CHAPTER III

Joint Venture.
The most innovative and radical aspect of Gorbachev's new foreign trade initiative was adopting the measures concerning joint ventures with foreign participants within the Soviet Union. Right from the beginning of the economic reform process, joint ventures have attracted a lot of attention. This chapter is an attempt to analyse the necessity of joint ventures in the Soviet Union, the problems faced and bottlenecks that came across during that period and the subsequent outcome of these innovations.

The specific goals of this move were to attract new foreign technology, managerial experience and other advanced production factors, to substitute some imports, to expand the export sector of Soviet economy, and to destroy a taboo on foreign capital participation in Soviet enterprises as well as to use that same foreign capital to help modernize and restructure Soviet industry. Soviet reformers also looked to joint ventures as a means to broaden economic links between Soviet and Western industry.¹

By improving the technology used to produce consumer and industrial goods and by using western managerial expertise, Gorbachev hoped (a) the Soviet produced goods would become competitive on world markets. That would help the Soviet economy by moving consumer tastes away from western to domestically produced goods and by enhancing sales of Soviet exports abroad. Thus easing Soviet hard currency shortages, which had resulted from Soviet trade deficit with the west. (b) Soviet industry is far behind the developed west in terms of technology and efficiency and the gap is getting wider. The Soviets realized this and hoped that joint ventures, together with a more liberal foreign trade regime will help to close the gap. (c) For import substitution and development of export base (d) for better integration transactions with world economy. Stressing this point. Mr. Kislanko, the head of the main engineering and technical directorate of the ministry of Foreign Trade (later merged with the State Committee for External Economic Relations to form the Ministry for Foreign Economic Relations (MVES),
commented this,
"we don't think that joint ventures should replace all other forms of economic ties. Its just one form, but a very promising one ... its success will depend not only on the Soviet side. There is much talk in the west about what Moscow ought to do in order to create the necessary conditions for joint enterprises... However they sometimes forget what the west ought to do".  

Joint Ventures are either international or foreign direct investment. In the narrow sense, JVs consist of the participation of one or more partners from country A in the founding capital of a newly established firm in country B. In Eastern Europe and the Soviet Union the term joint venture has been used for direct investment, although, at the same time other forms, especially sole ownership, are possible almost everywhere. Still participants on the joint venture model i.e. newly established firms, predominant, followed by foreign sole ownership.

Creation of a joint venture offers something more than mere cooperation. It offers the primordial advantage of sharing between partners from different countries. This sharing involves common business understandings, management  

2. Quoted by Margie Lindsay, "International Business in Gorbachev's Soviet Union", London 1989, p. 61.
activities, programming, goals and profits; and most of all common risks and responsibilities.

The whole purpose of the joint venture program, after all, was to expand Soviet financial resources and access to capital. Whether or not managerial expertise from the west could truly be utilized is another matter. But gaining access to western technology has long been a priority for soviet government and joint venture programme makes it all much simpler than when high technology in particular had to be produced in the face of a maze of restrictions and paid for with scarce hard currency now the soviets expected to have an in house technically working with them.

For the soviets the main attraction of setting up joint ventures with western firms was that the western imports of consumer goods and technology needed to reverse the trend of declining productivity in the soviet economy would be available internally in higher qualities then ever before, and it was not to cost the soviet union in hard currency reserves.3

3. This has been one of the main incentives for the soviets to set up joint ventures with foreign partners. The results, however, were not satisfactory.
Previously, when oil prices declined on world markets and the demand for soviet made weapons dropped, the squeeze on hard currency resources inevitably forced the Soviet Union to cut back on western imports. Under Gorbachev, there had been an expanded willingness to go into debt to western banks rather than cut the imports, because they comprised too important an element of Perestroika. Gorbachev and his team also believed that if joint venture program took hold, the soviets would reduce their risk in the international oil and weapons markets and would be benefited from a more diversified mix of products exported to the west. True, those exports would have been examples not of soviet creativity and workmanship but of west German, Finnish, Japanese or Italian workmanship. Yet they would be soviet made products in that they would be physically produced within the soviet union. More important, they would generate hard currency revenues for soviet treasury.\textsuperscript{4} The key requirement for the operation of joint ventures was that they cover

their foreign currency expenses with foreign currency proceeds, so in effect they would pay for themselves while providing the Soviets with all the benefits of foreign trade.

