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WORKING PAPER

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FOREWORD

This working paper is one of a series* produced by TES-MTC project discussing the problems of East-West Joint Ventures located in the CMEA countries on a country basis.

One of the most interesting and noticeable changes in East-West economic relations over the past years has been the rapidly increasing number of East-West joint ventures hosted in the Soviet Union. At the end of 1987, there were only 19 such joint ventures. In March 1988, the number had almost doubled (36). As of October 1988, the number is now approaching 100 (99 established). The number of East-West joint ventures located in other countries is also increasing at various rates. Many countries which are hosting such joint ventures are now analyzing the current practice as part of a common analysis of their national economic development and in some cases have already introduced changes in their legislation to improve the conditions provided for foreign joint venture partners (e.g., Czechoslovakia and Hungary). Many more joint ventures are being negotiated, and numerous proposals are still to be considered between both Eastern and Western partners.

With such high process dynamics, it is very important to remain up-to-date with the latest legislative changes and also to follow closely new results achieved by national groups and research institutes in analyzing financial and practical aspects of joint ventures.

The Management of Technological Change (MTC) project, part of the Technology, Economy and Society (TES) Program, has developed an international network which is performing an empirical study on practical problems of joint ventures hosted in various CMEA countries. This working paper is an intermediate report from the Soviet national group, headed by the All-Union Institute for External Economic Affairs in Moscow. The working paper highlights the practical situation in the USSR, both as regards legislation and managerial practice of operating joint ventures and also concentrates on certain issues concerning the current practical experience of operating joint ventures in the USSR. The authors are both participants in MTC's international network and close collaborators of the project.

F. Schmidt-Bleek
Leader
Technology, Economy and Society Program

*To date, the following papers have been published:

Djarova, Julia Joint Ventures: A New Reality of East-West Cooperation (State-of-the-Art), June 1988, WP-88-054.

Benedek, Tamas Some Experiences of Joint Venture Establishment and Operation in Hungary, September 1988, WP-88-88.

JOINT VENTURES WITH FOREIGN CAPITAL PARTICIPATION IN THE SOVIET UNION:

Experiences and Future Outlook

V. Ranenko and I. Soloviev¹

Until early 1987, the implementation of foreign investments into the Soviet economy was only carried on through various contractual forms, i.e. on the basis of pay-back, license or turn-key agreements. At the same time, there were over 100 mixed companies established abroad with the participation of Soviet partners.

In January 1987, the Decree of the Presidium of the USSR Supreme Soviet on "Questions concerning the Establishment and Operation of Joint Ventures in the Territory of the USSR" was adopted.

Accordingly, the Council of Ministers of the USSR adopted the decision N48 and N49, which determined the main features of establishing and operation joint ventures in USSR territory with the participation of Soviet organizations with firms and companies from Socialist and Western Countries. In September, 1988, the Decree of the CPSU Central Committee and the USSR Council of Ministers on additional measures to improve the country's external economic activity under new conditions of economic management was adopted. This decree created further opportunities for joint venture activity in the USSR. During 1987-1988, various regulations pertaining to issues involved in the creation and operation of joint ventures were also adopted.

All of the aforementioned documents as a whole represent the Soviet Legislation System covering the issues of establishing joint ventures in our country.

The main aims of establishing joint ventures in the USSR are the following:

- * To satisfy more fully national requirements in certain types of industrial products, raw materials and foodstuffs;
- * To attract to the Soviet national economy modern foreign technology and management as well as additional material and financial resources;

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- * To improve the country's export capabilities;
- * To reduce unnecessary imports.

Thus, external economic cooperation at the enterprise level in the form of joint ventures fully corresponds to the goals of the reforms of the State economy as a whole and to those in the field of external economic affairs. First of all, joint ventures as a new form of external economic activity are capable of expanding business cooperation with foreign and in particular with Western countries. Secondly, joint ventures are capable of involving Soviet production enterprises in the director process of cooperation with foreign partners.

As a result, Soviet joint venture partners may take advantage of this new form of cooperation by adopting the new technology and management as well as by increasing the efficiency of their own financial resources and to get additional hard currency inputs.

Participating in joint ventures may provide Western partners with additional profits, access to the vast Soviet market, natural resources, materials and labor force. Thus, in fields where joint venture partners have common aims, the appropriate joint venture may act effectively.

