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# The Investment Climate in the Commonwealth of Independent States

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## Introduction

The dissolution of the Soviet Union left the successor states with numerous economic problems. In comparison with other developed countries, the Soviet Union had a large industrial sector which in itself was biased towards heavy industry. The light industry was relatively small, while the service sector was virtually non-existent. Furthermore, the economic activities of the Soviet Union had developed with little reference to criteria of economic efficiency. To facilitate planning, industries were often highly concentrated in a single area and were of a large scale. There were hardly any small and medium sized enterprises. To settle the vast Siberian expanse and to put industries out of reach of German forces during the Great War, heavy industries were often located east of the Ural mountain range. The light industries, producing consumer goods, were concentrated in the western parts of the empire. The washing machines for entire Soviet Union, for example, were mostly produced in Belarus. The republics on the southern rim of the Soviet Union had relatively little industry. As transport and energy costs were kept low, this uneven economic structure could be sustained.

The break up of the Soviet Union signified the end of central planning. Supply chains were broken and enterprises henceforth had to find their own suppliers and customers, and were confronted with (foreign) competitors. As the system of central planning had discouraged the introduction of technological progress, most production facilities were economically obsolete in the new market environment. Both heavy and light industry needed to be modernised to become competitive in the world market and a service sector needed to be developed.

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The restructuring of the economies of the successor states required high levels of investment. However, the economic crisis that followed the dissolution of the Soviet Union wiped out the savings that could have been used to finance these investments. The governments of the CIS countries did not have sufficient means available to compensate for the lack of savings by financing investments out of the budget.[3] Moreover, the new owners of privatised firms proved to be more creative in transferring capital out of the CIS, than in raising and using capital to finance the restructuring of the production processes. As a result, investments in fixed assests remained low in the CIS countries throughout the first decade and a half after the dissolution the Soviet Union.

In this contribution, we will examine the investment climate of the successor states and discuss what is done and what needs to be done to successfully attract investments to restructure the economies. We will concentrate on the conditions for attracting foreign investment. An alternative route would be to study what needs to be done to prevent capital from flowing out of the country. But arguably, if a country is attractive for foreign investment, it also is attractive for domestic investment. A practical argument is that conditions to attract foreign investment are more widely discussed in literature than those for domestic investments. Furthermore, it is likely that domestic investment will increase before foreign investment as domestic investors have better knowledge of the local situation and thus see opportunities before foreign investors can.[4]

In the first section we will briefly review how historically, Russia overcame the lack of domestic savings to finance investments. As is the case today, domestic savings in the 19th century were insufficient to finance the required levels of investment, and Russia critically depended on foreign investment for its economic development. The tsarist regime, however, maintained a firm grip on the economic development and was reluctant to allow foreign ownership of the means of production. The successive governments, however, attracted foreign investments, mostly bonds, to Russia. During the communist regime, foreign investments were not solicited at all. The industrialization was financed by so-called forced-savings. This section will also discuss the present levels of foreign

[3] This paper will only discuss the situation in the successor states that formed the Commonwealth of Independent States (CIS). The CIS countries are: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. The Baltic States, Estonia, Latvia and Lithuania followed a markedly different track from the other states and aspired EU membership which they received in 2004.

[4] Another way of increasing domestic investment would be to close the border for (outgoing) capital flows.

investments in the countries of the CIS. The second section will focus on the strategic factors that foreign investors distinguish in their investment decisions and will argue that most of the CIS countries do not meet these requirements. It can be argued that the CIS countries are not very attractive destinations for foreign investments and do not attract much of it. The third section expands on the actual investment climate and discusses, in more detail, what type of institutional environment investors encounter and what type of policy making the investors have to deal with. This section will also pay attention to the role that the break-up of the Soviet Union has played in the establishment of the investment climate. The final section will conclude.