Also, according to Soviet reformers, essentially, when western firms would go into joint ventures with the Soviet Union, they would be transferring capital to Soviet economy. Given the customary distinction between debt and equity, it can be argued that putting up equity in a Soviet venture is not the same as making a loan, interest and principal are repaid out of earnings generated by Soviet exports, and there is no necessary and direct connection between the proceeds of loan and source of repayment. In a joint venture arrangement, western investors do not expect to receive a predefined level of return on their capital. However, they do expect some return, presumably more than with a loan. For their equity investment western participants expect to share in profits of the enterprise, which should be high enough to compensate them for the uncertainty as to exactly what the rate of return will be. In short, both debt and equity are claims on future revenues based on putting up capital.
From the soviet point of view, joint ventures offered significant advantages over commercial and government supported loans. It's a no loss situation. If a particular joint venture failed to meet the goals imposed by the soviet government, it could be liquidated by the soviet council of Ministers, because its activities "do not fall in line with the objectives and tasks envisaged in founding character." In the meantime the soviet economy gains from having had access to capital from outside the system. Capital was not monitored by the Bank for International Settlements on the Organization for Economic Cooperation and Development.

Attractiveness to Foreign Investors

The countries of Eastern Europe and Soviet Union were not at all important as target countries for foreign direct investment until far into the 1980s. It was only after 1985 that the possibilities for joint ventures increased considerably.

erably in the CMEA. With the wave of reforms in these countries, and the picture presented by the new economic structure. Soviet and East European economies offered considerable economic advantages for new enterprises. The success that foreign firms expect from an investment in Eastern Europe is obviously based on the assumption that the domestic economy will for a long time be unable to make use of potential profitability offered, even after a deregulation of the economy, for structural reasons, because of lack of know-how, but also because of a lack of capital. In addition to this, the Soviet Union, with its vast resources, provides attractive incentives to the foreign investors.

By investing in Soviet Union, foreign investor could get an access to the Soviet market with more than 200 million consumers. In mid 1980s, documented personal savings plus cash held by individuals totaled several hundred billion rubles. The bulk of those financial resources represented suppressed demand to be released in future.

The Soviet Union has enormous natural resources. Foreign firms could expect considerable benefits from leasing land and related infrastructure, particularly in the Far East, Siberia and Soviet North. Among the most important resources were the untapped reserves of oil, gas, non ferrous and rare earth minerals contained in the sea shelves of the Pacific and the Arctic oceans.

Foreign investors may well be interested in some aspects of Soviet technology. The level of design and technical sophistication of several Soviet products already made them internally competitive. Machine tool industry, first class manufacturing plants existed, with solid experience in producing for exports, including the Krasy Boletari plant in Moscow, the Sverdlvsk machine tool plant in Leningrad and numerous others. The technology existed also for producing numerically controlled machine tools of export quality, although that potential could not be fully realized. 7

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The Soviet Union had a relatively large pool of skilled workers and artisans. And the overall salary level substantially lower than in the west. In addition, savings could be achieved on the cost of land. Because of the country's vast territory and low population density, land lease rates were lower than those in many western countries and even in some central European countries. 8

Various empirical studies have shown that international investment decisions are increasingly inclined to favour locations that are in direct proximity to a firm's sole market and that offer that qualitative condition for manufacturing processes with high level of technological innovation such as infrastructure, qualified and skilled workers and managers and services. Production and labour cost differentials still play an important role, although this role is diminishing. A central motive is early presence on a sales market that could later prosper. For firms guided by these motives, it is important in the short term to analyze closely the future changes of a small joint venture to stand

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8. Ibid.
out the presence of a capable work force, and to become themselves better acquainted with the business environment.