This paper is aimed to elaborate the particular features of Soviet legislation on joint ventures, to describe the real process of forming these enterprises in the USSR, to distinguish the main problems which they are confronting now, and to suggest different points of view on the future development of joint ventures. It is quite obvious, however, that the scope of a short paper cannot comprehensively address these issues; we can only discuss them in general terms.

1. SOVIET JOINT VENTURE LEGISLATION

The existing Soviet joint venture legislative system provides joint ventures with the following opportunities:

- a) To act as a juridical individual;
- b) To act independently from the planning economic bodies, bearing in mind, for instance, that joint ventures elaborate their own operational and strategic plans;
- c) To arrange for export/import transactions abroad independently;
- d) Within the frame of the production program, to purchase and sell through the local wholesale system, through the branch

supply systems as well as by using the appropriate Soviet foreign trade organizations. It should be noted, however, that joint venture transactions on the local market are allowed both in roubles and in hard currency on the basis of contractual prices.

- e) To accumulate and reinvest profits through establishing their own development funds;
- f) To have the right for certain tax exemptions. The joint venture profit subject to taxation can be calculated by decreasing the profit on sales to the volume of Reserve and Development funds. The two-year period of the tax exemption begins from the moment profits are first declared. The USSR Ministry of Finance has the right to decrease the tax rate or completely exempt a joint venture from the tax on profits.
- g) To employ and compensate the personnel of the joint venture in accordance with its own requirements, within the frame of Soviet legislation;
- h) To distribute the remaining profit (after taxation and reinvestment) between the partners according to their share in the authorized fund.
- i) To receive credits.

The following basic requirements are determined in the relevant USSR legislative acts:

- a) Financial resources required during the establishment and operation of joint ventures could be obtained only by using their own funds or credits. This refers also to assets in hard currency required for imports, for foreign personnel salaries and for transferring the joint venture's foreign partner's profit.
- b) At present, the share of the joint venture's foreign partner in the authorized fund cannot exceed his 49% ownership limit.
- c) The Chairman of the Board and the Director General of the joint venture should be Soviet citizens.
- d) The joint ventures has not rights to export or import goods which cannot be regarded as the subject of their productive activity.
- e) Auditing the financial and commercial activities of joint ventures can only be carried by the Soviet organization "Inaudit" and the accounting forms can only be presented to the joint venture's partner-companies.

- f) A joint venture is obliged to establish a Reserve Fund. Deductions from profits shall be added to this fund until it totals 25% of the authorized fund.
- g) A joint venture may obtain credits from foreign banks or firms, subject to receiving the appropriate approval from the Vnesheconombank of the USSR.
- h) A joint venture is bound to pay a tax on profits. A foreign partner is bound to pay the tax on profits transferred abroad at the rate of 20%, if other terms and conditions are not stipulated in bilateral inter-governmental agreements.

The following guarantees are provided to the foreign partners of joint ventures:

- a) Equipment of any kind, technology, materials and other supplies imported by foreign partners of joint ventures located in the USSR as part of their contribution to the authorized fund are exempt from custom duties.
- b) As far as the transfer of foreign technology to a joint venture is concerned, it should be noted that any relevant conditions can be stipulated by a foreign partner in the Basic Agreement covering such a transfer.
- c) In the case of liquidation or upon withdrawal from the agreement, a foreign partner of a joint venture has the right to return his contribution in financial assets or in kind according to the residual balance value of that contribution at the moment of the joint venture's liquidation.
- d) A foreign partner has the right to participate in the managing activities through membership in the Board and Directorate.
- e) A foreign partner has the right to transfer the profit due him abroad in hard currency, within the frame of hard currency financial assets of the joint venture.
- f) The foreign partner has the right to apply both to the Soviet and foreign legal bodies on issues regarding various disputes.

The above mentioned legislative framework outlines the economic environment in which joint ventures are created and operate. The financial flowchart (Figure 1) presents the inter-relations of these conditions in graphic form.

CASE #1

The creation of a joint venture may be undertaken both by using its own financial resources (authorized fund) and by using credits borrowed mainly from the State Bank (Gosbank) and the Bank for Foreign Economic Affairs of the USSR (Vnesheconombank).

