



Russia-OECD Accession Discussions: Improving the Russian Business Environment

BIAC Statement to the OECD

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The Business and Industry Advisory Committee (BIAC) to the OECD is the officially recognised voice of business at the OECD. BIAC's members include the industrial and employers' organisations in the OECD Member countries.

Introduction

Russia has been making important achievements on the road to becoming an OECD member, such as the conclusion of its WTO membership negotiations¹ and its recent adherence to the OECD Anti-Bribery Convention. BIAC welcomes this recent progress and recognises that 2012 constitutes a crucial time-window in Russia-OECD discussions, since the majority of OECD committees will carry out their accession reviews. Hence, it seems likely that Russia may become an OECD member in the near future, which would be particularly timely in view of Russia's upcoming G20 presidency.

Russia's OECD membership will help to leverage and promote important reforms to improve the Russian business environment. Specifically, encouraging Russia's adherence to OECD instruments is, in our view, a "win-win" process: we believe that this will yield significant benefits for Russia and for the global economy. Already the accession process is working to encourage Russia to align itself according to the OECD *acquis*, and we would expect that peer review and monitoring should continue during a transition period *after* membership.

The progress being made by Russia to align to the OECD *acquis* is welcomed by the OECD business community, though at the same time it is indispensable to underline the need for effective implementation of reforms. Drawing upon their experience in investing in, trading with, and working in Russia, BIAC members are thus eager to contribute their views and experiences to Russia's OECD accession discussions and post-membership transition. In June 2008, BIAC produced a comprehensive policy paper on "OECD-Russia Accession Negotiations: Improving the Business Environment in Russia", which provided OECD business views across eleven different policy areas relating to Russia's business environment. In addition, BIAC produced papers in 2008 and 2009 detailing specific concerns regarding Russia's intellectual property rights regime. Subsequently, BIAC presented an updated and revised paper in March 2011 on Improving the Business Environment in Russia.

In support of the progress currently being made in Russia-OECD discussions, and recognising the near-completion of many OECD committees' accession reviews, BIAC herewith delivers an updated and focused 2012 paper outlining business perspectives on some of the remaining challenges and possible ways forward. This paper shall focus on:

- Russia's Economy and Business Environment: Overview
- Rule of Law, Public Administration and Anti-Bribery
- Trade and Investment
- Competition and the Role of the State
- Corporate Governance
- Chemicals

These policy areas have been selected for special focus as regards timeliness and relevance for Russia-OECD accession discussions. The limitations of this paper should not infer that those policy issues that are not mentioned in this particular paper are of any less concern to business.

¹ Russia's WTO accession is expected to be ratified by the Russian Parliament during the summer 2012.

Furthermore, while this paper has mainly been prepared by the OECD business community, BIAC is working to build dialogue on the issues raised in this paper with the Russian business community and is particularly grateful to the Russian Union of Industrialists and Entrepreneurs (RSPP) for its contributions to this paper.

Russia's Economy and Business Environment: Overview

Russia has been making significant progress across many aspects of its economy, such that many macroeconomic and social indicators show that Russia “is within the range of OECD countries, not an outlier”². Its economy’s various advantages include little public debt, high labour force participation, and one of the highest proportions of science and engineering graduates in the world. Through various reforms over recent years, Russia has been edging closer towards OECD standards and practices. In terms of its projected growth, the 2011 OECD Economic Outlook suggested that Russia’s growth momentum seems likely to continue, supported by high oil prices, projecting 4.1% real GDP growth in 2012 and 2013.

However, despite its achievements to date, the country is running below its potential and major obstacles to Russia’s economy remain to be overcome. For example, despite a significant increase in foreign investment in 2011, this was offset by net capital outflows which more than doubled from 34 billion USD in 2010 to 82 billion USD in 2011. Even with high commodity prices and low interest rates in many major OECD economies, net inflows to Russia have not resumed, which is in striking contrast to many emerging market economies. The recent return of international investment in Russian equities since the beginning of 2012 remains volatile and does not appear to be due to improvements in Russia’s economy, but instead due to a return of risk appetite in global financial markets³. Overall, the pace of recovery in investment activity in Russia since the 2008-09 global economic crisis would appear to be insufficient.

