COMMENT

THE FOREIGN INVESTMENT REGIME OF THE RUSSIAN FEDERATION: PROGRESS TOWARD A SYSTEM OF FREE ENTRY

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I. INTRODUCTION

In 1991, the Russian Federation ("RSFSR") enacted a law that revolutionized the prospects for foreign investment in one of the world's largest economies.[1] The RSFSR foreign investment regime provides a system of guarantees that lays the groundwork for the unrestricted participation of foreign capital in the Russian market. This system of guarantees departs from an earlier attempt to attract foreign capital by means of joint ventures in that it allows businesses to be fully owned by foreigners. The advent of the RSFSR's new foreign investment regime comes at a time when the privatization of state enterprises has presented foreign investors with a confusing array of investment choices.

The Russian economy needs the infusion of new technology, management expertise and capital resources that foreign investors can provide. This Comment compares three models of foreign investment in terms of their ability to achieve these pressing policy objectives. The free entry model of foreign investment attracts capital by allowing foreign investors to take advantage of lower production costs in the host country. The negotiation model of foreign investment lures foreign investors by promising monopoly rents and other contractual rewards for participation. Finally, the combined approach attempts to target certain sectors for negotiation while generally guaranteeing free entry. The negotiation model attracts capital quickly, but the free entry model provides for stable growth

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1. RSFSR Foreign Investments Act (1991) (RSFSR).

that is not limited by the inefficiencies of negotiated monopolies. The combined approach offers the greatest potential of the three models by capturing the benefits of the free entry system while allowing the host government to share monopoly rents in noncompetitive sectors of the economy.

This Comment sets forth five basic requirements of a free entry system to evaluate how faithful the RSFSR has been to the free entry model. The RSFSR foreign investment regime covers all five aspects of the free entry model through its system of guarantees: the right to establish fully-owned corporations, a guarantee of equal treatment, free repatriation of earnings, unrestricted use of the local currency and freedom of banking, and legal protection against nationalization. These standards reveal many weaknesses in the RSFSR legislation. First, the guarantees fall short of their stated purpose because of important exceptions. Second, the system of guarantees imposes unneeded administrative requirements that place obstacles in the path of foreign capital participation. Finally, the legislation does not provide badly needed methods of valuation and implementation. The RSFSR Privatization Act contains further violations of the free entry model that undermine the meaning of the Foreign Investments Act system of guarantees.

Section II of this Comment details the three strategies of foreign investment. Section III compares these three models in light of host country policy goals of foreign investment. This section concludes by providing five tenets of the free entry model. The final section evaluates the RSFSR Foreign Investments and Privatization Acts, focusing on those provisions that violate the five tenets of the free entry model.

II. ACHIEVING DEVELOPMENT GOALS THROUGH FOREIGN INVESTMENT

A. THE THREE MODELS OF FOREIGN INVESTMENT

A host country may choose one of three strategies to pursue foreign investment: the free entry model, the negotiation model, or a model which combines elements of free entry and negotiation.

1. The Free Entry Model[2]

The free entry model relies on market forces and international competition to stimulate investment in the host country. The free

2. Although no country has established a perfect regime of free entry for foreign investment, many countries have utilized economic liberalization as a means to speed development. Malaysia, Singapore, Taiwan, and Thailand have all successfully implemented the free entry model to various extents (supplemented by economic incentives). For a detailed analysis of the process of establishing a free entry regime in these four countries, see LINDA Y.C. LIM & PANG ENG FONG, FOREIGN DIRECT

entry model assumes that the host country holds out some advantage that would lead to lower production costs within an industry.[3] If there are no impediments to entry into the host country's market, the existence of such advantages attracts foreign investors by promising higher rates of return on capital.[4]

Once a significant number of producers within a given industry have taken advantage of the lower production costs of the host country, the supply curve shifts, and international competition forces down the price of the industry's final product. Market participants who have not taken advantage of the host country's relative advantages find that they are not competitive at the new lower price. In the long term such producers must either take advantage of the host country's lower costs or leave the industry.[5]

2. *The Negotiation Model*[6]

The negotiation model also begins with the assumption that the host country holds out the promise of lower production costs. The theory behind the negotiation model is that together, a host government and selected foreign investors can jointly exploit these same lower production costs. The host government grants rents to selected companies in selected sectors[7], then shares in these rents through a contract formula. The host government benefits directly from the resulting venture through its contractual share of rents.[8]

INVESTMENT AND INDUSTRIALIZATION IN MALAYSIA, SINGAPORE, TAIWAN AND THAILAND (1991).

3. Examples of such relative advantages are lower labor cost, greater access to local markets, and abundance of available natural resources.

4. Foreign investors in Singapore claim that the main reasons for their entry into the Singaporean market were the comparative advantages of the host market (such as inexpensive labor) and the freedom from 'red tape.' HELEN HUGHES & YOU POH SENG, FOREIGN INVESTMENT AND INDUSTRIALIZATION IN SINGAPORE 187 (1969).

5. For an in-depth analysis of the factors considered by multinational corporations in their decision whether to enter the host country, see GEORGE A. PETROCHILOS, FOREIGN DIRECT INVESTMENT AND THE DEVELOPMENT PROCESS: THE CASE OF GREECE 12-25 (1989).

6. The choice between negotiation and free entry is an intensely political one. For a study of Mexico's transition from the economically nationalistic negotiation model to free entry, see VAN R. WHITING, JR., THE POLITICAL ECONOMY OF FOREIGN INVESTMENT IN MEXICO: NATIONALISM, LIBERALISM, AND CONSTRAINTS ON CHOICE 227-41 (1992).

7. In the 1970s the Turkish government used the negotiation model of foreign investment in an attempt to build an industrial infrastructure. Turkey's bitter experience with negotiated foreign investment in the manufacturing sector is analyzed in ASIN ERDILEK, DIRECT FOREIGN INVESTMENT IN TURKISH MANUFACTURING: AN ANALYSIS OF THE CONFLICTING OBJECTIVES AND FRUSTRATED EXPECTATIONS OF A HOST COUNTRY 228-35 (1982) (epilogue describes the 1980 Economic Liberalization that followed Turkey's foreign investment crisis).

