

Risky Business:

Barriers to Doing Business in Emerging Economies

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Introduction

Even under the best of circumstances, conducting business in far-distant places is difficult. Transportation costs and risk of loss increase. Problems related to the products themselves, their distribution, their after-market service, and virtually anything else, are amplified. Of course, these challenges range in magnitude. It's one thing to conduct business between New York and California. It's another to deal with the evolved overseas markets of Western Europe. It's quite another matter altogether, however, to attempt to conduct business in emerging economies, such as those of Eastern Europe or the former Soviet Union. The business and legal cultures are totally different, and there are a number of economic and legal factors that create significant, and sometimes insurmountable, barriers to doing business.

Why then, would a rational businessperson attempt to enter such a market? The answer, of course, is opportunity. Great risk affords great opportunity. A majority of those dabbling in this environment will fail, but those who succeed will reap great rewards. Timing is critical. As an emerging economy evolves, there comes a time when a particular type of business undertaking suddenly becomes possible. For those poised to take advantage of the situation, the opportunities can be significant.

An emerging market trader or investor must "catch the wave" just as it begins to break. There are many stories of traders and investors in the former Soviet Union who mounted their surfboards too early. Assets were placed at risk before adequate mechanisms existed to protect them. When problems arose, contractual rights could not be enforced, stranding assets. Ironically, this process benefits the emerging market in a very real sense, because the failed foreign investment absorbs into the economy. This is of little comfort to the foreign investor, however, and news of the failed foreign investment discourages future risk-takers. That, in turn, slows the emergence of the market.

This article examines some of the business challenges characteristic of Russia at this time. The analysis is similar for many other emerging economies, such as those of Eastern Europe and the former Soviet Union. By understanding the nature and practical effects of these barriers, individuals proposing to do business in the emerging market can minimize current risks, and plan strategically with current trends in mind.

Enforcement of Court Judgments

In the United States, we are accustomed to a legal system by which it is relatively easy to enforce performance of some contracts, and to obtain damages for breaches of others. This is not the case in many emerging markets, due to a combination of factors, most importantly the historical lack of independence of the judiciary. Under the Communist structure, judges were low-level administrators who were controlled by the Communist Party. Although the analogy is imperfect, the situation resembled a governmental structure in which the executive branch controlled the judicial branch. The Party controlled funding for judges, and at times, judges would consult with Party officials to determine the correct result in a particular case. Effectively, there were no separate branches of government. Everything was run from the center.

Progress has been significant in the past six years. The judiciary has become more financially and administratively independent. By law, court judgments are to be enforced, even when they run against the government. A new law improves the success rate for enforcement. The complete implementation of that law faces significant obstacles, however, given the overwhelming number of judgments, and that the system requires government-directed employees to personally execute all of the courts' judgments. In the United States, the prevailing party's lawyer typically facilitates enforcement of judgments. The Russian system for enforcement is an inefficient allocation of resources. There is much to be said for the motivation built into a system in which the prevailing lawyer has the duty of collecting on behalf of the client.

Enforceability of judgments in Russia is moving in the right direction, but judicial recourse is still far less reassuring than it is in the United States. The solution for the foreign businessperson in Russia is to engage in deals in which the parties perform their contractual responsibilities because they *want to*, not because they *must*. This is easier said than done, and requires significant reorientation for a businessperson who is accustomed to doing business in a reasonably predictable and reliable legal environment.

Privatization of Property

Little is more fundamental to the old Soviet ways of thinking than the notion that all "immovables" (land, buildings and fixtures) belong to the People. Recognizing that private ownership of such property is critical to a free

market, Russia has undertaken a deliberate privatization over the past several years. How far the process will go, and how long it will take to reach its eventual end-point, are matters of much speculation. The first type of immovables to be privatized was primary residences. The occupant or family could privatize their primary residence, once occupied at the whim of the government, by undergoing a registration process. Upon privatization, the occupant did not have to pay the government for the residence. The residence simply became the property of the occupant. Now the occupants can keep the residence or they can sell it. Sadly, in many of the latter cases, the proceeds have been squandered, and the former owners have become homeless. In theory, the residence can also be mortgaged, but for the moment, a fledgling system of title registration hampers this process.

