such main targets as forming the necessary environment for the development of sectors with high competitive power and capital renovation (Zelenskaya & Preobrajenskiy, 2012). For these targets, Russia has been undertaking important steps for modifying its regulations for foreign investment and for improving a favorable climate for FDI.

5.1. Legal Regulations Related to FDI in Russia

Effective and sufficient legal regulation for the aim of increasing foreign investment into a country plays an important role in economic development. In this respect, laying the institutional background for foreign investments is an important task. However, Russia's policy and regulatory performance has not been a success as trust of foreign investors in the Russian markets fluctuated as a result of "*fragility of property rights, the arbitrariness of fiscal policy and the unpredictability of the trade policies*" (Buccellato & Santangelo, 2009, p.2).

Even though legal regulations related to FDI into Russia dates back to Soviet Union era, significant developments in this area were observed with "*The Law on FDI in the Russian Federation*", which had become effective on July 9, 1999. This law was regulating the conditions of enterprise by foreign investors in the Russian Federation and the rights of foreign investors (Gordiyenko, 2011). The law targeted multiple areas of an economy in transition; as it was aiming at increasing foreign financial resources in the Russian economy and their effective utilization, transfer of technology and managerial experience, stabilization of the operational circumstances for foreign investors and adjusting to international regulations (Kalinin, 2008).

Some amendments were made to "*The Law on FDI in the Russian Federation*" on June 18, 2001 in order to improve tax system. As a result of these amendments, investors were exempted from all taxes except social security taxes and regional taxes. In addition to these changes, some amendments were also made to the Tax Code in order to increase FDI, which is clearly in contradiction with "The Law on FDI". According to the Tax Code amendments foreign investors will be subjected to taxes in two ways. First, the investors would be exempt from all payments and taxes (except value-added tax, income tax, taxes pertaining to natural resources, land taxes and customs duties) during the course of contacts according to current laws in force. Second, foreign investors would be exempted from all federal taxes, including local and regional taxes, but value-added tax and taxes pertaining to social security.

Another development for increasing FDI was the tax reform. Modifications in value-added tax returns which had become effective on January 1, 2002 resulted in investment incentives and a subsequent rise of investments in the country (Pronychyev, 2006). Today, special tax applications are also applied for the development of different sectors. In this respect, tax deductions are applied to firms in certain sectors and income tax exemption is applied to firms operating in certain regions. However, it is reported that, in general, investments incentives through tax system has not been falling short in creating expected investments throughout the country (Savelyeva, 2012).

On April, 29, 2008, "*The Law on the principles of FDI to Commercial Enterprises which are strategically important for National Security*" was put into effect with the aim of increasing FDI, which is strategically important for economic development, and providing national security. Some modifications were made to liberalize this law on November, 16, 2011 16.11.2011 and the law was made effective again on December 12, 2011. However, amendments to liberalize the law have made solutions of some problems complicated and limited FDI in strategic sectors. Such problems aggravated by the amendments include (Stepanchenko, 2013):

- Inclusion of a wide range of economic activities,
- Definite indication of the share of foreign investment in enterprise,
- Lack of a clear definition of the conditions of seizing of control of foreign companies operating in Russia by other foreign companies,
- Lack of a clear definition of the conditions where prior approval of the Government Commission is required in cases of applications for establishment of affiliate companies or subsidiaries by foreign investors

At a global level, most important step for increasing FDI is joining of Russia to World Trade Organization (WTO) in 2011. After 18 years of efforts, Russia's inclusion in WTO has made the Russian domestic market more attractive to foreign investors.

Another action aiming at a favorable investment climate is the establishment of *Foreign Investment Fund*. This fund makes joint investments with foreign investors, with the aim of modernizing the country's economy. By this way, a risk-sharing mechanism, under which the risks faced by foreign investors are minimized, is established (Lebedyev & Yuriyev, 2012).

6. PROBLEM OF UNEVEN REGIONAL DISTRIBUTION OF FDI IN RUSSIA AND SOLUTIONS

Uneven regional distribution of FDI in Russia is an apparent problem. Foreign investors often choose to invest in regions with relatively higher purchasing power or in regions which are financially, organizationally and industrially more developed, and where large-scale projects for extracting natural resources are executed. In addition, foreign capital flows are much higher to those regions in where regional laws improved the local investment climate (Zimenkov, 2009). For example, Moscow receives more foreign investment than the whole Asian part of the country. 80% of all FDI into Russia's east is made to raw material-exporting regions of Tyumen, Krasnoyarsk and Yakutsk. Moreover, 12 Russian regions have not been receiving any FDIs so far. Moscow, St. Petersburg and Yekaterinburg are urban areas that attract most of the FDI in Russia. Inadequacy of production and transportation infrastructure in other regions limits the access of these regions to foreign investment (Voronina & Gorechkaya, 2007).

