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## Notes

### **So You Want to Invest in Russia? A Legislative Analysis of the Foreign Investment Climate in Russia**

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Even at the height of the cold war, a foreign business presence existed in Russia. Only recently, however, has the Russian government begun actively soliciting foreign investment. This change in policy coincided with Russia's attempt to create a market economy after the demise of the Union of Soviet Socialist Republics (Soviet Union).<sup>1</sup> Russia needs foreign capital and technology to become a free-market economy. An increase in foreign investment would bring the Western technology, products, and know-how necessary to expedite this transformation. Foreign companies that can provide capital are tempted by the possibilities that investment in Russia offers. Foreign investors are drawn to the virtually untapped market of the former Soviet Union, a vast wealth of raw materials, and a cheap yet highly educated work force.

Despite these incentives, foreigners hesitate to invest in Russia because of uncertainties regarding the economy and barriers to profitable investment. The Russian government has responded by promoting its nation as a stable foreign investment.<sup>2</sup> Russia asserts that its political environment is now stable, that the economy is recovering, and that there are institutionalized

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1. William G. Frenkel & Michael Y. Sukhman, *New Foreign Investment Regimes of Russia and other Republics of the Former U.S.S.R.: A Legislative Analysis and Historical Perspective*, 16 B.C. INT'L & COMP. L. REV. 321, at 323 (1993).

2. President Yeltsin has taken an active role in encouraging foreign investment in Russia. Increased trade relations and the economic status of Russia have become major foreign policy issues in discussions between Russia and the United States. For example, during the September 1994 summit meeting between the two countries, President Yeltsin took advantage of the opportunity to sell Russia to potential foreign investors. Alessandra Stanley, *On U.S. Visit, Yeltsin Looks For Investors*, N.Y. TIMES, Sept. 25, 1994, § 1, at 9.

incentives for foreigners to invest.<sup>3</sup> Giving credence to these assertions, Russia has hurriedly enacted legislation to attract foreign investors.

This Note analyzes the effects that existing legislation has on the foreign investment climate in Russia. Part I outlines the history of foreign investment in Russia. Part II discusses new Russian law created to alleviate fears about investing in Russia. Part III outlines various international agreements and organizations created to attract foreign investment. Part IV analyzes common obstacles to investment in Russia and legislative efforts to overcome these obstacles. This Note concludes that although Russian legislation designed to attract foreign investment is encouraging in form, in practice it is ineffective in creating a stable investment climate.

### I. EARLY ATTEMPTS TO ATTRACT FOREIGN INVESTMENT INTO RUSSIA

During the existence of the Soviet Union, foreign investment in the economy was almost entirely forbidden.<sup>4</sup> The Communist regime considered foreign capital to be inconsistent with the basic principles of a socialist economy.<sup>5</sup> As a result, economic contact with the Soviet Union existed primarily as a limited trade in goods.<sup>6</sup> A foreign company could establish a presence in the Soviet Union only through a representative office.<sup>7</sup>

In its final years the Soviet Union turned its failing economy toward capitalism. On March 15, 1985, Mikhail Gorbachev introduced *perestroika*.<sup>8</sup> A key goal of *perestroika* was to remove

3. *Id.*

4. See Frenkel & Sukhman, *supra* note 1, at 321 (discussing barriers to investment).

5. Mark David Davis & Robert J. Sokota, *The Development of the Foreign Investment Environment in the Russian Federation*, 24 CASE W. RES. J. INT'L L. 475 (1992). The basic principals of a socialist economy are central planning and regulation, concentration of all productive assets in the state and disapproval of foreign economic entanglements. Foreign investment is often viewed as contradictory to these principals. *Id.*

6. Trade was limited by mutual distrust, disproportionate risk, export controls and lack of interest in finished Russian goods on the part of Western traders, even though they had a continuing interest in gold, oil, and raw materials. *Id.* at 477.

7. *Id.* Since these representative offices could not engage in production, provide services, or carry out other operations in the Soviet Union, the threat of capitalist intervention was slight. *Id.*

8. *Perestroika* consisted of three integrated parts: *glasnost* (openness), *demokratizatsiia* (democratization of the political process), and *uskorenie* (accel-

the legal impediments to foreign investment in the Soviet Union. Initially, this goal included no specific legislation, but merely invited foreign investors to participate in the economic development of the Soviet Union under existing Soviet law.<sup>9</sup> The Soviet Union took no affirmative steps to convince foreign investors that it was a stable business environment. Not surprisingly, this policy had little success in bringing foreign capital into the country.

In 1987, the Soviet government enacted a more detailed law known as the Joint Venture Law.<sup>10</sup> This law permitted, and even encouraged, foreign investment in the production and service enterprises of the Soviet Union. Nevertheless, the law still contained significant limitations on foreign investment. For example, the law prohibited foreign investors from holding more than fifty percent of a venture,<sup>11</sup> required a majority of management to be Soviet citizens and required both the chairperson of the board and the director general to be citizens of the Soviet Union.<sup>12</sup> Furthermore, the law required the joint venture to obtain approval from the Council of Ministers of the Soviet Union.<sup>13</sup> It also mandated that the Soviet joint venture partner be a government agency or be connected to an agency and acting with its permission.<sup>14</sup>

Because these limitations inhibited foreign investment, the Council of Ministers issued additional edicts which made it more lucrative for foreign investors to start joint ventures. The edicts eliminated the restriction preventing foreign investors from holding more than fifty percent ownership in a joint venture.<sup>15</sup> In addition, the edicts allowed foreign investors to exercise man-

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eration of the pace of economic development). Christopher Osakwe, *The Host Country Perspective on Foreign Investments in the Soviet Union: Law and Policy*, 24 VAND. J. TRANSNAT'L L. 207, 209 (1991).

9. *Id.* at 210.

10. On the Procedure for the Creation on the Territory of the USSR and the Activities of Joint Enterprises with the Participation of Soviet Organizations and Firms of Capitalist and Developing Countries, *translated in* 26 I.L.M. 749 (1987) [hereinafter Joint Venture Law].

11. Joint Venture Law, *supra* note 10, § II, art. 5.

12. Joint Venture Law, *supra* note 10, § III, art. 21.

13. Joint Venture Law, *supra* note 10, § I, art. 1.

14. Joint Venture Law, *supra* note 10, § II.

15. On the Procedure for the Creation on the Territory of the USSR and the Activities of Joint Enterprises with the Participation of Soviet Organizations and Firms of Capitalist and Developing Countries, *as amended by* Edict No. 352 of Mar. 17, 1988, *translated in* 29 I.L.M. 263 (1990).

agerial and executive control over joint ventures.<sup>16</sup> Finally, in 1990, the Soviet government permitted wholly-owned foreign subsidiaries to do business in Russia.<sup>17</sup>

In 1991, almost 3500 joint ventures were registered in the Soviet Union. Less than ten percent of the ventures were actually operating,<sup>18</sup> and the amount of foreign investment in each venture averaged less than \$115,000 (U.S.).<sup>19</sup> These figures fell far short of the \$30-\$50 billion worth of foreign investment expected annually.<sup>20</sup> It became obvious that new laws were needed to attract foreign investment to the Soviet Union.

## II. RECENT LEGISLATIVE ENACTMENTS TO ENCOURAGE FOREIGN INVESTMENT

### A. THE LAW ON FOREIGN INVESTMENT

After the demise of the Soviet Union, the Russian economy was a disaster.<sup>21</sup> Russian leaders looked to the West for aid. Russia sought to attract foreign capital, technology, managerial techniques and jobs.<sup>22</sup> To do this, Russia enacted the Law on Foreign Investment (Investment Law), which established formal guidelines for foreign investment.<sup>23</sup> The Investment Law contains numerous provisions reducing the risk of investing in Russia. The law guarantees foreign investors the same property and investment rights available to citizens of Russia.<sup>24</sup> It precludes discriminatory legislation, and protects foreign investment from nationalization. Foreign investments may be

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16. On the Procedure for the Creation on the Territory of the USSR and the Activities of Joint Enterprises with the Participation of Soviet Organizations and Firms of Capitalist and Developing Countries, *as amended by Edict No. 385 of May 6, 1989, translated in* 29 I.L.M. 263 (1990).

17. Davis & Sokota, *supra* note 5, at 479.

18. Richard N. Dean, *Considering Business Opportunities in the Soviet Union in the 1990's*, 24 VAND. J. TRANSNAT'L L. 325, 334 (1991).

19. *Id.*

20. Economic Ministry on Foreign Investment Needs, Oct. 8, 1993, F.B.I.S.-Sov. 93-196, at 68 (Oct. 13, 1993).

21. See generally Frenkel & Sukhman, *supra* note 1.

22. See Memorandum from the Subcommittee on Investment of the American Chamber of Commerce in Moscow, Major Issues Affecting Investment in Russia 8 (Mar. 8, 1994) (on file with the *Minnesota Journal of Global Trade*) [hereinafter Chamber of Commerce memo].

23. Russian Federation Law on Foreign Investments of July 4, 1991, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Foreign Investment section) (1995) [hereinafter Russian Foreign Investment Law].

24. *Id.* at ch. II, art. 6. This provision continues to recognize exceptions which are contained within the Law of Foreign Investments itself.

requisitioned or confiscated only under "extraordinary circumstances in the interest of society."<sup>25</sup> In the event of requisition, a foreign investor is entitled to timely, adequate and sufficient compensation.<sup>26</sup> The Supreme Soviet of Russia has authority to make decisions on issues of nationalization.<sup>27</sup> Decisions by administrative bodies concerning seizure of foreign investments may be appealed to Russian courts.<sup>28</sup> Centralized decision making and the ability to appeal decisions give investors some guarantees of stability.

The Investment Law grants privileges as well. It guarantees foreign investors unconditional rights of repatriation<sup>29</sup> for certain funds received in foreign currency after all taxes and duties are paid.<sup>30</sup> It guarantees the use of funds which the foreign investor receives in Russian currency.<sup>31</sup> These funds may be re-invested in Russia, used to purchase foreign currency on the internal market, remitted abroad, or deposited in a bank account within Russia.<sup>32</sup> The Investment Law gives foreign investors advantages in customs duties and in the export and import of goods and services. For example, a customs duty is not levied on assets brought into Russia if it is the foreign investor's contribution to a venture, if the item is for the foreign investor's own production purposes, or if it is for the personal requirements of foreign personnel at the enterprise.<sup>33</sup> Enterprises with a foreign investment of thirty percent or more may, without a license, ex-

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25. *Id.* at ch. II, art. 7. Article 7 is not specific about what might entail "extraordinary circumstances in the interest of the society." Although it provides protection against seizure of property, this protection is not absolute. *Id.*

26. *Id.* Article 7 also provides that a foreign investor has the right to compensation for losses, including the loss of profits incurred as a result of compliance with orders of government bodies, or their officials, that contradict the legislative acts of Russia. *Id.* The amount of allowed compensation must correspond to the actual value of the investments at the time the foreign investor received notice of nationalization, plus interest. *Id.* at ch. II, art. 8.