In BIAC’s view, Russia will only achieve strong, sustainable and inclusive economic growth if it succeeds in addressing several fundamental weaknesses. As emphasised throughout the 2011 BIAC paper on Improving the Russian Business Environment, and reinforced by the 2011 OECD Economic Survey of the Russian Federation, Russia’s business environment is a “glaring and persistent handicap for the Russian economy”⁴. Various improvements have been made over recent years, and we welcome steps to increase business consultation and interaction with the Government in fostering a better entrepreneurial climate, such as the active Russian business involvement in the drafting of the “Strategy-2020” (ordered in 2011 by then-Prime Minister Vladimir Putin). Nevertheless, some basic fundamentals of a business-friendly environment, such as effective rule-of-law, good governance, anti-corruption measures, open markets for trade and investment, and fair competition policy, require substantial progress in Russia (for detailed information see BIAC’s aforementioned 2011 paper).

While Russia faces many challenges in improving its business environment, the country is on track to becoming a member of the world’s leading organisation on the subject – the OECD. BIAC firmly believes that Russia can benefit from the OECD’s knowledge, expertise and

² OECD Economic Survey of the Russian Federation (2011), p11.

³ “Russia: risk-on for foreign investors”, Financial Times, 6 February 2012.

⁴ OECD Economic Survey of the Russian Federation (2011), p13.

technical assistance, thus contributing to Russia's economic growth. Ahead of its accession, BIAC advises that Russia and the OECD should jointly identify and address the remaining major priorities for reform (this BIAC paper highlights some of these in the following pages), and Russia should set in motion any necessary measures to meet these objectives prior to its accession. Russia and the OECD should start discussions on post-accession transition, such that Russia can continue to benefit from the OECD's technical assistance and monitoring in these key reform areas during a defined time period after its membership.

In Focus: Rule of Law, Public Administration and Anti-Bribery

Reforming the public sector in order to strengthen the rule of law, to reduce burdensome bureaucracy, and to tackle corruption more effectively will have positive effects for business confidence in Russia and will encourage domestic and foreign investment. Cutting down on corruption could moreover lead to important savings for the Russian economy.

BIAC welcomes Russia's efforts to tackle corruption, especially Russia's step towards upholding international anti-bribery standards by joining the OECD's Working Group on Bribery and accede to the OECD Anti-Bribery Convention. This is a significant milestone and underlines the political priority that the Russian government has given to its fight against bribery and corruption.

However, more efforts must be taken to ensure that these laws and initiatives are enforced and properly implemented in order to make progress. The detailed OECD reviews of its anti-bribery laws to confirm that Russia meets the Convention's standards and that these laws are effectively implemented will be an important step forward – also with regard to the G20 Action Plan. Efforts by Russian business, such as the RSPP Convention of the Basic Principles of Anti-Corruption Behaviour of RSPP Members, are also important initiatives in fighting corruption.

BIAC encourages greater harmonisation of Russia's laws in line with OECD and other international standards. Foreign investing companies report that the inconsistent application of laws and regulations on a non-transparent basis, as well as the weak enforcement of laws and court decisions, facilitates corruption. Lack of legal transparency and discretionary decision-making by contracting authorities also impedes access to the public procurement market. In addition, BIAC members report that multiple inspections during applications for licenses and permits are often arbitrary, also contributing to corruption. Growing concerns also exist among foreign and Russian companies regarding inadequate competence of auditors during these inspections, despite reports that many Russian companies do not regard the present licensing system as a hurdle to doing business⁵.

Some reported examples are as follows:

- In several cases, obtaining water, wastewater and electricity has been a source of significant delay for foreign investors. Too often the Russian customs do not accept the

⁵ RSPP (2012) Report on Business Environment 2007-2011.

tariff category and the value given in the invoice, which leads to burdensome supply of additional information which causes delay in delivery and extra costs.

