

# **RUSSIA**

## **TRADE SUMMARY**

The U.S. trade deficit with Russia was \$8.9 billion in 2004, an increase of \$2.7 billion from \$6.2 billion in 2003. U.S. goods exports in 2004 were \$3.0 billion, up 20.9 percent from the previous year. Corresponding U.S. imports from Russia were \$11.8 billion, up 37.5 percent. Russia is currently the 38<sup>th</sup> largest export market for U.S. goods.

The flow of U.S. foreign direct investment (FDI) to Russia in 2003 was \$1.2 billion, up from \$666 million in 2002. U.S. FDI in Russia is concentrated largely in the banking and information sectors.

Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). By the end of 2004, the Government of Russia had met over 20 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. In 2004, the Russian Federation concluded bilateral agreements on goods and services market access with the European Union and other WTO members; negotiations continue with a number of other trading partners, including the United States.

## **IMPORT POLICIES AND PRACTICES**

Russia continues to maintain a number of barriers with respect to imports, including tariffs and tariff-rate quotas, 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 or modify them to be consistent with internationally accepted trade policy practices.

### **Quotas**

In January 2003, the Russian Government announced the imposition of a quota for poultry and tariff-rate quotas for pork and beef. These quotas became effective in April and May 2003, respectively. The United States reached an agreement in principle in September 2003 with the Russian Government for market access parameters on poultry, pork and beef. The agreement has yet to be finalized. However in November 2003 and December 2004, Russia announced quota allocations for U.S. poultry, pork, and beef for 2004 and 2005, respectively, based on historical U.S. export levels as provided for in the agreement.

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## **Customs**

The new Customs Code, which is intended to bring Russia's customs regime into compliance with WTO requirements, came into force on January 1, 2004 and, despite some early transitional difficulties, overall assessments have been positive. The new Code simplifies customs procedures and establishes specific procedures for the application and payment of tariffs. Draft legislation on customs valuation is being prepared within the Government of Russia and will take the form of amendments to the Customs Tariff Law. 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. Russia has announced that it is considering a pre-shipment inspection program for selected goods, although such a program has not yet been formally introduced.

Since 1995, Russian import tariffs have generally ranged from five percent to 30 percent. Import tariffs have declined in importance as a revenue source in recent years, but they remain significant. Under a major revision of the Russian tariff system that took effect as of January 1, 2001, 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 higher tariffs on some used goods. The Russian government proceeded with the tariff unification to help combat customs fraud and improve collections; however, while there have been some improvements in this regard, the overall weakness of Russian customs administration still leads to many abuses.

A value-added tax (VAT) is applied to virtually all imports, and excise taxes are applied to a small selection of goods. As of January 1, 2004, the VAT, which is applied to the price of the imported good plus its tariff, was reduced to 18 percent, and there are ongoing discussions to lower it to 15 percent or 16 percent at some point in the future. 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.

Several industries complain of excessively high tariffs and discriminatory tariff policies over a range of sectors, including motorcycles, sugar, distilled spirits, wine, fruit, processed food, and forest products. Pharmaceutical importers have complained that new pharmaceuticals imported in the clinical trial stage (prior to registration) were improperly assessed the VAT because they could not produce a certificate of registration. Russian import tariffs on automobiles, aircraft, and aircraft parts 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, in 2003 the Russian government passed a law that increased customs

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duties to 25 percent of the customs value for used cars between three and seven years old. 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 and other customs handling fees, the amount of total taxes paid on the importation of foreign aircraft exceeded 40 percent in 2004.

### **Non-Tariff Barriers**

The Russian government continues tight controls on alcohol production (including wine), 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 encryption software and related equipment, radioactive materials and waste including uranium, strong poisons and narcotics, medicines and dietary supplements, raw and processed sugar, combat and sporting weapons, self-defense articles, explosives, military and ciphering equipment 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 Ministry of Internal Affairs. In some industries, such as pharmaceuticals, alcohol, and encryption software and related equipment, activity licenses are also required. According to U.S. information technology companies, overly broad and non-transparent import licensing requirements on cryptography equipment, combined with unclear product standard requirements, create a barrier to doing business in Russia.

