

# RUSSIA

## TRADE SUMMARY

In 2003, the United States had a trade deficit with Russia of \$6.1 billion, an increase of \$1.7 billion from the 2002 deficit of \$4.5 billion. U.S. goods exports to Russia totaled \$2.4 billion in 2003, an increase of 2.2 percent from the previous year. Russia was the United States' 38<sup>TH</sup> largest export market in 2003. U.S. imports from Russia totaled approximately \$8.6 billion in 2003, an increase of 25 percent from 2002 levels. The flow of U.S. foreign direct investment (FDI) into Russia in 2002 was \$617 million, down from \$709 million in 2001. U.S. FDI in Russia is concentrated largely in the banking and information sectors.

The 1991 United States-Union of Soviet Socialist Republics (USSR) Trade Agreement provides for normal trade relations (NTR) between the United States and Russia and governs other aspects of the bilateral trade relationship. The USSR signed the agreement in June 1990, and it was approved by the U.S. Congress in November 1991. The agreement, however, was not ratified during the existence of the USSR, and the United States offered the agreement (with minor technical changes) to Russia and each of the other emerging states of the former Soviet Union. Russia's parliament approved the agreement, making it possible for the United States to extend Most-Favored-Nation (now NTR) status to Russia on June 17, 1992.

Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). By the end of 2003, the Government of Russia had met twenty-one times with WTO members in formal Working Party meetings and many more times in informal Working Party sessions, plurilaterals, and bilaterally. Russia tabled its initial goods and services market access offers in February 1998 and October 1999, respectively. Russia has subsequently revised its goods and services offers and is currently actively engaged in negotiations with Working Party members on those offers.

## IMPORT POLICIES

Russia continues to maintain a number of barriers with respect to imports, including discriminatory and prohibitive charges and fees and discriminatory licensing, registration, and certification regimes. Discussions continue within the context of Russia's WTO accession to eliminate these measures.

Depressed purchasing power, which had been the most important factor restraining U.S. exports in recent years, has ameliorated gradually, allowing U.S. export levels to rise back to pre-1998 levels. While purchasing power shortfalls account for part of the depressed level of imports, Russian companies' expanded market share at the expense of imports, particularly in the food processing and light manufacturing sectors, also accounts for the continuing low levels of imports from the United States.

Russia has developed legislation in order to bring its customs regime into compliance with the requirements of the WTO. The Duma approved a new Customs Code on April 25, 2003, which was signed into law by President Putin on May 28. The new Customs Code simplifies customs procedures and establishes specific procedures for the application and payment of tariffs. The Russian Government drafted amendments to Chapter 21.1 of the Tax Code that set new customs valuations, but these amendments were withdrawn before Duma consideration. The Russian Government plans to resubmit the content of these amendments in the form of a separate and free-standing piece of legislation on customs valuation.

In January 2003, the Russian Government announced the imposition of a quota for poultry and tariff-rate quotas for pork and beef, which became effective in April and May 2003, respectively. The United States reached an agreement in principle with the Russian Government for market access parameters on poultry,

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pork and beef in September 2003. In November 2003, Russia announced quota allocations for U.S. poultry, pork, and beef for 2004, based on historical U.S. export levels, as provided for in the agreement.

Specific barriers to textile and apparel imports have not been observed in Russia, although Russia is not a major consumer of U.S. textile goods at present. Customs authorities continue to assess duties on the royalty value of imported audiovisual materials, such as TV master tapes and DVD masters, rather than basing these duties on the physical value of the material.

Since 1995, Russian import tariffs have generally ranged from five percent to 30 percent. In addition, a value-added tax (VAT) is applied to virtually all imports, and excise taxes are applied to a small selection of goods. The VAT, which is applied to the price of the imported good plus its tariff, was 20 percent in 2003. As of January 1, 2004, the VAT was reduced from 20 to 18 percent. Although pharmaceuticals and printed matter were exempt from the VAT and some food products and items for children (e.g., diapers) were taxed at a lower VAT rate of 10 percent, the government of Russia took steps to eliminate such special provisions in January 2002. Pharmaceutical importers have complained that new pharmaceuticals imported in clinical trials stage (i.e. prior to registration), which should be exempt from the VAT, were assessed the VAT because they could not produce a certificate of registration.