8. The host government can collect economic rents in any number of ways, including negotiated user fees, royalties, excess profits taxes, or through long-term leases.

3. *The Combined Model*[9]

A final model of foreign investment law combines features of both the free entry and negotiation models. The host country may adopt a foreign investment law that guarantees free entry, yet negotiate contracts with foreign investors in selected sectors of the economy. The selected sector version of the combined model targets industries which naturally lack the element of competition essential to the free entry model.[10] In these sectors, implementation of the negotiation model can help host countries capture monopoly rents and to set internationally optimal levels of production.[11]

B. Four Goals of Foreign Investment Law

In designing a foreign investment regime, policymakers focus on four primary goals of foreign investment policy: technology transfer, transfer of management expertise, foreign capital inflow, and integration of the host country into the world economy. An effective foreign investment regime will secure these in a permanent fashion.

1. *Technology Transfer*

How one defines technology transfer determines which foreign investment model is preferable. The process of transfer begins when a foreign company simply uses such technology in the host country production. The next step occurs when the technology is "spilled over" within the foreign company's industry, and to other industries in the host country.[12] A host country has reached the ultimate stage of transfer when native companies are able to improve on the

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9. Indonesia has pursued a rough equivalent of the combined approach. The Indonesian financial sector has grown steadily more independent since limited deregulation in 1968. During this same period, the Indonesian government has closely regulated the extractive sector through negotiated concession agreements and production sharing contracts. For more information on the Indonesian approach, see ROBERT B. DICKIE & THOMAS A. LAYMAN, FOREIGN INVESTMENT AND GOVERNMENT POLICY IN THE THIRD WORLD 28-120 (1988).

10. Natural resources present developing countries with opportunities to control exploitation over time and to maximize revenues within the international market by means of controlled extraction. Without intervention, the world market will not yield the optimal level of extraction for the host country. *See* John Due, *The Developing Economies, Tax and Royalty Payments by the Petroleum Industry, and the United States Income Tax*, NAT. RESOURCES J., Jan. 1970, at 10.

11. As a result of monopoly or oligopoly, economists have theorized that intervention by the host government can increase the social welfare of the host country. *See* Santiago Levy & Sean Nolan, *Trade and Foreign Investment Policies Under Imperfect Competition—Lessons for Developing Countries*, 37 J. OF DEV. ECON. 31, 60 (1991).

12. For a more complete discussion of the way in which technology spills over into the local economy, see MAGNUS BLOMSTROM, HOST COUNTRY BENEFITS OF FOREIGN INVESTMENT 1 (National Bureau of Economic Research Working Paper No. 3615, 1991).

existing technology. Developing countries generally desire that technology is not simply used on their soil, but that new technology spreads throughout the economy through spillover. In evaluating the alternative models, technology should be considered transferred only when this process begins to take place.

The negotiation model offers a quick way to encourage the use of technology in the host country. The host country can target sectors that would immediately benefit from the advantages of technology, then share these benefits with the transferring corporation through economic rents.[13] However, two factors severely limit transfer in the negotiation model after this initial stage. To understand the first, it is necessary to detail the dynamics of the negotiation model.

The host government and the foreign corporation each begin with a valuable asset. The host government offers access to local resources while the foreign corporation offers valuable technology. After the initial deal is struck, the host country can enforce the foreign corporation's contract compliance with the threat of taxation, or even nationalization. When the foreign corporation in the negotiation model transfers its valuable technology, it loses its main bargaining tool. In order to enforce its bargain, the foreign corporation must retain control of the technology by prolonging the process of transfer and by guarding against spillover within the host country.[14] In the negotiation model, foreign corporations disfavor the training of foreign employees with respect to the technology since they are likely to facilitate transfer of technology to the host country.

The negotiation model also fails to make use of competition as a means of technology transfer. Since the host country and foreign investors share in economic rents, other producers will remain in business using outdated technology. Instead of forcing the industry supply curve upward, the negotiated production has no effect on market prices. The existence of economic rents also allows the foreign corporation to weigh the risks of dissemination against the

13. Chile made use of the negotiation model to attract the foreign technology necessary to mine her extensive copper resources in the first decade of the twentieth century. For an in-depth account of the struggle for control of these resources and their means of extraction, see THEODORE MORAN, MULTINATIONAL CORPORATIONS AND THE POLITICS OF DEPENDENCE (1974).

14. Regardless of whether it has made an ex ante commitment to negotiated tax rates and other terms of participation, it is often in the interest of the host country to force renegotiation after a multinational corporation ("MNC") has invested significant capital and transferred sensitive technology. The empirical result of this problem is that firms which must face reorganization employ less capital and less sensitive technology in their investment projects. Eric W. Bond & Larry Samuelson, *Bargaining with Commitment, Choice of Techniques, and Direct Foreign Investment*, 26 J. INT. ECON. 77, 77-78 (1989).

marginal benefit of using state-of-the-art technology.[15] A MNC may rationally choose to implement outmoded technology and sacrifice some of their economic rents rather than risk dissemination of sensitive technology.

The free entry model attracts technology slowly in its initial stages since the benefit of relocation is measured only by the marginal cost advantage of the host country. Whereas participants in the negotiation model can rely on guaranteed rents, free entry participants must carefully weigh the advantages of the host economy against the risks of capital involvement. However, as the advantages of the host country are exploited by a substantial number of foreign investors in an industry, the industry supply curve shifts upward. This forces competitors to lower costs or leave the industry. The mechanism of competition ensures the transfer of technology for use in the host country through the price mechanism.[16] In the competitive free entry model, firms cannot afford not to use the best technology in a particular industry. Only the most efficient producers in a competitive industry will survive.

After technology is transferred for use in the host country, the free entry model facilitates spillover of technology between industries.[17] Unencumbered by a narrow contractual participation in the host economy, foreign investors "branch out" in a manner that is not possible if every new step into the host market must be negotiated. The entry model also facilitates inter-industry spillovers that occur between foreign and domestic firms.[18] A foreign venture can stimulate demand for local suppliers of needed components. New products introduced by foreign ventures into the local market may also increase the productivity of domestic firms that purchase the foreign venture's higher-technology products.

