

Offshore orientation of Russian Federation FDI

Alexander Bulatov*

The research note analyses the geographical profile of FDI of the Russian Federation, which is characterized by the prevalence of offshore entities and conduit (transshipment) countries. It puts forward a hypothesis about the traditional motives (tax minimization) and the non-traditional motives (insufficient safeguarding of legal business, poor level of financial market development, high incidence of monopolization) for this phenomenon. The hypothesis is supported by methodological and empirical arguments constructed against the background of trends and practices in the BRICS and developed economies.

Key words: Russian Federation, FDI, offshore, conduit (transshipment) countries, capital flight, capital round-tripping, BRICS

JEL: *F21*

1. Introduction

Traditionally the adjective “offshore” refers to tax havens and offshore financial centres. The lists of such entities differ. For example, in 2000 the Organisation for Economic Cooperation and Development (OECD) counted 41 tax havens plus 21 jurisdictions with potentially harmful preferential tax regimes, whereas the International Monetary Fund (IMF) and Financial Stability Forum counted 47 offshore financial centres. In 2005, the Tax Justice Network counted 69 tax havens. The lists differ because of the criteria adopted for identifying such entities and also some jurisdictions with potentially harmful preferential tax regimes can also contain tax havens or offshore financial centres (Tax Justice Network, 2007). International campaigns against offshore entities in recent years have attained some positive results, particularly in respect of transparency. However, such campaigns yielded little results in other aspects; e.g. the share of offshore entities in international banking assets has not changed since 2009 and remained close to 13–14 per cent (BIS, 2014) and even increased up to 17% by the end of 2016 (BIS, 2017).

The term “conduit countries” (sometimes called “transshipment countries”) as used in this analysis refers to jurisdictions that are not offshore entities (though some of them are included in the Tax Justice Network list) but are jurisdictions through which

* Alexander Bulatov is Professor at the Department of World Economy of MGIMO University, Moscow. Contact: bulatov.moscow@mail.ru

large volumes of foreign direct investment (FDI) transit because they host special purpose entities or other entities that facilitate transit investment and offer advantages to investors. UNCTAD's *World Investment Report* calls this type of jurisdiction a conduit country and applies the term "offshore hubs" to 42 tax havens and conduit jurisdictions (*WIR15*). Leading conduit countries are Luxemburg, Ireland, Austria, Switzerland, the United Kingdom and the Netherlands. The last two, in addition to special purpose entities, have international financial centres and their own nets of offshore entities. The United Kingdom has 14 British overseas territories (including Cayman and the British Virgin Islands) and 3 crown dependencies (Jersey, Guernsey and the Isle of Man), which are offshore jurisdictions financially served by the City of London.¹ The Netherlands has a smaller financial centre and a web of offshore jurisdictions – the Caribbean dependent territories of the Netherlands (Curacao, Bonaire, Sint Maarten, Sint Eustasius, Saba and Aruba). Both the United Kingdom and the Netherlands offer advantageous financial infrastructure and legal framework for offshore operations. The United Kingdom allows foreign residents to be taxed only on their United Kingdom income, applies a low corporate income tax rate², has a very liberal law on United Kingdom–controlled foreign companies, and allows the establishment of limited liability partnerships in England and limited partnerships in Scotland, which have less stringent auditing requirements (Tax Justice Network, 2015a). The Netherlands hosts 12,000 special financial entities (three quarters of them "letterbox" entities), used by foreign companies to route €4 trillion through the country every year using participation exemption (exempts international subsidiaries from Dutch corporation tax) as well as enjoying the absence of withholding taxes on interest and royalties (Tax Justice Network, 2015b). Transshipment mechanisms of the Netherlands and United Kingdom have been addressed in numerous studies (e.g. Brooks, 2013; Palan, 2012; Shaxson, 2011; Eurodad, 2015).

This research note uses the term "offshore orientation" with respect to FDI to describe a large share of tax havens, offshore financial centres and conduit countries in FDI flows. In this sense, all major countries participating in FDI are "offshore oriented" to a certain extent. However, the FDI of the BRICS countries (Brazil, the Russian Federation, India, China, South Africa) is significantly more oriented towards offshore entities than major economies of the developed world. Table 1 does not cover all offshore entities and conduit countries because the table has been brought into line with the less detailed statistics of some BRICS economies and because, for generalization purposes, it covers only those offshore entities and conduit countries that have substantial flows of FDI with at least two BRICS countries.

¹ The City of London is estimated to have 17 per cent of the global market in offshore financial services (Tax Justice Network, 2015a).

² The corporate income tax rate in the United Kingdom is set to be reduced from 28 per cent to 18 per cent by 2019.

Table 1. Russian Federation and some other countries: offshore focus of FDI outflows and inflows, US\$ billion