27. *Id.* at ch. II, art. 7.

28. *Id.*

29. Repatriation is the process by which profits from a foreign investment are returned to the investor's home country. Frenkel & Sukhman, *supra* note 1, at 406.

30. Russian Foreign Investment Law, *supra* note 23, at ch. II, art. 10. Funds which may be repatriated include: revenues from investments; amounts received as settlement claims; amounts received through partial or complete liquidation; and amounts received because of nationalization. *Id.*

31. *Id.* at ch. II, art. 11.

32. *Id.* Foreign investors may not transfer Russian funds out of the country. These limitations allow the foreign investor the opportunity to make effective use of profits without allowing USSR currency out of the country. *Id.*

33. *Id.* at ch. IV, art. 24.

port their own manufactured products and import products to satisfy their needs.<sup>34</sup>

The Investment Law offers additional guarantees, benefits and protections to foreign investments in "free economic zones."<sup>35</sup> These benefits include simplified procedures for registering enterprises,<sup>36</sup> preferred tax treatment,<sup>37</sup> lower lease rates for the use of land and other natural resources,<sup>38</sup> special customs treatment,<sup>39</sup> and easier ways to enter and exit the country.<sup>40</sup> Although the Investment Law establishes guidelines for the creation of free economic zones and provides general benefits, the details of the zones are specified in the statutes creating the zones.<sup>41</sup>

St. Petersburg (Leningrad) exemplifies a free economic zone.<sup>42</sup> This zone demands that the government cap rates for land rentals,<sup>43</sup> assuring foreign investors of some stability in forecasting costs. The St. Petersburg zone also provides special tax benefits.<sup>44</sup>

Legislation has been drafted to amend the Law on Foreign Investments.<sup>45</sup> These amendments would provide even more guarantees and benefits to foreign investors. For example, one amendment establishes a legal basis for granting tax reductions or tax exemptions in large investment projects.<sup>46</sup> An additional

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34. *Id.* at ch. IV, art. 25.

35. *Id.* at ch. VII, arts. 41 & 42. "Free economic zones" are areas which are established in certain regions of Russia to attract foreign capital, advanced technology and management experience, and to develop Russian export potential. *Id.*

36. *Id.* at ch. VII, art. 42.

37. *Id.* This preferred tax treatment includes taxes on profits transferred abroad. The reduced tax rates in "free economic zones," however, may not be lower than 50% of the tax rates for foreign investors in other areas of Russia.

38. These rental incentives include the right to a long-term lease of up to 70 years, with the right to sub-lease. *Id.*

39. The special customs treatment for "free economic zones" includes lowered customs duties on the import and export of goods, and a simplified procedure for crossing the border. *Id.*

40. This simplification of entry and exit also applies to foreign citizens without visas, since visas are often difficult to acquire. *Id.*

41. *Id.*

42. See generally Statute on the Free Enterprise Zone in the City of Leningrad of June 11, 1991, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Foreign Investment section) (1995).

43. *Id.* at para. 9.

44. *Id.* at paras. 21,22.

45. Christopher Smeall & Jonathan H. Hines, *Pending Changes in Russian Law May Offer Favorable Provisions for Foreign Investors*, RUSSIA AND COMMONWEALTH BUS. L. REP., Nov. 1, 1993, at 4.

46. *Id.*

amendment would protect foreign enterprises having more than \$100,000 in foreign investment from adverse changes in legislation for ten years following their date of registration.<sup>47</sup> President Yeltsin's Foreign Investment Edict contains a similar provision protecting foreign investment.<sup>48</sup> Unlike the proposed amendments, there are no monetary requirements for protection in this Edict.<sup>49</sup>

## B. THE RUSSIAN PRIVATIZATION PROGRAM

Russia promotes foreign investment by allowing foreign firms to participate in the privatization of its state and municipal enterprises.<sup>50</sup> The 1994 Privatization Program<sup>51</sup> supersedes the 1992 program<sup>52</sup> and is even more favorable to foreign investors.

While the 1994 program expands the rights of foreign investors in the privatization process, the procedure is complex and contains restrictions. The privatization program divides the country's industries into one of five categories:<sup>53</sup> (1) those in which privatization is prohibited;<sup>54</sup> (2) those requiring approval

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47. *Id.* This proposed amendment would contain exceptions for changes in law relating to national security, the environment, and industrial safety. *Id.*

48. See *infra* notes 77-79 and accompanying text.

49. Eric K. Johnson, *Yeltsin Edict Seeks to Protect Foreign Investors from Adverse Changes in Future Legislation*, RUSSIA AND COMMONWEALTH BUS. L. REP., Oct. 18, 1993, at 5. The Foreign Investment Edict only applies for three years. *Id.*

50. Russian Foreign Investment Law, *supra* note 23, at ch. V, art. 37. Article 37 of the Foreign Investments Act guarantees the right of foreign investors to take part in the privatization process. *Id.*

51. Fundamental Provision of the State Program for Privatization of State and Municipal Enterprises After July 1, 1994 of July 22, 1994, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Privatization and Entrepreneurship section) (1995) [hereinafter 1994 Privatization Program].

52. For a discussion of the 1992 privatization program, see Georgi G. Angelov, *Legal Framework of Privatization in Russia*, 2 MINN. J. GLOBAL TRADE 207 (1993).

53. The program includes extensive lists designating the categories under which various industries fall. The most attractive industries for foreign investment, such as oil and gas industries, defense industries, and manufacturing industries, generally require federal government and *Goskomimushchestvo* approval. *New Russian Privatization Program Expands Rights of Foreign Investors, Adds to List of Restricted Industries*, RUSSIA AND COMMONWEALTH BUS. L. REP., Mar. 7, 1994, at 6 [hereinafter *New Russian Privatization*].

54. Privatization is prohibited for federally owned industries such as: natural resources; military equipment; nuclear power stations; railroads; radio and television transmission facilities; facilities for burying radioactive and toxic waste; and cultural or historical assets. *Id.*



by the federal government;<sup>55</sup> (3) those requiring approval by the State Property Committee or *Goskomimushchestvo*;<sup>56</sup> (4) those controlled by local governments;<sup>57</sup> and (5) those in which privatization is mandatory.<sup>58</sup> Privatization of certain key industries<sup>59</sup> is governed by industry-specific procedures.<sup>60</sup>

Privatization of industries requiring federal government approval and *Goskomimushchestvo* approval may result in one of several decisions. The federal government or the *Goskomimushchestvo* may prohibit privatizing a particular industry.<sup>61</sup> In this situation, that industry either becomes an open-type joint stock company, with the government retaining 100% of the shares, or a state institution financed from state sources.<sup>62</sup> The government may also permit privatization with

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55. Industries that require federal government approval for privatization include: arms manufacturers; cold storage facilities; enterprises that process precious metals, precious and semi-precious stones, and radioactive materials; oil and gas enterprises; refineries; pipelines; coal extraction enterprises; commercial banks; railroad transportation enterprises; maritime and air transportation industries "of federal significance;" television and radio broadcasting companies; printing and publishing houses; certain medical industry facilities; and certain historical and cultural assets. *Privatizing Russia's Industrial Jewels Entails Additional Restrictions*, RUSSIA AND COMMONWEALTH BUS. L. REP., Mar 21, 1994, at 5 [hereinafter *Russia's Industrial Jewels*].

56. Industries that require *Goskomimushchestvo* approval include: large enterprises valued at more than one billion rubles; enterprises not included in the federal government category or banned from privatization that account for more than 35 percent of the production of its particular goods or services in the domestic market; research and development institutes valued at more than one million rubles and not under any other restricted categories; oil and gas construction enterprises and facilities; liquor, wine, and tobacco production or packaging; nuclear machine building; baby food production; and certain printing enterprises and publishing houses not under other restrictions. *Id.*

57. Local governments must approve the privatization of such facilities as urban and suburban passenger transportation facilities, service facilities, pharmacies (with a state license), and regional and local seaports. *New Russian Privatization*, *supra* note 53, at 6.

58. Privatization is mandatory for industries in the wholesale and retail trade, construction and construction materials, food enterprises, taxi services, bankrupt enterprises, hotels, boarding houses, housing, and certain municipal service industries. *Id.*

59. The key industries listed in the 1994 program that require industry-specific privatization procedures are: oil and gas industries; oil refineries; petroleum product support services; defense industries; electric power generation; nuclear power stations; the coal industry; extraction and processing of precious metals and stones; railroads; cultural and other facilities attached to enterprises undergoing privatization; and the facilities of the *Rossiyskii Nikel* Russian joint stock company. *Id.* at 3.

60. *Id.*

61. *Russia's Industrial Jewels*, *supra* note 55, at 5.

62. *Id.*

restrictions,<sup>63</sup> allowing the government to retain a specific amount of ordinary voting shares of either 51%, 38%, or 25.5%,<sup>64</sup> or a "golden share," which permits it to hold a controlling interest in the enterprise.<sup>65</sup> The government is limited to holding a block of shares in a privatized company for a maximum of three years and can only do so in particular industries.<sup>66</sup> A final option is to allow privatization without restrictions.<sup>67</sup>

The 1994 privatization program allows the foreign investor to purchase enterprises formerly owned by the central government.<sup>68</sup> The 1994 program explicitly allows foreign buyers to purchase privatization vouchers and use them as a means of payment in the privatization process.<sup>69</sup> Foreign buyers must notify the Russian Finance Ministry of their plans.<sup>70</sup> Because this is the only approval required, the foreign investor does not have to obtain permission from state committees, ministries, departments, or regional, local, and municipal governmental bodies.<sup>71</sup>

### C. PRESIDENTIAL EDICTS TO PROMOTE FOREIGN INVESTMENT

Under the Russian Constitution,<sup>72</sup> the President can issue edicts and directives which have the effect of law.<sup>73</sup> Presidential decrees must conform to the Russian Constitution and the fed-

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63. *Id.*

64. *Id.*

65. *Id.*

66. The types of industries in which the government may retain a block of shares include: communications; electric power generation and distribution; extraction, refining, and sale of all natural gas; extraction and processing of precious metals, stones and radioactive rare-earth materials; arms and munitions production; production of liquor; freight companies over water and air; airports, seaports, and river ports; the patent service; research and development enterprises; specialized enterprises for constructing or operating facilities for national security; publishing houses; printing industries; pipelines; the Russian Circus; wholesale trade enterprises performing purchases for the state; and export-import operations in connection with international agreements. *Id.* at 6.