The authorized fund should be created on the account of both Soviet and foreign partners. Accordingly, various assets could be accumulated in this fund, including:

- * the cost of licenses and "know-how;"
- * the cost of buildings and equipment;
- * the cost of land and other natural resources, leasing as well as any monetary assets in hard currency and in roubles.

In determining the amount of the authorized fund, the partners can make calculations both in hard currency and in roubles on a contractual basis, taking into account relevant world market prices and using the official exchange rate established by the USSR State Bank on the date agreed upon between the partners.

Joint ventures can purchase goods on the local market from the appropriate manufacturing enterprises on the basis of contractual prices in hard currency or in roubles. Joint ventures can arrange for required imports in accordance with their own plans and programs of economic activities.

Joint ventures can also sell their own products on the local market (in roubles or in hard currency) and arrange for exports abroad.

The joint ventures' sales profit can be spent on the following:

- * To repay credits and relevant interest, if any;
- * To establish the Reserve Fund and Development Funds required for further development of R&D programs, equipment, training, creation of joint venture affiliated companies, etc. (Funds must stay at the disposal of the joint venture and are not subject to taxation.)
- * To finance taxation as well as for compensation and social development.

The remaining part of the profit can be distributed among the partners on the basis of their shares in the authorized fund.

From the chart, the concept of the "joint venture's hard currency self-reliance" can be clearly seen. The requirement of self-reliance of a joint venture is connected first of all with

the need for imports from Western countries and with the need of foreign partner for profit repatriation.

The concept of joint venture's hard currency self-reliance is based on relevant terms of the Soviet joint venture legislation which outlines the lack of State liability for any obligations of a joint venture and among those for the obligation to guarantee the repatriation of profit in hard currency. This therefore means that all the necessary assets in hard currency must be furnished by a joint venture only through exports or sales on the local market in hard currency. The minimum size of such earnings depends on the volume of joint venture expenditures, including the foreign partner's profit.

The question which is often posed by our Western counterparts is: "What should be the minimum share of joint venture sales in hard currency with regard to the total sales volume?"

As may be seen on the graph (Figure 2), in the case when profit makes up only 25% of total expenditures, the joint venture is bound to receive only approximately 4% of its total sales in hard currency. When the profit amounts to 150% of total expenditures, the joint venture is obliged to sell about 20% of its total sales in hard currency (see Line A in Figure 2).

Should a joint venture, for instance, have imports (or expenditures in the USSR in hard currency) amounting to 10% of total expenditures (see Line B), then under $p = 25\%$, $k = 12\%$ and under $p = 150\%$, $k = 234\%$. Accordingly, under hard currency expenditures amounting to 30% of total expenditures (see Line C), the required sales volume in hard currency may approach over 31%. For the time being, all joint ventures operating in the USSR have between 5 and 15% of their total sales in hard currency.

2. CREATING A JOINT VENTURE IN THE USSR

At the beginning of November 1988, the USSR Ministry of Finance registered 122 joint ventures in the country, with the participation of 180 Soviet enterprises and amalgamations as well as 150 foreign firms and companies representing 28 countries.

It can be seen on Table 1, that 18 of the shown joint ventures have been created with partners from Socialist countries, 5 with the partners from developing countries, and as many as 99 with partners from Western industrial countries. As the table shows, the greatest number of joint ventures have been established with the Federal Republic of Germany (20), Finland (16), Italy (10), and Austria (9). The existing level of total USSR trade turnover with these countries is 40% of total USSR trade turnover with Western countries. Therefore, the level of bilateral econo-

mic relations creates favorable provisions for establishing joint ventures.

It should be noted here the activities of Soviet-Austrian joint ventures, located in the USSR, most of which are mainly engaged in machine-building, electro-technical industry, computer software, and services. The total Austrian investments to authorized funds are over US\$ 16 million, of which US\$ 14 million is invested in the "Volmat" joint venture.

Fifteen joint ventures in the USSR are engaged in machine-building, the most important of which are Soviet-FRG "Homatek" (authorized fund is US\$ 79 million), producing machine tools and Soviet-Italian "Sovitalprodmach" (authorized fund is US\$ 32.3 million), producing refrigeration equipment for trade operations.