	Outflows						Inflows									
	Russian Federation, 2013	Brazil, 2014 **	India, 2011 *	China, 2013	South Africa, 2010 ***	United States, 2013	Japan, 2013	Germany, 2013	Russia, 2013	Brazil, 2014 **	India, 2011	China, 2013	South Africa, 2010 ***	USA, 2013	Japan, 2013	Germany, 2013
Total	86.7	19.6	16.9	107.8	86.7	328.6	135.7	40.9	70.7	47.3	23.5	117.6	148.5	230.8	2.3	10.5
Hong Kong (China)	0.2	...	0.2	62.8	0.1	5.4	1.8	0.3	0.1	0.4	0.3	73.4	...	1.4	0.2	-0.4
Singapore	0.3	0.1	4.0	2.0	...	17.5	...	1.5	-0.5	0.2	3.3	7.2	0.1	1.4	0.3	0.4
Mauritius	...	...	5.1	...	7.8	0.3	-0.5	0.01	...	...	8.1	...	0.3	0.2	0.0	0.02
Bermuda	0.6	...	...	...	...	5.6	-0.1	0.1	1.1	0.7	...	0.7	1.1	2.3	-0.02	0.4
Bahamas	0.6	0.4	...	...	...	1.8	0.01	0.5	2.8	0.2	...	0.1	...	0.5	0.0	0.3
Cayman Islands	0.5	6.0	0.4	9.3	...	16.6	0.4	0.1	-0.1	0.6	...	1.7	...	8.8	-1.0	3.8
British Virgin Islands	62.3	1.2	0.3	3.2	...	...	3.0	0.1	9.4	-0.1	...	6.2	...	...	-0.1	0.3
Cyprus	7.7	...	...	...	...	0.2	-0.1	0.1	8.3	...	1.6	0.1	...	...	0.0	0.1
Luxembourg	1.3	1.9	...	...	15.0	42.8	0.9	9.8	11.6	6.4	...	0.4	2.3	26.1	1.3	11.4
Ireland	0.3	...	...	...	0.4	29.6	1.7	1.3	10.4	0.1	...	0.1	0.3	15.4	-0.7	-2.9
Austria	5.3	2.2	...	...	3.8	2.0	0.02	2.9	-0.3	0.3	...	0.2	0.2	0.6	-0.1	2.0
Switzerland	1.4	0.2	0.2	...	1.2	5.3	-0.1	-2.5	1.1	1.9	0.2	0.3	6.7	17.0	-0.4	-0.9
Netherlands	-3.0	-0.9	1.5	...	2.5	57.6	8.7	-28.5	5.8	6.7	1.3	1.3	26.0	12.8	0.5	-12.7
United Kingdom	1.3	0.1	0.4	1.4	14.3	32.4	13.4	2.3	19.9	1.7	2.8	0.4	73.7	41.9	0.6	-3.6

Sources: OECD, 2014, 2015; Bank of Russia, 2015; Banco Central de Brazil, 2014b, 2013; China Statistical Yearbook, 2014; Khan, 2012.

... = negligible or no data

**2010/2011 financial year

** Stocks (shares) only

*** FDI accumulated by the end of 2010

Traditional explanations of FDI orientation towards offshore entities and conduit countries cite tax planning motives. In developing economies, this motive can explain why the focus of FDI on offshore entities is high but not why it is higher than in developed economies. Some studies have described the issue in general (e.g. Borga, 2016; Kalotay 2012). More attention is paid to the offshore orientation of Chinese FDI (e.g. Vicek, 2010; Xiao, 2004) and less to that of Russian Federation FDI (e.g. Peltó, Vahtra and Liuhio, 2004) – the latter sometimes focusing on corruption motives (Ledaeva, 2013, 2015).

We put forward a hypothesis about the traditional (tax planning) and non-traditional (insufficient safeguards for legal businesses, poor levels of financial market development, high incidence of monopolization) motives for FDI in offshore entities. The negative elements of the investment climate in developing economies generate additional, non-traditional motives for an offshore orientation. Among these countries, the Russian Federation is the champion in terms of the share of offshore entities in FDI flows, and its case gives substantial evidence to support the hypothesis.

2. Russian Federation and other developing economies in global FDI

Developed economies were traditionally the dominant sources and recipients of FDI. In the current decade, the trend has been changing: developing economies (including transition economies) are becoming the leading players as both host and home of world FDI.

The *World Investment Report* of the United Nations Conference on Trade and Development categorizes Hong Kong (China), Singapore, the Republic of Korea and Taiwan Province of China in the developing economies group, but international financial organizations (the Bank for International Settlements, the IMF, the World Bank Group) traditionally identify these as developed economies. Apart from the “four tigers”, the leading position in outward and inward FDI stock belongs to China, and the second position in outward FDI stock to the Russian Federation (which holds the fifth position in inward FDI stock, after China, Brazil, Mexico and India). Among other developing economies with substantial FDI flows are Indonesia, Malaysia, Saudi Arabia, Thailand and Turkey in Asia; Argentina, Chile and Colombia in Latin America; Nigeria and South Africa in Africa; and Kazakhstan in transition economies (UNCTAD, 2016).

The growing role of developing economies in the world’s FDI flows can be accounted for by two factors. On the one hand, it is the result of the rising level of their economic development, which generates traditional motives for FDI flows. On the other hand, the specificities of their investment climates (intrinsic to developing economies) add

Table 2. World FDI: outflow and inflow, US\$ billion (percentage of total in brackets)

	2007		2010		2014		2015	
	Outflow	Inflow	Outflow	Inflow	Outflow	Inflow	Outflow	Inflow
World, total	2,272.0	2,002.7	1,467.6	1,422.3	1,354.0	1,228.3	1,474.2	1,762.2
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Developing economies*	381.6	682.6	478.8	718.8	468.1	681.4	377.9	764.7
	(16.8)	(34.1)	(32.3)	(50.5)	(38.9)	(59.4)	(25.6)	(43.4)
Africa	10.6	63.1	9.3	44.1	13.1	53.9	11.3	54.1
Nigeria	0.5	6.1	0.9	6.1	1.6	4.7	1.4	3.1
South Africa	3.0	5.7	-0.1	3.6	6.9	5.7	5.3	1.8
Asia	225.6	338.2	284.1	401.9	431.6	465.3	331.8	540.7
China	26.5	86.7	68.8	114.7	116.0	128.5	127.6	135.6
Hong Kong (China)	61.1	54.3	86.2	70.5	142.7	103.3	55.1	174.9
India	17.2	25.4	15.9	27.4	9.8	34.4	7.5	44.2
Indonesia	4.7	6.9	2.6	13.8	7.1	22.6	6.2	15.5
Korea, Rep. of	15.6	2.6	28.3	9.5	30.6	9.9	27.6	5.0
Malaysia	11.3	8.5	13.4	9.1	16.4	9.8	9.9	11.1
Saudi Arabia	12.7	22.8	3.9	29.2	5.4	8.0	5.2	8.1
Singapore	27.6	35.8	33.4	55.1	40.7	67.5	35.5	65.3
Taiwan	11.1	7.8	11.6	2.5	12.7	2.8	14.8	2.4
Thailand	2.9	11.4	4.5	9.1	7.7	12.6	7.8	10.8
Turkey	2.1	22.0	1.5	9.1	6.7	9.1	4.8	16.5
Latin America and the Caribbean*	56.0	162.6	46.9	131.7	23.3	159.4	40.0	167.6
Brazil	7.1	34.6	11.6	48.5	-3.5	62.5	3.1	64.6
Chile	2.6	12.5	10.5	16.8	13.0	22.9	15.5	2.2
Colombia	0.9	9.0	5.5	6.4	3.9	16.1	4.2	12.1
Mexico	8.3	27.4	15.1	26.1	5.2	22.8	8.1	30.3
Transition economies	50.1	78.1	62.0	75.0	63.1	48.1	31.1	35.0
Kazakhstan	-	-	7.9	11.6	3.6	9.6	0.6	4.0
Russia	45.9	57.0	52.6	43.2	56.4	21.0	26.6	9.8

