

## Doing Business Framework: A Case Study on Sourcing from Russia

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### Abstract

Today, the countries are moving towards borderless world, enabling flow of goods and services under less restrictive environment. The extent to which the flow is free is associated with different dimensions of "openness to trade" by different countries. These dimensions are broadly classified under tariff and non-tariff barrier for goods and services and General Agreement for Trade in Services (GATS) for services. However, goods not only move exclusively under buyer-seller transaction (that is exporting-importing mode), but also through buyer's originating their supplies to their country by setting up of business (as subsidiary, own company or joint ventures) in the sellers' country. This refers to buyers' setting up business in sellers's country to ensure an un-inhibited flow of goods. This is feasible based on the extent of ease of doing business (EODB) in a particular country. So far, the dimensions associated with EODB have been laid down by the World Bank, especially to measure the rank of each country in EODB. In this paper, a systematic literature review of the relevant dimensions has been carried out. The results show that EODB index computed by the World Bank misses out many of the salient dimensions. The study has been extended to compare Russia with India in the proposed framework incorporating all significant dimensions.

**Key Words:** Doing Business Framework, Sourcing, GATS, EODB Countertrade.

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**1. INTRODUCTION**

Today the countries are moving towards borderless world, enabling flow of goods and services under less restrictive environment. There are different forms of sourcing across borders. These include Direct or Indirect Export and Production in Foreign Country. The forms of direct or Indirect Export include exporting, piggybacking and countertrade. The different forms of production in foreign country include contract manufacturing, licensing, franchising, management service contract, turnkey projects, foreign direct investment, joint venture and wholly owned subsidiary. The extent to which the flow is free and associated with different dimensions of “openness to trade” by different countries. These dimensions are broadly classified under tariff and non-tariff barrier. However, goods not only move exclusively under buyer-seller transaction (that is exporting-importing mode), but also through buyer’s originating their supplies to their country by setting up of business (as subsidiary, own company or joint ventures) in the sellers’ country. This refers to buyers’ setting up business in sellers’ country to ensure an un-inhibited flow of goods. This is feasible based on the extent of ease of doing business (EODB) in a country. So far, the dimensions associated with EODB have been laid down by the World Bank, especially to measure the rank of each country in EODB.

**2. LITERATURE REVIEW**

**Cavusgil et al (2012)**, in their book on doing business in emerging markets, identified the key dimensions as competition (from domestic players), economic restraint, government rules and regulations (on investments, trade finance, and taxation), infrastructure efficiency and cultural factor. These were quoted as uncontrollable factors. Brunetti (1997) carried out a questionnaire survey of more than three thousand entrepreneurs spanning over 69 countries. The questions focussed on perceptions of investors on key dimensions such as predictability of laws and policies, reliability of judiciary, corruption and security of intellectual property rights (IPR). The findings are shown in table 1 as below.

**Table 1: Doing Business: Issues and Challenges**

Economy	Issues	
Less Developed Country		
Unreliable judiciaries are perceived as major problems in many developing countries. This applies in particular to the Commonwealth of Independent States and to Latin American countries Commonwealth of Independent States.	Uncertainty in policies and unforeseen variations in rules that can seriously affect their business. Entrepreneurs are the most sceptical about new announcements.	There is a perception that authorities do not adequately guarantee their personal safety and do not reliably enforce their property rights. Finance, higher taxes and tax regulation are also major obstacles
Latin America	Corruption, Crime, theft, and inadequate infrastructure.	
Asia	Entrepreneurs have the most trust in government	Entrepreneurs in South Asia and Southeast Asia ranked