- Companies report a significant increase in red tape as a consequence of the 2007 federal excise stamp duty on alcoholic beverages. There is also perceived to be discretionary assignment of licenses for spirits.
- Exporters of fruit are confronted with burdensome bureaucratic procedures with Russian customs authorities who request stricter Maximum Residue Limits (MRLs) of pesticides on vegetable products and higher levels of contaminants in foodstuffs than the level required by EU and international standards. The fact that Russian legislation does not apply MRLs to certain products leads to legal uncertainty and potential abuses by customs authorities.

According to recent survey information⁶, Russian business generally appears to be increasingly positive about the Government's progress in improving the quality of legislation and the judicial system. However, Russian business appears to be particularly concerned about the low level of protection of private property. Furthermore, survey information suggests that most Russian companies perceive that there is virtually no opportunity to defend themselves in court in litigation with regional governments and municipalities.

Foreign investors are meanwhile concerned about outside powers and corruption influencing both the judicial system and law enforcement agencies, meaning that business owners cannot feel safe from possible state expropriation or corporate raiding. BIAC members report that the lack of separation between the judicial and other branches of government leads to blurred lines of authority and opaque decision-making by judges. The end result is a judicial system that is subject to abuse of power by those outside the judiciary.

On the issue of customs regulation for example, changes in customs regulation are carried out without proper public consultation and transition periods. While customs regulation strongly affects business, it is excluded from the scope of preliminary regulatory impact assessment. Customs law enforcement practices often vary from one regional customs to another, while the Federal Customs Service lacks providing proper and transparent rules for customs regulation enforcement.

From the Russian business perspective, it is reported that during the period 2007-09 regional authorities were regarded more as a hindrance than a benefit to the business climate, but then from 2010 onwards the perception changed: efforts made by regional authorities have been positively received by the Russian business community. Nevertheless, BIAC members report that Russia's federal, regional and local laws are often vague, confusing or even contradictory, while government agency requirements and guidelines are unclear and vary by agency, leading to misunderstandings in application and interpretation. Court procedures, even in simple cases, can be very slow and companies are often left uncertain about changes in future legislation or have been misguided on existing legislation. There are major legal obstacles to taking effective criminal or civil action. Among the issues are: a lack of corporate criminal liability, including for

⁶ RSPP (2012) Report on Business Environment 2007-2011.

intellectual property crimes; lack of deterrent penalties, e.g. fines proportionate to corporate revenues; overly burdensome ownership proof requirements for commencing proceedings; a narrow scope of relief regarding injunctions; low levels of criminal penalties and civil damage awards; lack of an appropriate legal regime to combat copyright theft online and lack of corporate transparency.

Specifically, BIAC would like to draw attention to some troubling developments pertaining to the legal scope and treatment of contraband under Russian law. On 17 November 2011, the State Duma of the Russian Federation adopted a new draft Federal law “On introduction of the changes into the Criminal Code of the Russian Federation and certain enactments dd. 08.06.2011”. Business is concerned that the draft law eliminates Article 188 on smuggling in the Russian Criminal Code, which criminalises contraband, i.e. the attempt to import/export goods by concealment or without customs control, and replaces it with a significantly more narrow definition that encompasses only dangerous products or other products under special regulation (for example, poisons, radiant matter, drugs, or firearms). The smuggling of all other goods will be decriminalised and treated as administrative offenses. We fear that this change is inconsistent with efforts to strengthen the rule of law and will undermine the protections in the legal enforcement structure and adversely implicate the environment for the rights of trademark owners. For example, customs officials, whose statistical metrics/objectives are driven by criminal actions, will have less incentive to take effective measures against the smuggling of legally branded products. Moreover, the administrative penalties for smuggling such products will be greatly reduced from jail time to small penalties and confiscations. The Russian government should be urged to either keep Article 188 without any changes, or extend the scope of the new contraband definition to include goods subject to excise tax.

