

FOREIGN INVESTMENTS BETWEEN OFFSHORE FINANCIAL CENTERS AND RUSSIA: INSTITUTIONAL ARBITRAGE OR INSTITUTIONAL ESCAPE?

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This paper focuses on a virtually unexplored empirical phenomenon: round-tripping of Russian capital via offshore financial centers to Russia as foreign investment. We review existing literature on the role of offshore centers in foreign investments to and from emerging economies, and look for explanation of the round-tripping phenomenon from the institutional and transaction cost approaches. We argue that due to their superior knowledge on the institutional context in Russia, round-trip investors would be in a more advantageous position in comparison to genuine foreign investors when exploiting the business opportunities in Russia. At the same time, they would benefit from having access to the same supportive institutions abroad as genuinely foreign investors. Such opportunity to exploit institutional differences is defined as *institutional arbitrage* in the literature. To empirically test this argument we apply data acquired from the Russian statistical authority (Rosstat), which provides information on all fully or partially foreign-owned firms in Russia. We test the potential differences in the investment behavior between round-trip investors of Russian origin and genuine foreign investors in a sample of 3007 firms. Our findings indicate that the round-trip investors would have a better ability to cope with corruption, and lower entry barriers to resource-based industries than genuine foreign investors.

Keywords: Round-trip investment, Russia, institutions

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1. INTRODUCTION

Emerging economies have become increasingly important targets of inward foreign direct investment (FDI) since the early 1990s. A more recent phenomenon is outward FDI made by investors from emerging economies, which started to increase rapidly in the early 2000s and the growth continued to the global financial crisis. Outward FDI flows from emerging economies¹ jumped from 56,136 million dollars in 2003 to 134,591 million dollars in 2004, and the growth continued until 2007 at an average 40% rate annually (WIR, 2010). A major part of these flows originates from the largest emerging economies, before all China and Russia. According to UNCTAD statistics, outward FDI flows from Russia totaled 45,916 million dollars in the last precrisis growth year 2007, making it responsible for a 13% share of all OFDI from emerging economies (WIR, 2010).

The reasons behind such rapid growth include emerging economies' government policies encouraging their firms to "go global", and improved financial situation of these firms. However, outward foreign investment from emerging economies has a number of specific features, due to which the applicability of traditional theories of foreign investment and firm internationalization has been questioned (see, for example Buckley et al., 2007; Boisot & Meyer, 2008). One of the distinctive features of outward foreign investment from emerging economies is the importance of offshore financial centers as investment destinations (Morck et al., 2008; Sutherland et al., 2010; Aykut & Ratha, 2003). In the case of Russia, the outward investment flows in the 1990s were dominated by capital flight instead of real OFDI. Funds were transferred to offshore locations in order to avoid taxes, to disguise funds obtained through murky privatization schemes, or to avoid

¹ Including the categories of developing economies, and South-East Europe and the CIS of UNCTAD classification

appropriation by corrupt officials and hostile takeovers (Settles, 2008). It has been estimated that the value of annual capital flight from Russia in the 1990s would have been 15-20 billion dollars (see e.g. Loungani & Mauro, 2001; Abalkin & Whalley, 1999).

Moreover, a distinctive feature of foreign investment patterns of the Russian Federation is the correlation between inward and outward investment flows between Russia and offshore financial centers. According to Russian statistics, the key offshore destinations of Russian registered capital outflows, Cyprus and British Virgin Islands, are persistently among the major source countries of inward foreign investment into Russia (Rosstat). According to Rosstat the top ten of investor countries to the Russian economy in 2009 included five offshore financial centers² (Luxembourg, the Netherlands, Cyprus, Switzerland, and the British Virgin Islands). Their combined share of all inward foreign investment to Russia in 2009 was 45%, and of inward FDI 63%. At the same time, these countries were among the top ten destinations of outward foreign investment from Russia in 2009 with a 64% share of all outward foreign investment, and with 81% share of OFDI (Rosstat).

These figures can be viewed as evidence for the "round tripping" phenomenon, i.e. the transfer of funds abroad in order to bring some or all of the investment back as FDI and claim tax and other benefits offered to foreign investors (Kalotay, 2005). Moreover, part of investment flows between Russia and financial centers, such as the Netherlands or Luxembourg, can partly be viewed as "institutional escape" by large Russian corporations. Particularly in the 1990s large Russian privately-owned corporations sought for "safety nests" from abroad to protect themselves from domestic uncertainty (Kalotay & Sulstarova, 2010). In other words, firms establish subsidiaries in such locations in order to enjoy more favorable institutional environment such as better functioning financial markets (Witt and Lewin, 2007). Financial transactions, including investment in Russian

² According to the IMF definition from June 23, 2000

assets, are then executed from the foreign subsidiary and therefore registered as FDI³. In sum, a large share of investment flows from and to Russia cannot be classified as real foreign investment but rather as asset round tripping by Russian investors for different reasons.

The role of tax havens and offshore financial centers in the foreign investment behavior of firms from emerging economies has started to receive academic attention only recently. Theoretically-driven existing research has, however, empirically drawn almost exclusively from the Chinese context (see e.g. Sutherland et al., 2010; Morck et al., 2008; Boisot & Meyer, 2008). Here, the main emphasis has been on the drivers of Chinese OFDI to tax havens and offshore financial centers, and its implications to internationalization and FDI theory. Moreover, contributions focusing on Russia are mainly empirical and limited to the assessment of the magnitude and determinants of capital flight from Russia (Abalkin & Whalley, 1999; Loungani & Mauro, 2001; Mulion, 2002; Buiter & Szegvari, 2002). Hence, the other side of the round-tripping phenomenon, reinvestment of such capital back to Russia, remains practically unexplored. This paper aims at contributing to filling this gap by comparing the strategies of round-trip investors with those of genuine foreign investors.

The paper is structured as follows. In section 2 we discuss the patterns of capital flight and foreign investment from Russia to offshore countries, and inward investment to Russia from these countries. Section 3 reviews existing theoretical literature relevant to the round-trip investment phenomenon, and section 4 outlines the research hypotheses of the paper. Section 5 describes the data and section 6 presents the results. Finally, section 7 concludes and outlines policy implications of the main results.

³To diminish such misclassification errors, FDI statistics in some countries such as the US makes a distinction between the source country (the residence of the firm making an investment) and the original source of funds (the residence of the owners of a firm) (Aykut & Ratha, 2003). Rosstat does not, however, make such distinction.

2. CAPITAL FLOWS BETWEEN OFCs AND RUSSIA

2.1. Capital flight from Russia to OFCs

Capital flight⁴ from Russia was especially massive during the 1990s. According to Kramer (2000) "estimates by the US Treasury Department, the International Monetary Fund, and other sources suggest that a net of well over \$100 billion has left Russia - legally or illegally - over the past decade. Some estimates reach as high as \$200 billion". In accordance to Abalkin & Whalley (1999) estimates, annual capital flight from Russia was \$17 billion in the period of 1994-1997 and Russian citizens have accumulated about \$125-140 billion abroad between 1 January, 1992, and 30 September, 1997.

Russian experts point out that the main flow of capital from Russia has been channeled through the so-called offshore companies and accounts (Iwanow, 1997:19; Sinuraya, 2007). Sinuraya (2007) notes that "in reality, practically all of the investment-related assets from Russia that are located abroad can have some connections to the offshore zones which serve as the gateways to wider international markets." Cyprus is the most popular destination of Russian capital flight. In accordance to Sinuraya (2007) there are about 4000 Russian companies registered in Cyprus.

