



OECD-Russia 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.

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Introduction

1. BIAC firmly supports OECD enlargement and enhanced engagement with OECD non-member economies. We feel that these processes support the OECD in building global co-operation for policy formation. Having provided active input to OECD accession discussions with Chile, Estonia, Israel and Slovenia, which have all now become full OECD members, BIAC continues to welcome opportunities to provide private sector views and guidance to OECD-Russia accession discussions.
2. Encouraging Russia's adherence to OECD legal instruments and norms is, in our view, a "win-win" process: we believe that this will yield significant benefits for Russia and for the global economy. Drawing upon their experience in investing in, trading with, and working in Russia, BIAC members are eager to contribute their views to contribute to this overall OECD-Russia accession process.
3. Thus, 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 as further input to the OECD-Russia accession process. BIAC engaged in discussions on these issues with OECD Ambassadors and senior Secretariat representatives.
4. Following these previous activities, BIAC herein presents an updated and revised paper on Improving the Business Environment in Russia. As Russia is making significant progress in its accession to the WTO, we expect that its progress in its accession to the OECD should accelerate over the coming several months. BIAC therefore considers it particularly timely to communicate business views to OECD-Russia discussions at this time, and we look forward to providing continued input throughout the accession process.
5. This 2011 version focuses on the following priority areas currently of major concern to the OECD business community:
 - rule of law, public administration and anti-bribery;
 - competition and the role of the state;
 - investment;
 - trade;
 - taxation; and
 - intellectual property rights.

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6. These policy areas have been selected for special focus in the interests of timeliness and relevance for OECD-Russia accession discussions. The limitations of the scope of this paper should not infer that those policy issues that have not been mentioned in this particular paper are of any less concern to business. Further BIAC papers on specific policy issues may be produced later during 2011 and 2012, depending on advances in the OECD-Russia accession discussions and developments in the Russian business environment.
 7. Furthermore, while this paper has mainly been prepared by the OECD business community (expressing the perspectives and experiences of non-Russian business), BIAC hopes to build dialogue on the issues raised in this paper with the Russian business community.
 8. BIAC's intention is that this paper will assist OECD committees in undertaking their thorough accession reviews of Russia, while at the same time highlighting to Russian government officials the benefits that can be reaped by addressing the policy issues raised.

Russia's Economy and Business Environment: Overview

Impressive growth after 1998 crisis...

9. The medium- to long-term trends in Russia's economy since 1998 until the global economic crisis in 2008-09 witnessed a tremendous increase in Russia's per capita GDP and wages and an impressive cut in unemployment and poverty. During this time, Russia's strong current account surpluses pushed its international reserves up to nearly USD 600 billion, making it the third largest reserves-holder after China and Japan. The decade from 1998 until 2008 also saw the creation of Russia's banking system, an increase in the credit to GDP ratio from 10 to 40%, and the introduction of credit histories, venture capital and other financial instruments.

...but badly hit by the 2008-09 global economic crisis...

10. Russia experienced a 30% drop in goods and services import volumes between 2008 and 2009, a peak in unemployment at 9.4% in February 2009, an 11% fall in output in 2008-09, and a real GDP growth rate of -7.9% in 2009¹. In addition, foreign investors pulled billions of dollars out of Russia during the same period. Net capital inflows to the private sector plummeted from USD 82.4 billion in 2007 to -132.8 billion in 2008 and -52.4 billion in 2009. Meanwhile, fixed capital investment growth fell from 9.8% in 2008 to -17.0% in 2009².
11. With its major international reserves, Russia was better placed than many emerging economies to cope with the impacts of the global economic crisis in 2008-09. The Central Bank of Russia spent one-third of its reserves to slow the devaluation of the rouble³. However, despite this cash injection, Russia was in fact one of the hardest hit countries by the global economic crisis as oil prices dropped dramatically and Russian banks and firms experienced a severe lack of foreign credit.

...which revealed structural weaknesses in Russia's economy.

12. It is certainly true that Russia is showing some signs of a steady, though unspectacular, economic recovery. Growth over the projection horizon of 4-4.5% is expected to reduce the degree of slack in the economy, with the output gap closing in 2012.⁴ The 2010 figure for fixed capital investment growth was much improved at 6%⁵, and state external debt figures are relatively healthy. However, the severe effects of the 2008-09 global economic crisis brought to light many underlying structural weaknesses facing Russia's economy.
13. One of these weaknesses is the fact that Russia is an overly resource-dependent economy, as shown by the dent on Russia's exports during the recession. For example, demand for gas in Europe fell 13% in 2009, and this drop was

¹ OECD Economic Outlook (2010): Russia, p208.

² World Bank in Russia: Russian Economic Report, March 2010, p5 and p11.

³ CIA World Factbook (2010): Russia Country Profile.

⁴ OECD Economic Outlook, volume 2010/2

⁵ Rosstat and Ministry of Economic Development

accompanied by increasing investments in alternative energy sources, such as shale gas and liquified natural gas, causing Russia's traditional natural gas industry to suffer⁶. With a state-owned enterprise such as Gazprom reportedly accounting for 8% of Russia's GDP, the consequences of falling demand for its natural gas and other natural resources signal the importance of diversification for the Russian economy.

14. In addition, the high degree of state ownership in Russia, with state-owned enterprises responsible for around 60% of GDP⁷, has a negative impact on competition, innovation and productivity growth. These three areas are inter-related. For instance, the current shortage of business innovation, also partially induced by weak incentives for private R&D and inadequate protection of intellectual property rights (IPR), has a limiting effect on potential productivity. According to the World Economic Forum "Global Competitiveness Report 2009-10", Russia ranked 51st out of a total of 133 countries in terms of its innovation score, while China and India came in at 26th place and 30th place respectively.
15. Another key business concern centres on the nexus between insufficient rule of law, burdensome administration, and widespread corruption. Russian President, Mr. Dmitry Medvedev, has himself claimed that there exists a "legal nihilism" in Russia where investors do not feel safe that law enforcement agencies will protect them from harm, or that the legal system will not secure justice or redress⁸. In an environment of weak rule of law and inefficient bureaucracy, corrupt practices by public officials continue to pose a serious challenge to entrepreneurship and productivity, by increasing the cost of public transactions, undermining trust in public institutions, and deterring foreign investment and trade.
16. The crisis has also highlighted the extent to which Russia's labour market needs more flexibility. The lack of social protection, which became particularly evident in the crisis, makes it very difficult to change labour legislation. The current laws mean it is hard for a company to lay off an employee, yet an employee can very quickly quit a job to take up other work. There needs to be some rebalancing to make the labour market more efficient.
17. Finally, indicators specific to the Russian private sector relating to business facilitation detail some worrying findings. For instance, according to the World Bank, when it comes to the ease of doing business in the country, Russia is ranked as low as 123rd globally⁹. BIAC hopes that advances in OECD-Russia accession discussions can act as a driver to raise this ranking.

⁶ Clover, C. (1 December, 2010) "Burning need for gas production", *Financial Times*.

⁷ Clover, C. (1 October, 2010) "A search for new sources of growth", *Financial Times*.

⁸ FT.com (24 December 2008) "Laying down the law: Medvedev vows war on Russia's legal nihilism"

⁹ World Bank 2010. *Doing Business 2011: Making a Difference for Entrepreneurs – Russian Federation*, p2.