Another motive some firms accordingly hoped to take advantage of the intra-CMEA trading system of trade protocols, while others also believed that they would be able to sell products to other CMEA countries for hard currency. The prospects of using joint ventures in Eastern Europe as a spring board for exports to EC appear attractive to investors from United States, Japan and threshold countries, especially of trade agreements, or even as association of host countries (e.g. Poland) with the EC eliminate customs barriers and non tariff trade obstacles.

Another motive for establishing a joint venture could be that of conceding to the wishes of the trading partner. In the past there have been such cases in Eastern European countries the firms wanted financial aid and were themselves under pressure from their ministry to establish a joint venture or wanted to gain tax advantages that applied only
Before we proceed to trace the development after the implementation of JV legislations it will be worthwhile to have a look at the general problems faced by their Eastern European economies in their transition phase.

General Problems of Investment in the Transition from a Command Economy to a Market Economy:

1. Information Problems: The discovery of specific competitive advantages takes place in a market economy via a system of relative prices, which at the international level includes the exchange rate of the country's currency. The distorted price rates caused by administrative price setting or price controls, which are still widespread in the Eastern countries, albeit to differing degrees, make it much more difficult to determine profitability potential domestically.

2. Motivation Problems: If the competitive advantages have been determined, the Eastern partner must have the appropriate motivation to realize them, and this in turn presup-

poses profitability oriented thinking and behaviour, which is the rule only in a functioning market economy. In Eastern European countries, even in Poland, this precondition is not yet at hand, the most important constitutive element of this system, a multifaceted structured private sector, still plays a marginal role in all the countries and probably contributes only about 10 percent in the social product in Poland and even less in all other Eastern European countries. Various empirical studies leave doubts whether the large state industries can allow themselves to be guided by thoughts of profitability in their behaviour, in the beginning phase of a systematic change. As a consequence, there could be considerable losses due to friction in the management of a joint firm when western investors enter into a joint venture with an Eastern state enterprise.

3. **Sales Problems**: Specific competitive advantages are sufficiently interesting for firms only when they encounter a sufficiently large market volume in the new locations. The transition from a socialist command economy to a market economy is, however, accompanied by an inevitable recession, which makes it more difficult for all firms to realize the
originally expected profits and turnovers. As a direct consequence of the forced transition to a market economy, Poland and East Germany suffered severe decline in market volumes.

4. **Procurement Problems**: The procurement of raw materials also becomes a problem in some cases. From the standpoint of potentially interested foreign investors, the attractiveness of input from the guest countries depends on its kind, availability and price.

5. **Uncertainties Concerning Organizational Capacities**: Every firm needs the necessary organizational capacities to realize competitive advantages. But in practice there remain considerable uncertainties in this regard concerning a firm's own organizational capacities to overcome internal as well as external problems in Eastern European countries. Investors in these countries cause across a number of problems related to acquisition of skilled personal mainly capable and motivated managers having necessary knowledge of foreign languages. Until a joint venture begins as operation, a multitude of other obstacles outside the firm have also to be overcome, obstacle that increase costs and therefore make
the location unattractive despite the existing competitive advantages of the firm. The problem of finding a suitable partner, licensing procedure, which has been very restrictive, registration with a court etc. delay the actual operation of the ventures. Hopes that the transition to a market economy would facilitate this procedure have not been realized in any of the Eastern European countries.


As a result of the gradual loosening of administrative control and the implementation of decentralization of the economy, the first measures concerning joint ventures were adopted in 1986. They consisted of two Resolutions of CPSU central committee and of the council of ministers of USSR "on measures to improve the management of foreign economic relations" and "on measures to improve the management of economic, scientific and technical cooperation with social-
ister countries". The two Resolutions contained two provisions of utmost importance.