## 1 The need for Investments

The humiliating loss of the Crimean War in 1856 convinced the tsarist regime of Alexander II of the military and economic backwardness of the Russian empire. The regime set out a course to close the economic gap between the Russian empire and the European countries. An important part of that course was a policy to industrialise the country. To protect its domestic industry, the state raised trade barriers. But the state lacked the resources to finance its ambitious plans to speed up railway building, and to develop heavy industry.[5] Because domestic savings also were insufficient, the state had to issue bonds and sell these to foreign investors. With the inflow of foreign capital, Russia was indeed able to develop its heavy industry. Although foreigners did own some Russian enterprises, the state maintained a large influence over the economic development. The economic policy was relatively successful and Russia's national income almost quadrupled in the period between 1861 and 1913. However, growth was biased towards heavy industry. The production of crude steel (measured in 1000 metric tons) was 700 times bigger in 1913 than it was in 1861, the production of pig iron was 14 times bigger, the production of coal 95 times, and there was 70,000 kilometre of railway in 1913 against 2,000 kilometre in 1861. Due to the large population growth, income per head did not quadruple, but increased by two thirds.[6] World War I and the ensuing civil war undid most of the progress; industrial production in 1920 was at 20 per cent of the

[5] Between 1860 and 1905, the state commissioned the building of more than 50,000 kilometers of railroad. Railroad building was an industry in itself, but it also allowed for the development of other heavy industries.

[6] Paul Gregory and Robert Stuart, Russian and Soviet Economic Performance and Structure, 7th edition, Addison Wesley, Longman, 2001, tables 2.1. and 2.2. The increase in income per capita was somewhat lower than that in other European countries and the USA.

1913 level. Because the communists had disowned foreign owners and defaulted on Russia's foreign debt, foreign investors were not willing to finance Russia's recovery.[7]

With the introduction of the Five Year Plan, in 1929, the communist regime embarked on a strategy of high growth. Capital investments increased considerably, most investments being directed towards the development of heavy industry. The costs of this so-called forced industrialisation were very high indeed and had to be carried domestically. Savings were forced by keeping the production of consumption goods and thus consumption levels very low. Furthermore, agricultural output was exported to pay for the necessary imports of machinery and equipment. Many people died in the first years of the industrialisation drive.[8] The industrialisation was successful. During the first three decades of central planning, growth of fixed capital was nearly 10 per cent annually. Since the 1960s, investment growth has slowed down somewhat, but remained high and above the growth of fixed capital of almost all rich countries until the end of the communist system.[9] As in the tsarist times, investments continued to be biased towards the heavy industry. Even though the aim of the Soviet developments was to catch up and overtake the market economies, the Soviet authorities were unable to build a capital stock that was as productive as the one in market economies. The Soviet Union needed more capital to produce a unit of income than the market based countries. The planned economy proved unsuccessful in developing and introducing technological development.[10] There was a tendency to over invest in existing technology to replace existing and expand (known) production capacity to facilitate the fulfilment of plans. Towards the end of its existence, the Soviet Union was a highly industrialised country, although its industrial structure was biased towards heavy industry and its capital stock was obsolete.

The successor states thus inherited an economy that was in great need for restructuring. The transition towards a market based economic system was supposed to create

[7] In 1922, the communist regime established the Union of Socialist Soviet Republics.
[8] It was not just the industrialization drive, but also the forced collectivization of agriculture which led to the famine of the 1930s. See for instance: Alec Nove, An Economic History of the U.S.S.R., Penguin Books, 1989
[9] Paul Gregory and Robert Stuart, Russian and Soviet Economic Performance and Structure, 7th edition, Addison Wesley, Longman, 2001, tables 10.3 and 10.4.
[10] On the failure of the Soviet economy to develop and introduce new technologies see, among others, Berliner, Joseph, The Innovation Decision in Soviet Industry, MIT, 1976; Padma Desai, The Soviet Economy. Problems and Prospects, Basil Blackwell, 1987; Alec Nove, The Soviet Economic System,, George Allen & Unwin, 1977