Structural reforms are necessary for stronger, more sustainable growth.

18. The global economic crisis has accentuated structural weaknesses that continue to negatively impact on the Russian economy and its business environment. Russia's political leaders have indicated their recognition of the problems and have identified areas for reform, though implementing these reforms and ensuring compliance may be particularly challenging.
19. The OECD is a global leader in sharing best practices and providing recommendations to policy-makers on the selection and implementation of medium- to long-term structural policy reforms. Russia's membership to the OECD should therefore yield significant advantages for economic growth in Russia. In the meantime, Russia should make full use of its accession discussions with the OECD to jointly identify and address priorities for reform, which will not only help to accelerate its membership to the OECD, but will also help to set Russia on a path for stronger, more sustainable and more balanced growth. This is a unique opportunity for co-operation that will benefit both Russia and the global economy.
20. In particular, BIAC would like to highlight the following areas for reform as mentioned in the following pages.

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

Current Situation:

21. Russia's political leadership are well aware of its legal problems, with President Dmitry Medvedev using the term "legal nihilism" to describe the current system. Yet there have not been any major indications of substantive progress on this front. Investors are deeply 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. The lack of separation between the judicial and other branches of government also leads to blurred lines of authority and opaque decision-making by judges. This results in a judicial system that is subject to abuse of power by those outside the judiciary.
22. Moreover, 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 businesses 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 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; and lack of corporate transparency.
23. Businesses have also reported legal issues relating to personal liability. According to Russian legislation, it is possible for Russian authorities to make certain personnel working in a company personally liable for unjustified intercompany transactions that, from the authorities view, could be interpreted as fraudulent. The personal liability can in worst cases mean criminal charges against the personnel in question with the possibility of the personnel having to go to prison. In practice, this means that taking a deduction in the local tax return for an "undocumented" (not sufficiently documented) intra group charge could involve the employee "signing off" on behalf of the Russian subsidiary, facing criminal charges and potentially ending up in jail. This specific rule is very different to international standards and greatly complicates doing business in Russia, as a group often experiences difficulties in having certain specific intercompany transactions signed off by the responsible personnel on the side of the Russian subsidiary. It also means that on the flip-side, with the absence of criminal liability for corporate entities under the Russian current Criminal Code, corporate entities cannot be held criminally liable. Regarding cases of IPR infringement for example, it is often very difficult to find a natural person criminally liable for infringement (this requires proof that the person had a direct intent to commit the infringement). This can lead to judgments against only the retail staff found selling pirate products at the time of a seizure or raid, rather than the corporate entity or the corporate owner itself – with the effect that the decision has little deterrence against the retail establishment.

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24. In addition, according to Russian law, it is possible for minority shareholders to disallow certain group projects and/or intercompany transactions as a majority of the minorities have to approve all intercompany transactions. These minority shareholders are potentially also key employees within the company. As such, these key employees of the company may have a personal interest that goes against the interest of the company/group as a whole and as such makes it harder for headquarters to implement group initiatives. These rules also apply even if the parent company owns 89% of the subsidiary.
25. A separate legal issue concerns the difficulty in having foreign court orders and rulings applied in Russia. In order to avoid some of the complexities and complications of the Russian legal system, foreign companies (especially in joint ventures) have recourse to foreign courts. The execution of these court rulings is often difficult. The ruling tends to be analysed and interpreted in the light of Russian law despite the fact that the recourse to a foreign court was meant to avoid exactly that. A foreign court ruling then becomes difficult to apply or applied only partially in Russia.
26. Alongside shortcomings in the legal system, Russia's excessive bureaucracy poses challenges for investors. As an example, Russia ranks 108th out of 183 countries in terms of starting a business, based on indicators of time, cost, procedures and paid-in minimum capital¹⁰. It is also reported that since 2000, the number of Russian bureaucrats has increased by 66%, and the cost of maintaining the bureaucracy has increased from 15% to 20% of GDP¹¹. Yet for all this bureaucracy, many companies still find it difficult to identify who is adopting the decisions that directly affect their business activity. The procedure to realise warehouse receipts, for instance, is so slow that the instrument is almost not used at all in agriculture. In addition, there are a great many different environmental agencies responsible for delivering the different permits that a site needs to be able to operate: they often interpret legislation in different ways, making it hard for companies to comply with such legislation and satisfy different demands.
27. A separate example of bureaucratic inefficiency concerns the authorities' demands on businesses to substantiate and document intra group services and charges. It is currently required that headquarters can prove that the service (e.g. the management fee) has added value to the company, which in certain circumstances can be very difficult to document.
28. With public tenders, some businesses have reported problems in the process of registration and standardisation, which slow down the introduction of new technologies. Another concern is the approach to the liability concept in contracts. Companies have to deal with no limitation of liability and with clauses of indirect or consequential loss or damage. This implies, in some cases, a huge risk difficult to assume by the company. The liability of the contractor should not exceed the contract value.
29. In an environment of weak rule of law and inefficient bureaucracy, corruption among public officials thrives and poses a serious obstacle to entrepreneurship and productivity, undermining investor confidence. According to the 2010 Transparency International Corruption Perception Index, Russia ranks as 154th (with a score of 2.1) out of a total of 178

¹⁰ World Bank and International Finance Corporation (2010) "Doing Business 2011: Russian Federation".

¹¹ Economist (9 December 2010) "Frost at the core".

countries, where 1st equals “most clean” and 178th equals “most corrupt”. Between 20-30% of Russia’s citizens are estimated to have paid a bribe in 2009 to public authorities, while 53% feel that corruption has increased over the past three years, with the police, civil servants and judiciary considered as the most corrupt institutions¹². Given this background, many companies get very concerned when asked to relay sensitive information to the authorities.

30. 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. Businesses also complain that multiple inspections during applications for licenses and permits are often arbitrary, also contributing to corruption. Furthermore, reports suggest that corruption in the judicial system is widespread, with political interference in the selection of judges for individual cases purportedly being the norm, and judges have been reportedly pressured to decide in favour of state institutions¹³.

Recommendations to Policy-Makers:

- i. Create clearer laws and more transparent, independent and respected courts in which companies can place their trust. The judicial system should be improved in order to provide an impartial and reliable forum for settling disputes and enforcing rights on a non-discriminatory basis. Legislation that addresses cases where there is a clear conflict of interest in companies (labour code) and in state authorities (at all levels) is required. The efficiency of investigation and prosecution services should also be strengthened.
- ii. Russia should bring its practice of having a criminal liability for economic issues¹⁴ in line with the internationally accepted practice that those issues are considered to be administrative non-compliance matters which do not provoke criminal prosecution.
- iii. Seek and eliminate contradictory federal and regional legislation. Such contradictions give rise to a fertile environment for venal administrators who exploit the inconsistencies. For example, to address the problems of waste and water treatment, the law on concessions needs to be harmonized at the regional and the federal levels.
- iv. Take clear steps to effectively insulate the judiciary from outside influence, including increasing judges’ pay, rotating judges geographically, requiring judges and their immediate families to disclose income and property, and instituting strong whistleblower protections for employees of the judiciary.
- v. Consult more thoroughly with both domestic and foreign companies on proposed legal and regulatory reforms and give greater information to companies on the status of the progress of these reforms

¹² Transparency International (2010) “Global Corruption Barometer 2010”.