BIAC members are also concerned with attempts to cancel the Principle of National Exhaustion of Exclusive Intellectual Property Rights, as a change from the Principle of National Exhaustion to the International one could lead to significant growth of fake product importation. As a result, there will be a number of negative consequences including higher risks to consumers, deterioration of the business climate and a decrease in Russia’s investment attractiveness. Currently, the most effective method of market protection from fake products is the Principle of National Exhaustion of Exclusive Intellectual Property Rights. It is a barrier to the importation of counterfeit and parallel importation by operators who bear no responsibility for the imported products. This method has proven its effectiveness and has significantly decreased the entry of fake products, which usually imitate most popular and reliable brands registered in Russia. Cancellation of the Principle of National Exhaustion will lead to the inability of control by customs authorities and will provide easy access of fakes to the market, as they usually mimic parallel importation. Above all, cancellation of the national principle will hurt law abiding companies, who invest in market development, consumer research, development of local production and products that are made with the highest quality and the safety of consumers in mind. In case of cancellation of the Principle of National Exhaustion, law abiding companies will be competing with fake product producers, who do not bear all mentioned costs and exploit the positive image developed by others.

In Focus: Trade and Investment

Russia has made, and continues to make, important progress in opening up its economy and building a more secure, predictable environment for business. As the world's 9th-largest economy, with a burgeoning middle class and growing demand for goods and services, Russia is an important market for many OECD countries.

Russia needs foreign capital to boost its economy, particularly in terms of investment in business development (which suffers from under-investment due to the lack of competition), infrastructure, R&D and human capital. Decision-makers in Russia acknowledged that the Russian industry needs a strategic partnership to improve efficiency and to increase investment. FDI will be an essential element in the Russian Government's push for diversification and modernisation of the Russian economy.

Improving the investment policy environment should be a top priority for Russian policy-makers. Russia should thus bring its investment policies fully in line with the standards promoted by the legally-binding OECD investment instruments, as well as the Organisation's Recommendations and Declarations.

For many companies, problems with visa applications have been a major obstacle, despite advances in easing migration procedures for qualified migrants and their families⁷. When there are problems in obtaining a visa, appointments are often difficult to organise at short notice. Reforms to the visa system with improved opportunities for the temporary movement of natural persons into Russia for business purposes and a simplification of the expatriate work permit regime would reduce existing barriers to investment.

Russia's WTO membership is a very tangible sign of how the Government's attitude toward the business environment is changing. Russia's accession to the WTO is an important and necessary step in further opening the country to rules-based trade. Full and rapid implementation of WTO rules and the specific market access commitments must be ensured. Specific attention should be given to the enforcement of intellectual property rights, free trade in agricultural products, automobiles and construction materials, import licenses (especially for products containing encryption technology), improvement of the customs system, value-added tax (VAT) refunds and the dual pricing of energy. On the issue of intellectual property rights, for example, the challenge is not the legislation that entered into force on 1 January 2008, but rather its implementation. Concerning the protection of geographical indicators, business is concerned as Russia does not apply the national treatment principle. In BIAC's view, Russia should be encouraged to adhere fully to the trade-related OECD Recommendations and other OECD instruments.

Selected sector-specific issues:

Raw Materials:

⁷ According to the RSPP (2012) Report on Business Environment 2007-2011, difficulties in obtaining work permits is also reported to be an obstacle for Russian businesses which attempt to attract foreign workers in order to compensate for shortages in highly qualified professionals and specialists.

Since 1999, Russia has applied restrictions on scrap iron exports. As a member of the WTO, however, Russia will now have a transitional period of 5 years to reduce the tariffs applied on scrap iron from 15% (15€/ton) to 5% (5€/ton). Meanwhile, Russian customs authorities have closed the St. Petersburg port to the scrap iron trade and they have diverted exports to a minor port with shallower waters. This has meant that the freight and handling of goods becomes more expensive and the final product cost has risen by 20-30%. Companies report this is a technical barrier to trade.

Air transit:

BIAC sees the need for the Russian Federation to bring itself into conformity with international norms governing the ability of other countries' air carriers to transit its airspace, i.e. to engage in "overflights." The ability of air carriers to transit or "overfly" the airspace of other countries is largely governed by the International Air Services Transit Agreement (IASTA), agreed in Chicago, 7 December 1944 – a multilateral treaty to which 129 states have become parties, and which freely grants overflight rights to the carriers of the other party states.