incentives for firms to restructure and to invest in new and efficient capital stock. However, investment levels remained disappointing. Not only did investors not invest in the CIS countries, they were actually moving capital out of the transition economies.[11] The low investments may partly be explained because of the deep economic crisis that hit the CIS countries. Gross capital formation continued to hover around 25 per cent of GDP.[12] Given the decline of income, this meant that investment was also decreasing. With the low levels of investment they had, the CIS countries had little hope of reconstructing their obsolete capital stock and become competitive in the world economy. Even though the private saving rate was relatively high as people were recovering their lost savings, absolute savings were insufficient to finance the reconstruction of industry, so much the more because new owners were often asset stripping their enterprises and exporting capital. An alternative source of finance could have been foreign capital. However, foreign investment too, remained low. As in the tsarist and the communist times, the governments of the CIS countries were reluctant to allow foreign ownership of production. Unlike, the tsarist times, the governments could not issue bonds to finance investments, as the state needed their means to stabilise the economy. Russia, for instance, borrowed considerable amounts from the International Monetary Fund (IMF) for that purpose. The states actually required so much credit that it was virtually impossible for private enterprises to attract any credits. There was little private borrowing to finance restructuring. The capital markets were underdeveloped and neither foreign banks nor foreign investors built up a large portfolio of CIS assets. Furthermore, foreign firms did not show a large appetite to directly invest in the CIS countries and if they did, they were often not permitted to take a (majority) share privatised companies.[13]

This was mildly surprising as the obsolete industrial structure of the CIS countries allowed for major improvements in the productivity of capital and thus for high returns

[11] Russian authorities estimated the capital flight out of Russia in the period 1992 - 1996 to be in the range of 50-200 billion US dollars. A. Abalkin and J. Whalley (eds), 1999, The Problem of Capital Flight in Russia, The World Economy, Vol. 22, no. 3. Capital Flight has abated since then, but did not stop. See also Prakash Loungani and Paolo Mauro, Capital Flight from Russia, IMF Policy Discussion Paper, PDP/00/06, June 2006

[12] Calculated from Commonwealth of Independent States in 2002, Statistical Yearbook. We used the tables per country on the use of GDP.

[13] Foreign direct investment is established when the investor acquires at least 10 per cent of the ordinary shares or voting power on enterprise abroad. The acquisition is supposed to set up a long-term relationship, and gives the investor an effective say in the management of the acquired enterprise. Report of the Working Group of the Capital Markets Consultative Group, September 2003.

of investment. The levels of foreign direct investment were smaller in the CIS than they were in the Central and East European countries with which they share a past of central economic planning. The cumulative foreign direct investment in the CIS countries per capita still is less than 10 per cent of that in Central and East European countries. Initially, of all the countries in transition Hungary attracted most foreign direct investment only to be surpassed by Poland in 1996, the Czech Republic in 1997, and the Slovak Republic in 2000. Of the CIS countries, only Russia attracted more foreign direct investment than Hungary, in 1997 and 1998, but then fell behind again. Only in 2001, Russia received more foreign direct investments than did Hungary. Kazakhstan, also in 2001, started to attract more direct investment from abroad than Hungary. Of all the countries in the CIS, Russia attracted most foreign direct investment.

Table 1: Net Foreign Direct Investment in the CIS (in million US$)

| CIS | 1994 | 1996 | 1998 | 2000 | 2002 | 2004 | 89-04 per cap. |
|---|---|---|---|---|---|---|---|
| Am | 8 | 18 | 221 | 104 | 111 | 217 | 333 |
| Az | 22 | 627 | 1023 | 149 | 1048 | 2351 | 1190 |
| Be | 11 | 105 | 201 | 119 | 453 | 168 | 218 |
| Ge | 8 | 54 | 221 | 153 | 122 | 503 | 386 |
| Kz | 635 | 1137 | 1143 | 1278 | 2164 | 5548 | 1413 |
| Ky | 38 | 47 | 87 | -7 | 5 | 131 | 112 |
| Md | 12 | 23 | 75 | 127 | 132 | 148 | 255 |
| Ru | 408 | 1656 | 1492 | -463 | -72 | 2132 | 54 |
| Tj | 12 | 18 | 25 | 24 | 36 | 272 | 76 |
| Tm | 103 | 108 | 62 | 131 | 276 | 330 | 300 |
| Uk | 151 | 516 | 747 | 594 | 698 | 1711 | 168 |
| Uz | 73 | 90 | 140 | 75 | 65 | 187 | 42 |
| total | 1480 | 4399 | 5437 | 2284 | 5038 | 13699 | 203 |
| CEEB | 4580 | 10023 | 15098 | 19689 | 21504 | 16288 | 2235 |