¹³ Business Anti-Corruption Portal (2010), available online at: <http://www.business-anti-corruption.com/country-profiles/europe-central-asia/russia/corruption-levels/judicial-system/>

¹⁴ For example, fining tax returns with misstatements by USD 68K (material misstatement as defined in the penal code).

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- vi. Seek ways to make public administration more efficient and streamlined, while also continuing the Government's efforts in privatising many state-controlled companies and properties.
 - vii. Implement simplified fast procedures for warehouse receipts.
 - viii. Bolster and expand the income-reporting requirements made of public officials and their families. Increase penalties for misrepresenting such income.
 - ix. Reduce the potential for corruption by reducing the need for subjective decision-making by civil servants and simplifying procedures.
 - x. Carry out a full OECD integrity and anti-bribery review as soon as possible to identify possible recommendations for policy actions against corruption by both officials and in the corporate sector, and adhere to the OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions. This process is particularly important in the context of Russia's accession to the OECD and should begin quickly, given the significant time required to carry out these in-depth evaluations.

Benefits for Russia:

- 31. Reforming the public sector in order to strengthen the rule of law, to reduce burdensome bureaucracy, and to tackle corruption will have positive effects for business confidence in Russia and will encourage domestic and foreign investment. Cutting down on corruption could potentially save the Russian economy billions of dollars per year.
- 32. BIAC welcomes Russia's efforts to tackle corruption, including the April 2010 Anti-Corruption Strategy 2010-2011, new laws within the framework of the Concept of Administrative Reform, the five year programme of reform of the civil service (launched in 2009), and possible further amendments to the Criminal Code. BIAC also welcomes the recent submission to the Duma of the draft law on foreign bribery. However, more efforts must now be taken to ensure that these laws and initiatives are enforced and properly implemented in order to make progress.

In Focus: Competition and the Role of the State

Current Situation:

33. 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 and moves by the Government to privatise some state-owned enterprises (SOEs), BIAC is concerned that 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 remain unable to take advantage of the potential to compete in Russia.
34. The OECD business community is concerned about the strong role of the State in the economy. A relatively small number of large State-controlled companies hold dominant market positions in many sectors, undermining competition and thus leading to problems of economic inefficiency. According to OECD 2008 figures, for example, the degree of state control in Russia is estimated as being at least double the average degree of state control in the OECD area as a whole¹⁵. Moreover, the State's involvement in business operations is over twice the average level of involvement in the OECD area, and its use of price controls is over five times the OECD average¹⁶. In addition, the presence of subsidies in different sectors can slow down technology transfer and knowhow.
35. Experience from both Russian and international companies suggest that current law and practice are often abused as tools to exercise unjustified pressure on business. Some foreign companies have even considered Bilateral Investment Treaty arbitration in relation to Russia because they feel application of domestic competition law nullifies their rights for equitable and fair treatment.
36. Russian competition law is also itself fraught with legal shortcomings which only aggravate the situation. For instance, Russian federal law on competition contains a highly questionable formal definition of a "*collective* dominant position" that has no analogue in other known competition jurisdictions and no economic justification. Based on this unfortunate definition, many successful companies in a multitude of markets may easily be found, without any analysis of the specific market conditions, to enjoy a "collective dominant position" and suffer penalties for "abuse" of that position. In reality, such "abuse" may well be rational business behaviour of somewhat larger competitors in a highly competitive market, yet none of which have market power. This formal definition of collective dominant position can therefore be misused to unfairly penalise rational behaviour of truly non-dominant companies.

¹⁵ OECD Economic Survey of the Russian Federation (2009), p128.

¹⁶ Ibid.

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37. In the same vein, Russia maintains public registries of companies holding high market shares, including at the level of regions. Although these registries have been originally intended to make the behaviour of dominant companies more transparent and more accountable, the information in these registries is often entered without sufficient analysis of the product and geographical market definition. Hence, the information on "high" market shares contained in the registries often does not match economic reality, and the registries include names of many truly non-dominant companies. In our view, such registries are very often unhelpful, since they artificially "divide" product and geographical markets and very often provide distorted data on markets and market shares. Yet the public information in these registries is relied upon in merger control and competition investigations, including as evidence for finding a dominant position and for imposition of penalties. All of this leads to highly unfair treatment in Russia of many successful and fairly competing companies.
38. A so called "3d anti-monopoly reform package" that is being discussed now and should soon go to the Parliament (Duma) for adoption is aimed to significantly improve Russian competition law and practice. However, it still leaves many unclear provisions unaffected which will give rise to dangerous discretion. Importantly, the current reform package does not propose to eliminate the above shortcomings concerning the definition of a collective dominant position and the reliance on unhelpful registries of companies with high market shares.
39. In addition, the proposed amendments include new provisions which are equally dangerous for business. By way of example, such provisions include the risk that any new business conditions that companies include in their contracts (and which are not provided under other Russian laws) may be interpreted as "a sign of restricting competition". In addition, there is a new legal risk regarding auction sales in commodity exchanges. If the relevant proposed rules are adopted, a successful company selling its goods at a commodity exchange can easily be penalised for abuse of a collective dominant position by charging "excessive" prices. A large number of cumulative legal conditions make it hardly achievable for any company to establish that its auction sales prices at commodity exchanges are not excessive.
40. While companies have concerns about competition policy, as outlined above, the privatisation process recently initiated by the Russian government is ambitious and welcomed. The State has taken some steps to sell minority shares in public companies to raise funds while retaining control, giving an opportunity for the private sector to share both risks and profits. It is important to ensure that the privatisation process can enhance the management and the corporate governance of these public companies in order for the full potential benefits to be realised.

Recommendations to Policy-Makers:

- i. Maintain and apply competition law in accordance with sound legal and economic analysis, following OECD guidance on cartels and mergers, and taking into account decades of well established practice of the most experienced competition law jurisdictions, including the EU and US.
- ii. Keep separate the roles of the government as an owner and as a regulator of SOEs.
- iii. Make SOEs accountable to all general laws and regulations.
- iv. Ensure that stakeholders and competitors of SOEs have access to efficient redress and a fair ruling when they consider that their rights have been violated.
- v. Ensure that SOEs face competitive conditions regarding access to finance.
- vi. Improve the corporate governance of SOEs, using the OECD Principles as a best practice guide.

Benefits for Russia:

41. The recent moves by the Russian Government to privatise several SOEs are welcome and should increase foreign investment. 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.

