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# Foreign Direct Investments in the Russian Territories of the Barents Region

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## Executive Summary

In 2000, at the end of the Finnish chairmanship of the Barents Euro-Arctic Council, the Finnish Ministry of Trade and Industry ordered a study on foreign direct investments (FDI) in the Russian territories of the Barents Region from the University of Lapland and the Helsinki School of Economics and Business Management. The study was made by Tero Lausala, Head of the Finnbarents Unit, University of Lapland, and Inkeri Hirvensalo, Director of the Center for Markets in Transition, Helsinki School of Economics and Business Administration.

Geographically, the study covers the Murmansk and Arkhangelsk Oblasts, the Republics of Karelia and Komi, as well as the Nenets Autonomous Okrug. The Republic of Komi is included in the report as a comparative region, although it is not a member of the Barents Regional Council, despite having applied for membership. Together, these five regions are referred to as the Russian territories of the Barents Region (RTBR).

The development of FDI in the RTBR based on statistical analysis shows that the share of the region in focus is small when compared to the total FDI in Russia. It also is less significant for the regional economies when compared to the regional gross product, industrial production, investments in fixed assets or population than in Russia on average. However, there are significant differences among the regions in question. While the significance of FDI in the Republics of Karelia and Komi reaches about half of the national level, the FDI in Arkhangelsk and Murmansk Oblasts lag behind significantly. Most investments have been made in the energy sector, whereas forest industries rank second in the amount of investments received. The share of FDI in all foreign investments during 1994-1999 is only 20%, indicating that most foreign investments have been given as credits. The Arkhangelsk Oblast, in particular, has been a favoured recipient of credits, as 2/3 of them were received by the Oblast. Among the most recent sources of investment the share of Cyprus is conspicuously high, which partly indicates a return of Russian capital to the region. The low level of FDI in comparison to the vast resources of the region also indicates that there is, in theory at least, vast potential to increase FDI in the studied areas.

Material on legislation and other normative acts concerning FDI in the RTBR has been collected during the study. The material includes documents on Russian federal legislation pertaining to foreign investments, in particular the Foreign Investment laws of 1991 and 1999, as well as the Law on Production Sharing (1995/1999). All regions have passed legislation allowing foreign investors to be granted various privileges. Typically these privileges concern exemption from regional taxes for the duration of the projects' pay-back times. In addition, various regulations on special economic zones and other instruments have been passed.

Material on a number of case studies is also included in the report. The case studies cover venture capital investments by a regional venture fund of the European Bank for Reconstruction and Development, mining sector activities in Murmansk Oblast, forest industry investments in Karelia and the Leningrad Oblast, oil and gas exploitation and transportation by Fortum and Kvaerner Masa-Yards, as well as other projects e.g. environmental investments by the Nordic Investment Bank and the Nordic Environment Finance Corporation. Although the cases describe experiences of widely different companies in different industries, some general conclusions are drawn. Foreign investors are very cautious and have only exceptionally made large investments in the region, even though there is potential interest for investments among the investors. A common strategy among both the

companies and the financial organisations is a step-wise approach, starting from small experimental projects.

The study also included visits to the target region to interview local authorities, companies and research institutes. The material collected from these visits shows that all the regions have developed various instruments to attract foreign investments – typically legislation allowing privileges for investors. However, these instruments are not well known among potential investors and there is ambivalence concerning the relationship of these regional instruments with federal instruments. Thus, the main factor determining the investment climate in these regions is seen to be the competence, attitude and level of pragmatism of the regional and local authorities.

On the basis of the statistical, legislative and other material collected, the case studies analysed, and the interviews conducted for this study, some conclusions on FDI development and the investment climate in the RTBR are put forth. Firstly, the region's attractiveness for investors is decreased by objective factors such as harsh geographic and climatic conditions; poorly developed transportation, communal, energy, communications, social and financial infrastructure; long distances to markets; as well as various security risks related to the environment, crime, health risks etc. On the other hand, the relative advantages of the RTBR in FDI attraction are rich natural resources, especially forests, oil and gas, minerals and fish, as well as a relatively well-trained and low-cost work force including technical and scientific expertise.

Another main conclusion is that in comparing the investment climate in the RTBR with competitors in Russia, the RTBR are not considered very favourable investment environments. In international comparison, RTBR ranks as a high risk area for foreign investors and does not provide competitive fiscal or other incentives provided by the Baltic countries, or favourable financing alternatives available in the Nordic countries.

Most FDI and plans for FDI in the RTBR have been directed to projects aiming at utilising the rich natural resource base of the region. For such projects the major attraction is the possibility to export raw materials from the region, as there is not enough demand for locally produced products in the region, or the local price level for the raw materials is not high enough to justify investments. Therefore, the level of export tariffs and transportation costs is of crucial importance for such projects. So far, the local administrations have often viewed these tariffs mainly as sources of additional budgetary income and not as subjects of potential incentives for foreign investors.

In the RTBR, the investment climate is seen by investors to be weakly developed. This is attested both by the relatively high investment risk ratings and by the very low rate of FDI in the region as well as the failure of a large number of investment projects during the 1990s. In general, the policies of the regional administrations in the RTBR are seen by foreign investors to be ambivalent: on one hand many measures have been taken aiming to attract FDI; on the other hand foreign investors have had great difficulties in working with regional officials on e.g. taxation, customs, land use rights, user rights to natural resources, and various licences needed for production and sales.

Main barriers to investments in the RTBR are connected with i.a.: policies of regional and local administrations, long distances to markets, poor infrastructure, taxation and customs problems (companies with foreign ownership are often monitored especially vigilantly by tax

and other inspectors), lack of transparency in companies (ownership, structure of management, taxation etc.), difficulties in agreeing user rights for natural resources, a high political risk for investments, as well as a lack of encouraging examples of successful investments in the region. The relationship between the federal and regional levels complicates the investment climate in the RTBR. The division of competencies between the two levels is often unclear.

At the present, the regional administrations in the RTBR are involved too directly in investment projects. Administrations play a central role in negotiations on new projects and are often themselves stakeholders, even owners of partner companies.

For the regional strategy to attract more FDI, the regional governments should concentrate on providing a stable and predictable investment climate as well as improving infrastructure in their regions. Various tax exemptions and other legal instruments including special economic zones play an important role but do not compensate for predictability and stability.

Despite the barriers, there are some signs of improvement of the investment climate in Russia and the RTBR, mainly due to economic growth and some positive steps taken by the Federal Government to support entrepreneurship and to develop the tax system as well as other legislation on FDI.

## 1. Introduction

During Finland's chairmanship of the Barents Euro-Arctic Council (BEAC)<sup>1</sup> in 1994-95, an extensive effort was made to promote investment and technical assistance projects in the Russian part of the Region (Murmansk Oblast, Arkhangelsk Oblast, Republic of Karelia, Nenets Autonomous Okrug). Under Finland's 1999-2000 chairmanship, the work was continued in the form of an update on the progress of investment projects in these same regions plus the Republic of Komi<sup>2</sup>. As a result, information on the investment possibilities and challenges in the Russian territories of the Barents Region (RTBR) has been disseminated to financiers, companies, the EU as well as to other interested parties<sup>3</sup>.

In 2000, at the end of the Finnish chairmanship of the BEAC, a study on foreign direct investments (FDI) in the Russian territories of the Barents Region was ordered from the University of Lapland and the Helsinki School of Economics and Business Management by the Finnish Ministry of Trade and Industry. The study was made by Tero Lausala, Head of the Finnbarents Unit, University of Lapland, and Inkeri Hirvensalo, Director of the Center for Markets in Transition, Helsinki School of Economics and Business Administration.

The authors of the study have reported on their progress to the BEAC's Working Group on Economic Co-operation which operated under Russian chairmanship for the period March 2000 – March 2001.

Geographically, the study covers the Murmansk and Arkhangelsk Oblasts, the Republics of Karelia and Komi, as well as the Nenets Autonomous Okrug (included in this study as part of the Arkhangelsk Oblast). The Republic of Komi is included in the report as a comparative region, although it is not a member of the Barents Regional Council despite its having applied for membership. Together, these five regions are hereby referred to as the Russian territories of the Barents Region (RTBR).

The objectives of the study have been to:

- Summarise the main investment barriers in the RTBR;
- Describe the investment climate in the RTBR;
- Present FDI levels and flows in the RTBR;
- Compare FDI in the RTBR with other regions of the Russian Federation as well as between the territories themselves;
- Summarise experiences from case studies of FDI;
- Disseminate information on the investment legislation and policies of the RTBR.

The study has concentrated on foreign direct investments i.e. not portfolio investments, nor investments in the form of loans and grants from international financing institutions (IFIs) or other bodies. In accordance with International Monetary Fund guidelines, foreign direct

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<sup>1</sup> BEAC is an inter-governmental organisation established in 1993 and consisting of Finland, Denmark, Norway, Sweden, Iceland, the Russian Federation and the European Commission and including several observer countries e.g. USA, Japan, France and Great Britain. The chairmanship of BEAC rotates annually.

<sup>2</sup> Lausala, Tero: *Barents Region Investment Projects: Update on Project Development*, 15.11.1999.

<sup>3</sup> The Republic of Komi is not a member of the Barents Euro-Arctic Regional Council; therefore the term Russian part of the Barents Region is used to refer to the member regions Murmansk Oblast, Arkhangelsk Oblast, Republic of Karelia and Nenets Autonomous Okrug; whereas the term Russian territories of the Barents Region (RTBR) is used to refer to the member regions plus Komi.



investments (FDI) are defined as capital investments where the investor's holding or proportion of the voting rights in a company is 10% or more. FDI can basically be carried out either as greenfield investments – meaning newly created companies – or acquisitions – referring to cases where investors acquire existing companies or parts of them.

The study has been made utilising the following methods of data collection:

- Collection of written material on FDI in Russia and the RTBR (reports, statistics, newspaper articles, material on internet etc.)
- Interviews with relevant representatives of regional administrations, western financiers, companies, researchers etc.

In order to collect data and to make interviews, the following visits to the Region were made:

- Murmansk, May 2000
- Moscow, May 2000
- Syktyvkar, June 2000
- Arkhangelsk, September 2000.
- Petrozavodsk, November 2000 (by project assistant).

Russian partners made an invaluable contribution to the study. Professor Sergei Sutyurin of the St. Petersburg State University has submitted material on foreign investment legislation on the federal and regional levels. A review of Russian literature on FDI has also been made by Professor Sutyurin and Assistant Olga Trofimenko. Other partners in north-west Russia and Moscow have also been contacted for collection of information. The Embassy of the Russian Federation and the Commercial Representation of the Russian Federation in Helsinki as well as the Ministry for Foreign Affairs of the Russian Federation have also provided valuable assistance in the project. The regional administrations have also aided in the collection of information and in the organisation of meetings with relevant contacts.

## **2. Profile of the Russian Territories of the Barents Region**

This chapter provides a profile of the Russian territories of the Barents Region from the viewpoint of infrastructure, natural resources, administration and economy.

### **2.1. Geography**

The total area of the Russian Federation is 17 075 040 km<sup>2</sup>, of which the RTBR cover 1 321 500 km<sup>2</sup> or 7.7%. Thus, the combined surface area of the RTBR is about four times that of Finland. The population of Russia on 1st of January, 1999, was 146.3 million, of which the share of the RTBR was only 4.4 million or 3.0%. The Region is extremely sparsely populated, with an average of 3.3 inhabitants per km<sup>2</sup>. The population is concentrated in several large industrial and administrative centres such as the cities of Murmansk, Arkhangelsk, Petrozavodsk, and Syktyvkar, and the rest of the area is sparsely populated. For example, the Nenets Autonomous Okrug has a population density of only 0.3 inhabitants per km<sup>2</sup>.

The geographical characteristics of the RTBR are harsh. The Region borders Norway and Finland in the west, other Russian republics and oblasts in the south, the Ural Mountains in the east, and the Arctic Ocean and its seas in the north. The northernmost parts of these regions lie above the Arctic Circle, and there are large expanses of tundra and permafrost areas near the Arctic Ocean. Boreal coniferous forests cover huge areas of the Region, and there are even predominantly mountainous areas in parts of the Murmansk Oblast and Republic of Komi. The climate in the RTBR is characterised by long, cold winters with plentiful snowfall, and short, light summers. Thus, ecological systems in the Region are fragile to environmental changes.

Geologically, the Kola Peninsula is a part of the Fennoscandian crystalline shield, and the Republic of Karelia lies on its south-eastern slope. The main part of the Arkhangelsk Oblast is situated on the Paleozoic Russian platform containing a large variety of sediments and rocks. The largest, western part of the Republic of Komi's territory is occupied by the north-eastern part of the East-European Plain, a fragment of the ancient Russian Platform, formed by Precambrian crystalline rocks partly covered by sedimentary rocks from Palaeozoic and Mesozoic periods. Different geological histories have resulted in a large number of rich mineral and hydrocarbon deposits in the RTBR, which contain a huge potential for further economic development.

The climate in the area is arctic or sub-arctic. The arctic zone is characterised by low temperatures, permafrost, and ice cover in the seas and rivers during the long winters. The weather in the sub-arctic zone is milder with more snow in the winter and large differences between summer and winter temperatures.

### **2.2. Administration**

The RTBR are part of the Northern Economic Zone (NEZ) of the Russian Federation. Constitutionally, they are among the 89 subjects of the Russian Federation. Thus, also the Nenets Autonomous Okrug is an independent and separate subject of the Russian Federation. The administrative forms of Oblast (region), Republic, and Autonomous Okrug are assigned specific responsibilities and powers according to the Russian Constitution. As of August 1999, treaties on division of powers between the Federal Government and the regional

administrations had been made by the Murmansk Oblast and the Republic of Komi. The Republic of Karelia, the Arkhangelsk Oblast, and the Nenets Autonomous Okrug are preparing such agreements with the Federal Government.

### **2.3. Population**

The RTBR are experiencing a steep demographic decline. The populations of these regions reached their peak at the end of the 1980s, and have since then continuously declined. In total, the population of the RTBR has fallen by 364 000 or 7.6% since 1991. The largest absolute and relative decline has been experienced in the Murmansk Oblast, where the population has fallen by 141 000 or 12.2% between 1991-98. This negative demographic trend is expected to continue, as the population of the Region is projected to fall by 458 000 or 10% between 1997-2010. Main factors in this development are the steep economic recession in the Region and the related closing down of industrial facilities and military installations. This has led to mass emigration, especially of young and highly trained people, as well as reduced birth rates and somewhat raised death rates among the population resident in the Region.

The declining economic situation and the fall in population in the RTBR in the 1990s are reflected in the development of average life expectancy. In 1989-90, the average life expectancy in the Region was the same as in the Russia Federation as a whole, 69.4 years. In the period 1989-97, however, life expectancy in the RTBR fell as low as 61.9 years. The situation of the male population has been especially worrying.

The degree of urbanisation in the RTBR is very high, amounting on average to 78%, and being as high as 92% in the Murmansk Oblast. The majority of the population centres depend on the operation and economic success of one or a few industrial combines for their sustenance. The settlement pattern is principally a result of the industrialisation and security policies of the Soviet Union.

The populations of the RTBR are ethnically diverse. The indigenous populations living in the area (Sami, Komi, Nenets, Vepse and others) have been supplemented by large numbers of Russians who have moved to these northern areas. In addition, large numbers of people of other nationalities such as Ukrainians and Belorussians have moved to north-west Russia, especially after the Second World War.

### **2.4. Natural Resources**

The RTBR are extremely rich in various natural resources. The original settlement was attracted to the area by the availability of fish, game, forests, and later by minerals and energy. Today, these resources still form the basis of the Region's economic activities. The main base for the regional fishing industry is the Barents Sea, and the White Sea as well as fresh inland waters are also significant fishing grounds.

Productive forests are found in the Arkhangelsk Oblast, the Republic of Karelia, and the Republic of Komi, as well as in some parts of the Murmansk Oblast. The largest forest area in the Region is in the Republic of Komi which has over 30 million hectares of forest land and 2 960 million m<sup>3</sup> of standing timber. The RTBR have total timber resources of 6 531 million m<sup>3</sup>, forming 7% of Russia's resources. A large share of the forests are mature and over-mature, especially in the Arkhangelsk Oblast and the Republic of Komi. Boreal coniferous forests, which consist mainly of pine and spruce, are economically the most important types

in the Region. The RTBR produce a significant share of pulp and paper in the Russian Federation, and also the mechanical wood industry in the Region is of growing significance. Four of the five largest forest industry enterprises in Russia are located in the Region.

The Russian Federation obtains 100% of apatite concentrate, 99% of ceramic pegmatites, 88% of phosphates, 78% of micas, and a significant portion of copper, nickel, cobalt, rare metals and rare earth elements, bauxites and building stones, as well as hydraulic cement from the RTBR. Mining activities are concentrated on the Kola Peninsula, but non-hydrocarbon minerals are also exploited in the other RTBR. The most important mining towns are Apatity, Kirovsk, Olenegorsk, Kovdor, Zapoljarny and Revda, as well as the coal mining centres of Komi. Deposits of industrial minerals are spread throughout the north-western parts of Russia.

Most of the oil and gas resources in the RTBR are found in the Timan Pechora oil and gas province, covering the Nenets Autonomous Okrug and the northern parts of the Republic of Komi, as well as in the Barents Sea shelf and the Pechora Sea. Oil deposits are located onshore in Timan-Pechora as well as in the Barents and Pechora Seas. Main natural gas and condensate deposits lie in the Barents Sea, especially in the huge Shtockmanovskoye structure. Oil and gas exploitation in the Region is still at a preliminary stage, although exploration and production has begun in Timan Pechora. As the gas production in Western Siberia starts to decline, and as new gas fields need to be developed to meet a growing demand in Europe, both the Barents Sea and Yamal Peninsula deposits need to be developed. Thus, the RTBR hold strategic natural gas reserves for Western Europe for the next several decades. At the present, however, oil and gas transportation from the Region is not sufficient to meet the coming demand.

## **2.5. Infrastructure**

Sufficient infrastructure is an important precondition for the development of natural resources in the RTBR. However, the existing infrastructure in the Region is in urgent need of modernisation, and in addition new infrastructure needs to be constructed. In all parts of the Barents Region, infrastructure has been mainly built in the north-south direction, serving main cargo flows.

Railways and waterways are used for 80-90% of all freight transportation in the RTBR. The road network is, on average, in poor condition, and has less significance in freight transportation. Flight passenger traffic is important due to long distances, and forms the only connection to a number of isolated northern communities. Due to weak roads and difficult soil conditions, winter roads are widely used for heavy transports, especially in the Arctic permafrost areas. A number of important investment projects for the improvement of transportation infrastructure in the Region are under development.

The export harbours on the Barents Sea - Murmansk and Arkhangelsk - have a strategic significance for the whole of Russia, as they are its only access points to the world's seas not limited by difficult and potentially restricted navigation routes. At the present, however, these harbours require urgent refurbishment. In the long term, the use of the Northern Sea Route and the transportation of hydrocarbons from Western Siberia and Timan Pechora provide potential for expansion of these harbours' exploitation.

Energy supplies are extremely important for the economies of the RTBR due to cold climate, long distances, and energy intensive industries. The oblasts and the republics of the Region

are, however, in quite different positions regarding their energy sector. Some of them have their own oil, natural gas or hydropower resources, while others lack practically all economically feasible local resources. Of these regions, the largest producer and consumer of electricity is the Murmansk Oblast which has four VVER-440 nuclear reactor units at the Kola nuclear power plant in Polyarnye Zori, as well as 17 hydropower plants. Energy efficiency measures are of key importance for all the RTBR.

Telecommunication is a vital part of efficient infrastructure, and is nowadays inadequate in north-west Russia. The basic telephone system dates back to the Soviet time, and has a limited capacity and low technical standard. However, the long distance connections work satisfactorily to major cities and main industrial companies in the Region. The NMT and GSM mobile phone networks have been developed in the areas close to the Nordic countries.

In addition to transport, energy and telecommunication, a good infrastructure should offer various kinds of technical, administrative and social services. Unfortunately these social infrastructure sectors have suffered greatly in the RTBR in the 1990s, mainly due to the economic decline and ensuing budget shortages of the Region.

## **2.6. Economy**

Today, the economies of the RTBR still rely on heavy industry founded during the Soviet industrialisation. Industrial production is concentrated in large plants around which settlements have evolved and on which they have grown dependent. The RTBR have, on average, a higher standard of living, including higher salaries and social payments, than most other parts of Russia. However, the economic crisis of the 1990s has caused a major downturn in the economies of these northern regions. Earlier benefits and subsidies for these regions from the federal centre have been reduced significantly. The economic survival strategies of the RTBR have principally concentrated on the promotion of foreign trade and the development of their exporting industries. A major pre-condition for economic recovery in the Region is the growth of both domestic and foreign investments into local industries.

As a whole, the RTBR' gross regional product (GRP) makes up about 3% of the gross domestic product (GDP) of the Russian Federation. However, the economic significance of these regions of Russia is based on the fact that they are major producers of important raw materials and their derivatives, especially wood, pulp, paper, minerals and mineral products, oil, natural gas, and coal. The Republic of Komi has, on average, had the largest GRP of the RTBR, largely due to the hydrocarbon production taking place on its territory. The Republic of Karelia has clearly the smallest economy of the RTBR.

Industrial production volumes of the RTBR fell by 35-54% between 1990-98. In 1997, all these regions experienced a slight recovery, even a growth of 13% in the Murmansk Oblast. However, the Russian economic crisis which began in August 1998 set back the promising stabilisation of economic development. Industrial production in the Region fell by 2-4% in 1998. GRP per capita in the Region fell from USD 2641 in 1997 to under USD 2000 in 1998. The negative effects of the Russian economic crisis have been somewhat offset by the accompanying steep devaluation of the rouble which has supported exporting industries such as the forest and hydrocarbons industries. Nonetheless, many of the Region's enterprises are in a bankruptcy situation. In order to survive, the companies need to find new customers, organise their own sales and marketing activities, and, finally, be able to compete in the domestic and export markets.

In 2000 and the beginning of 2001 the economies of the Region have, however, showed clear signs of recovery. Industrial production has grown significantly in all sectors, and growth has been especially strong in the forest and mining industries. The oil and gas producing regions (Nenets and Komi) have also benefited greatly from the rise of world oil prices.

The main industrial region of the RTBR has traditionally been the Murmansk Oblast where heavy mining and metal industries are located.

Inflation has been at a very high level in the RTBR throughout the 1990s. Consumer prices rose by over 200% during 1994. Inflation fell to a relatively low level of 8% in 1997, but then the economic crisis beginning in August 1998 aggravated inflationary problems and raised annual inflation back to about 75% in 1998.

The average monetary incomes of the populations of RTBR have been above the Russian average for a long time. The fact that incomes have been higher in the Region than elsewhere in Russia has been partly due to the higher wage level of workers, as well as different forms of subsidisation and support given to the regions of northern Russia. The Murmansk Oblast is relatively the wealthiest region of the RTBR, with an average nominal monetary income per capita of about USD 230 in 1997, and USD 143 in 1998.

