LAPPEENRANTA UNIVERSITY OF TECHNOLOGY
Northern Dimension Research Centre
Publication 28

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POTENTIAL FOR ENTERPRISE COOPERATION BETWEEN SOUTHEAST FINLAND AND NORTHWEST RUSSIA

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Lappeenranta 2006

ISBN 952-214-154-2 (paperback)
ISBN 952-214-155-0 (PDF)
ISSN 1459-6679

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Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia. NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the European Union (EU), with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and the environment, the forest cluster, the ICT sector, and Russia's logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

This study describes several key sectors in both Southeast Finland and Northwest Russia. It discusses existing cooperation between companies representing these sectors and analyses cooperation potential in the future. The study has been compiled by the Center for Markets in Transition (CEMAT) of Helsinki School of Economics. The research was mainly conducted by Hannu Kaipio, Päivi Karhunen, Simo Leppänen, Olga Mashkina, Elmira Sharafutdinova and Jeremy Thorne. The chapter describing formal business environment in St. Petersburg and Leningrad province was written by Oksana Ivanova and supervised by Tauno Tiusanen from NORDI. This research is a part of a larger project, *Competition and Co-operation between Finnish and Russian Enterprises*, financed by the National Technology Agency, TEKES, and run by Lappeenranta University of Technology. The project, which is coordinated by Anna Kyrki at LUT, is also part of the Finnish Academy's research programme *Russia in Flux*. The study is published in both NORDI's and CEMAT's publication series.

The aim of this study was to find out, how enterprises in Southeast Finland could better exploit the economic potential in Northwest Russia. The study focused on industries and services that have an importance for the regional economies of the three Finnish provinces (South Karelia, Kymenlaakso and South Savo), and/or where the role of Russia is particularly important: the forest industry, food industry, metal-working industry (i.e. electronics and electro-technical industry, mechanical engineering and metals industry), information and communications technologies sector, logistics, tourism, and energy and environment.

Lappeenranta, January 2006

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1 Introduction

The Russian Federation is by far the largest post Soviet state with a population of some 142 million. Russia has a mighty resource base containing almost all possible useful minerals and more forests that any other country in the world. Thus, development prospects in Russia are excellent. Finland, with only 5.2 million inhabitants is one of the Western industrialized countries, which applies the so-called ”Scandinavian model” of the modern welfare state. Finland has a modest resource base, except for its plentiful timber reserves that are traditionally used as industrial raw material. These two neighbouring countries are not at the same developmental stage in the early years of the 21st century. There are several options for measuring living standard differentials between national economies.

The most often used measure in this context is the Gross Domestic Product (GDP) per head of population. Obviously, international comparisons can only be made by converting different GDP per capita figures into one currency, for example, US dollars or euros. The latter is more and more often applied in European living standard comparisons. Thus, the euro is used here. However, as various output per capita figures are counted into a common currency, the underlying message can be distorted by exchange rate (ER) effects. Imperfect currency markets overvalue some currencies and undermine others. A thousand euros buy more goods and services in a poor country than in a rich one. Thus, it can be maintained that the currency of the poor country is undervalued at current (official) exchange rate. This is true too for all transitional economies. However, the level of undervaluation varies within the group of post-communist countries.[1]

GDP figures are made more accurate when converted into the countries’ money via exchange rates calculated on a purchasing power parity (PPP) basis. This means that official ERs need to be adjusted so that any identical sample of basic goods and services (average consumer basket) costs the same in one country as another. Obviously, it is not easy to calculate GDP per capita figures on a PPP basis, which adjusts for national variations in the prices paid for goods and services. Some international agencies, such as the World Bank, provide international GDP data, PPP adjusted, all in US dollars. The Northern Dimension Center (NORDI) normally relies on statistics compiled by the Vienna Institute for International Economic Studies (WIIW), which has a very long tradition in dealing with communist and

[1] For details see Tiusanen and Kinnunen 2005a and 2005b.

post-communist economies. Thus, WIIW's experience in dealing with PPP-adjusted GDP calculations is invaluable. Table 1 illustrates the effect of this adjustment.

Table 1: Gross Domestic Product, 2004, in euros per capita

	A GDP at exchange rate	B GDP at PPP	ERDI* (B/A)
Russia	3.311	8.360	2.52
Finland	25.500		

Source WIIW
*ERDI=Exchange rate deviation index

In the light of the "original" (A) figures, Finland seems to be almost eight times better off than Russia. It is important to note that GDP per capita figures do not take price differences between countries into consideration. As the Russian average consumer goods basket with a lower price tag than in Finland is considered, the difference in "real" living standard becomes much more moderate: it is only three factors, not eight. PPP adjusted GDP in Russia is over 8000 euros per capita. Moreover, on the basis of the figures above, it is possible to measure the level of rouble undervaluation. This is done via exchange rate deviation index (ERDI), derived by dividing the PPP adjusted GDP per capita figure by the original figure (GDP at exchange rate). This ERDI value in Russia is about 2.5, indicating that a 100-euro note has ca. 2.5 times more purchasing power in Russia than in euro area.

ERDI is an extremely important tool in making market research in transitional economies. Average monthly gross wage in Russia was in 2004 about 190 Euro, while the equivalent figure in Finland was about 2300 euro. The difference is striking. However, the Russian figure must be multiplied by 2.5 in order to receive the "real" value of the average pay: the monthly income has almost 500-Euro purchasing power in Russia. Furthermore, Russia has a "flat" income tax of 13%, which means that income differentials are not evened out by progressive income tax. Also, ca. 60% of Russians "inherited" their accommodation from the communist system (via privatization) and electricity bills are heavily subsidized in the household sector. Thus, taxes and housing costs are moderate in Russia leaving relatively high discretionary income. In addition, Russia has an extensive "unofficial" economy, which supplements concrete living standards.

Moreover, Finland is a small country with a high level of foreign trade. In 2004, Finland's merchandise export had a total value of 48.8 billion euros, which is close to 10,000 euros per capita. The equivalent figures in Russia were about 147 billion and about 1000 euros. In the import comparison, differences are striking: Finland imported goods in total value of 40.3 billion euros in 2004, which is about 8,000 euros per capita, while the equivalent figures in

Russia were 76.3 billion and 540 euros. Thus, Finland exports about 10 times more per head and imports about 15 times more in relative terms then Russia. In this context, it is worth noticing that certain export items, e.g. oil and timber have "export" duties, and thus there is an incentive for unofficial exporting. It is a well-known fact that not all imports entering Russian territory are declared at their "real" value. Finland imports mainly input goods, while Russia is self-sufficient in many raw materials and intermediary goods.

In the early 1990s, situation in the Russian market was in many senses paradoxical. The overall economy declined very rapidly. Industrial production decreased by almost 50%. Inflation was rampant. Investment in real terms collapsed. At the same time, the average monthly gross wage increased no less than eight-fold between 1992-19997, calculated in ECU (the basket currency of EU in the pre-euro period). This odd phenomenon has a special background. Amid a very strong inflationary wave, the rouble exchange rate appreciated in real terms rapidly against Western currencies. It means that the nominal rouble exchange rate depreciated, but not fast enough to cover the local inflation effect. As a semi-fixed exchange rate was launched in January 1998, the central rate (RUR 6.2=$1) was too "strong". Thus, heavy speculation against the rouble took place in the summer of 1998 causing a substantial depreciation of the rouble (for details see Tiusanen, 2003).

The pre-crisis situation created a golden era of Western consumer goods exporters, including foodstuffs. Local supplies decreased, while imports were rather convenient in price comparison. This era was extremely advantageous for the Finnish food industry (including beverages) in direct exports to Russia. At the turn of the century, the Russian market has experienced two fundamental novelties. Firstly, the depreciation of the rouble caused a turnaround in investment activity. Especially certain import–substituting branches have profited from this investment boom. Secondly, the world market price of oil increased about threefold in 2000, and has further increased after that. This external factor has fundamentally affected Russian economic growth in the early years of the 21st century.

Between 1999 and 2003 industrial production in Russia increased over 30%. One of the highest growth rates in the period can be observed in the food processing industry, which grew by about 40%. Obviously, this industrial branch is price sensitive: in the post devaluation period, local production has gained price advantage in comparison to imported alternatives (For details see Tiusanen and Jumpponen, 2006). In the sphere of consumer durables, including cars, the situation is more complicated. For example, consumer electronics are in high demand due to increasing income. A big part of products in this sphere

come from overseas, because brand, quality and technological novelties play a decisive role. Creating local alternatives takes time.

This Russian boom in consumer durables has a clear positive effect on transit traffic via Finland, especially on the South Eastern part of the country. Unloading, storing, and rearranging container contents and transporting cargos to final destinations in Russia are so called "value added" services in logistics. In this segment of logistics, Finland offers high quality and security, but not necessarily the lowest possible price (for details see Pekkarinen, 2005). Mobile phones made in Finland can be classified as consumer durables: Nokia cell phones enjoy increasing demand in Russian market.

This Russian economic recovery during the first years of the 21st century has a multitude of spill-over effects on direct and indirect exports of Finland. In this context, however, it is extremely important to bear in mind that price levels and cost structures show considerable difference in the two countries under review in this report. The Russian rouble is still strongly undervalued which favors export and import substituting activities, while it makes imports expensive in the eyes of local buyers. Russia has earned considerable balance of payments on current account surpluses after 1998 devaluation crisis, which means that Russia is an important net exporter of capital (in relative terms). In the present decade the Russian current account has had in annual average a surplus equivalent of 10% of her GDP. This means that Russian could buy every year about 40-50- billion euros of goods more from the outside world without increasing her external debt. This sum is roughly the equivalent of the value of Finnish imports per year.

1.1 Objectives of the Study

The aim of this study was to find out how enterprises in Southeast Finland could better exploit the economic potential in Northwest Russia. In this context, Southeast Finland is defined as three Finnish provinces: South Karelia, Kymenlaakso and South Savo. The analysis of Northwest Russia is limited to St. Petersburg and the surrounding Leningrad Province. The study focused on sectors that have an importance for the regional economies of the three Finnish provinces, and/or where the role of Russia is particularly important: The forest industry, food industry, metal-working industry (i.e. electronics and electro-technical industry, mechanical engineering and metals industry), information and communications technologies (ICT) sector, logistics, tourism, and energy and environment. These industries are herein referred to as the case industries.

The aim of the study was divided into three more specific research questions that approached the research topic from different viewpoints: First, the **cooperation potential in the selected industries** was scanned by analysing their current stage in Southeast Finland and Northwest Russia, and thereby charting the motives and competitive advantage that Finnish firms could have from the cooperation. Second, the **formal business environment in Northwest Russia** was studied to get an idea of the formal institutional constraints (e.g. legislation), and informal constraints (e.g. administrative control) for businesses in St. Petersburg and Leningrad Province. Also, sources for business support were reviewed. Finally, the **expectations for and experiences from** Finnish-Russian business cooperation were depicted, to find out whether the expectations of Finnish and Russian firms coincide and what the most common barriers to and problems in the cooperation are.

1.2 Data and Methodology

The study combined different research methods and data sources. The analysis of the business environment and the sectoral development in the target regions builds on statistics and other documentary data. Companies' views of business cooperation were analyzed with semi-structured interviews. The interview data includes 41 companies, of which 21 are from Southeast Finland and 20 from Northwest Russia. Moreover, ca. half of the companies are already engaged in Finnish-Russian business cooperation whereas the other half has not yet entered it. The interviewed companies represent the case industries of the study, ranging from small and medium size enterprises (SME) to large companies.

The report is structured as follows. Chapter 2 summarizes the main economic indicators of St. Petersburg and Leningrad Province. Chapter 3 moves to the sector level by giving an overview of the case industries in Southeast Finland and Northwest Russia, and discussing the cooperation potential in each of them. Chapter 4 focuses on the formal business environment in Northwest Russia and Chapter 5 gives company characteristics and the enterprise viewpoint of Finnish-Russian business cooperation as well as how companies view the business environment in Northwest Russia. Chapter 6 concludes the analysis and gives managerial implications and policy recommendations for further development of business cooperation between Southeast Finland and Northwest Russia.