Source: Transition Report 2005, table A.2.8, p.55 (CEEB is Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia)

This does not show in table 1 as this reports net inflow. Russian firms, however, are also directly investing abroad. In 2004, for example, Russia received 11.6 billion US dollars worth of foreign direct investment, while outward investment was 9.6 billion US dollar.[14] Russian firms, for instance, are among the largest investors in other CIS countries.[15]

[14] UNCTAD, World Investment Report 2005, annex table B.1.

[15] Keith Crane, D.J. Peterson, and Olga Oliker, Russian Investment in the Commonwealth of Independent States, Eurasian Geography and Economics, 2005, 46, no 6, pp. 405-444.

## 2. Markets and resources

The deep economic crisis and the slow progress of restructuring the productive base of the respective economies suggest that the CIS countries are in need of foreign investments. The importance of foreign investments would even go further than to close the investment gap due to a lack of savings. The externalities that are associated with foreign direct investments include the transfer of managerial expertise, technology, information processing, as well as sales and marketing knowledge.[16] Investments in financial portfolios exercise a disciplining effect on the operation of firms, but this influence requires well functioning capital markets. We will focus here on direct investments which have a greater and immediate effect on the restructuring of firms and thus on the restructuring of the economy as a whole.

Firms have a number of motives to invest in foreign countries, which can broadly be categorised as market seeking or resource seeking motives.[17] An investment is supposed to be market seeking if the investor aims to service local and regional markets with his newly acquired or newly set up production facilities. It is resource seeking if the aim of the investment is to acquire natural resources, raw materials, or low cost inputs such as labour that are not or insufficiently available in the other countries of the investors activity. The actual form and size of the investment depend on a number of factors that depend on firm specific as well as country specific factors.

The abandonment of central planning opened up a market of 100 million consumers in Central and East Europe and 300 million in the successor states to the Soviet Union. Russia is the most populated CIS country with 145 million people, but Ukraine, with almost 50 million inhabitants and Uzbekistan with 25 million also are populous states. Most countries pursued a policy of free trade and allowed imports to satisfy domestic

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[16] Bessonova and others calculate a positive effect on the productivity of domestic firms as a result of trade openness and FDI as well. Evgenia Bessonova, Konstantin Kozlov and Ksenia Yudaeva, Trade Liberalization, Foreign Direct Investment, and the Productivity of Russian Firms, Paper for CEFIR conference "Negotiating Russia's WTO accession: strategic lessons from multilateral trade liberalization and club enlargement" December 2002.

[17] Different authors use different categorizations. Kinoshita and Campos, add efficiency seeking investments to market seeking and resources seeking, while in international business literature authors use a more detailed categorization. Yuko Kinoshita and Nauro Campos, Why Does FDI Go Where It Goes? New Evidence from the Transition Countries, William Davidson Institute Working Paper Number 573, June 2003. For the international business literature see e.g. Robert Pye, Foreign Direct Investment in Central Europe, European Management Journal Vol. 16, No 4, pp. 378-389, 1998.