In the Murmansk Oblast and the Republic of Komi, average wages have been above the Russian average for the whole of the 1990s. On the other hand, salaries in the Arkhangelsk Oblast and the Republic of Karelia have been below the Russian average. The average monthly salary in the RTBR was USD 236 in 1997, and USD 153 in 1998.

The real unemployment rate (International Labour Organisation) in the RTBR has risen from an average of 6% in 1993 to 13.3% in 1997 and 17.2% in 1998. The Murmansk Oblast has the highest unemployment of the four, with almost 23% of the population without work in 1998. Despite the recent economic recovery, unemployment remains at very high levels in all regions.

A major problem in the RTBR' economies has been the low level of domestic investments, which have continued to decline in 1997 and 1998. Foreign investments have thus become a valuable asset for these regions. However, the level of both domestic and foreign investments in the Region has been very low compared with actual needs. Despite their rich natural resources, the RTBR have attracted only about 1% of all foreign investments made in Russia.

The RTBR have succeeded in developing their foreign trade in the 1990s, as they have significantly increased their foreign trade turnover and trade surpluses in the last 4-5 years. The Murmansk Oblast has the largest foreign trade turnover in the Region, amounting to about USD 1.6 billion in 1997, and USD 1.1 billion in 1998. The exports from the RTBR consist mainly of raw materials, and imports principally of food, clothes, and manufactured goods.

The EU as a whole is the main trade partner of all the RTBR. For instance, EU countries receive about 50% of all exports from the Republic of Karelia, and they are responsible for 75-80% of its imports. The EU countries with relatively the largest trade volumes with the RTBR are Finland, Germany, Great Britain, the Netherlands, and Sweden. Other important trade partners include Norway and the United States.

## **2.7. Environment**

Extensive industrial and military activities combined with out-of-date production technology of the factories have caused severe pollution and environmental damage in some parts of the RTBR. This has created the need for large-scale investments in reconstruction and modernisation, especially in the mining and wood processing industries. Furthermore, there is an enormous need for cleaning up sites contaminated with chemicals, heavy metals, as well as radioactive and other hazardous waste. Air pollution around large industrial plants, radioactive waste storage and poor state of municipal drinking water have reached critical levels in many locations in the Region

On the other hand, there are also large areas of unspoiled nature in a virgin state, and extensive areas are reserved for nature conservation. Pollution in north-west Russia is concentrated in several so-called environmental hot spots, which are also both the backbone of economic development of the RTBR and their major population centres.

In the future, several major threats and risks to the regional environment can be identified, mainly undeveloped forestry practices influencing the nature protection values of forests and destroying old growth forests, as well as development of major oil and gas exploration and production ventures in Arctic areas.

## **2.8. Security**

The security environment of the RTBR, and, in a wider context, the European North, has changed significantly in the 1990s. In the 20<sup>th</sup> century, the militarisation of the Arctic transformed the RTBR, including the Barents Sea, first into a military flank and then into a military front in the Cold War Period. Especially the ice-free reaches of the Barents, Norwegian, and Greenland Seas were heavily militarised areas and targets for both the Soviet Army and the American military. In the 1990s, new actors such as non-governmental and intergovernmental organisations have become active in traditional security issues such as nuclear safety. Thus, there is a complex network of co-operation and competition influencing security issues in the European North.

The main legacy of the Cold War Period in the RTBR is the concentration of nuclear material there. In these regions, there are tens of nuclear weapon storage sites and bases for nuclear war-heads, the Russian Northern Fleet with more than 150 nuclear submarines, dumped radioactive waste, more than ten storage areas for nuclear waste, dumped nuclear waste, sunken and dumped nuclear reactors, as well as two nuclear test ranges on Novaya Zemlya, among others. The heritage of the Cold War can also still be seen both in the structures and policies of the RTBR: the continuation of strategic aspects and emphasis on traditional military-based security in the policy dealing with the North, and in nuclear risks and the whole nuclear problem of the Kola Peninsula and the nearby waters.

## **2.9. Future Challenges**

In the 21<sup>st</sup> century, there are huge challenges to be faced by the RTBR. Many negative tendencies in environmental degradation, demographic demise, and economic recession will continue. On the other hand, there is potential for positive development in the Region in the medium and long term, mainly in the sustainable utilisation of its rich natural resources. The

future development of the RTBR is very dependent on general economic and political conditions prevailing in the Russian Federation. Nonetheless, these regions have a major role in natural resources management, sustainable practices in relation to the environment, infrastructure development, as well as expansion of trade and investments on their territories. Therefore, the extent to which the significant development potential of the RTBR is exploited is also very much dependent on regional strategies and administration.



### **3. Development of FDI in the Russian Territories of the Barents Region**

This part of the study analyses the development of foreign direct investments (FDI) in Russia and the RTBR, in particular, on the basis of available statistical information. The focus is on FDI made by foreign investors in Russian companies with the aim of participating in a productive enterprise and making profits in the long term. The analysis is made on the basis of statistics collected both by the Russian Federal Statistical Office, Goskomstat, and the regional statistical offices. The section starts with an account of the methodology of compiling the Russian FDI statistics. International comparison is carried out on the basis of statistics published by the UN Economic Commission of Europe.

#### **3.1. Compiling of FDI Statistics in the Russian Federation**

The Russian Statistical Office follows the guidelines of the International Monetary Fund in defining foreign direct investments (FDI). Accordingly, FDI consists of investments made by natural or juridical persons, who own a minimum of 10 % of the shares of a Russian company and have corresponding voting rights and interest in influencing the functional activities of the company. In comparison to direct investments, portfolio investments are made by investors, who have acquired less than 10 % of voting rights and therefore cannot directly influence the operations of the enterprise.

Foreign direct investments include the following items:

- Investments in the equity or authorised capital of the enterprise; these can be made either in money or in kind, such as machinery, real estate or goods;
- Credits received from the foreign mother company;
- Other investments, such as additional shares acquired by the investor, reinvested earnings or in kind investments not included in the authorised capital.

Portfolio investments, in turn, include bonds, obligations, bills of exchange and similar monetary instruments in addition to shares in enterprises.

In the Russian statistics foreign direct investments are included in foreign investments, which, in addition to direct and portfolio investments, also include other forms of foreign investments, such as:

- trade credits for the purpose of financing exports or imports;
- financial credits received from international financial institutions;
- bank deposits of foreign natural or juridical persons in Russian banks/ deposits of Russian citizens in foreign banks.

In Russia, as elsewhere in the world, there are significant problems in assessing the FDI in real terms<sup>4</sup>. First, there are no price and/or quantity elements that would be needed for the evaluation of price developments. Secondly, evaluation of the investment flows also depends on the choice of currency. Thirdly estimating stocks of FDI present problems due to the fact that data on FDI stocks are mostly unadjusted book values. Finally, FDI data generally

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<sup>4</sup> See, e.g. World Investment Report, 1997

include funds involving only the foreign parent firm and foreign affiliates and exclude investment funds raised outside the investing company.

Thus, in Russian conditions of high inflation, considerable devaluation of the local currency and specific accounting rules for the revaluation of the assets, the statistical information on FDI can be strongly biased in real terms. On the other hand, it can be assumed that in the Russian investment environment characterised by high credit risks and nascent status of the local banking sector, outside sources of financing are not as significant as in other parts of the world.

However, the Russian federal and regional statistics are likely to provide a consistent approach and a sufficient basis for comparison between the regions, as they use the same methodology.

Information about direct and portfolio investments is collected in Russia by the regional statistical offices on the basis of a questionnaire sent to registered companies. Information of foreign investments in the Russian banking sector is compiled by the Central Bank of Russia on the basis of information received from Russian commercial banks. Both information from non-financial sector and the financial sector are combined and included in the balance of payments statistics compiled by the Central Bank and Goskomstat in co-operation with relevant ministries and other authorities.<sup>5</sup> Data provided by Goskomstat are, however, more detailed and are therefore used here.

All juridical persons are required by law to provide accounting information for the statistical authorities in Russia. For this purpose, among others, all organisations have to be registered by the Unified Register of Enterprises and Organisations (EGRPO, Edinoi, Gosudarstvennoi Register Predpriatii i Organisatsii). Information about investments, including foreign investments, is provided to the local statistical authorities by filling out a standard questionnaire. The local statistical offices collect such information quarterly, compile it and send it to the federal statistical office, Goskomstat in Moscow. In order to serve the local information needs they also prepare local statistical publications of their own. Goskomstat, in turn, publishes aggregated information for the whole Russian federation.

All registered enterprises, domestic and foreign owned alike, receive the questionnaire every quarter and are obliged to provide the requested information. However, receiving information from newly created companies, which have not yet entered the registry, is somewhat problematic. The local statistical offices try to keep track of newly created companies in several ways, including monitoring of the local newspapers. Yet, it is unlikely that they will be able to identify all new enterprises and information from these may reach them only belatedly. Information concerning the FDI of newly created companies is an example of additions/revisions that have to be made to the initially collected statistics.

The registered enterprises provide information on foreign direct investments in two different questionnaires: 1) as part of information covering investments in general by 25<sup>th</sup> – 29<sup>th</sup> day after the end of each quarter (statistical form N P-2) and 2) as part of information on foreign investments, in particular, by 15<sup>th</sup> day after each quarter (statistical form N1-invest).

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<sup>5</sup> Metodologitsheskie polozheniya po statistike, Gosudarstvennij komitet Rossiiskoi Federatsii po Statistike, 1996

The basic information on foreign direct investments in the Russian regions is available both from local statistical sources and the federal statistical office. However, information is not available for all the years or according to the same categories for all regions, which makes it somewhat difficult to compare the regions with each other or with the federal level data. Particularly the sectoral break-down of investments is different for most of the regions.

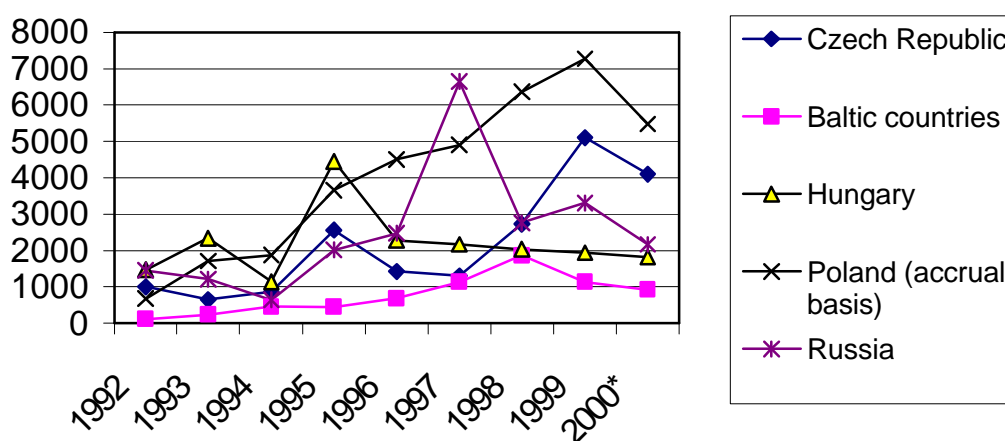
More specifically, for the Murmansk Oblast, information for some early years (1994-95) is not available. For Arkhangelsk Oblast it has to be noted that the statistics include information also for the Nenets Autonomous region, which is not available separately.

### 3.2. FDI in Russia Compared to FDI in Other Central and Eastern European Transition Economies

Among Central and Eastern European countries Russia started to attract significant flows of foreign direct investment in 1995. The FDI inflows in Russia peaked in 1997 at about 6 billion USD but decreased radically after the 1998 financial crisis and have not yet recovered their previous level. At the same time, FDI inflows particularly to Poland and the Czech Republic have continued to grow. Chart 1 depicts the inflows in Russia, Hungary, the Czech Republic, Poland and the Baltic countries. The Russian situation as a host to FDI is, however, unique in Eastern Europe as it is the only net exporter of capital. Accordingly, the net inflows of FDI have been considerably smaller than the total inflows of FDI.

Chart 1

**FDI inflows in Central and Eastern Europe  
1992-2000 (millions of USD)**



\* estimated on the basis of January-June 2000 statistics

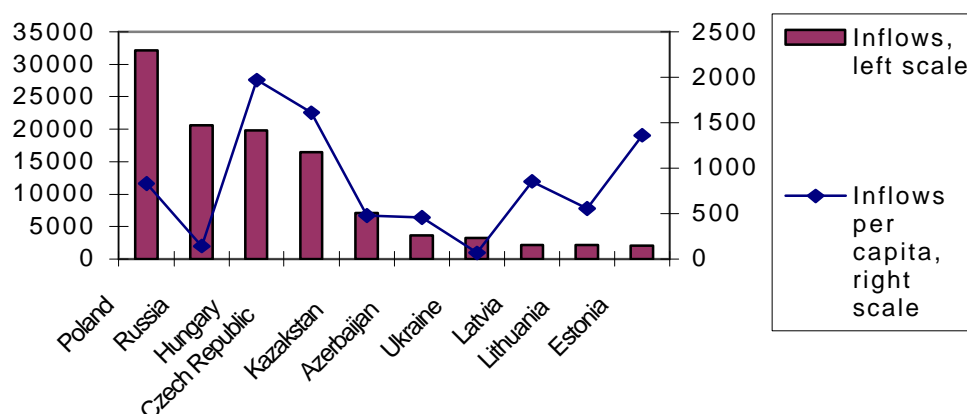
Source of the data: FDI and the Macroeconomy in the Transition Economies, Background paper for Special Session III on FDI and the Restructuring of Transition and Emerging Economies, Economic Analysis Division, UN/ECE

In terms of cumulative inflows of FDI Russia takes the second position among Central and Eastern European countries after Poland (Chart 2). However, the relative significance of FDI in terms of FDI per capita or in relation to the GDP is low in Russia in comparison to Hungary, the Czech Republic or the Baltic countries. In terms of current account and

investments the significance of FDI is also low in Russia. While, e.g., in the Czech Republic and Kazakhstan the inflows of FDI have been significantly greater than the current account earnings during 1997-99, Russia is an exception due to the status of a net exporter of capital. Thus for Russia FDI has not been a source of financing in the balance of payments as it has been for most transition countries in Central and Eastern Europe. Also the significance of FDI compared to total investments measured by the gross domestic fixed capital formation, has been low in Russia (charts 2,3).

**Chart 2**

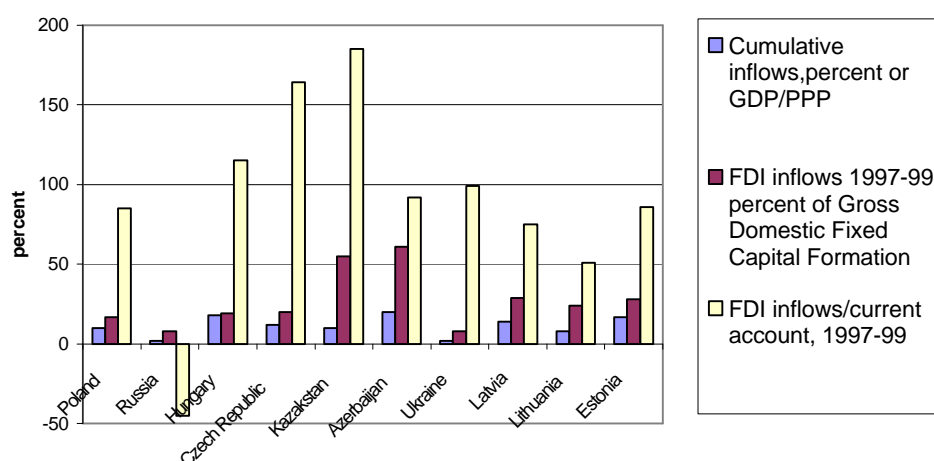
### Cumulative inflows of FDI in Central and Eastern Europe, 1988-99 (million USD)



Source of the data: FDI and the Macroeconomy in the Transition Economies, Background paper for Special Session III on FDI and the Restructuring of Transition and Emerging Economies, Economic Analysis Division, UN/ECE

**Chart 3**

### Significance of FDI inflows in Eastern Europe, 1988-99

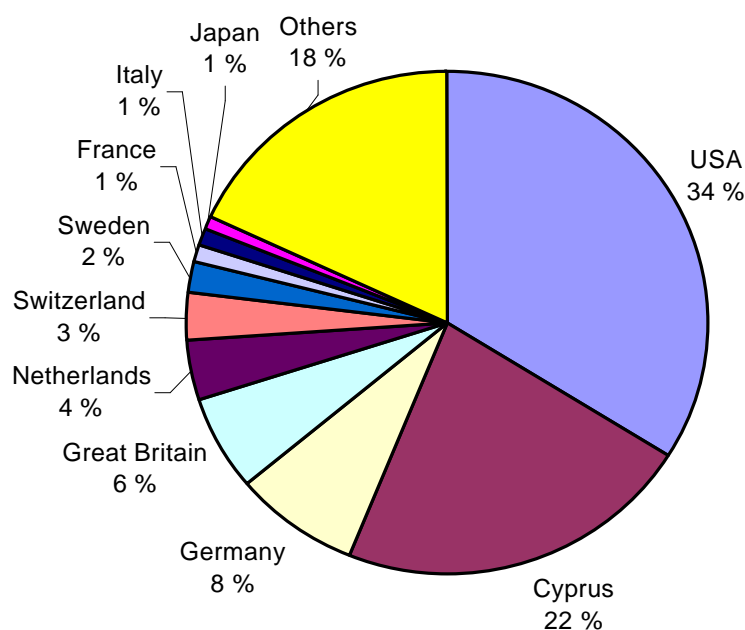


Source of the data: FDI and the Macroeconomy in the Transition Economies, Background paper for Special Session III on FDI and the Restructuring of Transition and Emerging Economies, Economic Analysis Division, UN/ECE

The sources of cumulative FDI in Russia are depicted in Chart 4. The USA is the leading investor country with the share of one third of all FDI; Cyprus takes the second position with about one fifth of the investments. The large amount of FDI originating in Cyprus is generally considered a sign of Russian capital returning back to the country.

**Chart 4**

### **Sources of Cumulative FDI in Russia, 1999/IX**



Source: Goskomstat (State Statistical Office of the Russian Federation)

### **3.3. Estimates of FDI in the Russian Territories of the Barents Region**

Table 1 provides basic statistical data on the development of total FI in the region. The total amount includes direct investments, portfolio and other foreign investments, such as credits.<sup>6</sup> The breakdown of foreign investments into direct, portfolio and other investments is provided in Table 6. Charts 5 and 6 illustrate, in turn, the development of FI and FDI in the RTBR.

Cumulative foreign investments in the RTBR amount to 980 million US dollars during 1995-1-6:2000. Table 1 indicates that, compared to the total of FI made in Russia, the share of the RTBR is small, amounting to an average of 2 % of total investments during 1995-1999. Compared to investments in the City of St. Petersburg, investments in the RTBR amounted to about one half of those made to the City. Compared to Moscow, they amounted only to about 3%, which illustrates the great significance of Moscow as a recipient of FI. The share of Moscow of all FI made in Russia was 57% during 1995-1999.

<sup>6</sup> See the above description of the methodology of compiling the statistics. There exist some discrepancies in the statistics provided by the regional statistical offices and the federal Goskomstat in Moscow. Such discrepancies are indicated in the footnotes to the tables. With these few exceptions the regional and federal statistics provide a consistent picture of the FDI development in the RTBR.

Chart 5 illustrates the development of FI in the four regions and shows the predominant share of the Republic of Komi and Arkhangelsk Region in 1998-1999 in the total foreign investments. Chart 6, in turn, illustrates the development of FDI in the four regions. Komi leads also in the amount of FDI whereas the direct investments to Arkhangelsk have been minimal compared to other forms of foreign investment.

Table 2 indicates further that the amount of foreign credits directed to the regions in focus by far surpassed the amount of FDI during 1994-1999. The Arkhangelsk Oblast, in particular, has received significant foreign credits in 1994 and in 1999 (from the EBRD for the Polar Lights JV operating at the Ardalín oil field in the Nenets Autonomous Okrug). Portfolio investment, in turn, has been negligent for the whole region. On average the share of FDI amounted to only 20% of all FI.

The yearly level of FDI in the region has generally remained below 20 million USD for all the regions. The FDI in Arkhangelsk in 1994 and Komi in 1999 are exceptions. In both cases the FDI amounted to about 40 million USD. In both regions the largest direct investments have been made in the energy sector. Komi has also received a large investment in its forest industry sector, mainly through a major Austrian investment at the Syktyvkar pulp and paper plant.

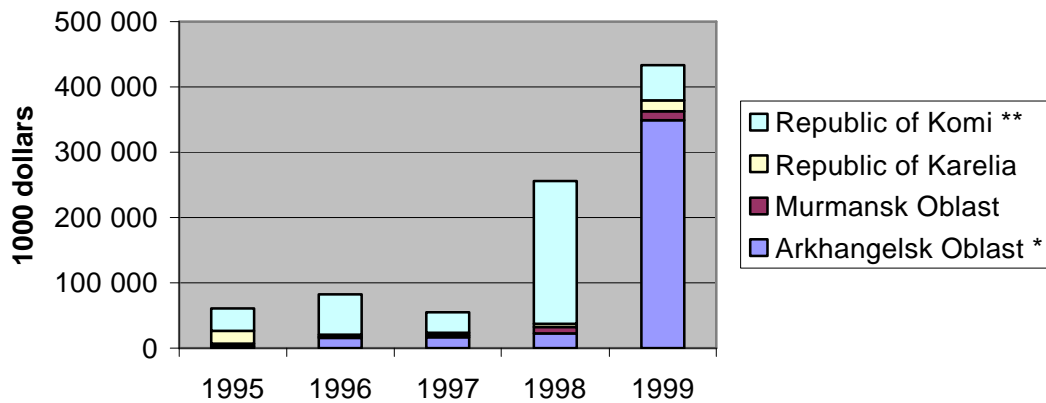
There are, however, significant differences between the four regions on the previous measures. While the Republics of Karelia and Komi reach about half of the national average, the Arkhangelsk and Murmansk Oblasts are far behind.