Source: IMF, 2015, 2008; UNCTAD 2016b, 2015, 2014, 2013a, 2013b, 2013c.

*Excluding financial centres in the Caribbean.

some non-traditional motives (from the point of view of FDI theories), expanding the scope of their FDI outflows. These non-traditional motives show themselves in the geographic orientation of developing economies' FDI, which is biased toward offshore entities and conduit countries.

Russia's FDI stock was growing rapidly until 2014, when economic crisis, the oil price drop and Western sanctions stopped this process. That said, 2015 data indicate that growth has resumed.

The ratio of outward and inward FDI stock to GDP in the Russian Federation is high and close to that of the top developed economies. Among other BRICS countries, only South Africa has a ratio of FDI stock to GDP that is close to those of developed economies. The high ratio of South Africa can be attributed to the fact that the country is a regional hub for Western transnational corporations (TNCs) in sub-Saharan Africa. But the Russian Federation case needs some other explanations because the country is rarely used by TNCs as a hub for investing in neighbouring countries. Instead its large FDI stocks can be attributed to intensive round-tripping FDI between firms owned by residents at home and abroad.

Table 3. Russian Federation: FDI stock, US\$ billion

	2000	2005	2010	2011	2012	2013	2014	2015
FDI outward stock	20.1	140.8	361.1	361.8	409.6	479.5	388.4	336.3
FDI inward stock	32.2	180.2	489.0	454.9	514.9	565.7	353.4	342.9

Source: Bank of Russia, 2016, 2015b, 2015c.

Table 4. Russian Federation and other countries: FDI outward stock and GDP ratio in 2014

	GDP, current US\$	FDI outflow stock, current US\$	Outward FDI stock to GDP ratio, per cent	Inward FDI stock, current US\$	Inward FDI stock to GDP ratio, per cent
Russia	1,861	432	23.2	379	20.4
Other BRICS					
Brazil	2,346	316	13.5	755	35.2
India	2,067	130	6.3	252	12.2
China	10,360	730	7.0	1085	10.5
South Africa	350	134	38.3	145	41.4
Developed countries					
United States	17,419	6,319	36.2	5410	31.1
Japan	4,601	1,193	25.9	171	3.7
Germany	3,853	1,583	41.1	744	19.3

Source: UNCTAD, 2015; World Bank, 2015.

3. Geographical pattern of Russian Federation FDI

The geographical pattern of FDI stock of the Russian Federation shows that the dominant sources and destinations of its FDI are offshore entities and conduit countries. No less than 75 per cent of the outward FDI stock is these jurisdictions, and the share of these jurisdictions in the inward FDI stock is 76 per cent.

Statistics on the geographical distribution of the FDI stock of the other BRICS states are scarcer, but the more readily available statistics on their FDI flows can compensate for that scarcity. Table 1 illustrates the prevalence of offshore entities and conduit countries in the geographic orientation of all BRICS states' FDI outflows. It allows us to conclude that:

- In Russian Federation FDI flows, offshore entities and conduit countries carry significant weight – 90 per cent of outflows and 97 per cent of inflows, with a focus on the Caribbean in outflows and Western Europe in inflows.
- In Brazilian FDI, offshore entities and conduit states account for 57 per cent of outflows and 41 per cent of inflows, particularly the Caribbean in outflows and Western Europe in inflows.

Table 5. Russian Federation: geographical allocation of outward and inward FDI stock in 2014, asset/liability concept, US\$ billion

	Outward stock	Inward stock
Total	384.7	365.4
Hong Kong (China)	1.3	0.4
Singapore	2.4	0.6
Mauritius	0.01	0.02
Bermuda	2.9	14.6
Bahamas	4.3	21.0
Cayman Islands	1.5	0.1
British Virgin Islands	47.1	14.3
Cyprus	105.2	100.9
Luxembourg	12.1	38.7
Ireland	2.7	0.02
Austria	36.1	6.3
Switzerland	17.7	10.9
Netherlands	49.1	51.4
United Kingdom	9.5	10.5

Source: Bank of Russia, 2015b, 2015c.

- In Indian FDI, 72 per cent of outflows and 75 per cent of inflows are through offshore entities and conduit states, in particular by Mauritius and Singapore, as well as by countries in the Caribbean and in Western Europe.
- In Chinese FDI, 80 per cent of outflows and 78 per cent of inflows are through offshore entities and conduit countries, especially Hong Kong (China) but also countries in Western Europe.
- In South African FDI, the share of offshore entities and conduit states is also very substantial – 53 per cent of the stock accumulated abroad and 75 per cent of FDI stock accumulated in the country, predominantly to and from Western Europe.