demand. As a result imports from market economies skyrocketed in the early years of transition as consumers used their savings to buy western products. However, the high inflation and economic crisis that followed the transition wiped out savings and reduced incomes and local consumers could no longer afford to buy western products. Consumers switched back to locally produced output. In Central and East Europe foreign investors had acquired local firms and were investing in the restructuring of these firms to upgrade the local output. With this output, they served local markets. They were helped by the return to economic growth in 1993 – 1994 in these countries which helped to sustain demand. Not only did the CIS countries start off with lower incomes per capita than the countries in Central and East Europe, the decline in their income was bigger and the recovery set in later. Per capita income in these countries, therefore, is low. This explains why despite the large number of consumers, the size of the CIS markets remained relatively small. Only for cheap products that people consume on a (near) daily basis, these markets may still be attractive. However, many of the CIS countries are also handicapped by their distance to major economic centres, most notably the countries of the European Union, and by their poor transport infrastructures. During Soviet times, the transport costs were held low and did not reflect the economic costs, but nowadays transport costs have increased and have become a constraint for the supply of low valued products, especially. Only if a product can be entirely made with local supplies and for a local market transport costs can be avoided by producing and supplying locally. As this is a rare case, it has become unattractive to produce products with low added value in and for remote areas. The production of light manufacturing and the agro-processing, for instance, already has disappeared in several Central Asian countries.[18] Even if the successor states have tried to maintain and at a later stage build a free trade area between them, the break up of the Soviet Union introduced borders and fragmented its economic space.[19] This process was aggravated by the introduction of 11 new currencies. All in all, market seeking investments were not very attractive in the CIS countries.

[18] Gael Raballand, Antoine Kunth and Richard Auty, Central Asia's transport cost burden and its impact on trade, Economic Systems 29 (2005) 6-31.

[19] The Fergana valley is an example where independency created trade impediments. Trade routes previously run through it, unconcerned with the jagged borderlines of the Soviet republics in that area. With the creation of 'real' borders, traders incurred costs to cross borders and sometime had to take large detours to avoid these costs and to get their products delivered.

Most foreign investment into the CIS indeed has been resource seeking investment. Russia, Kazakhstan and Azerbaijan are all well endowed with oil and gas and attracted most FDI of all countries in the CIS.[20] The development of oil production in and around the Caspian Sea is a major source of investment as are the development of the gas field in the Sakhalin Islands and the oil development projects in western Siberia. There seems to be little investment seeking the well educated and relatively cheap labour resources. A noteworthy exception may be the hiring of computer engineers for programming purposes. Again, the high transport costs may be responsible for offsetting the advantages of low labour costs, but there may also be indirect costs of hiring labour in the CIS countries. The successor states inherited a social security system that was built on direct payments out of company accounts. Companies often still pay for these services, which then form hidden labour and capital costs. A further point to note is that, although the labour force is technically and culturally well educated, it is much less so in economic areas as finance, accounting, marketing and management. Therefore, investments aimed at labour resources may not be as attractive as they seem at first sight. Especially, since the restructuring of firms that is likely to follow an acquisition of a local firm will result in lay-offs, which is a politically very sensitive issue.

Generally speaking, the CIS countries currently have small markets and most of them lack natural resources. Although this puts them in a difficult position to attract foreign investment, it does not mean that they could not be attractive for foreign investors at all. As mentioned above, Hungary attracted large amounts of foreign direct investment, yet Hungary with a population of only 8 million and a modest level of income per capita, also has a small market. And Hungary has no natural resources to speak. It does, of course, share a common border with the EU and the distance between the economic centres of Hungary and those of the EU is shorter, both in kilometres and in hours of transport time, than the distance between economic centres of CIS countries and those of the EU. But Hungary also, from the very beginning of its transition from a centrally planned economy towards a market economy welcomed foreign investors. They were, for instance, invited to buy Hungarian firms that were privatised and Hungary introduced an investment friendly regime.

[20] Investments in energy resources often take the form of a Product Sharing Agreement, where the western firm invests in (new) capacity and the revenues of the enterprise are shared between the investor and the government.

## 3. The Investment Climate in the CIS

Historically, the state has always played an important role in the economic development of the Russia. During the tsarist days, the state controlled the industrial development through its policy of licensing, protection and financing industries. In the communist era, the state was all pervasive. The relatively poor results of the Soviet economy contributed to the discrediting of direct state involvement in the production of goods and services and the transition towards a market economy is very much about pushing back the state. In a market economy, the state is not supposed to interfere in the production of goods and services. This does not, however, imply that the state has to become invisible. The successor states, however, have to 'reinvent' themselves and create favourable circumstances which attract investors. The modest inflow of foreign investment is a good illustration that thus far, they have not succeeded in this difficult task.