**Table 1 Total Foreign Investment in the Russian Territories of the Barents Region During 1995 – 1-6:2000**

Region	Foreign Investments (USD 1 000)							
	1995	1996	1997	1998	1999	Total 1995-1999	1-3/2000	1-6/2000
Arkhangelsk Oblast *	3 338	14 988	16 377	22 784	348 624	406 111	9 913	18 649
Murmansk Oblast	3 102	3 143	3 165	9 579	14 590	33 579	8 617	28 414
Republic of Karelia	19 612	2 417	4 299	5 137	15 492	46 957	9 056	13 709
Republic of Komi **	34 627	61 498	31 062	218 131	54 351	399 669	23891	33675
<b>Total</b>	<b>59 991</b>	<b>82 046</b>	<b>54 903</b>	<b>255 631</b>	<b>433 057</b>	<b>885 628</b>	<b>51 477</b>	<b>94 447</b>
Russia total	2 983 375	6 970 317	12 294 734	11 772 988	9 560 000	43 581 414	4 961 000	4 778 000
Share of RTBR***	2,01 %	1,18 %	0,45 %	2,17 %	4,53 %	2,03 %	1,04 %	1,98 %
St. Petersburg	154 727	145 272	171 336	413 280	698 536	1 583 151	258 946	538063
Moscow	1 876 900	4 291 604	7 076 723	5 860 016	2 653 760	21 759 003	698 042	1527765
Source: Goskomstat (State Statistical Office of the Russian Federation)								
* The local Arkhangelsk Goskomstat gives 16 565 USD 1000 for the year 1998								
** The local Komi Goskomstat gives 67 300 USD 1000 for the year 1998								
*** Russian territories of the Barents Region								

**Chart 5**

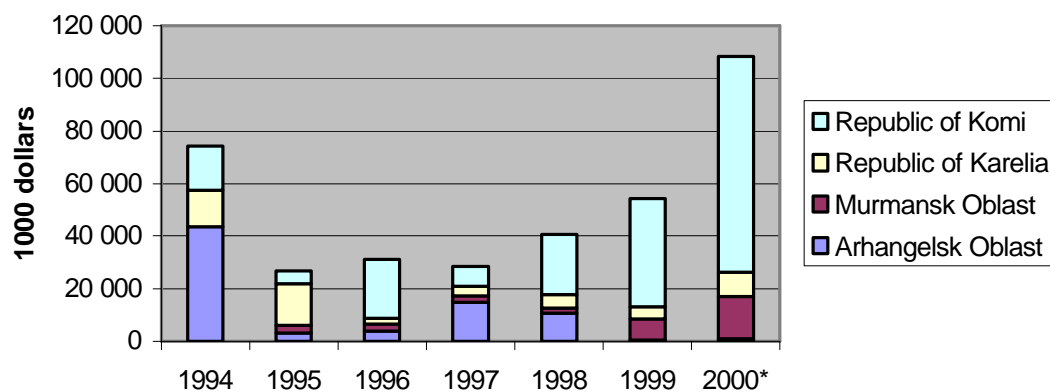
**Foreign investment in the Russian Territories of the Barents Region during 1995-1999**



Source: Goskomstat (State Statistical Office of the Russian Federation)

**Chart 6**

**Foreign Direct Investments in the Russian Territories of the Barents Region during 1994-2000**



\* estimated on the basis of the first 6 months of 2000

Source: Goskomstat (State Statistical Office of the Russian Federation)



**Table 2 Foreign Investments in Russian Territories of Barents Region in 1994 – 1-6:2000 by Type (USD 1000)**

Region of NW Russia	Direct (FDI)	Portfolio	Other	Total	Share of FI of regions in the whole FI of RTBR, %	Share of FDI in FI, %
	<b>1994</b>					
Arkhangelsk Oblast	43 536	0	395 064	438 600		10
Murmansk Oblast	n/a	n/a	n/a	n/a		
Republic of Karelia	13 797	0	786	14 583		95
Republic of Komi	16 800	0	14 300	31 100		54
<b>Total for 1994</b>	<b>74 133</b>	<b>0</b>	<b>410 150</b>	n/a		
	<b>1995</b>					
Arkhangelsk Oblast	3 142	0	196	3 338	6	94
Murmansk Oblast	2 776	0	326	3 102	5	89
Republic of Karelia	16 017	0	3 595	19 612	33	82
Republic of Komi	4 751	6 700	23 176	34 627	58	14
<b>Total for 1995</b>	<b>25 974</b>	<b>6 700</b>	<b>27 317</b>	<b>59 991</b>	100	<b>43</b>
	<b>1996</b>					
Arkhangelsk Oblast	3 940	0	11 048	14 988	18	26
Murmansk Oblast	2 550	0	593	3 143	4	81
Republic of Karelia	2 301	0	116	2 417	3	95
Republic of Komi	22 242	0	39 256	61 498	75	36
<b>Total for 1996</b>	<b>26 860</b>	<b>0</b>	<b>50 957</b>	<b>82 046</b>	100	<b>33</b>
	<b>1997</b>					
Arkhangelsk Oblast	14 941	0	1 436	16 377	30	91
Murmansk Oblast	2 331	0	834	3 165	6	74
Republic of Karelia	3 659	0	640	4 299	8	85
Republic of Komi	7 524	0	23 538	31 062	57	24
<b>Total for 1997</b>	<b>28 455</b>	<b>0</b>	<b>26 448</b>	<b>54 903</b>	100	<b>52</b>
	<b>1998</b>					
Arkhangelsk Oblast*	10 489	0	12 295	22 784	9	46
Murmansk Oblast	2 188	0	7 391	9 579	4	23
Republic of Karelia	5 137	0	0	5 137	2	100
Republic of Komi***	22 796	0	195 335	218 131	85	10
<b>Total for 1998</b>	<b>37 547</b>	<b>0</b>	<b>68 886</b>	<b>255 631</b>	100	<b>15</b>
	<b>1999</b>					
Arkhangelsk Oblast	400	0	348 224	348 624	81	0
Murmansk Oblast**	8 153	46	6 391	14 590	3	56
Republic of Karelia	4 532	0	10 960	15 492	4	29
Republic of Komi	41 109	0	13 242	54 351	13	76
<b>Total for 1999</b>	<b>54 194</b>	<b>46</b>	<b>378 817</b>	<b>433 057</b>	100	<b>13</b>
	<b>1-6/2000</b>					
Arkhangelsk Oblast	711	2 087	15 851	18 649	20	4
Murmansk Oblast	17 008	1 293	10 113	28 414	30	60
Republic of Karelia	2 905	204	10 600	13 709	15	21
Republic of Komi	12 670	0	21 005	33 675	36	38
<b>Total for 1-6/2000</b>	<b>33 294</b>	<b>3 584</b>	<b>57 569</b>	<b>94 447</b>	100	<b>35</b>

Source: Goskomstat (State Statistical Office of the Russian Federation)

When analysing further the significance of FDI for the regions the development can be compared to that of the gross regional product (GRP), industrial production, investments in fixed assets, and population (per capita). Tables 3, 4, 5 and 6 indicate that, so measured, the significance of FDI is smaller in the RTBR than in Russia on average. The share of FDI in the GRP during 1994-1998 was on average 0.27 % while in Russia the share of FDI in gross domestic product (GDP) reached 0,89 % for the same period.

**Table 3 Foreign Direct Investments' share in GRP in 1994-1998 in Russian Territories of the Barents Region**

Region	Share					Cumulative 1995-1998
	1994	1995	1996	1997	1998	
Arkhangelsk Oblast	1,70 %	0,10 %	0,10 %	0,459 %	0,49 %	0,26 %
Murmansk Oblast	n/a	0,09 %	0,08 %	0,07 %	0,09 %	0,08 %
Republic of Karelia	0,90 %	0,91 %	0,13 %	0,21 %	0,44 %	0,42 %
Republic of Komi	0,55 %	0,11 %	0,50 %	0,16 %	0,86 %	0,36 %
Total RTBR(average)	n/a	0,22 %	0,23 %	0,22 %	0,48 %	0,27 %
Russian Federation (FI/GDP)	n/a	0,59 %	0,58 %	1,22 %	1,21 %	0,89 %

Source: Goskomstat (State Statistical Office of the Russian Federation)

**Table 4 Foreign Direct Investments' share in the Industrial Production in 1994-1999 in Russian Territories of the Barents Region**

Region	Share						Cumulative 1995-1999
	1994	1995	1996	1997	1998	1999	
Arkhangelsk Oblast	3,00 %	0,13 %	0,16 %	0,83 %	0,81 %	0,04 %	0,36 %
Murmansk Oblast	n/a	0,10 %	0,10 %	0,09 %	0,12 %	0,66 %	0,17 %
Republic of Karelia	1,50 %	1,19 %	0,19 %	0,30 %	0,61 %	0,71 %	0,60 %
Republic of Komi*	0,97 %	0,20 %	0,91 %	0,37 %	1,35 %	3,29 %	1,01 %
Total RTBR(average)	n/a	0,30 %	0,36 %	0,37 %	0,72 %	1,31 %	0,52 %
Russian Federation	n/a	0,87 %	0,88 %	1,96 %	1,97 %	4,07 %	1,65 %

Source: Goskomstat (State Statistical Office of the Russian Federation)

**Table 5 Foreign Direct Investments as % of Investments into Fixed Assets in 1995-99 in Russian Territories of the Barents Region**

Region	Share					Cumulative 1995-99
	1995	1996	1997	1998	1999	
Arkhangelsk Oblast	0,7	0,9	4,3	10,4	1,0	2,3
Murmansk Oblast	0,6	0,8	0,6	2,5	19,9	1,4
Republic of Karelia	5,8	1,0	1,9	8,6	12,0	3,9
Republic of Komi	0,5	2,3	0,9	11,2	64,6	3,4
<b>Total</b>	7,6	4,9	7,8	32,6	21,6	2,8
Russian Federation	3,4	3,3	7,8	17,2	18,5	7,9

Source: Goskomstat (State Statistical Office of the Russian Federation)

**Table 6 Foreign Direct Investments per capita in 1994-1999 in Russian Territories of the Barents Region**

Region	Foreign Direct Investments per capita (USD)*						Cumulative 1995-1999
	1994	1995	1996	1997	1998	1999	
Arkhangelsk Oblast	28,12	2,05	2,59	9,91	7,03	0,27	21,84
Murmansk Oblast	n/a	2,60	2,43	2,26	2,15	8,15	17,42
Republic of Karelia	17,38	20,30	2,93	4,69	6,62	5,87	40,55
Republic of Komi**	13,98	4,01	18,95	6,48	19,63	35,78	84,40
Total RTBR(average)	n/a	5,83	6,85	6,35	9,13	12,32	40,34
Russian Federation		13,65	16,54	36,26	22,91	29,28	118,50

\* Rouble denominated figures converted to dollars using annual average exchange rates.

Source: Goskomstat (State Statistical Office of the Russian Federation)

The share of FDI in industrial production was 0,52% for the RTBR in 1994-99 while the share for the whole of Russia was 1,65 %. Likewise the share of FDI in investments in fixed assets for RTBR was 2.8 % in 1995-99 while the share for Russia was 7.9 %. Similarly, FDI per capita in RTBR reached only one third of the Russian average during 1994-99.

**Table 7 Foreign Investments in Russian Territories of the Barents Region by Country of Origin 1999 (USD 1000)**

Country	Arkhangelsk Oblast		Murmansk Oblast		Republic of Karelia		Komi Republic		Total RTBR	
	Sum	Share, %	Sum	Share, %	Sum	Share, %	Sum	Share, %	Sum	Share, %
Total investments:	348470	100,00	14728	100,00	15493	100,00	54300	100,00	432991	100,00
Austria	191	0,05		0,00	9102	58,75		0,00	9293	2,15
Belgium		0,00		0,00	2	0,01		0,00	2	0,00
Cyprus		0,00		0,00	455	2,94	50500	93,00	50955	11,77
France		0,00		0,00		0,00	700	1,29	700	0,16
Finland		0,00	41	0,28	315	2,03		0,00	356	0,08
Germany	23	0,01		0,00	16	0,10		0,00	39	0,01
Iceland		0,00		0,00	225	1,45		0,00	225	0,05
Israel	615	0,18		0,00		0,00		0,00	615	0,14
Luxemburg		0,00		0,00		0,00	100	0,18	100	0,02
Man Island	62	0,02		0,00		0,00		0,00	62	0,01
Norway	22	0,01	10405	70,65	251	1,62		0,00	10678	2,47
Portugal		0,00	7	0,05		0,00		0,00	7	0,00
Spain		0,00	33	0,22		0,00		0,00	33	0,01
Sweden		0,00	1447	9,82	1	0,01		0,00	1448	0,33
Switzerland		0,00		0,00		0,00	3000	5,52	3000	0,69
Turkey		0,00		0,00	5	0,03		0,00	5	0,00
United Kingdom	1547	0,44	2192	14,88	1093	7,05		0,00	4832	1,12
USA	346010	99,29	53	0,36	4028	26,00		0,00	350091	80,85
Other		0,00	550	3,73		0,00		0,00	550	0,13

Source: Goskomstat (State Statistical Office of the Russian Federation)

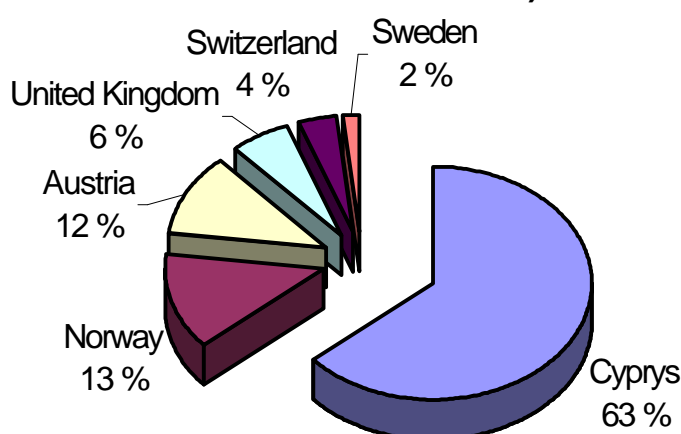
The most recent sources of FI in the RTBR show an interesting trend (Table 7 and Chart 7). For the first three months of 2000 about one half of the investments have come from Cyprus. This can be interpreted as a sign of Russian capital returning to the country.

The sectoral breakdown of foreign investments (credits included) indicates that the bulk of investments have gone to the energy sector. This applies to Arkhangelsk and the Republic of Komi, in particular. In the Republic of Karelia most investments have been made in the logging, wood processing as well as paper and pulp industry, while in Murmansk the investments have been more diversified (Charts 8-11).

In summary, the development of FI and FDI in the RTBR based on statistical analysis can be characterised as follows. The share of the region in focus is small when compared to the total foreign investments in Russia. It also is less significant for the regional economies when compared to the regional gross product, industrial production, investments in fixed assets or population than in Russia on average. However, there are significant differences among the regions in question. While the significance of FDI in the Republics of Karelia and Komi is about half of the national level, the FDI in Arkhangelsk and Murmansk Oblasts lag behind significantly. Most investments have been made in the energy sector and woodworking industries rank second in the amount of investments received. The share of FDI in all foreign investments during 1994-1999 is only 20% indicating that most foreign investments have been given as credits. The Arkhangelsk Oblast, in particular, has been a favoured recipient of credits, as 2/3 of them were received by the Oblast. Among the most recent sources of investment the share of Cyprus is conspicuously high, which most likely indicates a return of Russian capital. The low level of FDI also indicates that there is, in theory at least, vast potential to increase FDI in the region.

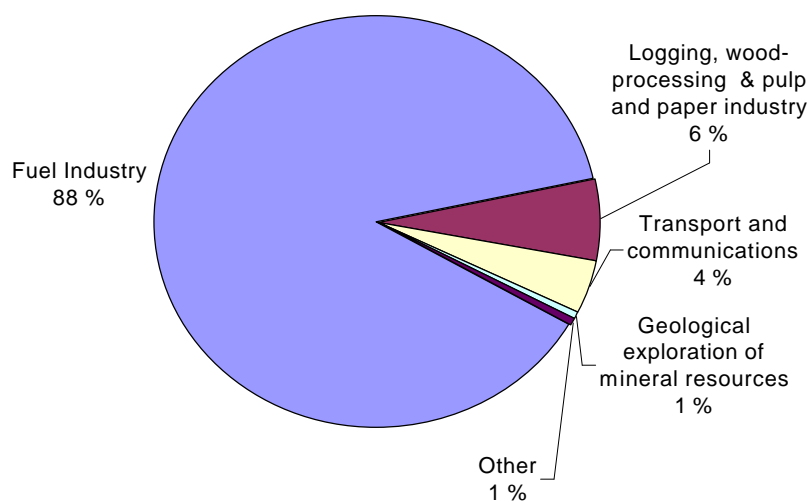
**Chart 7**

**Foreign Investments in Russian Territories of the Barents  
Region by country of origin in 1999 (Source: Local  
Goskomstat offices)**

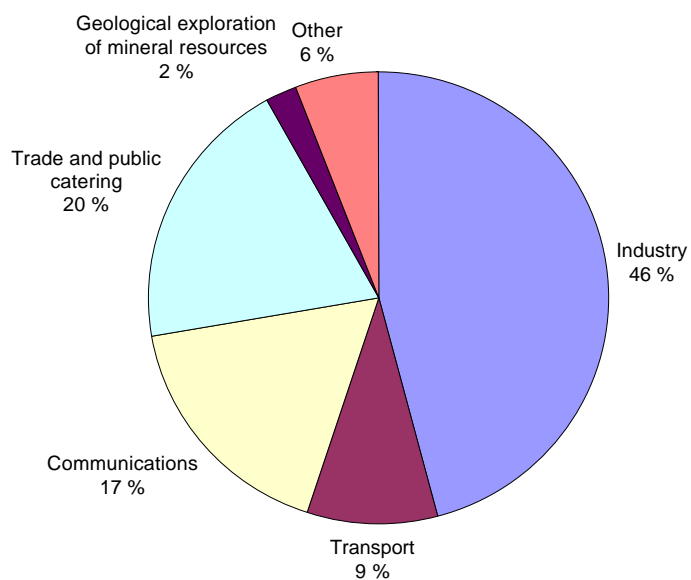


## Charts 8 and 9

**Cumulative Foreign Investments by Sector of Economy in Arkhangelsk Oblast in 1995-1Q2000 (source Goskomstat)**

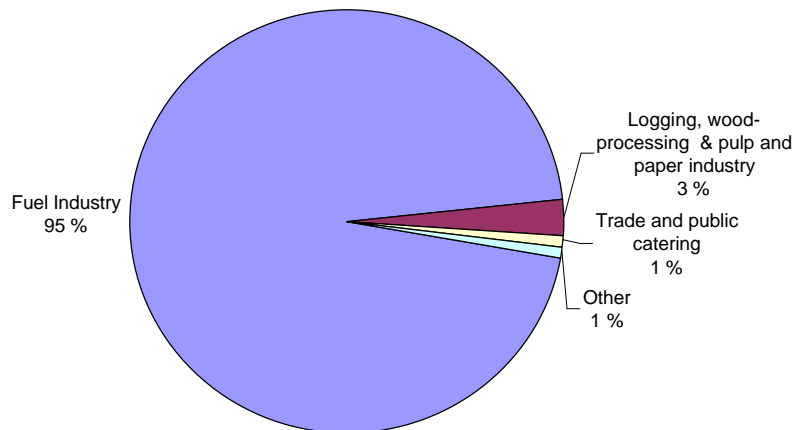


**Cumulative Foreign Investments by Sector of Economy in Murmansk Oblast in 1995-1Q2000 (source Goskomstat)**

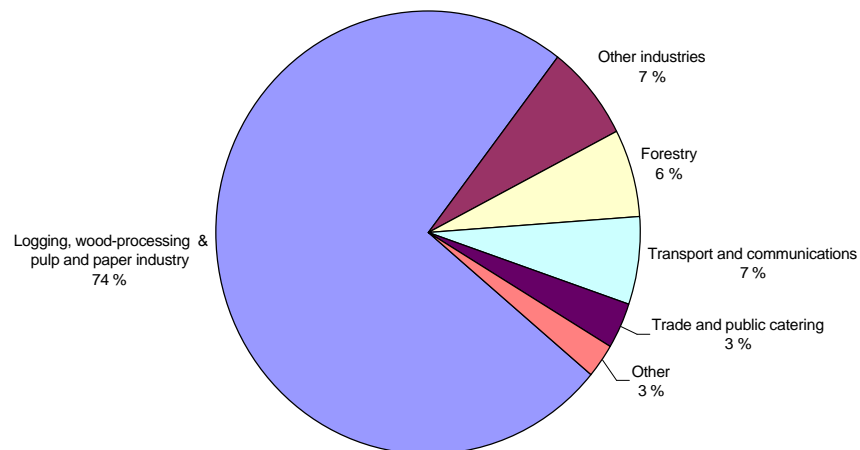


## Charts 10 and 11

**Cumulative Foreign Investments by Sector of Economy in Komi Republic in 1995-1Q2000 (source Goskomstat)**



**Foreign Investments by Sector of Economy in the Republic of Karelia in 1995-1Q2000 (source Goskomstat)**



### 3.4. Comparison of Investment Ratings of RTBR with Other Russian Regions

The Russian journal Expert has published investment ratings for Russian regions since 1995. The ratings are mainly based on statistical information published by various Russian authorities, notably the Federal Statistical Office Goskomstat, federal ministries and local authorities. The rating for investment risk is based on seven different components indicating legal, political, economic, financial, social, criminal and ecological risks for each region. The investment potential, in turn, is based on eight components measuring the level of consumption, availability and level of the working force, the level of production, infrastructure, financial resources, innovativeness and institutions as well as the availability of natural resources. The weights used for calculating the ratings for investment risk and potential are based on a survey of national and international investment specialists.

Various characteristics of investment climate are being measured and estimated all over the world by an increasing number of surveys among potential investors and experts in the field. Although such surveys seldom are scientifically or theoretically well founded, the results are usually widely publicised and attract wide interest, particularly among potential investors. Therefore, it can be assumed that they also influence the decisions of investors in choosing the location of investment. Russia cannot be an exception in this respect. On the contrary, with relatively little information available about the investment climate in the Russian regions it is likely that the Expert ratings attract high attention among potential investors.

The most recent ratings of Expert, published 30 October 2000, indicate that the RTBR are not considered very favourable investment environments in comparison to other Russian regions. The City of Moscow represents the best of all 89 regions in 1999-2000 and received the ranking of 1. The RTBR ranked as follows for the rating of investment risk: Murmansk Oblast 16, Republic of Karelia 31, Arkhangelsk Oblast 62, and the Republic of Komi 68. The ratings for investment potential range from 26 for Murmansk to 59 for the Republic of Karelia. Table 8 indicates the ratings for investment risk and potential for these regions. Compared to the ratings for 1995-1996, Arkhangelsk has fallen most (-24) while Karelia has gained most (+9).

**Table 8 Investment Risk Ratings for Russian Regions in 1999-2000**

<b>Risk rating 1999-2000</b>	<b>Risk rating 1998-1999</b>	<b>Rating for potential</b>	<b>Region</b>	<b>Weighted average rating for risk (Russia = 1)</b>	<b>Change in the level of risk +/-</b>
16	30	26	Murmansk	0,915	+0,013
31	31	59	Karelia	0,965	+0,058
62	71	43	Arkhangelsk	1,186	+0,054
68	67	33	Komi	1,241	+0,138
11	2	2	St. Petersburg	0,892	+0,223
1	1	1	Moscow	0,709	+0,096

Source: Expert November 30, 2000

The ratings shown in table 9 indicate that from the investment risk components legal, political, economic and social risks are considered highest in Arkhangelsk, financial risks are highest in Karelia, while criminal and ecological risks are highest in Komi. The highest risk ratings are given for ecological and political risks.