The high level of FDI in offshore entities is the principal feature of FDI outflows from and inflows to the Russian Federation, even in comparison with other BRICS countries. Moreover, this high level is a feature of other types of investment from the Russian Federation. Data from the Bank of Russia show that the above-mentioned set of offshore entities and conduit countries receives 76 per cent of the portfolio investment of Russia, at the expense of Western Europe (Bank of Russia, 2014b). As for other BRICS countries, data of the Banco Central do Brazil indicate that this set of countries receive 41 per cent of long-term securities invested abroad, especially those in the Caribbean and Western Europe (Banco Central do Brazil, 2015). Statistics of India's portfolio assets abroad shows that 50 per cent of them are located in those 14 countries, particularly in Luxemburg, Bermuda, Mauritius (IMF, 2017). According to the South African Reserve Bank, 66 per cent of outward portfolio investments are invested in that set of states and territories, particularly in the UK, Luxemburg and Bermuda (South African Reserve Bank, 2016).

Comparison with the United States, Japan and Germany (using the same set of offshore entities and conduit states) gives different results. Table 1 shows that although in 2013 this set of offshore economies received 66 per cent of United States FDI outflows and were sources of 56 per cent of United States FDI inflows, the distribution of FDI in Japan and Germany were very different. The set of offshore economies drew only 22 per cent of Japanese FDI outflows and delivered 27 per cent of Japanese FDI inflows. In Germany FDI outflows and inflows to and from offshore entities and conduit countries were negative in 2013; i.e. both German assets in these places and these places' assets in Germany were decreasing.

The UNCATD data corroborates this observation. In 2012, the share of investment stock from offshore and conduit countries in inward FDI was about 29 per cent in developed economies, in a declining trend, and 30 per cent in developing ones (24 per cent in Africa, 27 per cent in Latin America and the Caribbean, 31 per cent in developing Asia, 60 per cent in transition economies), in a rising trend (UNCTAD, 2015).

4. Instruments of offshore orientation of capital exports and imports

The majority of international investors from both developing and developed economies use offshore entities and conduit countries. However, the increasing scrutiny by the tax authorities in capital exporting countries has forced TNCs to take different approaches. In the Russian Federation, TNCs have resorted to following practices:

- To export capital first to conduit states and then to offshore entities affiliated with these states. For example, in 2010–2014, FDI flows from the Russian Federation to the United Kingdom and the Netherlands totalled US\$13.5 billion (excluding reinvestment), i.e. about 8 per cent of total FDI outflows from the country. Some offshore jurisdictions are also used by Russian Federation investors as conduits, especially Cyprus, where a relatively high corporate tax for an offshore economy (12.5 per cent) is offset by good financial infrastructure that is connected with other European Union (EU) member countries and numerous tax treaties with other offshore entities.
- To export capital without any registration in its country of origin, which is typical for many investors in offshore entities. For instance, in 2010–2014, unregistered capital outflows from the Russian Federation amounted to US\$43 billion (Bank of Russia, 2015d).³ Unregistered capital generated some 7 per cent of all capital outflows from the Russian Federation in this five-year period. Usually, unregistered assets cross borders as cash or contraband goods.
- Lending to non-residents without repayment. By the estimations of the Central Bank of Russia, by 2015 the total sum of outstanding loans from Russian Federation residents to non-residents that were not repaid was more than \$30 billion (Kommersant, 2015).
- To use so-called fictitious transactions, which predominantly consist of misinvoicing export and import contract prices and subsequently placing the difference between real and contract prices abroad, as well as making advance payments for imports that have not come into the country. This occurred in 2014 when the Central Bank of Russia discovered that in the two preceding years Russian Federation companies had paid \$48 billion to offshore entities for fictitious imports through Belarus and Kazakhstan, which do not have customs borders with the Russian Federation. A substantial part of fictitious transactions is fictitious securities trading, which

³ The IMF recommends identifying with it the systematically negative item, “net errors and omissions” in the balance of payments.

covers cross-border money transfers under the false pretext of purchasing foreign securities. Usually these transfers move through numerous bank accounts and after that are accumulated in a foreign bank account in offshore entities or conduit countries. Fictitious transactions with money transfers to non-residents comprise various operations, e.g. a fictitious honorarium for alleged consultation from abroad or alleged fines. In 2013–2014, several billion U.S. dollars were transferred from the Russian Federation to Moldova as fictitious fines for fictitious contracts signed by local affiliates of Russian Federation and offshore firms in Moldova. Later, the local Moldincombank transferred the money to offshore entities (OCCRP, 2014).

After registration of a firm in some offshore jurisdiction, a typical owner of FDI assets from developing economies traditionally exports a substantial part of these assets back to the home economy. Table 1 shows that the shares of offshore entities and conduit countries in FDI outflows and inflows are close. In FDI from the Russian Federation these shares are very close and high – 90 per cent and 97 per cent, respectively. The principal recipient of Chinese FDI outflows is Hong Kong (China), and from this offshore entity, China receives the bulk of its FDI inflows. For India, the principal FDI recipient is Mauritius and the principal FDI source is Singapore; for South Africa, Western Europe plays both roles. Brazil and the Russian Federation export their FDI mainly to the Caribbean and receive FDI from Western Europe (to which assets presumably flow from the Caribbean via European conduit countries).

This kind of capital movement is described by the term “round-tripping”. According to Sergey Glaziev, economic adviser to the president of the Russian Federation, 85 per cent of FDI in the country is investment by Russian Federation businesses through offshore entities (RBC, 2014). The treatment of round-tripping FDI gives rise to different estimates of the outward stock of Russian Federation FDI. The Bank of Russia assesses volumes of Russian Federation FDI outward stock using both the asset/liability concept (\$385 billion in 2014) and the directional concept (\$303 billion). The second method gives smaller stocks particularly in conduit countries: in the Netherlands in 2014, this stock was \$49 billion using the asset/liability concept and only \$37 billion using the directional concept. In the United Kingdom, the figures were \$10 billion and \$8 billion, respectively; in Switzerland, \$18 billion and \$13 billion; in Luxemburg, \$15 billion and \$14 billion; and in Cyprus (a combination of conduit country and offshore centre; see below), \$105 and \$93 billion. These five conduit countries account for \$60 billion of the total \$82 billion difference between the two methods of accounting.