Russian businessmen argue that Russian capital flight is mainly "grey" capital, i.e. these are not criminal money as, for example, is common for capital flight from countries of Latin America. According to estimates of Aleksander Lebedev (president of National Reserve Bank), the share of criminal money in capital flight does not exceed 5-15%. Pavel Gennel, the general director of the

⁴ Recent economic literature is not always clear how to define capital flight and how to distinguish it from ordinary outward investment. Loungani & Mauro (2001) define capital flight as "all outflows that occur in excess of those that would normally be expected as part of an international portfolio diversification strategy". This definition includes outflows of incomes earned through criminal activities; outflows earned through honest activities but which breach capital controls and fully legal outflows motivated by a desire to flee the country due to, for example, political uncertainty in the country. Abalkin & Whalley (1999) define capital flight as "transfers of assets denominated in a national currency into assets denominated in a foreign currency, either at home or abroad, in ways which are not part of normal commercial transactions".

"Capital Financial Corporation", in his interview to radio "Finam FM" (16 February, 2009) argue that "the share of corruption money in capital outflow is very small".⁵

However, most likely money laundering of criminal money (including corruption money) plays a significant role in capital flight from Russia though it is hard to identify. According to Simpson (2005) and Perez et al. (2011) between 7 and 16 billion US dollars of Russian capital flight was allegedly laundered through the Bank of New York between 1996 and 1999. Much of this money was allegedly the proceeds of criminal activity in Russia, and some of it was said to be looted IMF loans to that country. In this context Shelley (2003) also argues that Russia's billions earned through corruption have been laundered in many countries including offshore locations. She further argues that the true extent of Russian organized crime's capital resources will never be known "because much of it is parked in anonymous bank accounts and carefully masked trusts in offshore locations." As common locales of Russian money laundering Shelley (2003) names the Caribbean, Cyprus, Switzerland, Liechtenstein, Austria, Marshall Islands and Nauru Island in the South Pacific.

2.2. Round-trip investment hypothesis in Russia: opinions and facts

Though it is not straightforward to formally identify the phenomenon of round-trip investment between OFCs and Russia, this is a hot topic for discussion in Russia. "If to look at foreign investors, registered at Russian stock exchange markets, it can be seen that most of open accounts belong to Cyprus, Netherlands and Luxemburg" – says vice-president of St. Petersburg Commodity Exchange, Michail Temnichenko. "I think that investors from these three countries represent investment of Russian businessmen, who have accounts in the mentioned countries, far too specific

⁵ http://finam.fm/archive-view/741/

is the list of countries – main investors into Russia" – thinks Lyudmila Lebedeva, the president of the First Republic Bank. "These three countries are traditional offshores of Russian business, and we cannot exclude that Russian parent companies just reinvest into Russia their capital from foreign accounts", - agrees analyst of "Alfa-Capital" Dmitriy Chernyadiev.⁶

"Most of Cyprus' Russia-bound investments are nothing other than Russian oligarchs' capital that was shipped overseas during the turbulent period of the '90s," said a Moscow-based bank analyst who requested anonymity. "It's more than clear to everyone with a basic knowledge of capital movements and investment trends in the global economy that this is all Russian money that has been laundered in Cyprus-based financial institutions," he added. "Evidence of this is that Cyprus' investments into other emerging economies are not as large as those pouring into Russia."⁷

Alexei Moiseev, the director of the department of macroeconomic analysis of "VTB Capital"⁸ suggests that "Russian businessmen first take out money from Russia, and then return them back in the form of foreign investment, as they find Russian business projects attractive but are afraid for security of investment".⁹ Similarly Pavel Gennel, the general director of the "Capital Financial Corporation", in his interview to radio "Finam FM" (16 February, 2009)¹⁰ argue that many Russian businessmen establish offshore company to hide their identity as owners. This offshore company establishes a company in Russia and becomes its 100% or 50% stock-holder. Hence, dividends are distributed into this "offshore low-tax jurisdiction". Hence, a stock-holder can spend money as he/she likes and Russian authorities do not know his/her exact identity. In fact this is a sort of secret mean of ownership. An owner, as an individual person can be hidden under legal

⁶ Interview for BMF.ru, available in Russian at: <u>http://lovecyprus.org.ru/news/kipr_glavnyj_investor_rossii/2010-08-21-235</u>

⁷ There is no official statistics on how much of the investments from Cyprus come from Russian-owned companies. Until recently Cypriot laws protected the identity of shareholders if they so desired. Most experts, however, agree that at least 75 per cent of these direct investments are controlled by Russian individuals or corporations (Kenneth, 2003).

⁸ <u>http://vtbcapital.com/index.php</u>

http://www.banki.ru/news/bankpress/?id=3115440

¹⁰ <u>http://finam.fm/archive-view/741/</u>

body. For a Russian owner this means that his/her income cannot be easily expropriated by Russian authorities. Tax saving is not very important in this case.

Different schemes of hiding profits from taxes via establishing companies in offshore jurisdictions which utilize Russian businessmen¹¹ give further support for round-trip hypothesis. For example, offshore companies are used for so called "imaginary deals" in export operations, i.e. export via offshore company when the major part of export profits remains in the offshore jurisdiction. First, a Russian exporter sells the goods at underestimated price to an offshore country (which in fact belongs to this exporter). And next, offshore company sells the goods at market price to the final buyer. Hence, major part of profits is not a subject to tax on profit in Russia. These profits, however, are often reinvested back into Russia. Offshore ownership of Russian real estate is another quite popular reinvestment scheme via offshore jurisdictions. Ownership of Russian real estate via offshore company gives its owner tax advantages in the home country. The real estate is also more protected from the nationalization by Russian authorities. Finally, it is easier to make any operations with the real estate formally owned by an offshore company (buying, selling, renting, etc.).

Official statistics on foreign investment out and into Russia also support the round-trip investment hypothesis. On figures 1 and 2 we present official Rosstat (Russian State Statistical Agency) statistics on geographical structure of cumulative inward and outward foreign investment of Russia in the period of 1999-2008.¹²

¹¹ Hiding profits in offshore countries is quite an international problem. E.g., many of the largest corporations in the USA hide profits made in the USA in offshore shell companies and sham headquarters in order to avoid paying billions in federal taxes (Tichon, 2009). ¹² Russian statistics on foreign investment flows by country is not publicly available before the year of 1999.

Figures 1 and 2



Source: Rosstat; authors' calculations

As can be seen, Cyprus and BVI – both well-known OFCs – are among main investing countries into Russia as well as among main destinations of Russian outward investment. The other OFC, the Netherlands is also a popular location among Russian natural resource companies to set up their financial subsidiaries and, at the same time, is one of the most important source countries of foreign investment into Russia. Moreover, one needs to keep in mind that part of investment directed to two non-offshore countries – both important recipients of Russian capital and key source countries of investment into Russia, the US and the UK, can be targeted to offshore locations in these countries (certain states in the US, and London in the UK). This further strengthens the hypothesis of round-tripping investment between OFCs and Russia.

On figure 3 we present the amounts of foreign investment between Russia and most popular offshore locations with Russian capital - Cyprus and BVI.