67. *Id.* at 5.

68. *New Russian Privatization*, *supra* note 53, at 3.

69. *Id.* at 5.

70. *Id.* at 4.

71. *Id.*

72. The new Russian Constitution was approved by voter referendum December 12, 1993. KONST. RSFSR *translated in* Constitution of the Russian Federation of Dec. 12, 1993, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Constitutional Law section) (1995).

73. The president's power to issue edicts basically allows the president to bypass the legislature without a counter-signature. *Id.* at art. 90, cl. 1. The implementation of these edicts is mandatory throughout Russia. *Id.* at art. 90, cl. 2.

eral laws of Russia.<sup>74</sup> President Yeltsin has used this power liberally, and has issued several edicts designed to attract foreign investors.

#### 1. Edict No. 1466

Presidential Edict No. 1466<sup>75</sup> contains several measures to improve the foreign investment climate in Russia. In the past, rapidly changing laws discouraged foreign investment.<sup>76</sup> In response to this dilemma, Edict 1466 provides that new laws regulating foreign and joint enterprises shall not be applied for three years to enterprises in existence on the date the legislation is enacted.<sup>77</sup> This Edict provides a guarantee to foreign investors that their businesses will not be harmed by adverse changes in the law for three years.<sup>78</sup> The three-year grace period does not apply to laws benefiting an enterprise, which take effect immediately.<sup>79</sup>

Another commonly cited obstacle to investing in Russia is uncertainty over whether the federal or local government has authority to act in a particular field.<sup>80</sup> Edict 1466 provides that only federal laws and presidential edicts may restrict the activity of foreign investors.<sup>81</sup> It invalidates other legislation enacted by federal ministries, departments, regional governments, or local governments that restrict foreign investment.<sup>82</sup> Local and regional governments may only adopt legislation that promotes foreign investment.<sup>83</sup> Finally, Edict No. 1466 mandates that the government produce draft legislation "with a view to ensuring

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74. *Id.* at art. 90, cl. 3.

75. O sovershenstvovanii raboti s inostrannymi investitsiami, Ukaz No. 1466, Prezidenta Rossiiskoi Federatsii [On Perfecting the Way of Dealing with Foreign Investments, Edict No. 1466 of the President of the Russian Federation] (Sept. 27, 1993) ROSSIYSKIYE VESTI 197 (366), Oct. 12, 1993, at III, translated in Eric K. Johnson, *Yeltsin Edict Seeks to Protect Foreign Investors from Adverse Changes in Future Legislation*, RUSSIA AND COMMONWEALTH BUS. L. REP., Oct. 18, 1993, at 5 [hereinafter Edict No. 1466]. This act directs the Council of Ministers to prepare amendments to the Foreign Investment Law.

76. The view of over 100 experienced U.S. companies was that the most significant barrier to investment in Russia was the uncertainty of the law. Chamber of Commerce Memo, *supra* note 22, at 8.

77. Edict No. 1466, *supra* note 75, at cl. 1.

78. Vadim Bardin, *Inostranniy kapital priobryol immunitet ot zakonov Possii* [Foreign Capital Has Acquired Immunity from Russian Laws], KOMMERSANT-DAILY 186, Sept. 29, 1993, at 3.

79. Edict No. 1466, *supra* note 75, at cl. 1.

80. Chamber of Commerce memo, *supra* note 22, at 8.

81. Edict No. 1466, *supra* note 75, at cl. 2.

82. *Id.*

83. *Id.*

favorable conditions for attracting foreign capital to priority economic programs."<sup>84</sup>

## 2. Edict No. 1928

Presidential Edict No. 1928<sup>85</sup> attempts to reduce risks for potential investors by allowing the government to share in those risks. The Edict provides that the Russian government will fund investment projects with 0.5% of the gross domestic product (GDP).<sup>86</sup> The government will select projects on a competitive basis.<sup>87</sup> The Edict requires that private investors provide 80% of the capital, 20% of which must be the investors' own funds.<sup>88</sup> The government's contribution to a venture can be in the form of a loan<sup>89</sup> or the ownership of shares.<sup>90</sup> The shares retained by the government will be sold on the market two years after it earns profits from the project.<sup>91</sup> Investors in a project acquire rights to the property in proportion to their share of expenses.<sup>92</sup> Since the investor has a controlling share of the venture and because the government must sell its shares after two years, the drawbacks of having the government as a partner are minimal. The Russian government's financial stake in the enterprise may actually add to the stability of the investment. The government will be reluctant to take action which might diminish its financial return on the investment.

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84. *Id.* at cl. 3. The legislation to be revised is the law "On Foreign Investment in the RSFSR," the law "On Free Economic Zones," and the tax laws. The new package of legislation must also include procedures for foreign investors' participation in the privatization programs on a par with Russian enterprises, and procedures for converting Russia's foreign debts into foreign investments. *Id.*

85. *O chastnich investitsiyach v Rossiiskoi Federatsii*, Ukaz No. 1928 Prezidenta Rossiiskoi Federatsii [On Private Investment in the Russian Federation, Edict No. 1928 of the President of the Russian Federation] (Sept. 17, 1994) ROSSIYSKAYA GAZETA 180 (1037), Sept. 21, 1994, at 4 [hereinafter Edict No. 1928].

86. *Id.* at cl. 1.

87. *Id.* The project submissions must have a business plan, the findings of a state environmental analysis, and a state non-departmental or independent analysis. *Id.* at cl. 3.

88. *Id.* at cl. 2.

89. *Id.* at cl. 4 (a).

90. The amount of shares retained by the government will be determined in accordance with the project's business plan. *Id.* at cl 4 (b).

91. *Id.*

92. *Id.* at cl. 6.

## 3. Edict No. 2270

The Russian government has amended its tax laws to make investment in Russia more attractive to foreigners.<sup>93</sup> Presidential Edict No. 2270 caps the tax rate on profits from all investments, including foreign investments.<sup>94</sup> The Edict provides that the federal government profit tax levy is 13%, and regional governments may independently set an additional amount if it does not exceed 25%.<sup>95</sup> This system allows for varying tax rates around the country,<sup>96</sup> which creates uncertainty. On the other hand, it allows local governments to compete for foreign investments by creating attractive tax rates.<sup>97</sup>

The Edict provides that if the new tax structure creates less advantageous conditions for those who are already operating a business under old tax laws, the older, more beneficial laws will apply.<sup>98</sup> The Edict also encourages improvements in technology by tax-exempting profits if they are reinvested in scientific research and experimental design work.<sup>99</sup> The expected amount, however, must not exceed 10% of the taxable profit of the enterprise.<sup>100</sup> The Edict stimulates the development of small enterprises<sup>101</sup> by exempting certain small businesses from taxes on profits during the first two years of operation.<sup>102</sup> These enterprises must operate in preferred activities,<sup>103</sup> and the income

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93. Revisions of the existing tax law was accomplished by Edict No. 2270 of the Russian President, On Certain Amendments to Taxation and the Interrelationship of Budgets at Various Levels of December 22, 1993, in *RUSSIA AND COMMONWEALTH BUS. L. REP.*, April 18, 1994, at 9 [hereinafter Edict No. 2270].

94. *Id.* at para. 2.

95. *Id.*

96. *Finer Points in the Russian Tax Edict Offer Foreign Investors Benefits, Restrictions*, *RUSSIA AND COMMONWEALTH BUS. L. REP.*, Apr. 18, 1994, at 5. Russia is comprised of 88 separate local regions or oblasts. Therefore, under the new tax structure it is possible that each could have a separate profit tax rate causing fragmentation of the tax regime. Jeffrey M. Trinklein, *Russia Makes Significant Changes to Profits Tax, Amends Excess Wages Tax and VAT*, 8 *TAX NOTES INT'L* 1039 n.5 (1994).

97. *Finer Points in the Russian Tax Edict Offer Foreign Investors Benefits, Restrictions*, *supra* note 96, at 5.

98. Edict No. 2270, *supra* note 93, at para.33.

99. *Id.* at para. 5.

100. *Id.*

101. The edict defines small enterprises as those in which the average number of employees does not exceed 200 individuals and in which state and municipal ownership does not exceed 25%. *Id.*

102. *Id.* at para. 9.

103. The profit tax exemption applies to all small enterprises engaged in the production of agricultural output, production of food produce, consumer goods, medical equipment, medicinal preparations, items for medical use, technical

derived from these activities must amount to 70% or more of the total income of the enterprise.<sup>104</sup> During the third year of operation, the tax rate for these industries is 25% of the normal rate, and in the fourth year, 50% of the normal rate, provided that 90% of the income is derived from the preferred activity.<sup>105</sup> In addition to all these favorable changes, however, Edict No. 2270 also expands the scope of the Russian tax on excess wages, a change which will be detrimental to foreign investors.<sup>106</sup>

### III. INTERNATIONAL AGREEMENTS AND ORGANIZATIONS CREATED TO ATTRACT FOREIGN INVESTMENT

#### A. U.S.-RUSSIA TAX TREATY

As a means of alleviating the problems of the Russian tax regime,<sup>107</sup> the United States and Russia formed a tax treaty in 1992.<sup>108</sup> The protocol to the treaty provides that any "qualified Russian entity",<sup>109</sup> and any banking, insurance or other financial business carried on in Russia by a permanent establishment owned by a U.S. resident, can continue to calculate its tax as provided under the profit tax existing before the treaty, regardless of any Russian domestic tax law changes.<sup>110</sup> This guaranteed treatment does not apply to permanent establishments outside of the financial industry.<sup>111</sup>

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equipment for disability prevention and disability rehabilitation, and in the construction of housing, production, social, and environmental protection facilities. *Id.*

104. *Id.*

105. *Id.*

106. For a discussion of the excess wage tax, see *infra* Part IV.B.

107. See *infra* Part IV.B (discussing the problems of the Russian tax system).

108. Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital of June 17, 1992, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Financial and Banking Law section) (1995) [hereinafter U.S.-Russia Treaty]. Russia ratified the U.S.-Russia Treaty on October 22, 1992, and the U.S. Senate ratified the treaty on November 20, 1993. The Treaty has been in force since January 1, 1994. Trinklein, *supra* note 96, at 1040 n.7.