First they created a new body at the ministerial level, the state foreign economic commission of the USSR council of ministers. This new body assumed the supervision and coordination of the work of all organizations involved in sphere of foreign trade. Among them were the ministry of foreign economic relations the state committee for foreign tourism. The Bank for foreign trade of USSR and the state customs Administration of the USSR council of ministers. Second the resolutions contained guidelines for the creation of joint ventures with capitalist countries. Three new decrees were enacted on January 13, 1987, retroactive as of January 1, 1987.

The first was "on questions concerning the establishment in the territory of the USSR and operation of joint ventures, International Amalgamations and organizations with the participation of Soviet and Foreign organization, firms and management bodies". The second enactment was of the USSR council of ministers "on establishment of territory of the USSR and operation of joint ventures, International Amalga-
mations and organizations of the USSR and other CMEA member countries". And the third was of USSR council of ministers "on the Establishment in the Territory of the USSR and operation of joint ventures with the participation of soviet organizations and firms from capitalist and Developing Countries". Thus the USSR became the first socialist country to opt for separate legal frame works with respect to joint ventures, depending on the country involved.

It should be mentioned at this point that joint ventures with other CMEA member-countries had been operating since May 26, 1983. That appears to be a reason for differentiating the legal frameworks in 1987. It should also be recalled that a number of specific measures and procedures have been already undertaken by CMEA member countries, arriving at an intra-COMECON integration. The joint ventures in question are regulated and financed by special COMECON institutions, such as the International Bank for Economic Cooperation and the International Investment banks. Integration within COMECON itself is undertaken under the guidelines of 15 year "comprehensive programme of CMEA member countries" specific and Technological progress up to the year 2000, which was adopted in 1985.
The key elements of these joint venture legislations included how ownership is structured, how much freedom and autonomy is granted to management, how operations are conducted with other Soviet enterprises, what kind of taxation treatment the joint ventures are given, how disputes are settled and what kind of conditions govern employee compensation and benefits. There was also the matter of guarantees from the Soviet government to protect foreign investors from being expropriated. All these points here spoke to concerns posed by Western businessmen. The fact that they had been incorporated into joint venture legislation indicated a high degree of responsiveness from Soviet government, which in turn indicate that joint ventures with Western firms were a high priority within the Gorbachev administration.

Specifically, the Soviet government had committed itself to allowing a foreign partner to hold up to 49 percent of authorized capital of a joint venture. As for management, there were to be two echelons due to function as a supervisory board responsible for making strategic decisions about composition of the balance sheet and the distribution of profits, the other as an executive body responsible for
routine day-to-day management. Both levels would have representa­tives from both the foreign and soviet partners. However, the president and the executive director of the joint venture must, by legislative decree, be Soviet citizens.

Joint ventures would have the freedom to operate on foreign markets by license from the USSR ministry of foreign trade. Within the Soviet Union joint ventures were expected to deal with appropriate foreign trade organizations, to sell to them and buy supplies from them at contractual prices to be paid in rubles. By "contractual" the soviet meant that joint ventures could negotiate prices and choose their suppliers instead by having to pay official domestic whole sale and retail prices. That would put pressure on traditional soviet enterprises not used to having to cater to customers or to compete against other suppliers all part of the plan, according to deputy chairman of the state foreign Economic Commission: "we have already explained to our own managers that this competition has been introduced internationally with the aim of pressing them to increase efficiency and quality of production".
To attract western firms to participate the incentive from soviet government came in the form of favourable tax treatment. For the first two years of operation, joint ventures would be favoured with a tax "holiday" by the soviet government, with no taxes on profits there were also additional tax incentives after the first two years. A portion of joint venture profits could be sheltered tax-free in the form of reserves that might be retained up to the level of 25 percent to the authorized capital. A portion of profits could also be used for modernization and expansion and treated as reinvestment also tax free. The remaining profit would subject to a 30 percent tax. All after tax profits were to be divided between the partners according to their shares of the authorized capital. The foreign partner presumable got up to 49 percent. The profit coming to the foreign partner could be 1) put in a soviet bank 2) spent within the soviet union 3) transferred abroad in foreign currency. The last option was subjected to a art holding fee, the exact rate of which depend on the tax agreements worked out between soviet union and various western countries. To induce other government to support joint ventures and to grant soviet enterprises reciprocal favourable tax
treatment, the withholding fee was negotiable - ranging from zero to 20 percent. 10