	announcements of policy changes and changes in rules;	the top obstacles to doing business as high taxes and tax regulations, inadequate infrastructure, inflation, labor regulations, and regulations for starting new businesses and operations
Latin America	Half of firms surveyed do not believe government announcements.	
Worldwide	Cost of doing business is substantially increased by theft and crime and	
Industrial countries	Major hindrances to doing business include tax regulations and high taxes, labor regulations, safety or environmental regulations, financing, regulations for starting new business and operations, and general uncertainty about the costs of regulation.	
Middle East and North Africa,	Lack of infrastructure a major obstacle	Corruption, high taxes and tax regulations, and financing are also issue of concern.
Sub-Saharan Africa	Corruption, tax regulations and high taxes, bother the entrepreneurs	inadequate infrastructure, inflation, crime and theft, and financing are also issue of concern.
Central and Eastern Europe,	Higher taxes and tax regulations  Firms do not believe government announcements	Financing, corruption, and inflation are also matter of concern.

**Gee et al (2015)** examined the issues and prospects of doing business in China. They concluded that major issues relate to cost of doing business in that country, restrictions on human capital and competition as major factors that impact doing business in China. **Swanz (1995)** indicated that the major factors include socio-economic environment, taxation rules, commercial laws, accounting and auditing, monetary issues and getting a business started in China. **Dunfee (2001)** **Tsang (1998)** worked on impact of Guanxi (relationship built amongst individuals) on doing business in China. **Harwit (1996)** stressed on constituents of export and import contracts, elements of logistics such as packaging, transportation and inspection processes. This works points out the discrepancies in regulations related to residence, trademarks, litigation, taxation and setting up of new ventures. **Pan, Fan and Zingang (2004)** pointed out that cross-cultural challenges are a significant dimension in doing business in a country such as China. The business climate has been uncertain in Russia in 1990s (**Puffer and et al., 1998**). The situation has been improving and the major challenges include, foreign employee regulations, currency exchange rates, sanctions, and localisation (**Shaposhnikov, 2015**), **Fey et al (2006)** concluded that 8 eight