109. The protocol to the U.S.-Russia Treaty defines a "qualified Russian entity" as an entity that is a resident of Russia and at least 30% beneficially owned by residents of the United States, and that has a total corporate capital of at least \$100,000. U.S.-Russia Treaty, *supra* note 108, Protocol, para. 8(b).

110. U.S.-Russia Treaty, *supra* note 108, Protocol, para. 8(c).

111. Jeffrey M. Trinklein, *The U.S.-Russia Tax Treaty: Has the Foreign Tax Credit Issue Been Resolved?*, 5 TAX NOTES INT'L 699, 700 (1992).

B. U.S.-RUSSIA TREATY CONCERNING THE ENCOURAGEMENT AND RECIPROCAL PROTECTION OF INVESTMENT

To stimulate capital flow and the economic development of both countries, the United States and Russia have signed a treaty to encourage and protect investment.<sup>112</sup> This treaty guarantees that investments in Russia and the United States will receive "national treatment."<sup>113</sup> National treatment is defined within the treaty as "treatment that is at least as favorable as the better of the most favorable treatment accorded by a party to state enterprises or to other companies or nationals of that party in like circumstances."<sup>114</sup> This is not an unlimited benefit, as the national treatment provision is subject to reservations made in the annex of the treaty.<sup>115</sup> The treaty also provides that investments must receive treatment consistent with the norms and principles of international law.<sup>116</sup> Furthermore, investments made under the treaty may only be expropriated or nationalized for a public purpose, in a nondiscriminatory manner, upon payment of prompt, adequate and effective compensa-

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112. Treaty Between the United States of America and the Russian Federation Concerning The Encouragement And Reciprocal Protection of Investment of June 17, 1992, PARKER SCH. FOREIGN & COMP. L. LEGAL MATERIALS—RUSSIA AND THE REPUBLICS (Foreign Investment Section) (1995) [hereinafter *Investment Treaty*].

113. *Id.* at art. II.

114. *Id.* at art. I (1)(h).

115. *Id.* at art. II (1). The Russian government reserved the right to maintain exceptions to national treatment in the following areas: electric power production; production of uranium and other fissionable materials; ownership of land and use of subsoil and natural resources; marine and inland sea fisheries; construction, installation, operation, and maintenance of communications lines; ownership and brokerage of real estate; mining and processing of ores of precious metals, rare earth metals and precious stones; air transport, ocean and river shipping; state loans; state grants; banking activities; brokerage and dealerships in securities and currency values; ownership of state securities; acquisition of state and municipal property in the process of privatization; insurance; mass media companies; and private detective and security services. *Id.* at Annex (1). The United States reserved the following exceptions: air transportation; ocean and coastal shipping; banking; insurance; government grants; government insurance and loan programs; energy and power production; custom house brokers; ownership of real property; ownership and operation of broadcast or common carrier radio and television stations; ownership and shares in the Communications Satellite Corporation; the provision of common carrier telephone and telegraph services; the provision of submarine cable services; use of land and natural resources; mining on the public domain; primary dealership in United States government securities; maritime services and maritime-related services. *Id.* at Annex (2).

116. *Id.* at art. II (2)(a).

tion, and in accordance with due process of law.<sup>117</sup> In cases of expropriation, the compensation shall be paid without delay.<sup>118</sup> The measure of the compensation is the fair market value of the investment immediately before expropriation plus interest from the date of the taking.<sup>119</sup> A party is given the right of judicial or administrative review to determine if the expropriation and compensation conform with the principles of international law.<sup>120</sup>

Protection of investments is extended to losses suffered during war, revolution, a state of emergency, insurrection, and civil disturbance.<sup>121</sup> The treaty specifically states that each party shall provide equitable treatment in terms of taxation.<sup>122</sup> In addition, the treaty provides detailed procedures for dispute resolution, including negotiation, consultation, and international tribunals.<sup>123</sup> Russia and the United States will enforce any arbitral awards within their territories.<sup>124</sup> This commitment to enforce awards is important since the treaty is applicable to the political subdivisions of both countries.<sup>125</sup>

### C. INVESTMENT ORGANIZATIONS

Russia and the United States have also created certain organizations to promote and guarantee investments in Russia. An example of such an organization is the Russian Government's Consultative Council for Foreign Investments, which was formed in 1994.<sup>126</sup> The Council is led by the Chairman of the Russian Government and is composed of ministers of the Russian cabinet as well as leaders from some of the largest Western industrial and financial companies.<sup>127</sup> The Council hears the concerns of potential investors. The Council utilizes the Western businessperson's perspective on how to increase investments

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117. *Id.* at art. III (1).

118. *Id.*

119. *Id.*

120. *Id.* at art. III (2).

121. *Id.* at art. III (3).

122. *Id.* at art. XI (1).

123. *Id.* at art. VI.

124. *Id.* at art. VI (3)(e).

125. *Id.* at art. XII.

126. Vladimir Lagovskiy, *V vozdukhye zapakhlo investitsiyami* [*The smell of investment in the air*], RABOCHAYA TRIBUNA 120 (1019), July 19, 1994, at 1.

127. Council for Foreign Investment Set Up, June 30, 1994, F.B.I.S.-Sov. 94-126, at 20. [hereinafter Council Set Up]. Some of the Western firms listed as participating in the Council are ABB, Coca-Cola, United Technologies and Gulf Canada. *Id.*



in Russia by overcoming barriers to foreign investment.<sup>128</sup> It is made up of three working groups, including a group for the investment climate, one for tax legislation, and another for the creation of a normal image of the Russian economy abroad.<sup>129</sup> The Council will meet several times a year to discuss investment in Russia.<sup>130</sup>

The governments of Russia and the United States created a similar organization. The "Partnership for Economic Progress," an agreement reached between President Clinton and President Yeltsin on September 28, 1994, claims that each country is striving to provide the other with free access to its market for goods and services.<sup>131</sup> To facilitate this commitment, the Russian-American Committee for the Development of Business Cooperation has become a valuable forum for discussing the issues of fair trade and access to markets.<sup>132</sup>

In addition to organizations that work to promote investment, both Russia and the United States have formed agencies that guarantee investment in Russia. Yeltsin's presidential edict on February 5, 1993 created the State Investment Corporation.<sup>133</sup> The purpose of the corporation is to create favorable conditions for foreign investment, as well as to protect Russia's state interests.<sup>134</sup> The principle task of the corporation is to insure foreign investors against political risks.<sup>135</sup> The corporation holds one billion dollars worth of property to guarantee Western investments.<sup>136</sup>

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128. Conference on Foreign Investments Opens in Moscow, June 27, 1994, F.B.I.S.-Sov. 94-123, at 14. Viktor Chernomyrdin, Prime Minister of the Russian Government and head of the Council, stated the purpose of the Council: "We would like to know what ways western business people suggest for increasing investments in Russia, what is hampering their work and how the Russian Government could help remove the unnecessary barriers on their way, including in the sphere of taxation." *Id.*

129. Council Set Up, *supra* note 127, at 20.

130. *Id.*

131. U.S. 'Partnership for Economic Progress' Detailed, Sept. 29, 1994, F.B.I.S.-Sov. 94-189, at 15.

132. *Id.*

133. Leonid Brodsky, *Korporatsiya budet strakhovat' ot politicheskikh riskov* [Corporation to Insure Political Risk], KOMMERSANT-DAILY 30, Feb. 19, 1993, at 10.

134. *Id.*

135. *Id.*

136. *Id.*

The United States has committed \$2.5 billion this year to guarantee investments in Russia.<sup>137</sup> These funds will be held by the Overseas Private Investment Corporation<sup>138</sup> (OPIC), a federal agency providing American businesses with loan guarantees and insurance against political risks in developing countries.<sup>139</sup> OPIC funds should generate investment in Russia because the guarantees will overcome American companies' concerns about political uncertainty.<sup>140</sup>

#### IV. PROBLEM AREAS WITH EXISTING LAW

Existing Russian law demonstrates a strong commitment to attract foreign capital to its economy. These laws grant various assurances and guarantees to foreign investors that government regulation or action will not arbitrarily and adversely affect their investments.<sup>141</sup> It is important to realize, however, that these laws have not effectively solved all the problems facing investors in the volatile Russian market. For instance, the existing legislation has not adequately addressed the barriers to foreign participation in the privatization process. Furthermore, Russian legislation has fallen short in addressing problems in taxation, currency convertibility, infrastructure, crime, culture, and political instability.

##### A. OBSTACLES TO FOREIGN PARTICIPATION IN THE PRIVATIZATION PROCESS

Although the 1994 privatization program creates new benefits for foreign investors, several barriers remain. Government approval of investment in certain industries discourages foreign investors.<sup>142</sup> Such approval can delay a project and can be very costly. Governmental approval is necessary for industries that are the most attractive to foreign investors, such as the oil and gas or defense industries, because Russia does not want to lose control over these industries.<sup>143</sup> Even if a foreign buyer receives permission to purchase a business in a restricted industry, further restrictions may prevent foreign participation. For exam-

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137. Agis Salpukas, *Texaco Gets Aid to Invest In Russia*, N.Y. TIMES, Sept. 3, 1993, at D1.

138. *Id.*

139. 22 U.S.C. § 2191 (1988).