**Table 9 Investment Risk Components for the Russian Territories of Barents Region**

<b>Risks/ Region</b>	<b>Legal</b>	<b>Political</b>	<b>Economic</b>	<b>Financial</b>	<b>Social</b>	<b>Criminal</b>	<b>Ecological</b>
Murmansk	39	6	13	27	13	4	82
Karelia	18	45	22	52	29	24	70
Arkhangelsk	42	59	42	21	78	41	75
Komi	30	40	40	38	72	75	83
St. Petersburg	22	83	28	3	4	45	48
Moscow	69	12	1	1	1	1	40

Source: Expert, November 30, 2000

Table 10 lists the ratings for components of investment potential in each of the RTBR. While the city of Moscow ranks number 1 in all other components of potential except in natural resources, the RTBR are ranked relatively high particularly in the level of natural resources. Their level of consumption, availability and level of labour force, level of production and financial resources are also ranked relatively high when compared to the average level of ratings. The least favourable ratings are given for the level of infrastructure particularly in Arkhangelsk and Komi.

**Table 10 Components of Investment Potential for the Russian Territories of Barents Region**

<b>Level of component/ Region</b>	<b>Consumption</b>	<b>Labour</b>	<b>Production</b>	<b>Infrastructure</b>	<b>Finance</b>	<b>Innovation</b>	<b>Institutions</b>	<b>Natural resources</b>
Murmansk	34	41	29	51	20	35	58	12
Karelia	61	59	47	45	47	64	40	38
Arkhangelsk	41	32	38	69	38	46	47	22
Komi	24	40	27	73	26	54	37	24
St. Petersburg	4	3	4	2	3	3	2	89
Moscow	1	1	1	1	1	1	1	89

Source: Expert, November 30, 2000

When the ratings for the investment climate are compared to the actual level of foreign direct investments received by the regions it can be noted that the Murmansk Oblast has clearly received less investments than its ranking as the best investment environment among RTBR would call for. On the other hand, Arkhangelsk and Komi have both received relatively more FDI than their evaluated investment risk and potential would imply. Thus there are apparently also other factors, which influence the FDI decisions. One significant factor, which is not fully reflected in the above components measuring investment risk or potential, is the regional policy for attracting FDI.

Another point of comparison for the Expert ratings is provided by a survey, which was carried out by the Finnish Central Chamber of Commerce among 1150 Russian enterprises in 2000.<sup>7</sup> The survey results indicate that the economic development and expectations for the future development among the Russian managers were more positive in other North West Russian regions, including Murmansk, and the Karelian Republic, than in the City of St. Petersburg or Moscow.

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<sup>7</sup> Keskuskauppakamarin Luoteis-Venäjän Business-barometri 2001, Keskuskauppakamari, joulukuu 2000, ISBN 951-8967-60-1

#### 4. Legislative Framework for FDI

Material on legislation and other normative acts concerning FDI in Murmansk, Arkhangelsk, Karelia and Komi has been collected during the study. The material includes documents on Russian federal legislation pertaining to foreign investments, in particular the Foreign Investment laws of 1991 and 1999, as well as the Law on Production Sharing (1995/1999). All regions have passed legislation allowing foreign investors to be granted various privileges. Typically these privileges concern exemption from regional taxes for the duration of the projects pay-back times. In addition, various regulations on special economic zones and other instruments have been passed.

One main observation made during the study is that these relatively new legal instruments which aim to attract FDI to the RTBR have not attained their objectives so far. There are various reasons for this. The foremost – and the one raised by companies with experience in the Region – is that these incentives for investors are outweighed by the general negative investment climate in the RTBR. Therefore the monetary value of tax breaks etc. in no way compensates for the general political risk and poor infrastructure which are omnipresent in the RTBR. It has also been remarked by many companies that if any costs are saved through tax privileges and other incentives then correspondingly the regional officials will gather these funds from the foreign investors in some other way, making use of the multitude of laws and regulations which characterises the Russian legal system.

Another observation, one raised mainly in Moscow, is that these regional investment laws are in conflict with the federal legislation, especially with the federal FI law of June 1999 and the newly adopted first part of the tax code. Many interviewees on the federal level also wondered about the logic of allowing regions which are net debtors to the federal budget the right to grant tax breaks to investors – to their mind this right should be only on the federal level.

A third factor which is central to the weakness of this legislative approach to FDI attraction is that the whole operation of granting tax incentives etc. is based on the central position of regional administrations. The criticism raised on this point suggests that since the regional investment laws typically apply only to so-called regional priority investment projects – meaning projects prioritised by the regional government and in some cases also by the regional duma and typically consisting of large infrastructure projects or modernisation of Soviet-era industrial production facilities – the investment incentives are tied to political and non market-based criteria for project selection. Therefore the process mainly serves to highlight the – by western standards – abnormally important role of regional officials in investment operations in the RTBR. Western companies do not base their investment decisions on the political criteria of regional administrations but on the economic and technical feasibility and profitability of projects, which they typically determine themselves. Therefore investment project implementation should be demand rather than supply driven. This criticism raised by many western actors applies directly also to the federal FI legislation which in fact determines that the various tax incentives and other privileges available to foreign investors only apply to investment projects prioritised by the Russian Government<sup>8</sup>.

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<sup>8</sup> “Priority investment project” in the FI law of 1999 is defined as a project in which the foreign investment share is at least one billion roubles or projects in which the minimum share of the foreign investors in the capital assets is at least 100 million roubles.

In addition to legislation, all of the regional administrations have been interviewed about other instruments they have at their use to attract FDI. One central instrument which is mainly relevant in larger infrastructure projects financed by the international financing institutions is formed by guarantees and counter-guarantees which can be provided for loans. So far, regional guarantees for investment project loans have been very difficult to organise in the RTBR, and a number of projects have suffered from this<sup>9</sup>. The guarantee facility is, on the basis of this study, still seen as a large risk for regional administrations.

Other instruments which were included in the discussions with regional administrations were foreign investment promotion centres and other investment information dissemination strategies as well as various forms of international co-operation in the form of joint training programmes, business development centres etc. with foreign partners. In general it can be concluded that the RTBR activities in these fields are still at an early stage and that there is confusion about what should be done on the regional level and what, on the other hand, on the federal level.

The legislative material collected and used for this study is listed below.

### **Russian Federation**

Law On Foreign Investments in the RSFSR, enacted on 4 July 1991

Federal Law about Foreign Investments in the Russian Federation, approved by the Federal Council on 2 July 1999

Federal Law about Production Sharing Agreements, approved by the Federal Council on 19 December 1995.

### **Republic of Karelia**

Order of the Head of the Republic of Karelia No. 235-P (? ) of 29 August 2000 "On the Main Directions of the State policy on development of Industry in the Republic of Karelia".

Order of the Head of the Government of the Republic of Karelia No. 169-P (? ) of 26 June 2000 "On approval of the administration procedure for the Budget for Development of the Republic of Karelia and State Support providing on competitive terms for Investment Projects from the means of The Budget for Development of the Republic of Karelia".

Resolution of the Petrozavodsk City Council No. XXIV/II-26 of 27 April 2000 "On Granting of Tax Allowances to Investors realising Investment projects the City of Petrozavodsk".

Order of the Head of the Republic of Karelia No. 90-P (? ) of 3 April 2000 "On the Republican programme of realisation of direction "Investment policy" in the Republic of Karelia in 2000-2002".

Statute on the Regional Energy Commission of the Republic of Karelia, approved by The Order of the Head of the Republic of Karelia No. 26 of 24 January 2000.

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<sup>9</sup> One notable case is the Murmansk waste water purification project which had involvement from the World Bank, Finland and NEFCO.

Republican Programme “Guide-lines of International Co-operation Development by the Government of the Republic of Karelia, 1999-2002”, approved by the Order of the Government of the Republic of Karelia No. 168-P ( ? ) of 27<sup>th</sup> of December 1999 (text in English available)

Statute on the Republican non-budgetary Energy Conservation Fund, adopted by the Order of Legislative Assembly of the Republic of Karelia of No. 125-II ?? of 7 July 1999 125. (The document is included to indicate possibilities of local co-financing for energy investment projects.)

Statute on the Procedure of work with International Projects and Programmes in the Republic of Karelia, approved by the Order of Head of the Republic of Karelia No. 52 of 3 February 1999.

Order of the Head of the Republic of Karelia No. 738 of 5 November, 1998 "On the Main Directions of Activities Providing for Foreign Investments in 1998-1999".

Order of the Head of the Republic of Karelia No. 655 of 30 September 1998 "On the Social and Economic Situation and the Prospects for Development of the Olonets Region" (text updated by Order of the Head of the Republic of Karelia No. 475 of 15 October 1999).

Law of the Republic of Karelia adopted by the Legislative Assembly of the Republic of Karelia on 8 April 1998 "On Investment Activities in the Republic of Karelia.

Decree of the Legislative Assembly of the Republic of Karelia "On maximal size of investments attracted with the State Guarantees of the Government of the Republic of Karelia for the year 1998” of 20 January 1998 (amended by The Decree of the Legislative Assembly of the Republic of Karelia 41-II ZS (?? ) of 21 October 1998).

Resolution of the Petrozavodsk City Council No. XXIII-XII/184 of 21 October, 1997 "On Granting of Tax Allowances to Enterprises and Organizations Providing Direct Investments into the City Economy".

Law of the Republic of Karelia adopted by the Legislative Assembly of the Republic of Karelia on 25 December 1996 "On Amendments to the Law of the Republic of Karelia "On State Support of Small Enterprises in the Republic of Karelia".

Order of the Head of the Republic of Karelia No. 960 of 19 November 1996 "On Acquisition of Debts of AOOT Segezhprom to the Budget of the Republic of Karelia".

Law of the Republic of Karelia adopted by the Legislative Assembly of the Republic of Karelia on 6 July 1995 "On State Guarantees for the Implementation of Foreign Investments in the Republic of Karelia"(text amended by Law of the Republic of Karelia adopted by the Legislative Assembly of the Republic of Karelia on 24 April 1997).

## **Komi Republic**

Interpretation Note of the State Tax Inspectorate Authority for the Komi Republic of 16 July 1999 "On the Specifics of Profit Tax Payments by Foreign Legal Entities"

Order of the Head of the Komi Republic No. 242 of 12 September 1996 "On the Adoption of the Regulation for the Procedure for the Provision of State Guarantees for the Implementation of Investment Activities in the Komi Republic"

Order of the Head of the Komi Republic No. 775-p of 25 September 1995 "On the Adoption of the Regulation on the Procedure of Technical and Economic Evaluation of Investment Projects Requiring State Guarantees on Part of the Head of the Komi Republic or Requiring Financing on Part of the Bodies of the State"

Law of the Komi Republic No. 4-RL of 25 January 1995 (with amendments enacted on 3 February 1999) "On the Attraction of Investments to the Economy of the Komi Republic" (adopted by the Legislative Assembly of the Komi Republic on 11 January 1995)

Order of the Head of the Komi Republic No. 273 of 12 December 1994 "On the Principles of Investment Activities in the Komi Republic"

Order of the Head of the Komi Republic No. 235 of 21 November 1994 "On the Measures for Attraction of Domestic and Foreign Investment to the Economy of the Komi Republic"

Resolution of the Council of Ministers of the Komi Republic No. 563 of 10 November 1993 "On the Adoption of the Procedure for the Co-ordination of the Volumes of Export of Self-Produced Timber Products for Enterprises with the Participation of Foreign Capital"

Instruction of the State Tax Inspectorate Authority for the Komi Republic "On the Procedure for Calculation and Payment of Income Taxes by Foreign Legal Entities Carrying Out Activities in the Russian Federation Without the Establishment of Permanent Representative Office"

Order of the Head of the Komi Republic No. 34 of 14 February 1997 "On the Priority Investment Programs and Projects in the Komi Republic for the Years 1997-2001"

Order of the Head of the Komi Republic No. 190 of 15 July 1997 "On the Regulation for the Procedure of Granting Tax Allowances for Investment Activities in the Komi Republic"

Order of the Head of the Komi Republic No. 77 of 22 February 1995 "On the Issues of the Ministry of Foreign Affairs of the Komi Republic"

Order of the Head of the Komi Republic No. 126 of 5 September 1994 "On the Directorate for the Enterprises Built Under Contracts with Foreign Companies"

Resolution of the Council of Ministers of the Komi Republic No. 198 of 16 May 1994 "On the Directorate for the Enterprises Built Under Contracts with Foreign Companies"

Resolution of the Council of Ministers of the Komi Republic No. 226 of 10 June 1991 "On the Procedure for the Establishment of Joint Ventures in the Sphere of Fuel and Energy Production on the Territory of the Komi Republic".

## **Murmansk Oblast**

Regional Law of 24 September 1998 adopted by the Legislative Assembly of the Murmansk Oblast "On Investment Activities and the Guarantees for Their Implementation"

Decree of the Administration of the Murmansk Oblast No. 234 of 10 June 1998 "On the Adoption of The Regulation on the Procedures for Registration, Modification and Amendment of Foundation Documents and on the Liquidation of Enterprises on the territory of the Murmansk Oblast"

Decree of the Administration of the Murmansk Oblast No. 156 of 27 March 1996 "On Measures for Regulation of Activities of Foreign Legal Entities and Enterprises on the territory of the Murmansk Oblast"

Resolution No. 238 of 21 March 1996 adopted by the Legislative Assembly of the Murmansk Oblast "On the Draft Law of the Murmansk Oblast "On Budget Fund for the Financing of Geological Survey Activities on the territory of the Murmansk Oblast"

Decree of the Administration of the Murmansk Oblast No. 444 of 29 December 1995 "On Amendments to the Decree of the Administration of the Murmansk Oblast No. 121 of 5 April 1995 "On the Amount of Subsidies for the Livestock Breeding Products"

Decree of the Administration of the Murmansk Oblast No. 157 of 27 April 1995 "On the Organization of Trading by Contract in the Murmansk Oblast"

Decree of the Administration of the Murmansk Oblast No. 414 of 27 September 1994 "On the Program for the Privatisation of State and Public Utilities Enterprises in the Murmansk Oblast after 1 July 1994" (with amendments contained in the Decree of the Administration of the Murmansk Oblast No. 552 of 19 December 1994)

## **Arkhangelsk Oblast**

Regional Law No. 405 of 7 July 1998 adopted by the Legislative Assembly of the Arkhangelsk Oblast "On the Amendments to the Regional Law on the Guarantees for Investment Activities in the Arkhangelsk Oblast"

Regional Law No. 236 of 1 October 1997 adopted by the Legislative Assembly of the Arkhangelsk Oblast " On the Guarantees for Investment Activities in the Arkhangelsk Oblast" (with amendments contained in Regional Laws No. 64-15-RL of 15 April 1998 and No. 78-17-RL of 7 July 1998)

Regional Law No. 686 of 15 September 1999 adopted by the Legislative Assembly of the Arkhangelsk Oblast "On Investment Activities in the Arkhangelsk Oblast"

Order of the Head of Administration of the Arkhangelsk Oblast No. 400p of 29 July 1999 "On the Participation in the Establishment of the Public Joint-Stock Company Unified Innovations Directorate of the North-Western Region"

## 5. Review of Earlier Studies on Investment Barriers

The Working Group on Economic Co-operation for the Barents Euro-Arctic Council published an analysis on trade barriers in the Barents Euro-Arctic Region in December 1997. The trade barriers identified in the report are also affecting investment activities and as such are also largely considered to remain obstacles still in 2000. According to the report, the investment related legislation is often less than adequate and wide differences in interpretation and implementation exist between the regions. A recent article in the Russian journal "Severo-Zapad"<sup>10</sup> lists the main obstacles for regional FDI increase as follows:

- Inefficient investment and tax policy of the local authorities;
- Lack of financial and informational resources in the Russian part of the region;
- Absence of common information field and of economic monitoring and co-ordination.

Several studies have been carried out during the 1990s to analyse investment barriers in Russia. Among them studies carried out in Finland have concentrated on the North-Western regions of Russia, especially St. Petersburg and the Leningrad region, where many Finnish companies set up subsidiaries in the first half of 1990s. However, there are only very few studies to our knowledge that have analysed the investment barriers especially in the Barents region, Murmansk, Karelia or Arkhangelsk oblasts.

The Barents Euro-Arctic Council, as many other international forums aiming to facilitate international trade and investment flows, holds the general view that FDI is beneficial for the development of the host countries. However, this view cannot always be taken for granted in the host countries, which are struggling hard to establish a working market economy. According to a recent sociological investigation carried out in Russia by a well-known "Public Opinion" Fund and published in *Rossijskaja Gazeta*<sup>11</sup> the majority of respondents (54%) support the limitation of FDI inflow into Russia and 49 % consider FDI an obstacle for the development of Russian economy. However, even though several foreign investors have encountered outright antagonism in Russia, there are others who have experienced neutral or even friendly treatment. Such differences in attitude among regions are also reflected in the legislative actions.

Foreign investors are often monitoring several potential and competing markets at the same time. It has been found out in several international investigations that favourable investment climate is a precondition for attracting FDI in increasing international competition among host countries for foreign investors. A recent International Monetary Fund study<sup>12</sup> concludes that both investor perceptions of country risk and survey-based indicators of a country's legal and political climate contribute significantly to explaining cross-country differences in attracting foreign direct investment among transition economies.

The Transition Report 1999 published by EBRD provides two different evaluations for the investment climate in the transition countries; the first is the transition indicator, which the yearly transition report has published since 1994, and the second is a new indicator,

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<sup>10</sup> G.P. Lusin and V.S. Selin "Problems and tendencies of international economic co-operation in European North of Russia", *Severo-Zapad*. N1, 1999

<sup>11</sup> Mikhail Subbotin in *Rossijskaja Gazeta*, N36, 1999,

<sup>12</sup> What Moves Capital to Transition Economies? Pietro Garibaldi, Nada Mora, Ratna Sahay, and Jeromin Zettelmeyer, International Monetary Fund, Draft May 31, 1999



investment climate score, assessed by companies operating the market. The investment climate score given in the report for Russia is less favourable than that for Central Europe and the Baltic countries corresponding to the average score given for the CIS countries. It reflects the failure of the authorities to enforce the basic rights of creditors and minority shareholders especially after the economic crisis of 1998. The newest transition indicator (Transition Report 2000) for Russia represents in turn a recovery from the setback triggered by the economic crisis in 1998.

### *Some Earlier Studies on Investment Barriers in Russia*

Among many international organisations the Union of Industrial and Employers' Confederations of Europe has paid attention to the development of investment environment in Russia. In their joint declaration of 1997 they point out that the lack of appropriate legal protection of economic rights, lack of transparent and reliable information about economic operators, unpredictable and inconsistent implementation of economic laws and regulations constitute major impediments to increased foreign as well as domestic investment in Russia.

According to the declaration, a special deterrent to entering into joint ventures with Russian companies is provided by the lack of laws and established procedures for shareholder protection. Particularly small and medium sized companies are deterred by the general insecurity as well as by difficulties with the local bureaucracy. The Russian tax system also remains a major disincentive for both domestic and foreign investors. Problems concern the large number of taxes, the lack of stability, transparency and lack of consistent enforcement. Tax rates are often high and there are frequent, often retrospective, changes. No distinction is made between inadvertent and criminal error, penalties are excessive and the appeal process is cumbersome. Closely linked to the tax problems are the anomalies, which arise when compared to the Western regulations, in accounting rules used to calculate taxes. Moreover, according to the joint statement, the poor quality of much public administration, particularly at local governmental level combined with the real and perceived level of crime and corruption, continue to seriously inhibit potential foreign investors.

In a study conducted during the first half of 1997<sup>13</sup>, among about 100 Finnish companies on the issues of financing trade and investments in Russia, The Finnish Confederation of Industry and Employers identified the inadequate legislation and its implementation as the main problem direct investors face in Russia. In particular, they pointed out lacking or unreliable registers on land and share ownership as well as the retroactive and inconsistent implementation of the existing legislation, as the sources of greatest barriers.

On the other hand, in three consecutive surveys in 1991, 1993 and 1995, concerning the experiences of Finnish companies in Eastern Europe<sup>14</sup>, the investment climate in Russia has been found to have continuously improved. However, when compared to that of Estonia the Russian investment climate has been found consistently less friendly and less attractive than that of Estonia. For example, in the 1995 study the Russian environment was most often characterised as "tolerable" whereas the Estonian climate was "satisfactory". This study also identified the unpredictability of customs regulations and taxation as well as the arbitrary and

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<sup>13</sup> Idänkaupan ja sen rahoituksen kehittäminen (Financing arrangements in Finland's trade with Russia) , Teollisuuden ja työnantajien keskusliitto, Helsinki 1997

<sup>14</sup> Laurila, Juhani and Hirvensalo, Inkeri (1996) Direct Investment from Finland to Eastern Europe; Results of the 1995 Bank of Finland Survey, Review of Economies in Transition, Unit for Eastern European Economies, Bank of Finland 5/1996

inconsistent interpretations of the regulations by local authorities as the greatest problems investors faced in Russia.

A study commissioned for the Baltic Sea Business Summit 98<sup>15</sup> at the end of 1997 focused on the barriers to FDI in the five transition economies around the Baltic Sea, namely, Poland, Lithuania, Latvia, Estonia and the St. Petersburg region of Russia. Also according to the results of this survey the foreign investors encounter more barriers in Russia than in the other Baltic Rim transition economies. Practically all investors have faced problems with tax legislation and accounting rules, particularly with retroactive stipulations that they could not take into account while planning their activities. However, there were clear differences among the respondents in their attitudes towards the difficulties encountered. As all had faced problems in these areas, some pointed out that the difficulties were not insurmountable and could be managed by investing time and energy into finding sufficient information and learning the matters in detail. Those companies that had operated in St. Petersburg already for years, faced smaller problems than newcomers to the market. In addition to taxation and accounting the companies interviewed faced specific problems in the field of insufficient protection of immaterial rights and restrictions in the local legislation to make public investments.

A more recent study analysing the operational and financial strategies of 12 Finnish companies in Russia at the end of 1998<sup>16</sup> reconfirmed that the most common experiences among the Finnish investors include difficulties in dealing with the local administration, particularly with the tax administration. In every subsidiary interviewed there is a strong fear for the tax police, whose decisions can be arbitrary and often depend on the person in charge. Foreign investors felt that the requirements put on them by the local tax administration were much more strict than the requirements put on local Russian companies, who more easily can hide income or even bribe the tax inspectors.

In spite of all such problems none of the case companies planned to shut down their operations definitively and leave the market. Instead, all companies were actively investigating ways to continue operations in the changed conditions. For some industries the crisis signified new possibilities. E.g. the growth of Russian exports in the aftermath of the devaluation presents possibilities to find new customers among the exporting industries. Also companies, who are studying the Russian market with a long term perspective have realised that the local cost level is much more attractive after the devaluation than before it. However, more significant than just the cost level, is still the relative stability of the economy. Therefore it could be expected that the devaluation alone will not be able to create huge new foreign investment in Russia.

