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Investors Like Regions With Warm Welcome

By Roland Oliphant

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Workers checking a car at Volkswagen's plant in Kaluga, which had the second best FDI growth from 2005-09. **Sergei Porter**

Foreign investors are more interested in the legal environment, tax incentives and attitude of the authorities in a region than location, natural resources or infrastructure, according to research released Friday.

The findings, drawn from interviews by KPMG in cooperation with the Russian Union of Industrialists and Entrepreneurs, suggest that regional governments that are not blessed with oil fields or rich mineral deposits can still compete for foreign direct investment.

Economic Development Minister Elvira Nabiullina welcomed the findings at a ceremony to release the report, saying the future of Russia's economic development lies in the regions, and that "investment climate in the regions will be an integral part of economic policy."

"Working with the regions to improve the investment climate there is one of our priorities for 2011," she said. Nabiullina said the government had discussed the question of regional investment on Wednesday and that "not everything is all right there, unfortunately."

As part of the strategy, billionaire Viktor Vekselberg promised to extend the benefits available in the new innovation city of Skolkovo outside Moscow to "any company doing R&D regardless of location."

Russia has managed to slow, but not reverse, a systematic fall in foreign investment sparked by the 2008-09 financial crisis. FDI was down 11 percent to $5.4 billion in the first half of 2010, the State Statistics Service reported in August. Overall foreign investment fell 5.5 percent to $30.4 billion.

Vekselberg, who heads the Skolkovo Development Foundation, pointed to World Bank figures that showed Russia is ranked 120 out of 138 countries for investment climate.

But investments are still skewed disproportionately toward Moscow and St. Petersburg and to energy-producing regions like Arkhangelsk and Sakhalin.

Five of Russia's 82 regions account for more than 70 percent of FDI, KPMG wrote in the report. Forty percent of FDI currently goes into mining. And 37 regions have attracted less than $100 million in FDI in the last four years, Andrew Cranston, a senior partner at KPMG, said in a presentation to investors and officials.

The consulting firm canvassed more than 70 investors in 12 regions and deliberately excluded Moscow and St. Petersburg, as well as regions blessed with mineral wealth, to get a picture of investment climates in "ordinary" regions.

Regional investment was hindered by a mismatch of expectations between foreign investors and regional authorities; high-level regional officials' friendliness not extending into the middle ranks of bureaucracy; and a proliferation of stake holders that makes coordination extremely difficult.

The good news, the report said, is that improving a region's investment climate depends more on the regional authorities' will than it does on more challenging factors, such as geography, a skilled work force or impressive infrastructure.

KPMG's researchers were surprised to find that investors were more interested in "soft" factors, like the legal environment, and financial and tax incentives.

"This is important because it shows us that for regions that are strong in hard factors, it is not enough; and it means that regions weak in hard factors can compensate by overperforming in soft factors," said Cranston, who helped compile the report.

A case in point is the Kaluga region. It has only some raw materials for production of construction goods, suffers from an imbalanced energy infrastructure, a small work force and unattractive business-to-business and business-to-consumer markets, the report said.

But through a combination of liberal legislation and tax breaks, Kaluga managed to win the title "Europe's Detroit" after Volkswagen opened a factory there in 2007. It has seen 168 percent FDI compound annual growth rate in 2005 to 2009, currently second only to oil-rich Sakhalin in terms of FDI per capita.

Kaluga Governor Anatoly Artamonov had no doubts about how best the federal government could help other regions.

"The federal authorities can do two things: Either they can help the regions do this with their own laws and legislation; or at least make sure regional laws and legislation are not disturbed," he said.

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