The question is why offshore entities and conduit countries are preferable for such round-tripping FDI. The answer is evident: they are the best jurisdictions when the bulk of FDI exported to offshore entities is planned to be imported back to the country of origin. Offshore affiliates are designed as letter boxes and conduits for foreign capital because of the simplicity of registration, low transparency and the absence of currency regulation, not to mention the low tax rates.

We can infer that a predominant share of FDI coming into the BRICS economies is their national capital returning with a foreign passport. In the case of the Russian Federation, this share is especially high.

5. The causes of FDI offshore orientation

Chapter IV of the *World Investment Report 2015* analyses the traditional orientation of multinational enterprises towards offshore entities and conduit countries from the point of view of tax considerations. It states that “the root cause of offshore hubs in global corporate investments is tax planning, although other factors can play a supporting role” (UNCTAD, 2015). These other factors, according to *WIR15*, are investment treaties, low formalities for investment, strong legal and regulatory frameworks, good infrastructure and banking and business services environments, and economic and political stability. However, “the relative importance of non-tax factors ...should not be overestimated” (UNCTAD, 2015). In other words, this is the set of push-in factors (motives), dominated by the tax factor, which are ensuring the orientation of multinational enterprises towards offshore entities and conduit states.

Such an approach, with a focus on push-in factors, is predominant in analysis of FDI flows’ orientation towards offshore entities and conduit states. However, this analysis does not pay much attention to the link between push-out factors and orientation towards offshore entities and conduit states of FDI from developing economies. In part, this is a consequence of the fact that modern research on FDI flows (as well as capital movement as a whole) pays less attention to capital flight than in previous decades when substantial work on capital flight (including from the Russian Federation) was produced (e.g. World Bank, 2012; Schneider, 2003; Loungani and Mauro, 2000; Claessens and Naude, 1993; Lessard and Cuddington, 1987; Dooley, 1986). “Broadly speaking, capital flight refers to outflows of private capital from developing countries” (Davies, 2010), and capital flight analysis traditionally focused on specific factors (motives) pushing capital out of these countries (particularly motives connected with a bad business environment). We argue that the combination of the two approaches can shed more light on the high level of offshore orientation of FDI of the Russian Federation.

The important aspect of capital flight is its geographical pattern. Very frequently it is aimed at offshore entities and conduit countries. It occurs for two reasons: on the one hand, owners of assets are attracted by the tax, registration and transparency climate in those jurisdictions; on the other hand, offshore entities and conduit countries are convenient for returning assets to a home country, where owners of those assets are familiar with the local specificities of business (giving them a good chance of doing profitable business in their native country) and have lower risks (due to tax evasion through offshore entities and additional protection from arbitrary measures arising from the fact that they are formally foreign business).

The crucial question is why FDI flows from and to the Russian Federation are more offshore oriented than those of other BRICS economies. As an answer, we can hypothesize that in BRICS (as well in many other developing economies) a high level of offshore orientation of FDI is due to insufficient safeguards for local business, a low level of financial market development and a high level of monopolization. We can also hypothesize that for developing economies these motives are no less important than the tax avoidance motive. In the Russian Federation, these specific (non-traditional) motives are in greater force than in other BRICS economies, which results in a comparatively higher degree of offshore focus of Russian Federation FDI.⁴

6. Arguments to support the hypothesis

The hypothesis that emphasizes the role of the local business climate is supported by data from the Global Competitiveness Report issued annually by the World Economic Forum, with its 12 groups of indicators (from one to seven marks) for each participant country, illustrating strong and weak points of its economy.

Table 6 shows that the Russian Federation and other BRICS economies have worse business climates than leading developed economies. This is one of the causes of capital flight from developing economies in general. As for the Russian Federation, it has a total score close to those of other BRICS economies, though it generally lags behind in three groups of indicators – institutions, financial market development and business sophistication.

The worst scores are observed in the institutional sphere. Detailed indicators in this group – property rights, strength of investment protections, effectiveness of legal framework in settling disputes and challenging regulations, independence of judiciary, reliability of police services, scope of irregular payments and bribes – show that the safeguards for legal businesses in the Russian Federation are worse than in other BRICS economies. It is not surprising that for the protection of property rights, Russian businesses export capital to, for instance, the British Virgin Islands.⁵ They do so not only for the zero local corporate tax but also for the possibilities of applying to the local court in cases of violation of the company's rights in other countries – including the Russian Federation – and of lodging an appeal with the Judicial Committee of the Privy Council in London. For these reasons, the majority of major private companies in the Russian Federation are de jure owned by firms or

⁴ Some authors also include these specific motives in the set of push-out factors in FDI outflows from BRICS and other developing economies (e.g. Sauvart, Mallampally and McAllister, 2011; Kuznetsov, 2011; Gammeltoft, 2008).

⁵ In 2000–2014, investment flows from the Russian Federation to the British Virgin Islands accounted for 17 per cent of all flows to this jurisdiction (UNCTAD, 2016).