The selected-sector model utilizes the negotiation process to ensure the influx of technology in sectors where competition would

15. E. MANSFIELD & A. ROMEO, TECHNOLOGY TRANSFER, PRODUCTIVITY, AND ECONOMIC POLICY (1980) (revealing that technology transferred by MNCs to developing countries was on average four years older than technology transferred to developed countries); and D.G. MCFETRIDGE, THE TIMING, MODE, AND TERMS OF TECHNOLOGY TRANSFER: SOME RECENT FINDINGS, IN MULTINATIONALS, GOVERNMENTS AND INTERNATIONAL TECHNOLOGY TRANSFER (A.E. Safarian & G.Y. Bertin eds., 1987) (supporting the findings of Mansfield and Romeo).

16. Economists have labelled this effect the theory of comparative advantage. The theory states that each country specializes in those goods which it produces at the lowest relative cost and trades with the rest of the world to obtain other commodities. *See* HARVEY S. ROSEN, PUBLIC FINANCE 546-47 (1988).

17. An empirical study of the Mexican economy revealed that foreign direct investment led to measurable spillover of technology from foreign to domestic firms. Magnus Blomstrom & Haken Persson, *Foreign Investment and Spillover Efficiency in an Underdeveloped Economy: Evidence from the Mexican Manufacturing Industry*, 11 WORLD DEV. 493, 493 (1983).

18. *See generally* BLOMSTROM, *supra* note 12.

not force inefficient producers out of the market. In the transition to a free market economy, the combined approach will prove especially useful in replacing inefficient state monopolies that remain profitable.[19]

2. *Management Expertise*

Management expertise takes the form of both written systems and actual managers.[20] The existence of the human element of management expertise complicates its transfer and underscores the need for a free entry model of foreign investment.

MNCs begin with two types of managerial technology, actual managers and written management systems. Since culture in part determines management style, the human element of management in the transfer process is extremely important since good management can adapt to the host country. Foreign companies possess managers with expertise in the target industry as well as managers who specialize in the implementation of management systems in new locales. However, this physical transfer does not complete the process of transfer of management expertise since a manager's stay in the host country is likely to be limited.

The host country benefits only when the foreign corporation takes two additional steps. Foreign managers need to actually adapt the management system of the MNC to the host country's culture and resources. MNCs will undertake this process as they seek to lower production costs and maximize strategic output. Still another step of management expertise transfer occurs when management is indigenized to the host country.[21] Indigenization involves the training of local personnel leading ultimately to their takeover of managerial positions formerly occupied by foreign managers.[22] The benefits from managerial expertise multiply once they are transferred to native managers. Training of labor and management which takes place in MNCs may be dispersed throughout the economy. Eventually, MNC trained employees may choose to exploit the human capital that they have gained by moving to domestic corporations or by starting their own corporations.

The free entry model accomplishes the transfer of managerial expertise more effectively than negotiation since it provides for the

19. Though state-owned oil companies may produce marginal profits, they generally lack the resources necessary to capture the entire amount of economic rents possible. For example, the Russian oil industry has acknowledged the need for new equipment, large-scale exploration, and refurbishment of idle wells. *Russia Seeks Western Oil/Gas Industry Investment to Reverse Falling Production*, EBRD Watch, Feb. 10, 1992, at *3, *available in* LEXIS, Nexis Library, EERPT File.

20. BLOMSTROM, *supra* note 12, at 53.

21. *Id.*

22. *Id.*

indigenization of such expertise. In a competitive equilibrium, foreign companies must train local managers to take advantage of lower salaries. In the negotiation model, the foreign firm faces no such market pressure. The negotiation model also hinders the transfer of management expertise by forcing foreign firms to protect against leaks of expertise to domestic firms. Native employees can prove dangerous conduits of management expertise to domestic firms, domestic or private.[23] Therefore, the MNC in the negotiation model has an incentive to withhold such expertise from native employees by denying managerial promotions. An alternative strategy may be to transfer native employees abroad once they have achieved a certain managerial level. Either way, the negotiation process stifles the process of indigenization of management expertise.

3. *Encouragement of Long-Term Capital Investment*

The free entry model more effectively stimulates long-term investment because it does not rely on the limited ability of the host government to negotiate away special privileges. In light of the capital shortage of most developing countries, the negotiation model may be a somewhat effective short-term fix. The guarantee of monopoly profits through the process of negotiation can be an effective stimulus to large capital investment. The free entry model of reform may be slow in producing such large capital investments, since at the initial stages of economic reform, after discounting for risk, the marginal cost of production in the RSFSR could be greater than the world market price of goods in many industries. In such cases, foreign investors will simply choose not to participate until the level of risk falls.

The benefits of the negotiation model in terms of capital investment level off in the long run since there are only a limited number of rents that the host country can grant. The host government must revoke or renegotiate contracts with foreign investors in order to provide economic room for growth. Yet any such behavior chills other potential foreign investors. In addition, domestic investors will once again be forced to remove their money from the stagnant host economy in favor of higher real foreign rates of return.

Under a free entry regime of foreign investment, if the host government is successful in reducing investment risks, more capital will become available on the domestic markets as local costs dip below those in competing countries. The free entry model also promises continued growth through the establishment of stable fi-

23. Studies of MNCs have revealed that such large organizations exist precisely because they harbor some form-specific managerial or technological expertise. *See* Ignatius J. Horstman & James R. Markusen, *Firm Specific Assets and the Gains from Foreign Direct Investment*, 56 ECONOMICA 41, 48 (1989).

nancial markets. The negotiation model deprives the local economy of stable financial markets since local financial firms can achieve only limited access to foreign ventures. In the negotiation model, host governments negotiate transactions with foreign firms and arrange financing through a central bank, or through foreign investment firms. In the free entry model, local investors negotiate their own deals with foreigners, and are free to make use of the local credit market, developing the market's ability to promote such transactions.[24]

Although the negotiation model may provide a host country with a quick surge of foreign capital participation, the free entry model offers long-term capital growth unshackled by the state's power to grant economic rents. Foreign capital participation in the host country usually makes up only a small percentage of total capital investment.[25] Therefore, developing countries should choose a free entry model in order to develop their own financial markets and to ensure the long-term participation of foreign capital.