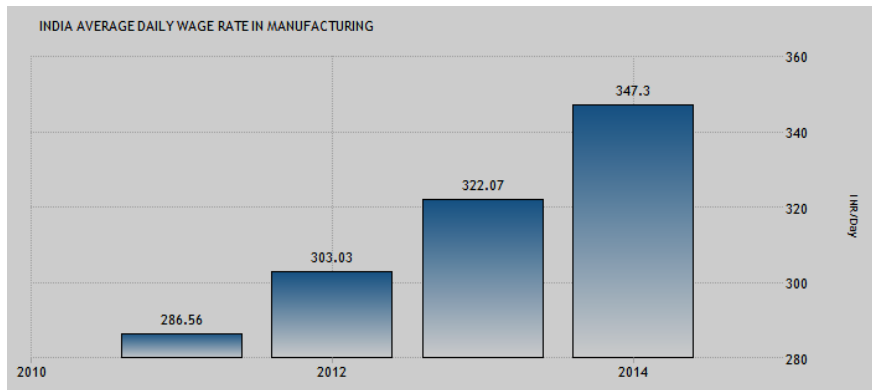
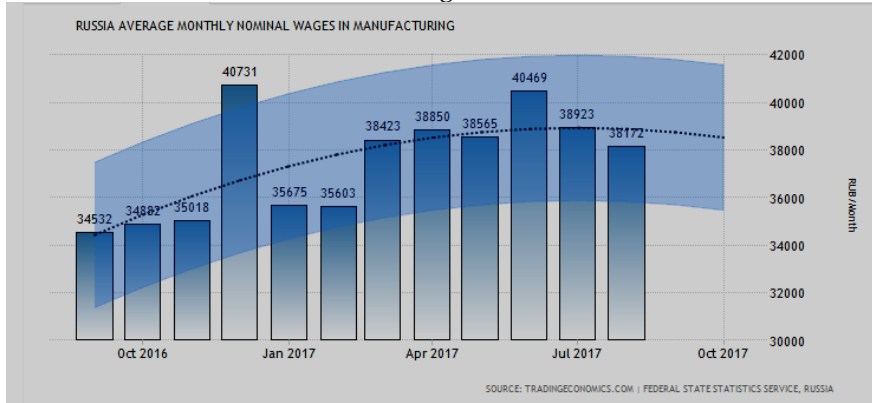
commandments to be borne in mind in doing business in Russia. These include key dimensions such as leadership, Organizational Culture, empowerment, flexibility, localisation, crisis management, corruption, and relationships. Ease of Doing Business Index by World Bank, rank different countries in terms of their primary data collected through questionnaire. The key dimensions include, starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. This index primarily captures the number of procedures and documentary compliance required, time and cost to complete the procedures (**Doing Business, 2018**). This is based on findings from several research papers. **Djankov (2002)** found that countries with higher barriers (in terms of regulations) of entry have higher corruption. **Geginat and Ramalho (2015)** concluded that time and cost to get electricity connection is highly varying in different countries. They suggested that getting another problem in the sector such as quality of electric supply and paying of bribes. This study also suggests that electricity connections affect firm performance. Simpler and less costly electricity connection processes are associated with better firm performance, especially in industries with high electricity needs, such as manufacturing motor vehicles. Djankov et al (2006), inferred that credit rises after improvement in credit rights and in information sharing. They concluded that legal origins are an important determinant of both creditor rights and information sharing institutions. **Djankov et al (2008)** developed index to find protection given to shareholders in different countries and hence concluded that this is an important factor in determining ease of doing business. **Djankov et al (2008)** found out that a delay of one day in shipment leads to reduction in trade by more than one percent. Put differently, each day is equivalent to a country distancing itself from its trade partners by about 70 km on average. One can control for potential endogeneity using a sample of landlocked countries and instrument for time delays with export times that occur in neighbouring countries. One can also find that delays have an even greater impact on exports of time-sensitive goods, such as perishable agricultural products. The results highlight the importance of reducing trade costs (as opposed to tariff barriers) to stimulate exports. **Djankov et al (2010)** showed that is a correlation between corporate taxes and investment in manufacturing. **Djankov et al (2003)** suggests that there are evidences to show that legal transplantation leads an inefficient procedural formalism, especially in developing countries. **Djankov et al (2008)** show that debt enforcement is highly correlated with per capita income and legal origin and predicts debt market development. Efficiency is influenced by various characteristics of debt enforcement procedures, such as the structure of appeals and availability of floating charge finance.

### 3. DISCUSSION AND ANALYSIS

The countries have accepted the dimensions led down by the World Bank for improvement of their ranking and suggesting their exporters the pros and cons of doing business in the other countries. However, there are certain other key dimensions that need to be included to change the perception of an entrepreneur on doing business in a country. These are; Labour cost, Exchange Rate Risks, Export Norms, Setting up Business as JV, Labour and Union, Environment, Owning Assets, Setting up of warehouse, Setting up of manufacturing centers, Sale of assets, Foreign Investments Permitted , Buying and selling shares, and Contract Manufacturing Regulations.

**4. ANALYSING DOING BUSINESS IN RUSSIA: A CASE STUDY**

**4.1 Labour Cost:** The labor cost in manufacturing in Russia is as follows:



The average monthly wage in Russia in the manufacturing sector is 38172 Rubble which around **648 dollars** whereas in India it is around 12000 Rupees which is around **190 dollars**. Thus, both the countries have lower wage rates as compared to the developed economies, but on the cost of labor aspect India is much more competitive than Russia.

**4.2 Exchange Rate Risks:** In a report by Deloitte almost every second company said that they faced an increase in the cost of production due to the devaluation of Rubble however the decrease in the value also had positive impact overall as it increased the competitiveness of the Russian exports in the global market. Companies have cited currency risk as the most important issue while manufacturing in Russia. Russia has a floating exchange rate and the value of the currency is decided by the market forces in play. The Rubble has depreciated 7.65% in the current year as compared to USD hence it poses exchange rate risks to the companies involved in trade with Russia. Whereas the INR has also depreciated 5.33% this year compared to USD as a result of which there is exchange rate risks involved and the companies need to hedge the risks while operating. Thus, while sourcing from Russia the exchange rate risk should be hedged to avoid losses in transaction.