Import tariffs have declined in importance as a revenue source in recent years, but they remain significant. A major revision of the Russian tariff system took effect January 1, 2001. Under this tariff unification, tariffs were consolidated into major product groups (raw materials, semi-finished goods, foodstuffs and finished products) with tariffs ranging from five percent to 20 percent for nearly all tariff categories. However, many rates are accompanied by alternative minimum rates, making the actual applied rate less transparent. The tariff unification resulted in an overall lowering of tariff rates. In addition, there are limited exceptions to the rate scheme, including higher rates for automobiles (25 percent), and minor additional adjustments have been made. The Russian government proceeded with the tariff unification to help combat customs fraud and improve customs collections, and, while there have been some improvements in this regard, the overall weakness of Russian customs administration still leads to many abuses. Several industries complain of excessively high tariffs and discriminatory tariff policies over a range of sectors, including distilled spirits, deciduous fruit, processed food, and forest products.

Russian import tariffs on automobiles and aircraft present particular hindrances to U.S. exports to Russia. In the case of automobiles, combined tariffs, VAT and engine displacement-weighted excise duties can increase import prices by 70 percent for larger U.S.-made passenger cars and sport utility vehicles. In addition, the Russian government recently passed a new law which increased custom duties to 25 percent of the custom value for used cars between three and seven years, effective December 15, 2003. The Russian government has also declared protection of the domestic aircraft industry a priority, and the current import tariff on aircraft stands at 20 percent. When the import tariff is added to the VAT (20 percent in 2003 but lowered to 18 percent as of January 1, 2004) and other customs handling fees, the amount of total taxes paid on the importation of foreign aircraft exceeded 40 percent in 2003.

The Russian government continues tight controls on alcohol production, including: duplicative and strict licensing requirements, import quotas on all distilled spirits except cognac and brandy, export duties, and increased excise taxes. Many of these controls are intended to increase budget revenues. Import licenses are required for various other goods, including color TVs; sugar; combat and sporting weapons; self-defense articles; explosives; military and ciphering equipment; encryption software and related equipment; radioactive materials and waste including uranium; strong poisons and narcotics; raw and processed sugar; and precious metals, alloys and stones. Most import licenses are issued by the Russian Ministry of Economic Development and Trade or its regional branches and are controlled by the State Customs Committee. Import licenses for sporting weapons and self-defense articles are issued by the

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Ministry of Internal Affairs. In some industries, such as pharmaceuticals and alcohol, activity licenses are also required.

Pharmaceutical products are included on reimbursement lists for state-provided healthcare without any objective and verifiable criteria. Reimbursement lists and state purchases do not adequately consider the quality and safety of the products, and, as a result, higher-priced imports are often discouraged.

### **STANDARDS, TESTING, LABELING AND CERTIFICATION**

U.S. companies report that Russian standards and procedures for certifying imported products and equipment are non-transparent, expensive, time-consuming, and beset by redundancies. Russian regulatory bodies are reluctant to accept foreign testing centers' data or certificates. U.S. firms active in Russia have complained of the limited opportunity to comment on proposed changes in standards or certification requirements before the changes are implemented. Occasional jurisdictional overlap and disputes between different regulatory bodies compound certification problems.

On July 31, 1998, amendments to Russia's Law on Certification of Products and Services went into effect, which Russia claims generally meet the requirements of the WTO. The law allows a manufacturer to submit a declaration of conformity in the certification procedure for a limited number of products. The government of Russia has established a list of 200 products eligible for this procedure. Approximately 30 percent of the 22,000 Russian standards now conform to international norms.

On July 2, 2003, the “umbrella” Law on Standards (technical regulations and sanitary and phytosanitary (SPS) measures) came into force. The law is intended to bring Russia’s standards regime into closer compliance with WTO norms and streamline the adoption of standards and the certification process for imported goods. Under the provisions of this law, many currently mandatory standards will become voluntary. Implementation of this new law will result in the amendment of approximately 300 separate laws and regulations. At the end of an implementation period, any existing technical regulation which has not been revised in accordance with the new law will become voluntary.

The current Russian product certification regime makes it difficult to introduce products into the Russian market. Manufacturers of telecommunications equipment, construction materials and equipment, and oil and gas equipment have reported serious difficulties in obtaining product approvals. Certification is particularly costly and prolonged for telecommunications equipment, which is tested for compliance with standards established by not only the State Standards Committee (Gosstandart) but the Ministry of Communications as well. This process has been known to take as long as 12 to 18 months. The new Law on Communications (in effect from January 2004) now allows self-certification of some telecommunications equipment. The law also attempted to harmonize the regulations of the Ministry of Communications with those of Gosstandart. Manufacturers still are generally unhappy with certification procedures, but admit that the new law is a small step forward.