140. Salpukas, *supra* note 137, at D12.

141. See *supra* notes 25-28 and accompanying text.

142. See *supra* notes 55-57 and accompanying text.

143. *New Russian Privatization*, *supra* note 53, at 4.

ple, the Russian Federal Counterintelligence Service has the right to recommend to the government that it prohibit foreign investors from acquiring a restricted industry.<sup>144</sup> The government can take such action within one month after foreign investors have already purchased the industry at auction.<sup>145</sup>

Another barrier to foreign investment in Russian privatization is the uncertainty of real property ownership.<sup>146</sup> Since Russian law does not provide for land ownership by foreign investors, privatization only gives the foreign investor ownership of the business and not the actual land upon which it rests.<sup>147</sup> Until the uncertainty of property ownership is settled, foreign participation in the Russian privatization process will be minimal.<sup>148</sup>

The fact that purchases must be made in rubles further discourages foreign investors from participating in the privatization process.<sup>149</sup> The 1994 program requires that all privatization transactions by foreign investors be made in rubles or vouchers.<sup>150</sup> Currency convertibility problems also impede foreign participation in the privatization process.<sup>151</sup> Central Bank instructions specify that foreign investors must use special ruble accounts to make investments in Russia,<sup>152</sup> and opening a ruble account is a bureaucratic nightmare.<sup>153</sup>

Another barrier to foreign participation in the privatization process is that the investor may be responsible for any liability attached to the business. Neither the Foreign Investments Act nor the 1994 privatization program guarantees that a foreign in-

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144. *Id.* This provision does not provide any due process. It merely states that following the auction, information about the successful foreign bidder will be sent to the federal government and the counterintelligence service. The government then adopts a decree based on the counterintelligence service's recommendation. *Id.*

145. *Id.*

146. Ted Smith, *The Foreign Investment Regime Of The Russian Federation: Progress Toward A System Of Free Entry*, 11 UCLA PAC. BASIN L.J. 310, 323 (1993).

147. *Id.* at 325.

148. *Id.*

149. *New Russian Privatization*, *supra* note 53, at 4.

150. *Id.*

151. Foreign investors are discouraged from dealing in rubles since this currency is unstable and is not freely convertible on the world market. *See infra* Part IV.C.

152. *New Russian Privatization*, *supra* note 53, at 4.

153. Christopher Osakwe, *Modern Russian Law of Banking And Security Transactions: A Biopsy Of Post-Soviet Russian Commercial Law*, 14 WHITTIER L. REV., 301, 351 (1993).

vestor will not be held liable for environmental damage done before the investor acquired the industry.<sup>154</sup> Because investors cannot foresee potential liability at the time of privatization, they are usually taking a gamble by purchasing the industry. A legislative guarantee that foreign investors will not be held liable for environmental damage which occurred before the industry was acquired through privatization would eliminate this risk and increase foreign participation.<sup>155</sup>

There are several other reasons why Russian privatization has not been attractive to foreigners. Foreign investors hesitate to acquire an industry when the government retains a controlling share.<sup>156</sup> Although the government can only retain its share for three years, the uncertainty and risk of having an unstable government as a business partner discourages foreign investors. The slow and complex procedures that govern Russian privatization and the inadequate infrastructure of existing industries also discourage foreign investors.<sup>157</sup>

#### B. TAXATION AS AN OBSTACLE TO FOREIGN INVESTMENT

The Russian tax regime is the primary remaining obstacle to foreign investment.<sup>158</sup> Many different levels and types of taxes, instability in the tax legislation, and uncertain enforcement of the tax regime all inhibit foreign investment. Existing law has failed to resolve these issues. A recent survey by the Russian Ministry of Finance indicated that there are at present forty-four different types of taxes in Russia at various levels.<sup>159</sup>

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154. Smith, *supra* note 146, at 329.

155. *Id.*

156. *Id.* at 325.

157. Frenkel & Sukhman, *supra* note 1, at 403.

158. Yevgeniy Rusakov, *Zavershilsya vizit B. Yeltsina v SShA A "stariki" po ryumke vyzalu, soidyasya v Rozabom sadu. Shto ombetilyi Prezidyent RSFSR i byvshiy direktor TsRu na voprosi cobkora "RT" v Soyedinennikh Shtatakh Yevgeniy Rusakov* [B. Yeltsin completes visit in U.S.A., "Old Men" Meet in Rose Garden With a Glass of Wine Each. How Russian Federation President and Former CIA Director Replied to Questions From Yevgeniy Rusakov, RABOCHAYA TRIBUNA's Own Correspondent in United States], RABOCHAYA TRIBUNA 170 (1069), Oct. 1, 1994, at 1. During a meeting with members of the western business community, President Yeltsin tried to alleviate their hesitancy to invest in Russia. The business community cited tax as an obstacle to investment. Yeltsin recognized that there were faults in the Russian tax system. "We ourselves realize that in 1991, when it was born again, Russia rather hastily drew up a law on taxes that contained some mistakes which are affecting both our businessmen and foreigners." *Id.* Yeltsin indicated that a new tax code is in preparation, and should be adopted in the next year. *Id.*

159. *Russian Budget Law Outlines Various Taxes, Sets Tax Rates For Certain Taxes*, RUSSIAN AND COMMONWEALTH BUS. L. REP., Aug. 8, 1994, at 1.

These include sixteen federal taxes,<sup>160</sup> five regional taxes, and twenty-three local taxes.<sup>161</sup> The Russian tax system also relies heavily on payroll, gross income or expenditures without regard to profitability.<sup>162</sup> This burdensome tax system can make an already high-risk investment less profitable.<sup>163</sup>

Russia recognizes the problems created by its tax system and is attempting to correct them. Proposed legislation would suspend profit taxes during the first five years after a company's registration.<sup>164</sup> It would also exempt the import of machines, technological equipment, spare parts, raw materials, and component parts for production from taxation or customs duties.<sup>165</sup>

To successfully attract foreign investment, Russia must alleviate other problems in the old tax regime. One such problem is the excess wage tax, which taxes employers for excessive salary payments at the same rate profits are taxed.<sup>166</sup> Ironically,

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160. Current federal taxes imposed in Russia include, but are not limited to: profits tax (35%-38%); excess wage tax; withholding tax; payroll taxes (40% of compensation); road use tax (generally .4% of gross sales); property tax (2% per annum); VAT (generally 23% with new Special Tax added); import tariff (although rates vary by category, generally 15%); excise tax (varies by good but rate for imports is higher than that for domestic goods); export tariffs (assessed without regard to profitability). Chamber of Commerce memo, *supra* note 22, at 4.

161. Regions and localities in Russia create new taxes at any rate. These taxes will not be deductible in calculating profits tax. Examples of local taxes are Moscow's advertising tax and its tax on visitors. *Id.*

162. *Id.*

163. Huntsman International is an example of an American corporation forced out of Russia as a result of the unpredictable tax structure. The company was promised an exemption from paying taxes for five years. This concession, however, was canceled by presidential edict. The company was then required to pay a 40% tax on all of its assets, numerous fines, and an interest rate of 250%. The total cost of the changed policy to Huntsman was \$500,000. Vladimir Mikheyev, *Amerikanskiye Investitsii v Rossiiu: Odni Ukhodyat, Drugiye Prikhodyat* [American Investment In Russia: Some Go, Others Come], *IZVESTIYA* 175 (24282), Sept. 13, 1994, at 1.

164. Sergei Rybak & Ivan Zasursky, *Politicheskovo Riska Bol'she Hyet* [No Political Risk Any Longer], *NEZAVISIMAYA GAZETA* 120 (796), June 29, 1994, at 1-2.

165. Russian Prime Minister Viktor Chernomyrdin, chair of the Russian Government Consultative Council for Foreign Investments commented on upcoming legislation, which privileges businesses with foreign investment. He indicated that revisions of the new tax code would be beneficial to foreign investors. Chernomyrdin On Measures To Encourage Foreign Investment, June 28, 1994, F.B.I.S.-Sov. 94-124, at 24.

166. The excess wage tax is a tax at the profits tax rate (13% to the federal budget and a separate amount to the regional government not to exceed 25%) on the amount of an employee's salary that exceeds six times the minimum monthly wage (currently 140,620 rubles). Therefore, any salary greater than roughly \$50.00 a month is taxed at 38%. Edict No. 2270, *supra* note 93, para. 3.

under this regime almost every Russian employee qualifies as being excessively paid.<sup>167</sup> Because Edict No. 2270 provides that the excess wage tax applies regardless of whether the enterprise is profitable, it is not a tax on net income, but an additional tax on expenditures.<sup>168</sup>

The stated purpose of the excess wage tax was to prevent state-owned enterprises from increasing wages without corresponding improvements in efficiency, thereby protecting the government treasury.<sup>169</sup> A more general purpose of the act was to control wage inflation.<sup>170</sup> In effect, however, the excess wage tax discourages higher levels of employment and stifles attempts to reward employees for hard work.<sup>171</sup> It also discourages employees from learning new skills and developing a healthy work ethic.<sup>172</sup>

The excess wage tax hinders the formation of a capitalist economy. Russia's transition to a market economy requires the market to determine wages in order to promote pay for performance.<sup>173</sup> This tax is also inconsistent with international standards,<sup>174</sup> and may be deemed non-creditable<sup>175</sup> in the countries of some foreign investors.<sup>176</sup> For example, under U.S. law the excess wage tax does not qualify for a foreign tax credit since it is a tax on expenditures and not a tax on net income.<sup>177</sup> Elimination of the excess wage tax will ease the financial burden on foreign investors, give workers incentive to excel, and conform with principles of a market economy.

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167. Scott C. Antel, *Demise of Russia's Excess Wage Tax Is Victory for Free Market Theory*, 9 TAX NOTES INT'L 1311 (1994).

168. Edict No. 2270, *supra* note 93, at para. 3.

169. Arthur Anderson & Co., *Proposals For Encouraging Investment And Rationalization/Simplification of Taxation System 5* (Apr. 1994) (on file with the *Minnesota Journal of Global Trade*) [hereinafter Arthur Anderson memo]. The purposes of the excess wage tax are not a reasonable explanation for punishing private enterprises, especially foreign businesses. Therefore, an enterprise with any foreign investment should not be subject to this tax. *Id.*

170. *Russian Finance Ministry Proposes Tax Changes, Including Excess Wage Tax Phase-Out*, 9 TAX NOTES INT'L 1050 (1994) [hereinafter *Tax Changes*].

171. *Id.*

172. *Id.*

173. Arthur Anderson memo, *supra* note 169, at 5.

174. *Id.*

175. Section 901(a) of the Internal Revenue Code permits foreign tax credit for income taxes paid or accrued to a foreign country. IRC § 901(a). For a discussion on determining if the Russian profit tax is eligible for the foreign tax credit, see generally Trinklein, *supra* note 111.