Another type of immovable property privatized early in the process is the dacha and associated land. The word "dacha" is sometimes translated as "summer house," but a deeper understanding of this important Russian tradition is necessary. The vast majority of dachas are tiny cabin-like structures, located on parcels no larger than 1/4 acre. Members of the extended family spend parts of the warm months at the dacha, primarily to cultivate vegetables for personal consumption, but also to relax. The building is often an uninsulated single room without plumbing or electricity. The primary purpose is to put food on the family table without having to buy it at the store. Retired grandparents typically spend much of the summer at the dacha, taking care of the grandchildren, to free up the parents to work at multiple jobs. Because this category of immovable property has now been privatized, owners may sell, or otherwise encumber, their dachas.

Businesses have also been partially privatized. This process began with the smallest businesses, such as retail shops and restaurants. Larger industries, especially those with significant capital holdings, were not slated for privatization until the later stages, because their denationalization has a greater negative impact on the national balance sheet. The government is also being cautious about privatizing industries whose vitality and functioning are deemed critical to the national interest. These include industries dealing with natural resources and those affecting national security.

The "second wave" of business privatization encompassed primarily medium-sized businesses. Some were sold at

quasi-public auctions. The price of others was set by more or less reliable valuation processes, and more than a few were sold to political insiders at less than fair market value. Typically, the purchases were financed through Russian banks, which took the stock of the often-undervalued businesses as collateral. When the purchasers of many of these businesses failed to pay the banks according to the terms of the loans, the banks accelerated the notes, and took control of the stock through the realization of their rights to the collateral. This is how Russia's infamous "billionaire bankers" emerged. Although this process leaves much to be desired, property is at least transferred into private hands, from which it will eventually trickle down to more efficient economic use.

Communist ideology about public ownership of immovable property is most deeply "rooted" in land. As such, a complicated overlay of "state" and federal controls still dominates the vast majority of Russia's land resources. Thus, in terms of the aggregate value of immovables that could be available for the reliable collateralization of financial obligations, not that much progress has been made. Simply put, a factory that needs to borrow money to refurbish capital assets does not have the practical ability to offer a reliable mortgage on real estate in exchange for the loan. Until this is possible, traditional asset-based financing will not become broadly available in Russia.

In part to accommodate those aspects of privatization that have already been accomplished, and in part to pave the way for the next steps of privatization, the Russian legislature recently passed a new title registration law. Title registration poses tremendous logistical problems. Aside from the sheer size of the country (1.8 times that of the United States), parcels have to be identified. Recording systems must be designed and implemented to compile the information to make it meaningfully accessible. In the early stages of this process, the volume of registrations threatens to overwhelm any system, no matter what its design. The creation of such a system is expensive by any standard, particularly in the context of present-day Russia. When the registration office opened in Moscow, waiting lines were literally three days long, and organized crime immediately took control of the situation, selling places in line, and offering expedited processing for those who could afford to pay a substantial premium.

Cultural and historical barriers are another problem. Recordkeeping in Russia is viewed with skepticism, based upon historical experience, as an end in itself, and as an excuse for non-productive governmental control. The notion that the ability to establish good title could lay the groundwork for the productive use of real property, for example by mortgaging immovable property for asset-based fi-

nancing, is not an intuitive one. As such, an extensive amount of public education is indispensable to any workable system of title registration. This process is difficult, expensive and time-consuming.

Axiomatically, asset-based financing assumes the existence of financing. Unfortunately however, the Russian banking system is still quite rudimentary. Historically, Russian banks have primarily served a tax collection function. Employers are required to withhold all taxes, and to send them to banks, so that the banks can forward the money to the government. Russians have been understandably reluctant to put savings into Russian banks, given recent experience with inflation and bank collapses. For all of these reasons, and as a result of fears of nationalization of private assets, the available lending base is not yet significant. If court judgments become increasingly enforceable, people will save more, and banks will begin to lend as deposits increase, and as more complete privatization of property affords a greater source of collateral for recourse.

The new title registration law is a necessary precondition for the next stages of privatization of land. The political evolution of Russia will also play an important part in the pace at which, and the eventual extent to which, the process of privatization will occur. Current political trends raise questions about the future of privatization. A slowing, or even a reversal, in the rate of privatization would worsen the already-unfavorable climate for asset-based lending. Even so, if the optimistic view turns out to have been warranted, we can expect a gradual strengthening of the banking system, an eventual increase in personal savings, and an economy in which both domestic and foreign investment will eventually be encouraged and protected. Even under the best of circumstances, however, the process will take years.