In December 2002, the Russian Ministry of Health put in place a mandatory conformity assessment requirement for pharmaceuticals. This certification requirement is duplicative of other certification requirements for pharmaceuticals and could lead to delays in the marketing of medicines. In addition to pharmaceuticals and telecommunications equipment, manufacturers of alcoholic beverages are also subject to duplicative certification requirements, with mandatory certification requirements imposed by Gosstandart and the Ministry of Health.

Russian SPS measures are burdensome and sometimes of questionable scientific or food safety value. As Russia continues its efforts to join the WTO, a more transparent, science-based and WTO-consistent SPS system will need to be developed. Bioengineered food products are likely to continue to attract regulatory

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attention from Russian authorities in the coming year, as companies continue to register new products and develop varieties for testing.

Russia has taken measures against U.S. poultry and beef exports due to alleged food safety concerns, although the scientific basis of these measures has often been questionable. In August 2002, the United States concluded intensive negotiations with Russia on a new veterinary certificate for U.S. poultry exports, following a ban earlier that year on all U.S. poultry exports to Russia. As part of the implementation of this new veterinary certificate, Russian veterinarians began re-inspections of U.S. processing and cold storage facilities in November 2002. Discussions on the criteria for these inspections continued through 2003, and in December 2003 preliminary agreement on the final outstanding inspection protocol issue (footwear) was reached. In December 2003, the Russian government announced a ban on U.S. beef due to concerns with BSE, although Russian officials have stressed the temporary nature of this measure and have announced that the quota share for U.S. beef will not be reallocated as a result.

Russia banned imports of U.S. beef in December 2003 with the detection of one positive case of Bovine Spongiform Encephalopathy (BSE) in the State of Washington. As of the publication of this report, the U.S. government is taking aggressive action and is working intensively to re-open the market as quickly as possible. In addition, the United States is working in the International Organization for Epizootics to revise international standards on BSE to reflect current scientific knowledge.

### GOVERNMENT PROCUREMENT

Russian ministries and government agencies are frequent purchasers of equipment, goods and services for their own needs or for the needs of various domestic organizations or groups (i.e., the military, regional health organizations, or population centers located in remote areas). In April 1997, the Russian government established procedures for public tenders for some government procurement, but this process needs improvement and clearer guidelines. A draft law on the Purchase and Delivery of Products for State Needs was submitted to the Duma in March 2003 but has yet to be adopted. The law would eliminate restrictions upon the participation of foreign suppliers, ensure transparency of the government procurement mechanism, and eliminate possibilities for corruption. Domestic suppliers currently are not accorded many official advantages or privileges in competing for government procurement. Nonetheless, the Russian government shows a strong political bias toward supporting domestic industries.

Manufacturers of telecommunications equipment, construction materials and equipment, and oil and gas equipment have reported serious difficulties in obtaining product approvals. On January 13, 1999, an amendment to the Federal Law on Communications went into effect, which appears to encourage government agencies purchasing communications equipment to give priority to systems using Russian-produced equipment.

### EXPORT SUBSIDIES

The Russian government's industrial policy guidelines emphasize export promotion and import substitution. In practice, there has been limited budgetary funding for such initiatives. In December 1999, then-acting President Putin proposed the establishment of a Russian export credit guarantee agency, but no action has been taken to date to implement this proposal. Russia has no direct export subsidies on agricultural products, although it has suggested in WTO accession talks that it would like to reserve the option to use agricultural export subsidies in the future.

The subsidy-like effect of Russia's current domestic gas pricing policy is a key issue due to the potential adverse impact on certain U.S. industries. The price of gas for Russian industrial consumers is believed to be artificially low, and it is generally accepted that prices are below the full cost of production. The

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downstream effects of this pricing policy are significant, as gas sells on Russia's domestic market for about \$21-\$24/tcm, while cost-recovery levels are at roughly \$35-\$40/tcm, and gas for export on the world market sells at \$100-\$120/tcm. Russia is currently considering numerous reform plans for the sector and has been gradually increasing domestic prices. However, the gas sector and Gazprom, Russia's designated monopoly supplier, play a significant role in Russia's economy. Consequently, the Russian Government is proceeding slowly and cautiously with reform of the sector. Therefore, while normal increases in domestic gas prices have been significant, the United States continues to seek an increase in energy prices in real terms to ensure that those prices cover total costs, including a reasonable rate of return on investment.

### INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

According to industry sources, estimated losses to U.S. copyright industries due to copyright piracy (films, videos, sound recordings, books and computer software) exceeded \$1 billion in 2003. Of special concern in 2003 were the continued large increases in illegal optical disc production far in excess of Russian demand, with pirated products intended not only for domestic consumption but also for export. The film industry estimates that over 80 percent of all DVDs on the Russian market are counterfeit. Piracy of motion pictures is estimated at approximately 80 percent of sales, piracy of music at approximately 66 percent of sales, and software piracy at approximately 88 percent of sales, all of which remained high in 2003. Although the Russian government established an interagency task force to combat piracy (IPR Commission), headed by then Prime Minister Kasyanov, in the fall of 2002, the Russian Government has taken few concrete steps to address optical media piracy and Russia remains a major source, destination and transshipment point for pirated optical media products.

As the copyright industries' estimated losses attest, piracy of U.S. videocassettes, films, music recordings, books, and computer software is extensive in Russia. The Russian government's Licensing Law, adopted in August 2001, did retain licensing for optical media producers and resulted in the suspension of several licenses in the Summer of 2003. However, U.S. copyright industries believe that this provision is inadequate to control optical media piracy.

U.S. and multinational companies also continue to report counterfeiting of patented and trade marked goods as a serious problem, especially for consumer goods, distilled spirits and pharmaceuticals. U.S. companies are required to take the necessary steps to protect their intellectual property, including registering their trademarks with the Russian Patent and Trademark Agency (Rospatent). Some U.S. companies have had difficulty registering and protecting well-known trademarks in Russia, although recently approved legislation has improved protection for well-known marks. The IPR Commission plans to more actively examine industrial property right issues, including pharmaceutical counterfeiting, in 2004.

Russia is a member of the Paris Convention for the Protection of Industrial Property, the Berne Convention for the Protection of Literary and Artistic Works, the Geneva Phonograms Convention, the Universal Copyright Convention and other major multilateral intellectual property conventions. The U.S.-Russia Bilateral Trade Agreement also requires Russia to provide protection for intellectual property. As part of Russia's accession to the WTO, Russia has passed a number of laws which will be required to fully meet obligations under the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). These include passage of amendments in 2002 and 2003 to Russia's laws on trademark and appellations of origin, patents, protection of layout designs for integrated circuits, plant varieties, and protection of computer software and databases. Russia still needs to pass amendments to its copyright law, which would provide protection of pre-existing copyrighted works and sound recordings, as required by the TRIPS Agreement and Bilateral Trade Agreement, and would implement obligations under the World Intellectual Property Organization (WIPO) Copyright Treaty and the WIPO

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Treaty on Performers and Performances Treaty (WIPO Digital Treaties). Several other TRIPS deficiencies remain in Russia's IPR regime, including lack of explicit protection for test data for pharmaceutical products and agricultural chemicals, a reciprocity requirement for protection of geographical indications, lack of the reversal of the burden of proof in process patent cases, and problems with enforcement authority.

There have been some marginal improvements in anti-piracy actions by Russian law enforcement agencies, including an increased number of raids by police, but overall enforcement of IPR remains inadequate. Enforcement actions depend on proactive initiatives by rights holders to investigate violations and then refer investigations to law enforcement agencies. Strengthened criminal penalties for IPR infringement went into effect on January 1, 1997, and even stronger penalties were adopted in Article 146 of the Criminal Code in 2003. But, while the Russian government has begun to pay more attention to enforcement, there are still few cases in which existing penalties have been applied. Even when violators have received jail sentences, the sentences are often suspended or general amnesties are issued, and imprisonment does not actually occur. In addition, goods seized during enforcement actions are rarely destroyed and consequently may return to the stream of commerce.

Administrative and judicial review bodies are beginning to become active in protecting IP in Russia, and the number of police and judges with relevant expertise is still small but is expanding. U.S. copyright industries believe that at the prosecutorial and judicial levels, officials often do not consider IP infringements to be serious offenses compared to other crimes, although an increasing number of prosecutors are willing to file cases related to copyright piracy. U.S. investors also consider the Russian court system to be ill-prepared to handle sophisticated patent cases. However, a specialized higher patent chamber has been established at Rospatent, which has brought greater expertise and efficiency to resolution of trademark and patent disputes.

### SERVICES BARRIERS

Discrimination against foreign providers of non-financial services are, in most cases, not the result of federal law, but can stem from the abuse of power, sub-national regulations, and practices that may violate Russian law. For example, a few foreign providers of services have sometimes noted discrimination in obtaining licenses from local authorities. Foreign providers are forced to pay a range of fees that domestic companies allegedly bypass via bribes. The federal law on "Banks and Banking Activity of 1996" permits foreign banks to establish subsidiaries in Russia. The law allows the Central Bank to impose a ceiling on the total amount of foreign bank capital calculated as a percentage of the total bank capital in Russia. However, the Central Bank has never imposed a ceiling. Russia has been asked to clarify the situation and remove any limits as part of its WTO accession. The Central Bank has indicated that it does not want this limit to dissuade foreign banks from operating in Russia.