176. Arthur Anderson memo, *supra* note 169, at 5.

177. Trinklein, *supra* note 96, at 1041.

After the original profits tax was enacted, the Supreme Soviet decreed that the excess wage tax would not apply to enterprises wholly owned by foreign investors or to foreign legal persons acting in Russia through permanent representative offices.<sup>178</sup> The language of Edict No. 2270, however, states that "all taxpayers"<sup>179</sup> will pay the excess wages tax. This suggests that the previous exclusion for wholly foreign-owned enterprises and foreign permanent representations no longer applies.<sup>180</sup> A Russian Government resolution claims the Russian excess wage tax extends to Russian legal entities wholly owned by foreign investors.<sup>181</sup> No official statement applies the excess wage tax to foreign legal entities doing business in Russia through representative offices.<sup>182</sup>

Applying the excess wage tax to foreign entities violates the U.S.-Russia Tax Treaty.<sup>183</sup> The U.S.-Russia treaty permits qualified Russian entities to deduct actual wages from profit taxes.<sup>184</sup> Similarly, U.S. corporations that maintain permanent establishments in Russia are allowed to deduct all expenses in determining profits.<sup>185</sup> Arguably, wholly foreign-owned Russian entities and U.S. permanent establishments may claim that the excess wage tax violates the treaty because it denies deductions for actual wages paid.<sup>186</sup>

The excess wage tax also violates the treaty provision which allows wholly foreign-owned Russian entities and permanent establishments in the financial sector to calculate taxes under the old profits tax regardless of changes in Russian law.<sup>187</sup> Edict No. 2270 removes the excess wage exclusion to the detriment of U.S. firms. As a result, U.S. entities have a right under the treaty to continue calculating their tax under the profits tax law in force at the time the U.S.-Russia Treaty was signed.<sup>188</sup> For

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178. *Id.* at 1040.

179. Edict No. 2270, *supra* note 93, at para. 3.

180. Trinklein, *supra* note 96, at 1040.

181. Scott C. Antel, *Tax Planning Can Reduce Effects of Excess Wages Tax on Wholly Foreign-Owned Russian Legal Entities*, 8 TAX NOTES INT'L 1435, 1436 (1994).

182. Scott C. Antel, *Russia's Excess Wages Tax Applies to Wholly Foreign-Owned Russian Legal Entities*, 8 TAX NOTES INT'L 1197 (1994). The prevailing expert opinion is that the Russian Government intends to include representative offices in the scope of this tax. *Id.*

183. Trinklein, *supra* note 96, at 1040.

184. U.S.-Russia Treaty, *supra* note 108, Protocol, para. 8(b).

185. *Id.* at art. 6, cl. 3.

186. Trinklein, *supra* note 96, at 1041.

187. *Id.*

188. *Id.*

these reasons, some Russian tax officials interpret the U.S.-Russia Treaty to exempt U.S. companies from the excess wages tax, while others maintain that U.S. companies are subject to the tax.<sup>189</sup>

The Russian government realizes that the excess wage tax burdens foreign investment. It is reluctant to act, however, because the tax makes up twenty to twenty-five percent of all taxes collected.<sup>190</sup> Therefore, the government has proposed to gradually phase out the excess wage tax and allow the revenue to be made up elsewhere.<sup>191</sup> One proposal raises the threshold salary from six times to eight times the minimum monthly wages for certain enterprises, and eliminates the excess wage tax for all wholly foreign-owned Russian enterprises and representative offices.<sup>192</sup> Another proposal cancels the excess wage tax and increases the profit tax rate.<sup>193</sup>

Current legislation provides no protection against the excess wage tax, and the U.S.-Russia Tax Treaty's protection is unclear. Therefore, until proposals eliminating the excess wage tax are enacted, a foreign investor must attempt to reduce the impact of the tax. Split employment contracts partially circumvent the excess wage tax. A split contract pays a foreign employee working partly in Russia and partly outside Russia under separate employment contracts.<sup>194</sup> Under this procedure only wages earned in Russia are subject to the excess wages tax.<sup>195</sup> Another way to minimize the effects of the excess wage tax is to use compensation items not included in the excess wage tax such as allowances and benefits.<sup>196</sup> Payments can be reclassified as management service or consulting fees which are not subject to the tax.<sup>197</sup>

Uncertainty and instability plagues the existing tax regime. The Russian government has altered its tax laws continuously,

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189. *Excess Wages Tax Not to Apply to U.S. Firms*, RUSSIA AND COMMONWEALTH BUS. L. REP., May 16, 1994, available in LEXIS, NEXIS Library, RCBLR File. The statement that the U.S.-Russia Treaty would take precedence over Russian law to exempt U.S. firms from the tax was made by Vladimir Gusev, chairman of the State Tax Service. *Id.*

190. *Tax Changes*, *supra* note 170, at 1050.

191. *Id.*

192. *Id.*

193. *Id.*

194. Trinklein, *supra* note 96, at 1042.

195. *Id.*

196. Antel, *supra* note 181, at 1436.

197. *Id.* at 1435.



radically, generally without notice, and often retroactively.<sup>198</sup> An investment that is profitable under one tax regime may be unprofitable or even unworkable when the tax law suddenly changes. This instability considerably increases the risk of investing in Russia.<sup>199</sup> To alleviate this instability, "grandfathering" principles would protect investors by ensuring that changes in the tax regime would not affect economic decisions made under a previous law.<sup>200</sup> Although Presidential Edict No. 2270 partially achieves this goal, its guarantee against adverse changes in taxation only applies to changes contained in Edict 2270 itself and does not protect against other legislation.<sup>201</sup> Similarly, although the U.S.-Russia Tax Treaty provides limited protections against adverse changes, it only protects against adverse changes in determining profit taxes.<sup>202</sup> The treaty is also limited to qualified Russian entities and permanent establishments in the financial industry.<sup>203</sup>

Presidential Edict No. 1466 gives existing investments more general protection against adverse changes in legislation. It provides that no unfavorable legislation will apply to then existing foreign companies and Russian joint ventures within three years of its enactment.<sup>204</sup> This protection from unfavorable legislation, however, has not actually materialized in the area of taxation.<sup>205</sup> Since the Edict's enactment, several tax changes have directly impacted foreign investors.<sup>206</sup> The most notable change was the repeal of the excess wage tax exemption previously extended to wholly foreign-owned Russian enterprises.<sup>207</sup> Authorities in the Moscow Tax Inspectorate and State

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198. Chamber of Commerce memo, *supra* note 22, at 4.

199. Arthur Anderson memo, *supra* note 169, at 6.

200. *Id.*

201. Edict No. 2270, *supra* note 93, para. 33.

202. U.S.-Russia Treaty, *supra* note 108, Protocol, paras. 8(b) & 8(c).

203. *Id.* For a definition of qualified Russian entity, see *supra* note 109.

204. Edict No. 1466 *supra* note 75, at cl. 1.

205. Changes in the tax law since the declaration of Edict 1466 have made no mention of the grace period allowed under clause 1 of Edict 1466. Furthermore, those implementing the new tax legislation have not adhered to the Edict either. Arthur Anderson memo, *supra* note 169, at 6.

206. Scott C. Antel & Oleg Lesnichy, *Applicability of Russia's Foreign Investment Decree No. 1466 Generates Discussion*, 8 TAX NOTES INT'L 1705 (1994). The tax changes that came into effect after the enactment of Edict No. 1466 were the repeal of the exemption from the excess wage tax that had previously been allowed for wholly foreign owned Russian enterprises, the extension of the VAT base, the local one percent education needs tax based on payroll, and the one dollar per-day tourist tax. *Id.*

207. *Id.*

Revenue Service do not agree whether Edict No. 1466 exempts foreign investors from the new taxes.<sup>208</sup> Until this issue is resolved, foreign investors can abide by the unfavorable tax changes enacted since Edict 1466, or risk incurring substantial penalties for not paying the taxes and challenging their validity under 1466.<sup>209</sup> Excess wage tax exemption adds to the uncertainty and instability that Edict No. 1466 was designed to eliminate. Significant investment will not occur as long as investors are unable to rely on stable tax legislation.

Procedural reforms could improve certainty and stability in the Russian tax system. An official and binding private ruling procedure may be such an improvement. This procedure would allow individuals and companies to request a binding ruling from tax authorities, in advance, on complicated transactions or interpretations.<sup>210</sup> Publication of all laws and directives would also provide certainty and stability to the tax regime. Currently, tax laws, regulations, instructions, and rulings are not published in a single official publication. Until an official publication is created, taxpayers must scour dozens of publications each day in search of new laws that might affect them.<sup>211</sup> Publication would also harmonize non-tax and tax legislation. Tax and non-tax laws have conflicted in the past and may continue to conflict with the enactment of the Law on Foreign Investment and the new civil code.<sup>212</sup>

Additionally, the Russian tax system does not allow the deduction of all necessary expenses. The present profit tax law only allows the deduction of items included in the cost of production.<sup>213</sup> The tax law could be revised to provide for the deduction of necessary expenses which are not included in the cost of production. In order to bring higher technology to Russian in-

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208. *Id.*

209. *Id.*

210. Arthur Anderson memo, *supra* note 169, at 2.

211. The American Chamber of Commerce in Moscow further recommends that new tax laws, regulations, instructions, or rulings should go into effect three months after official publication. In addition, a public comment period should be implemented in the drafting of regulations. The Chamber also recommends that tax laws should be codified to provide discipline in the drafting process and consistency in definitions and interpretations. Chamber of Commerce memo, *supra* note 22, at 5.

212. Lack of coordination between the Law on Foreign Investment, which created branches of foreign legal entities and the tax law, has caused uncertainty in how to tax the branches. To avoid further uncertainty, there must be coordination of legislation with the tax laws. Arthur Anderson memo, *supra* note 169, at 7.

213. *Id.* at 6.

dustry, the cost of production must also include expenses for training, research and development.<sup>214</sup> If certain expenses are not deductible, some countries may declare that the Russian tax will not be allowed as a credit against their own domestic tax laws.<sup>215</sup>

### C. CURRENCY CONVERTIBILITY

The difficulty of converting Russian currency on the world market further impedes foreign investment in Russia.<sup>216</sup> Degree of currency convertibility is based in part on economic reforms designed to eliminate price controls and government subsidies to Russian industries.<sup>217</sup> Since the government has indicated that it intends to issue subsidies and price controls again this year, it appears that the Russian ruble will not become freely convertible in the near future.<sup>218</sup> Although the ruble is internally convertible,<sup>219</sup> foreign investors still prefer to avoid dealing in rubles due to fluctuating exchange rates and inflation. Currently, no Russian legislation deals directly with the currency convertibility problems. To overcome this barrier, investors must rely on creative business practices.