As we have indicated, most of the CIS countries do not have a good starting position to attract FDI. They are small markets and many of them do not have resources that attract investors. Furthermore, most of them are land-locked with a poor, and neglected, transport infrastructure adding to the production costs and thus reducing revenues. The location of the countries and the availability of resources, especially raw materials and energy, of course, cannot be helped, but an argument could be made to increase the availability of an educated workforce. Furthermore, their markets need not to remain small, but for that to happen investments are needed and to attract investments the governments need to pursue investor friendly policies and create a favourable investment climate. Several factors contribute to a country's attractiveness for investors. Although there are large differences in the size and the form of investments, there is always the need for investors to commit resources to the project. To reduce the risk that their investment loses value, investors appreciate a stable and sound macro-economic basis in a country. In the second half of the 1990s, the CIS countries have started doing well, macro-economically. As indicated above, after the dissolution of the Soviet Union, the CIS countries experienced an economic crisis, which reduced their income considerably. In 2004, the income in the CIS as a whole had returned to 81 per cent of the 1989 level. Russia's income, in 2004, was at 82 per cent of its 1989 level. Belarus, Kazakhstan, Turkmenistan and Uzbekistan now have incomes that are higher than the ones in Soviet times. Moldova and Ukraine were the last of the CIS countries, in 2000, to return to economic growth. The oil boom is noticeable in the growth rates of Azerbaijan, Kazakhstan, Russia and Turkmenistan. Since 2001, growth rates in these countries have been close to or even above 10 per cent annually, but growth rates in other countries of the CIS seem robust as well.[21] Further success can be registered in the fight against inflation. After the initial years of high inflation, all countries have succeeded to bring inflation down to levels around 10 per cent annually. They have also been successful in bringing the budget under control. The oil exporters even have budget surpluses. Of those, Russia registers the highest surplus at 7.6 per cent. The highest deficit is recorded by Kyrgyzstan at 4.6 per cent of GDP. With inflation and budget deficits, the interest rates have decreased as well. It almost goes beyond saying that the oil exporters also have surpluses on their current accounts, although actually, Azerbaijan has significant deficits. The most likely explanation for this is that the investments in the oil industry are in kind, which requires products to pass the border. The current accounts of the CIS countries actually show mixed results, some are positive, others are negative; while overall the region has a small deficit with the rest of the world. All have improved their external balances from the early years of transition, which helped to stabilise their exchange rates. All these are positive signs for investors that need not fear the loss of value of their investments.

Second, investors appreciate if their investments are not threatened or devalued a result of policies that are directed to their activities. They do not want to run the risk that their assets will be expropriated. Countries that want to attract investments need to have a favourable institutional environment. Confusion may arise on what is included in the institutional regime and what is not, but in most surveys on the issue, the results for the CIS countries are not very favourable. An important indicator or actually a set of indicators is published annually in EBRD's Transition Report. The share of the private sector in the economy is one of the criteria used. In Belarus and Turkmenistan only 25 per cent of GDP is earned in the private sector, neither does Uzbekistan score very high on this criterion with 45 percent. Russia's private sector share actually is declining. The EBRD scores on both large scale privatisation and small scale privatisation are to be found in table 2. Budget constraints have remained rather soft and there have been too few reforms to promote corporate governance and as a result enterprise restructuring has not yet really set in. With respect to price liberalisation and the trade and foreign

[21] All figures from Transition Report 2005, table A.2.1 at p. 48

exchange system the scores are higher and at the same level as those of the other countries in transition. With respect to the competition policy, no country in transition, according the EBRD matches the criteria of a market economy, but the CIS is further from that target than the countries in Central and East Europe.[22] The development of the financial sector leaves much room for improvement. For banking reform and interest rate liberalisation and for the securities market and non-bank financial institutions the CIS states score lower than their competitors. The indicator for infrastructure is a composite of factors, including electric power, railways, roads, telecommunication, and water and waste water.[23] The focus is on administration and regulation of infrastructure, rather than on its physical quality. In electric power, for instance, a high score requires private sector involvement in distribution and generation and an independent regulator. A large degree of decentralisation and commercialisation is mentioned both for roads and for water and waste water.