Sixteen joint ventures are engaged in the chemical industry, the most important of which are: Soviet-FRG "Petrokam" (authorized fund is US\$ 15.7 million), production ethylenglicol; Soviet-Italian "Sovplastital" (authorized fund is US\$ 39.3 million), producing consumer plastics; and Soviet-USA "Pris", etc.

Fifteen joint ventures in the USSR are engaged in the construction industry; for example, Soviet-USA joint venture "Perestroyka" will be engaged in the reconstruction of industrial and civil buildings (authorized fund is US\$ 12.5 million) and Soviet-Finnish joint venture "Lentek" will undertake the construction and repair of civil and industrial projects, etc.

Fourteen joint ventures in the USSR have been established in the agro-industry sector, being operated mainly for processing, storage, and agricultural production as well as for the food industry. Among them are several large-scale joint ventures such as the Soviet-Swedish joint venture "Neptun" (authorized fund is US\$ 25 million) and Soviet-Japanese joint venture "Pilenga-Godo" on Sachalin Island (authorized fund is US\$ 36 million).

Sixteen joint ventures have started consulting and engineering services, providing them both to Soviet and foreign employers involved in multilateral economic cooperation, for instance, Soviet-Finnish joint venture "Vneshconsult" and "Projectsofin," Soviet-Austrian "Sterhautomatization" and others.

Sixteen joint ventures have also started activities in the field of electronics, with software taking into account the real local market requirements. Among them are Soviet-USA joint venture "Dialog" (authorized fund is US\$ 25 million), Soviet-French-Italian joint venture "Interquadro", Soviet-FRG "Kompan" and others.

In the field of health care, the Soviet-Swiss joint venture

"Diaplus" (medical diagnostic instruments) and the Soviet-Syrian joint venture "Avizenna" may be mentioned.

In light industry, such joint ventures as Soviet-FRG "Lenvest" and "Belvest" (shoe production), Soviet-Finnish "Estfinn" (ladies' garments) and others have started operations.

Thus, general capital investments into registered joint ventures, i.e. the total amount of joint financial assets into their authorized funds now amounts to approximately US\$ 1060 million, of which some US\$ 415 million are foreign assets.

3. CURRENT PROBLEMS OF JOINT VENTURES

When assessing these joint ventures, we cannot regard them as being essential in terms of their influence on the development of the Soviet economy as a whole. At the same time, we can also not ignore the legal, economic and management problems which joint ventures are facing now during the states of creation and operation.

3.1. Legal Issues

These are mainly connected with the fact that for the time being several most important topics are still to be settled. For example:

- * The regulations covering the use of joint venture dividends by Soviet partners have not yet been determined. This might be considered as one of the most important problems, taking into account that starting January 1989, all Soviet enterprises will be operating on the basis of self-financing.
- * The regulations regarding the inter-relation of joint ventures with regional authorities in terms of budgeting also still remain to be determined and legalized. For the time being, all tax on joint venture profits is forwarded to the State budget since many responsibilities for developing domestic infrastructure still lie with regional authorities. The legal terms covering the different forms of investment activities in the USSR are still to be agreed upon, although such activities are not prohibited by Soviet law.

Several Soviet legislative rules and regulations do not yet correspond to the requirements covering the stages of establishing and operating joint ventures. This can be easily illustrated by the fact that at the moment many Soviet policy-makers do not consider it pertinent to restrict the foreign partner's share in the Authorized Fund to 49% as well as to assign only Soviet citizens to the post of Chairman of the Board of a joint ventures, because it is quite obvious

that none of the partners should have an advantage of leadership in capital investment if they all have the right of consensus.

These above mentioned legislative rules and regulations as well as others are now under consideration in the country's policy-making bodies and are being revised in view of real requirements.

3.2. Economic Problems

The economic problems of creating and operating joint ventures are mainly connected with the following:

- * with the non-suitability of internal economic mechanisms;
- * with the non-convertibility of the national currency;
- * with the level of infrastructure in the USSR.

The USSR internal economic mechanism, the rules and conditions of relationships between Soviet enterprises are currently being improved in the process of the country's economic reforms. The major direction of such reforms -- increasing self-financing abilities of all enterprises, e.g. in the field of external economic relations. The recently adopted Law on State Enterprise, Law on Cooperative Activity, and Regulation on the Development of Wholesale Trade, etc. are aimed in this direction.