4. *Integration into the World Economy*

Developing countries generally consider integration into the world economy a goal in and of itself. Apart from political benefits, integration allows the host government to make internationally optimal use of its endowment of resources. The free entry model naturally achieves these advantages because at every step of the way, foreign investors weigh opportunities in the host country against those in other countries. The negotiation model does not achieve this international optimality. Instead, it relies on central planners to determine the types and extent of foreign participation. Although such planners are aware of the relative scarcity of goods, the very preferences they bargain with distort international economic choices.

The selected sector combined model does not necessarily hinder integration since it makes use of negotiation only in those areas of the economy where the market would not achieve competitive equilibrium on its own. By restraining production of natural resources, the host government can take advantage of international cartels and oligopolies to maximize its income.[26]

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24. Domestic commercial banks in Russia are already beginning to take advantage of the need for financial intermediaries. One domestic Russian bank already employs over 1200 Russians, all of whom are trained at no expense to the RSFSR government. *Press Conference with the Incombank Admin.*, Official Kremlin International Broadcast, Nov. 11, 1992, *available in* LEXIS, Nexis Library, SOVNWS File.

25. For example, economists estimated the share of foreign capital in Russia's economy in 1992 at one percent. *Russia: Foreign Investment May Increase 15% by 2000, Economists Forecast*, ROSSIISKIE VESTI, Jan. 20, 1993, at P3.

26. The oil market illustrates this phenomenon. Individually, producers in the host

C. THE FIVE ELEMENTS OF THE FREE ENTRY MODEL

Having sketched the basic advantages of the free entry model over negotiation, it is helpful to further define what the free entry model entails for the foreign investment legislation of a host country. There are five major tenets of the free entry model. First, foreign investors must be able to establish wholly owned companies or subsidiaries and to maintain complete control of their operation. Foreign investors are willing to take calculated risks, but seldom will they do so without control of their own enterprise. Host country laws that require a local joint venturer or partial host government ownership drive away foreign investment and inhibit the ability of existing foreign ventures to compete internationally.[27]

Second, foreign investors must be treated identically with their domestic counterparts.[28] Discrimination against foreign investors directly or indirectly raises the cost of their capital participation in the host country. At higher marginal costs, fewer foreign investors will find the advantage of participation great enough to outweigh its inherent risks.

Third, foreign investors must have the right to repatriate earnings without interference or delay. The right of foreigners to invest in a developing country loses its meaning without a corresponding right to retrieve the investment and earnings. For everyday business reasons, investors must constantly shift the form and locale of their business investments. Laws that restrict this natural movement of capital only serve to inhibit capital flow into the host country. Foreign investors find the right of repatriation especially important in the developing countries because of political risk. Foreign investors can discount for such risks, but they must be able to react to exogenous problems to protect their investments. Host governments that seek to control capital flow from their countries through restrictions on repatriation can expect to dampen foreign investors' enthusiasm. Given the virtual impossibility of stopping capital outflow by government decree, such provisions pay a high price for little effect.

Fourth, foreign investors must have the right to unrestricted

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country may face a set world price for oil. With control of collective production, the host country can participate in international cartels. *See generally* T.C. Bergstrom et al., *Efficiency Inducing Taxation for a Monopolistically Supplied Depletable Resource*, 15 J. PUB. ECON. 23-32 (1981).

27. An example is the former RSFSR law that required 50% participation of a local entity. Since there were very few local entities with sufficient capital to participate at this level, the law inhibited the growth of foreign investment.

28. This is the strong form of free entry theory. The weak form would provide that foreigners be treated at least as well as their domestic counterparts. Discrimination according to non-economic criteria such as domicile may introduce inefficiency into the host country's economy.

use of the local currency and freedom of banking. By controlling a foreign investor's use of local currency, a host imposes increased transaction costs for firms that import or export goods. Currency restrictions can also slow down transactions to such a rate that they are no longer economically feasible.[29] Finally, the host government must guarantee a system of legal protection of foreign investors against other entities and against the government itself. Legal protection against other entities requires a framework of commercial law that offers remedies for contract breach, and for tortious business practices.

Foreign investors must also discount for the likelihood of nationalization and the compensation provided in cases of nationalization. No law can eliminate the possibility of the political strife or reform that would lead to an abandonment of the free entry model. However, legislation can reassure foreign investors that they will be compensated fairly in the event of nationalization. As long as significant foreign investment remains in the host country after nationalization of a particular industry, the host country will be obliged to either abide by such legislation or face a reactionary flight of other foreign investors.

A successful foreign investment regime utilizing the free entry model requires adherence to these five tenets. When a host country fails to guarantee these rights, such deviations diminish the country's prospects for obtaining helpful foreign investment. Although no country can guarantee perfect adherence to the free entry model, host countries should deviate from its tenets only when there is a substantial policy justification. The foreign investment and privatization laws of the RSFSR reveal how the free entry model of foreign investment can be hampered by administrative restrictions and political necessity.

III. RSFSR FOREIGN INVESTMENTS AND PRIVATIZATION ACTS AND ITS ADHERENCE TO THE FREE ENTRY MODEL

The RSFSR has implemented a regime of foreign investment that resembles the free entry model. In the RSFSR Foreign Investments Act of 1991, the RSFSR adopted a system of guarantees intended to lay the groundwork for unhindered foreign investment in

29. For example, an international firm monitoring price movements may notice that the price of a domestic commodity has fallen below the world price. If the firm negotiates the sale of the domestic commodity in local currency, it may find that it cannot raise sufficient amounts of the local currency in time to take advantage of the lower price. This impediment differs from ordinary currency risk because the actual inability to convert currency not the movement of the currency does derails the transaction.

the RSFSR.[30] The 1991 Act guarantees equal treatment of foreign investments, protection against nationalization, repatriation of profits and founding of wholly foreign-owned enterprises.[31] Although this system addresses all five tenets of the free entry system, its subtle requirements undermine some of its effect.

The RSFSR has simultaneously attempted to encourage foreign participation in the process of privatizing state-owned enterprises and property.[32] Foreign investors find that the RSFSR Privatization Act also guarantees the right of foreign persons to buy property, enterprises, or shares of enterprises with either vouchers or rubles.[33] The Privatization Act departs from the free entry model of foreign participation in several important respects, placing important restrictions on foreign participation in the privatization process.