Tax Rates and Tax Enforcement

Under the Communist system, a very high percentage of Russia's gross domestic product was controlled and funded by the government. As a result, the government paid a large segment of Russia's work force. As privatization has progressed, the government has lost revenues. In theory, tax revenues generated by the newly-privatized industries should replace the revenues lost through the privatization of government industries. Tax enforcement costs money, however, and requires the development and implementation of tax collection mechanisms. The Russian government's cash flow has been adversely affected as a result. Early in the process, uncontrolled printing of currency fueled hyperinflation. This drove the cost of imports to unaffordable levels. At the same time, the previously-discussed structural disincentives to

foreign investment wreaked havoc with Russia's industrial sector. Eventually, external pressures, such as the unwillingness of the International Monetary Fund to provide assistance in the absence of tighter monetary controls, forced the Russian government to tighten its money supply. This caused significant delays in the payment of government salaries, with predictable and severe social consequences. In response, the government eliminated many government jobs, forcing large numbers of individuals into the private sector, or out of productive activity entirely. While this is arguably a positive trend from a macro-economic standpoint, the large-scale dislocation of the work force has had extremely negative social consequences.

As another means of generating revenue, tax rates on income from the productive use of capital, and tax rates on self-employment income, were initially set at confiscatory rates. In the context of a near non-existent enforcement mechanism, this has resulted in widespread tax evasion. Over the past several years, the tax system has moved toward equilibrium through a combination of decreasing tax rates, and increasing enforcement. Recent studies indicate that the government is collecting less than 20% of the taxes that are legitimately owed. Legislative enactment of a more realistic tax system has been difficult because the lower house of the Russian legislative branch is dominated by a de facto coalition of anti-reformers. Even so, gradual progress occurred for a time, because the executive branch strongly favored economic reform, and because the Russian constitutional structure affords the executive branch a high degree of indirect control over the legislative branch. At the same time, an increasingly independent judiciary, bolstered by better laws and greater administrative enforcement powers, holds promise for increased rates of tax collection.

On the political front, recently President Yeltsin has taken steps to improve tax compliance by Russia's largest industrial producers. Domestically, he has asked for an increased rate of voluntary tax compliance, and has received provisional assurances that it will be forthcoming. With respect to foreign investors, the government has taken steps to enforce tax compliance through court action. All of these trends are heartening, but the evolution of a fair and uniformly enforced tax collection process is slow.

Lawlessness

Another challenge confronting the would-be businessperson in Russia is the two-part problem of corruption and criminality. These concepts are related, although not identical. For purposes of this analysis, corruption is defined as a failure, by an instrument of the executive branch, to abide by generally-accepted

principles of a society operating under the rule of law. This behavior can manifest in the form of bribery, influence peddling and the like. Certainly, these forces are antithetical to the free market. On a deeper level, however, they weaken the court system, erode public confidence, and have other adverse impacts on the process of democratization. Outright crime is also a problem. There is some risk of extortion, theft, embezzlement, and physical violence.

There are profound cultural impacts associated with the conversion to a free market during ongoing privatization. Because of these forces on the evolution of crime in Russia, the rate has grown most noticeably in the sphere of economic crimes.

The Communist system was quite effective in controlling crime. This is one of the arguable benefits of a totalitarian regime. Anecdotally, rates of growth in crime since the collapse of the Soviet Union have stabilized, and in some sectors, dropped. Russian popular sentiment very much supports decreasing criminality as a social goal, and the democratic process can be expected to support this mandate. The extent to which a businessperson is likely to be confronted with problems relating to corruption and criminality depends, to a significant degree, on the particular economic sector and the geographic region in question. Good connections are always valuable, but Russians most value friendships and business relationships that have passed the test of time. More than anywhere, trust is critical to business in an economy not completely governed by a free market and the rule of law. If one cannot depend upon a predictable and reliable environment of contractual and property-related rights, one must place a very high premium on trusted relationships. The futility of dispute renders this critical.