Figure 3 Cyprus and BVI: Outward and inward cumulative foreign investment in 1999-2008, millions US dollars



Source: Rosstat; authors' calculations

We can see that Cyprus invested into Russia about 1,5 times more than Russia invested into Cyprus. However, one should keep in mind that this statistics does not include illegal capital flight and, hence, total outward capital from Russia into Cyprus might be considerably underestimated. In accordance to these data, BVI is considerably less important investment partner of Russia, though the round-tripping hypothesis seems to be relevant for this offshore country as well.

And finally, the round-trip hypothesis is supported by type and industrial structures of outward and inward foreign investment in Russia. According to official Rosstat data, in the period of 2000-2008 "other investment" strongly dominated both in outward and inward foreign investment (80-97% in OFI and 58-77% in IFI). In outward foreign investment this category is mainly represented by trade credits and bank deposits, in inward – by trade and other credits. Trade

credits, being major form of both inward and outward foreign investment in Russia, play important role in export-import operations of Russian businesses via offshore companies.

In industrial structure of OFI in the same period financial operations and manufacturing sector strongly prevailed (altogether around 80%, in average with a slightly higher share of financial operations relative to manufacturing) except the year of 2007 when trade accumulated 52%, manufacturing sector – 35% and financial operations – 2,4 % (in the previous years of the considered period the share of financial operations has not been lower than 30%). The industrial structure of inward foreign investment is strongly dominated by three sectors: trade, manufacturing and extraction of resources. As argued in Perez et al. (2011) firms engaged in international trade and financing are attractive vehicles for laundering money. For this purposes over- and under-invoicing or means of fictional transactions in services, loans, capital transfers, royalties and intra-company payments can be used. And this is thought to be a major mechanism for illegal capital flight and money laundering (ibid). For example, de Boyrie et al. (2005) estimated that over- and under-invoicing in US-Russian trade accounted for the movement of 1,01-4,85 billion US dollars per year between the two countries in the 1990s.

3. ROUND-TRIP INVESTMENT: THEORY AND LITERATURE REVIEW

3.1. Institutions and round-trip investment

In order to grasp theoretical grounds of the phenomenon of round-trip investment, we need to examine both directions of capital flows: the outward investment from the home country to the foreign country, and the re-investment back to the home country. The emerging literature addressing the role of tax havens and offshore financial centers in foreign investment patterns of emerging economies has mainly focused on the first question, i.e. searching for explanations for the popularity of such locations as OFDI targets for firms from emerging economies (see e.g. Sutherland et al., 2010). The drivers for such behavior identified include purely financial ones, such as tax evasion and the possibility to get access to financial incentives allotted to foreign investors when re-investing the capital back home (Boisot & Meyer, 2008). Such reasons are relatively evident in the case of China, where the government policy towards inward FDI entailed privileged treatment to foreign-owned firms over domestic ones (Sutherland et al., 2010).

In the case of Russia, in contrast, the state policy towards inward FDI has been less supportive and even restrictive. Moreover, in many Russian regions¹³ the regional authorities have rather erected barriers to foreign investors to protect incumbent firms from outside competition than provided incentives for foreign investors (Yakovlev, 2006). Therefore, the financial incentives for transferring capital abroad, such as the possibility to avoid home country taxes, are probably valid for Russia as well. In contrast, we maintain that the financial incentives granted to foreign investors are hardly a key explanatory factor for round-tripping behavior. Instead, we propose that capital flight, particularly in the purpose of its re-investment to Russia, is largely motivated by institutional factors.

¹³ Russia is administratively divided into 83 (formerly 89) subjects of federation, often called as regions.

The question of home country institutions' influence to OFDI is not new (Buckley et al., 2007), and it has started to receive research attention in the context of emerging economies as well. In the literature there are two views of how the institutional environment in emerging economies influences OFDI: one involves institutional constraints such as limited property rights protection, weak judiciary and legal systems, and unexpected changes in regulatory policies as prompting firms to avoid them by investing abroad. The other stresses institutional support, such as favorable evolving government policies, as encouraging local firms to expand (Luo et al, 2010). Buckley et al. (2007) proposed that in the case of China, government support in the form of privileged access to raw materials and financing, would be a driver for outward investment. Moreover, Luo et al. (2010) suggest that OFDI promotion policies set by emerging market governments would be institutionally complementary to offsetting competitive disadvantages of emerging market enterprises in global competition. Such disadvantages include, for example less advanced technologies and less sophisticated managerial capabilities due to the short history in operating in market economy conditions. In contrast to China, where the government launched its "go global" policy already in 1999 (Buckley et al., 2007), the Russian government has been less active in this front. The endorsement for Russian companies to go abroad was made only during the 2006 presidential election by the president-elect Dmitry Medvedev, who encouraged Russian firms to acquire the needed technology and resources in the global market (Settles, 2008).

However, a number of other researchers suggest that rather than supportive home country institutions, it would be institutional imperfections that prompt firms to escape home country institutional constraints through OFDI (Witt & Lewin, 2007). It has been shown that firms may relocate their domicile to avoid high home country taxes (Gordon & Hines, 2002; Vernon, 1998) or other burdensome regulation (Schoppa, 2006). Moreover, capital flight from developing countries has been identified as driven by political instability, economic risk, and policy uncertainty (Le &

Zak, 2006). The construct of institutional misalignment was proposed by Witt & Lewin (2007: 581) to conceptualize the gap between the firm's needs and the institutional environment, which leads to higher costs of doing business. OFDI would represent an escape response to such misalignment (Witt & Lewin, 2007). In the case of emerging economies, such components of poor institutional environment as rampant corruption, regulatory uncertainty, underdeveloped intellectual property rights protection, and governmental interference (Witt & Lewin, 2007; Yamakawa et al., 2008; Luo et al., 2010), are commonplace. OFDI to a location with more supportive institutions would provide means to escape these institutional constraints. Hence, some emerging economy companies would intent to develop an international presence immediately to safe guard against risks incurring from the domestic business environment (Settles, 2008).

According to Loungani and Mauro (2001) the root causes of capital flight from Russia in the 1990s consist of an unsettled political environment, macroeconomic instability, a confiscatory tax system, an insolvent banking system, and weak protection of property rights. Academician Leonid Abalkin emphasized that the main factor of the capital flight from Russia is "chronic multidimensional crisis of society, economy and state" (Glinkina, 2002). Russian businessmen excuse illegal export of capital by the following logic: "State created the rules of the game, which cannot be followed. Even if it is possible, these rules are not accepted by business society and no one follow them. The business society created another system of rules, which are recognized but not legalized. Common law is very different from written law". Interviews with many Russian entrepreneurs confirm the fact that at least partly capital outflow in 90s was a trial to escape country risks, the indicator of rational behaviour of new owners (ibid).

The discussion above sheds light on the question why Russian firms invest in offshore financial centers. However, one question remains open: Why do these firms re-invest the capital back to Russia with its unsupportive institutional environment instead of using the financial offshore center as a springboard to other foreign markets? We argue that this is due to their ability to exploit the institutional differences between the foreign location as the new home country, and Russia as the host country. These differences put them into superior competitive position vis-à-vis other foreign firms investing to Russia on the one hand, and in comparison to incumbent Russian firms, which operate on a domestic basis. We maintain that our argument finds theoretical support from both mainstream perspectives of international business strategies, the transaction cost (TC) perspective and the resource-based view, when combined with the institutional considerations. Such integrative approach has proved as particularly promising in the context of emerging economies (see, e.g. Meyer et al., 2009; Karhunen & Ledyaeva, mimeo). Instead of searching for explanations for firm behavior from the institutional theory only, institutions are increasingly viewed as moderators for transaction cost or resource-based explanations (Karhunen & Ledyaeva, mimeo).