With respect to pharmaceutical products, government decisions regarding which products to place on reimbursement lists for state-provided healthcare are having an adverse impact on U.S. exports to Russia. U.S. industry reports that higher-priced imports, which are often safer and of a higher quality than locally produced pharmaceuticals, are often discouraged from appearing on reimbursement lists and state purchases because the government focuses more on price concerns than on the quality and safety of the products.

Although Russia is expected to form one of the largest global markets for new nuclear plants, nuclear fuel, and enriched uranium over the next decade, U.S. companies' ability to supply the market continue to be hindered because of Russia's lack of nuclear liability coverage, which creates a prohibitive risk to business operations. Because no private company can operate without such liability insurance, the Russian state-owned nuclear energy company, TVEL, occupies an unassailable position in the domestic market. At present, Russia is not a signatory to either the Paris or Vienna Conventions related to nuclear liability.

While U.S. exporters face a variety of trade barriers in Russia, lower-than-expected imports from the United States can also be attributed to aggressive marketing and investment strategies of European companies, particularly in the consumer product, food processing, light manufacturing and machinery sectors, bolstered by geographical proximity. However, strong economic growth

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and an appreciating ruble have led to increased Russian purchasing power and have allowed U.S. agricultural export levels to rebound.

## **EXPORT POLICIES AND PRACTICES**

The Russian government's industrial policy guidelines emphasize export promotion and import substitution. In practice, there has been limited budgetary funding for such initiatives. The subsidy-like effect of Russia's current domestic gas pricing policy is a key issue due to the potentially adverse impact this policy may have on certain U.S. industries. The price of gas for Russian industrial consumers is artificially low, and, according to numerous reports, prices are well below the full cost of production. The downstream effects of this pricing policy are significant, as gas sells on Russia's domestic market for about \$25/tcm, while estimates of 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 monopoly supplier, play a significant role in Russia's economy. The Russian Government is proceeding slowly and cautiously with reform of the sector. 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.

Russia maintains export taxes on a variety of products. In May 1999, Russia imposed a 15 percent export tariff on ferrous steel scrap (amounting to not less than 15 euros per metric ton). Additional restrictions preventing steel scrap exports from certain Russian ports were imposed in 2001 and subsequently removed in early 2004. At a time when world demand and prices have been rising the export tax has tended to increase Russian steel scrap supply, providing artificially low scrap costs to Russian steel producers while limiting global supply of a key steel input. 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.

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

U.S. companies report that Russian standards and procedures for certifying that imported products and equipment meet those standards are non-transparent, expensive, time-consuming, and redundant. Russian regulatory bodies seem reluctant to accept foreign testing centers' data or conformity assessment certificates. U.S. firms active in Russia have also 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. Russia claims that amendments to the Law on Certification of Products and Services, which took effect July 31, 1998, generally

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meet the requirements of the WTO. The law allows a manufacturer to submit a declaration of conformity as part of the conformity assessment certification procedure for a limited number of products. The government of Russia has established a list of 200 products eligible for this procedure. U.S. industry estimates that approximately 30 percent of the 22,000 Russian standards now conform to international norms.

On July 2, 2003, the Law on Technical Regulations came into force. The law is intended to bring Russia's standards regime into compliance with WTO norms and streamline the adoption of standards and the conformity assessment certification process for imported goods. Under the provisions of this law, many 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 a voluntary standard.

The current Russian product certification regime makes it difficult to introduce foreign-produced 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 procedures for telecommunications equipment were thrown into confusion on January 1, 2004 when the Law on Communications went into effect, eliminating old certification procedures without replacing them with new ones. The law was a step forward in one sense, since it allowed for manufacturers to self-certify some products. However, no implementing regulations have been released specifying which equipment is eligible for self-certification. The situation is causing serious problems for telecommunications equipment providers who are unable to get new products certified for import, especially for those companies that regularly introduce new products with short life-spans (such as mobile phone manufacturers). Implementing regulations are not expected to be completed until mid-2005.