Since 1997, the Central Bank has required foreign banks to have a minimum of Euro 10 million in capital (the same requirement is applied to domestic banks) and to have at least 75 percent of the bank's employees and 50 percent of the bank's management board be of Russian nationality. Heads of foreign banks' Russian offices are required to be proficient in the Russian language. In the WTO talks, the U.S. has urged the Russian side to allow branches, as well as subsidiaries, to allow complete liberalization.

In the insurance sector, a law took effect in October 1999 that allowed foreign majority-owned non-life insurance companies to operate in Russia for the first time. Companies offering life and mandatory types of insurance, however, are subject to a 49 percent equity restriction. (This requirement was effectively grandfathered for the foreign firms that were active in Russia when it came into effect.) In addition, total foreign capital in the Russian insurance sector is limited to 15 percent. In September 2003, the Duma passed a law effectively exempting EU-based insurance companies from the 49-percent cap and raising

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the limit on total foreign charter capital in the sector to 25 percent. This law came into effect on January 17, 2004. The government of Russia has stated that access to the Russian insurance sector will be equalized for all potential foreign participants upon Russian accession to the WTO; however, until then, EU firms will enjoy an advantage over their counterparts from the United States and elsewhere, since they can offer life and mandatory forms of insurance in Russia directly, without the requirement to work through a majority Russian-owned partner. The new law retains the requirement that chief executives and chief accountants of foreign insurers operating in Russia be Russian citizens.

In the telecommunications sector, the new Law on Communications went into effect on January 1, 2004. The law provides the legal basis for the entire field for the next five to ten years. Its impact on the business of alternative telecommunications operators (many of which enjoy large foreign investment) could be substantial, since these companies will now fall under tighter government regulation. In particular, new regulations on interconnection (the process by which alternative operators connect their networks to the Russian public switched telephone network) place interconnection contracts and fees under tighter regulatory authority of the Ministry of Communications. The law states that interconnection contracts and fees should be non-discriminatory, but some alternative operators question how transparent the process will be. They also fear that interconnection fees will be raised ostensibly in order to subsidize network upgrades of the government-owned and ministry-controlled local and long distance operators. Many in the telecommunications industry were disappointed that the new law did not improve transparency in the licensing process. They complain about the Russian Government's lack of transparency in licensing and have criticized the five- to ten-year terms of the licenses, which they argue do not allow them sufficient time to recoup their investment. Russian policy in the telecommunications sector is a subject of debate in Russian WTO accession package, and current WTO members have expressed concern that the new law may deliberalize a now relatively open market, particularly through the adoption of new rules and regulations as set forth under the new law.

Russian entities with over 50 percent foreign ownership are prohibited from sponsoring television or video programs or from establishing television organizations capable of being received in more than 50 percent of Russia's territory or by more than 50 percent of the population.

Central Bank regulation 721-U required that purchases of foreign currency of greater than \$10,000 for a limited number of imported services, mainly in the hospitality and tourism sector, must receive advance permission from the Ministry of Finance. While intended to combat capital flight, this measure had the potential to delay financial transactions and impede the participation of foreign firms in this sector. The Law on Currency Monitoring and Regulation was signed by President Putin on December 10, 2003 and is now in effect. The law eliminates the need for licenses but requires Central Bank notification in most circumstances unless specifically noted in the law. It also renders inapplicable Regulation 721-U. Under the new law, all currency controls will be lifted by 2007. Tax preferences formerly provided to Russian film producers were abolished effective January 1, 2002.

### INVESTMENT BARRIERS

A Bilateral Investment Treaty (BIT) was signed between the United States and Russia in June 1992. The treaty was approved by the U.S. Senate in October of the same year, but it cannot enter into force until ratified by the Russian Duma. The Duma did not actively consider ratification of the BIT in 2003.

Despite the passage of a new law regulating foreign investment in June 1999, Russian foreign investment regulations and notification requirements can be confusing and contradictory. The law on foreign investment provides that a single agency (still undesignated) will register foreign investments and that all branches of foreign firms must be registered. The law does codify the principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, protect rights in

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Russian courts, repatriate funds abroad after payment of duties and taxes, and receive compensation for nationalizations or illegal acts of Russian government bodies. However, the law goes on to state that federal law may provide for a number of exceptions, including, where necessary, for "the protection of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state." The potentially large number of exceptions thus gives considerable discretion to the Russian government.