It has been shown that weak institutions and the associated heightened uncertainty increase transaction costs for firms operating in an emerging economy context (Meyer, 2001). Such costs incur from problems of bounded rationality and the opportunistic behavior that companies face, which are likely increase when crossing national borders (Boisot & Meyer, 2008). Hence, foreign companies are subject to higher transaction costs in comparison to domestic firms. However, the transaction costs are likely to decrease as the foreign firm accumulates experience on operating on the host market (Boisot & Meyer, 2008). Hence, we argue that due to their initial knowledge and experience on the Russian institutional context for business, round-trip investors face lower transaction costs in comparison to other foreign firms when investing to Russia, and hence a superior competitive position. This would be a strong motivation to re-invest back to Russia instead of expanding to other foreign markets.

Furthermore, the role of local experience and knowledge is again central when addressing the same question from the resource-based perspective. It has been shown that in emerging economies, intangible assets such as relationship-based networks and knowledge of local business practices are a key resource. Foreign firms investing to emerging economies are facing a liability of being foreign (Zaheer, 1995) due to the lack of such resources, and often need to acquire them by entering a partnership with a local company. On the other hand, they are in a superior competitive position in comparison to incumbent firms due to their superior organizational capabilities, and the favorable institutions in the home country. This in part compensates the higher monitoring and control costs incurring from the partnership. Again, we propose that round-trip investors would be in a superior position against both other foreign investors and incumbent firms. They do not face such liability of being foreign due to their local networks and knowledge. At the same time their access to resources such as foreign banking and financial expertise (Sutherland et al., 2010) and managerial know-how through the offshore investment puts them in a superior position towards purely domestic firms.

A recent theoretical construct, capturing the situation described above, is that of *institutional arbitrage* (Gaur & Lu, 2007; Boisot & Meyer, 2008), which refers to the situation where a firm is provided opportunities to exploit differences between two institutional environments. Gaur & Lu (2007: 88) argue that a firm is most familiar with its domestic institutional environment, although it would be the most favorable one for its business activities. The unfavorable home country institutions may prompt the firm to search for a more favorable institutional environment in a different country through OFDI. Boisot & Meyer (2008) call such behavior *strategic exit* from the domestic market, and argue that it may explain the internationalization of many Chinese firms better than the conventional view of the pursuit of an entry strategy to foreign markets. Through the access to more efficient institutions of the foreign location, the emerging economy firms going abroad neutralize the localization advantages of foreign firms in their home market (Boisot & Meyer, 2008). Round tripping provides one example of an institutional arbitrage operation (Huang,

2003). Moving abroad first may increase the firm's bargaining power when returning home, as the firm is able to capture advantages of the same legal and economic protections outside of the home country enjoyed by foreign firms operating there (Boisot & Meyer, 2008). At the same time, the round-trip investor possesses the same ability to 'manage institutional idiosyncracies' (Henisz, 2003: 174), including the ability to protect against the 'grabbing hand' of government (ibid) and opportunistic behavior of local business partners. At the same time it can actively take advantage of domestic business opportunities (Sutherland et al., 2010). Hence, round-tripping should be viewed not only as means of avoiding taxes but it can represent a deliberate international business strategy (Sutherland et al., 2010).

Following the discussion above, we build hypotheses that support our argument that the round-trip investors would have a better ability to cope with the Russian institutional environment than genuine foreign investors, and therefore better possibilities to exploit the business opportunities provided by Russia. In our analysis of institutional environment we focus on one single factor: corruption. This is justified by the poor performance of Russia in international corruption rankings, and by the identification of corruption repeatedly as a key obstacle faced by foreign investors entering Russia.

Of the single informal institutional factors corruption is perhaps the most studied one with regard to FDI flows. On the one hand, it has been found to discourage FDI to a nation (see e.g. Gastanaga et al., 1998; Wei, 2000; Habib & Zurawicki 2002). Interestingly, it is not only the absolute corruption level that inhibits FDI but also the "corruption distance" between home and host economies (Habib & Zurawicki 2002). These results support the view that corruption is "sand" in the wheels of commerce by increasing transaction costs. According to an alternative view, however, such additional costs may be compensated by the benefits that corruption provides in terms of bypassing underdeveloped regulations and formal institutions (Leff, 1964; Egger & Winner 2005;

Cuervo-Cazurra, 2008). Therefore, whether corruption is "sand" or "grease" in the wheels of commerce would be context-specific. In our empirical context one might expect that round-trip investors of Russian origin would be more knowledgeable about how to "grease" the system to take advantage of it. Hence, they would feel more comfortable in regions with high level of corruption than genuine foreign investors. This way of arguing enables us to hypothesize:

<u>Hypothesis 1:</u> Round-trip investors of Russian origin tend to invest into more corrupt Russian regions than genuine foreign investors.

While discussing the role of corruption in genuine foreign investment distribution we should take into consideration the fact that they can alleviate the problems associated with corruption by establishing joint ventures with local partners. Javorcik & Wei (2009), for example, argue that corruption increases the value of using a local partner to cut through the bureaucratic maze. Earlier study building on the same dataset as this paper (Karhunen & Ledyaeva (forthcoming)) found that corruption distance between home country and Russia as host country increases the probability of establishing a joint venture with local partner. This finding shows that, in the case of corrupted Russia, the benefits of having a local partner exceed the costs of controlling the joint venture for investors from countries that are distant in terms of corruption (i.e. non-corrupt). These arguments point to the following hypothesis:

<u>Hypothesis 2:</u> The hypothesis 1 will have stronger implication to the case of wholly owned enterprises than joint ventures.

There are serious grounds to suggest that much of round-trip investment most likely occurs between the same Russian region (i.e. home and host regions is the same) and offshore country. Primarily it concerns "offshore" schemes for reinvestment of Russian capital in the form of foreign investment described above (e.g. investment in real estate, investment to hide the identity of a Russian owner, export-import operations via offshores and money laundering). We argue that in corrupt regions such reinvestment schemes via offshores are more likely. First, money laundering is more likely in corrupt Russian regions: there are more possibilities for collecting bribes in such regions by authorities' representatives and hence, there are more money needed to be laundered in offshore jurisdictions. Second, when local authorities are more corrupt, there are more incentives for Russian businessmen to hide their identity and profits when investing in Russia in order to make authorities' inference in their business activities less likely.

As was described above reinvestment schemes via offshore countries are widely used in trade and services sectors. Furthermore real estate sector can be an important channel for money laundering (FinCEN, 2008). In general investment into real estate is internationally considered as one of the most important methods of money laundering (see e.g. Shkurkin, 2007). Consequently, we argue that investment between corrupt Russian regions and offshore countries is more likely in the mentioned sectors and hence, we hypothesize that:

<u>Hypothesis 3:</u> The hypothesis 1 will have stronger implication to the case of trade, service and real estate sectors.

3.2. Resource potential and round-trip investment

Resource-based industries in Russia are quite attractive for both domestic and foreign investors because of their high profitability. This creates a rather high competition for resources among them. Obviously, domestic companies have competitive advantage over foreign companies in obtaining access to natural resources. Moreover, very often in Russia state and regional authorities control access to natural resources by issuing special permissions and licenses to companies which further complicates the procedure for foreign investors. Taking this into account it is reasonable to expect that round-trip investors of Russian origin have a competitive advantage over genuine foreign investors when investing into resource industries due to their superior connections with local private companies and authorities on different levels.