The non-convertibility of the USSR national currency creates certain difficulties in establishing the concept of self-financing of joint ventures. In order to resolve these problems, joint ventures are allowed, for example, to sell their goods to domestic Soviet enterprises for hard currency. The ability to exchange roubles at currency market exchange rates is now under consideration, having in mind to arrange for such exchanges based on currency auctions. The radical reform of prices is now also under consideration; further elaboration and implementation could help to optimize the level of prices in the USSR.

For the time being, many more financial assets are forwarded from the State budget and from funds of ministries and enterprises for developing infrastructure, in particular transport, communications, and civil construction.

3.3. Management Problems

These problems also have a complex character and should be analyzed separately.

First of all, joint ventures do not have much flexibility

when obtaining materials and information. They are also separated from each other in their activities.

Secondly, the existing level of an internationally unified process of negotiations for creating joint ventures still requires further development.

And finally, it should be noted that most Soviet managers are not yet ready to deal with external activities.

Some additional regulations are now under consideration, which should allow joint ventures to use the State system of supplies and sales and are believed to facilitate the procedures of joint ventures' interrelation with State bodies and authorities. The use of free-trade zones for establishing joint ventures is also under consideration in scientific studies and with managers.

Applied scientific studies are being undertaken by leading Soviet economic and research organizations and institutions aimed towards facilitate the process of creating joint ventures in the USSR.

In this connection, the "Provisional Standard Procedure for Estimating the Economic Effectiveness of the Establishment of a Joint Venture" is being elaborated and implemented. This document is actually a set of guidelines for preparing feasibility studies and is aimed at estimating the economic effect of establishing a joint venture, both for the Soviet and the foreign partners. In the guidelines, internationally approved indicators are used which could be applied to relevant investment projects.

Guidelines on obtaining and evaluating proposals and selecting foreign partners when establishing joint ventures in the USSR has also been elaborated and is now being implemented. This document is intended to facilitate the process of selecting foreign partners for a joint venture within the territory of the USSR and describes the approach and methods to evaluate proposals from foreign firms on a competitive basis.

Recently, the major guide for foreign businessmen and managers, "USSR - New Business Opportunities," was published. This book includes wide information on the Soviet economy, the process of reconstructing the system of Soviet external economic affairs, the legislation on creating, establishing, operating joint venture activities.