In Focus: Investment

Current Situation:

42. Russia's FDI inflows dropped by over 40% in 2009 year-on-year to USD 15.9 billion, well below the pre-crisis levels of USD 60–70 billion¹⁷, and USD 21 billion of capital reportedly flowed out of Russia during the first ten months of 2010¹⁸. While this outflow has mainly occurred due to the global economic recession, it is also apparent that many investors perceive the Russian investment environment as particularly challenging, and this may be resulting in a slower recovery and a longer-term underperformance in terms of FDI inflows to Russia.
43. Investor perceptions link closely to evidence showing Russia's restrictiveness to investment. According to evidence from 2008, barriers to investment (and trade) in Russia were over five times more restrictive than the OECD average¹⁹.
44. Many regions within Russia fail to attract significant funds²⁰. Investors often perceive that they are mistrusted by regional authorities which become overly involved in determining their economic base (e.g. determining salary levels, employment numbers, and so on). Investors also report lack of support or even hostility at the regional level during the implementation of investment strategies. Public administration, explored in greater detail earlier in this paper, can have a huge negative impact on investment – for instance in the construction sector, it can be necessary to obtain over a hundred separate permits. The overall requirements and administrative processes are complicated, often unpredictable, and sometimes can outweigh the benefits of investment. These benefits may already be compromised by some practical regional elements faced by investors, such as remote location, poor infrastructure and logistics, lack of qualified labour, and a lack of high quality subcontractors and service providers.
45. This last point, on subcontractors and suppliers, is especially relevant to Russia. Modern manufacturing companies operating in the country rely on a network of high quality local businesses because of long distances and bureaucratic customs procedures. For some major investments (often related to tax relief), there is a requirement for a big or a steadily growing share of Russian manufacturing. Yet in some manufacturing sectors, such as the car and household machinery industries, there are often a very limited number of price competitive Russian companies that are actually capable of producing the high quality technology, parts and components that can fulfil quality requirements and can deliver on time. Improving the overall business environment for Russian companies would help to reduce these supplier issues, which would encourage further investment from abroad.

¹⁷ Reuters (27 February 2010) "Russia 2009 FDI falls to fourth of pre-crisis level", available online at: <http://in.reuters.com/article/idINIndia-46532320100227>

¹⁸ Economist (9 December, 2010) "The State of Russia: Frost at the core".

¹⁹ OECD (2009) Economic Surveys: Russian Federation, p148.

²⁰ Russian Union of Industrialists and Entrepreneurs (RSPP) and KPMG (2010) "Increasing FDI in the Russian regions". On page 5 of the report, it is mentioned that "FDI into Russia is highly concentrated: on the one hand, Moscow, St. Petersburg, Sakhalin and Arkhangelsk attract significant funds; on the other hand, there are 37 regions that attracted less than 100 USDmn over the last 4 years".

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46. FDI is also affected by Russia's Law on Strategic Industries, which came into force in 2008 and defines 42 sectors in which foreign acquisitions require prior government approval. The law requires that investment deals are to be reviewed by a committee chaired by the Prime Minister if they involve a foreign investor taking a stake in a company operating in one of the strategic sectors of at least 50%. While this law provides a clearer mechanism for foreign involvement in the economy as compared to the previous situation which was largely non-transparent and ad-hoc, the sectoral coverage is too broad and may act to deter much-needed investment²¹. Furthermore, foreign investors are concerned that the evaluation process for government approval is opaque. Greater clarity is required regarding both the standards that are being used to evaluate investment in these 42 sectors, as well as the conditions that need to be met for this investment to be accepted. More transparency would help foreign investors greatly when preparing investment bids.
47. Investors are also cautious about the lack of a competitive environment in Russia (60% of GDP is estimated to be produced by state-controlled companies²²), as well as widespread corruption and an inadequate legal system (discussed in more depth earlier in this paper). They are also very aware that the break-even oil price, at which the state can balance its budget with oil revenues, has climbed to over USD 100 per barrel, compared with USD 20-30 per barrel before 2007²³. This increasing vulnerability of the fiscal budget to the oil price is creating uncertainty about potential tax rises for business.
48. In addition, investors are concerned about the lack of investment protection in Russia. According to the World Bank and International Finance Corporation's "Doing Business 2011" report, Russia ranks 93 out of 183 countries in terms of its regulations for protecting investors, on a par with China and lagging behind Brazil and India. Shareholder rights and fundamental principles of corporate governance are not sufficiently respected in Russia. Poor management leads to reduced productivity and significantly reduces the attractiveness of Russian corporations to investors. Good corporate governance of both state-owned and privately held firms is essential if the government's modernisation goals are to be realised. Cumbersome, redundant and contradictory reporting and registration requirements leave corporations vulnerable to potential manipulation. Foreign investors are also concerned at the quality of corporate governance in Russian firms.
49. Russia is much less attractive to FDI as long as Russia's human capital is in a precarious state. Public health issues, including alcohol and tobacco abuse, have tangible economic dimensions, and currently, companies are almost the only "door" to get a minimum and efficient health insurance that gives access to available health institutions. Regarding education, the quality of Russia's human capital is eroded by widespread corruption. The overall education levels need to be raised, which requires addressing both the quality and quantity of vocational and higher education.

²¹ As the 2009 OECD Economic Survey on Russia highlights, while many OECD countries also have concerns with protecting essential security interests, these interests are typically limited to the "safeguard of the national defence, public order and health". The 42 strategic sectors identified by Russia go beyond this.

²² Clover, C. (1 October, 2010) "A search for new sources of growth", Financial Times.

²³ Belton, C. (2 December, 2010) "Russia investment climate worsening, says banker", Financial Times.

50. As recently summarised by Russian President Dmitry Medvedev, “unfortunately, our nation’s investment climate, to put it lightly, leaves something to be desired; it is bad”²⁴. Russia needs foreign capital to boost its economy, particularly in terms of investment in business development (which suffers from underinvestment due to the lack of competition), infrastructure, R&D and human capital. FDI will need to be an essential element in the Russian Government’s push for diversification and modernisation of the Russian economy.

51. Based on these wide-ranging concerns, improving the investment policy environment should be a top priority for Russian policy-makers.

Recommendations for Policy-Makers:

- i. Develop a predictable and high confidence investment environment as a key objective. Russia should work towards full compliance with the principles of non-discrimination and transparency, open FDI regimes for all sectors, and effective enforcement of property rights.
- ii. Safeguard minority shareholders’ rights by requiring greater transparency and improving corporate governance structures.
- iii. Reduce the quantity and detail of documents required to comply with government-mandated reporting requirements. Similarly, the number of government agencies required to approve and register corporate activity should be reduced.
- iv. Shorten the list of strategic sectors in the 2008 Law on Strategic Industries and develop a more transparent evaluation process for government approval of foreign investment in those remaining affected sectors.
- v. Significantly reduce restrictions to the free movement of labour, both domestic and foreign, so as to alleviate the growing shortage of labour precipitated by demographic factors.
- vi. In light of the above, Russia should bring its investment policies fully into line with the standards promoted by the legally binding OECD investment instruments²⁵, as well as the Organisation’s Recommendations and Declarations²⁶.

²⁴ Speech by President Dmitry Medvedev (28 December 2010) “Meeting on economic issues”, at: <http://eng.kremlin.ru/transcripts/1538>

²⁵ Decisions on the Codes of Liberalisation of Capital Movements and Current Invisible Operations; Decisions related to the Declaration on International Investment and Multinational Enterprises.

²⁶ Declaration on International Investment and Multinational Enterprises; Recommendation on the OECD Benchmark Definition of Foreign Investment; Recommendation on OECD Principles for Private Sector Participation in Infrastructure.

Benefits for Russia:

52. Addressing the above recommendations would represent a significant step forward in improving Russia's policy environment for both foreign and domestic investment. This investment will greatly assist the Russian Government's drive for greater diversification and modernisation of the Russian economy. According to 2008 figures, reduction in the barriers to FDI could result in an average improvement in Russian welfare across regions of 3.7% of GDP²⁷.
53. In this context, BIAC welcomes Russia's recently announced reforms to reduce the restrictions on foreign investment in strategic sectors, as well as abolition of capital gains tax on long-term investments post-2011. BIAC also welcomes actions by the Government to privatise companies across many economic sectors, to help create a more competitive business environment that is attractive for investors. Finally, the positive direction of the WTO accession negotiations, addressed in the trade section of this paper below, should give foreign investors greater confidence.