The following discussion highlights the departures of the RSFSR Foreign Investments Act and the Privatization Act from the free entry model. Whereas some deviations from the model are justified by political or economic reality, others serve very little purpose. The RSFSR can improve these laws by removing those deviations that hinder foreign investment without substantial alternative justification.

A. Equal Treatment of Foreign Investments

Article 6 of the foreign investment law codifies a central theme of the RSFSR Foreign Investments Act by guaranteeing equal treatment to foreign investors.[34] Yet even the Foreign Investments Act limits the scope of the equality it holds out in several ways, violating the tenet of equal treatment.

Under Article 6, the legal regime of foreign investments and the activity of foreign investors in pursuit thereof may not be less favorable than the regime for property, property rights, and investment activity of juridical persons and citizens of the RSFSR, subject

30. RSFSR Foreign Investments Act.

31. *Id.*

32. RSFSR Privatization of State and Municipal Enterprises Act [Privatization Act], 1991 (RSFSR). The Privatization Act furnishes an administrative procedure whereby state enterprises can be privatized from within (by employee work counsels or managers) or from without (by interested investors and possibly foreign investors. Article 37 of the Foreign Investments Act guarantees the right of foreign investors to take part in the privatization process. RSFSR Foreign Investments Act, art. 37.

33. With few exceptions, the RSFSR has given all Russian citizens a privatization voucher. Citizens are free to alienate these vouchers, and foreign investors may purchase these vouchers directly from holders. All vouchers have a nominal value of 10,000 rubles which the state must honor upon tender. Vouchers can be used in privatization auctions or as a cash alternative in the competitive tender process. Privatization Act.

34. RSFSR Foreign Investments Act, art. 6.

to the provisions of the foreign investments act.[35]

How the RSFSR courts interpret Article 6 will determine whether it actually has its intended effect of protecting foreign investments from discriminatory legal treatment. The first question of interpretation that will confront the RSFSR courts is whether the "legal regime" of foreign investments includes the tax system of the RSFSR. Due to the capital crisis of the former Soviet States, the current political question has been whether there should be favorable tax treatment for foreign investments. Incentives such as tax holidays[36] and lower tax rates have already been implemented and subsequently abolished as a means of attracting foreign investment.[37] The pendulum may swing the other way as a result of political factors such as economic nationalism, persuading the RSFSR government to control foreign participation through unfavorable tax treatment. Article 6 could be an important source of law for foreign investors in such situations, allowing them to fight reactionary political measures in the courts. Whether foreign investors will wield this weapon against discrimination depends upon whether the RSFSR courts define "legal regime" to include taxation.

Other problems of interpretation may arise from the amorphous concept of the "legal regime" of foreign investment. For example, although the RSFSR may abide by the rule of no special taxes for foreign investors, it could indirectly achieve similar goals through taxation of employees of foreign corporations. If such an end-around is permitted, the guarantee of equal treatment will certainly lose effectiveness. Other possible methods of indirect discrimination are not difficult to imagine. For example, within a particular industry, the technology required may dictate that the only participants are MNCs. An export tariff on such an industry would effectively impose substantial discriminatory burdens on foreign investors. The question remains whether these types of indirect discrimination would be tolerated under the present regime.

The concept of "legal regime" apparently allows the RSFSR to control foreign investment through administrative requirements. The Foreign Investments Act itself places several restrictions on foreign investors that simply do not exist for domestic entities. For example, Article 38 subjects foreign investment in real property to

35. *Id.*

36. Developing countries frequently excuse foreign investors from taxation in the initial years of their participation in the host country's economy. Such preferences toward foreign investors violate the strong form of the free entry model by discriminating against domestic investors.

37. The most recent reversal is the repeal of Tax Holidays for all foreign persons establishing enterprises in the RSFSR. However, foreign enterprises that were registered prior to January 1, 1992 and that are engaged in material production have again gained a two-year tax holiday. *Changes in the Rules in Regulation of RSFSR External Economic Activity*, EKONOMIKA I ZHIZN, Sept. 1, 1992, at 3.

an entirely separate code.[38] Privatization places similar administrative burdens on foreign investors. Foreign investors, unlike their domestic counterparts, must purchase rubles at a rate not lower than the Central Bank exchange rate.[39] Foreign investors must also use special privatization accounts established by the Central Bank.[40]

These numerous exceptions to the principle of nondiscrimination undermine the significance of the equal treatment guarantee of the Foreign Investments Act. In some cases, such as foreign ownership of real property, insoluble political problems underlie the violation of the free entry model. However, foreign investors can easily circumvent currency exchange requirements and the requirement of Central Bank accounts for privatization serves no clearly defined purpose. Although it would be impossible to guarantee foreign investors absolute equality, it should limit its violation of the tenet of equal treatment to situations of absolute political necessity. This will lower the costs facing foreign investors and provide for greater participation.

B. Right to Form Wholly Foreign-Owned Companies and to Own Real Property

Article 3 of the RSFSR Foreign Investments Act guarantees the right of foreigners to found fully-owned foreign enterprises.[41] This provision represents a major departure from the former regime of foreign investment, which required foreign participation through the conduit of joint ventures.[42] This change will accelerate the establishment of new ground-up ventures in the RSFSR, something which has not been possible under the joint venture law. However, the Privatization and Foreign Investments Acts place important restrictions on the foundation and control of foreign-owned ventures that water down the guarantee of complete ownership when foreigners purchase state enterprises. Restrictions in the RSFSR law on real property ownership by foreigners also call into question the seriousness of the Foreign Investments Act full-ownership guarantee.

The Privatization Act does not allow foreign investors to gain complete ownership of privatized state enterprises in many situa-

38. RSFSR Foreign Investments Act, art. 38.

39. *Id.* art. 37.

40. *Press Conf. by the Chairman of the RF State Committee for Mgmt. of State Property Anotoly Chubais*, Official Kremlin International News Broadcast, Feb. 9, 1993, *available in* LEXIS, Nexis Library, SOVNWS File [hereinafter *Press Conference*].