Table 6. BRICS countries versus developed countries: some investment climate indicators

	Russian Federation	Brazil	India	China	South Africa	United States	Japan	Germany
Institutions	3.5	3.2	5.5	4.2	4.4	4.8	6.7	5.2
Property rights	3.3	3.9	3.8	4.4	5.5	5.5	6.2	5.8
Judicial independence	2.9	3.4	4.0	3.9	5.4	5.3	6.2	5.8
Reliability of police services	3.2	3.9	3.8	4.3	3.6	5.7	6.0	5.9
Strength of investor protection	5.1	6.3	7.3	4.5	6.8	6.6	6.3	5.9
Irregular payments and bribes	3.4	3.1	4.1	4.0	4.3	5.1	6.3	5.5
Efficiency of legal framework in settling disputes	3.2	2.8	4.2	4.0	5.3	4.9	5.4	5.3
Efficiency of legal framework in challenging regulations	2.9	2.9	4.1	3.5	5.0	4.8	4.6	5.2
Infrastructure	4.8	3.9	4.4	4.7	4.1	5.9	6.2	6.1
Macroeconomic environment	5.3	4.0	3.7	6.5	4.5	4.4	3.7	6.0
Health and primary education	5.9	5.1	4.1	6.1	4.2	6.1	6.7	6.5
Higher education and training	5.0	3.9	3.9	4.3	4.1	5.9	5.4	5.6
Goods market efficiency	4.2	3.7	4.2	4.4	4.6	5.1	5.2	4.9
Labour market efficiency	4.4	3.7	3.9	4.5	3.8	5.4	4.8	4.6
Financial market development	3.5	4.0	4.1	4.1	5.0	5.5	4.7	4.7
Affordability of financial services	4.2	5.0	4.1	4.4	5.3	5.7	5.1	5.5
Financing through equity market	3.1	3.4	4.0	4.0	5.6	5.5	5.1	4.8
Soundness of banks	4.0	5.8	4.3	4.7	6.4	5.6	5.8	5.4
Regulation of securities exchanges	3.7	4.9	4.2	4.5	6.1	5.2	5.7	5.2
Technological readiness	4.2	4.4	2.7	3.7	4.6	5.9	5.7	6.0
Market size	5.8	5.8	6.4	7.0	4.9	6.9	6.1	6.0
Business sophistication	3.8	4.1	4.2	4.3	4.4	5.6	5.8	5.7
Extent of market domination	3.7	3.9	4.0	4.2	3.9	5.1	5.9	5.4
Effectiveness of anti-monopoly policy	3.7	3.9	4.1	4.2	5.1	5.2	5.4	5.1
Effect of taxation on incentives to invest	3.1	2.0	4.8	3.8	3.9	4.0	3.8	3.8
Total tax rate, as % profits	48.9	69.0	61.7	64.6	28.8	43.8	51.3	49.8
Local supplier quantity	4.4	4.7	4.6	5.2	4.6	5.4	6.2	5.8
Local supplier quality	4.1	4.3	4.3	4.3	4.8	5.5	6.2	6.0
Value chain breadth	3.5	3.8	4.4	4.2	3.9	5.5	6.2	5.9
Production process sophistication	3.5	4.0	3.9	4.1	4.4	6.1	6.4	6.2
Innovation	3.3	3.2	3.7	3.9	3.7	5.6	5.5	5.5
Total score	4.4	4.1	4.3	4.9	4.4	5.6	5.5	5.6

Source: World Economic Forum, 2015.

funds from offshore entities and conduit countries. Of the 50 top private companies of national origin (which produce one quarter of Russian Federation GDP), 23 were of this type. For instance, the controlling interest in the leading Russian Federation car producer AvtoVAZ is in the hands of a company registered in the Netherlands (Kheyfets, 2013).

The Global Competitiveness Report indicators on financial market development show low marks for the Russian Federation because of the weak local equity market, the undeveloped banking system and the inefficient regulation of securities exchanges. Consequently, Russian Federation companies use their offshore affiliates to reduce transaction costs when entering the financial markets of the United Kingdom, the Netherlands, Luxembourg and Switzerland. As in other BRICS economies (besides South Africa), for Russian Federation companies, the quickest way to place securities in the financial markets of developed economies is to create a firm in some offshore entities affiliated with these economies or in conduit countries with their international financial centres. This also is the traditional way for a Russian Federation bank to diversify its assets or assist its clients. For instance, at least five leading Russian Federation banks (VTB, Alfa Bank, AvoVAZbank, Privatbank, Promsvyazbank) have affiliates in Cyprus, as do numerous financial and investment affiliates of other Russian Federation parent companies. This island country is the most attractive offshore jurisdiction for Russian Federation investors (see table 5), not due to its corporate tax rate for offshore companies (which is higher than in many other offshore entities at 12.5 per cent) but due to numerous tax treaties with other offshore entities (which provide easy conduits to offshore entities with lower taxation rates) and also because the civil code of Cyprus is based on United Kingdom law. The last point is successfully used by Cypriot affiliates of Russian Federation banks and finance companies when, on behalf of their parent companies, they issue eurobonds in line with the standards of the London Stock Exchange in order to trade them at the exchange, the biggest in Europe. The issuance of those securities is less costly but more difficult in the Russian Federation with its continental law.

The indicators on business sophistication reveal other weak points of the Russian Federation economy that are pushing capital out of the country. First is the monopolization and oligopolization of the economy: 400 leading companies (with sales greater than 15 billion roubles; i.e. US\$700–750 million by purchasing power parity) produced 41 per cent of GDP in 2014 (Expert, 2015), and many of them were monopolies (Gazprom, Norulsky Nickel, Russian Railways, Aeroflot, Transneft) or leading oligopolies (LUKOIL, Rosneft, Sberbank, Rostelecom, Megafon) in their industries. It leads to a dominance of monopolies (oligopolies) and the ineffectiveness of the national anti-monopoly policy in Russia – even in comparison with other BRICS economies, where these indicators are also not high compared with leading developed economies (see table 6). As a result, the cost of entry to many industries in the Russian Federation is high for mid-sized local businesses not affiliated with

regional or federal authorities. As a result of this barrier to local markets, these investors often go abroad, including to offshore jurisdictions.

Another argument connected with business sophistication indicators is that though the corporate income tax is lower in the Russian Federation than in Brazil, India and China (see table 6), the tax system in the Russian Federation gives few allowances to companies reinvesting profits. At the beginning of the 2000s, the former finance minister Alexey Kudrin banned some of such deductions. This situation forces some Russian Federation investors to park their profit at affiliates abroad and finance their investment at home from those affiliates. Owing to their low taxes and liberal regulation, offshore financial centres are preferred by those investors.