Furthermore, it is not uncommon that Russian politicians fear that foreign investors may exploit local resources at Russia's expense (Fabry & Zeghni, 2002). In order to control foreign investment into oil, gas and gold industries the Law on Production Sharing Agreements (PSA), the major law that regulates foreign presence in natural resources industries, was passed in December 1995 in Russia. PSAs, which encourage investments by companies developing resources by offering them favourable tax treatment in exchange for a share of production, were expected to bring billions of dollars into the country. But so far little progress has been made, as the process has been beset by numerous delays and disagreements over how to balance protecting domestic producers and workers, and the urgent need for investment from foreign companies that want less restrictions. One of the most contentious issues has been Russian demands on the use of domestic employees (a minimum of 80 % of all staff) and of domestically manufactured equipment (70 %).

Finally, Russian exporters of local resources might use different schemes of round-trip investment via offshores for the purposes of tax saving or hiding the identity of an owner. E.g. first, they might "hide" export profits from Russian taxes in offshore countries, and next reinvest these profits back into Russia. In this case, it is logical to expect that such investment prevails between resource abundant Russian regions and offshore countries.

The discussion above enables us to hypothesize:

<u>Hypothesis 4:</u> Round-trip investors of Russian origin tend to invest into Russian regions with higher resource potential than genuine foreign investors.

In the remainder of the paper we apply advanced analytical methods to investigate the potential differences between round-trip and genuinely foreign investors.

4. RESEARCH DESIGN

4.1. Data set

Our empirical analysis applies the dataset with information on the location choice of about 26, 600 firms with foreign capital registered in Russia in the period between 1990 and 2008. We excluded from the analysis firms with multiple foreign ownership (when foreign capital of a firm is represented by several foreign firms either from the same country or from different countries), i.e., we retain only foreign companies that are fully owned by one foreign entity, and joint ventures between one foreign company and any number and any type (company, citizen, authority) of Russian partner(s). We also excluded all the companies with less than five million roubles (approximately 125,000 Euros) in capital in order to discard micro and small firms. We also excluded companies with a foreign ownership of less than 10%, that is to say, portfolio investment. Finally, we exclude firms with foreign capital from the Netherlands, Luxemburg and Liechtenstein. These three countries can be considered as offshore countries popular with Russian flight capital. At the same time, a large portion of foreign investment from these countries might have "real foreign" origin. Hence, it is difficult to decide to which group, "real" foreign investors or offshore investors of Russian origin, they belong. The final sample consists of 3347 firms. Around 56% of the firms in this sample have foreign owners from OFCs. The offshore owners are mainly represented by Cyprus (60%), British Virgin Islands (25%), Panama, Belize, Seychelles and Bahamas (around 10% altogether). The non-offshore owners are more diversified: the top ten of main investors consists of Germany (15%), USA (13%), Great Britain (12%), Switzerland (7,4%), Finland (5,7%), Austria (3,9%), China (3,4%), Turkey (3,3%), France (2,8%) and Sweden (2,8%).

The time dynamics of firms' entry is represented on figure 4.



Figure 4 Establishment of firms with foreign ownership by year

Source: Rosstat

As can be seen from the figure 5, in general the time dynamics does not vary between offshore and "real" foreign investors. We also conclude that before the year of 1998, by number of the firms established, "real" foreign investors prevailed. However, since 1999 OFCs` investors strongly dominate. This indicates that Russian capital started to return from abroad massively after the financial crisis in 1998.

In industrial composition of our sample the leading sectors are service sector (28%), trade sector (22%), manufacturing industries (19%) and operations with real estate (13%). In order to further examine firms' industrial distribution in the sample we present the detailed industrial structure of established firms in tables 1 and 2. We consider two time periods: 1990-1998 and 1999-2007.

Table 1 Distribution of firms with foreign capital by industry in the period of 1990-1998

	All	%	Offshore	%	"Real" foreign	%	Share of offshore
Industry					10101811		firms
	(1)		(2)		(3)		(2)/(1)*100
Wholesale trade, including trade through agents, except for trade in vehicles and motorcycles	147	19,17	56	16,62	91	21,16	38,10
Trade in vehicles and motorcycles, their maintenance service and repair	11	1,43	2	0,59	9	2,09	18,18
Retail trade, except for trade in vehicles and motorcycles; repair of household products and subjects of a private use	23	3,00	9	2,67	14	3,26	39,13
Services	176	22,95	100	29,67	76	17,67	56,82
Communication	24	3,13	4	1,19	20	4,65	16,67
Operations with real estate	106	13,82	67	19,88	39	9,07	63,21
Extraction of resources	44	5,74	21	6,23	23	5,35	47,73
Manufacturing industries:	207	26,99	60	17,8	147	25,48	28,99
Wood and wood products, except furniture	23	3,00	8	2,37	15	3,49	34,78
Food products and beverages	36	4,69	13	3,86	23	5,35	36,11
Chemicals and chemical products	21	2,74	6	1,78	15	3,49	28,57
Paper and pulp industry	10	1,30	3	0,89	7	1,63	30,00
Rubber and plastic products	16	2,09	3	0,89	13	3,02	18,75
Textile production	4	0,52	2	0,59	2	0,47	50,00
Metallurgical production	6	0,78	3	0,89	3	0,70	50,00
Construction	14	1,83	5	1,48	9	2,09	35,71
Radio, television and communication equipment	4	0,52	0	0,00	4	0,93	0,00
Other non-metallic mineral products	26	3,39	5	1,48	21	4,88	19,23
Publishing, printing and recording media	9	1,17	4	1,19	5	1,16	44,44
Fabricated metal products	11	1,43	2	0,59	9	2,09	18,18
Electrical equipment and apparatus	8	1,04	1	0,30	7	1,63	12,50
Precision and optical instruments	7	0,91	1	0,30	6	1,40	14,29
Other Manufacturing	12	1,56	4	1,19	8	1,86	33,33
Other	29	3,78	18	5,34	11	2,56	62,07
Total	767	100	337	100	430	100	43,94

Source: Rosstat; authors' calculations

Table 2 Distribution of firms with foreign capital by industry in the period of 1999-2007

Industry	All	%	Offshore	%	"Real"	%	Share
	(1)		(2)		foreign		()/(1)*
	(1)		(2)		(5)		(2)/(1) 100
Wholesale trade, including trade							
through agents, except for trade in	486	18,83	292	18,88	194	18,76	60,08
vehicles and motorcycles							
Trade in vehicles and motorcycles, their	26	1.01	10	0.65	16	1.55	38.46
maintenance service and repair		_,		-,		_,	
Retail trade, except for trade in vehicles	F 1	1.00	25	1 6 2	26	2 5 1	40.02
products and subjects of a private use	51	1,98	25	1,02	20	2,51	49,02
Services	670	25.96	488	31.54	182	17.60	72.84
Communication	24	0.93	15	0.97	9	0.87	62.50
Operations with real estate	343	13.29	270	17.45	73	7.06	78.72
Extraction of resources	42	1.63	27	1.75	15	1.45	64.29
Manufacturing industries	640	24.80	259	16.74	381	36.85	40.47
Wood and wood products, except							
furniture	62	2,40	23	1,49	39	3,77	37,10
Food products and beverages	89	3,45	48	3,10	41	3,97	53,93
Chemicals and chemical products	55	2,13	14	0,90	41	3,97	25,45
Paper and pulp industry	21	0,81	3	0,19	18	1,74	14,29
Rubber and plastic products	58	2,25	17	1,10	41	3,97	29,31
Textile production	9	0,35	2	0,13	7	0,68	22,22
Metallurgical production	16	0,62	9	0,58	7	0,68	56,25
Construction	99	3,84	59	3,81	40	3,87	59,60
Radio, television and communication	6	0,23	1	0,06	5	0,48	16,67
Other non-metallic mineral products	60	2,32	20	1,29	40	3,87	33,33
Publishing, printing and recording	12		24		24	2.02	50.00
media	42	1,63	21	1,36	21	2,03	50,00
Fabricated metal products	33	1,28	13	0,84	20	1,93	39,39
Electrical equipment and apparatus	17	0,66	5	0,32	12	1,16	29,41
Precision and optical instruments	7	0,27	3	0,19	4	0,39	42,86
Machinery and equipment	38	1,47	9	0,58	29	2,80	23,68
Other Manufacturing	28	1,08	12	0,78	16	1,55	42,86
Other	299	11,58	161	10,41	138	13,35	53,85
Total	2581	100,00	1547	100,00	1034	100	59,94