**4.3 Export Norms of Russia:** The customs procedures for export in Russia are as follows:

<b>Restrictions</b>	<input type="checkbox"/> Export of items such as precious stones and metals, cultural and artistic goods need special authorization while items such as mineral ores, semi-precious stones, perishable materials, liquor, caviar and arms are prohibited.
<b>Export Taxes</b>	<input type="checkbox"/> Russia has imposed export taxes in around 154 lines of Harmonized System, primarily goods concerning energy products, ferrous and non-ferrous mineral ores, skin and wood. The export duty could be as high as 50%
<b>Export Clearance</b>	•Exporters get refund of VAT. They can claim by providing certain documents and takes 3 months. At airport Customs VAT refund includes a Custom fees of minimum 0.15 % or so. Refund is given only when the seller is a Russian legal entity and no intermediaries can be involved.

**4.4 Setting up Business as JV in Russia:** Russian Federation allows the companies from other countries to set up business in Russia in collaboration with the domestic companies in the form of joint ventures without having to incorporate a new company. This is known as the contractual Joint Venture. In 2012, a new legislation was passed by State Duma for the purpose of investment partnerships which also encompasses the joint ventures.

**Corporate Joint venture** in Russia is the most employed type of Joint venture. According to the Russian law, following types of Corporate Joint venture structures are available in Russia:

- Limited Liability Companies
- Joint Stock Companies
- Limited and Unlimited Partnerships
- Additional Liability Companies

Setting up of Joint venture comes under the Russian Civil Law. It states that the Joint Ventures can be operated after setting up of an agreement between the parties involved. These types of agreements are called Joint Venture Contracts. JV entities need to abide by Competition and Anti-trust laws. The foreign party need to obtain power of attorney when they act on behalf of the company.

**4.5 Labour and Union:** Minimum wages in Russia is 4330 rubbles which is equal to 125 EUR per month.

**4.6 Contract of Employment:** Contract of employment in Russia is an agreement between an employer and his employee under which the employer assumes the following roles:

- He provides the assigned work to his employee;
- He ensures that the working conditions are according to the labor law and the contract of employment;
- He pays timely and full wages to his employees.

And the employee assumes the following responsibilities:

- He performs the assigned work personally;
- He follows the rules of work according to the enterprise;

The contract of employment is for indefinite time-period.

**4.7 Working Hours:** The normal working hours in Russia are maximum of 40 hours per week. They can be reduced in certain circumstances:

- Reduced by 16 hours if the worker is less than 16 years of age;
- Reduced by 5 hours for workers who are qualified as invalid;
- Reduced by 4 hours for the workers who are between 16 and 18 years of age
- Reduced by 4 hours or more for the workers working in the hazardous conditions.

Overtime is allowed after the written consent of the employee. Overtime should not be more than 4 hours in 2 consecutive days and should not be more than 120 hours per annum.

**4.8 Ending Employment:** The contract of employment in Russia can be terminated in the following ways:

- If the agreed term expires in case of temporary contract;
- If the notice is given by the employer to his employee;
- If there is termination by mutual-agreement;
- If there is death of the employee.

**4.9 Environment:** Environmental authorizations for mining are governed in Russia by Law "On subsoil Resources".

**Article 22** of the Law "On Subsoil Resources" states that: "A subsoil user is obligated to adhere to standards approved in the prescribed manner that regulate the protection of subsoil resources, the air, lands and water bodies and the putting of land plots and other natural resources disturbed by the use of subsoil resources into a usable condition."

**Article 26** of the Law "On Subsoil Resources" states that: "Mining enterprises and subsurface structures not related to mining operations must be dismantled or mothballed upon the expiry of the license or the early termination of the use of subsoil resources."