Foreign investors show a great interest towards wood production and wood processing sectors of Russia. Excess wood stocks of the country are the cause of channeling of relatively more foreign investment in these sectors. A significant portion of FDI also made in food sector. In recent years, however, focus of foreign investors is the real estate sector, which is a result of rapid increase of real estate prices throughout the country, especially in Moscow. Engineering, geology and geophysics projects are also observed to attract significant amounts of foreign investment.

Looking at sectors with low FDI, insurance sector gets the lowest foreign investment in Russia. FDI are also low in industry which was not subjected to restructuring. For example, manufacturing of electronic, electric, optical and radio and television devices, production of medical materials and textiles are among the industrial sectors that receive lowest amounts of FDI in the country. Importing readily-made products into Russia, even in higher prices, are more advantageous and profitable for foreign investors than producing these industrial products within Russia (Orlova, 2008).

Establishment of an investment climate favorable to foreign investors is the key to solving regional inequalities in receiving foreign investment. An effective investment policy must be formulated for social and economic development of regions that cannot receive sufficient investments. In addition, policy should be institutionally supported with legal improvements. Legal and regulatory roles of central, regional and municipal governments should be clarified and institutionalized to increase trust of foreign investors and encourage them for investing in the Russian regions (Ögütçü, 2002). Currently, policy of attracting investment into such problematic regions includes formulation of legal regulations for specific economic activities, provision of information to investors and supporting of investor-company relations.

In Russia, tax deduction is the most-commonly used tool for the solution of regional investment problem. Postponement of income tax payments and tax deductions in case of transfer of advanced technologies are generally employed for increasing investments into regions (Shahbanov & Bagirova, 2013). Although such tax deductions vitalize regional investment climate, their effects are limited; they cannot bring about expected increases in investment. Since taxes are used as a common tool for increasing regional investment, improvement of tax practices through the following measures should be considered:

- Application of tax incentives, except some certain economic sectors, to all regions in need of investment,
- Increasing deductions for companies which are actively investing,
- Supporting small scale enterprises,
- Application of tax deductions primarily to companies which are investing in regional projects.

In order to improve the efficiency of tax policy practiced in the Russian regions, some authors suggested to consider the ratio of change in tax potential to change in gross regional product, the ratio of change in tax potential to change in investments to real regional capital and the ratio of change in tax potential to amount of collected regional income tax as indicators (Sevriukova & Trusova, 2014). However, recent research by suggests that FDI attraction policy by tax incentives is not viewed very favorably by foreign investors; as such policies implicate hidden costs for investors "*due to complexities in administration, additional reporting and excessive disclosure requirements*" (Strasky & Pashinova, 2012, p.7).

7. CONCLUSION AND RECOMMENDATIONS

Economic crises at the global scale in recent years have resulted in significant decreases in foreign investment to Russia, which occupies an important place in development of its economy. In order to reverse the situation and increase the amount of foreign investment into the country, creation of a favorable investment climate for foreign investors is vital. The most important and first measure for a favorable investment climate is changing the state policy. Effective policies to eliminate widespread corruption and to curb bureaucracy in commercial transactions are needed to attract foreign investment in the first place.

Another important problem for Russia is the outflow of a significant portion of the income generated by FDI. Measures should be taken at the policy level in order to keep such financial capital within the country. An effective policy to this end may be the determination of export duties in proportion to income generated by the investment. By this way, investors would be motivated to use their profits for re-investment within Russia and an important stock of foreign currency would be kept within Russia.

Establishment of a modern information system that relays information about investment opportunities in Russia to foreign investors is important for a favorable investment climate. This system should also include such services as consultancy and marketing of programs and projects related to investments. Such a system will facilitate attraction of foreign investors by acting as a bridge between potential investors and investment projects.

Increasing cooperation between domestic firms and foreign firms is also important. Establishment of an effective cooperation mechanism will have positive effects in the amount of FDI to Russia. Suggested mechanism includes provision of assistance by two firms to each other for business targets in Russia and abroad, even for different targets. Business targets of parties may differ but their common ground is making profits. This type of mutual interaction by companies will facilitate achievement of individual economic objectives. More easy access to Russian markets through this type of “designated partnership” would make FDI easier to realize.

Uneven regional distribution of FDI in Russia is an important problem which may have serious consequences for development of the country. In this respect, adoption of a participatory strategic regional planning process may provide a solution. Overcoming regional inequality problem through a strategic lens starts with a better understanding of socioeconomic conditions and potentials of each individual region. Strengths and weaknesses of each region should be assessed through a participatory planning process that includes the population living in these regions. Local people not only have an idea of what potential a region possess but may also provide ideas on how to utilize this potential in a beneficial way. SMEs are also a vital part of strategic regional development planning for problematic regions. Planning for facilitating economic activity through SMEs and creation of new SMEs would result in increases in regional tax base and employment. By this way, regions with considerable economic activity would be more attractive to foreign investors. In short, tax incentives should support strategic targets of an SME-based regional policy, rather than being the dominant tools, in increasing attractiveness of regions to foreign investors.

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