In the event of a dispute the joint venture legislation guaranteed the foreign partner due process of law disputes were to be settled either in the courts on through arbitration either in the Soviet Union or in the third country. The choice was up to the partners of course, since the partners were always represented in accordance with capital structure, and the capital structure was always dominated by 51 percent share owned by Soviet interests, one could assume that the choice of courts would tend to favor the Soviet side of partnership. Thus, when the Soviet government guaranteed that foreign property would be protected within the Soviet Union on the same basis as the state property, that property "could not be confiscated or expropriated by administrative decisions, and that actions pertaining to the property might be taken only through the court or arbitration.

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In general, working conditions and salaries for employees in joint ventures must comply with Soviet standards. Management would be allowed, however, to bring foreign technicians, whose salaries would be determined by individual contracts. According to the joint ventures legislation, the "residual" portion of a foreigners salary may be transferred abroad in foreign currency subjected to an income tax of 13 percent (the term "residual" suggesting that some portion of salary would be automatically deducted on behalf of the government in keeping with Soviet practice. Some managements may wish, as stated in the legislation to introduce additional personal benefit plans "with the endorsement of the trade union".

Some other issues were also meant to reduce the concerns of foreign investors. The Soviet government guaranteed remittance of profits in foreign currency — subject of course, to the decisions reached by the partners about retained earnings and reinvestment. In case of liquidation, the foreign partner was entitled to transfer abroad his contribution to the authorized capital of the enterprise at its book value on the day of liquidation part of Soviet governments guarantee under due process of law.
In their pitch to potential western investors, the soviets stressed particular advantages: abundant resources - skilled labour and a huge market. Moreover, joint ventures have no state imposed quotes or production plans to fulfill management will be entirely free to determine the level of output. Joint venture will also receive "favourable" treatment from soviet transportation and communication services. Finally, they would be exempted from customs duties on machinery and equipment that represent contributions to the capital of joint venture enterprise.\footnote{Business Eastern Europe, B.I.S.A. Feb. 9, 1987, p. 41.}

The outcome of reforms:

Although the outlines of the joint venture program were fairly clear, \textit{a great number of details remained vague}, for example, soviet domestic prices were often artificial and the ruble was not convertible. How would the soviet 51 percent contribution to the joint venture and the cost of soviet labour and supplies be priced? However, the quality of soviet supplies and their timely delivery to be guaran-
teed? would the foreign partner have the ability to select and retain the soviet engineers and workers it wanted? How would the legal restrictions against transferring information to foreign governments be reconciled with foreign requirements of reports for income tax and export control purposes? If the venture is liquidated, how was the value of the foreigners position to be evaluated?

All these ambiguities and the initial western skepticism about soviet foreign economic reforms gave an unsteadily start to the setting up of joint ventures. By October 1987, soviets had received 250 joint venture proposals, only eleven agreements could actually be signed by that time. 12 Five of the signed agreements were with West German companies and other involved firms from Finland, Japan, Italy, India and the United States. 13


The inflow of foreign investment amounted to $40 million by the end of 1987, which was by any means not an encouraging outcome.

Because no immediate enthusiastic response was forthcoming, the Soviet authorities modified their pitch, adding more bottomline financial incentives and reassuring western firms that they will have some control over their capital investment, by making changes to the earlier joint enterprises law, and allowing a majority western holdings, instead of the earlier 49 percent limit. This resolution which was adopted in December 1988, made some other changes as well - The manager of a JV need no longer be a Soviet citizen but could be a foreigner; Taxation of JVs located in the Soviet far East was waived for the first three years after profit begins to be achieved. As an additional incentive, the Ministry of Finance was granted right to waive or reduce dividend taxation for JVs located in the Soviet Far East or for any producing consumer goods, medicines, medical equipments, high-technology goods and goods of particular significance to the national economy. Fundamental questions of operation of a JV could now be resolved at a meeting of the
board on the basis of unanimity, regardless of the western state in the venture. Wages and bonuses paid to workers in a joint venture were now open to negotiation. Minimal customs duties on goods imported by a JV to develop production were now to be levied and some such goods might be totally exempt from customs duties.