²⁷ Tarr, D.G. (2008) "Russia" in OECD (2008) *Globalisation and Emerging Economies*, pp251-282.

In Focus: Trade

Current Situation:

54. Russia's economy is highly dependent on exporting many types of natural resources and commodities, meaning that strong trade is essential for continued growth. The economic crisis, however, marked a dramatic reduction in Russian trade, with a year-on-year fall of over 35% in imports and exports in 2009 from 2008²⁸. While the global economic crisis sparked this decline, several unilateral measures adopted by Russia have also harmed trade flows. It is reported that since the G-20 Summit in Toronto, Russia has introduced 85 measures (more than any other country monitored by Global Trade Alert) across 36 sectors which almost certainly discriminate against foreign commercial interests, and which potentially affect over 140 trading partners²⁹. These measures included, for example, increased import tariffs on automobiles, trucks, combine harvesters, soy meal, selected dairy products, and some construction equipment, and many of these supposedly temporary measures have been renewed³⁰.
55. On 1 January 2010, the Russia-Belarus-Kazakhstan Customs Union (CU) came into force. The introduction of a new Common External tariff, which extended most of Russia's temporary 'anti-crisis' tariff increases to Belarus and Kazakhstan, has resulted in a deterioration in the terms of trade for many OECD exporters. Furthermore, the harmonisation of import licensing regimes within the newly-formed CU had a major short-term practical effect on business, as administrative difficulties created by the change meant that many goods were held at the Russian border for a substantial period of time.
56. Regulatory barriers and tariffs in Russia are several times more restrictive than the OECD average³¹. In terms of the business environment for trade, the World Bank and International Finance Corporation's "Doing Business 2011: Russian Federation" ranks Russia as 162nd out of a total of 183 countries in terms of ease for trading across borders³². For example, Russia requires 36 days to import goods compared to only 21 days in China, 17 days in India, and 13 days in Brazil.
57. Specific examples of such barriers include, among others:
- **Import and Activity Licenses:** The Russian Government requires that any product containing encryption technology must be tested and approved by Russia's Federal Security Service before it can be imported to Russia, which can often take six months or more to complete, acts to impede imports. In the case of pesticide licensing, for example, there are frequently changing regulations and

²⁸ European Commission (September 2010), Statistics on Russia, at: <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/russia/>

²⁹ Global Trade Alert (2010) The 8th GTA Report, p176.

³⁰ United States Trade Representative (2010) "National Trade Estimate Report on Foreign Trade Barriers".

³¹ OECD (2009) Economic Surveys: Russian Federation, p148.

³² This is measured by taking into account the number of documents required to export and import, the number of days required to export and import, and the cost per container to export and import.

even when all papers are submitted on time and in full, long delays have been experienced – far beyond the time periods specified in the regulations.

- Customs Issues, Taxes and Tariffs: Customs authorities in Russia continue to assess duties on the royalty amounts for the domestic use of imported audiovisual materials, which represent a form of double taxation, since royalties are also subject to withholding, income value added, and remittance taxes. Industry also reports that Russia does not publish all regulations, judicial decisions and administrative rulings of general application to customs matters. All draft regulations should be published with suitable time available for comment by foreign and domestic Russian companies. In addition, it is reported that customs enforcement varies by region and port of entry, and that frequent changes in regulations are unpredictable. This leads to additional costs and delays at the border. Exporters frequently report being forced to store their materials in distant warehouses, and product samples often struggle to get through customs.
- RoRo Terminals: Exporters to Russia have also mentioned the fact that roll on roll off (RoRo) terminals do not exist in Russian ports, and there does not seem to be any intention to develop such an infrastructure in the near future.
- Consolidation of Customs Checkpoints: Russia continues to consolidate and transfer its inland customs checkpoints to its external borders, mainly towards the Western borders of Russia. Furthermore, a major consolidation is implemented in the Moscow metropolitan area, with plans to significantly reduce the number of customs clearance offices and terminals (from approximately 120 to around 30). The implementation timeframe is by 2014 for road transports, and by 2020 for rail transports. This is already inefficient today, and would act to even further negatively impact overall customs clearance efficiency. This would increase export costs into Russia, and would negatively impact Russian customers for key imports reducing their efficiency and driving up local costs.
- Export Policies: Russia maintains export duties on nearly 450 types of products for both revenue and policy purposes³³. Export duties on crude oil, for example, can reach up to 65% in some cases and are reportedly deliberately intended to redirect crude oil to domestic refineries. Export duties should only equalise prices on the domestic and global markets and should not have a fiscal component. Russia also operates 50% export taxes on copper scrap, which has had the effect of drying out trade flows in this product to the EU while at the same time giving the Russian copper industry exclusive access. Concurrently, copper scrap from the EU can still be freely exported to Russia. These sorts of export restrictions, either in the form of direct export duties or through administrative intricacies, are not conducive to free markets and have inevitable competitiveness impacts. To name just one specific sector where this has been reported as an issue, authorities require special permits and complicated

³³ United States Trade Representative (2010) "National Trade Estimate Report on Foreign Trade Barriers".

bureaucratic processes for the exporting of processed food. Many companies have also faced constant changes in the purchase regulations of export quotas, with in some cases, the amount assigned for export declining and the quota being set to zero.

Furthermore, sudden policy decisions impact heavily on global trade and commodity prices: following the major fire in Russia in 2010, for example, the Russian government decided a temporary ban on cereal production exports that led to a sharp upward adjustment in wheat prices in international markets between July and August 2010.

- Services Barriers: Russia does not allow foreign banks, insurers or reinsurers to establish branches in Russia. The insurance sector is also concerned at the licensing procedures for insurers. Significant discretion is given to the insurance regulator on granting (or not granting) a licence. The process lacks transparency and licences are often refuted on grounds that contradict local laws and regulation. Although the situation is improving, European insurers are also concerned about discrimination against foreign-invested insurers in the area of compulsory insurance and public procurement. Likewise for telecommunications, industry reports a lack of transparency in the licensing process, while the 5-10 year license validity period does not allow companies sufficient time to recoup their investments.
- Local content requirements: These can be unclear and prone to change, which makes it difficult for businesses to ensure compliance. This is in addition to the clear detrimental effect on trade that such requirements have.

58. Trade barriers such as those mentioned above not only negatively impact on trade – they also undermine competition and technology diffusion. In BIAC’s view, Russia’s WTO accession is a critical pre-requisite for OECD accession, and it will serve to enhance the transparency, predictability and security of the Russian trade regime. We welcome the recent progress in Russia’s WTO accession negotiations.

59. Furthermore, some issues that stalled previous accession negotiations do not appear to be as significant in current negotiations. The EU’s decision to end its WTO veto — mainly because of the Russian government’s commitment to phase out export tariffs on timber and rail freight fees — removes a major obstacle to Russia’s accession to top trading nation status. The situation regarding US-Russia bilateral relations also looks more promising: by the end of 2010, Washington and Moscow had reached agreements in principle on issues such as intellectual property rights, government procurement, and transparency in the decision-making process on trade-related issues.