2 Overview on St. Petersburg and Leningrad Province Economies

The city of St. Petersburg and Leningrad Province are two of the 89 so-called subjects of the Russian Federation. St. Petersburg has a territory of 1439 km^2 and 4.6 million inhabitants. The surrounding Leningrad Province has 1.6 million people within its 84 500-km2 area (see map below). Even though the two regions were administratively separated in 1931, St. Petersburg can be regarded as the capital of Leningrad Province as it has no capital of its own.

Figure 1: Map of St. Petersburg and Leningrad Province

This chapter gives an overview of the economies of St. Petersburg and Leningrad Province, focusing on the macroeconomic development of the regions since the 1998-crisis. The description focuses on main socio-economic indicators. The reports of the project Economic Monitoring of Northwest Russia (ECOMON)[2] are the main data source utilized here.

2.1 Gross production

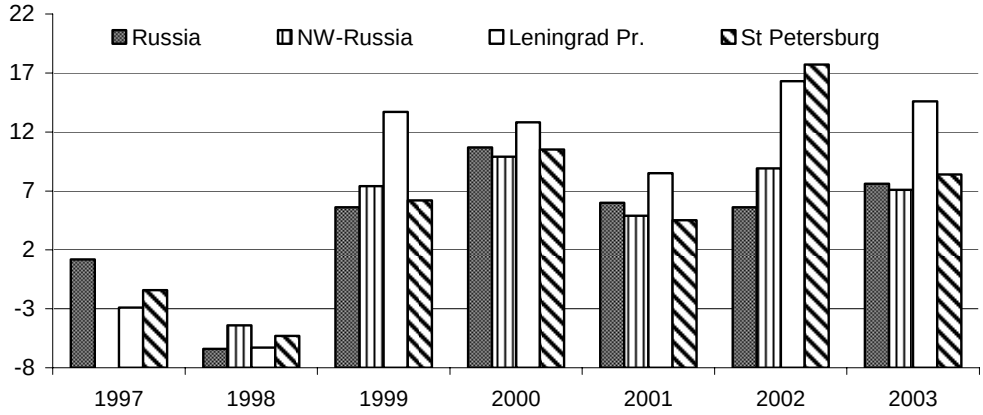
Both regions have a strong industrial sector and in addition Leningrad Province has a significant, although recently declining, agricultural sector. In the Soviet economic system, St. Petersburg (then Leningrad) was an important centre of military production (Eskelinen and Vartiainen, 1997). However, as the old system broke down causing a sharp decline in the military orders, the city's industry collapsed. Leningrad Province for its part also suffered in the turmoil of the early 1990s, but it was in a better position because its heavy industrial production has been mainly civilian-oriented.

Just as the economic situation started to improve and the decline of gross regional product (GRP) was decelerating, a major financial crisis struck Russia in August 1998. This can be

[2] The reports are available at http://www.economicmonitoring.com

seen in Figure 2 below, where the GRP of the two regions follows closely the development of the whole of Russia and the Northwest Russia during the crisis.

Figure 2: Annual real growth of GDP in Russia and GRP of regions in 1997-2003, %[a]



Source: Statistics Finland
a. 1997 figure for Northwest Russia unavailable.

However, Russia recovered from the crisis surprisingly fast. Since 1999 Leningrad Province's GRP growth has topped the Russian average and at a seemingly accelerating rate. The Soviet heritage is still clearly visible in the enterprise structure, as large enterprises dominate the activity. However, as seen in Table 2, in St. Petersburg the share of small businesses' output is more than two times higher than in Russia on average and Leningrad Province.

Table 2: Share of small businesses (products and services) of gross product, %

	1997	1998	1999	2000	2001	2002	2003
Russian Federation	13.6	10.8	10.2	9.9	11.0	12.3	14.5
Leningrad Province	8.0	13.7	9.0	7.2	9.5	12.5	14.1
St. Petersburg	21.0	34.2	23.9	23.5	18.3	26.0	31.8

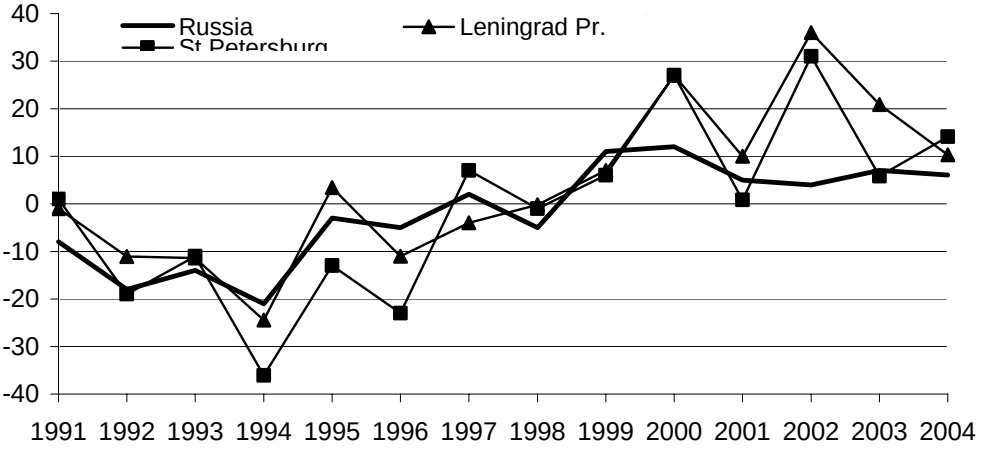
Source: Calculations based on information from Regiony Rossii and Rosstat

Within the small business sector of St. Petersburg employment is quite evenly distributed among industry, construction, and trade and catering. The combined employment share of the three sectors was 76%. In Leningrad Province and Russia as a whole small business employment is more unevenly distributed. In Leningrad Province, industry is employing one third, construction 28% and trade and catering 21% (combined share of 83%). As to dynamics of the small business sector's role in the gross production, Leningrad Province is following the general Russian trend where the role of small businesses decreased during the 1998 crisis and the couple of years following it. However, in St. Petersburg, the share of small businesses' output actually increased in the crisis year 1998 but dropped in 2001. There is no straightforward explanation for this.

2.2 Industrial production

In general terms, the development of industrial production has been similar to that of the gross production[3]. Figure 3 shows the severity of the decline caused by the collapse of the Soviet Union. Russia regained positive growth only in 1999 although the trend turned for the better already in the mid-1990s. This positive trend was interrupted by the 1998 crisis but soon regained its direction.

Figure 3: Annual industrial production growth of regions in 1996-2004, % [4]



Source: Rosstat

Table 3 below shows the five biggest industries and their shares of total industrial production for the two regions in 2004. St. Petersburg industrial sector is clearly less diversified than one of Leningrad Province. In St. Petersburg, the three biggest industries constitute more than three quarters of the city's total industrial production. The machine building industry has regained its former leading position. The food industry has dramatically increased its importance as its share in the years preceding the 1998-crisis hovered around 15-17%, but was 30% in 2004. It has been one of the most compelling examples of the boost given by the crisis to the import substituting production.

[3] This is, of course, quite natural as approximately one third of Russia's GDP is currently generated by the industry -sector.

[4] The reader should take caution in reading these figures since there are considerable uncertainties in Russian statistics, especially concerning the turbulent years in the beginning of the 1990s. Furthermore, there is some variation in the figures depending on the statistical source.

Table 3: Five largest industries in St. Petersburg and Leningrad Province in 2004

St. Petersburg	%-share of industrial production in 2004	Leningrad Province	%-share of industrial production in 2004
Machine building	35,4	Food industry	24,2
Food industry	30,1	Power industry	16,5
Power industry	10,8	Forest and wood-working	13,8
Construction materials	2,9	Fuel industry	13,5
Wood processing	2,5	Machine building	12,3
Combined share	81,7	Combined share	80,3

Source: Petrostat (2005)

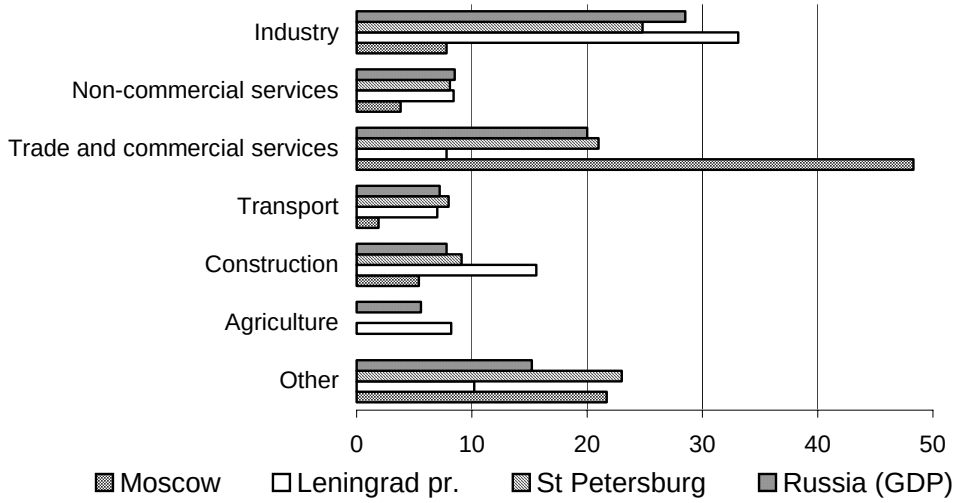
The industrial structure of the Leningrad Province is more diversified, although its five biggest industries constitute almost as much of the region's industrial production as they do in St. Petersburg. Currently the food industry is distinctively the leading industry with 24% of total industrial production in 2004.

2.3 Service sector

One sign of Russia's transformation towards a market economy is the strong growth of the service sector. Whereas the share of production of goods in the Russian GDP was 47,8 % and that of services 44,7% in 2000, the situation had reversed in 2002 to 43,3% versus 49,6 %, respectively. The same pattern is repeated in St. Petersburg and Leningrad Province. Naturally, the service sector is especially strong in the biggest Russian centres, Moscow and St. Petersburg. Although St. Petersburg is traditionally a city of heavy industry, it is also a city of education, culture and tourism and thus possesses a natural base for the development of the service sector[5]. In 2002 the share of services in GRP was as high as 75,3% in Moscow and 56,4% in St. Petersburg. In Leningrad Province the share of services in 2002 was considerably less (33%) but the share was nevertheless higher than in 2000 (28,4 %). Figure 4 shows a more detailed GDP/GRP structure in 2003.

[5] For example, the number of museum visits per 1000 citizens in 2003 in St. Petersburg was four times higher than in Moscow and eight times higher than the Russian average.

Figure 4: GDP/GRP-structure in 2003, %



Source: Rosstat

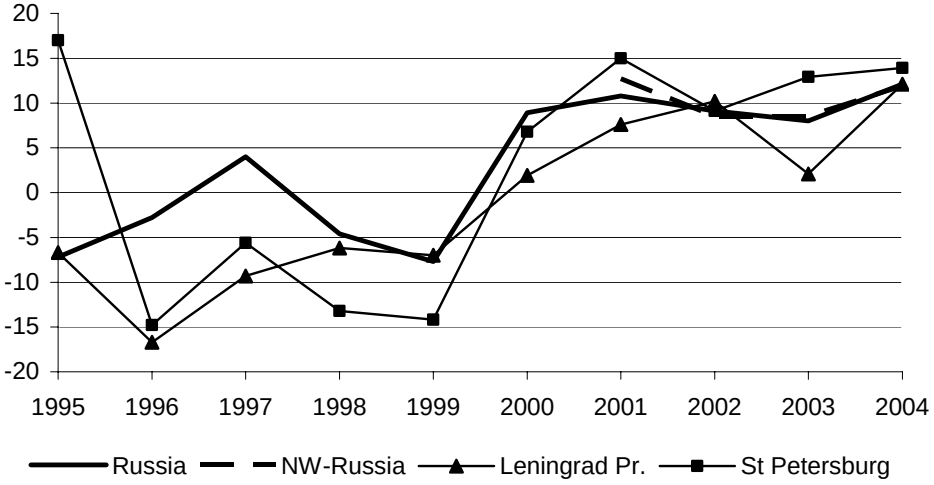
A few noteworthy service sub-sectors in St. Petersburg are trade, transportation, finance, tourism and communication[6]. Since 2000 retail trade turnover in the city has grown fast, usually more than ten percent annually. Furthermore, retail chains are increasingly capturing market shares from unorganized forms of trade (open air markets, kiosks etc.) and new outlets as well as outlet types are constantly established in the city (Kaipio and Leppänen 2005). St. Petersburg also has natural potential as a transportation hub due to its location on the Gulf of Finland. However, a bad infrastructure is hindering the growth of the city's transportation sector especially concerning road transportation. The inadequate transportation infrastructure is also an obstacle for tourism growth.