In December 2002, the Russian Ministry of Health established a mandatory conformity assessment requirement for pharmaceuticals. This certification requirement appears to be duplicative of other certification requirements for pharmaceuticals and could lead to delays in the marketing of medicines. Although the 2002 certification requirement was to be replaced by self-certification through a declaration of conformity in 2004, to date no guidelines have been issued for the self-certification scheme. Companies therefore must continue to comply with the old certification requirements. In addition to pharmaceuticals and telecommunications equipment, manufacturers of alcoholic beverages are also subject to certification requirements imposed by the Federal Agency for Technical Regulation and Metrology and the Ministry of Health.

Russian sanitary and phytosanitary (SPS) measures are often burdensome and at times do not appear to be grounded in science-based concerns regarding food safety. Bioengineered food products are likely to continue to attract regulatory 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

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concerns. In August 2002, the United States concluded intensive negotiations with Russia on a new veterinary certificate for U.S. poultry. In December 2003, the Russian government announced a ban on U.S. beef after the detection of one positive case of Bovine Spongiform Encephalopathy (BSE) in the State of Washington. Russian officials, however, 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.

## **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 clearer guidelines. A draft law on government procurement was being considered within the Government of Russia in late 2004. The law would eliminate restrictions on the participation of foreign suppliers, ensure transparency of the government procurement mechanism, and reduce opportunities for corruption. However, the draft law also contains a provision that would allow the government to limit procurement of foreign goods, works or services. Domestic suppliers are not currently 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. The new Law on Telecommunications overrode an amendment to the Federal Law on Communications that encouraged government agencies to purchase Russian-produced equipment.

## **INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION**

Significant deficiencies remain in Russia's regime for the protection of intellectual property. Due to these deficiencies, a case remains pending to review Russia's status as a beneficiary country under the U.S. Generalized System of Preferences (GSP) Program. Russia has been on the Special 301 Priority Watch List since 1997.

Intellectual property violations continue to be a serious problem in Russia. According to industry sources, estimated losses to U.S. copyright industries due to copyright piracy (films, videos, sound recordings, books and computer software) continue to exceed \$1 billion annually. 2004 saw a continued rise in illegal optical disc production capacity far in excess of Russian demand, with pirated products intended not only for domestic consumption but also for export. The U.S. film industry estimates that over 80 percent of all DVDs on the Russian market are pirated. Piracy of music is estimated at approximately 66 percent of sales, and software piracy at approximately 88 percent.

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In 2004 the Russian government took some steps to combat IPR problems. Following reorganization of the Russian government in the spring of 2004, IPR issues were placed under the direction of the Minister of Science and Education Andrey Fursenko, who has stressed the importance of protecting intellectual property in order to stimulate Russian innovation and economic development. The Federal Service for Intellectual Property, Patents and Trademarks (Rospatent) has been given an overall coordinating role between the various Russian government agencies involved in IPR issues.

In July 2004, the Interministerial IPR Commission, which was established in 2002 and was reconstituted under Prime Minister Fradkov, approved an IPR Action Plan that includes a combination of legislative changes, administrative measures and enforcement actions to be undertaken by a variety of federal ministries. While the plan contains a number of welcome actions, its success will rely primarily on the effectiveness of the Russian government's enforcement efforts, which remain the weak link in Russia's IPR regime.

In order to gain accession to the WTO, Russia has passed a number of laws in order to meet obligations under the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). In 2004, Russia passed amendments to the Law on Copyright and Related Rights to provide protection for pre-existing copyrighted works and sound recordings. In 2002 and 2003, Russia enacted amendments to laws on trademark and appellations of origin, patents, protection of layout designs for integrated circuits, plant varieties, and protection of computer software and databases. 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. The Russian government's Licensing Law, adopted in August 2001, included licensing requirements for optical media producers, and several licenses were suspended in the summer of 2004 for failure to meet these requirements. However, U.S. copyright industries believe that the licensing scheme provision is inadequate to control optical media piracy and have pressed the Russian government to adopt a comprehensive regulatory framework dealing with the production and distribution of optical media.