Recommendations for Policy-Makers:

- i. Upon WTO accession, ensure full and rapid implementation of WTO rules and the specific market access commitments according to the schedule agreed with its trading partners. Specific attention should be taken with respect to the enforcement of IPR, free trade in agricultural products, automobiles and construction materials, import licenses (especially of products containing encryption technology), improvement of the customs system, value-added tax (VAT) refunds and the dual pricing of energy.
- ii. Adhere fully to the trade-related OECD Recommendations and other OECD instruments³⁴.
- iii. Phase out discriminatory trade measures introduced during the economic crisis and bind Russian tariffs and export duties for a range of sectors at low levels, comparable to those of other industrialised countries. Russia should also subscribe to a permanent moratorium on imposing custom duties or other border measures on electronic transmissions.
- iv. Commit to a reasonable timetable for phasing out Russia's dual pricing of energy in order to unify Russia's domestic and export energy rates at world market prices.
- v. Improve opportunities for the temporary movement of natural persons into Russia for business purposes and simplify the expatriate work permit regime. Reforms to the visa system would help in this regard.
- vi. Use the International Accounting Standards as the norm for Russian accounting practices.
- vii. Ensure the swift implementation of electronic customs clearance across Russia.
- viii. Undertake regulatory and legislative reforms in the areas of bankruptcy law, credit risk protection, deposit insurance as well as reforms designed to create more uniform banking and insurance supervision.
- ix. Remove the prohibition on the start-up of branches for foreign banks, insurers and reinsurers.
- x. Schedule full market access and national treatment commitments for the sectors that are associated with the infrastructure needed for business-to-consumer e-commerce.
- xi. Further improve the Russian customs systems, including establishing a single-window, fees levied at a reasonable level proportionate to the services undertaken, assessing customs duties for audio-visual works based on the value of the carrier medium, and formally adopting an effective and transparent customs dispute settlement mechanism.

³⁴ Recommendations on Common Approaches to the Environment and Officially Supported Export Credits, the Procedure for Labelling (and Registration of) Pharmaceutical Specialities, Administrative and Technical Regulations which Hamper the Expansion of Trade, as well as the Arrangement on Officially Supported Export Credits and Declaration on Trade Policy.

Benefits for Russia:

59. Embracing open markets and turning away from protectionism will stimulate stronger and more sustainable trade between Russia and its trading partners. It is in this context that BIAC fully supports Russia's expeditious accession to the WTO in 2011, subject to Russia's legislative and regulatory framework being entirely compliant with WTO rules and agreements. We believe that WTO accession would bring major benefits to the Russian economy. Russia's \$1.2 trillion economy makes it the largest outside the WTO. A World Bank commissioned study estimated that entry could increase Russian gross domestic product by as much as 3.3% in the medium term and 11% in the long term³⁵. The positive knock-on effects on foreign investment could be substantial. Furthermore, greater openness (for instance with respect to encryption technology) would facilitate the creation of an innovative and knowledge-based economy required for Russian industry to become more globally competitive.
60. There could also be positive impacts on employment in Russia as a result of reducing trade barriers, as suggested by the joint OECD, ILO, World Bank and WTO report on "Seizing the Benefits of Trade for Employment and Growth", prepared for the G20 Seoul Summit in November 2010. In that report, OECD modelling analysis suggests that if Russia and other G20 countries were to halve their most favoured nation tariffs and non-tariff barriers, in the long-run Russia could expect increases in employment of 1.85% for less-skilled workers and 3.01% for skilled workers, with an increase in real income of 8.22%.

³⁵ Jensen, J., T. Rutherford and D.G. Tarr (2007), 'The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organisation'. *Review of Development Economics*, 11(3): 482-506.

In Focus: Taxation

Current Situation:

61. In recent years, significant efforts have been undertaken in Russia to improve the tax environment, particularly in the areas of tax policy, tax collection and tax administration as well as a reduction in the number of taxes and the tax rates. It is unanimously concurred that the Russian tax system has become more transparent and less anti-business than it used to be. We appreciate the steps that have been taken to curb the burden of tax audits.
62. Nevertheless, like any other emerging economy, much remains to be done to make the Russian tax laws, and especially in their application, compliant with international standards and OECD principles in particular. The main challenges are as follows:

Application of domestic law by tax authorities

63. One of the key concerns of the Russian tax system is arbitrary application of tax legislation by the tax authorities. The changes in the tax law application practices are quite sudden, not always supported by the legislation, which makes the Russian tax system quite unpredictable. It is also reported that extreme actions by the government may result from a lack of communication beyond the control of the company, such as where the company is unable to respond to some important documentation quickly because of a delivery failure. Furthermore, a legitimate business can receive a large tax claim simply because the tax authorities would deem its suppliers to be “bad faith”, hence any deductions and VAT credits (“tax benefits”) taken on these suppliers’ invoices should be disallowed.
64. In addition, the tax authorities have massively abused the local notion of economic justification of a business expense. Similarly to the “ordinary and necessary” expense doctrine existing in most Western tax jurisdictions, the Russian tax law stipulates that an expense is deductible if it is incurred in connection with the activities aimed at deriving income. Based on a ruling from the Higher Arbitration Court of Russia, tax authorities are not allowed to challenge economic justification of costs incurred by the taxpayers unless there is any proven bad faith in their actions. In practice, not all (local) tax authorities adhere to this ruling. The Russian tax authorities at their discretion may claim any expense as being of no economic justification and disallow the tax deductibility of it. Examples vary from denied deduction of gasoline expenses to consulting fees, business mail costs, to license payments for the use of the world-known trademarks.

Form over substance environment

65. Even though the transactions with all the necessary documentation in place are constantly challenged under the substance over form approach, in absence of paperwork the substance of a transaction with good economic reasons may also be successfully challenged by the tax auditors. The authorities require providing numerous documents to substantiate even a basic business transaction not to speak of those that are complex in nature. Several companies have literally had to provide trucks full of documents at the request of the tax authorities. Not only are the documents required in great number; it is also demanded that they comply with the established statutory formats (which often fall short to

properly reflect the transaction) and are in hard copies since electronic format is not really acceptable. This puts a huge compliance pressure on businesses and often limits their ability to substantiate transactions with documentary support acceptable by their own internal standards. This approach is based in the law which considers formal documentation a pre-requisite for deductions, rather than evidence.

Tax dispute resolution

66. Although much has been improved since the middle of the 90s, resolving a tax case with the tax authorities continues to be very problematic. Unless the matter is taken to court, the tax authorities rarely accept a position of a taxpayer irrespective of how technically strong it might be. This largely stems from the fact that the tax bodies find it more reasonable to adhere to their own internal instructions which often contradict the provisions of the tax law rather than the tax legislation itself. Currently in more than 70% of cases the taxpayers have to go to court with the tax disputes being unable to solve them with the tax authorities. For example, it is difficult to get refunds of overpaid tax without going through layers of administration, even for relatively modest amounts.

Tax rulings

67. Unlike many jurisdictions, Russia has no system of advance pricing agreements or private letter rulings obtained by a taxpayer from the tax authorities. A taxpayer may obtain a clarification of a certain technical provision in the tax legislation from the Ministry of Finance, but such a document is not binding (even though the law does provide for the binding effect of the clarifications on the tax authorities, the Ministry of Finance itself denies such effect, and this view is supported by the courts). In reality, such clarifications can only provide indemnity against fines and late payment interest but not the tax itself. It should be noted that a tax ruling can be given on any tax matter whereas advance pricing agreements (which are yet to be introduced) only on transfer pricing related issues.