Soviet officials made good on their promises to revise and improve the joint venture law to make JVs more attractive to Western partners. But there were still unanswered questions and problems to solve. The issues that remained unaddressed were: access to local supplies, financing or Soviet export policy in the Soviet economic context.

Despite the conflicts, resolved and otherwise, the December 1988 resolution was welcomed by foreign investors. A number of firms entered into joint ventures, the number of JVs registered at the end of 1989 reached 1300, and foreign investment touched $450 million. Although the number of registered JVs had no direct relation with the number of actual operating firms, still by conservative estimates...

somewhere between 25 to 35 percent of the registered firms were carrying out operations by the end of 1989. This is evident from the foreign investment flow in 1990. Though the number of JVs registered more than doubled between December 1989 and December 1990, the actual investment declined to $350 million in comparison to $450 million in the previous year. The number of JVs registered had also started declining in the second half of 1990 which can be attributed to a number of factors including the increasing economic difficulties for the local enterprises. According to Soviet sources the number of JVs at the end of 1990 so had reached 3000.

**General Trend of the JVs:**

1. The proportion of JVs already functioning, at the end of 1990 stood between 20 to 30 percent of the number of JVs registered.

2. The majority of the projects were relatively small, employing 40 percent or less, per project with a declining trend.

3. The share of JVs in Gross National Product in the first half of 1990 was 0.3 percent. It was 0.13 percent in the same period of the preceding year.\textsuperscript{16}

4. JVs largely operated in quasi enclaves concentrated in the services sector, and specialized operations where high returns were possible with low levels of capital commitment through exploitation of loopholes and inconsistencies in the existing regulations.

5. In direct foreign investment inflow the trend had been as follows. The first inflow in 1987 was roughly $40 million. Then the stream quadrupled in 1988 placed at $450 million in 1989 and begin to taper off, declining to roughly 50 percent of the 1989 high in 1991. But the dramatic drop begun after the August coup with a fall from $52 million in the quarter of 1991 to $20 million in the first quarter of 1992.

6. Cases of legal disorder and corruption were on the rise after 1989. The supply of anecdotal evidence and press reports detailing massive confusion in legal affairs was abundant on the whole.\textsuperscript{17}

7. Despite the overall slowdown in growth of economy and poor performance of foreign trade in 1990 and early 1991, the volume of sales from joint ventures doubled.\textsuperscript{18}

\textsuperscript{16} Annual Sales of JVs in the year 1990-91 amounted to around 9 billion rubles; Soviet GNP for the same period was 18 billion rubles - that brings


\textsuperscript{18} The Soviet output in 1990 fell by 8% according to official estimate for details please see - \textit{The Economist}, August 1991, p. 67. \textit{Rassivskaya Gazeta} chastised a Russian manufacturer who awarded identical but conflicting exclusive distribution contracts to a firm in Panama and to its competitor in Chile. There were several such cases. For details
That said, two aspects of their growth provide pointers to the future. First, just over a quarter of their sales were accounted for by computers and computer services. That suggested that at last, the least modern part of Soviet economy - its information technology industry had begun to pick up.

Surprisingly the bulk of the joint ventures revenues came from sales made in convertible currencies within the Soviet Union and not exports i.e. Soviet citizen and westerners paying for goods and services in dollars. This suggests that even while the rouble remained inconvertible, it was possible to earn hard currency.

The impact of foreign direct investment had been minimal in terms of both foreign capital infusion and overall contribution to economic development. The factors responsible for such an outcome could be derived from the political social and economic crisis in the Soviet Union which drastically worsened in the second half of 1990. There were also uncertainties due to the rapid change in political and economic legislations. The inadequate of the legal and institutional securities non convertibility of Rouble, size

continuation

of joint ventures information problems, procurement problems, financial problems and the practical problems of financing were important deterrents offsetting the attractiveness of the potential market mineral riches, low labour costs as well as the drive to beat out competitors by being first.