The law also provides a "grandfather clause" that stipulates that existing "priority" foreign investment projects with foreign participation of over 25 percent be protected from unforeseeable changes in the tax regime or new limitations on foreign investment. The law defines "priority" projects as projects with a foreign charter capital of over \$4.1 million and with a total investment of over \$41 million. However, the lack of corresponding tax and customs regulations means that any protection afforded investors by this clause is only theoretical.

The new Land Code that was passed in 2001 allows equal treatment of domestic and foreign entities to buy land and buildings, although purchase of agricultural land by foreigners is still prohibited. Foreign entities are restricted from buying land close to federal borders and in areas that the President determines are critical to national security.

Current Russian legislation restricts foreign investment in the aerospace industry to less than 25 percent of an enterprise. Foreign investment in the natural gas monopoly, Gazprom, is formally limited to 20 percent, and in the electrical power giant, Unified Energy Systems, to 25 percent. In practice, these limits have been exceeded, and there is discussion of whether to eliminate or raise the limits. Foreign investment in Russian spirits concerns is limited to 49 percent. In 2001, the Duma rejected draft legislation which would have prohibited and/or allowed restriction of foreign investment in a wide range of sectors in the economy.

A major tax reform law that became effective January 1, 2001, reduced tax-related investment barriers. It substantially amends the VAT, excise taxes, personal income tax and unified social tax. The Government of Russia has stated that it plans to implement another round of tax reductions to reduce the tax burden to 31 percent of GDP by January 2005. The 2001 amendments established a flat income tax rate for residents and a 30 percent income tax rate for non-residents. In addition, six taxes were abolished entirely: the 1.5 percent social and housing turnover tax; the Employment Fund tax; the state border clearance fee; the vehicle tax; the vehicle acquisition tax; and the oil and lubricant product sales tax. The road users turnover tax, reduced from 2.5 percent to 1 percent of turnover, was abolished entirely in January 2003. Regions and municipalities received authority to grant exemptions to the regional portion of profits taxes. Some regions received specific regional exemptions, particularly the Leningrad oblast. However, regions will no longer be able to grant individual tax exemptions. Another amendment to the tax code enacted in 2001 lowered the corporate profit tax to 24 percent from 35 percent, effective on January 1, 2002.

Notable VAT tax changes since 2000, aside from the reduction in the VAT from 20 to 18 percent as of January 1, 2004, include VAT tax relief for small businesses; considerable clarification to deductibility rules; reduction of import VAT exemptions; and an attempt to provide a zero VAT tax on exports, although the VAT refund system still does not function well. Companies report that VAT refunds due to an exporter, which should be provided within three months after a claim is submitted, often do not occur on time, with a number of burdensome additional requirements for refund applied by customs and tax authorities. In addition, input VAT is often not refunded for a number of reasons, forcing exporters to avail themselves of the court system.

Duties on the production and export of oil have been adjusted several times over the past few years. In 2003, new legislation restored to the Government full discretion in establishing export duties on refined

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petroleum products. In 2004, the Government is expected to consider bills that would establish a differentiated tax on oil production and, more broadly, higher taxes in the oil sector.

Crime and corruption in commercial transactions and problems with the implementation of customs regulations also inhibit investment. Trade and investment would benefit, for example, from improved dispute resolution mechanisms, the systematic protection of minority stockholders rights, conversion to international accounting standards, and the adoption and adherence by companies to business codes of conduct. Initiatives are underway to address these shortcomings, either through regulation or government-sponsored voluntary codes of conduct. More transparent implementation of customs and taxation regulations is also necessary.

In 2003, President Putin signed legislation implementing legal amendments to Russia's regime for production sharing agreements (PSAs). PSAs are designed for energy projects that require high capital expenditure and a long period before profits -- or significant tax revenues -- are generated. Implementation of these amendments severely restricts the opportunity for conclusion of future PSAs by limiting the number of energy deposits eligible for PSA status and by establishing, in effect, a right of first refusal for companies that may wish to bid to develop energy deposits on a non-PSA basis. International oil companies have insisted that PSA legislation, while not sufficient in itself, is a precondition for investment in certain major energy projects in Russia. The \$2 billion invested to date in the Sakhalin II consortium and ExxonMobil's announcement that it is proceeding with a \$12 billion development plan for Sakhalin I, both "grandfathered" PSA projects, demonstrate the tangible benefits to Russia of foreign energy investment on PSA terms.