Source: Rosstat; authors' calculations

As can be seen from tables 1 and 2 in both periods OFCs' investors prevailed in service sector (57 and 73%, respectively) and operations with real estate (63 and 79%). "Real" foreign investors dominate in both periods in manufacturing industries (71 and 59%, respectively) and trade in vehicles and motorcycles (82 and 61%, respectively). In the second period (1999-2007) OFCs' investors also dominate in wholesale trade, communication, extraction of resources, food industry, metallurgical production and construction.

On figure 5 we present average capital size of established firms for main industries.

Figure 5 Size of capital of firms by industry (in million roubles, at the registration date): 1990-



Source: Rosstat; authors' calculations

As we can see from the figure "Russian" foreign investors establish larger firms, especially it is evident for extraction of resources, trade and services sectors.

In figure 6 we present the average share of foreign ownership of established offshore vs. non-offshore firms for main industries.

Figure 6 Share of foreign ownership by industry (%, at the registration date): 1990-

2007



Source: Rosstat; authors' calculations

In general the average share of established firms is very high for both types of investors though it is slightly higher for offshore investors irrespective of industry.

Since data for the most of explanatory variables in our model is available from the year of 1995, in this study we focus on the period of 1996-2007 (due to using "one-year lag" approach explained below). Consequently, our final sample for estimation purposes consists of 3007 firms.

4.2. Variables

The dependent variable is equal to 1 for firms with foreign capital from offshore countries popular with Russian flight capital (Cyprus, British Virgin Islands, Panama, Seychelles, etc.) and 0 otherwise. Hence, we look at differences between two groups of foreign investors (round-trip and genuine) with respect to considered explanatory and control variables. For estimation purposes we utilize binary logit model.

In this study our main focus is on corruption and resource potential in Russian regions as explanatory variables. We, however, control for such regional characteristics as democracy development, market potential, educational background, sea port availability, transport infrastructure, institutional potential and investment risk. We also include several firm-level control variables: size of capital, share of a foreign owner (%), industrial and year dummies. The control variables have been selected according to the existing literature on determinants of foreign direct investment, data availability, and particularities of the Russian economy.

We measure regional corruption *CORR* by the corruption dimension of Moscow Carnegie Center's democracy index as average for the period of 2000-2004. It is measured on a 5-point-scale, where 1 indicates the highest level of corruption level and 5 - the lowest. This indicator refers mainly to the state capture in a broader sense, i.e. interconnections between political and business elites and their interventions in the political decision-making. To our knowledge this is the only indicator of corruption across Russia which is available for all Russian regions.¹⁴ We are aware that this indicator cannot capture all the conceptual richness that is used in models of corruption (see, e.g., Shleifer and Vishny, 1993) which poses certain limitations on our study.

We measure the natural resources' potential variable *RES* by *Expert* journal¹⁵ regional natural resources potential's rank¹⁶ in a region i (where the firm j (j=1,...,3007) is located) in a year t-1¹⁷ (from 1 to 89: 1 corresponds to the highest potential and 89 corresponds to the lowest potential).

Following Akhmedov and Zhuravskaya (2004), we measure democracy *DEM* in a Russian region by the index developed by the Moscow Carnegie Center. We utilize the index as average for

¹⁴ The only alternative is the index of corruption of Transparency International and Fund INDEM (2002). However, it was computed only for 40 Russian regions which would pose serious limitation on our study.

¹⁵ <u>http://www.raexpert.ru/ratings/regions/</u> (webpage in Russian language).

¹⁶ This indicator reflects average weighted availability of balanced stocks of principal natural resources in Russian regions.

¹⁷ The use of lagged explanatory variables (where data is available) helps to solve possible endogeneity problems. It further relates to a simple hypothesis for the foreign investor decision making: foreign investors are assumed to make an investment decision for a given year by referring to the observable variables of the previous year (e.g. Iwasaki and Suganuma, 2005; Ledyaeva (2009), Karhunen and Ledyaeva (2011)).

the period of 2000-2004 since only for this period it is publicly available in disaggregated form (which we need to extract corruption dimension). The experts were requested to evaluate each region by a 5-point-scale (with 5 being the highest degree of democracy and 1 – the lowest) for the following ten dimensions: regional political organization, openness of regional political life, freedom of elections at all levels, political pluralism, independence of the media, corruption, economic liberalization, civil society, elites, freedom of local municipalities vis-à-vis their dependence from the regional government (for a more detailed description of the dimensions, see Appendix 1). In particular, we computed a simple average of all the dimensions except corruption. The corruption dimension is excluded because this paper aims to assess its separate influence on foreign firms' location choice and also because it does not correlate highly with other dimensions. We found that while all the dimensions except corruption correlate highly with each other (for all pairs, correlation coefficients are more than 0.5), all the correlation coefficients between the corruption dimension and other dimensions are less than 0.5 (see Appendix 2). This enabled us to suggest that the corruption dimension reflects patterns somewhat different from other democracy issues and therefore should be considered as a separate explanatory variable.

The market size variable *Market* is the first principal component of three variables (gross regional product, total population, and population density) in a region i in a year t-1. The same indicator for market size in Russian regions has been used in the study of Iwasaki and Suganuma (2005) and Ledyaeva (2009). The proportion of variance of the first component reaches 80%, and furthermore, its eigenvector and component loading show that this variable is suitable as a general index of the market size. This variable is also one-year lagged.

The educational background of population variable EDU is measured by the share of the population with at least a medium level of professional education to the population with no

professional education in a particular Russian region in the year of 2002 (The data comes from ROSSTAT).

We introduce two variables to measure the level of transport infrastructure development in a particular Russian region that should have an impact on transportation costs of a foreign investor. The first variable, *Port*, reflects the presence of a seaport in a particular Russian region (equals to 1 if there is at least one sea port in a region, and 0 otherwise). The second variable, *Roads*, reflects the regional development of railways and highways and is measured by the average density of railways and highways in a region i in a year t-1 (where data is not available – for the nearest year).

Next, we introduce indicators of institutional potential and investment risk in Russian regions.

Regional institutional potential, *RIP*, is an *Expert* journal rank of institutional potential¹⁸ from 1 to 89 for a particular Russian region i where a firm is located in a year t-1 (1 is assigned to a region with the highest potential in Russia, and 89 is assigned to a region with the lowest potential).