The city has also a constantly developing financial sector, which weathered quite well the 1998 crisis as well the "semi banking crisis" of summer 2004. The sector is currently under restructuring due to the entry of many big players from Moscow and banks with foreign ownership. Banks are increasingly engaging in e.g. new construction projects. The financial sector can be expected to grow further and become more efficient as bank deposit guarantees and credit information agencies have started to operate. The communications sector seems to be at the moment one of the most successful sectors. It will be discussed more in detail in Chapter 3.

[6] Trade and transportation are sometimes (e.g. in statistical classifications) considered as their own sectors apart from the service sector. However, these are so closely related that they are discussed here under the same topic.

In Leningrad Province development has been less dramatic although a similar 1998-effect is recognizable also in the province. Industry still has a clearly dominant position,[7] although this role has been gradually diminishing. The trade sector has been developing quite well. It has grown around ten percent annually excluding a temporary deceleration in 2003 and currently is growing the fastest among the Northwest Russian regions. Large retail chains (such as IKEA) have started to establish outlets in the Province. Figure 5 below shows Leningrad Province's retail trade growth which has been lagging behind St. Petersburg's and Russia's average but which currently, at least temporarily, seems to be narrowing the gap.

Figure 5: Annual retail trade sales growth, %



Source: Goskomstat/Rosstat and regional statistical offices

Recently the administration of Leningrad Province announced its intention to raise the importance of the weakly developed and previously neglected service sector[8]. The location of the Province around St. Petersburg, decently growing incomes of the population and the regional administration's support are factors that will most likely further increase the role of the service sector in Leningrad Province's economy.

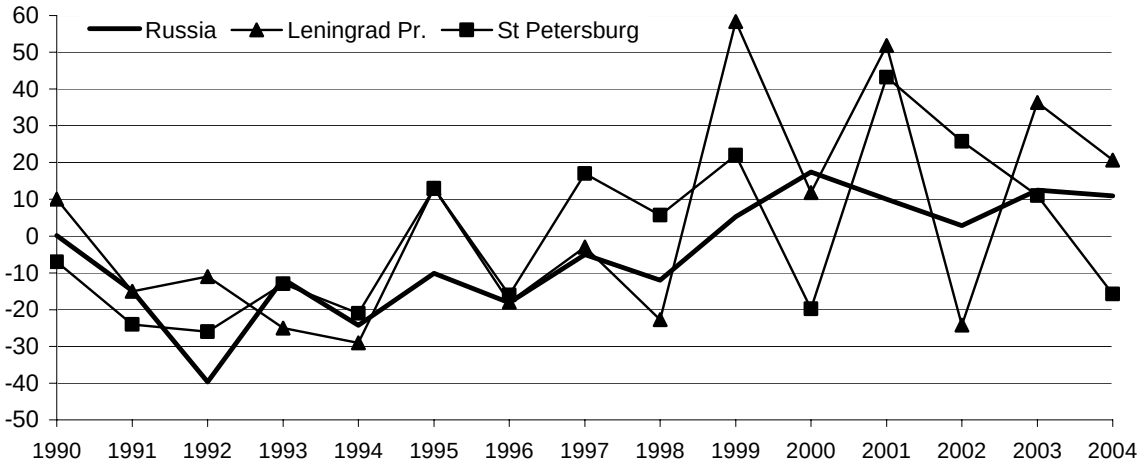
2.4 Investments

The collapse of the Soviet system also decreased the amount of investments (Figure 6). Russia did not achieve positive fixed investment growth before 1999. St. Petersburg got on a positive investment development path a bit earlier. However, its investment dynamics have been very volatile. Furthermore, the city has not been so alluring to private investors as one might expect (one reason for this is high corruption). The public investments have had an

[7] Actually, one of the strongest among Northwest Russia's regions.
[8] Especially concerning trade and tourism. In tourism Finland is a major competitor of Leningrad Province. More on Finland's role in Russian tourism, see (Kosonen et al. 2005).

important role. Figure 6 shows the investment peak from 2001 onwards which was largely due to the investment injection related to the 300th Anniversary preparations of the city. Currently there are many joint public-private investments in the city targeted at transportation and service infrastructure.

Figure 6: Index of actual fixed investments volume in regions, annual %-growth, 1990-2004

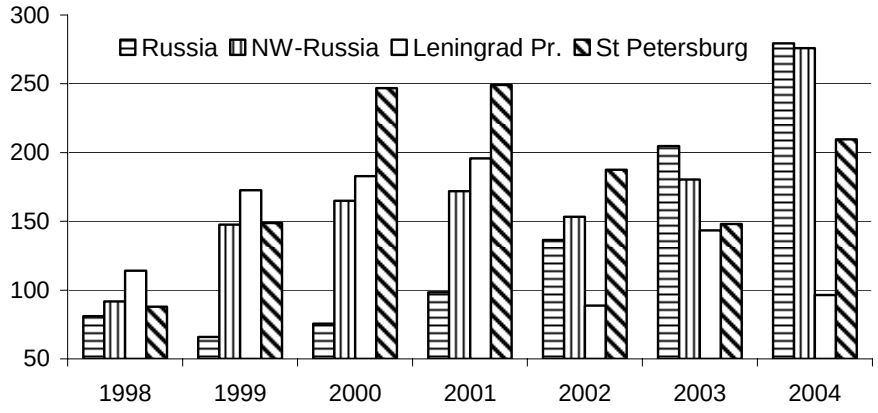


Source: Rosstat

The Leningrad Province administration started to actively promote investments in the late 1990s, which has paid off: the Province is ranked very high in investments per capita among all Russian regions. It has had only one year of declining investments in 1999-2004. The province is benefiting from its proximity to St. Petersburg as firms are starting to look for commercial space outside the city due to lack and the high price of commercial estate within the city.

Figure 7 provides the dynamics of the foreign investment inflow. After the 1998-crisis foreign investments to Russia have steadily grown whereas the two regions as well as all of Northwest Russia have developed in a more cyclical manner. The increased inflow of foreign investments is partly related to a wave of import substituting production after the crisis when imported products became too expensive for a normal Russian consumer. Also, the statistics on foreign investments by country of origin show that capital flown from Russia in the 1990s is being partially repatriated. For example, according to the statistics Cyprus is among one of the leading investors in Russia. The investments arriving from offshore countries (e.g. Cyprus and Virgin Islands) are very likely money of Russian origin, which is returned in a tax evasive form. This way the role of foreign producers in the Russian economy was diminished in the aftermath of the crisis.

Figure 7: Foreign investments inflow, USD per capita[9]



Source: Ecomon

St. Petersburg and Leningrad Province were enjoying a foreign investment peak in 2000–2001 as they clearly topped both Northwest Russia's and the whole of Russia's inflows in per capita terms. A noteworthy aspect of Leningrad Province's foreign investment inflow is its instability. This is related to the region's investment structure with its high share of large-scale investments. Finnish investors have a visible role in both regions. In 2004 ten percent of foreign investments to St. Petersburg came from Finland, whereas in Leningrad Province this share was fourteen percent. Two recent Finnish investment projects in Leningrad Province are the Nokian Tyres factory in Vsevolozhsk and the Metsäliitto woodworking plant in Podporozhye. Currently in St. Petersburg Finnish Stockmann is expanding and Elcoteq is building an electronic components plant. In 2004 the most attractive industries in St. Petersburg for foreign investors were machine building (46% of all foreign investments) and the food industry (22%, respectively).

2.5 Foreign trade

The rouble devaluation in 1998 hardly affected Russian exports, while correspondingly imports decreased clearly (Table 4). However, imports started to recover soon after the crisis following the positive general economic growth of Russia. This was mainly caused by a strong oil price hike on the world market, which also led to an increase in the value of exports.

[9] In per capita figures presented in this chapter the following average figures for populations have been used: Russia (145 million), St. Petersburg (4,7 million), Leningrad Province (1,67 million), Moscow (10,4 million) and Northwest Russia (14 million).

Table 4: Foreign trade dynamics 1997-2004

		1997	1998	1999	2000	2001	2002	2003	2004
Russia (bln USD)	Exports	86,9	74,4	75,6	105	101,9	107,3	135,9	183,2
	Imports	72	58	39,5	44,9	53,8	61	75,4	94,8
	Trade balance	14,9	16,4	36,1	60,2	48,1	46,3	60,5	88,4
St. Petersburg (million USD)	Exports	3622	1588	2102	2527	1911	1739	2747	3993
	Imports	5424	3632	2329	2487	3961	4877	5795	6916
	Trade balance	-1802	-2044	-227	40	-2050	-3138	-3048	-2923
Leningrad Pr. (million USD)	Exports	1479	1444	1520	2120	2104	2176	2918	4834
	Imports	381	307	357	449	725	888	1201	1707
	Trade balance	1098	1137	1163	1671	1379	1288	1717	3127

Source: Goskomstat/Rosstat, regional statistical offices and Statistics Finland

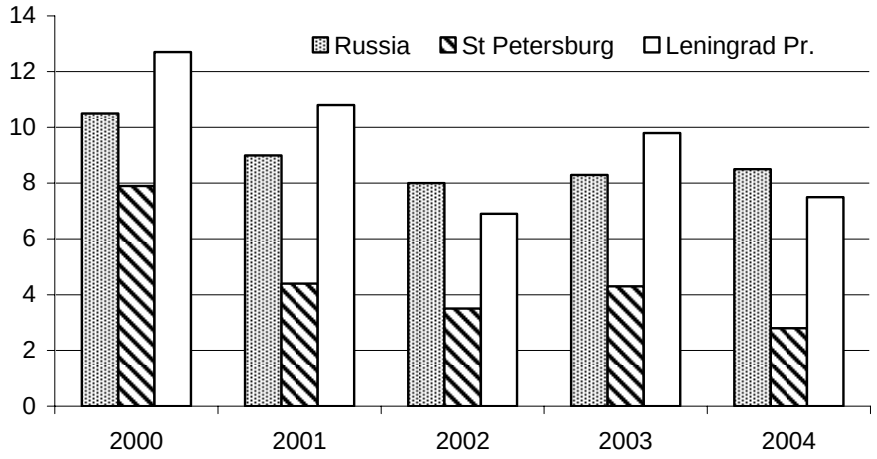
In the case of Leningrad Province similar development was apparent but in a less drastic form. In 1998 and 1999 there was a small drop in imports whereas exports started to increase quite rapidly right after the crisis. Moreover, there was a dramatic increase in the Province's exports in 2004. This was a direct consequence of the record high oil prices since the fuel industry accounted for 80% of the Province's exports in 2004. Also imports reached a growth record in 2004 due to the strengthening rouble and increasing purchasing power of citizens. Currently the most important trade partners of Leningrad Province are the Netherlands, Great Britain, and Switzerland (in exports) and Germany, the USA and Finland (in imports). Machine and construction as well as food products currently constitute a majority of the Province's imports. For several years the region has maintained trade surplus and currently it even seems to be increasing.

St. Petersburg's development is somewhat different concerning foreign trade, which is captured in the table. First, imports have actually followed the trend of Russia and Leningrad Province depicted above but the trade balance has been on surplus only once during the last eight years. The rouble devaluation only temporarily enhanced growth in exports resulting in a trade surplus in 1999. Currently there are no signs of a considerable decrease in the negative trade gap. Major export articles of the city are the heavy machinery and metals, and thus the city's heritage of heavy industry is visible today. The biggest import articles of the city are foodstuffs and machinery and equipment. The most important trade partners in imports are Germany and Finland. Moreover, a major share of Russian oil exports go to the Netherlands' spot market and thus that country is well represented in trade statistics even if it re-exports the main part of Russian oil.

2.6 Employment and wages

In the Soviet Union unemployment was practically non-existent by the nature of the economic system. As the transition began people were faced with a new kind of threat – unemployment – that was an inevitable consequence of the restructuring of the economy. After the 1998-crisis the employment situation has somewhat stabilized, as has been the case in many other economic respects. Figure 8 shows the unemployment rates since 2000 according to the International Labour Organization's (ILO) methodology[10].