Most countries that are not parties to IASTA nevertheless also grant such rights to other countries' carriers on the basis of comity and reciprocity. Notably absent from this global regime is the Russian Federation, which has traditionally withheld the right of other countries' carriers to overfly its territory except to the extent specifically provided in bilateral air services agreements, which typically limit the routes that may be flown and number of flights per week that may be operated. Certain routings, including in particular the so-called "Trans Siberian" overflight routes – which are the shortest routes between points in the Far East and Western Europe – have generally been made available only to carriers entering into commercial agreements providing for the payment of substantial monetary "royalties" to the majority State-owned carrier Aeroflot or another Russian carrier. These payments are in addition to the user charges paid to the air traffic control authorities to cover services provided, such as radar, communications, controller staffing, etc., which are generally not in dispute.

The European Union, whose carriers face the biggest financial burden from these practices, has insisted on abandoning the royalty regime applicable to Trans Siberian overflights in connection with Russia's accession to the WTO. In this context, it appears to have been agreed that existing frequencies operated by EU carriers on the Trans Siberian routes will continue to be subject to the payment of royalties through the end of 2014, at which time the requirement to make royalty payments will end. In the meantime, additional or incremental frequencies inaugurated on these routes by EU carriers may be operated without attracting payment of royalties. Eurocontrol is to administer these charges during the phase-out period through the end of 2014.

As Russia proceeds toward membership in the OECD, it is essential that the understandings already reached with the European Union be fully and faithfully implemented, and that opportunities similarly be made available to the carriers of other countries to utilise the Trans Siberian overflight routes subject only to payment of transparent, non-discriminatory, and cost-based user fees, and without the need to enter into commercial agreements with Russian carriers or to otherwise pay "royalties" in order to access these overflight routes.

In Focus: Competition and the Role of the State

BIAC recognises that there have been some positive developments and achievements concerning the competitive environment in the last years worth mentioning, such as: major state-owned companies have been publishing their plans for acquisitions; privatisations of large stakes of state-owned companies are being prepared; the Government promotes the concept of independent directors for boards of state companies; regional investment ombudsmen have been appointed; and as foreign investment ombudsman, First Deputy Prime Minister Igor Shuvalov received 83 complaints, and solutions were found for 62 of them.

However, despite the creation in 2004 of the Federal Antimonopoly Service (FAS), which is now a relatively well-regarded part of the Russian regulatory system, as well as recent improvements in the competition laws, BIAC is concerned by the extent to which serious anti-competitive practices persist in Russia. In fact, so long as all the requisite dimensions of a modern competition policy and the complex infrastructure to support it, such as a properly functioning legal system with respect for the rule of law, rights to property and governance are not introduced, the FAS alone will not be able to create and maintain competitive conditions in Russia and OECD business will continue to find it difficult to develop the potential to compete in Russia.

BIAC remains concerned about the strong role of the State in the Russian economy and serious anti-competitive practices persisting. A relatively small number of large State-controlled companies hold dominant market positions in many sectors, undermining competition (notably affecting the growth of SMEs) and thus leading to problems of economic inefficiency. In addition, the low number of SMEs that can provide high quality services and the presence of subsidies in different sectors can slow down technology transfer and know-how. Reducing the role of the State in the economy and encouraging private sector economic growth is important to boost competition, attract foreign investment, and thus stimulate economic growth.

For example, business is concerned when it comes to freedom to provide services for the staffing industry. The Duma has prepared a bill proposing to ban the activities of temporary work agencies. Such a ban would be contrary to the ILO Convention 181 and the freedom to provide services. It would also be against the WTO principles and the freedom of business.

In Focus: Corporate Governance

BIAC members remain concerned about the quality of corporate governance practices in Russia. Good corporate governance practices, including high levels of transparency, strong and independent boards of directors and respect for minority shareholders are a hallmark of OECD country economies and help ensure long-term stability and promote the legitimacy of economic systems. While Russia adopted a corporate governance code in April 2002, respect for and compliance with the code has at times been lacking, and confidence in the ability of Russian companies' level of governance compliance has been affected as a result.