Regional investment risk, *RIR*, is an *Expert* journal rank from 1 to 89 for a particular Russian region¹⁹ where a firm is located in a year t-1. 1 is assigned to a region with the smallest risk in Russia, and 89 is assigned to a region with the largest risk.

Finally, we control for several firm-level characteristics. The data comes from Rosstat.

Firstly, SIZE variable is a natural logarithm of a firm's capital size at the moment of its registration. The logarithmic transformation is generally used to normalise the size variable, which might otherwise be badly skewed (Demirbag et al., 2009).

Secondly, SHARE variable is the share of foreign ownership (percentage) in a firm j.

¹⁸ This indicator reflects the level of development of principal market institutions in Russian regions and we expect it to be positively related to location decision of foreign investors.

¹⁹ This is a qualitative indicator that simultaneously reflects political, economic, social, criminal, financial, ecological, and legislative risks for investment activities in Russian regions.

Thirdly, we introduce dummies for several industrial sectors: manufacturing industries, service and trade sectors, operations with real estate, extraction of natural resources and agricultural/hunting/forest (altogether) sector.

Finally, we control for the year when a firm j has been established by year dummies.

5. RESULTS

5.1. Baseline results

Correlation matrix of variables is presented in Appendix 3. There can be a serious multicollinearity problem in our data since most of variables which represent regional characteristics are highly correlated. To address this issue we utilize stepwise binary logit model. The results are presented in Table 3.

Table 3 Baseline results: stepwise binary logit model

Variable	Whole sample		Full ownersh	lip	JV			
	Estimate	Score Chi-	Estimate	Score Chi-	Estimate	Score Chi-		
		Sq.		Sq.		Sq.		
Intercept	-2,51		0,4		-4,27			
_	(0,58)***		(0,71)		(0,89)***			
Firm-level variables								
SIZE	0,14	27,35***	0,11	7,57***	0,24	28,8***		
	(0,03)***		(0,03)***		(0,05)***	-		
SHARE	0,01	25,36***			0,01	27,37***		
	(0,002)***	,			(0,002)***	,		
Industrial dummies								
Agrucultur/hunting/forest								
8								
Manufacturing industries								
Service sector	1,04	52,57***	1,11	55,47***	0,8	15,73***		
	(0,11)***		(0,14)***		(0,15)***			
Extraction of resources	0,78	7,67***						
	(0,32)**							
Trade sector	0,34	9,21***	0,38	6,32**				
	(0,11)***		(0,14)***					
Real estate operations	1,35	84,92***	1,46	35,39***	1,05	25,37***		
1	(0,14)***		(0,18)***	, ,	(0,21)***	-		
Region-level variables								
DEM								
Port	-0.27	7.27***	-0.59	13.14***				
	(0.12)**	,	(0.16)***	,				
Market	0.04	4 06**			0.08	58 82***		
	(0.14)**	.,			(0.02)***			
RIR	(*,)				-0.01	9 12***		
					(0 004)***	>,		
EDU					(0,001)			
CORR	-0.27	12 56***	-0.63	56 26***				
Coluc	(0,2)	12,50	(0.11)***	50,20				
RIP	(0,1)		(0,11)					
RES	-0.01	4 31**			-0.01	5 22**		
KL5	(0,002)***	ч,51			(0,004)***	5,22		
Vear dummies	(0,002)				(0,004)			
Poads			0.002	5 01**				
Roads			(0,002)	5,21				
V1007	0.61	14 01***	0.63	6 5 1 * *	0.84	7 77***		
11997	-0,01	14,91	-0,03	0,34	-0,04	7,77		
¥1009	(0,18)		0.61	(2**	(0,29)			
1 1998			-0,01	0,5				
V2001	0.24	£ 0.1**	(0,22)					
1 2001	0,34	5,04**						
	(0,14)**				0.45	(11++		
1 2005					-0,43	0,41**		
NT 1	2007		1025		(0,2)**			
IN.ODS.	3006		1825		1181			

Note: *** - 1% significance; ** - 5% significance; * - 10% significance; standard errors in parentheses.

As can be seen from the results, our hypotheses 1, 2 and 4 are confirmed. In particular we find that "offshore" investors in general tend to invest into more corrupt Russian regions (hypothesis 1) than genuine investors and this conclusion does not apply to joint ventures (hypothesis 2). We further find that in general "offshore" investors invest more than genuine investors into resource abundant Russian regions (hypothesis 4).

There are also other interesting results. Firstly, irrespective of ownership type of a firm, offshore investors tend to invest consistently more into service sector and operations with real estate than "real" foreign investors. In general offshore investors also invest more into extraction of resources industries and trade sector. The latter result is more relevant for wholly owned foreign enterprises.

Secondly, we find that offshore investors tend to establish larger firms (by capital size) and with higher share of foreign ownership. Thirdly, we conclude that among year dummies the most significant and robust one is for the pre-crisis 1997 year. This result indicates that "Russian" foreign investors had knowledge about possibility of collapse of Russian economy in the year of 1998 and consequently did not invest much in the country in the year before it. This result further indicates that major part of offshore investment is most likely made by Russians who belong to business and political elites as only their representatives could have enough information about the possible collapse of Russian economy in the year of 1998.

5.2. Results for main industries

In table 4 we present estimation results of our baseline model for several industrial sectors: manufacturing industries, service, trade and operations with real estate sectors. These sectors strongly dominate in industrial distribution of foreign firms in our data.

Table 4 Results for industries: stepwise binary logit model

Variable	Manufacturing	3	Service		Trade		Real estate	Real estate	
	Estimate	Score Chi-Sq.	Estimate	Score Chi-Sq.	Estimate	Score Chi-Sq.	Estimate	Score Chi-Sq.	
Intercept	-2,11 (1,06)**		-2,28 (0,97)**		-1,74 (1,3)		5,52 (1,18)** *		
Firm-level	variables								
SIZE	0,14 (0,06)**	6,26**	0,14 (0,05)***	7,32***	0,19 (0,06)***	8,5***			
SHARE			0,01 (0,00)***	9,87***	0,01 (0,005)**	6,95** *			
Region-lev	el variables	÷	• • •		• • •				
Dem					-0,49 (0,21)**	5,89**			
Port									
Market	0,08 (0,03)***	6,17**							
Inv_risk									
EDU							-3,74 (1,08)** *	4,19**	
CORR							-0,73 (0,29)**	11,2***	
Inst_pot			-0,02 (0,01)***	24,45***			-0,04 (0,01)** *	7,35***	
Res_pot	-0,02 (0,004)***	11,46***					0,02 (0,01)**	4,51**	
Roads					-0,002 (0,001)***	5,5**			
Year dumn	nies	1							
Y1997			-0,68 (0,31)**	4,8**	-1,11 (0,37)***	6,12**	-2,17 (0,46)** *	27,52***	
Y1998					-1,3 (0,34)***	8,24** *			
Y2001									
Y2002					-0,65 (0,28)**	4,49**			
Y2005	-0,74 (0,33)**	5,28**			-0,56 (0,28)**	4,11**			
N.obs.	541		499		672		402		

Note: *** - 1% significance; ** - 5% significance; * - 10% significance; standard errors in parentheses.

An interesting result is that corruption variable is important only for the sector of operations with real estate. First, this might indicate that this sector more than others is associated with money laundering hypothesis of capital flight and its returning to Russia. Second, in corrupt Russian regions there are more incentives for Russian businessmen to hide their identity as owners of real estate.