41. RSFSR Foreign Investments Act, art. 3.

42. In the first five years of the joint venture law, over 3000 joint enterprises were formed, with perhaps a third actually operating. W.E. Butler, *Investing in the Soviet Union*, 2 MULTINATIONAL BUS. 1, 1 (1991).

tions. The main obstacle to complete control by foreign investors lies in the privatization process itself. First, if a firm is sold to foreign investors through the process of competitive tender (direct negotiation for the purchase of an enterprise through private sale), the privatization plan may place very specific demands on the purchaser's post-sale treatment of the enterprise.[43]

A privatization plan may call for all of the following:

1. honoring obligations to produce specific products, and to keep the enterprise operating over a fixed period;

2. maintenance of existing work force and established social guarantees to enterprise employees (for a period of up to one year);

3. financing and use of social facilities within the assets complex during the privatization plan period.[44]

As the privatization plan calls for greater and greater control of the privatized state enterprise, it becomes apparent that the foreign purchaser does not have complete ownership of the enterprise, even if he has nominal ownership.

The Russian government can also maintain partial ownership and control of a privatized enterprise through the two-step process of commercialization and sale of shares. All enterprises that are not already in the process of privatization must be commercialized.[45] During the process of commercialization, a joint-stock company is created and its shares are allocated according to a plan devised by the working commission within the enterprise.[46] The RSFSR, through the local privatization committee, can decide to retain partial ownership of selected enterprises. The government commonly retains what is called a "golden share"; a fifty percent interest in the newly privatized company.[47]

Whether the government obstructs foreign ownership through the privatization plan or through the retention of a stock ownership interest, such methods violate the tenet of full ownership. As a result, foreign investors will either discount severely for such restrictions or simply choose to avoid the problem by starting an enterprise from the ground up. This may lead to a great deal of waste within the economy by deflecting the inflow of capital away from state enterprises.

The RSFSR can pursue the combined model through these same provisions. Instead of restricting the control of foreign inves-

43. RSFSR President's Edict No. 66 on the Faster Privatization of State and Municipal Enterprises, app. 4, § 3.1 (Jan. 1992) (RSFSR).

44. *Id.*

45. *Id.* app. 3, § 4.1.

46. *Id.* § 4.5.

47. RSFSR President's Edict No. 1392 on Industrial Policy in the Privatization of State Enterprises § 4 (Nov. 16, 1992) (RSFSR).

tors in competitive sectors, the government can limit its use of the golden share to form joint production companies in natural resource and naturally monopolistic sectors.

The absence of well-defined foreign rights in real property also violates the guarantee of full ownership. Article 3 of the Foreign Investments Act, which directly empowers foreign investors, unfortunately dances around the issue of land ownership. The article guarantees the right to hold shares, found wholly-owned enterprises, and even to acquire the property complexes, buildings, and structures.[48] The closest that the statute comes to guaranteeing foreign investors ownership of real property is the guarantee of the right to *use* land and other natural resources.[49] This anomaly in the Foreign Investments Act has particularly confusing ramifications for the privatization of state enterprises. A foreign investor can buy a privatized state enterprise with extensive holdings while the foreigner's ownership of the actual land tracts is never addressed, either in the Foreign Investments Act or the Privatization Act.[50]

The drafters of the foreign investment legislation intended not to address the issue of land ownership. Indeed, article 3 asserts that all ownership guaranteed by the Foreign Investments Act must be in conformity with effective RSFSR legislation.[51] The undetermined real property regime facing foreign investors will surely discourage foreign investment. While the political wisdom of such restrictions on ownership is not within the scope of this Comment, the RSFSR must realize that withholding these rights from foreign investors seriously undermines efforts to attract foreign capital.

Ongoing restrictions on the operations of privatized companies deviate from the free entry model and promise to make many state enterprises undesirable to foreign investors. State retention of a golden share in enterprises will also inhibit foreign capital inflow unless the enterprise operates in a noncompetitive sector of Russia's economy. In noncompetitive sectors, the golden share can be used to pursue the combined model of foreign investment through joint production.

C. Right to Repatriate Earnings

The RSFSR Foreign Investments Act allows foreigners to

48. RSFSR Foreign Investments Act, art. 3.

49. *Id.*

50. These restrictions on real property holding have led to some interesting solutions. Coca-Cola settled on a 49-year lease on the property where it is now building a bottling plant. In addition to ruble consideration, Coca-Cola purchased $650,000 of medical equipment for a local children's hospital and donated $150,000 to a business university scholarship fund. *Amid Russia's Turmoil, Coca-Cola is Placing a Bet on the Future*, Wall St. J., Apr. 6, 1993, at A1.

51. RSFSR Foreign Investments Act, art. 3.

freely repatriate earnings connected with their investments. This guarantee provides the basis for compliance with the tenet of free repatriation. However, administrative requirements that serve little purpose threaten to make the guarantee of repatriation less effective.

Article 10 of the Foreign Investments Act states that "foreign investors shall be guaranteed, *upon due payment of taxes and duties*, unimpeded transfer abroad of payments *in connection with their investments*, where these payments were *received in foreign currency*."[52] In addition to Article 10's guarantee of income repatriation, the Foreign Investments Act also allows unhindered return of business assets in the event of full or partial liquidation.[53]

Although the Foreign Investments Act establishes the general rule that funds can be repatriated, there are three notable restrictions. First, the foreigner must pay relevant taxes and duties.[54] This would not seem to be a burden for sophisticated investors, yet in a situation where tax liability is almost always uncertain, this measure could effectively freeze the funds of an investor who disputes the assessment of the Russian tax authorities. RSFSR tax legislation will undoubtedly undergo several changes in the upcoming years.[55] Therefore, disputes over tax liability will occur often. In such situations, the Russian tax authorities could conceivably deny or delay repatriation. This exception also shifts the burden of proof regarding tax payment to the foreign investor upon repatriation.

Foreign investors may fear that repatriation could be an occasion for tax authorities to confiscate earnings. As a result of such fears, foreigners may choose not to leave accumulated capital in the RSFSR. Therefore, this restriction may have the opposite of its intended effect, causing foreign investors to remove capital from the country before the tax authorities get around to challenging an investor's tax record.