One way to avoid the currency convertibility problem is counter-trade. Under this principle, the foreign investor agrees to trade its product for another product, usually a commodity or raw material which can be sold on the world market for hard currency.<sup>220</sup> Unfortunately, some commodities are difficult to find and in short supply.<sup>221</sup> Stringent export and licensing requirements also make counter-trade difficult.<sup>222</sup> For these reasons, counter-trade is only a limited alternative to true currency conversion.

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214. *Id.* at 7.

215. The accounting firm of Arthur Anderson suggests that the government should provide guidance as to what expenses are necessary. *Id.* at 6.

216. Davis & Sokota, *supra* note 5, at 488.

217. Chamber of Commerce memo, *supra* note 22, at 5.

218. *Id.* The Government intends to issue substantial credits primarily to the agriculture and coal industries. However, other industries have threatened to strike if they are excluded from the government subsidies. *Id.*

219. *See id.*

220. As an example of counter trade, Davis and Sokota cite to a practice conducted by PepsiCo. As part of its profits from the sale of Pepsi Cola in Russia, PepsiCo may take Russian mushrooms for use by its Pizza Hut subsidiary outside of Russia. Davis & Sokota, *supra* note 5, at 489 n.68.

221. *Id.* at 489.

222. Dean, *supra* note 18, at 335.

Another way to avoid dealing in rubles is to manufacture goods sold on the world market for hard currency.<sup>223</sup> In order to do so, however, the venture must produce goods of such high quality that they can compete in a more sophisticated market. The stagnation of the Russian manufacturing industry makes this difficult,<sup>224</sup> and many foreign investors avoid the currency convertibility problem by simply selling services to the international community.<sup>225</sup> Such enterprises include restaurants, communication companies, consulting firms, and hotels. All of these service industries can raise hard currency by making direct sales to customers.<sup>226</sup>

Even if foreign investors sell goods and services for hard currency, they cannot entirely avoid the pitfalls of currency convertibility. Russian enterprises are required to convert fifty percent of any foreign currency sale into rubles by selling the profits on either the currency market or to the Central Bank of Russia.<sup>227</sup> This currency conversion requirement prevents many companies with foreign currency sales from purchasing the technology and equipment needed to modernize Russian industries.<sup>228</sup> Article 25 of the Russian Law on Foreign Investment would have resolved these problems by exempting enterprises with foreign investments of thirty percent or more from the requirement of mandatory currency conversion.<sup>229</sup> Russian currency enactments, however, removed this exemption.<sup>230</sup> Despite the negative impact this requirement has on foreign investors, a proposal for increasing the mandatory currency requirement to 100% of foreign currency sales is presently under consideration.<sup>231</sup> Such a requirement would, of course, make it even more difficult for Russian companies to import badly needed western technology and equipment.<sup>232</sup>

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223. Davis & Sokota, *supra* note 5, at 488.

224. *Id.* at 489.

225. *Id.*

226. *Id.*

227. The currency conversion requirement is intended to apply only to exports. However, banks also apply these rules to internal hard currency transactions. For this reason, it should be made clear that conversion of hard currency sales is not required for purely domestic sales. Arthur Anderson memo, *supra* note 169, at 9.

228. Chamber of Commerce memo, *supra* note 22, at 6.

229. Russian Foreign Investment Law, *supra* note 23, at ch. IV, art. 25.

230. *Hard Currency Regulations Remove Exemptions for Foreign Investor*, RUSSIA & COMMONWEALTH BUS. L. REP., Aug. 24, 1992, at 3 [hereinafter *Hard Currency*].

231. Chamber of Commerce memo, *supra* note 22, at 6.

232. *Id.*

In order to attract foreign investment, the Russian government must address the currency convertibility problems. First, it must control inflation in order to stabilize the economy and the ruble, thereby accelerating the progression to a freely convertible ruble.<sup>233</sup> Second, it should exempt Russian companies from the mandatory currency conversion requirement when they purchase technology or equipment.<sup>234</sup> Finally, it must exempt from mandatory conversion all foreign currency sales by foreign companies.

#### D. INFRASTRUCTURE

Russia's deteriorating physical infrastructure frustrates potential foreign investors. Transportation services are outdated, and communications systems are both ineffective and expensive.<sup>235</sup> There is also a shortage of housing and office space for foreigners.<sup>236</sup> One solution is to rebuild the failing infrastructure by introducing new technology. Unfortunately, this requires money that the Russian government does not currently possess. One proposal suggests raising revenue through municipal bonds or similar means.<sup>237</sup> An alternative solution is to give Western companies incentives to aid in the development of the infrastructure. These companies can provide the technology and finances to improve transportation, construction, and communications in Russia.

The problems associated with the deteriorating physical infrastructure are compounded by the lack of market infrastructure. Ivan Korolyev, the director of the Institute of World Economics and International Relations, stated that the main obstacle to foreign investment in Russia is not legislative restrictions, but the "actual absence of market infrastructure in Russia."<sup>238</sup>

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233. *Id.*

234. An example of such an exemption was a purchase financed to Lukoil (a Russian privatized integrated oil company) by the Japanese EximBank. *Id.*

235. Dean, *supra* note 18, at 337 (noting that, in 1991, mere installation of a direct-dial long distance telephone line could cost as much as \$20,000).

236. *Id.*

237. Chamber of Commerce memo, *supra* note 22, at 7.

238. Boris Yeltsin: *Russkiy dolgo zapagayem, no bystro yedet* [Boris Yeltsin: *Russian Slow to Harness, But Rides Fast*], ROSSIISKAYA GAZETA 120 (977), June 29, 1994, at 3.

## E. CRIME

Although the fear of crime in Russia is somewhat exaggerated, it is often cited as a disincentive to foreign investment.<sup>239</sup> The fact that crime is often commercially related in Russia adds to this fear.<sup>240</sup> Organized crime controls most of Russia's 2,200 banks and more than half of their capital.<sup>241</sup> Crime is also evident in the privatization of state and municipal property.<sup>242</sup> For example, within the first five months of 1993, approximately 2,590 privatization-related crimes were detected.<sup>243</sup> One of the reasons cited for these startling figures is that the current Criminal Code lacks articles dealing with commercial crimes.<sup>244</sup> Existing laws have failed to alleviate crime in Russia. The enactment of a new criminal code is expected to help solve these problems.<sup>245</sup> Until something is done, however, investors must take measures to reduce the risks. The most common means to reduce the risks of falling prey to Russia's organized crime is to

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239. Thomas Pickering, U.S. Ambassador to Russia, listed three obstacles that need to be eliminated in order to encourage U.S. capital to flow into Russia. These obstacles included high tariffs on U.S. export commodities, the Russian bureaucracy, and crime. Pickering noted that foreigners are often charged for protection, and bribes are often demanded if you want procedures simplified. U.S. Envoy Notes Obstacles to Economic Ties, Sept. 22, 1994, F.B.I.S.-Sov. 94-184. A U.S. cigarette maker's kiosks in St. Petersburg are destroyed with hand grenades. A small rocket destroys a U.S. company's Moscow office. A German company loses 25 luxury automobiles from a 100-car fleet within days of receiving extortion demands. "Thugs beat, kidnap, rape or murder staff of foreign firms. Welcome to doing business in Mother Russia." Jan H. Schut, *Russian Roulette*, INSTITUTIONAL INVESTOR, March 1995, at 26.

240. Chamber of Commerce memo, *supra* note 22, at 2.

241. Schut, *supra* note 239, at 26. A report by the Center of Strategic and International Studies in Washington indicates that Russia has 5,700 criminal groups, of which 200 are sophisticated organizations entrenched in the economic system. *Id.*

242. Valeriy Nikolayev, deputy chief of the Internal Affairs Ministry investigation committee, noted that organized crime is more actively involved than ordinary citizens in the privatization process. Internal Affairs Aide Links Privatization, Crime Surge, June 30, 1993, F.B.I.S.-Sov. 93-124 [hereinafter *Crime Surge*].

243. Mikhail Serdyuk, first deputy chief of the Internal Affairs Ministry Main Administration for Economic Crimes, asserts that these numbers are only a small indication of the larger problem. *Id.* at 238.

244. *Id.* at 238.

245. *Id.* Valeriy Nikolayev, deputy chief of the Internal Affairs Ministry investigation committee, has indicated that immediate action must be taken until the new criminal code is drafted. "Everything in Russia will have been plundered by the time the Supreme Soviet adopts a new Criminal Code and a new Criminal Procedure Code." *Id.*

hire Western security consultants.<sup>246</sup> Risk can be reduced by thoroughly researching prospective business partners and employees.<sup>247</sup>

#### F. CULTURAL BARRIERS TO FOREIGN INVESTMENT

Cultural differences between Russia and most Western nations obstruct foreign investment in Russia. Russian values, traits, and characteristics differ from those in the West.<sup>248</sup> These traits have developed over hundreds of years, and "aren't easily swept aside with a coup, decree, or promise of things to come."<sup>249</sup> Russian officials claim that Western business partners approach a deal with a paternalistic and condescending attitude.<sup>250</sup> The Russian business world is tired of hearing that Russia does not understand the complexity of the economic situation in the West.<sup>251</sup> This external attitude toward Russia can have a drastic effect on the political stability of the country. Reformists in Russia assert that the nationalist and neo-fascist forces thrive on national humiliation.<sup>252</sup> The West must demonstrate to the Russian public that the world needs Russia and

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246. Schut, *supra* note 239, at 26. Johnson & Higgins, a London-based security consulting firm, conducts quarterly brainstorming sessions on crime for clients in Russia. *Id.* These sessions have yielded effective loss prevention techniques. For example, firms plagued by car thefts should install steering-wheel and engine immobilizers, park in garages instead of on the street, and change the make of their cars from imported Mercedes to locally built Ladas. *Id.* A large Asian electronics company reduced theft from its warehouses by simply removing the company's brand name from the building and installing a fence and lights. *Id.*

247. *Id.*

248. Russians are often portrayed by Westerners as pessimistic, yet resilient, somewhat xenophobic, and jealous of good fortune. From a Western viewpoint, some of these characteristics may seem negative. In a survival society such as Russia, however, such characteristics are invaluable and American traits such as optimism are not. H. Michael Mears, *Structural Challenges Facing the Republics*, in LEGAL AND PRACTICAL ASPECTS OF DOING BUSINESS IN THE SOVIET REPUBLICS 17 (1992).