Table 2: Transition indicator scores 2005

| | Large scale priv. | Small scale priv. | Governance enterprise restructuring | price | Trade forex system | Competiti on. policy | Bank reform | Non-bank financial Institution | Infra-structe reform |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | 4- | 4 | 2+ | 4+ | 4+ | 2+ | 3- | 2 | 2+ |
| Azerbaijan | 2 | 4- | 2+ | 4 | 4 | 2 | 2+ | 2- | 2 |
| Belarus | 1 | 2+ | 1 | 3- | 2+ | 2 | 2- | 2 | 1+ |
| Georgia | 4- | 4 | 2+ | 4+ | 4+ | 2 | 3- | 2- | 2+ |
| Kazakhstan | 3 | 4 | 2 | 4 | 3+ | 2 | 3 | 2+ | 2+ |
| Kyrgyzstan | 4- | 4 | 2 | 4+ | 4+ | 2 | 2+ | 2 | 2- |
| Moldova | 3 | 3+ | 2 | 4- | 4+ | 2 | 3- | 2 | 2+ |
| Russia | 3 | 4 | 2+ | 4 | 3+ | 2+ | 2+ | 3- | 3- |
| Tajikistan | 2+ | 4 | 2- | 4- | 3+ | 2- | 2 | 1 | 1+ |
| Turkmenistan | 1 | 2 | 1 | 3- | 1 | 1 | 1 | 1 | 1 |
| Ukraine | 3 | 4 | 2 | 4 | 3+ | 2+ | 3- | 2+ | 2 |
| Uzbekistan | 3- | 3 | 2- | 3- | 2 | 2- | 2- | 2 | 2- |

Source: Transition Report 2005, table 1.1, p.4

The above discussed EBRD transition indicators describe the institutional environment at a relatively abstract level. Investors also take into account factors that directly influence their business operations. Not only need the rules and regulations be clear, they also need to be enforced. There cannot be too much discretion in its application. This also puts demands on the political and administrative execution. Property rights should actually be

[22] The East European states as well as the Baltic States greatly benefited from the accession to the European Union, which required them to adopt the Union legislation. They do still have to act to reduce the abuse of market power and to promote a competitive environment.
[23] The infrastructure indicator is developed in Transition Report 2004.

protected, the bureaucracy needs to operate efficient and transparent, the tax system also needs to be transparent and favouring investments.[24] Corruption also is part of the institutional environment as is racketeering. Rent seeking by public administrators or criminal organisations is made easier in situations of weak public administration and low levels of compliance with commercial law. According to the legal indicator surveys that the EBRD also performs annually, the CIS countries fall short in the level of compliance with international insolvency standards and the level of compliance with international standards if corporate governance.[25] These countries are also criticised for their extensive government regulation in the form of capital controls, business licensing, inspections, and certifications among others.[26] All this adds to the costs of doing business and creates uncertainty for investors.

A third factor that influences the attractiveness of the CIS countries as recipients of investment concerns the consequences of the break-up of the Soviet Union. A formerly single economic and legal space has been cut-up in new jurisdictions with distinctive characteristics, politically, legally and economically. Most countries experienced some degree of political instability. There have been problems of political succession, capture of the state by particular interest groups and inconsistencies in regime building. In the process of privatisation, all countries allowed insiders to take possession of firms. The new owners were well-connected to state authorities and received implicit and explicit subsidies. The regimes that were built by the individual CIS countries differed from one another. The individual countries also had a different economic basis. Some were highly industrialised and produced more than they could sell domestically, others were much less industrialised and depended on imports for the supply of many products.[27] Even though the CIS countries concluded numerous agreements to reduce trade barriers, the single economic space was effectively broken up which made it difficult to service more

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[24] See e.g. Report of the Working Group of the Capital Markets Consultative Group, Foreign Direct Investment in Emerging Market Countries.
Through www.imf.org/external/np/cmcg/2003/eng/091803.htm

[25] See EBRD Transition Reports 2004 and 2005.