Figure 8: Unemployment, ILO-method, % of economically active population



Sources: Goskomstat, Petrostat

The average unemployment seems to have stabilized around eight per cent in Russia. The development dynamics are very similar to the Russian one in the two regions under examination, showing a decline since 2000 with a short jump in 2003. Leningrad Province suffered a higher than average unemployment in the beginning of the millennium but seems to have reversed the situation now as in 2004 its unemployment rate was one percentage point less than in Russia as a whole. St. Petersburg for its part is on a totally different scale showing amazingly low unemployment figures. The unemployment rate in 2004 (2.8%) is actually reaching its theoretical minimum[11] and currently the number of vacancies offered by job exchange is clearly higher than the amount of officially registered unemployed.

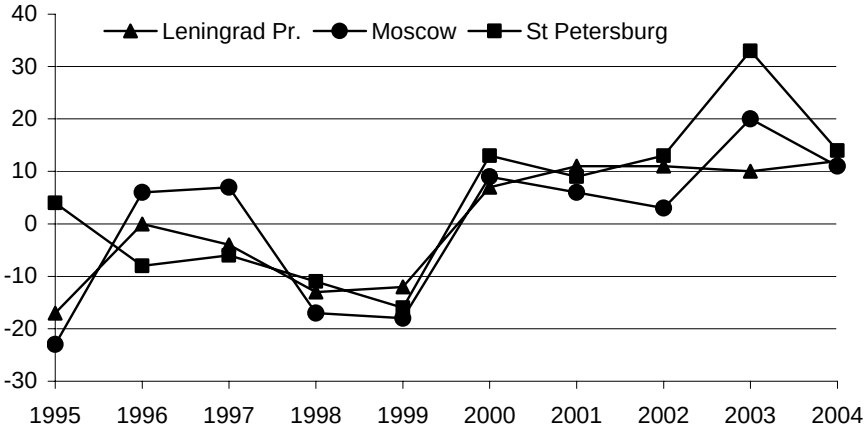
One would expect that the growing economy and improving employment would be eventually reflected in the income level of the population. Figure 9 shows the dynamics of real monetary incomes in 1995-2004, where the two regions are compared with the Russian economic centre

[10] ILO-methodology usually shows considerably higher unemployment rate as the officially registered one and it is considered more realistic.

[11] Even in a well-functioning market economy a zero level unemployment is impossible in practice due to friction caused by people who are between jobs.

Moscow. The dynamics have been very similar among the regions, but it has to be kept in mind that all three regions face the serious problem of grey incomes, which are not reflected in statistics.

Figure 9: %-change in real monetary incomes (in roubles)



Source: Statistics Finland

An average wages comparison might provide a better picture of the living standard situation than average income since capital incomes are very concentrated and a considerable amount of citizens are still living in poverty. Table 5 below shows the nominal average wages in the three regions. Since the figures are nominal (not adjusted to inflation), they do not reflect the real improvement in living standard. However, the figures in Table 5 allow us to compare wellbeing in three different locations.

Table 5: Average monthly wage, RUR

	2000	**2001**	**2002**	**2003**	**2004**
Moscow	3 229	4 924	6 388	8 612	10 638
St. Petersburg	2 512	3 695	5 435	6 468	8 152
Leningrad Province	2 179	3 258	4 528	5 466	6 777

Source: Statistics Finland

The Table shows that in 2000 St. Petersburg's average wage level was just 78% of Moscow's. In 2004 the figure was 77%, so the two cities' wage development has been quite similar. However, Leningrad Province's share of Moscow's and St. Petersburg's wage levels in 2004 were 64% and 83% respectively, so the Province has been lagging in the wage development although in recent year its economy has been growing faster than St. Petersburg's.

2.7 Conclusion

The overview of the recent economic development and the current situation in St. Petersburg and Leningrad Province reveals a few things that arose as important factors in the development. First, the effect of the Soviet Union's collapse, which initiated a major restructuring of the economy, was especially severe in St. Petersburg, a former centre of military production. Another notable incidence was the 1998-crisis that gave an immense boost to import substituting production. This was reflected especially in food production. Moreover, the service sector has been increasing its importance in both regions. In St. Petersburg, services already constitute a majority of gross production. Furthermore, retail trade is growing in both regions at a fast pace as domestic and foreign retail chains are toppling the traditional unorganized forms of trade.

As to investments, Leningrad Province has procured a remarkable amount of investments in Russia. However, due to large-scale projects the development has been fluctuating. The foreign trade dynamics in the two regions have been very similar: a boost in exports after the drastic depreciation of the rouble in 1998 and slowly but increasingly recovering imports. However, St. Petersburg is experiencing a notable trade deficit and it will still probably continue for quite some time. Finally, unemployment in St. Petersburg is extremely low. In Leningrad Province it is relatively high despite good economic growth. Finally, the average wage in the city is almost one fifth above that of the Province.

3 The Case Industries in Southeast Finland and Northwest Russia

The report moves now to analyze the case industries of the study. First, an overview of these industries in Southeast Finland and Northwest Russia is given. Second, the cooperation potential and competitive advantages arising from the cooperation is analyzed for Finnish companies.

3.1 The case industries in Southeast Finland

This section discusses the case industries of this study in Southeast Finland in general, and their business relations to Russia in particular. The sectoral analysis is based on relevant statistical information indicating the industries' importance to the regional economies and their development dynamics.

3.1.1. Forest industry

Traditionally, the wood-processing industry, especially pulp and paper, has been the backbone of Finnish manufacturing. In the globalization process, this branch has experienced an intensive consolidation period, which means that there are only three major producers left (UPM, Stora-Enso, M-Real) and one medium sized (Myllykoski). This capital-intensive branch is heavily concentrated in Southeast Finland, which has one of the biggest wood processing industry clusters in the world. (Table 6)

Table 6: Basic indicators of forest industry, per capita (euros) and share (%) of whole industrial sector

For year 2003	**Kymenlaakso**		**South Karelia**		**South Savo**	
	Per capita	%	Per capita	%	Per capita	%
Gross value of production	13 702	56,4	18 277	70,8	2 660	24,1
Total number of hired personnel (per 1000 inhabitants)	41	47,6	44	50,8	16	24,4
Total value of investments	795	62,5	393	47,6	79	10,7
Total value of exports	10 002	77,9	12 828	88,7	1 825	47,5
Average monthly wage[A]	3305	114,3	3013	111,2	2147	91,6

Source: Calculations based on Statistics Finland Internet database

A. As the authors were not able to find wage levels classified by both region and industry, the wage figures in the table were calculated as follows: adding the forest industry's gross wages (before taxes) paid to workers and officials and dividing this figure by the total amount of hired staff and finally dividing this figure by twelve (months).

The forest industry is very important to South Karelia and Kymenlaakso, constituting more than two thirds and over a half of the regional gross industrial production, respectively. In

South Savo the share of the forest industry in the province's gross industrial production is smaller, but nevertheless ca. one fourth. An interesting detail not visible in this data is that structure of forest business in South Savo is different from the other two provinces. Namely, forestry and services related to it are manifold in South Savo compared to Kymenlaakso and South Karelia.

It would seem that the forest industry in South Karelia is more capital intensive than in Kymenlaakso as they employ roughly the same number of workers in relative terms although in South Karelia the sector's share of gross industrial production is clearly higher than in Kymenlaakso. In both provinces they are in any case major employers as approximately half of all industrial workers work in the forest industry. In South Savo the forest industry employs workers in line with its share of gross industrial production - i.e. roughly one quarter of all industrial workers.

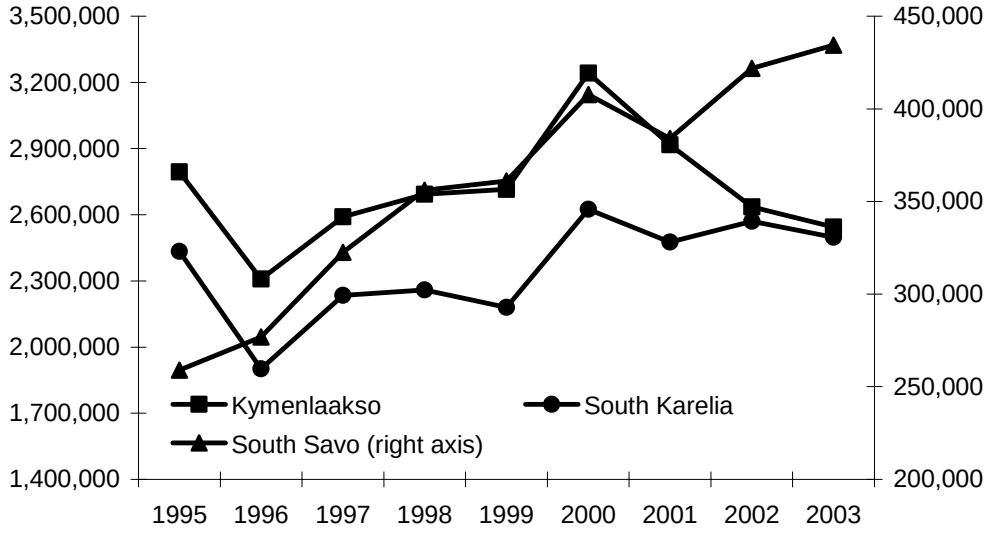
For a couple of decades the forest industry has invested more outside of Finland than in the home market. Paper production is moving closer to the final demand. The wood processing industry produces pulp basically only for its own use. Producing pulp for the global market is not regarded as profitable in a high-cost country like Finland. Thus, the relative importance of the pulp and paper industry is in decline in Finland, while its absolute meaning for the local output and export is still considerable. In Kymenlaakso and South Karelia the latest peak in investments in the forest industry was in 2001. In South Savo the share of the forest industry in all industrial investments is only ca. 10%. In all three provinces forest industry companies are very export-oriented. In South Karelia almost nine tenths of forest industry products are sold abroad.

Finally, the somewhat differing structure of the forest industry in the three provinces is reflected in wage levels. In South Savo monthly wages in the forest sector are almost ten percent less than average industrial wages. One explanation for this might be the smaller size of forest industry firms within the province compared to Kymenlaakso and South Karelia (not visible in the table). In South Karelia and Kymenlaakso the monthly wage in the forest industry is more than ten percent higher than average industrial wages. However, one has to keep in mind when analyzing wage levels that the forest industry in Finland has a very strong labour union.

Figure 10 below shows gross production dynamics in the forest industry. Taking into account the previous analysis, one might expect a fading forest sector development in South Savo. However, Figure 10 shows a clear upward trend for South Savo although in absolute figures it

is far behind Kymenlaakso and South Karelia. In Kymenlaakso the production trend shows decline since 2000. In South Karelia the upward trend of the late 1990s reached its peak in 2000 and stagnates to the level of Kymenlaakso. It might be that the trend of recent years to make new forest industry investments abroad and downsize Finnish operations starts to show in statistics. This argument is supported by the export dynamics data, which shows rising exports for Kymenlaakso forest industry until 2000 from where they have been in decline.

Figure 10: Dynamics of forest industry gross production, 1000 euros



Source: Statistics Finland Internet database

Concerning dynamics of other indicators, the number of personnel has remained quite stable in South Savo and South Karelia whereas roughly one thousand jobs have been lost from the forest sector of Kymenlaakso. Secondly, investment development has been very volatile. For South Savo and South Karelia the annual percent changes in both directions have often been more than 70%. One has to remember, however, that the forest industry is very capital intensive and thus investments are often large-scale, which statistics reflect as big relative changes.

3.1.2. Food industry

The food-processing branch in Finland has developed mainly on the basis of local demand. After Finland's EU entry in the mid-1990s, this branch has faced new challenges in international competition. The collapse of communism in the former Eastern Bloc in 1989 and the dismantling of the Soviet Union in 1991 created new opportunities for the Finnish food processing industry, which were in part lost in the 1998 crisis. Concerning Southeast Finland, Table 7 shows that in all three provinces the food sector is not a major industrial employer.