Market potential is significant and positive only for manufacturing sector. This indicates that "offshore" investors of Russian origin establish firms in manufacturing industries which are more oriented towards local consumers than genuine investors. This result has an important policy implication and indicates that returning from abroad Russian capital invested into manufacturing back of Russian capital from abroad.

We further find that regional resource potential is statistically significant for manufacturing and real estate sectors, but with opposite signs. For manufacturing sector, we preliminary conclude that "offshore" investors tend to establish manufacturing firms in Russian regions with higher resource potential than genuine foreign investors. Firstly, this again indicates that foreign investors of Russian origin have better access to Russian natural resources than genuine investors. Secondly, it indicates, that manufacturing firms established by "Russian" foreign investors are more resourcebased than those established by genuine foreign investors.

For the real estate sector, the result points to the positive relationship between resource potential and establishment of firms by genuine foreign investors. This might indicate that genuine foreign investors get access to Russian natural resources via investment into operations with real estate.

6. SUMMARY AND CONCLUSIONS

This paper sheds light on a virtually unexplored phenomenon, round-trip investment from Russia to offshore financial centers and back to Russia. Our brief overview of statistics on Russia's outward and inward foreign investment flows shows that offshore financial centers, such as Cyprus and British Virgin Islands, are both key destinations of Russian outward FDI, and main sources of inward FDI to Russia. This provides support to the existence of round-tripping phenomenon of Russian capital via offshore financial centers back to Russia in the form of foreign investment. Our search for explanation for such behavior in the literature indicates that in the case of Russia, transfer of funds abroad was particularly in the 1990s rather capital flight than genuine OFDI. In contrast to some other emerging economies (such as China), the Russian government has not actively encouraged the Russian companies to go global until recently. Hence, many of the outward investment from Russia can be better described as institutional escape rather than a result of active internationalization strategy of Russian companies.

A more interesting question, however, is why the funds transferred abroad are re-invested back to Russia. Here again, the most evident explanation identified in the case of other emerging economies, access to benefits granted to foreign investors, does not seem to be particularly valid in the case of Russia. In contrast to the Chinese government, the Russian government has not actively attracted foreign investors to the country but rather followed a restrictive policy. Here, we propose that the round-tripping of funds via offshore centers back to the Russian economy would represent the situation of institutional arbitrage (Gaur & Lu, 2007; Boisot & Meyer, 2008). The use of offshore financial centers as "home base" would provide Russian companies access to more developed infrastructure for financial operations vis-à-vis purely domestic firms. In addition, the knowledge of the Russian institutional context would put the round-trip investors to a superior position when compared to genuinely foreign investors.

We empirically test the validity of this argument on firm-level data on foreign-owned firms in Russia. Our comparison of the behavior of round-trip investors and genuine foreign investor reveals that the former may indeed be better equipped to cope with institutional deficiencies, which in our analysis are measured by the level of corruption. The round-trip investors tend to invest into more corrupt Russian regions than genuine foreign investors. In addition, the latter need more often a local partner, which helps to cope with the corruptive environment. Furthermore, we find that round-trip investors invest more into regions with higher resource potential. This result indicates that round-trip investors are better able to exploit the business opportunities provided by the Russian natural resources than genuine foreign investors. This often requires allying with authorities, which according to our results seems to be easier for round-trip investors than for genuinely foreign investors.

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Appendices

Appendix 1

Moscow Carnegie Center's democracy index's description

The Index of Democracy represents a ranking of Russian regions based on expert evaluations between 1991-2001, compiled by Moscow Carnegie Center experts Nikolai Petrov and Alexey Titkov. It includes 10 indicators, measured on a 1-5 scale (1 being the least democratic, 5 the most). The index is composed of aggregates of the individual ratings, with the highest possible score being 50 and the lowest possible being 10. The individual ratings represent the situation between 1991-2001, with additional aggregates provided for years 2000-2004, and 1999-2003. The index covers 88 regions, and excludes Chechnya. This paper uses the scores in 1991- 2001 which is also publicly available in disaggregated form (i.e. for each indicator).

The full indicator scores are published in the *Nezavisimiy institut sotsial'noy politiki* website at http://atlas.socpol.ru/indexes/index_democr.shtml.

The index is composed of the following indicators:

1) [Openness:] The openness of political life (the extent of transparency and of public involvement in political life)

2) [Free and fair elections:] The level of democracy in federal, regional and local elections held in the regions (the existence of free and fair elections for posts at all levels, their competitiveness, the use of so-called administrative resources, including the direct interference by the authorities or the courts, and the limitations of realizing political rights) 3) [Political pluralism:] The extent of political pluralism (the existence of stable parties, factions in the legislative assembly and coalitions during the elections and afterwards)

4) [Independent mass media:] The degree of media freedom and independence

5) [Economic liberalization:] The extent of economic liberalization, including privatization (through regional legislation and in practice)

6) [Civil society:] The development of civil society (nongovernmental organisations, referenda, various forms of public activity, demonstrations, pickets, and strikes not sanctioned by the authorities)

7) [Political regime:] The region's political regime (the balance of power, the number of elected officials versus appointed officials, the independence of the judiciary and law enforcement agencies, and the extent of citizen's rights)

8) [Elites:] The quality, perpetuation, and turnover of political elites (changes in leadership implemented by means of elections that do not lead to dismantling of the whole system, varied nature of the elites, and vitality for the mechanisms for compromises between competing elites)

9) [Corruption:] The degree of corruption (the merging of political and economic elites and corruption scandals)

10) [Local self-government:] The amount of local self-administration (the existence of elected bodies of local governance and their level of activity and influence) (Petrov, 2004).

Appendix 2

Table A2 Correlation matrix of democracy index components

Dimension	Open	Elect	Plur	Media	Liber	Vivil	Org	Elites	Corr	Munic
Openness	1,00	0,67	0,73	0,70	0,71	0,74	0,65	0,68	0,31	0,58
Election		1,00	0,69	0,64	0,54	0,55	0,61	0,67	0,34	0,53
Pluralism			1,00	0,70	0,64	0,76	0,67	0,71	0,29	0,59
Media				1,00	0,67	0,75	0,69	0,60	0,30	0,51
Liberalization					1,00	0,63	0,56	0,63	0,40	0,58
Civil						1,00	0,72	0,65	0,31	0,56
Organization							1,00	0,61	0,46	0,62
Elites								1,00	0,40	0,68
Corruption									1,00	0,42
Municipality										1,00

Note: correlation coefficients more than 0,5 are denoted by bold.

Appendix 3

Table A3 Correlation matrix of dependent and regional explanatory variables: 1996-2007. Pearson coefficients

	Market	Inv_risk	EDU	Port	Dem	Corr	Inst	Res_pot	Roads
DV	0,17	-0,09	0,12	-0,10	-0,04	-0,17	-0,13	0,09	0,13
Market	1	-0,53	0,78	-0,35	-0,08	-0,69	-0,64	0,74	0,81
Inv_risk		1	-0,60	0,17	-0,02	0,40	0,59	-0,69	-0,71
EDU			1	0,00	0,20	-0,52	-0,69	0,78	0,69
Port				1	0,28	0,21	0,08	-0,22	-0,41
Dem					1	0,40	-0,34	-0,02	-0,06
Corr						1	0,51	-0,50	-0,58
Inst							1	-0,46	-0,66
Res_pot								1	0,75
Roads									1

Note: Correlation coefficients higher than 1 are denoted by bold.