Despite concerted efforts, several other deficiencies remain in Russia's IPR regime, including: a lack of explicit protection for test data for pharmaceutical products and agricultural chemicals, denial of national treatment for protection of geographical indications, and problems with enforcement.

U.S. and multinational companies also continue to report counterfeiting of patented and trademarked goods as a serious problem, especially for consumer goods, distilled spirits and pharmaceuticals.

While the Russian government has begun to pay more attention to IPR enforcement, this issue remains the weak link in the protection of IPR in Russia. Even where Russian law provides for serious penalties such as the destruction of counterfeit or pirated goods, goods seized during enforcement actions are rarely destroyed and consequently may return to the stream of

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commerce even if they are found to be illegal. In the vast majority of cases, alleged infringers receive miniscule fines or suspended prison sentences.

Administrative and judicial review bodies are beginning to become active in protecting IPR in Russia, and the number of police and judges with relevant expertise, though still small, is expanding. At the prosecutorial and judicial levels, many officials still do not consider IPR infringement a serious offense when 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 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 patent disputes.

## **SERVICES BARRIERS**

Discrimination against foreign providers of non-financial services is, in most cases, not the result of federal law, but can stem from 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.

Central Bank regulation 721-U previously 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 (e.g. Russians seeking to buy foreign currency to pay foreign suppliers), 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, signed by President Putin on December 10, 2003, eliminates the need for advance permission but requires Central Bank notification in most circumstances unless specifically noted in the law. Under the new law, all currency controls are to be lifted by 2007.

## **Financial Services and Insurance**

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, although the Central Bank has never availed itself of this clause. Russia has been asked to clarify the situation and explicitly remove any limits as part of its WTO accession, and the Central Bank has indicated that it does not want to dissuade foreign banks from operating in Russia. Since 1997, the Central Bank has required new foreign bank subsidiaries to have a minimum of Euro 10 million in capital (the same requirement is applied to domestic banks) and that 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 WTO accession talks, the United States has urged the Russian side to liberalize

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completely by allowing branches, as well as subsidiaries.

In the insurance sector, since 1999 foreign majority-owned insurance companies have been allowed to operate in Russia subject to a 49 percent equity restriction. (Foreign firms that were active in Russia when this requirement came into effect were grandfathered in and not subject to the foreign cap limit.) In addition, total foreign capital in the Russian insurance sector is limited to 25 percent. However, on January 17, 2004, a law came into effect that effectively exempts EU-based insurance companies from the 49-percent cap (based on a 1994 Russia-EU treaty). This exemption also applies to insurance companies based in the EU that have since been purchased by non-EU foreign companies. 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.

### **Telecommunications**

In the telecommunications sector, the new Law on Communications went into effect on January 1, 2004; however, final implementation regulations corresponding to the Law have not been released. The Law's impact on the business of competitive 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 the tight regulatory authority of the Ministry of Communications. Alternative operators fear that interconnection fees will be raised in order to subsidize network upgrades of 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, and have criticized the five- to ten-year license terms, 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 negotiations on Russia's WTO accession, and current WTO members have expressed concern that the new Law on Communications may de-liberalize a now relatively open market, particularly through the adoption of new rules and regulations as set forth under the new Law.

In December 2004, the legal situation in the telecommunications sector was no clearer than at the beginning of the year. As noted above, the Law on Communications is a framework law that depends on implementing regulations in order to function properly. Very few of these regulations have been completed, leading to much legal confusion in the sector over such important issues as licensing requirements and procedures, equipment certification, and the nature of the Law's universal services provision. The regulations are not expected to be

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completed until the middle of 2005.