Table 7: Basic indicators of food industry, per capita (euros) and share (%) of whole industrial sector

For year 2003	Kymenlaakso		South Karelia		South Savo	
	Per capita	%	Per capita	%	Per capita	%
Gross value of production	1 852	7,6	1 082	4,2	927	8,4
Total number of hired personnel (per 1000 inhabitants)	7	8,0	6	7,0	6	8,6
Total value of investments	26	2,1	95	11,5	56	7,7
Total value of exports	100	0,8	74	0,5	17	0,4
Average monthly wage	1 999	69,1	2 203	81,3	1 973	84,1

Source: Calculations based on Statistics Finland Internet database

Interestingly, although South Karelia has the smallest food industry share, its investments in the industry are clearly highest in both per capita and share of whole industrial production terms. However, if the figures were from 2002 the picture would be completely different since after several years of decline there was more than an eight fold increase in food industry investments in the province in 2003.

Food sector products in all three provinces are mostly consumed domestically. This may in part be due to the 1998 crisis in Russia, which caused a drop in Finnish food exports to Russia. Furthermore, it is unlikely that any major growth in this respect will be witnessed in the future, as the strengthening trend in the Finnish international food business is to start local production in Russia (see Kaipio and Leppänen, 2005). One indication of relative unimportance of this industry branch is the low wage level in the food industry in the provinces. This is especially visible in Kymenlaakso, where the food industry average wage is 30% less than the industrial average.

When looking at food industry dynamics within the three provinces it can be seen the production trend during the last eight years has been positive for Kymenlaakso and South Savo food industries. In South Karelia the trend has been decreasing despite a small rise in 2001–2002. However, as stated above, it might find a steady growth path if its recent investment injection pays off. In Kymenlaakso investments in the food sector have followed a declining trend since 1999 whereas in South Savo investments have been on the rise since 2000. However, it is unlikely that any new large investments in this sector will be made in the future. The current trend in the Finnish food industry seems to be a rationalization of production and closing units rather than investing in new ones.

3.1.3. Metal-working industry

The Finnish metal-working industry traditionally has a strong link to the wood processing industry, turning out timber harvesting machines, sawmill and plywood equipment, as well as pulp and paper making machines. However, in the machinery and equipment branch mobile phone producer Nokia is by far the single most important Finnish exporter in the early years of the 21st century. Nokia's mobile phone production has had a large spill-over effect in Finland: a network of suppliers has come into being. However, suppliers of mobile phone companies face intensifying competition on the global scale. Therefore, this industrial branch must look for cost effective locations in labour-intensive activities.

In the metal branches, Finland created considerable capacities in ship building on the special demand factor from the former Soviet Union. After considerable restructuring of the branch after the collapse of the Soviet state, shipbuilding has survived in Finland, specializing in high value-added vessels like luxury cruisers. Metal-working industry is also important for the regional economies under review, in particular for South Savo.

Table 8: Basic indicators of metal-working industry, per capita (euros) and share (%) of whole industrial sector

For year 2003	**Kymenlaakso**		**South Karelia**		**South Savo**	
	Per capita	%	Per capita	%	Per capita	%
Gross value of production	2139	9,3	2810	11,3	3986	38,5
Total number of hired personnel (per 1000 inhabitants)	20,5	25,1	20,2	24,4	64,4	36,9
Total value of investments	60,8	6,1	82,0	11,2	99,3	30,2
Total value of exports	738	5,8	1297	9,0	725	18,7
Average monthly wage	2406,7	82,9	2505,5	92,0	2747,2	117,3

Source: Calculations based on Statistics Finland Internet database

In Kymenlaakso and South Karelia, the metal-working industry's share of total industrial output is smaller than its share in the industrial workforce. One explanation for this is the industrial structure of the provinces, dominated by the capital-intensive forest industry. Also, the share of the metal-working industry in all industrial exports in the two provinces reflects this, i.e. it is even lower than its share in total industrial output. Moreover, the wages are somewhat lower than the industry average, where the higher wages in the forest and paper industry have great weight. For South Savo, the situation is different. The share of metal-working industry in the industrial output and workforce is close to 40 percent, and in investments 30 percent. However, the province's metal-working industry seems to be oriented more to domestic markets, since its share in industrial exports is considerably lower than its share in all industrial output.

As to the development dynamics in the metal-working industry, the gross value of production in Kymenlaakso has been in decline since 2000, although the annual decrease was somewhat smaller in 2003 than in the preceding year. In South Karelia the gross value of production has been fluctuating between slight growth and decline. In South Savo the situation is completely different. A drop in output in 2002 was followed by a real boost in 2003, when the gross value of production more than doubled. This growth was mainly due to the increase in the production of machinery and equipment, where the value of production grew approximately five-fold. Second, the investment figures for the metal-working industry in Kymenlaakso and South Karelia show that in both provinces there has been a peak year in investments, 2001 and 2002, respectively. Otherwise, the amount of investment has been on a relatively stable level. In South Savo investments in the metal-working technology industry have followed a cyclical trend.

The following section will take a closer look to the provinces' information and communications technologies (ICT) sector, which is in part included in the metal-working industry. This sector has been developing rapidly in Finland during recent years, but the analysis will show that the majority of Southeast Finland's metal-working industry's activities are, however, still due to the traditional metal industry.

3.1.4. ICT sector

The ICT sector is a very broad field and very difficult to grasp through statistics, since it includes both manufacturing and service activities. One way to classify the ICT sector is to divide it into the production of tangible assets (hardware and telecommunication equipment) and of intangible assets (Internet and telecommunication services, software development and intellectual services) (Selioukova, 2005). The ICT sector, in particular its manufacturing part, has become an important backbone of the Finnish economy. About one fifth of Finnish industrial exports nowadays are high-tech products. The peak year in high technology exports was in 2000 when their share of all Finnish exports was 23,3% (11,5 billion euros) whereas the figure has declined to 17,5% (8,5 billion euros) in 2004.

Comprehensive regional statistics are available only for the manufacturing part of the industry[12]. Furthermore, due to the small number of ICT manufacturing firms in South Karelia

[12] The category "Manufacturing, repair, installing and maintenance of electronic, electrical and optical equipment category" is comprised of the following sub-industries: Manufacture of office machinery and computers, Manufacture of electrical machinery and apparatus n.e.c, Manufacture of radio, television and communication equipment and apparatus, Manufacture of medical, precision and optical instruments, watches and clocks.

whose data are not published in order to guarantee their business secrets, the data in Table 9 is for year 2002.

Table 9: Basic indicators of the manufacturing of ICT equipment, per capita (euro) and share (%) of whole industrial sector

For year 2002	Kymenlaakso		South Karelia		South Savo	
	Per capita	%	Per capita	%	Per capita	%
Gross value of production	128	0,5	58	0,2	10,7	3,5
Total number of hired personnel (per 1000 inhabitants)	1	1,4	1	0,7	3,0	4,8
Total value of investments	4	0,3	2	0,2	3,2	0,4
Total value of exports	23	0,2	14	0,1	77,4	2,4
Average monthly wage	2 233	79,1	2 049	77,0	1 768	85,6

Source: Calculations based on Statistics Finland Internet database

Table 9 shows us that the manufacturing of ICT equipment has not yet reached a prominent role in the provinces' economies. It can be said to have some significance only in South Savo. In comparison to the metal-working industry in general (which the ICT equipment manufacturing is a part of), workers employed in ICT equipment manufacturing are in a worse position. Also, both investments and exports are still at quite insignificant levels in all three provinces. Something can also be said about dynamics. In South Savo ICT equipment manufacturing dynamics show a clear upward trend since 1999 in terms of gross production and exports that grew six-fold during 1999-2002. In Kymenlaakso gross production and exports have reached a new higher level compared to mid-1990s but the current direction is not unambiguous. In South Karelia the higher level has been reached in exports but gross production has not yet permanently exceeded the mid-1990s level.

The service part of the ICT sector can be analyzed based on data for the sub-sector Data processing services.[13] Here, it should be noted that the sectoral indicators are compared to *all industries* (i.e. the production of goods *and services*) within the region, whereas previously we compared the production of forest, food, metal-working and ICT equipment manufacturing sectors to *industrial production*.

[13] Defined by Statistics Finland as automatic data processing related hardware- and software consulting, software design, production and publishing, computer- and processing services, database hosting, repair and maintenance of computers and other data processing services.

Table 10: Data processing services indicators, in absolute figures and share (%) of all industries

For year 2003	Kymenlaakso		South Karelia		South Savo	
	Absolute	%	Absolute	%	Absolute	%
Number of firms	84	1.1	85	1.4	80	1.0
Hired personnel (per 1000 inhabitants)	1.2	0.5	4.9	2.3	1.0	0.5
Turnover per capita (euros)	140	0.3	663	1.4	90	0.4

Sources: Ohjelmistoalan toimialaraportti 2005 syksy, Statistics Finland Internet database

As in ICT equipment manufacturing, also the role of ICT services in the three provinces' economies is rather insignificant. In terms of personnel and turnover the sector has some relevance in South Karelia. This is due to the location of some large employers of this sector in the province. For example, TietoEnator alone employed 160 persons in Imatra and 125 in Lappeenranta in 2004 in its forest-industry related information technology development (Kareltek annual report 2004). In general, the three provinces' data processing services are supporting the leading industries of the provinces', such as the metal-working industry in South Savo.

The regional development trends in the sector are difficult to analyze statistically, because the data available for this report combined Kymenlaakso and South Karelia into a single category Southeast Finland until 2002. However, it seems that the two provinces jointly are developing more rapidly than the Finnish average. This is due to the increase in the number of personnel and turnover, which exceeds the Finnish average growth rate in this sector. In South-Savo activity in this sector is also increasing, but its share in the Finnish total has remained the same since 2000. (Ohjelmistoalan Toimialaraportit 2002-2005)

Data on regional wage levels in the ICT services were not available for this study. However, they are in general higher than in the manufacturing part of the sector. For example, according to a recent survey the average monthly wage in the Finnish information technology sector is 3608 euro (IT-ammattilainen tienaa…).

3.1.5. Logistics sector

In addition to industrial sectors, Southeast Finland has potential in its service sector. Concerning Russia, it has a natural role as a logistic hub due to its geographical location and excellent Finnish transportation network. Table 11 below gives some basic indicators of the logistics sector in 2004[14].

[14] Note that previously we compared forest, food and ICT industry production to gross production of *industrial sectors*. Here, we make comparison to all firms from *all industries* within the region.

Table 11: Logistics sector indicators[A], in absolute figures and share (%) of all industries

For year 2004	Kymenlaakso		South Karelia		South Savo	
	Absolute	%	Absolute	%	Absolute	%
Transport, storage and communication						
Number of firms	948	11,9	679	11,5	912	11,7
Hired personnel (per 1000 inhabitants)	41	17,4	26	11,8	20	11,1
Turnover per capita (euros)	5 647	11,4	2 729	5,4	1 625	6,1
Supporting and auxiliary transport activities, travel agencies						
Number of firms	219	2,8	93	1,6	61	0,8
Hired personnel (per 1000 inhabitants)	17	7,3	5	2,1	1	0,7
Turnover per capita (euros)	2 397	4,8	830	1,7	166	0,6
Post and telecommunications						
Number of firms	43	0,5	43	0,7	51	0,7
Hired personnel (per 1000 inhabitants)	6	2,3	5	2,4	4	2,5
Turnover per capita (euros)	490	1,0	557	1,1	408	1,5

Source: Statistics Finland Internet database

A. In the table "Transport, storage and communication" is the main branch and the two other branches are its sub-branches, i.e. their figures are already embedded in the main branch figures.

Of the three provinces Kymenlaakso has the strongest logistics sector, which creates more than 11% of total turnover of the region's firms. Logistics sector employs in Kymenlaakso as much personnel as the forest industry, or almost one sixth of all personnel working in the province. The logistics sector can be considered to be important in South Karelia and South Savo too, even though the share of logistics in the regions' economies is approximately half of that in Kymenlaakso. Interestingly, the share of logistics firms in the company structure is practically the same in all three regions. The sub-branch of logistics – Post and telecommunications – has marginal relevance only as an employer. During 2000-2004 the turnover of Kymenlaakso's logistics sector has been on a steady rise as well as its share of province's firms' turnover. In South Savo the logistics turnover has been steadily growing in 2000-2004. The sector has however developed slightly slower than the rest of the region's economy as its share declined a bit within the same period.

Transit transport in Finland (both Eastward and Westward) is largely related to Russian-international trade and it is highly concentrated in the Kymenlaakso and South Karelia provinces. Many firms prefer exporting to Russia through Finland, in part due to a shortage of proper storage places in Russia for perishable and valuable products. Table 12 shows the development of transit transport in Finland in volume terms.