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<sup>15</sup> Barriers to Foreign Direct Investments in the Baltic Sea Region, Inkeri Hirvensalo and Colin Hazley, ETLA and Baltic Sea Business Summit 98, Nordisk Bokindustri AB, Stockholm 1998

<sup>16</sup> The cases are described in full in the book of Hirvensalo, Inkeri (1999) "Sijoitukset Venäjälle; Kokemuksia Venäjälle tehtyjen sijoitusten rahoituksesta", Elinkeinoelämän Tutkimuslaitos ETLA, Taloustieto OY, Helsinki 1999

## 6. Case Studies

Material on a number of case studies has been collected and summaries of the interviews and other collected material are presented below. The case studies cover the following sectors:

- venture capital investments
- mining sector investments
- forest industry investments
- oil and gas exploitation and transportation
- other projects (environmental investments, infrastructure, fishing etc.).

The material collected on case studies has been used in the drawing up of the conclusions which follow in Chapter 8.

### 6.1. Stora Enso

Stora Enso is a major global producer of forest products. It holds world-leading positions in magazine papers, newsprint, fine paper and packaging boards, and also conducts extensive saw-milling operations. Stora Enso, including the recently acquired Consolidated Papers, has sales totalling approximately EUR 12 billion, with an annual paper and board production capacity of about 15.3 million tonnes. The company has some 45,000 employees in more than 40 countries.

Stora Enso sources a significant portion of its raw materials internally, thus ensuring continuity of production. It owns some 2.6 million hectares of forest in Finland and Sweden, 0.3 million hectares in the USA and has significant forest holdings in Canada and Portugal.

In Finland, Stora Enso uses some 23 million m<sup>3</sup> of timber annually for its own operations. The annual round wood imports to Finland from Russia were about 11 million m<sup>3</sup> in 2000, with Stora Enso using some 50% of this. The round wood for the company's use is imported mainly from the Republic of Karelia (some 2 million m<sup>3</sup> annually), as well as the Novgorod and Vologda Oblasts. Smaller dispatches come from other regions such as Komi and Leningrad Oblast. The bulk of imported timber is birch pulpwood, which is important for the Finnish forest industry.

The total industrial wood usage in Finland is only slightly smaller than the total forest cuttings in the Russian Federation (70-80 million m<sup>3</sup> annually). This demonstrates the severe decline in the Russian forest industry, since still at the end of the 1980s fellings in Russia were on the 300 million m<sup>3</sup> level.

Stora Enso has a long co-operation history with Russia, beginning in 1892 in wood trade. The present day forest sector business with Russia has changed drastically since the Soviet times when, for example, wood trade was based on annual delivery agreements between companies and Russian central trading houses. Nowadays wood deliveries are based on direct agreements with suppliers in Russia, who take care of fellings and transportation to the border. Stora Enso's strategy is to tie direct contacts to the suppliers thus ensuring security of supplies and direct payment channels without mediators. The main challenges in wood trade presently involve the high export tariffs (for example 5% for birch), high freight costs (paid in dollars)

as well as numerous taxes and fees which have to be paid by suppliers on the Russian side. All of these factors contribute to the fact that the price level paid for wood in Russia is relatively close to the Scandinavian level.

In the last few years, clear signs of recovery for the Russian mechanical wood industry can be discerned. As the industry is gradually modernised and revitalised in the coming decades, new investments are needed to replace out-of-date technology now in place. The Russian chemical wood processing sector, on the other hand, is not seen to be attractive for foreign involvement in the near future due to the huge costs involved in modernisation.

Stora Enso has made some relatively large investments in Russia, mainly in the packaging board sector. However, these investments have not been directed to North West Russia. There, the company has carried out only one investment project and a second one is under preparation.

The first project is a JV called Ladenso, operating in the Republic of Karelia since 1990. Stora Enso owns 49% of the company, the other shareholders being the Karelian municipalities of Pitkäranta and Sortavala as well as smaller Russian owners. Ladenso is a wood harvesting company operating in the vicinity of an old sawmill (Läskelä). Originally, the sawmill as well as the surrounding municipal infrastructure were part of the Ladenso deal, but later Stora Enso divested of these assets. Presently Ladenso harvests some 300 000 m<sup>3</sup> annually, and some 2/3 of this is exported to Finland. The potential harvest from the cutting areas of Ladenso is estimated by the company to be 2 million m<sup>3</sup> annually, but the Russian legislation in force limits harvesting to 600 000 m<sup>3</sup> annually.

Stora Enso has viewed Ladenso as a pilot project in Russia, to test the operating environment. Thus through this step-by-step, cautious investment strategy it has avoided the large losses incurred by several other western forest companies in North West Russia. A major success in the project has been the introduction of Scandinavian forest harvesting technology and methods to Karelia.

The major challenges in the Ladenso project have been the diversity and conflicts of the Russian partners as well as the difficult investment climate in the Republic of Karelia. Russian owners have lacked a long-term strategic objective for the development of the company, and instead they have concentrated on pursuing personal interests. The financing of investments into harvesting equipment has also been seen as difficult due to the poor state of the Russian banking system. An additional difficulty has been posed by the high cost of using western entrepreneurs in the project, due to punitive legislation in Karelia.

Major challenges in general in operating in Russia are the punitive attitude of tax and other officials towards foreign companies - competition is distorted by the fact that foreign companies have to be careful to pay all required taxes and payments, whereas their Russian competitors often simply do not pay their taxes. Corruption is also a major hindrance for doing business in North West Russia.

The second pre-study project Stora Enso has in Karelia is a planned investment into a new sawmill in the Republic. The investment has been under planning for a long time, and is now viewed favourably due to the fact that it would facilitate the continuation of wood imports to Finland; the raising of the degree of processing on the Russian side of the border is also favoured by the Karelian Government as well as environmental organisations; finally,

domestic demand in Russia for sawn wood is growing and is estimated to develop positively in the near future. At the present, the investment is under planning. The crucial factors in the investment decision involve taxes as well as the security of raw wood supplies to the sawmill. The attitude and practices of the regional government is also an essential factor in the investment decision.

A precondition for the sawmill project is that taxes and tariffs will have to be agreed upon in advance so that they are predictable. Also various tax incentives offered by the regional government will have to be in accordance with the Federal tax code and they will have to be agreed upon in detail.

The Karelian Government led by President Katanandov is seen to be supportive of foreign investments. Indeed, political backing from the regional government in the form of, for example, inclusion on regional priority investment project lists, is essential for any project. So far, however, Karelia has a tarnished reputation in investment issues, largely due to the Segezha pulp and paper mill controversy involving Swedish Assi Domän. The support of the Federal Government is also seen to be essential in operating in Karelia to balance regional decisions and attitudes. The possibilities for foreign companies' operations in North West Russia will improve significantly as regional and federal legislation is harmonised.

## **6.2. Kvaerner Masa-Yards**

In the aftermath of the disintegration of the USSR a significant part of the Russian arctic tanker fleet remained in the hands of the newly independent Latvian Republic.

In 1992, the Finnish Masa Yards (later to become a subsidiary of the Anglo-Norwegian Kvaerner) had an idea to establish a joint venture with Murmansk Shipping Co and operate one cargo ship in the region. The Russian partner had majority ownership in the joint venture. Financing was planned on the basis of a three-year leasing arrangement, after which the ownership of the ship would be transferred to the joint venture. However, the operation did not materialise as planned, mainly due to problems in financial flows to Russia.

In 1995, the ship was taken out of Russia and later on the CEO of the venture was dismissed. According to the conclusion on the Finnish side, the Russian partner never had a genuine interest in the joint venture. In the meanwhile, Kvaerner Oil and Gas of Norway established a joint venture with the Zvezdochka submarine yard in Severodvinsk. This JV has been operating successfully in executing engineering tasks for international oil companies in Nenets Autonomous Okrug as well as in subdeliveries to Norwegian offshore projects like Aasgaard. The JV has also operated as an agent for Masa-Yard's imports from Russia and Norway. Imports from Russia include among other things propellers of high quality for Azipod propulsion units.

Outside of the Barents Region in North-West Russia, Kvaerner invested in a small shipyard in the city of Vyborg on the Finnish-Russian border. Following the strategy of the Norwegian mother company, the shares held by Kvaerner were sold back to the Russian partners after restructuring the shipyard. Restructuring was carried out by Finnish management, and as a result the personnel of the shipyard was reduced from 5000 to 800. Those who remained in the company were highly motivated to develop the shipyard further. Presently Kvaerner Masa

Yards continues to co-own two arctic tankers under the Finnish flag together with Fortum Oil and Gas, which carry cargo in the region.

The present situation in the Barents Region shipping industry is that Lukoil Arctic Tanker Co. is building a monopoly in the region. It has bought the majority of the shares of Murmansk Shipping Co. and has invested in ships bought from the former East Germany and St. Petersburg.

Kvaerner Masa Yards is also keeping a close eye on the development of the oil and gas field exploitation in the Barents and Pechora Seas. In the longer term, Masa Yards' interest is also directed at the icebreakers operating in the Barents Sea, as they will become outdated by the year 2005 and would have to be replaced by new ships.

The development of Production Sharing Agreements for oil and gas fields in the Barents Region is monitored closely by Kvaerner. In general, the oil and gas development in the onshore and offshore areas are now dominated by two of Russia's largest companies, Lukoil and Gazprom which also compete with each other for control of the region's best projects. Lukoil has been particularly active in buying out smaller Russian companies in the region as well as buying western independents' field exploitation rights.

In the beginning of 2000 the law on subsoil resources was amended and according to it issuing licences for exploration also on the basis of earlier work and not only on the basis of public tendering became possible. This will increase the possibilities of western companies, who already have carried out extensive exploration in the region. On the other hand, the involvement of western companies in the oil and gas investment projects in the Barents Region is very much dependent on the activities of and competition between Gazprom and LUKoil.

According to a representative of Kvaerner, most difficulties for westerners in FDI issues in Russia are related to understanding the Russian mentality. In many cases the Russian view still seems to be that foreign companies operating in Russia should be exploited to the full through various fees and permitting arrangements: foreign companies are mostly viewed as potential sources of extra income.

The question of Russian mentality and communication materialises on two levels: federal and local. In Russian legislation (at least up to the era of President Putin) there is also the principle of duality of competencies – the one of federal authorities and the other of regional authorities; the federal and regional actors however need to find a common ground in key issues. Both levels are interested in benefiting from the presence of foreign investors. However, from the point of view of foreign investors, the regional administration has to be approached first as the use of land and local taxation are determined by them. The regional and local authorities are also highly interested in tying the energy sector investments to the local infrastructure investments, such as harbours, railways and roads, and these often become preconditions to the eventual energy sector investments.

The best way to operate in the region is through investing in personal relations with key Russian managers and decision-makers. This is clearly a chance for Finland due to the long common border and generally high patience with the Russians compared to other nationalities. Finland has practically all the technology needed for the development of the Barents Region through natural resources. What is missing is the financing required. The

role of Finland could also include financial engineering for the development projects. For her own interests, Finland could also support the oil/gas terminal in Murmansk Oblast but this is not yet realised.

### **6.3. Fortum**

Within the Oil and Gas division of Fortum Corporation (former Neste), Russia is one of the three major sources of crude oil and natural gas production, alongside Norway and Oman. Fortum has a long experience of crude oil imports from the former Soviet Union and Russia. Today all gas and about half of Fortum's crude oil imports come from Russia and in 2000 about 20-30% of the company's operating profits accrued from oil imports. Most of the Russian crude oil is transported by train to the Porvoo refinery. In addition to crude oil, Russian gas condensate is imported from Ukhta in the Republic of Komi. At the beginning of the 1990s crude oil imports from Russia were stopped for a couple of years due to problems in the quality of oil and, to some extent, quality problems still exist. In addition to Russia, crude oil is also imported from Kazakhstan by railway.

So far, Fortum has not made any major investments in Russia. In addition to downstream investments in the service stations around the city of St. Petersburg only small investments in product terminals and storages have been made. However, Fortum has for more than a decade shown keen interest in the development of oil and gas fields of the Barents Sea and North West Russia. The reason for Fortum's concentration on this part of Russia is the rich resource base of the region (mainly the so-called Timan-Pechora region and the offshore areas in the Barents and Kara Seas). In addition, the region has been relatively stable politically and it has the advantage of relative proximity to Fortum's operative base and markets. However, the political and economic instability of Russia has so far acted as a hindrance for sizeable direct investments.

Russia has ca 35 % of the world's proved natural gas reserves. Roughly 90% of Russia's natural gas reserves are located in Western Siberia. Most of the natural gas produced in Russia is consumed domestically, even though the price is significantly below the world market level, and often not paid at all. Gazprom, the Russian gas monopoly, does not have the resources needed for the planned large-scale investments to develop new gas deposits in the country. In the oil sector, Russia has some 5% of world proved reserves. The major player in the Russian oil business is LUKoil, which also dominates oil operations in North West Russia.

Fortum is involved in two separate projects in North West Russia. The first is a stake in the Shtokmanovskoye gas and condensate field in the Barents Sea, situated some 550 km north-east of the Murmansk Oblast. The second concerns a group of oil fields in the Nenets Autonomous Okrug and the Republic of Komi owned by the JV Severtex.

The Shtokmanovskoye gas and condensate field in the Barents Sea is one of the world's largest known gas fields. In May 2000, the field was accepted by President Putin to be developed in accordance with the Production Sharing Law. Now the detailed agreement setting out the rights and obligations of project partners in the field - the Production Sharing Agreement (PSA) - is under negotiation. The foreign partners in the project are Fortum, Conoco, Norsk Hydro and TotalFinaElf. The license for the development of the field is held by Rosshelf, a subsidiary of Gazprom. A JV between Fortum and Gazprom, North Trans Gas,

is presently studying the pipeline routes for the export of gas from the Shtokmanovskoye field to Europe. The most likely route would land in Teriberka on the Murmansk Oblast coast and continue south to the Republic of Karelia and then via the Baltic Sea to Germany. Options through Finland are also considered.

Presently there are many positive signs in the investment climate; the political climate is relatively stable, the economy is showing signs of recovery and the export earnings are not being wasted but used for repaying the debt. However, there are many requirements that still need to be fulfilled before the project could go ahead at full speed. Firstly, the PSA has to be finalised and harmonised with other legislation, notably the tax code in order to incorporate more predictability. In addition, the tax code itself would need to be changed from the present revenue based system to a more profit based system. Also, the protection of investor rights needs to be clarified, including the question of dispute settlements.

Presently, 6-10 % royalties and 10 % subsoil taxes are divided between the federal and local authorities. In addition, numerous local taxes are levied. Russian authorities would need legal specialists from Russia to be trained by the western companies in order to understand the requirements for a workable tax regime in the oil and gas projects.

The second project that Fortum is involved in North West Russia is an oil extraction JV named Severtok. The JV has licenses to develop four fields, one in the Nenets Autonomous Okrug (Yuzhno-Shapinskoye, the largest of the four) and three in the Republic of Komi. Originally, the JV established in 1996 had three partners: Fortum / Neste, Komitek and Elf, the French oil company. After Elf left the project in 1998 and the majority of Komitek's shares were bought by LUKoil, the project is now a 50/50 joint venture between LUKoil and Fortum. Fortum is considered a good partner by the regional Nenets AO administration. The regional government, led by Governor Butov, is interested in securing the benefits of the project also for itself through taxes. Although the situation is to some extent similar in Komi, the Government of the Republic of Komi stresses the equal rights of large and small companies and has been a more straight forward partner. In general, local companies are often favoured because the regional governments have stakes in them (for example Nenets Oil Company). To some extent the tax treatment of regional and foreign oil companies is unbalanced.

The transportation of the oil produced at the largest field owned by Severtok - Yuzhno-Shapinskoye - involves building a pipeline from the field to Usinsk in Komi, where oil can be pumped into the existing Transneft pipeline network. Transportation solutions are crucial for the project. By May 2001 decisions have to be made by the consortium on how the field is going to be developed, incl. transportation options. Fortum has also transported oil and condensate from Komi to Porvoo via railway. Rail transport is significantly more expensive than pipeline transportation. However, railways are favoured in some cases due to the fact that there are limits on the export quotas of foreign JVs producing oil in Russia and there are also taxes on oil exports through the Transneft network. In practice reliance solely on pipeline transportation forces foreign oil investors to sell a significant share of produced oil on the Russian market, where the price level for oil is considerably lower than the world market price (about 60%). Sea transportation all the way from the Timan-Pechora region is not yet a feasible option, but may become so in the future.

A major project to increase oil export capacity from the Timan-Pechora Region is the so-called Baltic Oil Pipeline System (BOPS). The project involves the construction of a



connecting pipeline from Komi to the Kharyaga field in the Nenets AO as well as the construction of a new pipeline from Kirishi to Primorsk. At the present, the construction of a new oil terminal in Primorsk (Koivisto) on the coast of the Gulf of Finland is under way and is estimated by the Russian side to be ready by the end of 2001. However, the Primorsk terminal has major challenges to face in its operation: the ice conditions in the eastern parts of the Gulf of Finland are especially difficult, and the terminal cannot therefore be operated in the winter without a fleet of icebreakers serving the tankers. In addition, there are significant environmental risks involved - all tankers should preferably be double-hulled. Furthermore, there are significant nature conservation areas in the vicinity of the terminal construction site. Therefore Fortum has also suggested that the oil pipeline from Kirishi should be continued to Porvoo to complement the use of the new Primorsk terminal.

The financing of the Severtsk and Shtokmanovskoye projects has been preliminarily discussed with some financiers, but decisions are still open.

In addition to the mentioned active projects, Fortum has a 39% stake in the non-active Pechormorneft company which has a license for an offshore deposit on the Russian Arctic shelf. Kvaerner also has a 10% stake, the rest 51% being held by Russian partners.

In summary, Fortum has a step-wise approach to investments in North West Russia. Investments are made in small steps in order to test the environment and find workable solutions to the many significant questions in the field of the investment climate that still remain open.

## **6.4. Outokumpu**

Outokumpu was founded in 1910 to exploit a rich copper ore deposit in Outokumpu in eastern Finland and became an integrated copper producer over the following decades. The company built up new mining and metals processing operations, which included nickel, zinc, chromium, ferro-chrome and ultimately, in the 1970s, stainless steel. It also developed proprietary technology and earned the title of technology leader in its field. In 2001, after intensive international expansion, the company operates in all major markets focusing on metals and metals technology.

Outokumpu's exports to the former USSR peaked in 1982, when two large smelters were delivered to the Norilsk nickel factory in Siberia. In North West Russia Outokumpu had, already in 1991, negotiated the renovation of Pechenga Nickel smelter. It was a huge project, which would have filled the order books of the company for a long time. The project never saw daylight, because it had been negotiated with persons, who chose the losing side in the events of 1991, that led to the disintegration of the USSR. However, through the project negotiations the awareness of environmental problems within the Russian metallurgical industry increased greatly in Outokumpu.

In the early 1990s, Outokumpu started small mining companies with Russian partners in North-West Russia, one in Murmansk, one in Petrozavodsk and one in Arkhangelsk. Outokumpu's ownership in the first two mining companies increased to 80-90% due to the fact that the research work at the sites was financed through increases in the authorized capital, and the Russian partners were unable to provide additional equity. Ownership in the last JV remained at 40%.

The joint venture in Murmansk Oblast with Norilsk Nickel (called Polar Mining) aimed at developing the operations of the Pechenganikel mine including a study on a possible new mine at the site. By 1998 the joint venture had developed concrete plans for the development of the mine and planned to approach potential financing sources. However, the Russian crisis, which broke out in August 1998, changed the situation profoundly: the JV was put on hold. In the meantime, the strategy of the mother company Outokumpu in Finland also changed and the company decided to sell its nickel producing units in Finland. As a result, Outokumpu's interest in developing the JV in Murmansk Oblast also disappeared. The JV in Karelia is still operative but not very active and the JV in Arkhangelsk is also practically on hold as a result of the strategy changes of the mother company.

On the other hand, Russia continues to be an important market for Outokumpu both as a source of raw materials and as a target for exports. The present turnover of trade is about 1 billion FIM; most of that is imports but also exports are on the rise. In February 2001 the company announced a new co-operation agreement with Norilsk Nickel covering imports of raw material in Finland and imports of technology in Russia.

Outokumpu's experience of investing in Russia is that there is a profound difference in the legislative basis and the way of thinking in Russia and that of the rest of the world. The Russian history of socialism and before that autocracy have clear implications on the present situation.

The business culture in Russia is not easy for foreign companies. In the Russian organisations there is no organisational level which would correspond to the level of vice presidents, on which strategic, scenario-based planning is practised in western companies. The CEO of the Russian organisation is burdened with everyday managerial decisions and has little time for strategic discussions. Neither first subordinates have much interest for such questions, probably because they lack any decision-making powers.

The Russian tradition is also to handle matters in a consecutive order, one after the other, and not simultaneously. This is very time consuming, and the interest of the foreign company is often lost as a result of the slow decision-making process.

## **6.5. EBRD North West and West Russia Regional Venture Fund**

The EBRD established a regional venture fund (RVF) for NW Russia in 1995. The fund operated in the Murmansk and Arkhangelsk Oblasts as well as in the Republic of Karelia. Later in 1999 the fund was merged with the West Russia RVF. The fund is planned to operate until the end of 2005. The capital from the EBRD and Norum (the management company responsible for operation of the fund) equals USD 63 million. In addition, the governments of Finland, Sweden and Norway committed themselves to supporting the management and technical assistance of the fund with USD 20 million for the 10-year operation of the fund.

The investment policy of the Fund is as follows:

- Funds can be invested in commercially viable projects in Russia to secure a return for the investor (purely commercial fund)

- Mainly in small and medium sized companies with good management, significant growth prospects, focused core business, without substantial restructuring,
- Only for private sector enterprises,
- At least 25% of capital in companies without foreign strategic investor,
- 75% within the region: Murmansk, Arkhangelsk, Karelia, St. Petersburg, Leningrad Oblast, Vologda, Novgorod, Tver, Pskov,
- Between USD 300,000 and USD 6 million, minimum in practice on level of USD 1 million,
- Always minority shareholding position for EBRD fund.
- Environmentally acceptable projects,
- Outside the list of restricted areas: casinos, armaments, speculative real estate, banking, insurance, financial services, alcohol, tobacco, immoral or illegal activities.

The Fund has screened 1000 companies and project ideas during its operation. Of these, the Fund has made a capital investment in only 18. Four companies have been financed in the Russian territories of the Barents Region:

- Saw mill (LDK # 3) Arkhangelsk 1996 31%
- Hotel Poliarnie Zori Murmansk 1996 34%
- Teplichnoye (greenhouse) Severodvinsk 1996 45%
- Esta (cable tv) Severodvinsk 1999 25%

Norum's main investment focus is on:

- food and food related industries (catching, growing, processing, packing, storing, distributing)
- forest and forest related businesses,
- import substitute production,
- local raw material based projects to limit devaluation effect,
- Russian management skills in general, which has been the best trigger for success,
- Hands-on management through the Boards and with TC, strong support and control together,
- Projects mostly with Russian origin (better exit value),
- In some cases with foreign strategic partner from the beginning, if there is a need for special know how,
- Norum prefers investments in size USD 2-3 million on first round,
- Main focus on Russian markets, export is welcome.