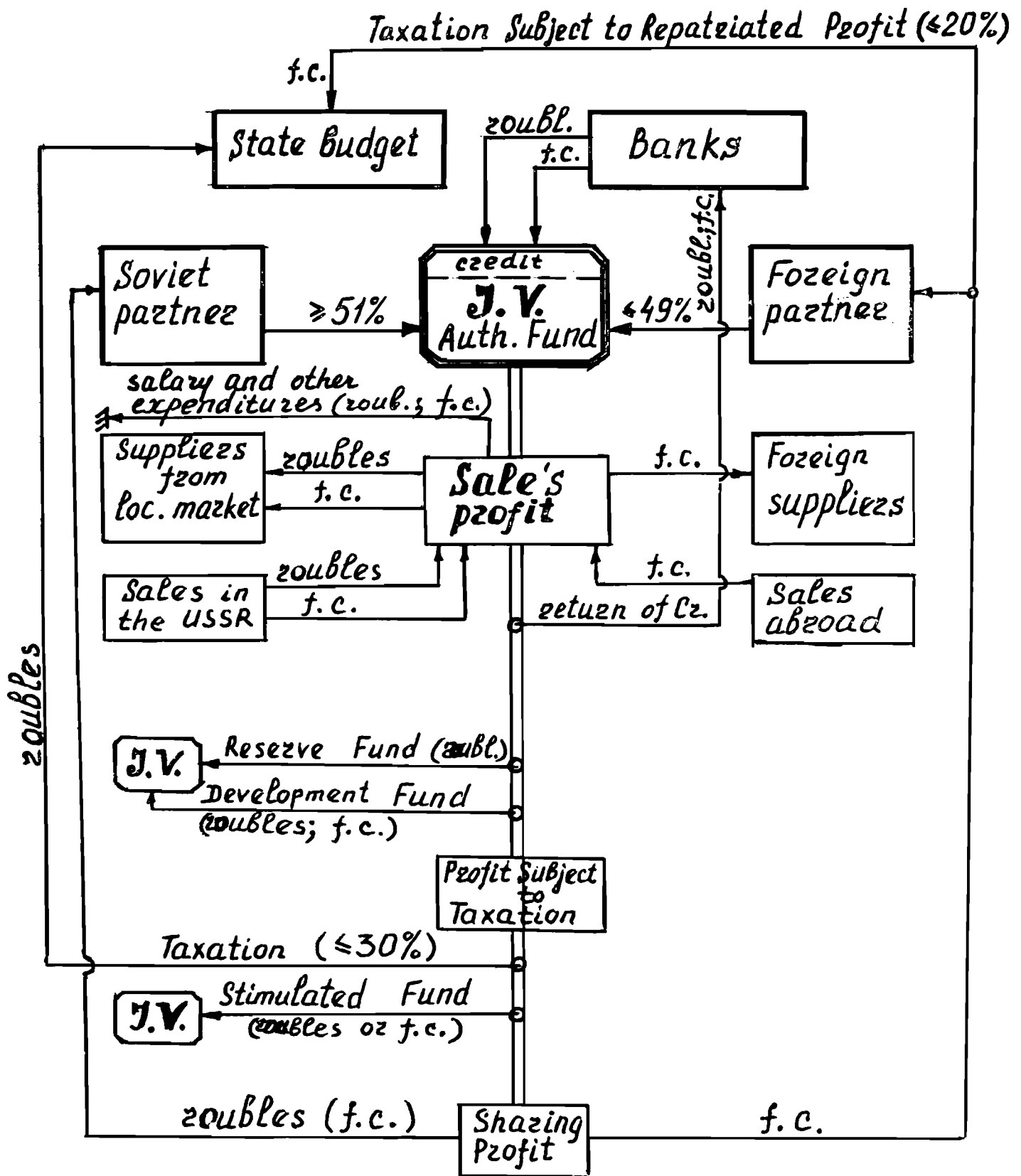
All of these materials have now been delivered to IIASA in order that specialists from interested countries can become acquainted with them and can contribute their views.

As far as the lack of knowledge on the part of Soviet managers in the field of internal economic affairs is concerned,

this is really taking place. Soviet enterprises were isolated from proper economic relations with foreign firms for a long time. Now, wide measures in the USSR, including training joint venture managers, are being undertaken. In this year alone, over 30 such workshops were organized in Moscow, Leningrad, Tallin, Kiev, and other industrial centers. In these training workshops, not only Soviet specialists participate, but also many experts from international organizations (UNIDO, ECE, etc.) as well as from foreign consulting firms. New higher institutions for managers and new facilities at the leading economic universities are also being established.

It is obvious that all of these measures will facilitate the formation of joint ventures in the USSR. At present, approximately 300 projects of new joint ventures are being examined. These joint ventures will probably be created during 1989. Among them are some major projects, for example a gas field project "Tengiz-polimer" with participation of Soviet, Italian and Japanese companies (with estimated established capital is over US\$ 6 billion). There are several joint venture projects with participation of U.S. companies Ford, Kodak, Chevron, and others. These joint ventures will cooperate within the frame of the Soviet External Consortium and American Trade Consortium.