Table 12: Transit transport via Finland, 1000 tons, 1996–2004[A]

Year	Total rail transit	Rail transit		Total road transit	Road transit		Total sea transit	Sea transit	
		Eastward	Westward		Eastward	Westward		Imports	Exports
1996	3234	629	2605	1304	1204	100	4199	1711	2488
1997	3362	581	2781	1929	1848	81	4861	1964	2897
1998	2948	359	2589	1455	1379	76	4128	1523	2605
1999	2811	230	2581	957	896	61	3332	825	2507
2000	2673	223	2450	1239	1182	57	3366	1234	2132
2001	4008	237	3771	1532	1402	130	5680	1689	3991
2002	3461	211	3250	1791	1664	127	5245	1814	3431
2003	3194	202	2992	2243	2127	116	5469	2207	3262
2004	3201	234	2967	2591	2490	101	5630	2638	2992

Source: Statistics Finland (2005)

A. According to Statistics Finland, the majority of transit goods imported to Finnish harbors come by sea from the west and continue by land or sea to Russia. The majority of transit goods exported from Finnish harbors come by sea or land from Russia and are exported by sea to the west.

The table shows that currently the transit transport by road is at a record level, due to a steady growth in road transit to Russia since 2000. Also, imports by sea (i.e. mainly transit goods from the west to Russia) have been increasing since 2000. Rail transit to Russia also picked up in 2004 after a decline in 2002-2003. However, the main volume of rail transit still goes westward in the form of Russian raw materials. Moreover, transit exports by sea (i.e. transit goods from Russia to the west) have been declining since 2002. This is most likely due to the recent years' investments in St. Petersburg's and Leningrad Province's harbor system, which have increased capacity and competitiveness in Northwest Russia. Finally, the time series reminds us of the vast effects of Russia's 1998 financial crisis. It led to a virtual halt in Russian imports, which is reflected in the transit transport statistics as a drastic drop in Eastward transit cargo by all transport means. The crisis also drove many Finnish transport firms and entrepreneurs into bankruptcy.

Due to large differences in the cost level in Finland and in Russia, the future competitiveness of Finland's logistics sector in Russian transport is clearly based on value-added services, such as further processing of products in warehouses and offering total services (Pekkarinen, 2005). The competitive advantage of Finland is in the logistical knowledge and service quality, including reliability, flexibility and speed of delivery (ibid). Due to the considerably lower level of fuel prices and wages of e.g. truck drivers in Russia, firms registered in Finland are not able to compete in the actual transportation of goods.

In addition to the actual transportation of goods, supporting activities such as forwarding are of importance for the regional economies of Southeast Finland. Even though Russia's

customs' procedures have become less complicated and arbitrary over the years they can still cause considerable difficulties, especially for smaller exporters. Thus, demand for services of forwarding and similar firms exists. Table 9 above presented data for this sub-industry of transport, storage and communication – "Supporting and auxiliary transport activities, travel agencies". This branch includes for example forwarding. Unfortunately, travel agencies cannot be extracted from this branch classification, which would make more accurate analysis possible. However, it can also be thought as strongly influenced by Russia when we are dealing with border regions.

This transport-supporting branch has a notably larger role in Kymenlaakso compared to the other two provinces. In Kymenlaakso, this sub-branch constitutes more than 40% of total logistics turnover and almost five percent of the province's firms' turnovers. Furthermore, its importance to the province's economy has been increasing during 2001-2004. In South Karelia, a similar process is going on but at a much lower level and pace. Finally, due to the relative remoteness of South Savo from the Russian border, the role of this transport-supporting sector is rather insignificant.

3.1.6. Tourism

Another service branch where Russia is very important to Southeast Finland is tourism. Currently, Russia is the third largest country of origin (after Sweden and Germany) of foreign tourists visiting Finland with more than ten percent share. Russian tourists are fond of Eastern Finland regions due to their geographical proximity and the clean environment. Currently, a new trend in tourism is emerging as some Russian tourists are investing in Finnish real estate (Hernesniemi et al. 2005). The number of Russian tourists and their overnight stays in Finland has, however, been decreasing for the last two years. In 2003 the number of Russian tourists in Eastern Finland was a little less than 140 000, which is more than two thirds of all Russian tourists in Finland.

Due to its geographical location, Southeast Finland also benefits from transit travel from Russia to other parts of Finland. Most of the tourist flows between Russia and Finland go via the Southeast Finnish cross border points. In 2005, ca. a third of Russian tourists visited Lappeenranta during their trip, which was a figure almost the same as for Helsinki. Also, Kotka and Hamina were among the most visited destinations. However, a large share of these visits seem to be transit or day trips, since accommodation figures show that Russians don't stay in these Southeast Finnish cities as often. (TAK, 2005) As for South Savo, it is located somewhat farther away from the main routes used by Russian tourists, i.e. from St. Petersburg and Moscow via Southeast Finnish border crossing points to Helsinki. Therefore, Russian

tourists visiting South Savo come there usually for vacation purposes, such as renting cottages. Shopping tourism is not as common as in the two other regions under investigation. Therefore, a cautious conclusion could be made that Russian tourists might be more important for local retail industry in Kymenlaakso and South Karelia, and for hotel and accommodation business in South Savo. This is supported by the accommodation statistics below, which show that the nights spent is the highest in South Savo. These statistics do not, however, specify customers by country of origin so it is difficult to estimate the real share of Russians in the figures.

Table 13: Basic accommodation figures in 2004

	Number of accommodation establishments	Number of rooms	Number of beds	Nights spent
Kymenlaakso	32	1243	2692	282599
South Karelia	44	1941	4598	427910
South Savo	88	2884	7536	659936

Source: Statistics Finland

In addition to Russian tourists who have Finland as the only destination during their trip, there are also two other groups of Russian travelers that visit Finland. These are travelers using Finland as a transit route to a third country, and tourists who visit Finland as a part of a package tour including other destinations such as Scandinavian countries. These travelers usually buy their travel product from Russia and use few services in Finland. However, there is also a group of travelers who have Finland as their main destination but would be also interested in visiting other countries while staying in Finland. Here, the Finnish tourism companies could increasingly offer their services to assist these tourists to arrange trips to neighboring countries. (Kosonen et al., 2005)

3.1.7. Energy and environment

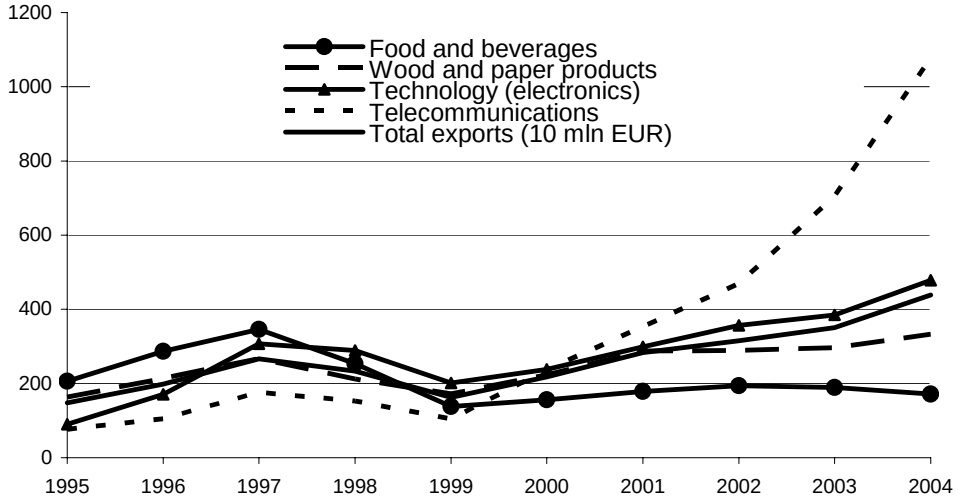
Finland with her low population density, cold climate and thin energy resources has been forced to develop energy saving methods and technologies. In addition, the development of chemical wood processing industry has created incentives to invent environmentally friendly solutions to energy-intensive process industries. In the system of Soviet central planning, there were no incentives to save natural resources and hardly any concerns on environmental damage. Therefore, there is plenty of potential demand in the post-Soviet Russia to improve energy efficiency and to introduce environmentally friendly methods and technologies. In this sphere, Finland has plenty of know-how and technical solutions to offer.

3.1.8. Southeast Finland's business relations to Russia

After reviewing the case industries in Southeast Finland, this section briefly discusses the business relations of the three Southeast Finnish provinces to Russia. In the absence of relevant and comparable statistics, the analysis is qualitative and based on occasional data sources, mainly the regional authorities and other public sector organizations' registries and studies on the regional firms' exports and other operations with Russia. Also, nation-level statistics of Finnish exports to Russia by sector are used as a reference.

Finnish-Russian trade has been developing very positively in recent years and in the third quarter of 2005 Russia already became Finland's biggest foreign trade partner. Figure 11 shows the development of Finnish exports to Russia from 1995-2004 by main export sectors.

Figure 11: Finnish exports to Russia for certain trade items[15], million euros



Source: Statistics Finland

The recent growth in exports is mainly due to a boost in telecommunication exports, mostly mobile phones. Also, exports of technology and forest industry products are growing, while food industry exports are in slight decline due to the intensified competition in Russia in the food sector. Foreign producers have a clear incentive to establish local production. The impact of the 1998 financial crisis is shown clearly in the statistics. In other sectors the pre-crisis exports level has been exceeded, but in the food industry such recovery is not visible.

[15] Since the customs statistics classification differs from the sector classification available for this study, the classification in the export figure is somewhat artificial and has been compiled as follows: "Food and beverages" = Food and live animals + Beverages and tobacco – Live animals – Tobacco; "wood and paper products" = Cork and wood manufactures + Paper and paper products and artefacts of paper pulp, paper and paperboard; "Technology (electronics)" = Office machines and automatic data processing machines + Electronic machines, appliances and parts; "Telecommunications" = Telecommunication, sound recording and reproduction apparatus.

Service exports to Russia are also growing. In service exports Russia was the second largest trade partner in 2004, right after Sweden. The value of service exports to Russia was 434 million euro in 2004, which is ca. 11 per cent of all service exports. A major share of this was construction services, which accounted for over 70 per cent of all service exports to Russia. The exports of construction services grew almost threefold from 2003. (Statistics Finland)

Imports from Russia are growing as well. In 2004, the value of imports was 5,3 billion euro. The growth from 2003 was 22%. The imports are still heavily dominated by energy and raw materials. The combined share of energy (electricity, gas, coal, oil and oil products) was almost 65%, whereas metals and minerals accounted for 14,7%, chemicals 7,1% and wood 9,8%. The highest growth figures were registered in imports of metals (+32%) and oil and oil products (+35%). The imports of wood grew by 9 per cent. (Finnish customs statistics) Service imports for their part are not as significant. The share of Russia is ca. 7% of all service imports. (Statistics Finland)

According to Russian statistics, Finland is the 7th largest foreign investor in Russia. Approximately 80% of all Finnish investments are made in Northwest Russia, where Finland is currently the third largest investor with its 17% share of all foreign investments. (Rosstat) Large-scale Finnish investments in Northwest Russia have been made to food production, forest industry and electronics manufacturing. In addition to direct investments, Finnish firms have cooperation with Northwest Russian firms in e.g. the metal industry and textile industry subcontracting.

Kymenlaakso's business relations to Russia

For Kymenlaakso, the enterprise registries of Kotka-Hamina and Kouvola regions give some information on the number of export companies of the region by sector, and for Kouvola region also on business with Russia. These data are presented in Table 14.

Table 14: Kymenlaakso province's export companies, number of firms[16]

Sector	Kotka-Hamina region	Kouvola region	Kouvola region, firms specialized in Russia*
Industry	16	12	1
Construction	1	14	1
Wholesale and retail trade, automobile repair	31	37	3
Transportation, storage and communications	179	4	10
Business-to-business and personal services	7	19	15
Other	-	8	1
Total	**234**	**94**	**31**

Source: Information from Kotka-Hamina region of Finland Ltd., acquired in December 2005 and Kouvola region business registry (http://www.kouvolaregion.fi/yritysrekisteri)
*According on their own announcement in the business registry

The sectoral distribution of all export companies gives a clear indication of the foreign trade structure of Kymenlaakso. In contrast to the other two provinces, service companies seem to be more active than industrial enterprises. In the Kotka-Hamina region, export operations are dominated by logistics services like transportation and supporting services such as storage and forwarding services. It can be assumed that these services are mainly related to Russia. Also, a large part of trade activities and business-to-business services are probably related to Russia, as indicated by the data for Kouvola region. However, Kymenlaakso province's construction companies do not seem to be involved in Russian exports yet. In industry, the number of exporting companies is rather modest. Here, most export operations are probably performed by the large industrial enterprises in e.g. forest industry, located in the region and mainly targeted to other markets than in Russia.