The list doesn't end here. In 1990 the Institute of International Economic of Washington D.C. reported the results of a formal private sector survey of 54 "fortune 500 size" western investors in the Soviet Union and Eastern Europe (Collins and Rodrik, 1991) political uncertainly the major perceived obstacle, was followed in descending order by lack of legal protection for private property, inability to repatriate earnings, bureaucratic complication, poor distribution systems, lack of information and unproductive labour force at the bottom of the rating scale.19

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Keith Crane attempted to create a composite picture of the concerns and factors that large multinational companies interested in the Soviet Union weighed in making investment decision. The investigation embraced several hundred clients in America, Europe and Japan and the results were large potential investors were focused on the size of the market and stability of the macro economy. Aggregate economic indicators such as output and inflation rates were monitored for use as signals to postpone investment decisions. In the absence of sensible monetary and fiscal policies, no one was too optimistic about convertibility dimming prospects for unrestricted repatriation of profits. 20

The nonconvertibility of the ruble caused difficulties from the very outset in calculating a partners capital share. The founding capital which was set by both parties as a definite ruble sum, was in practical terms always a combination of currency investments, machinery and equipment technologies, know how etc. Now the deserved sum of basic capital were to be achieved was thus necessarily an object

20. Ibid., p. 311.
of laborious and prolonged negotiations. The existence of at least three different exchange rates, the official, the commercial and the special auction rate, added additional confusion to the negotiations. Still, a decree of the Ministry of Finance of 6 June 1990 eliminated some of the discrepancies between Soviet and Western book keeping procedures, so that it was now easier to determine important financial parameters, but especially profits, in accordance with western principles.

In view of extreme overvaluation of Rouble compared with the US dollar and the high rate of inflation more than 10 percent at the end of 1990 direct foreign investment in Soviet Union were exposed to an especially grave threat in the form of the risks of devaluation, which could be contractually diminished only to a limited degree. The risk referred not only to the possible loss of value in hard currencies after a potential repatriation of capital investments if the western partner terminated his direct investment or after taxation of ruble profits due to devaluation if imports were in hard currencies. Both of these risks could be at least mitigated by exchange rate guarantee
clauses. But it is also true that devaluations destroyed the premises on which a JV operates. All JVs in Soviet Union had calculated more or less precisely what share of production must be exported and how great the share of imports must be to achieve the desired share of hard currencies in total turnover the calculation would then have to be made anew.

Price reform, which had been overdue for years, proved to be one of the most central problems facing foreign investors. The distortions in the price system made it more difficult for foreign investors to determine their own competitive advantages in a serious manner in a Soviet locality. For that reason, the investment risk was generally high and accordingly, the amount of investment remained low. Moreover there also remained considerable uncertainty as regarding the scale of the often announced price reform. Originally, there was to have been an administrative adaptation of prices to an equilibrium level but no total liberalization of price as in Poland and Hungary. Of course that would not have eliminated the fundamental difficulties driving from the lack of a functioning system of relative prices. But in the mean time the future of the economic reform in general had become doubtful. Another difficult
area was the question of financing joint ventures. In general, JVs could obtain credits in Rubles and in foreign currency. Credits in foreign currency came either from Uneshe-konom bank or from foreign banks, with the consent of the latter. If there is no sufficient security, a firm must pay higher guarantee fees. In addition, western banks endeavor to share the financial risk with Vueshekonombank in accordance with the capital shares of the participants of a JV receives a credit. The political developments in the Soviet Union around 1990-91 contributed adversely to the financial environment of joint ventures.

Incentives Given:

Not that the Soviet authorities did not realize the existence of these problems, they did and took steps to remove source of those obstacles by providing incentives in the form of liberalizing various JV laws and also taking steps to make the environment congenial for western investors.