Elsewhere in the energy sector, the \$2.6 billion Caspian Pipeline Consortium (CPC) project, inaugurated in 2001, shows the vulnerability of projects to efforts to violate contracts and/or founding agreements. In 2002 and in 2003, the CPC had to resist bureaucratic pressure to designate it as a "natural monopoly," even though its founding agreements explicitly exempt it from application of the Law on Natural Monopolies. Such a designation could cast doubt on CPC shareholders' discretion regarding transportation fees and access rights for the pipeline. In addition, local officials continue to insist that CPC pay port fees, despite the fact that its founding agreements explicitly exempt it from such fees. Elsewhere, non-transparent environmental regulations concerning environmental permitting and pipeline access remain of concern to potential U.S. investors. Central Bank restrictions on medium-term loans (more than 180 days) of hard currency for the purchase of imported inputs have also presented an obstacle to foreign investment projects in Russia's energy sector. Existing PSA projects include local content requirements or targets for equipment and local labor. Another provision in the existing PSA regime limits the total amount of foreign investment to 30 percent of Russia's "strategic" oil reserves. The precise meaning and significance of this restriction remain unclear.

Russia has assumed obligations under Article VIII of the IMF Articles of Agreement to permit free payment of current transactions, but the Central Bank continues to maintain controls on capital flows, despite several new currency control amendments enacted in 2001. The only major change was to lower from 75 percent to 50 percent the mandatory requirement to surrender hard currency by exporters, without reducing the 100 percent repatriation requirement. The proposed law on currency control under current government review would lower the surrender requirements to 30 percent, and would completely abolish them by 2007. Russia continues to maintain restrictions on profit repatriation with respect to investments in restructured Russian sovereign domestic debt (S accounts). However, while S accounts still exist, they are largely irrelevant, because all investors holding treasury bills in an S account were allowed to exit earlier, if they so chose, and there is a mechanism in place which allows current holders of S accounts to exit. Investors can also repatriate coupon payments on government and corporate bonds and invest in other bonds.) However, licenses are still required for most transactions transferring money into or out of Russia, with exporters incurring exchange fees and substantial compliance expenses. The proposed law

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would eliminate the licensing requirement in favor of simple notification, but it is not clear what ultimately will be approved.

Of potential concern to some investors are export tariffs imposed since 1999 by the Russian Federation, which have become a very significant revenue source for the government. Export tariffs are levied on a range of goods, including oil, gas, forest products, ferrous and non-ferrous metals and scrap, hides and skins. Export tariff rates for oil and gas, like excise rates, have been raised and lowered in parallel with changes in oil price levels.

A presidential decree signed in early 1998 provides investment incentives for large investments in the automobile industry that meet local content requirements. Although the decree is technically still in place, the Government of Russia has stated that no new contracts will be concluded under the law and that the law itself will be abolished in the near future. In practice, U.S. investors in this sector have faced difficulty in obtaining relief promised by the Russian Government from local content requirements and for special customs treatment.

Despite an aging civil aviation fleet and use of outmoded avionics and engines, replenishment of the Russian fleet has not proceeded. Current Russian law stipulates preferential treatment (tax holidays, guarantees on investment) for Russian and foreign investors in aviation-related research and manufacturing ventures. However, it limits the share of foreign capital in aviation enterprises to less than 25 percent and requires that board members and senior management staff be Russian citizens. There is speculation that the 25 percent limit could be raised or done away with altogether to make way for further investment. Some observers, however, doubt that recent proposals to raise the limit only to 49 percent would be sufficient to garner significant new capital infusions from abroad for Russia's aircraft industry.

In 1996, the United States and Russia concluded a Joint Memorandum of Understanding (MOU) reflecting U.S. concerns about barriers to the Russian civil aircraft market and the application of international trade rules to the Russian aircraft sector. The MOU states that U.S. aircraft manufacturers will be able to participate in the Russian market and share in its growth. The MOU also makes clear that the Russian aircraft industry will become fully integrated into the international economy over time. Russia pledged to eventually undertake the same international trade principles in the aircraft sector as the United States and many others have done as embodied in the WTO Agreement on Trade in Civil Aircraft. In the interim, the MOU commits Russia to take steps, such as the granting of tariff waivers, to enable Russian airlines to meet their needs for non-Russian aircraft on a non-discriminatory basis.