The lands which are provided for mining in Russia under the applicable Russian laws are not zoned under a separate category and are not differentiated from the other lands according to their primary designation which is in contrast with the urban and rural settlements in Russia which are zoned on the basis of their designation.

Lands in Russia which are provided by the government for subsoil use are zoned as the special lands for transport, industry, communication and for other purposes. Legal status of these lands are governed by the general provisions which establish the legal framework for the land of this category. These kinds of land in Russia are treated in a different manner depending on their subsoil resources within their legal status.

**4.10. Owning Assets:** The foreign legal entity or even the Russian legal entity needs to pay asset tax on movable and immovable property (usric.org, 28/01/2017). There is a typical Russian accounting principles. One need to map their country accounting principle with the Russian principles. Acquisition of a company is treated as a single property unit. Under the Tax code of Russia, a concept of positive or negative goodwill is made applicable. A buyer gets tax benefits if he buys a company at a price in excess of the net assets (positive goodwill). The excess amount is depreciated over five years for purpose of determining the profit - tax. The seller has to pay tax on the positive goodwill. In case of negative goodwill, the situation is reverse. This is so because it is treated as price discount being availed by the buyer.

There are no restrictions on foreigners' purchasing property in Russia. Some restrictions may apply in case of purchase of agricultural land. An asset in Russia can be held on ownership right or as lease right. In the former case the buyer can possess, use and dispose the asset. In the latter case, the buyer has to abide by lease terms. Lot of reforms in these areas is in the anvil. Concept of development right to land, and encumbrances, such as usufruct, option to purchase assets and the right of benefit from property

**4.11 Setting up of warehouse:** Items imported to Russia may declared as bonded warehouse cargo and can be kept in such a warehouse for period not exceeding 3 years. VAT and duties are applicable only if it is taken out for domestic consumption. No duty or VAT is imposed if it is re-exported. The materials can be stored without any change of its form and nature.

**4.12 Setting up of manufacturing centers:** There are three ways to start manufacturing business in Russia by a foreigner:

1. Start as an individual entrepreneur
2. Establish using a Branch or Representative office
3. Establish Russian Legal entity as a Limited Liability Company

Lately, investors have been talking about corruption in Russian government. But the government seems to be destined to change this by the way of introducing reforms. Doing business rank of Russia is 40 which speaks volumes about Russian government's efforts to change the climate of business for better.

**4.13 Sale of assets:** Sale of financial Assets is freely permitted but it attracts capital gains taxes. All the taxes are directed by Tax authorities of Russia. Sale of Fixed assets also require paying capital gains tax but it is not freely permitted. Sale to Russian party is easier as compared to Sale to another foreigner. Also, doing business with Russia if you have any ties with Ukraine is difficult as it doesn't recognize Ukraine as a country. So foreigners have to be very careful about not breaking any laws and can expect jurisprudence to be low in Russia.

**4.14 Foreign Investments Permitted in Russia:** After reaching record levels of FDI in 2013, FDI flows into Russia have been falling since 2014, due to political issues between Russia, Ukraine and the Western countries. Also, ongoing economic crisis in the country has taken its toll. Between 2013 and 2015, FDI inflows fell from USD 53.4 bn to a mere USD 11.9 bn. However, in 2016, FDI flows picked up, reaching USD 37.7 billion, mainly as a result of the privatization of the Rosneft oil company.

**Table 2: FDI in Russia**

Foreign Direct Investment	2014	2015	2016
FDI Inward Flow (million USD)	29,152	11,858	37,668
FDI Stock (million USD)	290,039	262,748	379,035
Number of Greenfield Investments	194	216	280
FDI Inwards (in % of GFCF)	6.7	4.2	13.9
FDI Stock (in % of GDP)	14.1	19.2	

Source: UNCTAD, Data accessed from <https://en.portal.santandertrade.com/establish-overseas/russia/foreign-investment>

One can see from the table above that FDI inwards peaked up in 2016.