Last but not least, the group of business sophistication indicators reveal a high level of de-industrialization of the economy in the Russian Federation, which lags those of other BRICS countries in quantity and quality of suppliers, value chain breadth and production process sophistication (see table 6). As a result, the scope of choice for national investors is limited, particularly when many profitable local industries are monopolized and local financial markets are not mature enough to provide credit for long-term projects in manufacturing. In this situation, some national investors prefer to keep part of their assets abroad, waiting for better times in the domestic economy.

Many weak points of the business environment and the economy as a whole are reflected in the growing debates among economists in the Russian Federation. They insist on structural reforms in the domestic economy, particularly when it is in recession (GDP growth was only 0.6 per cent in 2014 and -3.7 per cent in 2015 and is -0.2 per cent in 2016). The majority of economists stress the weakness of institutions, financial markets and business sophistication in the Russian Federation today. Whereas neo-liberal economists (e.g. Alexey Kudrin, 2016) focus on institutional reforms, neo-Keynesian economists (e.g. Sergey Glaziev, 2015) focus on a short- and mid-term approach – restructuring financial markets through quantitative easing and increasing business sophistication through re-industrialization. Nowadays in the Russian Federation neo-liberals have the upper hand in the government: in April 2016, Kudrin was appointed the deputy head of the Presidential Economic Council (President Vladimir Putin is the head) and the head of the Government's newly established Strategic Development Centre. The activity of the neo-Keynesians is increasing: they are the authors of the programme of the new Party of Growth, which is based on political activists from small and mid-sized enterprises. As for the de-monopolization of the economy, some practical steps have already been taken by the Government to support small and mid-size businesses, and each year the Russian Federation is improving its rank in the World Bank's annual "Doing Business" report.

7. Conclusion

The business environment in the Russian Federation and other BRICS economies provides non-traditional motives for private investors to use offshore entities and conduit countries, and these motives are not less important for them than tax avoidance. In the Russian Federation, some negative aspects of the business environment have deeper effects than in other BRICS economies, and this enlarges the scope of capital round-tripping from the country and strengthens its offshore orientation.

References

- Banco Centrale do Brazil (2015). Brazilian Long-term Securities Placements, <http://www/bcb.gov.br/textonoticia.asp?codigo=3891&IDPAI=NEWS>.
- Banco Centrale do Brazil (2014a). Census of Foreign Capital in Brazil, <http://www.bcb.gov.br/rex/CensoCE>.
- Banco Centrale do Brazil (2014b). Historical Series of the Balance of Payments, <http://www.bcb.gov.br/?BALANCESPECIAL>.
- Banco Centrale do Brazil (2013). Brazilian Capital Abroad (CBE) Survey – Base Year 2013, <http://www.bcb.gov.br/rex/CBE/Ingl/CBE2013results.pdf>.
- (BIS) Bank of International Settlements (2014). Detailed tables on provisional locational and consolidated banking statistics at end-September 2014, Tables 6a, 7a. 7b.
- (BIS) Bank of International Settlements (2017). Summary of locational statistics, by currency, instrument and residence and sectors, Table A 1.2.
- Bank of Russia (2015a). Direct Investment, http://www.cbr.ru/Eng/statistics/print.aspx?file=credit_statistics/bal_of_payments_new_14_e-htm&pid=svs&sid=itm_48213.
- Bank of Russia (2015b). Russian Federation: Outward Foreign Direct Investment Position by Geographical Allocation in 2009–2014, <http://www.cbr.ru/Eng/statistics/?PrtlId=svs>.
- Bank of Russia (2015c). Russian Federation: Inward Foreign Direct Investment Position by Geographical Allocation in 2009–2014, <http://www.cbr.ru/Eng/statistics/?PrtlId=svs>.
- Bank of Russia (2015d). Balance of Payments of the Russian Federation in 2014, <http://www.cbr.ru/Eng/statistics/?PrtlId=svs>.
- Bank of Russia (2015e). International Investment Position of the Russian Federation for the Third Quarter, <http://www.cbr.ru/Eng/statistics/?PrtlId=svs>.
- Bank of Russia (2014a). Foreign Investments in the Economy of Russia, http://www.gks.ru/bgd/regl/B11_04/IssWWW.exe/Stg/d04/2-in-invest.htm.
- Bank of Russia (2014b). Total Portfolio Investment Assets of the Russian Federation (Equity and Debt Securities) in 2001–2013, http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/portfolio_total.htm&pid=svs&sid=ITM_48_
- Borga, M. (2016). “Not All Foreign Direct Investment Is Foreign: the Extent of Round-tripping”, *Columbia FDI Perspectives* No. 172.