South Karelia's business relations to Russia

In South Karelia, the regional administration maintains a business registry of the region's enterprises' business operations[17], including their foreign trade in general and with Russia in particular. Table 15 summarizes the foreign trade operations of South Karelian firms by sector, and the share of firms having exports to or imports from Russia.

[16] For Kotka-Hamina region data on trade with Russia was not available
[17] Available on the Internet at http://tpr.ekarjala.fi/

Table 15: Foreign trade companies in South Karelia as 30 April, 2005 (number of firms)

Sector	Exports	Imports	Exports to Russia	Imports from Russia
Agriculture, forestry and fishery	8	7	4	2
Extraction of minerals	6	2	3	1
Industry	153	96	72	38
Electricity, gas and water	1	-	1	-
Construction	29	21	23	6
Trade	169	196	140	45
Accommodation and catering	4	4	3	1
Transportation, storage and communications	49	52	43	42
Financial services	1	2	1	1
Business-to-business services	88	43	48	17
Public administration and defense	1	-	1	-
Education	-	1	-	-
Healthcare and social services	3	7	3	2
Other services	9	11	1	2
Total	**521**	**442**	**343**	**157**

Source: Preliminary information on the 2005 update of South-Karelian business registry, acquired in November 2005

The table shows that there are some sectors where Russia has a prominent role in companies' foreign trade operations, when measured by number of firms. The number of firms with export to or import operations from Russia is largest in industry and trade in absolute terms. The relative share is highest in transportation, storage and the communication sector, trade and construction, where the majority of exporting firms operate with Russia. Also, in business-to-business services approximately half of all foreign trade companies are targeting Russia. The public sector and healthcare have recently been involved in Russian operations as well, probably in the framework of EU-funded projects.

South Savo's business relations to Russia

Foreign trade operations of South Savo firms are not registered as systematically as in Kymenlaakso and South Karelia. However, the Small Business Center of Helsinki School of Economics has studied the Russian business operations of South Savo firms every second year since 2001. These studies give an indication of the magnitude and development of these operations (Table 16). It should be noted, however, that the general sample in these studies is rather limited (ca. 150 exporting enterprises) and formed qualitatively instead of based on a uniform business registry, which makes the results somewhat biased. The above-mentioned studies also reveal that the importance of Russia as an export market has been somewhat greater for South Savo than for Finland on average, both in the total export volume and for single enterprises. For those firms that have operations with Russia, it is either the only export

market or its share of total exports is significant. In forest industry and machinery and equipment Russia was already in 2002 the most important export market.

Table 16: Number of South Savo firms with Russian operations[A]

Sector	No. of firms
Machinery and equipment	7
Metal industry	4
Mechanical woodworking	8
Textile and clothing industry	4
Wholesale and retail trade	3
Services	3
Construction	1
Total	**30**

Source: Sikanen and Ukkonen, 2003

[A] Including trade, investment and contractual operation modes

The table indicates that as in South Karelia, industrial companies of South Savo are more active in business with Russia than service companies. The Russian operations' situation reflects the general industry structure of South Savo, where mechanical woodworking and the metal industry are important. Also, the textile and clothing industry (beyond the scope of this study), is rather active in its contacts with Russia. In contrast, as in Kymenlaakso, South Savo construction firms don't seem to have found the Russian market yet.

3.2 The case industries in St. Petersburg and Leningrad Province

After reviewing the case industries in Southeast Finland, this section will give an overview of these industries in St. Petersburg and Leningrad Province. As for sectoral industrial growth, infrastructure, telecommunications and information technologies in the Northwest region (primarily in Leningrad Province and St. Petersburg) have grown second fastest in Russia after the Central Federal District, which includes Moscow. However, the fastest growth rates have been seen in food and tobacco industries, which, again, are concentrated in Leningrad Province and St. Petersburg. The reason for this is the large domestic market for their products and the attractiveness to foreign investors. A common problem in Northwest Russia among many industries (such as metallurgy, pulp-and-paper and machine building) is the relative underdevelopment of relative and supporting activities, such as logistics. In general, the Northwest region serves as a gateway to Russia for European countries, which allows new technologies to be absorbed there faster than anywhere else in the country. (Dudarev et al., 2004)

On a general level, the main factors in the competitiveness of Northwest Russian industries are cheap natural resources, labour and transportation. However, these have to be considered

only temporary and not capable of offering long-term competitiveness. A permanent advantage of Northwest Russia compared to many other regions in Russia is the common border with the European Union, which offers possibilities for cooperation. At the same time, there are many factors that reduce the competitiveness of the region. These include e.g. poor infrastructure development, poor business transparency, high level of corruption and a lack of clear industrial policy. (Dudarev et al., 2004)

Sectoral development in St. Petersburg and Leningrad Province

Regional industrial production has been dependent on large export orders for many years, but now the focus of the industrial producers in St. Petersburg is gradually shifting to the domestic market. The giant machine-building companies of the city have traditionally acted as engines of economic growth. This industry's growth rates have been cyclical in recent years, but it seems that the magnitude of the cycles is decreasing (Table 17).

Table 17: Industrial production in selected St. Petersburg industries, % change from the previous year

	2001	**2002**	**2003**	**2004**
Food industry	15.5	2.6	2.5	8.7
Wood processing	4.9	8.3	3.3	-7.1
Chemicals	0.8	-4.3	-5.7	-11.5
Construction materials	0.8	13.8	0.6	2.1
Power industry	-0.3	8.8	5.7	1.0
Light industry	-2.9	-15.1	-4.5	-11.1
Machine building	-5.6	49.4	14.8	24.2
Metallurgy	-23.2	30.2	32.9	13.3

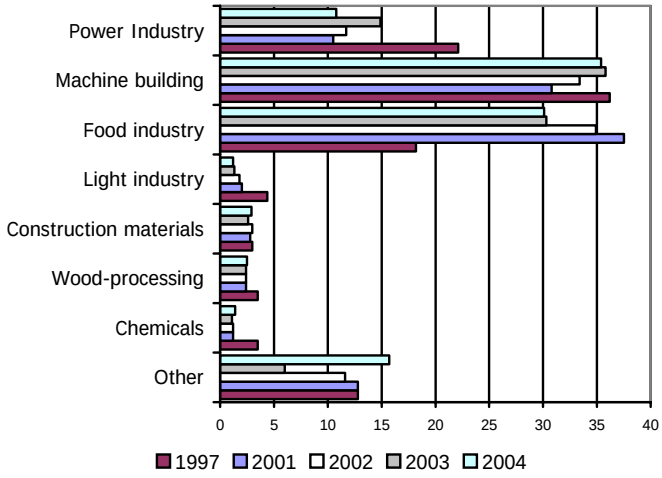
Source: Petrostat

As seen from the table, in 2004 the fastest growing industries were machine building, the food industry and metallurgy. Production in wood processing, chemicals and light industries contracted. The production of construction materials show fluctuations, which indicate that the recent boom in housing construction has not reflected in an increased demand for locally manufactured construction materials.

Among the sectors with most negative development is light industry, which suffered greatly after the collapse of the Soviet Union. The domestic production of clothing and footwear is "sandwiched" between imports of expensive brand items and of cheap items manufactured in low-cost locations such as China and Turkey (Tiusanen, 11 January 2006). The drop in output in this sector indicates that there would be vacant labour resources available for light industry production (ibid). The dynamics in metallurgy are more affected by global development

trends. For example, the rapid increase in the sector's output in 2002-2003 and the subsequent slowdown in the growth in 2004 is obviously related to the China-led growth in demand for steel in the world market. The growth dynamics are also reflected in the shares of different industries in the total industrial output (Figure 12).

Figure 12: Structure of industrial production by branch in St. Petersburg, %



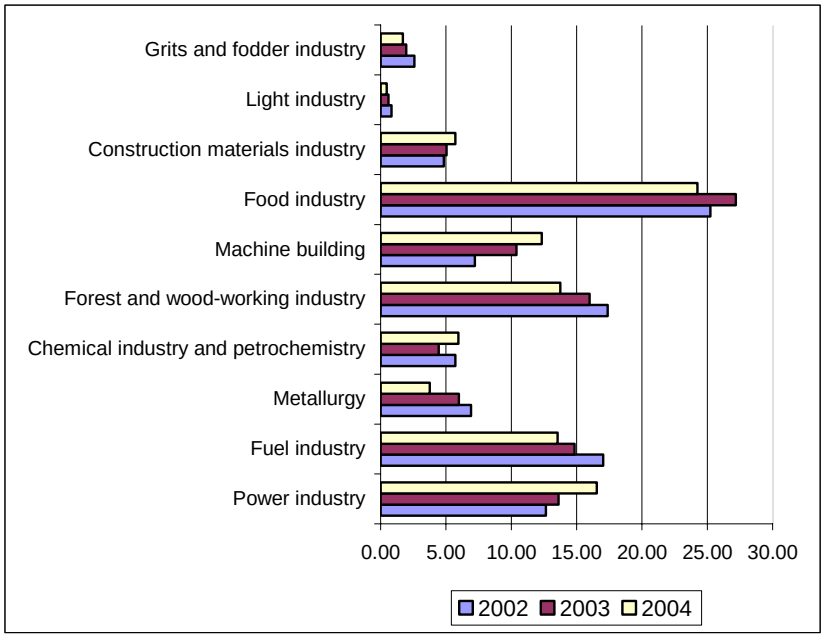
Source: Petrostat

Machine-building and food production industries held 35.4% and 30.1% shares of the total production of the city and thus clearly dominated the production in 2004. Power generation is losing its position (ECOMON, 2005). Forest and woodworking industries are also among the main industries of St. Petersburg, but they do not belong to the largest ones (Committee of Economic Development, b). Still, the logistical position of St. Petersburg is good for wood transportation. St. Petersburg is a good place also for wood-processing companies, as the consumer demand is high there (Saarinen and Pirilä, 2003). On the other hand, nothing prevents these companies from locating to Leningrad Province, which is considered to be more investor friendly and is close to consumers of St. Petersburg.

As in St. Petersburg, also in Leningrad Province the machine-building industry had the highest growth rate (60%) in 2004, mostly due to automobile production. Light industry is in decline in Leningrad Province, as in almost the whole of Russia. But, unlike in St. Petersburg, metallurgy production decreased in 2004 by 0.9%, mostly due to increased competition from large national producers. Other industries performed moderately, with growth rates ranging from 2.3% in construction materials to 8.9% in the grits and fodder industry. The boom in the food industry continued: in 2004 it grew by 6.1%. This may still prove to be a temporary phenomenon. Within wood processing industry, some categories such as paper and cardboard,

had strong growth in 2004 (27%). Plywood production grew by 18%. (ECOMON, 2005) Figure 13 shows the structure of industrial production in Leningrad Province.