Significant barriers have been identified in the provision of satellite telecommunications services in Russia. In particular, satellite regulation is not transparent, and the legal requirements and administrative responsibilities associated with the provision of these services appear to be discriminatory. The Russian Federation establishes a preference for the use of Russian satellite communications systems, which puts competing satellite systems at a disadvantage.

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. Tax preferences formerly provided to Russian film producers were abolished effective January 1, 2002.

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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. In 2004, the Russian Duma did not actively consider ratifying the Bilateral Investment Treaty (BIT) between the United States and Russia that was signed in 1992 and ratified by the U.S. Senate that same year.

Corruption in commercial and bureaucratic 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 to address these shortcomings, either through regulation, administrative reform or government-sponsored voluntary codes of conduct have made little headway in countering endemic corruption. More transparent implementation of customs, taxation, licensing and other administrative regulations is necessary. Anecdotally, transfer-pricing tactics continue to be employed by large Russian holding companies to the detriment of minority shareholders.

### **National Treatment**

The 1999 Investment Law codifies principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, protect rights in 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

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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 those 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 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. Discussion on specific land policy continues, including legislation on transfer of use, but a conclusion has not yet been reached. 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 addition to a burdensome certification process, the satellite industry reports that a local presence requirement and discriminatory treatment create barriers to doing business in Russia. Telecommunications companies also report investment restrictions.

## **Taxes**

Effective January 1, 2005, the Unified Social Tax, which is paid by employers and covers pensions, healthcare and social security, dropped from an effective rate of about 30 percent to a top rate of 26 percent on salaries up to 280,000 rubles (about \$10,000) a year. A major tax reform law became effective January 1, 2001 and reduced tax-related investment barriers, substantially amending the VAT, excise taxes, personal income tax and unified social tax. It established a flat income tax rate of 13 percent for residents and 30 percent for non-residents. The corporate profit tax has been 24 percent since 2002.

Regions and municipalities have the authority to grant exemptions to the regional portion of profits taxes, with some regions granted specific regional exemptions, particularly the Leningrad region. Regions are not able to grant individual tax exemptions.

The VAT refund system functions poorly. Companies report that VAT refunds due to a Russia-based exporter, which should be provided within three months after a claim is submitted, often do not occur on time, with customs and tax authorities applying a number of burdensome additional requirements for refunds. In addition, input VAT is often not refunded for a number of reasons, forcing exporters to avail themselves of the court system. VAT refunds on exports

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are also the source of a great deal of fraud, making it that much more difficult for legitimate exporters to obtain their refund.

Duties on the production and export of oil, which are generally quite high, have been adjusted several times over the past few years. In 2003, new legislation restored full discretion to the Russian government in establishing export duties on refined petroleum products. To take advantage of revenues generated by high oil prices and foster diversification in the economy, changes in the tax code in 2004 shifted the burden away from manufacturing and services and towards the energy sector. In 2004, the Government considered bills to establish a legislative mandate for a differentiated tax on oil production and, more broadly, higher taxes in the oil sector, but nothing has been signed into law as of yet.

### **Energy Sector**

A new Law on Natural Resources (also called the Subsoil Law) is expected to be presented to the Duma in spring 2005 with passage most likely slated for the middle of the year. The law deals with the natural resources licensing regime and represents a modest improvement over the current law (as amended). In the current draft, the government has included several of the key provisions that industry had been seeking, including a guarantee that licenses will carry over from the exploration to the development stage, a provision that licenses will be based on civil rather than administrative law, and a limitation on the number of reasons for license revocation. However, the law will likely also include a provision allowing only companies registered in Russia to participate in auctions to win the right to use natural resources. There is also a possibility that the law will contain language reserving the right for the Russian government to allocate certain "strategic" reserves outside of a transparent auction process.