[26] See, among others: Clinton R Shiells, FDI and the Investment Climate in the CIS countries, IMF Policy Discussion Paper/03/5, november 2003; and Nancy Vandycke, Economic Development and Private Sector Growth in the CIS-7 Countries: Challenges and Policy Implications, in: Clinton R. Shiells and Sarosh Sattar (eds.), The Low-Income Countries of the Commonwealth of Independent States, IMF, World Bank, 2004.

[27] Agglomeration effects actually caused industries to leave the less industrialized regions. These effects are also held responsible for the fact that more than half of all foreign direct investment in Russia goes to Moscow and Moscow oblast. See: Harry Broadman and Francesca Recanatini, Where Has All The Foreign Investment Gone in Russia, World Bank Policy Research Working Paper 2640, July 2001

countries from a single location using economies of scale to reduce production costs. All this imposed barriers of entry and created uncertainties for business, which increased business costs and prevented increased earnings.

The dissolution of the Soviet Union and the creation of separate institutional regimes had a discouraging effect on foreign investment, but a distinction can be made between investments from one CIS country into another that now registers as foreign investment and investment from other countries. As indicated above, Russia is both a recipient of foreign investment and a foreign investor. Although it is difficult to determine the exact levels, Russia is an important investor in other CIS countries. [28] The (poor) countries of the CIS also receive savings from friends and relatives working abroad, often in Russia, to finance their investments. Some of the investment from the rest of the world, for instance from Cyprus and the Virgin Islands, actually is capital that is returning to the CIS after being exported in the 1990s. The energy sector, oil and gas and electricity, attract most investments, but Russian companies also invest in financial services and in industry.

Investors from other CIS countries have several advantages over investors from the rest of the world. Among others, they have a better knowledge of the local conditions. They have personal contacts with government authorities and know how the bureaucracies in these countries work. They also have a better understanding of the business culture. At the same time, they often do not require the same kind of guarantees that firms from the rest of the world want before the commit their resources. [29] The investment often brings back together the conglomerates that were disrupted by the dissolution of the Soviet Union and the investors are ready to deal with any sort of problem if and when it is presented.

Conclusion

The CIS countries thus far did not attract much foreign direct investments. Starting their transition later and from a lower level of income, they found themselves in a

[28] Keith Crane, D.J. Peterson, and Olga Oliker, Russian Investment in the Commonwealth of Independent States, Eurasian Geography and Economics, 2005, 46, no 6, pp. 405-444.
[29] Crane et al. point out that Russian investments in the CIS are also caused by excessive liquidity and the wish to diversify their portfolio, given the administration’s hostility towards some business circles.

disadvantageous position in the competition for investments with the countries in Central and East Europe. They were and are even more handicapped by their distance, both measured in kilometres, time and costs, to the economic centre of the European Union. Being land-locked, the only feasible means of transport is by road and rail. Low volumes travel over long distances, which add to the costs of the output. Transport regulations often add to the time it takes to bring products to their destination.

Given the small size of their markets and, in many of them, the lack of natural resources, CIS countries are not likely to attract foreign direct investments in large quantities. But the CIS countries made it more difficult on themselves by favouring insiders in the privatisation of their economies, thus bereaving themselves of the externalities of foreign direct investment. Their scores on the transition indicators also leave room for improvement. The government should actively pursue a policy to improve those scores and at the same time restrain itself from active engagement in the operation of enterprises.

The break-up of the Soviet Union disrupted a single market, ruled by a single institutional regime into 12 separate markets with their own distinct regulatory regimes. Although the CIS countries continue to work together in several ways, the creation of multiple jurisdictions and political entities reduced the possibilities of creating economies of scale and made it less attractive for firms to become active in the countries of the CIS.
The CIS countries would be advised to work together to reduce the investment barriers that arise from different investment regimes.