International tax concepts not recognised

68. Despite some progressive legislative efforts, Russia continues to fail to recognise some tax concepts which are accepted by most tax jurisdictions. Overall, the tax authorities do not differentiate between the business roles of the entities and are not familiar with most of the terms applicable herewith (for example, a group of affiliated entities, an entrepreneur, a commissionaire, a distributor, a service company, a manufacturer, a toller, etc.).

69. The other following concepts are not supported by the Russian tax system:

- Tax consolidation. Entities which are part of the group of companies are treated separately for local tax purposes. The Russian legislation does not permit consolidation of tax reporting of these entities. Consequently, there is no consolidated group taxation, each entity files and pays separately. Income and/or costs transfer between the group entities are not permissible either even if this is done domestically with no cross-border charges. The Ministry of Finance has previously announced its plans to introduce this concept into the law, but the draft has not yet been seen.

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- Cost sharing. Since the local regulations separate local branches from the global group of companies to which they belong, any costs incurred by regional cost centres for the benefit of the branches may not be shared with them, but have to be absorbed at the regional level (unless the taxpayer may demonstrate straight-forward services rendered by the cost centres which is usually not possible). This results in these costs being lost for regional tax purposes because they relate to Russia and should be allocated to and deducted by the Russian branch.
 - Tolling. International toll is barely possible in Russia due to very limited legislative basis, potential risk of double VAT and private equity (PE) risk of a foreign toller should it attempt to toll with a Russia tolling service provider.
 - VAT only registration. Unlike in many Western jurisdictions to obtain a VAT registration, a foreign company has to become the Russian taxpayer obtaining a tax registration for all taxes even in cases where there are no activities on the Russian territory leading to a direct taxation through a PE or any other form. This has been used by the tax authorities as ground to recognise a PE status of a representation and allocate it to sales performed by the headquarters, with no link to the representation whatsoever.

70. In addition to the above mentioned challenges,

- *There is lack of expertise for specific sector tax issues*. For example, while there is a specialist tax district for banks, there is no such specialist tax district for other types of financial services firms, such as broker-dealers and the local tax offices have little or no experience of dealing with financial products. In addition, there is no tax ruling concept in the Russian Tax Code.
- *Documentation requirements to prove an expense from a tax accounting perspective are very burdensome*. For example, a hard copy contract, an invoice and an "act of acceptance" are required to be able to include the expense in the tax books and records (even though no "acts of acceptance" are required under commercial law except for very few cases). This is before you then decide whether the expense is "economically justifiable". This requirement is time and labor intensive for many business operations. Furthermore, it is difficult to get refunds of overpaid tax without going through layers of administration, even for relatively modest amounts. Input VAT suffered by Russian companies rendering service (such as consulting, accounting, engineering, etc.) to foreign companies without any presence in Russia is not refunded but deductible for corporate income tax (CIT) purposes. Hence, rendering services to foreign companies becomes more costly as compared to rendering services to Russian companies.
- *Oil and gas companies operating in Russia have highlighted a number of wide-ranging concerns*. There has been a delay in complex oil and gas industry tax reform, which if implemented effectively should make oil and gas taxation more profits tax based rather than revenue based. Furthermore, lifting existing exemption of infrastructure assets from property tax would affect oil and gas companies directly by an increased property tax burden on, for example, trunk pipelines and main roads, as well as indirectly through the increased tariff on crude oil and gas shipping.

71. In addition to the general comments provided above and recommendations below, BIAC is providing separate specific comments to the OECD transfer pricing accession review.

Recommendations to Policy-Makers:

- i. The key goal of the state tax system should be to create a stable fiscal and legal regime to instill the trust of long-term investors and to improve the investment climate. Consultation with industry and industry associations as well as allowing sufficient transition period (at least two years) before a proposed tax law change takes place should contribute to the stability and predictability of the tax system
- ii. The Ministry of Finance should adopt a policy of providing certainty in advance to tax payers with questions on specific tax issues. Such a mechanism could be a very useful instrument of tax policy in Russia.
- iii. Significantly increase the technical quality of tax laws in order to reduce the grounds for tax controversies based on difference in the interpretation of the law.
- iv. Simplify and streamline the taxation system. Russia should minimise administrative difficulties and simplify tax instruments wherever possible. The current extensive documentary requirements should be alleviated and electronic documents should be allowed to enable companies to automate accounting and tax compliance in any existing IT systems.
- v. Encourage the activities needed for long-term economic viability through incentives (for innovation, technology, etc).
- vi. Create more transparent tax laws, with independent, respected and “specialised” courts for taxation disputes, and counter against arbitrary enforcement actions.
- vii. Accept international practices without the addition of some arbitrary clauses.
- viii. Enforce rights on a non-discriminatory basis. There should be a balance between the tax authorities’ powers and competences and the rights of the taxpayers.
- ix. Develop proper and more transparent communications between tax authorities and companies.
- x. Restructure the taxation of natural resources toward profit-based taxation.

Benefits for Russia:

72. Simplified and streamlined taxation mechanisms that reduce the surfeit of red tape currently in place will lower costs for Russian as well as international companies. This will help the Russian economy to diversify and will free up corporate resources, the benefits of which are especially important for small and medium sized enterprises (a key component of an advanced, modern economy). Modification of the Russian tax code presents an opportunity to bring it into line with international standards, eliminate the current lack of clarity, and eliminate inconsistent interpretations. Reforming the overall tax system, increasing the tax base fairly and consistently, and investing in the activities needed for long term economic viability is a requirement for a strong Russian economy.

In Focus: Intellectual Property Rights

Current Situation:

73. In November 2008 and June 2009³⁶, BIAC already provided detailed information to the OECD about the intellectual property rights (IPR) regime in Russia. We noted that a lack of strong intellectual property provisions and inadequate enforcement of IPR in Russia are major concerns for business and raise questions about Russia's preparedness to meet its WTO TRIPS obligations. It is particularly important that Russia is able to demonstrate progress in this area if it is to realise its full inward investment potential, notably in the hi-tech industries, biopharmaceuticals, agriculture (including agrochemicals) and electronic media sectors, and strengthen innovation throughout the economy.
74. Russia has made some strides in improving its IPR regime in recent years, by improving its judicial system and developing new laws on copyrights, trademarks and patents, though it still has significant outstanding issues to address. Russia needs to update its copyright legal framework to address the massive problem of online piracy. It was due to these shortcomings that Russia remained on the United States' "Priority Watch List" in 2010 of countries showing serious deficiencies in their respect for IPR issues. Russia has been on this Priority Watch List for 13 consecutive years.