In September 2004, the government announced that Gazprom would merge with state-owned oil company Rosneft, and through a share-swap grant the state a direct, controlling stake in the gas giant. President Putin also indicated that the "ring-fence" -- the cap on foreign share ownership in Gazprom -- would subsequently be eliminated. Removal of the "ring fence" would clearly be a boon for investors (increased ability to trade in Gazprom shares) and Gazprom (improved access to capital), but the long-term significance is that it is the first step in reforming Gazprom. However, it is unclear whether the government has the political will to follow through with reform of this omnipresent giant. In addition to this, Gazprom has been acquiring other assets in related industries (electrical generation and oil) in what appears to be an effort to create a national champion in the energy sector. Several major oil companies are working out the terms for joint exploration and development of large gas fields under Gazprom's control.

In 2003, President Putin signed legislation implementing legal amendments restricting Russia's use of 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. These amendments severely limit the number of energy deposits eligible for PSA status and favor companies that bid to develop energy deposits on a non-PSA basis. The PSA amendments 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.

More than \$5 billion has been invested to date in the Sakhalin II consortium, and ExxonMobil has announced that it is proceeding with a \$12 billion development plan for Sakhalin I. The \$2.6 billion Caspian Pipeline Consortium (CPC) project, inaugurated in 2001, has periodically 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. CPC is currently working out the details that will allow expansion of the pipeline's capacity.

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. In addition, non-transparent regulations concerning environmental permits and pipeline access remain of concern to potential U.S. investors.

## **Aviation**

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 to 49 percent would be sufficient to attract capital 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

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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.

Despite continued bilateral assurances that the Russian Government would join the Agreement on Trade in Civil Aircraft, Russia has expressed an unwillingness to join the Agreement in the context of WTO accession. Through 2004, discussions continued with the aim of securing a commitment that Russia join the Agreement, including adopting a commitment to eliminate tariffs on aircraft and parts.

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 the leasing of Russian-manufactured aircraft, the Russian Government has injected over \$100 million (in the form of share purchases) into two domestic aircraft leasing companies -- Ilyushin Finance Company (IFC) and Finance Leasing Company (FLC). Several Russian airlines operate Western aircraft. Two of the airlines (Aeroflot and Transaero) acquired these aircraft through tariff waiver schemes in the mid-1990s. The other airlines that operate Western aircraft acquired them more recently and paid the import tariffs. While Russian airlines have been vocal about seeking further tariff waivers, the Russian Government has been equally vocal in saying they will not be granted.

### **Capital Flows**

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. A new law on currency controls took effect in 2004, which reduces the maximum amount to which Russia's surrender requirement for export earnings may be set to 30 percent, and which will completely abolish the requirement by 2007. In November 2004, this surrender requirement was reduced to 10 percent of export earnings, well under the 30 percent limitation imposed on the Central Bank. Investors may repatriate coupon payments on government and corporate bonds and invest in other bonds. Licenses are not required for most transactions transferring money into or out of Russia, but proper notification is required. Russia also maintains an advance import prepayment requirement that serves as a trade barrier.

### **ELECTRONIC COMMERCE**

E-commerce has yet to become a serious market in Russia. Though Internet access in Russia is steadily growing, penetration is only around 15 percent of the population, with roughly half of these users located in the Moscow and St. Petersburg regions. Relatively low usage, combined with a low number of credit card users and onerous tax laws means that e-commerce will grow slowly in the near future. An electronic commerce bill has been under consideration for several years. The bill, while closely following an International Chamber of Commerce model bill, has

### **FOREIGN TRADE BARRIERS**

significant 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 World Intellectual Property Organization (WIPO) Digital Treaties should help promote the development of electronic commerce in Russia.

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.

A law on electronic digital signatures came into effect in 2002. The law defines electronic signatures strictly, making public-key technology the sole acceptable digital signature technology. It also requires that hardware and software used in digital signature authentication programs be certified in Russia. This gives the Russian government the right to insist on the decompilation of electronic signature programs, and thus gives the government access to the source code.

#### **OTHER BARRIERS**

The U.S. logging industry reports that illegal logging accounts for as much as 20 to 30 percent of Russia's timber harvest. Illegal wood supplies have begun to appear in China, hurting U.S. exports to that market.