- Brooks, Richard (2013). *The Great Robbery: how Britain Became a Tax Haven for Fat Cats and Big Business*.
- China Statistical Yearbook (2014). Appendixes 11-14, 11-19, <http://www.stats.gov.cn/tjsj/ndsj/2014/indexeh.htm>.
- Claessens, S., and D. Naude (1993). "Recent Estimates of Capital Flight", World Bank Policy Research Working Paper WPS 1186.
- Davies, Victor A.B. (2010). "Capital Flight and Violent Conflict. A Review of the Literature." *World Development Report 2011*. Background Note.
- Dooley, M. (1986). "Country-Specific Risk Premiums, Capital Flight and Net Investment Income Payments in Selected Developing Countries", International Monetary Fund, March 11.
- Eurodad (2015). Fifty Shades of Tax Dodging. The EU's role in supporting on unjust global tax system, A report coordinated by Eurodad, <http://www.eurodad.org/files/pdf/1546494-fifty-shades-of-tax-dodging-the-eu-s-role-in-supporting-an-unjust-global-tax-system.pdf>.
- Eurodad (2014). Hidden Profits: The EU's Role in Supporting an Unjust Global Tax System.
- Gammeltoft, Peter (2008). "Emerging Multinationals: Outward FDI from the BRICS countries", Papers of the IY Globelics Conference at Mexico City, September 22–24, 2008, p.2.
- Glaziev, Sergey (2015). "O targetirovaniy inflyatsii", *Voprosy Ekonomiki*, No. 9 (in Russian).
- IMF (2017). Coordinated Portfolio Investment Survey, <http://data.imf.org//sk=B981B4E3-4E58-467E-9B90-9DE0C3367363>
- Kalotay, K. (2012). "Indirect FDI", *Journal of World Investment and Trade*, 13(4).
- Khan, H.R. (2012). "Outward Indian FDI – Recent Trends and Emerging Issues", *Bulletin of the Reserve Bank of India*, <http://www.bis.org/review/r120306a.pdf>.
- Kheyfets, B.A. (2013). "Deoffshorizatsiya rossiyskoy ekonomiki", Institut Ekonomiki RAN. Moscow, 2013 (in Russian).
- Kommersant* (2015). "Zaimy prinujdayut k repatriatsii", 28.09.
- Kudrin, Alexey (2016). "My stoim na poroge izmeneniy, kotorye nazreli", <http://www.komitrtgi.ru/publications/2797> (in Russian).
- Kuznetsov, Alexey (2011), "Outward FDI from Russia and its Policy Context, Update 2011", Vale Columbia Center on Sustainable International Investment, August 2, 2011.
- Ledyeva, S., P. Karhunen, R. Kosonen and J. Whalley (2015). "Offshore Foreign Direct Investment, Capital Round-Tripping, and Corruption: Empirical Analysis of Russian Regions", *Economic Geography*, 91(3).
- Ledyeva, S., P. Karhunen and J. Whalley (2013). "Offshore Jurisdictions (including Cyprus), Corruption Money Laundering and Russian Round-Trip Investment", *NBER Working Paper*, No. 19019.
- Lessard, D., and J. Cuddington, eds. (1987). *Capital Flight and Third World Debt*, Institute for International Economics, Washington, DC.
- Loungani, Prakash, and Paolo Mauro (2000). "Capital Flight from Russia", Research Department, IMF, Conference on Post-Election Strategy, April 5–7, Moscow.

- OCCRP (2014) 20 milliardov dollarov na chetakh banka v bednoy strane. August 22 (in Russian) <https://www.reportingproject.net/therussianlaundromat/ru/the-20-billion-bank-in-the-country-of-the-poor.php>
- OECD (2015). FDI Flow by Partner Country, <http://www.stats.oecd.org/corporate/mne/statistics.htm>.
- Palan, Ronen (2012). *British Second Empire*, New Left Project.
- Pelto, E., P. Vahtra and K. Liuhto (2004). "Cyp-Rus Investment to Central and Eastern Europe – Russia's Direct and Indirect Investments via Cyprus to CEE", *Journal of Business Economics and Management*, 5(1).
- OECD (2014). International Direct Investment Statistics, http://www.keepeek.com/Digital-Asset-Management/oecd/finance-and-investment/oecd-international-direct-investment-statistics-2014_idis-2014_en_
- RBC (RosBusinessConsulting) (2014). Glaziev: Rossiya iz-za offshorov ejegodno teryaet 1 trln rub dokhodov byudjeta, <http://www.rbc.ru/rbcfreenews/20140314192550.shtml> (in Russian).
- Sauvant, Karl P., Padma Mallampally and Geraldine McAllister, eds. *Inward and Outward FDI Country Profiles* (2013), second edition. New York: VCC.
- Schneider, Benu (2003). "Measuring Capital Flight: Estimates and Interpretations", Overseas Development Institute Working Paper 194.
- Shaxson, Nicolas (2011). *Treasure Island: Tax Havens and the Men Who Stole the World*.
- South African Reserve Bank (2016). Quarterly Bulletin March 2016. pp.96-99.
- Tax Justice Network (2015a). Narrative Report on United Kingdom. p. 1, <http://www.financialsecrindex.com/PDF/UnitedKingdom.pdf>.
- Tax Justice Network (2015b). Narrative Report on Netherlands. p. 1, <http://www.financialsecrindex.com/PDF/Netherlands.pdf>.
- Tax Justice Network (2007). Identifying Tax Havens and Offshore Financial Centres. Briefing paper, http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf.
- UNCTAD (2016a). *Global Investment Trends Monitor*. No. 22. 20 January.
- UNCTAD (2016b). *World Investment Report 2016*.
- UNCTAD (2015). *World Investment Report 2015*.
- UNCTAD (2014). *World Investment Report 2014*.
- UNCTAD (2013a). Investment Country Profiles: India, 2 March, http://www.unctad.org/en/PublicationsLibrary/webdiaeia2013d4_en.pdf.
- UNCTAD (2013b). Investment Country Profiles: India. Table 6, 2 March, http://unctad.org/en/PublicationsLibrary/webdiaeia2013d4_en.pdf.
- UNCTAD (2012a). Investment Country Profiles: South Africa. Tables 12, 15, February, http://unctad.org/en/PublicationsLibrary/webdiaeia2012d4_engl.
- UNCTAD (2012b). Investment Country Profiles: South Africa. Tables 12, 15, February, http://www.unctad.org/en/PublicationsLibrary/webdiaeia2012d4_en.pdf0.

- Vicek, W. (2010). "Byways and Highways of Direct Investment: China and the Offshore World", *Journal of Current Chinese Affairs*, 39 (4).
- World Bank (2015). World Bank Data, <http://worldbank.org/indicator>.
- World Bank (2012). *Draining Development: Controlling Flows of Illicit Funds from Developing Countries*. Ed. by Peter Reuter.
- World Economic Forum (2015). *The Global Competitiveness Report 2015–2016*. Geneva.
- Xiao, G. (2004), "People's Republic of China's Round-tripping FDI: Scale, Causes and Implications", LAEBA Working Paper No. 24.
- 400 Expert (2015). "400. Ejegodny reyting krupneyshich kompaniy", *Expert* No. 43. October 19–25 (in Russian).