Sector focus: copyright

75. Internet piracy continues to be the main barrier for legitimate markets to develop. Russia has an Internet penetration of 32.3% (according to the International Telecommunication Union, there were 45,250,000 Internet users in June 2009 in Russia) and is now the 10th biggest broadband market in the world, just behind Brazil - but with far more mobile subscribers. Regrettably, from a content point of view, this infrastructure primarily serves as a conduit for the distribution of infringing materials rather than as a tool for legitimate e-commerce. This is the result of both enforcement and legal/regulatory inadequacies. The new Civil Code, which came into force in January 2008, fails to meet TRIPS and WIPO Treaties standards in various respects. Among the issues are an overly broad private copying exception that exceeds the boundaries of existing international law; and protection against circumvention of technological measures falling short of WIPO Treaty requirements. In addition, the law is inadequate for addressing Internet piracy as it lacks clear provisions on Internet service provider (ISP) co-operation and third party liability, and therefore fails to provide legal incentives for intermediaries to assist in curbing piracy. High piracy rates and the continued operation of various illegal peer-to-peer services as well as pay-per-download websites are preventing the legitimate online market from taking off.

³⁶ BIAC (November 2008) "Addressing Intellectual Property Rights in the OECD Accession Process: Views from the OECD Business Community" and BIAC (June 2009) "Intellectual Property Rights for Sustainable Economic Growth: An Opportunity for the OECD Accession Process".

Sector focus: agriculture and agrochemicals

76. Sustainable agricultural development relies on state-of-the-art technology that results from innovation and investment. Strong IPR are essential for maintaining the innovation cycle necessary for agricultural development in Russia and the rest of the world. Laws that provide for IPR in Russia must be harmonised with other OECD members; and appropriate enforcement of these laws will in turn support the long-term, global competitiveness of Russia.
77. It is reportedly currently the case that, in the crop protection business in Russia, it is forbidden to sell a generic plant protection product of which the original product is still patent protected, and it is not forbidden for generic producers of plant protection products to run safety and efficacy tests during the patent protection period. In addition, there is currently no legislation in place in Russia which provides for exclusive use periods for the test data that have to be submitted to Russian authorities to receive a marketing authorisation (registration) for agrochemicals (pesticides). The Russian Pesticides Legislation is currently under review, but it appears to foreign companies that the Russian authorities do not intend to incorporate provisions on data protection, despite Russia's WTO commitment to do so.
78. Agrochemical companies expend tremendous effort and resources conducting research to demonstrate the safety and efficacy of their life-saving and life-enhancing inventions. Patent protection, which runs concurrent with the protection of regulatory data, does not protect the effort and investment needed to prove safety and efficacy of these products. Unless the data developed to prove a product's safety and efficacy is effectively protected, companies are unable to recoup the significant investment required to generate the data and the costs of launching a product. As such, it is critical that the Russian government ensures the robust and effective protection of innovators' data.

Sector focus: biopharmaceuticals

79. In the biopharmaceutical sector, data protection is currently not implemented in Russia. To provide meaningful incentives for biopharmaceutical investment in the Russian market, Russia should implement effective and enforceable protection for clinical test data. In September 2010, the Russian Duma passed legislation to implement data protection for a period of 6 years in accordance with commitments made to the United States and European Union for WTO accession. The provision will enter into force upon Russian accession to the WTO. Given any uncertainty as to when Russia may join the WTO, the regulatory data protection law should be implemented at the earliest opportunity.

Recommendations for Policy-Makers:

- i. Improve the overall IPR regime in Russia as part of the Russian Government's "modernisation" programme, recognising the overall benefits of high quality IPR for innovation.
- ii. Undertake effective actions against Internet piracy – including takedowns of pay-per-download websites and actions against cyberlockers, BitTorrent sites, unauthorized music services, and Internet cafes, with criminal actions commenced (and deterrent penalties) against owners and operators of such sites.
- iii. Establish a special IP Unit in Department K, the department with responsibility for combating technological crimes and Internet fraud within the Ministry of the Interior - and confirm the Department's responsibility for copyright infringement cases.
- iv. Amend the Civil Code, Part IV, to:
 - a) fully implement the WIPO digital treaties – the WIPO Copyright Treaty (WCT) and the WIPO Performances and Phonograms Treaty (WPPT);
 - b) provide: (i) incentives for Internet Service Providers (ISPs) to cooperate with rights holders to effectively deal with Internet piracy – in civil and criminal law; (ii) rules that clarify the illegality of providing services that are intended to promote the infringement of copyright and related rights; (iii) injunctive relief and a duty on ISPs to provide information to law enforcement agencies and rights holders; and
 - c) implement notice and takedown procedures for websites hosting illegal material.
- v. Ensure that state approved monopolies for the collective administration of rights operate in a fair and transparent manner and that copyright owners maintain the right to exercise their rights with respect to Internet distribution as they deem appropriate, free from compulsory licensing or other limitations on the free exercise of rights.
- vi. Ensure that confidential business information is protected against unfair commercial use in perpetuity and that enforcement is backed up with significant punishments.
- vii. Put in place appropriate legislation on the protection of regulatory data with appropriate enforcement.
- viii. Effectively enforce Russia's provisions regarding the destruction of confiscated counterfeit goods and provide transparency for IP owners of its treatment of such goods.
- ix. Increase the criminal and administrative liabilities for counterfeiting so as to provide an effective deterrent against infringement.

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- x. Conduct strong national campaigns against infringement in order to inform the public opinion about its dangers for health (regarding the pharmaceutical and agrochemical sectors) and self-security (for the industrial and automotive sector), and about the sanctions against counterfeiters.
 - xi. Increase awareness on the issue that the protection of IPR is required to address R&D market failures and uncompensated benefits and costs generated by the interaction between benefits and skills.

Benefits for Russia:

80. The gains to be reaped by sufficiently addressing IPR issues in the accession process are considerable. A high-quality IPR regime is necessary to generate sustainable long-term economic growth, built on a solid foundation of strong inward investment in innovative, knowledge-intensive, and high value-added industries. Generating such investment is especially important for Russia to diversify its economy. In addition, greater IPR protection would also help to ensure better protection for human health and the environment. By ensuring comprehensive, effective, and reliable protection for IPR in all of their forms, Russia will be better able to attract the foreign and domestic investment needed to innovate, strengthen productive activity, generate new jobs, and achieve sustainable and diversified economic growth. Importantly, greater IPR protection should stimulate entry and expansion by producers of software, chemicals (including pesticides and pharmaceuticals), copyright industries, etc. by recapturing the market shares stolen by the pirates.

CONCLUSION

81. Russia's accession process to the OECD presents Russia with 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.
82. This paper, based on first-hand experiences from foreign companies operating in or trading with Russia, has presented several important areas for policy reforms which should be addressed during Russia's accession process. At the top of the list of priority reform areas, BIAC members have highlighted rule of law, public administration and anti-bribery, which are arguably the most pervasive challenges facing the Russian business environment. Other policy areas where reforms are needed include: competition; investment; trade; taxation; and intellectual property rights.
83. As mentioned earlier, several other policy reform areas have not been included in this paper. For example, health and human capital issues are also an important consideration – as Russia's population has been decreasing over recent years, it is urgent to consider the health of the available working force. Other important policy areas include labour market, environment and energy issues (for example, BIAC members encourage the implementation of the Law on Energy Efficiency). Further BIAC papers on such issues may be considered during the course of 2011-12, depending on the progress of OECD-Russia accession discussions.
84. While this paper has provided a detailed account of foreign investor perspectives and experiences in Russia, as well as BIAC's suggested recommendations, this paper has also pointed to the several advantages to be reaped by Russia once it carries out these much-needed policy reforms.
85. 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.