**Table 3: Main investing countries in Russia**

Main Investing Countries	2015, in %
Cyprus	28.8
Luxembourg	11.5
Netherlands	10.7
Ireland	7.7
Bahamas	6.9
Bermuda	4.3
Germany	3.9
British Virgin Islands	3.8
France	3.3
Switzerland	3
UK	2.9

Source: Central Bank of Russia: Accessed from <https://en.portal.santandertrade.com/establish-overseas/russia/foreign-investment>.

As one can see that Cyprus was the highest investing country in Russia in 2015. Also, most important sectors where investment activities are happening are

1. Trade, repair of motor vehicles
2. Manufacturing industry
3. Financial activities and insurance

Also, Ease of Doing business rank for Russia in 2016 was 40 which shows that it is relatively easy to invest in Russia 27% increase from the previous year. Russia ranked second in 2017 in terms of outbound capital investment. It increase its ranking by six places and as a result UK ranked 3<sup>rd</sup> in 2017. This increase is a significant 339% increase from 2016 (FDI Report, 2018)

**4.15 Buying and selling shares:** One can look at Foreign Portfolio Investment as proxy for finding out whether buying & selling shares is easy in Russia or not. From the data, one can see that Russia's FPI increased by USD 860 mn in June 2017. A foreign investor, if wishes to understand the stock market in Russia may start with investing in American mutual funds or ADRs (American Depository Receipts), or exchange traded receipts (ETF) way to gain exposure to the Russian stock market is by purchasing U.S.-traded mutual funds, exchange-traded funds (ETFs) or American Depository Receipts (ADRs). These are traded on U.S. exchanges investors can avoid the complexities and risks associated with investing directly, such as tax concerns, execution risk, and strange trading hours. Some popular Russian funds and ADRs include:

1. Voya Russia Fund (Mutual Fund: LETRX)
2. Market Vector Russia ETF Trust (NYSE: RSX)
3. Gazprom OAO (ADR) (Pink Sheets: OGZPY)

Share sale in private companies in Russia are divided into two groups:

1. The direct sale of the company, which is also known as a 'one-tier structure';
2. The sale of shares in a holding company with Russian subsidiaries, which is known as a 'two-tier structure'.

It is essential for the parties (the seller and the buyer) to draft a sale-purchase agreement to conclude the transaction. The main advantage of selling shares in a Russian companies is that the

transaction does not necessitate additional business permits, as in the case of assets sales. Share sales in Russia are VAT-free.

**4.16 Contract Manufacturing Regulations:** Russia is known for contract manufacturing in Pharmaceutical sector. Few years ago, climate for doing electronics contract manufacturing was also good but due to recent regulatory changes today electronics CMs are in decline. Around 350 sites are run by contract manufacturers in Russia in Biotech & pharma sectors. They also have a policy for Pharma 2020 in which they have highlighted promoting contract manufacturing in this sector. In precious metals & diamonds, no such incentives are available and it is important that one can find out sustainable way to procure such items from Russia because recent atmosphere in Russia is very volatile.

## 5. CONCLUSION

In today's world setting of business across borders is quite appealing as more and more barriers are reducing. However, one has to exercise caution on the issues that involve investments in fixed assets and in shares. The path to exit and recovery of investments need to be carefully looked into. This relates to disposing of assets and recovery of receivables. Besides, labour laws are also important. Hence, based on report that is developed by just gathering stakeholders' perception on limited number of dimensions may not enable an investor to analyse ease of doing business. Expert analysis on additional dimensions especially, Labour cost, Exchange Rate Risks, Export Norms, Setting up Business as JV, Labour and Union, Environment, Owning Assets, Setting up of warehouse, Setting up of manufacturing centers, Sale of assets, Foreign Investments Permitted, Buying and selling shares, and Contract Manufacturing Regulations are required. Further research in ways to introduce qualitative analysis using data mining techniques may be carried out.

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