Article 10 of the Foreign Investments Act does not provide any specific guidelines for the clearing of profits and investments before repatriation. Therefore, the administrative enforcement of this provision will determine whether it hinders the flow of foreign

52. *Id.* art. 10 (emphasis added).

53. *Id.*

54. *Id.*

55. Examples of recent changes in the tax system include changes in the export and import procedures, collection of the value-added tax on all imports and changes in the income tax for natural persons. An important recent development is the RSFSR's attempt to more effectively tax foreign legal persons. *See* RSFSR Tax Service Letter No. 104-4-06/71M (Nov. 5, 1992) (partial alteration of RSFSR export and import procedure); RSFSR Tax Service Letter No. VZ-4-05/55; 4-03-02 (Aug. 31, 1992) (implementation of the VAT); RSFSR Tax Service Instruction No. 8 (June 10, 1992) (application of RSFSR income tax on natural persons); RSFSR Tax Service Instruction No. 13 (as amended on Sept. 28, 1992) (taxation of profits and earnings of foreign legal persons).

capital out of the country. For example, tax authorities could use the provision to demand tax records upon every repatriation request. Alternatively, the RSFSR could use this provision only when a substantial dispute arises between tax authorities and a foreign entity that seeks to shield assets by moving them out of the country.

The second major restriction on the guarantee of repatriation is that to be repatriated, payments must be connected to the foreigner's investments within Russia. In particular, payments must be earnings from investments, sums paid on money claims, or sums received upon full or partial liquidation.[56] Although foreign investors would easily comply with this restriction, it imposes on the foreign investor a burden of proof with respect to the origin of sums to be repatriated.

The final restriction on the general rule of repatriation is that to be repatriated, payments must be "received in foreign currency."[57] This provision could be merely a reference to the general rule that the ruble is nonconvertible, and that it cannot be taken abroad. However, a more disturbing interpretation of this exception is based on its plain meaning; that is, if you sell goods or services for rubles, you are not guaranteed repatriation.

The legislative history of the Russian currency reform may help to explain the wording of this statute. The Foreign Investments Act actually predates the law which allowed foreigners to buy currency at official currency auctions.[58] At that time, to protect the nonconvertibility of the ruble, only the Central Bank was authorized to sell foreign currency. Since the only way that a foreign firm could legally "receive" foreign currency in exchange for rubles was through the government, this requirement served to funnel all ruble earnings though the Central Bank. Thus, the "received in foreign currency" restriction used to mean that foreign currency had to be purchased at the Central Bank to be repatriated. Recent legislation has created other legal ways to trade rubles for foreign currency, and the restriction merely requires that foreign currency be purchased in one of these ways.[59]

These three legal restrictions on currency use offer tax authorities and the Central Bank an opportunity to restrict the flow of re-

56. RSFSR Foreign Investments Act, art. 10.

57. *Id.*

58. Foreign investors now have the right to sell foreign currency on domestic currency markets for rubles, and are not required to sell foreign currency to the RSFSR government. Mandatory Sale by Enterprises of Part of Their Foreign Currency Earnings Through Authorized Banks and Conduct of Operations on the Domestic RSFSR Currency Market, RSFSR Central Bank Instruction No. 7 art. 18 (as amended Sept. 15, 1992).

59. *Id.*

patriated profits. The collapse of the Bank's control of its own currency has made currency restrictions on repatriation largely anachronistic. Whether the requirement that taxes be paid will violate the tenet of free repatriation depends on the implementation of that power.

D. Unrestricted Use of Local Currency

The Foreign Investments Act contains several provisions that restrict the foreign investor's ability to use the ruble in business ventures. These restrictions burden the free entry regime and may inhibit the growth of the RSFSR's financial sector. Since the host country's financial sector plays an important role in the acceleration of foreign investment, these restrictions could hamper the development of the Russian market.

First, foreigners cannot repatriate ruble earnings.[60] The previous section on repatriation details this restriction and its possible interpretations. Second, for the purposes of privatization, foreigners cannot use rubles that they purchase at an exchange rate below the Central Bank rate.[61] Third, foreigners wishing to participate in privatization must do so through special currency accounts at the Central Bank.[62] Fourth, all investors must sell part of their foreign currency earnings through authorized banks.[63]

These restrictions on the foreign investor's use of the ruble in business ventures strengthen the role of the Central Bank as a harbor of foreign capital. Yet the Central Bank remains completely unprepared to fulfill its vital new role. The Central Bank's role in determining a suitable exchange rate has become virtually meaningless.[64] Now that it is legal to purchase rubles at currency auctions, the restriction on repatriation of profits also does little to enhance the Central Bank's effectiveness in controlling the currency.

The requirement that foreigners participate in privatization through special currency accounts at the Central Bank has proven the biggest stumbling block for foreign participation. The process of privatization through auction of state assets has begun without the participation of foreign capital simply because the Central Bank has yet to allow the establishment of such accounts.[65]

The restrictions place an additional administrative burden on the already overtaxed resources of the state. The benefit of such

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60. RSFSR Foreign Investments Act, art. 10.

61. *Id.* art. 37.

62. *Id.*

63. RSFSR Central Bank Instruction No. 7 (as amended Sept. 15, 1992).

64. Currently, currency auctions determine the daily exchange rate. The Central Bank can do little but rubber-stamp the dictates of the market.

65. *Press Conference, supra* note 40.

restrictions eludes the observer. By eliminating such restrictions, the RSFSR can step out of the way of domestic banks that could offer the same exchange and banking services. The RSFSR can also improve the freedom of capital flow by easing restrictions on currency use that violate the tenet of free currency use.

E. Legal Protection of Foreign Investments

The Foreign Investments Act protects foreign investors upon nationalization of an industry and upon improper government action.[66] Although these broad provisions protect foreign investors in most situations, they do not touch on the foreign investor's fear of environmental liability. In the privatization context, foreign investors fear that they will be held liable or forced to clean up environmental damage done before their participation in privatization. A third guarantee of protection, against environmental liability, could remove one more barrier to foreign investment.