249. *Id.*

250. *Dialog s Zapadom huzhdayetsya b ser'yeznom pereosmycnenii* [*Dialogue With the West Needs Serious Revision*], KOMMERSANT-DAILY 181, Sept. 24, 1994, at 1 [hereinafter *Dialogue With the West*].

251. *Id.*

252. Kozyrev Insists Russia 'Not Sick Man' of Europe, Sept. 28, 1994, F.B.I.S.-Sov. 94-188 [hereinafter *Sick Man Of Europe*]. Foreign Minister Andrey Kozyrev fears that if Russia is not treated as an equal in the world market, the humiliation will fuel nationalism and extremism. "This is why we have to insist that any partnership with Russia be based only on the principle of equality and not on patronization—as if Russia were some historic loser that first has to be taught how to walk." *Id.*

considers it a strong partner.<sup>253</sup> Russia does not want a hand-out in the form of financial assistance; Russia wants the opportunity to provide for itself.<sup>254</sup>

Obviously, cultural barriers are not something that can be dealt with through legislation. The only solution for overcoming this cultural gap is mutual respect. Foreign investors cannot go into Russia and expect the people to change their way of life. The foreign investor must learn about Russian culture and business practices with an open mind. These cultural barriers may only be overcome after years of working together. In this respect, organizations formed to promote investment in Russia may also promote cultural understanding.<sup>255</sup> Training programs provide another valuable and more economically oriented means of overcoming cultural differences. Training provides Russia with knowledge about market economies without the insult of paternalism.<sup>256</sup>

#### G. POLITICAL INSTABILITY

Perhaps the most prevalent barrier to investment in Russia is the political instability of the Russian government. Despite its vast natural resources and an untapped consumer market, Russia is a politically risk-prone country.<sup>257</sup> Notwithstanding Boris Yeltsin's assurances that Russia has achieved political stability,<sup>258</sup> foreign investors will not invest in Russia until they

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253. *Id.*

254. Dialogue with the West, *supra* note 254, at 1. Andrey Kozyrev, the Foreign Minister of Russia, stated: "Instead of giving a needy man a fish each day, he should be taught how to fish. We are thankful for the technical assistance and the experience transferred to us. But it is time the Russian fisherman was allowed to the shores of the world ocean." *Id.*

255. See *supra* part III.

256. Recently 150 government employees of Russia flew to America for three weeks of intensive courses in entrepreneurial schools. These new courses in place of direct financial support will be the main area of support for the market transformation in Russia. Aleksander Platkovskiy, *Nashi Tsiplyata v Amerikanskikh Inkubatorah* [Our Chicks in U.S. Incubators], *IZVESTIYA*, Sept. 17 1994, at 3.

257. Russia is the third-highest risk country for foreign investors, following Iraq and Nigeria. Alexander Shalnev, *Pravitel'stvo Dayot Zelyoniy Svet Inostrannim Investitsiam* [Government Gives "Green Light" to Foreign Investments], *IZVESTIYA*, June 28, 1994, at 1.

258. In an attempt to attract American investors, President Yeltsin made the following assurances: "Yes, you were afraid of political instability, but today, let me assure you, we have achieved political stability." Timothy Egan, *Big Push On Trade; Yeltsin Visits Seattle, a Good Market*, *N.Y. TIMES*, Sept. 30, 1994, at D1.



can rely on a stable presidential government.<sup>259</sup> Given the popularity of the Nationalist party in the last election, foreign investors are concerned that their investments may be swept away with the economic reforms of an extremist party.<sup>260</sup>

Edict No. 1466 provides that new legislation regulating foreign enterprises shall not be applied for three years to enterprises that were in existence on the date the legislation was enacted.<sup>261</sup> This provides a guarantee to the foreign investor that their business will not be harmed by adverse changes in the law, thereby reducing the risk of investment in Russia. This protection is limited, however, to only three years.<sup>262</sup> Furthermore, the present Russian government has not strictly adhered to this edict.<sup>263</sup>

Edict No. 1928 indirectly approaches the obstacle of legislative instability. It provides that the Russian government may contribute a percentage of capital to certain investments in Russia, including foreign investments.<sup>264</sup> Investments taking advantage of this provision are indirectly protected from adverse changes in legislation because the Russian government will generally be reluctant to take action which might adversely diminish its financial return on the investment.

Edict No. 2270 and the U.S.-Russia Treaty also provide protection against adverse changes in legislation. But these protections are extremely limited.<sup>265</sup> The protections only apply to changes in tax legislation and only affect certain enterprises.<sup>266</sup>

259. Alexander Golts, a military observer for KRASNAYA ZVEZDA, noted: "Experience shows that foreign capital is an important lever to cure an ailing economy. But to make it come to Russia, political stability today is not enough. There must be a guaranteed political stability for decades to come. I am not sure that we can give such guarantees today." Alexander Golts, *Vsye dengi b gosti budyet k nam? [All Money Will Flow To Us?]*, KRASNAYA ZVEZDA 148-49 (21435-36), July 2, 1994, at 2.

260. *Id.* at 2. Ultra-nationalist leader Vladimir Zhirinovskiy has spoken out against the economic reforms in Russia: "We must come back to the past, for Russia to be a powerful, independent, cultured and wealthy state. We do not need any market economy for that. All processes in the state, society and economy shall be regulated." Valentin Pavlov, *Zhirinovskiy Demands Halt to Market Economy*, Oct. 7, 1994, F.B.I.S.-Sov. 94-195, at 5. Zhirinovskiy is also confident that his party will win both the presidential and parliamentary elections in 1996. *Id.*

261. Edict No. 1466, *supra* note 75, at cl. 1.

262. *Id.*

263. See *supra* notes 212-16 and accompanying text.

264. See *supra* text accompanying notes 93-99.

265. See *supra* text accompanying notes 201-03.

266. *Id.*

The Russian Foreign Investment Law and the Investment Treaty provide additional guarantees against political instability. Both provide that investments shall not be expropriated or nationalized except for a public purpose.<sup>267</sup> The treaty provides nondiscriminatory treatment toward compensation of losses incurred during war, revolution, a state of emergency, insurrection, and civil disturbance.<sup>268</sup> In the event of nationalization or expropriation, both the Foreign Investment Law and the treaty provide for prompt, adequate and sufficient compensation.<sup>269</sup> Pledges by the Russian government to take responsibility for wrongful takings indirectly insures against political instability. A more direct insurance against political instability is provided by Russian and American agencies that guarantee investments in Russia. OPIC<sup>270</sup> and the State Investment Corporation<sup>271</sup> were both set up to insure foreign investments against political risks.

The fragmentation of the Russian government contributes to its instability. Western companies often cite a lack of coordination between federal and local authorities as an obstacle to investment in Russia.<sup>272</sup> The problem with this lack of coordination is that an investor does not know with whom to negotiate or which level of government has ownership of the property. Many companies have been forced to negotiate with local, regional, and central government officials, as well as individuals.<sup>273</sup> If a key level of government is left out, administrative inquiries may call the legality of the entire venture into question.<sup>274</sup> This uncertainty has forced many American companies to abandon their ventures in Russia.<sup>275</sup>

Presidential Edict No. 1466 partially addresses government fragmentation. It provides that only the federal government can

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267. See *supra* text accompanying notes 25 & 117.

268. See *supra* text accompanying note 121.

269. See *supra* text accompanying notes 26 & 117.

270. See *supra* text accompanying notes 138-40.

271. See *supra* text accompanying notes 133-36.

272. American companies which serve on the Consultative Council on Foreign Investment listed fragmentation of government as an obstacle to investment. Chernomyrdin On Foreign Investment Prospects, July 20, 1994, F.B.I.S.-Sov. 94-139, at 15.

273. Chamber of Commerce memo, *supra* note 22, at 3.

274. *Id.*

275. The Weyerhaeuser Company, the World's largest timber company, put its operation in Russia on hold after facing several problems related to ownership of resources. A Weyerhaeuser spokesman stated: "it's a real tough place to do business. The question is: who owns the resources? Almost every time we go back there, we're dealing with somebody new." Egan, *supra* note 262, at D1.

restrict foreign investments. All other legislation enacted by political subdivisions that restrict foreign investments are invalid.<sup>276</sup> Although this provides certainty as to which government regulation applies when federal and local regulations conflict, it does nothing to solve the questions of ownership and authority in an area devoid of legislation.

Legislative assurances about political and legislative stability in Russia appear to have done little to ease the concerns of foreign investors. The fact that nothing prevents the Russian government from invalidating these assurances is a source of continuing concern. Much beneficial legislation has been issued in the form of presidential edicts.<sup>277</sup> Foreign investors fear that if a presidential edict can grant a guarantee, another can quickly rescind it. One American investor compared the actions of the Russian government to that of "a drunken sailor," who alters taxes, customs and investment rules without consistency or clear instructions to officials, and only furthers corruption and inefficiency.<sup>278</sup>

## V. CONCLUSION

Caution is the watchword for investing in Russia. The unstable Russian economy still lacks the essential institutions and traditions of a developed capitalist society. Among these risks, however, are signs of promise. Progress has been made in accommodating foreign investors by assuring them that government action will not arbitrarily affect their investments. Some progress toward enacting a comprehensive legal structure for regulating commercial transactions is being made. Ambiguities, inconsistencies, and conflicts, however, are still evident.

History demonstrates that Western political and economical ideologies achieve uncertain success in Russia. While one regime accepts the Western ideology, a succeeding regime may transform the country overnight. It is critical, therefore, that foreign investors in Russia exercise caution when undertaking business ventures in reliance on new legislation. A close analysis of most legislation will show that, in practice, it does not provide the extent of protection it purports to provide. The law has only begun to overcome the barriers to foreign investment in Russia. Obstacles remain in privatization, taxation, political in-

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276. See *supra* text accompanying notes 82-83.

277. See *supra* text accompanying notes 72-74.

278. Steven Erlanger, *Russia Lurches Further Along the Capitalist Road*, N.Y. TIMES, July 5, 1994, at A3.

stability, infrastructure, crime and cultural differences. Furthermore, the protections that the law affords can be taken away as easily as they were granted.

There are risks involved in undertaking an investment in Russia. Those foreign companies that take the challenge, however, may reap rich rewards. Such companies must be courageous, patient and well prepared. There will rarely be short term rewards. Thus investors should approach the Russian economy with a long-term strategy that will secure a place in the Russian marketplace of the future.