Freight Forwarding, Warehousing and Customs Clearance

Those businesspeople whose method of doing international business is pure trade face a variety of particular impediments. Those whose focus is foreign investment will almost inevitably encounter the same problems, although perhaps to a lesser degree. As mentioned earlier, the distances increase risk of loss and the costs associated with service and returns. Issues of language, and of divergent cultural approaches to business, complicate matters further. All of these considerations put a premium on the selection of reliable foreign partners.

With respect to trade, customs duties can be extremely high, and customs clearance can be time-consuming. One may encounter arbitrariness in interpretation and enforcement of rules of admissibility, and the traditional "opportunity to cure" may not be available. Likewise, warehousing and freight forwarding are logistically difficult, and potentially subject to corruption and crime.

Political Risk, Inflation and Currency Fluctuation

No credible student of Russia in 1998 will guarantee that political forces will not, to some degree, impair current trends of democratization and the free market. At this time, cataclysmic change seems unlikely. Even so, rates and endpoints of change, such as those relating to privatization, are hard to predict.

Impairment of property rights is always a possibility. The most dramatic such impairment would be an outright nationalization of private assets. Such an event might affect the assets of the investor, or those of a partner. It could also have more indirect, but still significant, impact on the market involved. Of course, political events far more subtle than outright nationalization can significantly impair property rights. For example, shifts in tax or duty rates have similar anticompetitive consequences. Political risk insurance is available, but the scope of such coverage bears scrutiny.

Some believe that the Russian court system has a diminishing, but persisting, pro-government predisposition. This is a natural after-effect of a seventy-five-year reign of Communist ideology regarding separation of powers. Fortunately, this influence is abating.

Over the past decade, the rate of inflation in Russia has been staggering. For a period, inflation moderated significantly, thanks to tighter monetary controls motivated in part by conditions placed on IMF loans. Then, recently, there was a cataclysmic burst of inflation. Long-term inflation trends are difficult to predict, and so, caution is advised. Aside from inflation per se, exchange rates fluctuate in a related but different way. Exchange rate fluctuation poses another risk to profits, and contracts should be drafted so as to minimize its impact.

Finally, one should observe that a wholesale change of government is a possibility, whether through peaceful or revolutionary means. Russia has a tradition of revolution, and in many sectors of society, discontent is justifiably high.

Successfully Doing Business in Russia Under These Constraints

If your business is importing, be sure to confirm the quality, conformity, count and condition of the imported goods before committing yourself to pay for them. If feasible, inspect the goods, either personally or through a reliable independent agent, prior to their departure from Russia. Russian exporters are increasingly familiar with letters of credit, and it is likely that payment for international trade transactions can be arranged on this basis. However, if a purchase is backed by a letter of credit, and if the importer delays the inspection until after the goods have been accepted, the issuing bank will be re-

quired to debit the importer's account, and to credit that of the seller, in exchange for the complete set of documents required by the letter of credit. After-discovered non-conformities may leave the importer with a claim for damages for breach of contract, but with little practical ability to enforce it.

If your business is exporting, obtaining payment is the key consideration. Having a confirmed letter of credit from the buyer is the preferred course, but this arrangement may not always be possible. The Russian banking system is still in the early stages of its evolution, and Russian banks will often only issue letters of credit to customers who have funds in the full amount of the letter of credit on deposit in the bank as collateral. Exporting products to Russia on credit is risky. If you propose to do it, take small risks, and develop confidence in your trading partner through a proven course of dealing. The United States government is interested in reducing the U.S. trade deficit, and as such, offers attractive export finance supports and incentives. The ExIm Bank's resources should be researched and utilized.

If your objective is to invest in Russia, you face many of the potential risks discussed throughout this article. Asset protection is a challenge. Do not commit assets without having a strategy for getting them out. If there is serious doubt as to whether the assets can be extracted, simply assume they are at risk. Keep abreast of changes in the law, because opportunity often presents itself to those who can respond quickly and appropriately to changing conditions.

Whenever possible, deal in cash, and tie pricing to United States dollars or other "hard" currency. This will reduce credit-related risk and loss due to exchange rate fluctuation. Letters of credit provide a safe, and increasingly well-recognized, means of ensuring payment.

Take affordable risks, nurture relationships, build trust, and above all, be patient.

Russia is a country of great natural resources. It has a highly educated workforce hungry for economic growth. Great risk foretells great opportunity. For those who can solve the riddle of doing business in an emerging economy, the rewards can be great.

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