Despite this, there are a number of developments we have seen over the last several years that, if continued and strengthened, might buttress Russia's commitment to corporate governance further:

- The development of the Independent Director Association providing support and education to Russia's small but growing cadre of independent, non-executive directors, as well as the Investor Protection Association, an independent watchdog established by institutional investors.
- The initiative of President Medvedev to raise Corporate Governance standards at State Owned Enterprises (SOEs), which has led to the appointment of independent directors on a large number of SOE boards of directors.
- The on-going reform of corporate law which seeks, among other things, to address the well-known weaknesses of current regulation, such as a loose definition of affiliated entities. Such weak definitions can allow space for minority shareholder abuses around related-party transactions.
- The passing of the Law on Consolidated Financial Reporting in 2010, which extended IFRS disclosure requirements to all issuers of publicly traded securities.
- The growth of independent blogs, websites and other independent media drawing attention to weaknesses in corporate governance and abuses at specific companies.

In Focus: Chemicals

While the Russian chemical industry accounts for a relatively small part of world production output, it has a dominant role on the world market when it comes to the production for specific chemicals. After a long recession, the industry has been showing positive developments over the last ten years. However, the development is still often hindered by low profitability and lack of investments. It should be underlined of course that Russia is a very important trade partner for many OECD countries for inorganic raw materials and products. Discussions on important regulatory reforms continue, such as in the area of the Technical Regulation of the Customs Union on Chemical Safety.

BIAC believes that Russia will benefit from full participation in the OECD Chemicals Programme when it accedes to the OECD. The OECD environment, health and safety (EHS) programme has made a major contribution to reducing barriers to trade, optimising the use of resources, and saving time and money for governments and industry through co-operative work on chemicals, pesticides and biotechnology. A study carried out in 2010 demonstrated that the OECD EHS programme leads to cost savings of around EUR 153 million per year by seizing opportunities for work sharing and harmonisation in the areas of testing and assessment.

The OECD system of mutual acceptance of data (MAD) in the assessment of chemicals, which consists of several Council instruments, is a cornerstone of the EHS programme. It requires that data generated in a Member country in accordance with OECD Test Guidelines and Principles

of Good Laboratory Practice (GLP) shall be accepted in other Member countries for assessment purposes and other uses relating to the protection of human health and the environment.

BIAC further believes that the specific value added of the EHS programme lies in its concrete cost-saving effects for industry and government by harmonizing testing and assessment approaches and avoiding duplicative data requirements through the MAD system. The work on GLP and harmonized test guidelines is a cornerstone of the OECD work on mutual acceptance of data, enabling common approaches to testing and assessment. It is a prime example of where OECD work adds unique value, saves resources, and helps build capacity. Industry is actively involved in the OECD work on test guidelines. A clear commitment regarding the acceptance of data is an important requirement of any adhering country.

In recent years, the OECD has enlarged its membership and has significantly stepped up its co-operation with key non-member economies. A number of non-member countries participate in the OECD MAD system as provisional adherents or full members. BIAC sees a unique and continuing role for OECD in promoting mutual acceptance of data and international harmonisation. In BIAC's view, the harmonisation of approaches to testing and the expanding number of countries that adhere to MAD remains a key priority.

BIAC therefore believes that it is important that Russia accepts the validity of data generated by another country in accordance with the OECD principles and guidelines when acceding to the OECD.

Conclusion

Russia's accession process and eventual membership to the OECD offers a valuable opportunity to undertake reforms, with the support of OECD analysis, instruments and recommendations, in order to create stronger and more sustainable economic growth.

This paper, based on first-hand experiences from foreign companies operating in or trading with Russia, and drawing upon information received from RSPP, has presented several important areas for policy reforms that should be addressed during Russia's accession process. While this paper has provided business perspectives and experiences in Russia, as well as BIAC's suggested recommendations, this paper has also underlined the progress being made and the advantages to be reaped by Russia once it implements these much-needed policy reforms.

BIAC encourages the OECD to consider the perspectives expressed in this paper in its accession discussions with Russia. The OECD business community stands ready and willing to provide detailed and constructive input and support as Russia's membership discussions continue.