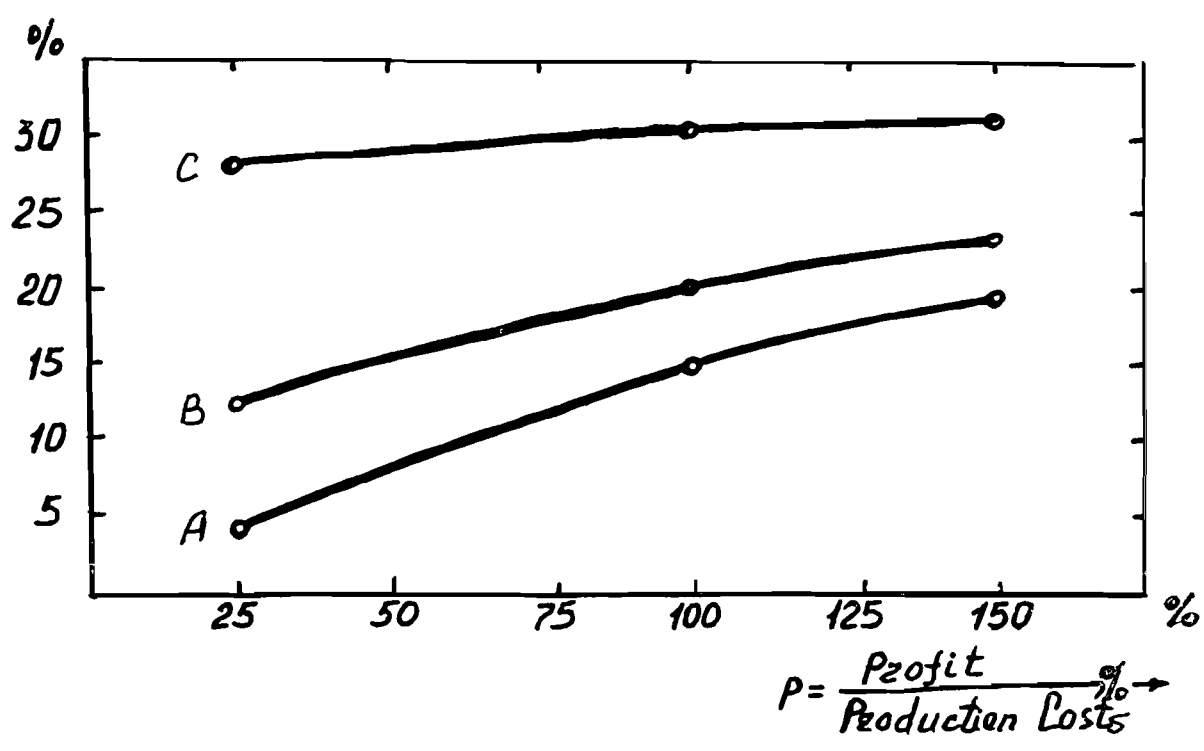
The development of the process for creating joint ventures is encouraged by strengthening the productive independence of Soviet enterprises and their contacts with foreign partners. The interests of Western firms to access Soviet natural, material and labor resources through joint venture activities with Soviet partners is also a factor. These aspects support the assertion that the process of creating joint ventures in the Soviet will be dynamic.



Financial Flow-chart

FIGURE 1.

$$K = \frac{\text{Hard currency sales, \%}}{\text{Volume of sales}} \rightarrow$$



Requizelements of Hard Cuzzency Sales
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FIGURE 2.

TABLE 3.

JOINT VENTURES LOCATED IN USSR WITH BREAKDOWN BY COUNTRIES AND SECTORS (S.I. 88)

COUNTRY	TOTAL	MECH. EN. & MACHINERY-TOOLS	CHEMICALS & WOOD PROC.	LIGHT IND.	TRANSPORT	ELECTRONICS & SOFTWARE	FOODS & AGRICUL.	BUILDING IND.	SERVICES	CONSULTING & ENGINEERING	HEALTH CARE	OTHERS
AUSTRIA	9	2	1			3	1		1	2		
UK	7					1				1	2	1
NETHERLANDS	1						1					
ITALY	10	2	2	1			2	1	1	1		
CANADA	4	1					1	1				2
USA	8					2	1	1		2		2
FINLAND	16	1	3	1	1		1	5	1	2		1
FRANCE	6	1	1			1				2		1
FED. REP. GERM.	20	4	2	3		2	2		3	2		2
SWITZERLAND	6	1	1		1				1	1	1	
SWEDEN	2		1				1					
JAPAN	6		1				3	2	1			
IRELAND	1											
SPAIN	1					1						
LIECHTENSTEIN	1									1		
AUSTRIA	1							1				
CYPRUS	1							1				
UN. ARAB EM.	1								1			
INDIA	1											
SAUDI ARABIA	2								1		1	1
CHINA	1								1			
KOREA REPUBLIC	1	1				1						
BULGARIA	4	1	1			2			1	1		
HUNGARY	7	1	1	1		2			1			
POLAND	1					1						
YUGOSLAVIA	7	1	1			1		1				
TOTAL	122	15	16	6	2	16	14	12	10	16	4	11