Article 7 of the Foreign Investments Act provides for swift, adequate, and effective compensation for damages due to nationalization.[67] However, the nationalization provision lacks a mechanism for compensation. Although compensation must be swift, adequate, and effective, the statute does not define the "real value" of investment for the purpose of reimbursement.[68] The RSFSR law also provides that compensation must be paid without unjustified delay, and that until payment is made, interest shall accrue on the amount of compensation "in accordance with the interest rate effective on the territory of the RSFSR."[69]

The calculation of the interest rate could be a very important issue for a foreign investor caught in the process of nationalization. Although the statute guarantees that interest will be paid at the domestic rate, the past few years have seen the advent of negative real interest rates in the Russian Federation.[70] Thus, if a foreign investor challenges a requisition or confiscation, he may find himself watching his claim deteriorate in real terms while his appeal is adjudicated.

The Foreign Investments Act extends the guarantee of recom-

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66. RSFSR Foreign Investments Act, art. 7.

67. *Id.*

68. Comment, *Regulation of Business Involving Foreign Investments in Ex-USSR Countries*, 14 Zakonadatelstvo i Ekonomika 27 (1991).

69. RSFSR Foreign Investments Act, art. 8.

70. In a recent appeal for government action to curb inflation, a government official pointed out that in early 1993, the RSFSR Central Bank's interest rate was 80% while in the market, rates hovered around 140%. The obvious conclusion from these figures is that inflation has been outpacing the nominal interest rate offered by state banks. *The Economy: Hand in Hand Along the Razor's Edge*, Moskovskiye Novosti, Feb. 7, 1993, at A13.

pensation to situations where officials have improperly performed their duties. Damages which result from "instructions contravening legislation" include loss of prospective gain.[71] This provision seems to function as an explicit waiver of sovereign immunity in the administration of foreign investment law.

Article 8 hints at the reason for this extension of governmental liability. That article provides that compensation for damages to a foreign investor will be made by the particular agency which allowed the improper act.[72] Its drafters built into the foreign investment law a method for the RSFSR to police its own agencies in their dealings with foreign companies. An agency which oversteps its authority will pay from its own budget.

Article 7 of the Foreign Investments Act directly addresses the foreign investor's apprehensions about the political risks involved with participation in the RSFSR market. However, it is questionable whether any such guarantees are taken seriously by foreign investors in the face of political revolution since such laws can be changed by a show of hands.

Although the RSFSR government is now reeling from its current fiscal crisis, foreign investors may see the day when a more healthy RSFSR government decides to experiment with nationalization of certain industries. In this event, issues of valuation for the purpose of compensation under article 8 will be instrumental. However, foreign investors will simply have to wait for the development of a case history that will elaborate on the critical issue of "real value" in the context of nationalization, confiscation, and requisition. This uncertainty may detract from the goal of increased foreign investment since foreign investors will probably assume the worst in their estimation of the potential damage of government intervention.

The Foreign Investments Act touches on the issue of the environment, but it does so only to restrict the entry of ecologically dangerous foreign ventures. Foreign investors must discount for the opposite risk; that the assets they acquire will come loaded with environmental liability. Pre-privatization environmental damage can go undetected through the process of privatization and surface years after an enterprise has already undergone its change of ownership. A guarantee against pre-privatization environmental liability would remove this exogenous threat from the process of foreign investment. Together with the guarantee against nationalization and improper government conduct, this guarantee would help the RSFSR move closer to a free entry system of foreign investment.

The legal protection provided by the RSFSR for foreign invest-

71. RSFSR Foreign Investments Act, art. 8.
72. *Id.*

ments promises to attract foreign investments into the RSFSR market. While the mechanism for compensation has yet to be realized, the statute offers the broad legal protection necessary to implement the free entry model. Protection against the undetermined toxic liability of state enterprises being privatized would go one step further in ensuring foreign participation.

IV. SUGGESTIONS FOR REFORM

With its 1991 Foreign Investments Act, the RSFSR has taken the first important step in attracting long-term foreign participation in the Russian economy. The RSFSR can achieve even greater foreign investment levels by extending the protection of foreign investor rights. First, the RSFSR must clarify the law regarding foreign ownership of real property. Without certainty in this area, foreign investors must discount for the political uncertainty surrounding their land holdings, leading to lower aggregate levels of investment. Second, the RSFSR can remove restrictions on privatized businesses that violate the full-ownership tenet of the free entry model. Such restrictions ensure that privatized assets will not be used for their market-determined highest and best use, and can be easily avoided by purchasers. Third, the RSFSR can insure all investors against environmental liability resulting from pre-privatization operation of state enterprises. Such a guarantee would make investment in the privatization process less of a gamble for investors, who already face the difficult computation of business and political risks.

The RSFSR can also increase foreign participation by removing administrative burdens that impede the flow of foreign capital into Russia. First, the repeal of currency restrictions would enhance foreign investors' ability to deal directly with Russian entities and remove an onerous burden from the investment process. Second, reform should eliminate the mandatory role of the Central Bank in foreign investment and privatization. By requiring that foreigners participate through the Central Bank, the legislation only ensures that foreign investment will slow to the pace of the Bank's bureaucracy. Third, the RSFSR can attract more foreign capital by eliminating restrictions on repatriation. The tax code may be a more suitable place for provisions that allow for seizure of funds for delinquency.

The RSFSR can pursue the combined approach of foreign investment by limiting its participation in privatized business ventures to noncompetitive sectors of the economy.[73] Natural resources,

73. The process of attracting foreign investment in noncompetitive sectors of the Russian economy has already begun. In the petroleum sector, the RSFSR government has directly negotiated joint-production agreements with TOTAL and Elf Aquitaine of France, Deminex of Germany, Panaco of Switzerland, and an international consortium

public goods such as transportation and communication, and other natural monopolies afford the RSFSR a chance to share in monopoly rents by negotiating individual deals with foreign firms. If the RSFSR restrains its use of negotiation to noncompetitive sectors of the economy, it can enjoy a quick influx of foreign capital and technology without sacrificing market-building competition.

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named MMM (Marathon and McDermott of the USA and Mitsui of Japan). *Western Companies are Investing in Russian Oil*, Business Eastern Europe, Apr. 6, 1992, *available in* LEXIS, Nexis Library, BUEEUR File.