In the view of Norum's management, the current investment climate in Russia is developing in a positive direction:

- The Russian Government is more favourable towards FI in general
- The Government is supporting entrepreneurship in Russia, also SMEs
- The Government is developing taxation systems in a positive direction
- The Government is developing the legal system and law enforcement (rule of law)
- The Government is supporting venture capital as a new tool to finance business
- The Russian economy is improving, mainly due to oil prices, and this gives more opportunities for the Government.

On the basis of the above, Norum's management states that the EBRD is committed to increase venture capital investments in Russia.

Regarding the Russian territories of the Barents Region, Norum's management has a cautious view and regards the investment climate in these regions as unattractive for FI. Main barriers to investments in these regions are connected with: policies of regional and local administrations, long distances to markets, poor infrastructure, taxation and customs problems (companies with foreign ownership are often monitored especially vigilantly by tax and other inspectors), transparency in companies (ownership, structure of management, taxation etc.), difficulties in agreeing user rights for natural resources (especially forest), a high political risk for investments, lack of encouraging examples of successful investments in the Region (on the contrary, cases such as the Segezhabumprom paper plant are still fresh in the minds of potential investors). Furthermore, the policies of the regional governments towards investors are very ambivalent, since great expectations are placed on the contributions of companies with foreign investment to regional budgets, even though at the same time regional legislation promises tax exemptions and other privileges for investors. For example, one of Norum's target companies, the Arkhangelsk LDK no. 3, has had to pay inappropriately high fees for ice-breaking services which are vital for the companies operations. Another example of making companies with foreign involvement pay for local infrastructure is the Petrozavodsk airport. Earlier, Finnair operated flights to the airport but later withdrew as demands were set for paying for the maintenance of airport services.

However, in many cases it must be said that the foreign investors have not acquired the necessary information about the regional investment conditions and have therefore been surprised by various demands and conditions set.

The Norum experience on methods of Russian regions to attract FI is that various tax exemptions and other legal instruments including special economic zones are not primarily what investors are looking for. Rather, the regional governments should concentrate on providing a stable and predictable investment climate as well as improving infrastructure in their regions. Investors will come if the general conditions for business are in condition.

## **6.6. Nordic Investment Bank**

The Nordic Investment Bank is a multilateral financial institution, established in 1975 and owned by the five Nordic countries. The bank finances projects of common interest within the Nordic region and international investment projects of mutual interest for the customer countries and the Nordic countries. In the Barents Region the bank endeavours to play an important role in the financing of investments aimed at improving the environment. Within North West Russia, in general, Nordic Investment Bank is involved mainly in environmental projects.

The basis for involvement in the Russian projects is an agreement of co-operation with the government of Russia. The agreement covers the status of NIB in Russia, which is the status of a preferred creditor and the same as IBRD and EBRD enjoy in Russia. The agreement also guarantees protection of investor rights and determines the basis for taxation. In practice the guarantee covers the transfer of payments from Russia. The agreement was ratified by the Russian Duma only in 1999. So far Russia has fulfilled all obligations under the agreement.

Normally a guarantee of Russian government is a precondition for any NIB credit for a Russian entity, but also other security arrangements can be considered.

Today NIB offers 2 kinds of credit facilities for projects in Russia:

- 1) Project investment loans (PIL), 90 % guaranteed by the Nordic countries
- 2) Environmental Investment Loans (MIL) up to 100 million Euros, which is 100 % guaranteed by the Nordic countries. It is aimed at environmental investments in north west Russia, the Baltic countries and Poland.

At the end of 1999 about 4 % of all outstanding loans, amounting to 8,9 million Euros, were given to the Central and Eastern European countries, including the Baltic countries. The share of Russia of all loans approved for the Baltic and CEE transition economies was about 15 % at the end of 1999.

The only credit agreement signed with a Russian entity within the Environmental Investment Loan Facility concerns restructuring of the wastewater treatment plant in Sestoretsk, which is part of the St. Petersburg Water and Environmental Services Improvement Programme. 50 % of the project is planned to be financed through grants from the Nordic countries. A loan agreement has been signed with SUE Vodokanal of St. Petersburg and the repayments of the loan are guaranteed by the City of St. Petersburg. The Vodokanal project will be co-financed with EBRD and bilateral grants, mainly from the Nordic countries. Russian Ministry of Finance is expected to support the project through a Project Support Agreement.

NIB has investigated several other projects in North West Russia and the City of St. Petersburg, in particular, as well as the Baltic countries. Among them are the following:

- Completion of the South Western Waste Water Plant in St. Petersburg
- Investment Program for Water Supply and Waste Water Treatment in the Leningrad Region
- Kaliningrad Water and Environmental Services Improvement Program
- Hazardous Waste Disposal site in Krasny Bor. St. Petersburg

In the Barents Region NIB has only one project under preparation. It is the Pechenga nickel smelter in Pechenga, Murmansk region.

During the last two years NIB has worked in the capacity of a technical and financial advisor to Norilsk Nickel on the rehabilitation of the nickel smelter in Pechenga. The purpose of the project is to reduce the emissions of sulphur and heavy metals by more than 90 per cent. Technical concept using Russian technology has been developed and the project has potential to be both technically and financially viable. The total value of the project is estimated to approx. USD 90 million. According to the present plans the Nordic supplies to the project will amount to at least USD 20 million. The planned financial package consists of a grant of USD 30 million from the Norwegian government and a long-term loan of the same size from NIB. Norilsk Nickel's share of the financing is about one third. The Norwegian government has already for years included this grant in the state budget. The Norwegian government is also not interested in giving the grant, if NIB is not involved in the project and if it does not take part of the financial risk. The environmental effect of the project will be monitored by an international expert group.

Norilsk Nickel, in turn, is known for unclear operations during the privatisation process. The company is also known for high profitability during the last few years but low interest in environmental investments. Presently the environmental taxes the company should pay are relatively high, but it is not known whether they actually are paid as tax arrears are a general problem within the Russian industries. Another problem with the project is that there is relatively little nickel left in Pechenga, which is why the company is not very keen in investing in the mine. It is foreseen that the mine will operate only until 2015<sup>17</sup>. The Norwegian government is interested purely in diminishing the significant pollution in the Kola peninsula.

NIB has, in principle, a growing interest in the Russian development projects and the environmental projects, in particular. However, the resources of NIB are too small for a large number of energy and infrastructure projects and NIB can finance only up to 50 per cent of the total costs of a project. Therefore, it is important that also other international financial institutions are prepared to co-finance projects with NIB in NW Russia.

In addition to limited resources the problem areas of NIB related to financing environmental projects in the Barents Region can be listed as follows:

- The guarantee of Russian government, a preferred precondition for NIB, is not easy to get.
- NIB has limited possibilities to evaluate the creditworthiness of Russian organisations and legislative developments without permanent presence in Russia; only in case reliable Nordic companies take full responsibility of projects in Russia, NIB can consider financing.
- NIB is mainly focusing on large-scale infrastructure projects and does not provide financing for the SME sector in Russia.

## **6.7. Nordic Environment Finance Corporation**

The Nordic Environment Finance Corporation (NEFCO) is an environmental financing institution which finances projects in Central and Eastern Europe. It was established in 1990 by the five Nordic countries and aims to facilitate the implementation of environmentally beneficial projects in the neighbouring region, with beneficial effects in the Nordic region. NEFCO's activities are carried out through two major funds: the Investment Fund, which provides equity financing and loans, and the Nordic Environmental Development Fund, which provides concessional funding for priority environmental projects.

In addition to having a positive environmental impact the projects funded by the Investment Fund should be based on co-operation between local and Nordic enterprises. The most important countries of operation are the Baltic countries, Poland and North West Russia. Priority is given to projects that lead to reduction of pollution in the Baltic Sea and the Barents Sea or reduction of transboundary airborne pollution. In addition to the direct project

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<sup>17</sup> An account of the transition process at Pechenga Nickel is provided by Rautio, Vesa "The Management of Modernisation of the Mining Industry in Northwestern Russia", University of Joensuu, Aleksanteri Institute, April 1999, mimeograph and by Andreev O. Tykkyläinen M. and Rautio, V. Modernisatsija gornodobyvajushih arionov Rossiiskovo Severa: totshki srenija I realnost, Nautshopraktisheskij Zhurnal 1/1996

financing NEFCO participates in the work of the Barents Euro-Arctic Council and the Baltic Sea Council.

By the end of 2000 the Investment Fund had accepted 92 projects and 57 of them were in the pipeline under preparation. The planned financing of NEFCO in those projects amounts to 73.6 million Euros, which is 9.2 % of the total value of 800 million Euros of these projects. There have been very few enquiries directed to NEFCO concerning financing of projects within the Russian Territories of Barents Region. Most of the enquiries concerning Russia have dealt with the City of St. Petersburg, Leningrad Oblast or the City of Moscow.

Within the Russian Territories of the Barents Region NEFCO has decided to use equity financing only for a couple of small projects in Murmansk Oblast. A planned investment project in a metal recycling operation using scrap metal from out of service ships in Murmansk Oblast is still in a pilot phase. In addition, NEFCO is planning to use equity instruments in an Energy Service Company (ESCO) project in Apatity, also involving a Norwegian partner. The ESCO project is also an experiment in NEFCO's use of equity in the Barents Region.

The Nordic Environmental Development Fund has also had several small environmental projects under negotiation within the Region 2 have been completed and 8 are under implementation

According to the experience gained in NEFCO there are several reasons that lie behind the small interest in investing in the Region:

- Communication with the potential partners and authorities in the region is complicated and time-consuming;
- The potential foreign investors shy away from the high risks involved in investments;
- Available negative references have a discouraging effect; the best known case of Segezha led to a total loss of about 100 million USD by the Swedish investor and received very wide publicity;
- Compared to the City of St. Petersburg or Leningrad Oblast the authorities in the RTBR do not provide sufficient information about crucial factors, such as potential tax incentives, and there is also competition from other Russian regions in providing investment incentives;
- The customs procedures in the region are very cumbersome;
- The pace of change in legislation and regulations is too great, which means that the predictability of income and profit of the projects is uncertain;
- The implementation of the legislation is even more changeable than the legislation itself and represents a great challenge for the regions in upgrading the skills of the local authorities.
- There is a perceived additional risk in projects in Russia connected to the security of supplies for companies from their contractors and subcontractors. This also increases the risks involved in project financing.
- The water supply and sanitation as well as heating utilities in the RTBR are typical possibilities for NEFCO financing, but at the present there are many restrictions on the development of these sectors, which limits investments. One main issue is the low level of tariffs of these utilities, causing cash-flow problems for loan paybacks.

In general, smaller companies in Russia have more difficulties in pursuing their interests than larger companies and this partly cultural factor also forms a barrier to financing SME projects. The administrations of the RTBR have developed various institutional solutions to the barriers for investments and financing of projects, but their implementation is greatly hindered by the lack of resources.

NEFCO makes an equity investment only if there is a Nordic partner in the project. NEFCO also needs well prepared project proposals with strong Nordic and Russian stakeholders. For credits NEFCO requires the guarantee of the regional administration, which in turn needs a foreign exchange licence issued by the Central Bank of Russia.

NEFCO can normally finance only up to 35 % of the project, which means that other funding is also needed. In equity financing a typical NEFCO share could be 25-35%, although in principle it can be as high as 49%. However, the local Russian banks are reluctant to provide loans for the Russian companies. On the other hand, the possibilities of the regions to provide financing is also limited due to problems in tax collection as well as the regulations concerning foreign loans taken by the regions, which have also been subject to frequent changes. Due to this development it is also not clear how the regional environmental funds will be able to continue their operations in the future.

## **6.8. Svetogorsk Pulp and Paper Mill in Leningrad Oblast**

### **Original Foreign Investor Tetra Laval**

Tetra Laval is the leading Swedish packaging group operating in more than 120 countries and employing over 40 000 people world-wide. The group was formed in January 1993 as a result of a merger of Tetra Pak and Alfa Laval and it consists of three industrial groups: Tetra Pak, Alfa Laval, and Alfa Laval Agri.

Tetra Laval made its first investment in the Svetogorsk pulp and paper mill in 1993 in the form of USD 10 million loan. The loan was directed to the reconstruction of one of the mill's paper machines in order to convert it into liquid packaging board manufacturing, which Tetra Laval needed as raw material for its Russian packaging production units. However, Tetra Laval soon realised that the required changes did not take place at the mill according to the planned schedule, and therefore, they decided to acquire a majority ownership in the combine in 1994.

### **Acquisition by International Paper and SCA Hygiene Products**

In June 1998, Tetra Laval announced that it had sold its share of the Svetogorsk pulp and paper mill to a U.S. based International Paper (IP). The transfer of ownership was to be organized as a step by step process, Tetra Laval slowly decreasing its participation in the operations and IP similarly increasing its participation. At the same time, the tissue production was separated as an independent unit and sold to SCA Hygiene Products (SCA).

International Paper is the world's largest forest industry company. It was set up in 1898 and after various mergers and acquisitions it currently operates in nearly 50 countries and the number of employees exceeds 100 000. It is headquartered in New York, U.S. IP has got experience of manufacturing operations in other parts of Eastern Europe (Kwidzyn, Poland)



but the investment to the Svetogorsk pulp and paper mill is the first manufacturing operation in Russia. The company has had an office in Moscow for approximately eight years to search for a suitable acquisition target. They conducted very thorough studies on various potential targets before making any investments. The Svetogorsk mill was studied for 1,5 years, i.e. as long as the mill was for sale.

SCA Hygiene Products is one of Europe's leading manufacturers of tissue and fluff products for personal hygiene and other applications. It is part of the Svenska Cellulosa Aktiebolaget Corporation that has almost 35.000 employees and operations in over 30 countries. SCA Hygiene Products has been operating in Russia for some five years now. They have mostly been selling imported Libresse and Libero products. In September 1997, the company bought a distribution company in Moscow with sales and administrative personnel totalling 80. However, by the end of year 1997 SCA came to conclusion that it could not compete profitably with the local players by importing products and began to study potential investment targets.

At the moment of the original acquisition, the mill was practically at a standstill and Tetra Laval began to implement a large scale investment plan in order to modernise the mill and make it profitable. In the negotiations with the local and regional administration, Tetra Laval was given guarantees that the investments would be supported by the administration and the company was also promised own wood cutting rights. However, in reality these promises did not have much meaning and, for example, the first wood cutting rights Tetra Laval received only in 1998 after heavy lobbying. The attitude towards the foreign investor was generally positive both among the Leningrad region administration as well as people living in Svetogorsk. However, there was a clear change to negative direction in the attitude after the 1998 economic crisis among the town residents. Local firms have had a very positive attitude towards them the whole time and their role as subcontractors was increased continuously.

In addition, the investments were hampered by various *gostnorms*, i.e. government regulations, which mostly date back to the Soviet times and are often unrealistic and impossible to follow, e.g., when building a new factory. Similarly, the high level of red tape was found problematic. Various licenses had to be obtained from federal, regional and local levels. It was complained that if one does not know the right persons in the offices, obtaining a license can take forever. Tetra Laval had also come across cases that the officials had advised them that by hiring a certain firm as "a consultant" the license will cost them USD 20 000. In case they decide not to hire the firm, it will cost USD 200 000 and it is not guaranteed whether they would get the license anyway.

Additionally, all kinds of fees had to be paid: road tolls, railway fees, taxes. New and surprising fees emerged all the time. Tetra Laval had to import a big part of the investment goods they needed for the modernisation of the mill. That turned out to be extremely expensive due to various customs fees that had to be paid as well as value-added tax, which also had to be paid but was not deductible in the taxation. In addition, the customs officials were claimed to be quite arbitrary and change the rules according to their own mind. Thus, the level of customs fees could not always be anticipated from beforehand.

By 1998 the product portfolio of the Svetogorsk combine consisted of pulp, tissue, fine paper and board. Only in board production Tetra Laval can be considered to have competitive advantage but all the other products clearly fall out of the core competence of the company. Also with respect to board it is fair to argue that they are more competent buyers than

producers and it is the production of packages made of board where their core competence lies. Therefore, in 1998 Tetra Laval sold the tissue production unit to SCA Hygiene Products (Sweden) and the rest of the combine to International Paper (U.S.), which is the largest forest industry company in the world. The mill was seen to turn into hands of a determinate owner.

Naturally, the change of owners made the people in Svetogorsk somewhat worried. They had heard of bad experiences with American investors who had conducted massive layoffs as soon as they received the ownership. Also the farce with various foreign investors at the Vyborg pulp and paper mill made them concerned. However, they soon realised that both SCA and IP had made the investment with serious intentions and had a long term strategy for the Russian market.

IP had screened potential investment targets for eight years before investing to Svetogorsk. The driving force behind their investment was the growth potential of the market. Factors supporting the choice of Svetogorsk were the high technical level of the machinery due to Tetra Laval's investments and the product portfolio, which leverages IP's Kwidzyn mill in Poland and enables them to serve the growing market demand in Russia and Eastern Europe. In SCA's case the main motivator of the investment was the high cost of imports which made them unable to compete with the Russian producers, who were selling lower quality and lower price products. The Svetogorsk mill was producing a tissue brand which was the market leader in St. Petersburg and Moscow areas and thus SCA received a 30% market share with the investment. Also three of SCA's foreign competitors were planning investments to Russia but the 1998 economic crisis made them withdraw the plans.

All the three investors received tax concessions from the regional authorities. However, the federal tax authorities do not always accept the tax breaks that regional authorities give to foreign investors in order to make the region more attractive for them. One of the latest reminders of this occurred in the beginning of year 2000 when International Paper ran into difficulties with the tax authorities who demanded payment of taxes which had previously been written off. The matter was solved only after the intervention of the Leningrad region governor Valery Serdyukov.

Also other controversies between the local, regional and federal legislation were reported but they were mostly criticized of continuous unexpected changes, which make the business environment uncertain. Combined with the economic instability it is relatively easy to understand why the country is not seen as a very attractive investment target. A factor which contributes to the deterioration of the investment climate in the Vyborg district in particular, is the power struggle between the city mayor and the head of the district administration.

In the north-west part of Russia the infrastructure is often deficient. This is the case also in the Vyborg district and the companies had come across problems with, for example, heating, roads and railways. When Tetra Laval made the first investments, they also negotiated about the gas supply to the mill and the entire town. These negotiations were relatively problematic and the town was without gas for a long time. Now that side is working and the mill provides heating for the entire town. The town is supposed to pay for it but in reality it does not always do that.

The location specific advantages of the Svetogorsk pulp and paper mill were clearly acknowledged. It is easier to hire foreign experts and managers to the mill because they can live on the Finnish side of the border. For example, IP has a policy that their personnel lives

in the country where they work. However, they have made an exception in this case and also their foreign personnel lives in Imatra, Finland. Proximity to the Finnish border is very advantageous also with respect to speciality chemicals deliveries and machinery maintenance.

It was pointed out by all the three investors that generally the investments in forest industry in Russia are extremely expensive because the machinery in the mills is outdated and inefficient. The modernisation of the mills requires huge investments and often results to considerable reductions of personnel, which may be difficult to carry out without protests from the employees. In Svetogorsk massive layoffs have been avoided but the reduction of personnel has still been remarkable. Currently the mill employs 3200 people while in 1989 the figure was nearly 7200. However, not only the search for efficiency has contributed to the reduction of personnel, but also the fact that some of the operations that used to be part of the combine's responsibilities have now been transferred to the city and the community. Such operations were, for example, the dairy, pig farm, school and children's day care.

## **6.9. Summary of Case Studies**

Table 11 summarises the major findings of the case-studies. Although the cases describe experiences of widely different companies in different industries, some general conclusions can be drawn. First, foreign investors are very cautious and have only exceptionally made large investments in the region even though there is potential interest for large investments among the investors. A common strategy among both the companies and the financial organisations is a step-wise approach, which starts from small experimental projects.

On the basis of the reported experiences one can make both positive and negative observations. In connection with positive experiences and successful operations, reference is made to positive attitude of the regional authorities towards potential foreign investors. This is particularly evident in the one case (Svetogorsk Pulp and Paper factory), which for comparative reasons was included in the study from the neighbouring Leningrad Oblast. On the other hand, in case of negative experiences their significance seems to stretch far beyond the single unsuccessful operation due to the fact that they are widely monitored and publicized. Reference is often made to such cases by other companies and they act as significant barriers to investment, particularly when they are not balanced by widely publicized information about successful operations. The negative case cited by several of the interviewed companies is the Segezha pulp and paper factory in the Karelian Republic.

All companies, including the relatively successful ones, have a long list of negative experiences, which can be considered barriers to other investment in the region. The list is headed by the general observation about an unattractive investment climate due to economic and political instability of the region and the frequent legislative changes, in particular. More specific comments are related to the taxation system, which is considered unfair by the foreign investors, as they have to pay taxes that are not charged from the local companies. A frequent complaint is also the inadequate infrastructure, particularly the lack of an efficient communications system.

What in the view of the different companies needs to be done in order to attract foreign investors differs from company to company. Generally matters ranging from development of legislation to development of the banking sector, which were considered as barriers, need to be changed more in favor in the foreign investors. In addition, among the companies

interviewed, special importance was placed on the possibilities of exporting energy and raw materials from Russia due to the fact that exports play an important role in securing the financing for many FDI projects.

The international financial institutions note that they are not willing to accept the credit risk of Russian companies and usually require the guarantee of Russian state or at least regional authorities for such loans or equity investments. On the other hand, due to the inefficient local banking sector, the Russian environment is not ready for large investments, where local financing is a prerequisite. Nor is the environment ready for project financing, where the proceeds of the project itself could be used as collateral. In light of the generally small investments of the potential foreign investors the international financial institutions are usually not the best sources of financing as their organisations are not well suited to deal with small investments. However, the large infrastructure investments, which are usually high on the preference lists of the regional authorities and not usually targets for direct investors, clearly would call for large international financial arrangements.