According to the Union law on "The Taxation of Enterprises, Associations and Organizations" of June 1990, only
JVs with a foreign capital share of more than 30 percent would enjoy the advantage of a special profit tax of only 30 percent, while JVs with a smaller capital share as well as most Soviet firms must reckon with a general tax rate of 45 percent.21 This gradation was meant to stimulate greater foreign participation.

The Soviet government also endeavored to facilitate the access of JVs to hard currencies. Earlier versions of the JV law permitted them to earn profits in hard currencies only through corresponding export. But with the revisions of JV laws, JVs could sell their products on Soviet market for hard currencies. In addition, since September 1990, on the basis of the council of Ministers' decree of 4 August on "the Formation of a Foreign Exchange Market" JVs could participate in the foreign exchange auctions held every two weeks by Vueshekonombank. These auctions were one way, of course not the optimal way, of changing easily earned profits from ruble transactions into hard currency. Accord-

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ing to Vueshnekonombank reports, JVs represented the largest single group of hard currency buyers at auctions. Cases have been reported where individual JVs had applied to purchase up to 3 million U.S. dollar, which indicates an enormous profit in rubles. The average sales rate was between 20 and 23 rubles per U.S. dollar, the commercial rate was about 1.66 U.S. dollars. The turnover increased from $10 million in September to $23 million in December 1990.

The presidential decree of 2 November 1990 "on foreign Exchange rules in 1991" also gives special treatment to JVs: JV and other forms of foreign engagement are not obliged, as are Soviet firms, to pay 40 percent of their export earnings in hard currencies to the bank at the commercial exchange rate.

These incentives no doubt encouraged foreign investors to participate in JVs in the Soviet Union, but in a limited way as the whole outcome was influenced by a number of other factors.

Assessment

The impact of foreign direct investment has been minimal in terms of both foreign capital infusion and overall contribution to economic development. Apart from the severe limitation of the inadequacy of legal and institutional structures, other obstacles stem from the risks and practical difficulties of conducting business in the USSR and the centralized allocation mechanism.

Notwithstanding the lacklustre performance, during this period, foreign direct investment could potentially make a major contribution to the structural transformation of the economy through capital infusion, the transfer of technology and managerial skills and, equally important, by exposing domestic enterprises to market competition.

A substantial increase in foreign direct investment, however could be expected only once the fundamental improvements had been made in the political, economic and regulatory environment. There was need for the reform effort to concentrate on three main areas: the broad constitutional aspects and legal system, the economic setting; and the
specific regulatory structure applying to foreign investment. There was need for an unambiguous determination of the legal status of private sector activity and a clear definition of the regulatory responsibilities of the different levels of government. Foreign investment could well have been regulated under laws, rules and regulations emanating from different levels of government. In the uncertain economic and political atmosphere, law on property for protecting foreign investors from confiscation and expropriation could have been timely.

Economic conditions for conducting business were inadequate and should have been extensively improved. This is as essential for domestic enterprises as for foreign investors. The latter needed to see a rapid development of domestic wholesale markets and liberalization of trade they could have had readier access to needed inputs. The development of domestic credit markets were essential and convertibility of the ruble could help enterprises manage their foreign exchange needs. In addition, potential foreign investors would be affected by the extent of competition permitted in domestic market as well as the extent to which all union market
remains intact.

Regulatory requirements applying specifically to foreign direct investment should have been simplified and legal protection strengthened. Authorization procedures needed to be liberalized and streamlined. Investment screening Investment policies should have been based on transparent criteria and confined to a very few sectors. Impediments to investment in service activities should have been removed. Administrative as well as legal guarantees were needed for the repatriation of investment income and the proceeds from liquidation and for the extension of full investment protection. Adequate arbitration and dispute settlement procedures should have been put in place. In all these areas regulatory mechanism and procedures should have conformed closely to internationally agreed principles and understandings. The draft foreign investment law presented to the supreme represented a step in right direction but still fell short of international standards. For example profit remittance and capital repatriation continued to be restricted to what could be self financed from retained foreign exchange proceeds.