The government is also looking to reorganize and revitalize Russia's aircraft industry in the context of a larger restructuring plan for Russia's defense industry. Specifically, the government is considering large-scale consolidation of the aircraft industry through mergers and privatizations. Additionally, to support leasing of Russian-manufactured aircraft, the Russian Government in August 2001 concluded deals with Ilyushin Finance and Finance Leasing Company (FLC). Under these deals the Russian Government will take a controlling interest in each company's aircraft leasing operations in exchange for an \$80 million infusion of government money in Ilyushin's IL-96 project and \$25 million in FLC's TU-214 project. In December 2003, the Russian government increased its ownership stake in each of the companies in the amount of almost 30 million dollars for Ilyushin Finance and almost 13 million dollars for FLC.

Aeroflot currently has 27 foreign aircraft (11 Boeings and 18 Airbus) in its fleet, which were acquired with tariff waivers. While Aeroflot can replace these 27 planes with other foreign planes without paying import duties, they currently cannot acquire more aircraft without paying import duties. Aeroflot's current quantity of foreign planes were granted waivers in exchange for Aeroflot's commitment to purchase six Ilyushin 96-300s. While Aeroflot and other Russian airlines have been vocal about seeking further tariff waivers, the Russian Government has been equally vocal in saying they will not be granted.

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## **ELECTRONIC COMMERCE**

Russian law does not currently provide identical legislative protection for both electronic and paper documents. Settlement issues need to be considered in conjunction with applicable currency control provisions. Registered trademarks are not recognized as entailing rights to the equivalent domain names and the property rights which trademarks secure for their registered owners are currently not protected for the purposes of Internet advertising and commerce through web sites. Tax implications from electronic commerce are unclear.

Electronic Russia (E-Russia) is a \$2.6 billion, nine-year plan announced by President Putin in July 2001 to boost information technology and Internet usage in Russia. It includes proposals to improve the telecommunications infrastructure of the country and to implement legislation to facilitate electronic commerce. Unfortunately, during its first two years of existence E-Russia received only 20% of earmarked funds and completed few of its stated goals. In December 2003, the Ministry of Communications unveiled substantial changes to the program. In its current form, E-Russia will focus on coordinating efforts to introduce e-government to the Russian Federation.

A law on electronic digital signatures was approved by the Duma in December 2001 and was signed into law by President Putin in January 2002. The law defines electronic signatures strictly, making public-key technology the sole acceptable digital signature technology. The law also requires that hardware and software used in digital signature authentication be certified in Russia. This gives the Russian government the right to insist on decompilation of programs, and thus, access to the source code. An electronic commerce bill is also under consideration. This bill, while closely following an International

Chamber of Commerce model bill, nevertheless has problems, including the fact that it limits electronic transactions to the sale and purchase of moveable goods, services agreements, and shipments. The adoption of the new WIPO Digital Treaties also would promote the development of electronic commerce in Russia.

In 1999, the Ministry of Communications confirmed the existence of the System of Operative and Investigative Procedures (SORM-2), a series of regulations that require internet service providers in Russia to install special eavesdropping equipment on behalf of the Federal Security Service (FSB).

Though certain provisions were struck down by the Supreme Court of the Russian Federation in September 2000, SORM-2 still allows the Russian government to intercept voice and data (e.g., email transmissions) supposedly for reasons related to law enforcement. The ultimate impact of the law is still unclear. Though it requires the FSB to obtain a warrant before it accesses private information, there appears to be no mechanism to prevent unauthorized FSB access to Internet traffic. The FSB has never publicly commented on how effective the regulations have been in the prevention and investigation of criminal activities.

## **OTHER BARRIERS**

Russia maintains export taxes on a variety of products. In May 1999, Russia imposed an export tariff on ferrous steel scrap of 15 percent (amounting to not less than 15 euros per metric ton). Additional certification requirements on ferrous steel scrap exports were adopted in 2001. At the time the export tariff was imposed, Russia was the world's largest steel scrap exporter. Russian exports of steel scrap have since declined significantly, at a time when world demand and prices have been rising. The export tax provides an artificial advantage to Russian steel producers by increasing domestic steel scrap supply, providing producers with an unfair advantage in Russia and in third markets. Moreover, it constricts

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global supplies of a key steel input, which has the effect of raising prices of steel scrap for otherwise competitive producers elsewhere, including those in the United States.

Russian export tariffs on copper cathode have also created a market distortion which is promoting vertical integration within the Russian copper industry. Russia currently maintains a 10 percent export tariff on copper cathode and a 0 percent export duty on copper wire rod. As a result, it is advantageous to export the higher value-added product (copper wire rod). Russian copper wire rod producers can obtain favorable prices on copper cathode, since cathode producers cannot export their product for its fair market value.