**Table 11 Comparison of Case Study Findings**

<b>Case-company</b>	<b>Barriers, problems encountered</b>	<b>Positive experiences</b>	<b>Negative experiences</b>	<b>What is needed</b>	<b>Current strategic view</b>
<b>Outokumpu</b>	The project of renovation of Pechenga Nickel smelter never saw daylight due to political struggle in 1991 <i>The economic crisis of 1998 put the planned investment on hold</i> The strategy of mother company changed as the company decided to sell the nickel producing units in Finland	Awareness of the of environmental problems in the Russian metallurgical industry	The business culture in Russia is not easy for foreign companies – no organizational level on which strategic planning is practised <i>Time-consuming decision-making process</i>	A more integrated approach in the enterprises when analysing questions concerning foreign investments	Cooperation agreement with Norilsk Nickel covering imports of raw material in Finland and imports of technology in Russia
<b>Fortum Oil &amp; Gas</b>	The political and economic instability of Russia <i>Local companies favoured due to the stakes or regional governments in them</i>	Positive signs in the investment climate <i>Fortum considered a good partner by regional administration in Nenets</i>	Tax treatment of regional and foreign oil companies is unbalanced	PSA has to be finalised and harmonized with other legislation, notably the tax code to increase predictability <i>Protection of investor rights clarified</i> Russian legal specialists trained in western companies <i>Transportation options for oil exports need to be</i>	A step-wise approach to investments in North West Russia

Case-company	Barriers, problems encountered	Positive experiences	Negative experiences	What is needed	Current strategic view
				<i>clarified</i>	
<b>Kvaerner-Masa Yards</b>	Transportation services are becoming national cabotage operations as a result of a new harbour in Pechenga. <i>Foreign companies are considered potential sources of extra income.</i> Communication made difficult by poor telecommunication networks in the region	Issuance of exploration licences on the basis of earlier work and not only on the basis of public tendering Good chance for Finland	Money sent to the JV in Murmansk was lost on the way and, as a result of this, threat of confiscation based on alleged tax arrears	Investment in personal relations with key Russian managers and decision makers	Long term interest in selling ships
<b>Stora Enso</b>	Russian legislation limits wood harvesting <i>Difficult investment climate in Karelia</i> Poor state of the banking system <i>High costs of using western experts</i> Foreign companies have to pay all taxes but locals not	Clear signs of recovery in the Russian mechanical wood industry <i>Karelian government supportive of foreign investments</i>	Diversity and conflicts between Russian partners <i>Pursuance of personal interests</i> <i>Segezha pulp and paper mill</i>	Security of raw wood supplies <i>Security of the level of taxation and congruence with the federal taxation</i> Positive attitude of the regional and federal governments	Small experimental projects
<b>Svetogorsk Pulp and Paper Mill in the Leningrad Oblast</b>	Cumbersome government regulations concerning new investments, building standards <i>Customs tariffs not predictable for imported equipment</i> Continuous unexpected changes in the regional and federal	Positive attitude of the authorities of the Leningrad region as well as the people of Svetogorsk <i>No massive layouts</i>	Requirements for bribery in acquiring certain licences <i>New and surprising taxes and fees all the time</i> Taxes already	The foreign investor needs to have a long term view and backing from the local authorities	Present investor IP has a long term strategy in Eastern Europe

Case-company	Barriers, problems encountered	Positive experiences	Negative experiences	What is needed	Current strategic view
	<p>legislation</p> <p><i>Power struggles between various authorities in the region</i></p> <p><i>Deficient infrastructure</i></p>	<p><i>were carried out</i></p> <p>Positive attitude of local subcontractors</p> <p><i>Tax concessions</i></p> <p>Personnel can live in Imatra, Finland</p>	<p>written off had to be renegotiated on a high level</p>		
<b>Comments of other interviewees</b>	<p>Large international oil companies have experience from operation in many unstable and difficult environments in the world. If Russia is considered too risky by them, how could other companies survive in Russia?</p> <p><i>EBRD and other International Financial organisations are talking too large sums.</i></p>	<p>Good signs: houses are being painted, the choice of services is getting larger every day</p>	<p>Registration of real estate ownership unclear: many people live in other addresses than those they are registered in, difficult to know who really owns the flats.</p> <p><i>Customs clearance much faster in Moscow than in Murmansk, goods cleared in Moscow</i></p>	<p>Foreigners need to take control of investment projects, otherwise the local personnel would steel time for their personal interests</p>	<p>Many Scandinavian companies have left the region</p>
<b>Financial institutions</b>					
<b>Nordic Investment Bank</b>	<p>Guarantee of the Russian government is not easy to get (NIB has limited resources for</p>	<p>An agreement of cooperation with the government of</p>	<p>Unclear division between utilities and municipality</p>	<p>In case the governmental guarantee is not</p>	<p>Growing interest in financing the Russian</p>

Case-company	Barriers, problems encountered	Positive experiences	Negative experiences	What is needed	Current strategic view
	evaluation of the creditworthiness of Russian organisations) <i>Russian environment is not ready for project financing</i>	Russia	<i>Lack of recovery on tariffs</i> Limitations on foreign borrowing	available a reliable Nordic company is needed to guarantee that the project will be carried out successfully	development projects in cooperation with other financial institutions
<b>NEFCO</b>	Communication complicated <b>High risks</b> No information about tax incentives <i>Cumbersome customs procedures</i> Low predictability of legislative changes <i>Low security of supplies</i> Low cash flow of utilities <i>SME's neglected</i> Lack of resources	2 small environmental grant projects completed	Large losses of Segezha <i>Local banks are inexperienced and bureaucratic in questions concerning foreign credits</i>	Funding needed also from local banking sector, which needs to be developed	Small projects
<b>EBRD North West and West Russia Regional Venture Fund</b>	Investment climate in these regions unattractive for FI <i>Main barriers of investments connected with policies of regional local administrations, long distances to markets, poor infrastructure, taxation and customs problems, transparency in companies, difficulties in</i>	The current investment climate in the whole Russia is moving in a positive direction	Lack of encouraging examples (as opposed to Segezhabumprom/ Assidomän)	Various tax exemptions and other legal instruments including special economic zones are not primarily what investors are looking for.	EBRD is committed to increase venture capital investments in Russia



Case-company	Barriers, problems encountered	Positive experiences	Negative experiences	What is needed	Current strategic view
	<i>agreeing user rights for natural resources.</i>			<i>Rather regional governments should concentrate on providing a stable and predictable investment climate</i>	
<b>Finnvera</b>	Problems in getting reliable information, low level of investments, inconsistent implementation of legislation, difficult taxation rules, customs bureaucracy, inadequate administration, ownership of real estate unclear, problems in the banking sector	Finnish SME's have become more active in the region, <i>Demand on the Russian home market is growing</i>	Unethical behaviour of enterprises and over-optimistic expectations of quick profits	Financing for the internationalization of Finnish SME's also in the North West Russian regions under development	Financing for the internationalisation of Finnish SMEs also in North West Russian regions under development

## **7. Investment Climate by Region**

In order to collect material and to interview authorities, researchers and companies in the target regions, visits were made to Murmansk, Arkhangelsk, Syktyvkar, Petrozavodsk, St. Petersburg and Moscow. Due to difficulties in arranging a visit, Naryan Mar, the capital of the Nenets Autonomous Okrug, was not visited. However, the regional authorities were contacted and a questionnaire on investment climate issues was sent, but no answer was received.

This chapter presents the reports from the visits to Russia. At the end of the chapter, these reports are summarised. The list of interviews made during the visits is at the end of this report.

### **7.1. Murmansk Oblast**

The report is based on discussions with Murmansk Oblast Administration and the Concept of Investment Policy of Murmansk Region developed by the authorities.

In 1999 the Economic Committee for Murmansk was changed into the Committee on Economic Policy, which has developed further the policies on investments and small business activity. The basis for attracting FDI in Murmansk is new legislation designed to promote FDI in the region, including: 1998 Investment law and 1999 Law on tax credit for investments. Additional regulations have been passed by the regional governor. One such regulation is the investment program developed for the region. Further, there is a regional law of zones for economical development.

However, the 1998 law on investment is not functioning yet and no small businesses have used the law. In addition there is a great need to change the law in accordance with the new federal investment law and further new legislation is needed.

The Murmansk administration has analysed the reasons why the regional investment law is not functioning. The reasons are:

- Lack of infrastructure
- Lack of personnel resources, there are only 5 persons in the regional international department;
- There is no interest in the investment projects listed in the investment project catalogue; In 1998 198 project proposals were investigated and 122 of them were adopted and included in the catalogue; the original plans came from the companies and were drawn according to subjective criteria of those companies;
- Many plans were badly prepared, included plans to invest in new technology that were not documented at all and for which there was no experience. Financial analysis was not well carried out. For example, in one case the project included investments worth of 600 million USD for one plant. However, when investigated investments for only 30 million were actually documented;
- Different administrative persons supported different projects – subjective criteria also in the administration.

Subsequently, the need emerged to create a list of prioritised investment projects on the level of the Murmansk government, and a list of 24 project was drawn up using the following main criteria:

- social role of the project; for example Sevredmet, which employs 2000 people in a village of 10 000 people.
- economic efficiency.

The investment promotion infrastructure in Murmansk is planned to be upgraded through plans to establish a regional investment agency as a holding company controlled by regional administration and working in close cooperation with the national investment promotion agency in Moscow. There is co-operation already with the office since 1992.

- Establishment of a regional information centre according to the model used, for example, in Novgorod and planned also in Tver.
- Establishment of a regional leasing company and a regional insurance company.
- Harmonization of the regional budget for development with the federal budget.
- Establishment of a Center for Development of Small Ecological Projects
- The list of investment projects updated yearly.

Many of the above plans have been copied from Velikii Novgorod with the help of a Finnish consultant, who has worked as a consultant in both cities. However, the financial department of the regional administration in Murmansk is opposing the plans as too expensive.

It is also realized that concrete investment incentives are needed, such as:

- Guarantees – there is very weak support of guarantees now as the regional budget does not allow giving investment guarantees.
- Tax privileges – up to 100 % in the working.

AFC Association of Financial Corporations is interested in promoting the investments in the region.

There are also plans to establish property funds but presently there are no regulations and no rules to govern such activities, also no support from financial department of the regional administration.

Free economic zones – there is a special law (Law on economic development) which is a framework law for the Murmansk shipyard and similar zones of depressed areas.

There are local tax credits on land or road which enterprises working in the non-ferrous mining industry are exempted from. However, Sevredmet pays taxes.

After Putin's visit to Murmansk in 2000 there is a complex of measures under preparation. However, no criteria have been accepted for the selection of foreign companies.

For example, there is interest from Iceland: an Icelandic fishing company is planning a 10 million dollar investment for the production of 3000 tons of cod and has applied for an investment guarantee for 5 years and for tax holidays. The Murmansk committee for fishery

is also considering the requirement for a fishing quota. Another project involves the establishment of a Fish factory by a Norwegian company. The business plan for the project is made and financing is available from Norway.

Other investment projects include:

- mining projects
- Production of fosphoric acid to produce fertilisers with apatite (131 million dollars)
- Production of rare metals (lapatite) with new technologies
- Small investments to develop SME's
- Plans for the utilisation of the Shtokmanovskoje gas and condensate field were worked out already in the 1980s. At the end of the 1990s, new interest for the fields materialised.

In addition to the Oblast administration, several other actors were interviewed in Murmansk. Foreign organisations operating in the region emphasised the following issues concerning the investment climate and FDI development in the Oblast:

- According to foreign operators in the area, successful investments in the Oblast are more dependent on networking, contacts and relations with key decision-makers than the operation of a system of rights and obligations for foreign investors. Therefore the weak state of the legislative and normative environment for investments in the Oblast emphasises the need for good relations with key figures in the regional and local administrations.
- The control of joint ventures has to be in the hands of the foreign partners, otherwise these projects will not work. There are a number of recorded cases of failed joint ventures where the foreign partners have been unable to work with the Russian partners and have been forced out of the company.
- One main obstacle to the success of joint venture investments is the fact that Russian employees of the JVs often have a large number of side businesses which they take care of at the cost of their main work.
- The risk of investing in the Oblast remains very high, due to the lack of political and economic stability and the lack of a working property and land ownership regime.
- The military in Murmansk (and also Arkhangelsk) still influences decisions on investment projects and can cause a barrier to investments. For example, LUKoil has planned to construct an oil refinery in the Kola fjord but has not been able to access land for the site due to military restrictions.
- The investment legislation developed to provide incentives for investors in the Oblast is of secondary importance compared with the need to develop a working environment for SMEs and compared with the need to develop the infrastructure of the Oblast to service investors.
- Customs difficulties pose a significant barrier to FDI in the Murmansk Oblast. Foreign companies mentioned that often it is easier to transport goods into and out of the Oblast via Moscow than to face the difficulties encountered with the regional customs officials.
- The future possibilities for foreign investors in the Oblast are mainly connected to the development of oil and gas resources of the Barents Sea and the Timan Pechora region.
- The prospects of the mining and metallurgy industries in the Oblast are not seen to be very positive by foreign companies. A huge restructuring is needed and costs are high, despite the rich resources. Export outlets are also in poor condition.

- Norwegian companies have been active in Murmansk in fish trade and in dynamite production. Kvaerner also has an office in Murmansk.
- Swedish companies have been active in subcontracting for computer production (a Swedish company has an affiliate component maker in Murmansk Oblast which exports the components to northern Sweden); export of reindeer meat and berries to the west; and dynamite and fertiliser production. Swedish companies are also involved in activities to construct a scrap metal plant in the Oblast to utilise metal from decommissioned ships.
- In the view of foreign actors, some of the main improvements in the investment climate have to be made in Moscow e.g. development of legislation and harmonisation of practices between regions and the federal centre.
- In investment guarantees and taking loans from the IFIs the Murmansk Oblast has very limited possibilities due its inability to take financial risks.
- The regional investment legislation is not functioning, partly due to conflicts with the federal legislation.

Discussions with representatives of a regional scientific organisation, the Kola Science Centre of the Russian Academy of Science, brought forth a strong suspicion of the motives of foreign companies operating in the Oblast. Experiences of the TACIS programme were mentioned as being especially negative, since the programme was seen to only promote preparation of feasibility studies by foreign consultants. In addition, there was a definite view that FDI is a zero-sum game in which the benefits for foreign companies (mainly in the case of Murmansk cheap raw materials and cheap labour) always entail negative consequences for the Oblast (lack of development of processing industries, low salaries etc.). It was also seen that in many cases the real objective of the foreign companies was to stop progress in developing competing industry in Murmansk, for example in fish processing or sawmilling.

## **7.2 Republic of Karelia**

Attraction of foreign investment (FI) is a priority for the Karelian Government. The Republican Programme "Guidelines of International Co-operation Development by the Government of the Republic of Karelia, 1999-2002", was approved in December 1999 (hereafter referred to as Programme) The programme states that "...creating regional conditions to increase the investment attractiveness of the Republic of Karelia is a key goal of the Government".

The following tasks directly related to investments are specified in the Programme:

- Establishment of a governmental support system to individual projects of large foreign investors in order to help them adapt, to free them from extraordinary "care" by different control and supervision agencies, and to clear bureaucratic obstacles;
- One example of such pilot projects is a sawmill producing high-quality sawn timber on the basis of an agreement between the Republic's Government and "Stora-Enso" Finnish-Swedish company in July 1999;
- Amending the republican legislation and working out an accurate system of preferences and guarantees to foreign investors;
- Translation of legislative acts and norms into the English language;

- Providing investors with information, including databanks on the investment potential of the Republic, ideas and feasibility studies on specific investment projects, incomplete construction objects, and general information on resources, etc.;
- Promotion of the idea of Kostomuksha free economic zone at the federal level. The Republican Government hopes that this project will meet understanding and support from the Government of the Russian Federation; the Government of Karelia will also encourage creation of local free economic zones in other cross-border areas of the republic and, in the first place, in Sortavala town;
- Establishment of a reliable commercial bank, possibly, with the participation of foreign capital, able to deliver services in accordance with international standards;
- Development of an action programme to upgrade the international image of the investment climate of the region;
- Organisation of a Karelian-wide study aimed at disclosing the factors diminishing the attractiveness of the republic as measured by the domestic ratings by the Expert journal;
- Building up steady ties with different international financing institutions and potential strategic investors;
- Promotion of ready-made projects of Karelian enterprises to international markets of investment resources.

The Programme also states that the major mechanism for implementation will be Inter-Sectoral Investment Committee established in April, 1999. It is also planned to develop a special programme to attract both domestic and foreign investments to the republic in order to reach the annual target volume of foreign investments included in the economic development plans of the Republic of Karelia.

The Karelian Government uses the following instruments to attract FI:

- Legislative instruments
- Organisational instruments (state bodies of the Republic of Karelia are endowed with relevant authorisation)
- Information.

The following comparative advantages of the RK for attracting foreign investments can be listed:

- Geopolitical position of the Republic of Karelia (near by to international / EU market)
- Considerable Resources available (nature resources, labour, scientific skills, etc.)
- Infrastructure available (customs and transport infrastructure).

In addition, the following factors facilitate the inflow of FI:

- geographic position,
- tourist, recreational and cultural potential,
- well-developed network of scientific, research and educational institutions.

Organised work in order to attract FI has been conducted for the last 8 years in the Republic of Karelia. During this period the number of enterprises with foreign investments, volume of foreign investments and their impact on the regional economy's development have had a positive trend.

By January 1, 1999, the cumulative foreign capital in the republic's economy, including repaid credits from foreign organisations, amounted to 48,4 million US dollars. The largest investments were made in the industrial sector (94% of all dollar investments). Within the industrial sector the overwhelming share of investments is directed to the forestry, wood-processing and pulp and paper industries (76,3%). 134 enterprises with foreign investments operate in the republic and employ 4500 thousand people. In practice they do not differ from purely Russian enterprises, which is why there are no reasons to assume that foreign investors set up companies in the republic only to obtain privileged conditions for conducting business. Compared to Russian enterprises the foreign-owned enterprises are more stable and effective. Their production rates are higher than the Russian average and their technical level is also higher. Of the total amount of investments into Karelia's industry over the last three years, the share of foreign-owned enterprises amounts to 23,3%, and their share of the industrial production in the Republic of Karelia amounts to 4,2%. In sum, during the recent years foreign-owned enterprises have become a considerable factor in the economy of the republic.

During the interview the following positive examples of FI were named:

- Ladsenso (Finnish investments)
- Pegas International Ltd. (100% of the US ownership)
- Medvezhegorskiy Complex forest industrial (Investments from Canada)
- Kondopozhskiy KLPH (timber company) (Investments from the UK)
- AO Kondopoga (pulp and paper plant) (there are also credit lines from its German shareholders)

Segezhabumprom (AssiDomän, Sweden) was named as a negative example of FI in the Republic of Karelia

There is no regional FI promotion centre in the RK. Responsibilities for attracting FI are assigned to the Ministry of Foreign Relations and the Ministry of Economics. The Ministry of Foreign relations is responsible for accreditation of representative offices of foreign companies and their branches and assignment of locations to the enterprises with foreign investments on the territory of the republic of Karelia. State registration of enterprises with foreign investment carried out by The Ministry of Law

The Karelian Government promotes FI independently but is guided by the Federal legislation on FI and international co-operation agreements. The inflow of large loans is regulated in co-operation with the Federal Government.

During the interview the following obstacles to FI were named:

- General social economic situation in the country is unstable from the point of view of foreign investors;
- Deficiencies in the legislation;
- Frequent changes of legislation on international economic activities (customs, taxation legislation etc.)

There following sectors are considered by the Karelian Government as priorities for FI attraction:

- Wood-processing
- Mining complex (particularly nature stone extraction and treatment)
- Energy sector
- Tourism
- Fish catch and processing

According to the authorities poor attraction of foreign investments is, in the first place, a Russian-wide problem. Political and financial instability, imperfect legislation and its frequent modifications, low personal security and high taxation make investments unattractive and hazardous. Especially in North West Russia (particularly in Arkhangelsk region and the Republic of Komi) consumer demand is relatively low and financial markets underdeveloped. Poorly developed transport infrastructure hinders the effective use of transit operations between the Western Europe and the North West Russia. In investment attractiveness Karelia ranks somewhere in the middle on the list of Russia's regions.

The Programme also names particular reasons for the unattractive investment climate of the republic of Karelia, such as:

- The absence of effectively working investment legislation. The laws on "State Guarantees on Foreign Investments in the Republic of Karelia" #60-ZRK and "Investment Activity in the Republic of Karelia" #289-ZRK are not in force;
- Lack of reliable banking system, which would be acceptable to foreign investors;
- Lack of information about the investment potential of the RK;
- The debts of Karelian enterprises to different budgets and the absence of mechanisms for their liquidation in case of foreign acquisitions;
- Low management level, that "disables enterprises to seriously present their projects to foreign investors;
- Non-regulated issues in the fields of property rights, land ownership and utilisation of forest resources etc.

The Government considers foreign investments, along with domestic investments as one of the significant sources for restructuring the republic's economy. On the other hand the government assumes that attracting foreign investments depends, in the first place, on the Russian-wide conditions: general political and macro-economic situation, the federal legislation and taxation rates.

The Republic of Karelia is a member of Association "North west" ("Severozapad") and the Karelian minister of foreign relations heads its committee on external economic relations. The common policies on FI of the members in the Association is under development.

### **7.3 Arkhangelsk Oblast**

A visit to Arkhangelsk was made in September 2000. The following is a summary of the interviews made.

In discussions with academics at the Pomor State University and the Arkhangelsk State Technical University, the main points raised about FDI were the following:



- Foreign investment as shown in the statistics is not directed to primarily to the Arkhangelsk Oblast but to the Nenets Autonomous Okrug, which is included as one of the “rayons” or districts of the Oblast statistics. The FI is directed purely for oil and gas projects in Nenets.
- As the Oblast was the leading forest industry area of the Soviet Union, there is great potential to involve foreign investors in this sector. However, so far there have been almost no foreign investments into the forest industry, due mainly to the reluctance of the regional authorities to allow foreign involvement in this strategic sector.
- However, there is an Austrian equity investor at the Arkhangelsk Pulp and Paper Plant and there is also a foreign investor involved at the Kotlas Pulp and Paper Plant.
- There is a lack of trained personnel to help foreign companies operate in the Oblast and this shortfall should be addressed.
- There is a need for an organised centre in the Oblast to help companies develop business plans and to attract foreign investment e.g. by assisting prospective investors and by disseminating information about the investment potential of the Oblast.
- Arkhangelsk has received some foreign investment through involvement in district heating projects financed from the EU’s Tacis programme and through a World Bank loan.
- The Arkhangelsk State Technical University has been involved in preparing business plans according to international standards for companies and consults the Head of the Oblast Administration on FDI issues.
- The South African company De Beers wanted a controlling stake in the Lomonosov diamond deposit but the Oblast Administration was opposed and eventually De Beers sold its stake to RosAlmaz.
- The regional investment law of the Oblast provides possibilities for tax breaks for investors, for both foreign and domestic, but only applies to projects included in the priority listing of the Arkhangelsk Oblast administration. The tax breaks concern taxes which would be paid to the Oblast budget. The tax breaks can be given for a maximum of 5 + 2 years (for the duration of the project’s payback time plus a maximum of 2 years more). After the payback time the exemption from paying the regional profit tax is 70% for the first year and 50% for the second year. Property is 100% exempted from taxation for 2 years after the payback time.
- Under the new tax code of the Russian Federation, the Oblast still has some freedom to give tax breaks from payments which would go to the regional budget, but in the future it is possible that President Putin will cancel this freedom.
- The strengths of the Oblast in FDI attraction are: rich natural and human resources.
- The main barriers to FDI are lack of regional financing for projects, general instability in the Russian Federation, as well as the reluctant attitude of the Oblast Administration to allowing majority foreign ownership of companies operating in the region.
- The development of the PSA legislation being worked on by President Putin’s administration will be positive for FDI in the Oblast.
- The efforts by President Putin to harmonise legislation and implementation of laws between the federal and regional levels is positive for FDI.

In discussions with the regional and city administrations, the following points were raised concerning FDI in the Oblast:

- An Investment Law has been passed on the regional level and provides incentives for foreign and Russian companies investing in the region e.g. tax breaks.

- No central organisation exists in the Oblast for FI attraction and this is a shortfall.
- The priority sectors into which foreign funding is needed in Arkhangelsk City are municipal and energy infrastructure.
- According to the city representative, the main reasons for the low level of FDI in the Oblast are the high level of taxes and other fees and the lack of stability.
- City Administration works with companies to prepare projects and presents them through regional authorities (project priority list) to prospective investors.
- Issues of FDI in the Oblast are the responsibility of both the Economic Policy Dept. and the Foreign Affairs Dept.
- The legislative base is settled but still needs improvement (regional law on investments including guarantees for investors). The federal tax code changes will be important
- Main potential sectors for FDI are forestry, agriculture, energy, transportation and communications.
- A Law on Free Trade Zones in the Oblast exists but needs updating since it is in conflict with the new federal tax code.
- There is a State Unitary Company for Investments in the Oblast and its aim is to link financiers, consultants and local banks. However, the Company is not operating successfully.
- A regional investment promotion centre is planned to work with financiers and to prepare investment project proposals and to help investors. The regional forest company Arkhlesprom has similar activities and the regional investment centre could be modelled after this. The information on investment possibilities is planned to be put on the internet in English.
- There are special support programs and laws aimed at SME development in the Oblast. Therefore in the future there is potential for foreign investors' involvement in regional SMEs.
- The Arkhangelsk Oblast is involved in the Association North West which has a Committee on Investment Policies of which the Arkhangelsk is the chairman. An inter-regional investment fund is planned. The work of the Committee has so far concentrated on analysing the structure of inter-regional relations and discussing on investment promotion and instruments with the Central Bank of Russia.
- In the forest industry there is great potential for expanding operations, since the total allowable cut is 20 million m<sup>3</sup> and only 8 million m<sup>3</sup> is presently harvested. Therefore it would be possible to establish new companies for wood processing and sales. Traditionally the Oblast has been a major wood and wood products exporter, but now the main harvesting areas are already in use and new areas have to be taken into use. Therefore a new forest strategy incl. use of new technology and logistics is needed. The Oblast Administration is thus interested in attracting FDI into the forest sector if investors present proposals which meet the criteria included in the forest strategy e.g. income for budget, employment effects, positive social consequences (e.g. population of isolated settlements), and exploitation of bioenergy potential.
- In the energy sector, the main barrier to investments is the tariff policy which keeps energy prices too low to provide cash flow for investment payback. Kyoto Protocol application could bring foreign investments into the Oblast (joint implementation).
- There is potential for FI in the minerals sector, for example in production of abrasive materials and mineral wool for construction. The advantage of these projects is that no major capital investments are needed. The growing domestic demand for housing and construction provides viability for these projects. In addition, there is huge potential in diamond extraction (Lomonosov deposit), and oil exploitation (offshore or in Nenets).

- In transportation, investments are needed into the port facilities in Arkhangelsk City and along the Northern Dvina River. The Arkhangelsk Commercial Port has a potential cargo turnover of 10 million tons per year, although currently it is operating at 1.5-1.8 million tons per year. The use tariffs need to be raised in order to finance the necessary reconstruction of the port, but the management opposes these raises since it fears clients will leave.
- In machine construction, the ship-building industry has great potential, especially in the Severodvinsk area which earlier concentrated on building nuclear submarines and other military equipment. The conversion of military capacity is under way and provides opportunities for investors.
- The Oblast Administration's attitude to FDI is positive in general. Earlier the Administration worked closely with developing business plans for individual projects, now concentrates on setting framework conditions. Main tool for FDI promotion is granting tax privileges through the regional investment law.
- The Oblast Administration is also involved in working with foreign companies through its ownership in regional banks and other financial organisations e.g. Northern Clearing Chamber.
- The high investment rating of the Oblast shows that there is potential in the region.

## 7.4 Republic of Komi

Syktyvkar, the capital of the Republic of Komi, was visited in June 2000. In discussions at the Syktyvkar State University, including interviews with the rector and representatives of the Economics Department, it emerged that so far no academic studies or strategy papers on FDI in Komi have been prepared. However, there is co-operation between the university and the Republic's Administration on foreign investment issues and in developing instruments to attract FDI into the region. A visit to the regional statistical office, Goskomstat, confirmed that not even this organisation is involved in drawing up forecasts of analysis of data on FDI, and therefore the issue is mainly handled by the Komi Government.

In interviews with representatives of the Komi Administration, the main points put forward were:

- There is scope for forest sector co-operation with foreign companies: the Komi Government has prepared a forest sector strategy which includes the starting of a timber construction programme in co-operation with Finland.
- There are a large number of oil and gas projects under way in Komi and the Government of the Russian Federation is preparing a general plan for Timan-Pechora oil development. LUKoil is a very strong actor in northern territories (Komi, Nenets and offshore).
- A major project which would increase the economic potential of Komi and thus also improve possibilities to attract FDI into the region is the construction of the so-called Belkomur railway which would create a direct connection between the Urals, Komi and the port of Arkhangelsk. The track would be primarily used for transportation of coal, oil and forest industry products and raw materials.
- Foreign investors are welcome to join projects to build power plants which utilise the huge coal reserves in Komi. These projects have a strong social element.

- The Administration would like to see foreign companies involved in energy efficiency projects in co-operation with the regional power company Komienergo.

In discussions with Russian and foreign companies operating in the region, some of the main points on FDI put forward were:

- The Komi Administration is generally viewed positively regarding its pragmatic attitude to working with foreign companies.
- Main barrier to FI is badly working legislation which is often also in conflict with federal laws.
- The regional investment legislation includes possibilities for tax breaks for investors but the mechanism is not very flexible and is not working very well.
- Representatives of Russian companies and officials voiced the concern that most of FDI in Komi goes into the oil and gas sector, but the problem is that the oil is exported and therefore not enough money stays in Komi (regional budget). Therefore taxes on oil production and exports need to be raised.
- PSA legislation will be beneficial for Komi, 5 projects have already been selected for development on PSA terms.

In discussions with the investment department of the Komi Government, an interesting and quite unique approach to FDI attraction was presented. In Syktyvkar, there is an office of the United Nations Industrial Development Organisation (UNIDO), which works in close co-operation with the regional administration on FDI attraction and investment issues in general. UNIDO has been entrusted with many of the responsibilities for FDI attraction which are taken care of in the other RTBR by regional officials. Some of the main points raised in an interview at the local UNIDO office were the following:

- Main function of UNIDO office in Syktyvkar is to develop investment guides and to promote Komi investment projects.
- The UNIDO world-wide network (incl. 10 investment centres) is utilised in project promotion work.
- The new regional law on investments needs to be aligned with federal legislation (New tax code etc.).
- The strategy of Komi is to improve the climate not only for foreign but also domestic investors.
- UNIDO co-operates with regional and federal banks to promote projects.
- Komi Administration has entrusted project promotion function to UNIDO.
- A portfolio of about 100 potential investment projects in Komi has been developed by UNIDO in co-operation with the regional administration. Later material updated and developed into investment guide. The analysis showed that only some projects met western requirements and 25 were chosen.
- Main problem in developing and promoting investments in Komi is lack of financial documentation for projects e.g. data on expected future sales and data on financial situation of companies according to international accounting standards.
- The Komi administration has concluded that instead of priority investment project listings and their promotion it is more important to support the making of proper business plans.

- The Finland-Komi ad hoc Working Group on Economic Co-operation is a good instrument to attract foreign investors and projects have been developed in the framework of this co-operation.
- The information on investment possibilities needs to be upgraded and presented in English through internet.
- So far the co-operation with federal investment promotion centre and other agencies in investment promotion has been meagre.
- The local bank and government have established an investment promotion agency which works in co-operation with UNIDO. The centre failed due to preference of Russian investors to deal directly with companies without intermediary.
- Main weakness of Komi in attracting FDI is lack of local financial resources and project sponsors.
- Law on FI in Komi passed in March 2000 and can give tax breaks from regional taxes. Earlier tax breaks relied on acceptance by RF Ministry of Economy but now more flexible. Policy of Putin administration remains to be seen on this.
- The tax breaks are not the most important factor in attracting foreign investors, first there must be predictable and stable political conditions and working and flexible administration. The land ownership issue also has to be resolved (federal legislation needed).
- A barrier to developing forest industry in the region by foreign investor is that rent of forest lands is limited from the theoretical 50 years to 5 years in practice since Forestry Committee wants to verify that reforestation responsibilities have been met. The activities of international environmental protection movements such as Greenpeace and WWF in Komi also hinders development of forest industry.
- Over 50% of the equity of the Syktyvkar Pulp and Paper Plant is owned by Austrian Frantschasch. The US Eximbank has extended a loan to the SPPP and the loan has been guaranteed by the RF government.
- There has also been a foreign investment in gas processing at Sosnogorsk (Severgazprom) – loan from Chech bank and works by Chech contractor.
- There are some 160 JVs registered in Komi, but only some 60 are operational. Some of the JVs operating in Komi are however registered in Moscow (equity over RUR 100.000)
- New plan on FI being prepared by Komi MinEcon and UNIDO.
- Komi cannot provide regional guarantees for projects since it is a huge burden on the budget. The regional budget law stipulates the maximum share of regional budget revenues that can be extended as guarantees. This creates a barrier to investments and international projects, since for example the World Bank requires regional guarantees.
- The main barriers to investments are: a) historically Komi has been a raw material provider and human resources have not been developed enough. Many sectors have been neglected. Therefore there are huge human resources costs for establishing businesses such as furniture making and it is better to do this in other regions such as Kirovsk. b) northern location and distance to markets and cost of technology needed vs. climate c) regional consumer market is small and therefore local producers cannot compete e.g. in foodstuffs d) Federal legislation on investments still needs development and Komi is dependent on this e) poor infrastructure.
- Main strengths: a) good administration able to work with business but also able to stamp down corruption e.g. in local administrations and officials b) rich natural resources – processing needs to be developed in place of exports.

- One main challenge for Komi government is to lessen dependence on oil production and LUKoil. Therefore the regional economy should be diversified.

## 7.5 Summary

Table 12 summarises the evaluations by regional authorities concerning the investment climate in the four Russian Territories of the Barents Region.

Both in Murmansk and Karelia the local authorities stress the significance of new legislation and local investment programs in attracting FDI. On the other hand they realise that the legislation is not fully implemented and therefore not working effectively. The same applies for Arkhangelsk Oblast, where the administration is proud of the investment legislation and emphasises the possibilities it provides for foreign companies, but at the same time it is admitted that the legislation is now working and still needs development. The progress in federal investment, tax and land ownership legislation is emphasised in all cases as a key factor to facilitate the working of regional investment legislation and incentive systems. In the Republic of Komi, the regional investment legislation was not emphasised to the same extent as in the other regions, rather a pragmatic and working relationship between the Republic's Government and foreign companies was emphasised as the key element in attracting FDI.

The authorities also realise that there are significant weaknesses in the investment climate and infrastructure. All regions suffer from a lack of financial resources and reliable banking systems. In all the RTBR there are plans to set up new banks and financial organisations to facilitate investments. In Karelia also indebtedness and low management level of the local companies is mentioned as a weakness of the investment climate.

Murmansk, Karelia and Arkhangelsk have not set up promotion or information centres to attract investments but all have plans to that effect. All three have drawn up lists of prioritised or ready-made projects for the consideration of potential investors but, particularly in Murmansk, it is pointed out that there is no interest among the investors in the prioritised projects. In Komi the approach has been different, since investment promotion activities have been delegated to the UNIDO office in Syktyvkar and in addition the Komi Government has to some extent lessened its emphasis on working with prioritised investment project lists. This is due to the fact that this approach is seen to have failed in the past.

In Murmansk there already exist some free economic zones and in Karelia the establishment of such zones are planned. However, on the topic of special economic zones, harmonisation of the regional policies with the federal policies is a key issue and it is not evident that on the federal level such policies, which include considerable tax and other privileges, are acceptable.

In addition, all four regions are members of the Association North West and, what is more important, the new North West Federal District, which is one of 7 new administrative districts of Russia created by President Putin. These organisations are presently formulating common policies on FDI, among other issues. It remains to be seen whether the regions can co-operate to attract FDI to North West Russia, or whether natural competition for FDI will be too great an obstacle.

According to the new tax legislation, which was adopted by the federal Duma in 2000, the maximum level of profit tax that the local administration can levy on foreign companies is 19 %. Local tax concessions, in case the local administration favours them, can thus play a significant role in diminishing the overall tax burden of enterprises. The federal profit tax rate is 16 %. However, there is little evidence that this instrument has been widely used in the target regions after the initial tax brakes were accorded to foreign joint venture parties at the end of 1980s. There is also hard international competition in the field of incentives aimed at attracting FDI. For example, within the Baltic Sea region, Poland and the Baltic countries offer significant tax advantages to foreign investors whereas the Nordic countries provide many kinds of financial incentives and considerable help from the local administrations.

In summary, the interviews with the regional and local officials in the RTBR showed that all these regions have more or less common views on the possibilities and barriers to FDI. All regions are developing instruments to attract FDI and welcome foreign investment into certain sectors of their economies. However, there are major limitations on the involvement of foreign companies wanted by the regional administrations, and in all cases there are conflicting views of the objective results of FDI between foreign companies and the regional administrations. For foreign companies investment in the RTBR is motivated by profit. For the regions themselves, there are much wider objectives of social and economic development and progress in infrastructure and budget revenues.

**Table 12 Criteria for Evaluating the Regional Investment Climate**

<b>Region\ Criteria</b>	<b>Murmansk</b>	<b>Karelia</b>	<b>Arkhangelsk</b>	<b>Komi</b>
<b>Strengths</b>	New legislation, 1998-1999. <i>New investment policy developed.</i> Rich mineral resources and trained workforce.	Guidelines of International Cooperation adopted in 1999; <i>Geopolitical position near to EU markets;</i> Considerable resources; <i>Infrastructure available</i>	New legislation on investments and co-operation with NW Association. <i>Rich natural and human resources.</i>	New legislation 2000 <i>Rich natural resources.</i> Flexible and working regional administration. <i>Good relations with Moscow.</i>
<b>Weaknesses</b>	The legislation is not implemented; <i>Lack of infrastructure;</i> Lack of resources, both financial and human; <i>No interest among the investors in the projects prioritised by the Oblast Administration.</i>	Investment legislation not working effectively; <i>Lack of reliable banking system;</i> Lack of information about investment possibilities; Debts of Karelian enterprises; Low management level. <i>General socio-economic situation unstable</i>	Lack of infrastructure and need for reconstruction of ports and other transportation routes. <i>Lack of regional financing for projects.</i>	Poor infrastructure. <i>Lack of local sources of finance.</i> Low level of processing of raw materials. <i>Distance to markets.</i>



<b>Region\ Criteria</b>	<b>Murmansk</b>	<b>Karelia</b>	<b>Arkhangelsk</b>	<b>Komi</b>
<b>Strategy/goals</b>	Utilisation of the list of prioritised investment projects, which is planned to be updated yearly.	Creation of regional conditions to increase the investment attractiveness of Karelia.	Creation of framework conditions and providing tax breaks and other incentives for projects included in the regional list of priority investment projects. <i>Strategy of Administration to attract investments supporting its own budgetary and strategic objectives.</i>	Regional investment program incl. project promotion through UNIDO network. <i>Co-operation with regional and federal banks and organisations such as Finland-Komi Working Group.</i> Goal to develop degree of processing and to diversify economy.
<b>Promotion</b>	Plan to establish a regional investment agency and information centre.	No regional FI promotion centre; <i>Investors' databanks planned;</i> Build-up of steady ties with different international financing institutions and potential strategic investors	Plan to establish a regional investment agency and information centre. <i>Plan to set up NW Association inter-regional investment fund.</i>	Through UNIDO network and through regional MFA.

<b>Region\ Criteria</b>	<b>Murmansk</b>	<b>Karelia</b>	<b>Arkhangelsk</b>	<b>Komi</b>
<b>Instruments</b>	Establishment of a new leasing company and insurance company; <i>Establishment of a Centre for Development of Small Ecological Projects</i> Tax privileges planned <i>Free economic zones</i>	A system of governmental support planned with freedom from the "care" of many controlling and regulating agencies; <i>Alterations to legislation;</i> Local free economic zones; <i>Establishment of a reliable commercial bank;</i> Organising a Karelian wide study on obstacles of investments; <i>Promotion of ready-made projects</i>	Regional legislation providing tax incentives for investors. <i>Plans for more effective dissemination of information on investment projects.</i> More effective regional financing through commercial banks and investment funds.	Regional investment legislation. <i>Support of regional government to investors including support against local officials and other barriers.</i> Co-operation between government and UNIDO and the federal government. <i>Regional investment funds and financing through banks operating in Komi.</i>
<b>Region/Federation relationship</b>	The regional budget needs to be harmonised with the federal budget	Kostomuksha free economic zone at the federal level;	Working relations.	Good relations.

## 8. Conclusions

On the basis of the statistical, legislative and other material collected, the case studies analysed, and the interviews conducted for this study, the following conclusions are put forth:

1. From the viewpoint of foreign investors, some of the main characteristics of the RTBR are:
  - Harsh geographic and climatic conditions which pose various additional costs on project infrastructure and financing;
  - Poorly developed transportation, communal, energy, communications, social and financial infrastructure;
  - Rich natural resources, especially forests, oil and gas, minerals and fish;
  - Large and complex regional and local administrations;
  - Dependence of regional and local economies on natural resource extraction based heavy industry and, correspondingly, weak development of SMEs and the service sector;
  - A relatively well-trained and low-cost work force;
  - Long distances to markets and correspondingly high transportation costs;
  - Weak condition of export outlets (harbours, railways, roads, air routes);
  - Various security risks related to the environment, crime, health risks etc.
2. The investment climate in the RTBR is a sum of all factors contributing to the operating conditions for an investor in a certain region. Legislation, regulations and policies of the federal, regional and local governments make up one part of the investment climate. The implementation of these rules by officials, the existence of the above-mentioned main characteristics, as well as the existence of business and investment opportunities in general also form parts of the whole investment climate.
3. The investor takes all of these factors into consideration when making an investment decision. The investor also compares the characteristics of the RTBR with those of other regions in Russia as well as alternate investment targets in other countries. Within Russia the RTBR are not considered very favourable investment environments in comparison to other Russian regions according to recent investment climate evaluations. In international comparison RTBR ranks as a high risk area for foreign investors and does not provide any particular fiscal or other incentives provided by the Baltic countries, or favourable financing alternatives available in the Scandinavian countries<sup>18</sup>.
4. Most FDI and plans for FDI in RTBR have been directed to projects aiming at utilising the rich resource base of the region. For such projects the major attraction is the possibility to export raw materials from the region, as there is not enough demand for locally produced products in the region or the local price level for the raw materials is not high enough to justify investments. Therefore the level of export tariffs and transportation costs is of crucial importance for such projects. So far, the local

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<sup>18</sup> See e.g. Oman, Charles P. "Policy Competition and Foreign Direct Investment, A Study of Competition among Governments to Attract FDI and Hirvensalo, Inkeri "Foreign Direct Investment around the Baltic Sea; Is there policy competition among the countries?, paper presented at OECD Conference on Fiscal Incentives and Competition for Foreign Direct Investment in the Baltic States in Vilnius, Lithuania, May 30, 2000

administrations have viewed these mainly as sources of additional income and not as subjects of potential incentives for foreign investors.

5. Within the region Murmansk is ranked as the best investment environment both from the risk (number 30 among all 89 Russian regions) and investment potential (number 26 among all 89 regions) point of view. The other RTBR rank significantly behind Murmansk. However, Murmansk has received less investments than its ranking would call for, while Arkhangelsk and Komi have both received more than their investment risk and potential rankings would imply. Therefore there must be also other factors in play and one significant factor, which is not fully reflected in the rankings, is the regional policy for attracting FDI.
6. The share of the RTBR in FDI made in Russia is very small. It also is less significant for these regional economies when compared to the regional gross product, industrial production or population than in Russia on average. However, there are significant differences among the regions in question. While the significance of FDI in the Republics of Karelia and Komi reaches about half of the Russian national level, the FDI in Arkhangelsk and Murmansk Oblasts lag behind significantly. Most investments have been made in the energy sector, and woodworking industries rank second in the amount of investments received. The share of FDI in all foreign investments during 1994-1999 is only 20% indicating that most foreign investments have been given as credits. The Arkhangelsk Oblst, in particular, has been a favoured recipient of credits.
7. In the RTBR, the investment climate is poorly developed. This is attested both by the relatively high investment risk ratings and by the very low rate of FDI in the Region as well as the failure of a large number of investment projects during the 1990s. In general, the policies of the regional administrations in the RTBR are seen by foreign investors to be ambivalent: on one hand many measures have been taken aiming to attract FDI (such as regional investment legislation and promotion of regional priority investment projects as well as organisation of various business meetings etc.); on the other hand foreign investors have had difficulties in working with regional officials on e.g. taxation, customs, land use rights, user rights to natural resources, and various licences needed for production and sales. The sheer multiplicity of officials on the regional and local level is also a problem, as investors need co-ordinated assistance in dealing with various investment issues.
8. Main barriers to investments in the RTBR are connected with i.a.: policies of regional and local administrations, long distances to markets, poor infrastructure, taxation and customs problems (companies with foreign ownership are often monitored especially vigilantly by tax and other inspectors), lack of transparency in companies (ownership, structure of management, taxation etc.), difficulties in agreeing user rights for natural resources, a high political risk for investments, lack of encouraging examples of successful investments in the Region (on the contrary, cases such as the Segezhabumprom paper plant are still fresh in the minds of potential investors).
9. The relationship between the federal and regional levels complicates the investment climate in the RTBR. The division of competencies between the two levels is often unclear. In legislation there are even clear conflicts between the regional and federal levels. The harmonisation of legislation and regulations as well as practices towards

foreign investors is generally seen as a positive step to improve the investment climate in the RTBR.

10. At the present, the regional administrations in the RTBR are involved too directly in investment projects. Administrations play a central role in negotiations on new projects and are often themselves stakeholders, even owners of partner companies. Regional investment laws stipulate that privileges can be extended to investors participating in prioritised investment projects, meaning regionally (politically) prioritised projects typically in the infrastructure sector or concerning the modernisation of large Soviet-era industrial production units. In general, this approach to FDI attraction is not seen as beneficial by western investors who would prefer the administrations to concentrate their efforts on improving the general framework conditions for investments e.g. infrastructure.
11. Despite the weakly developed investment climate in the RTBR, in many cases however it must be said that the foreign investors have not acquired the necessary information about the regional investment conditions and have therefore been surprised by various demands and conditions set.
12. For the regional strategy to attract more FDI the regional governments should concentrate on providing a stable and predictable investment climate as well as improving infrastructure in their regions. Various tax exemptions and other legal instruments including special economic zones play an important role but are not primarily what investors are looking for. Investors will come if the general conditions for business are in condition and the general level of taxation is acceptable.
13. Many difficulties for westerners in FI issues in Russia are related to understanding the Russian mentality, differences in business cultures and different organisational structures. Several cases of FI in Russia indicate that the employment and training of Russian management is a good strategy for success.
14. There are some signs of the improvement of the investment climate in Russia and the RTBR, mainly due to economic growth and some positive steps taken by the Federal Government to support entrepreneurship and to develop the tax system as well as other legislation on FI.

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