Figure 13: Structure of industrial production by branch in Leningrad Province, %



Source: Petrostat

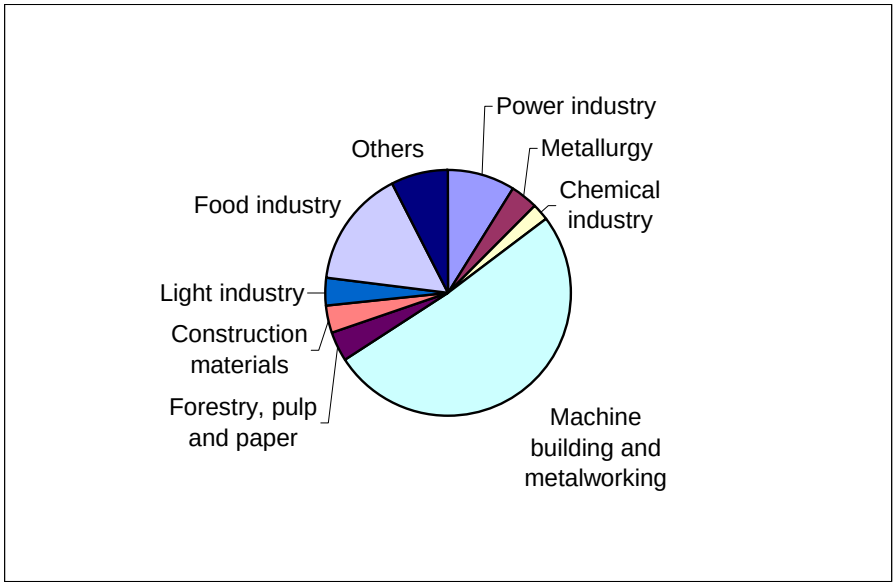
The figure reflects the increasing role of machine-building and power generation. The growing share of the latter might be explained by the nationwide rise in the price of electricity in 2004. The shares of the two largest sectors, food industry and the forest and woodworking industry, shrank in 2004. Increasing world prices for fertilizers helped to increase the share of the chemical branch in regional industrial output. It can be concluded that in 2004 the most intensive growth was observed in domestic market-oriented branches producing consumer durables (the automobile industry). Most branches showed a moderate increase of output, while light industry showed no signs of recovery.

Of other sectors of the economy, the transport sector in both St. Petersburg and Leningrad Province grew considerably in 2004. Total volume of cargo transports increased by 6.6% in St. Petersburg and by 20.2% in Leningrad Province. In St. Petersburg, the highest growth was reported by marine transport (140%) and in Leningrad Province by pipeline transport (21.2%). Stevedore operations grew a lot in the Province. Other modes of transport grew also, if somewhat less impressively. (ECOMON, 2005)

The employment situation and wages in St. Petersburg were discussed earlier in Chapter 2, but here is some more detailed information on the situation. The shares of different industries

of employment in all industries can be seen in Figure 14 below and the wages in different industries in Table 17. Unfortunately, similar data could not be found for Leningrad Province.

Figure 14: Shares of different industries (middle- and large enterprises) of employment in all industries in St. Petersburg in 2004



Source: Committee of Economic Development (c)

As seen in the figure, the traditionally important machine building and metalworking industry still employs approximately half of the workforce employed in industrial production. When compared to industrial production figures given in Chapter 2, it can be noted that this sector seems to be more labour intensive than the next largest employer, the food industry.

Table 18: Average wages in different industries in St. Petersburg in December 2004

	Average wage, roubles	Average wage, euro[A]	% growth to Dec. 2003	% of the all-industry average
All industries	10921	289	26.0	100.0
Power industry	14871	393	34.7	136.2
Ferrous metallurgy	12218	323	23.0	111.9
Non-ferrous metallurgy	11388	301	38.6	104.3
Chemical industry	6487	172	25.7	59.4
Machine building and metalworking	11407	302	27.4	104.4
Forest, paper and pulp	5375	142	23.1	49.2
Construction materials	10432	276	12.3	95.5
Light industry	4937	131	15.1	45.2
Food industry	13186	349	17.9	120.7

[A]Exchange rate 37,8104 as of 31.12.2004

Source: Committee of Economic Development (c)

The table reveals that nominal wages are rising substantially in all industrial sectors, although the wage level is still considerably lower than in Finland. Interestingly, the wages are among the lowest in forest, pulp and paper industry, which is a situation opposite to Finland. The highest wages are observed in power and food industries. In the latter, wages are probably boosted by the large foreign companies that have invested in the industry in recent years.

3.2.1 Forest industry

For geographical reasons, the structure and importance of the forest industry is different in the two regions (Table 19). Leningrad Province has considerable forest resources -according to Goskomstat, the forested area of Leningrad Province in 1998 was 3,475 thousand hectares- and it is the second industry in the Province in terms of industrial production (Economic Monitoring, 2005). St. Petersburg for its part hosts more value-added operations. The largest furniture producers in the Northwest region are located in the city. These companies are mainly oriented to the domestic market, as their design and quality do not usually satisfy Western customers. Also, R&D centers of the forest industry are concentrated in St. Petersburg. (Dudarev et al., 2002)

Table 19: Production of forest cluster products (in thousand cubic meters, unless otherwise indicated)

	1995	1997	1998	1999	2000	2001	2002	2003
Leningrad Province								
Timber	1562.5	1458.1	1538.3	2603.8	2171.2	3289.9	3519.1	3323.6
Sawn timber	393.5	338.6	275.0	323.2	392.4	429.1	342.9	490.7
Plywood	4.4	6.0	7.8	11.1	13.0	15.1	13.6	11.6
Paper pulp*	274.6	236.9	245.1	319.2	374.3	453.9	482.3	509.6
Paper*	243.6	214.3	217.9	271.4	304.9	359.9	396.0	415.9
Cardboard*	120.3	97.9	113.9	198.6	277.1	310.8	326.4	366.5
St. Petersburg								
Sawn timber	231.3	79.8	38.2	32.8	31.5	58.0	57.6	64.4
Plywood	25.6	43.8	67.7	84.2	82.0	89.4	116.5	123.7
Paper*	21.7	11.6	14.2	27.4	28.1	29.4	29.2	32.4
Cardboard*	4.8	3.6	2.6	4.8	7.6	6.9	9.2	11.6

Source: Goskomstat
*in thousand tons

In Leningrad Province, statistics show a steady increase in the production of pulp, paper and cardboard since the 1998 crisis. The foreign direct investments in the Svetogorsk paper mill have a major effect here. International Paper (USA) acquired 85% share in the mill from Swedish Tetra Laval in 1998. Both companies have invested heavily in upgrading the mill's capacity, which was constructed by Finnish companies in the Soviet era. The investments,

which have mainly been made in paper production, have resulted in an increase in production volumes. In 2003 the Svetogorsk mill produced 263.9 tons of paper and 83.7 tons of cardboard (Minkevich). The mill's paper production thus represents 63.5 percent of Leningrad Province's total paper production. The development of production volumes in less value added forms of the forest industry, especially timber, is not unambiguous. In St. Petersburg, the production volumes are much smaller but there is a cautious upward trend in all fields of production.

Despite the positive dynamics, there are several problems in the forest sector of Northwest Russia. First, the state exercises control over the forest stock, but it is rather weak nowadays. Reforestation has almost ceased and illegal cuttings are not rare. (Dudarev et al., 2002). Second, the level of technologies applied by local producers is low and thus the economic potential of this forest stock cannot be utilized to the fullest. The major competitive advantages are, as in many other industries, exploitation of cheap resources and qualified labour force, which give a cost advantage compared to some international competitors. However, to remain competitive in the future will demand large investments in infrastructure, technology upgrades, R&D and professional training of personnel. The local producers of equipment specialize primarily in production of harvesting and pulp-and-paper machinery, but they are not competitive in the world market. Because of this, those companies that can afford it prefer to buy new imported equipment. Other companies buy old imported equipment or use their old equipment. (Dudarev et al., 2002)

As for enterprise structure in the forest industry, forestry and harvesting as well as mechanical wood processing are dominated by small and medium-sized enterprises, which often operate locally. However, on regional and higher levels there exists a network of large mechanical wood-processing and pulp-and-paper companies. Many of the companies are integrated vertically and controlled by a holding company. The most profitable companies are in the pulp-and-paper industry, and the least profitable in the forestry and harvesting industry. (Dudarev et al., 2002)

Of the most interest to Leningrad Province's economy are probably mechanical wood processing (e.g. plywood, fiberboard and furniture production) and pulp and paper production. These sub-industries have some comparatively (inside Northwest Russia) large companies in the Province. Especially the pulp and paper industry is important to Leningrad Province, and to the Northwest region in general. In 2000, companies in this industry in the region produced over half of all Russian pulp and paper. The industry is also export-oriented:

the share of pulp-and-paper industry of the region's exports in 2000 was over 40%. (Dudarev et al., 2002)

A competitive advantage of Leningrad Province compared to national competitors in more remote regions is a relatively well-developed transport infrastructure and proximity to European markets. However, the quality of logistics is below Western-European standards. Whereas the share of the Northwest region in total Russian exports is around 10% it is significantly higher in forest products, ca. one third of all Russian forest products exports in 1999. (Dudarev et al., 2002)

Domestic demand conditions for forest cluster products are good and demand probably continues to grow at quite a good rate (Russian Wood Trade and Dudarev et al., 2002). There exists an extensive domestic market for primary goods of the forest cluster (raw wood, sawn timber, paperboard, furniture, tissue, wallpaper etc.). In 2001, the total sales of forest products in Russia amounted to $5.6 billion, of which about $2 billion were imports. With good and growing demand conditions, even companies with fairly ineffective production technologies can find their niche in the market. The total value of low-cost and low-quality products sold exceeds by far the value of high-quality products, but this may be gradually changing. The high-quality products are currently sold primarily in big cities (such as St. Petersburg), where the wealthiest consumers are concentrated. (Dudarev et al., 2002)

3.2.2 Food industry

The food industry is the second largest industry in St. Petersburg. Five food production companies belong to the ten largest corporate taxpayers of the city and 5% of all the jobs of the city are in this industry (Committee of Economic Development, a). An important factor in the development of this industry is the heavy investment activity, as the industry has received quite a large share of all foreign direct investment (FDI) targeted to St. Petersburg in recent years (Economic Monitoring, 2001-2005). Another distinguishing feature is its concentration in the domestic market and not on exports (Dudarev et al., 2004). In 2003 alone, investments in large- and medium-sized companies in the food production industry accounted for 50.5% of investments to all industries in St. Petersburg (Committee of Economic Development, a).

Also in Leningrad Province the food industry has been one of the largest recipients of FDI in recent years, with only machine building and timber and wood-working having greater value of investments (ECOMON, 2001-2005). FDI made in the Northwest Russian food industry (which in the Russian statistics includes also tobacco product manufacturing) have been of large scale. These include, for example, the Phillip Morris cigarette factory and the Kraft

Foods coffee packaging plant in Leningrad Province, and the Coca-Cola and Pepsi plants and the Baltika brewery in St. Petersburg. The latter was partly a Finnish investment, as Hartwall was one of the original partners in the Baltic Beverages Holding that holds a majority share in Baltika. Other Finnish direct investments in this sector include the acquisition of a share in the Hlebnyi Dom bakery by Fazer in 1997, and the recent acquisition of the meat processing group Pit Produkt by Atria in 2005.

The 1991-1998 decline in food production in Leningrad Province ended in 1999. Since that time there has been stable positive development in the sector. Leningrad Province has 152 enterprises of food processing industry, which together employ approximately 10,000 people. Table 20 shows the development of production volumes in the food industry.

Table 20: Production of selected food products (in thousand tons)

	1995	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Leningrad Province								
Bread and baked goods	118.3	99.7	93.6	98.2	88.3	85.0	77.0	69.4
Vegetable fats	-	-	0.02	-	-	-	-	-
Distilled alcohols*	1.3	0.4	0.9	2.4	3.0	4.2	7.2	9.4
Beer**	348	477	65	175	983	1888	1160	424
Meat (incl. some by-products)	47.0	33.5	34.9	38.9	42.6	56.0	73.3	84.0
Whole-milk products	103.1	93.8	101.0	123.1	103.4	113.4	113.9	98.3
St. Petersburg								
Bread and baked goods	398.6	312.6	327.1	340.2	316.2	316.9	312.0	299.4
Vegetable fats	-	-	0.07	-	-	2.8	2.7	2.6
Distilled alcohols*	2.3	1.0	2.6	2.4	2.5	3.3	4.3	4.8
Beer**	17605	41884	58674	80797	110685	137669	151655	144648
Meat (incl. some by-products)	11.2	2.5	2.6	2.2	2.0	1.7	1.4	1.1
Whole-milk products	198.5	231.1	267.6	280.8	312.7	346.3	351.9	394.5

Source: Goskomstat
* in million decalitres
** in thousand decalitres

The table indicates that the structure of food industry production is different in the two regions. The production of meat is considerably larger in volume in Leningrad Province than in St. Petersburg, obviously due to the infrastructure needed for processing live animals. Moreover, St. Petersburg is one of the leading centers of beer production in Russia whereas in Leningrad Province beer production is in decline. A general problem with the food industry in Russia is that it is still dependent on imported raw materials (Kaipio and Leppänen, 2005). The local agricultural production has still not recovered from the crisis caused by the fall of the Soviet economic system. A major problem hindering its development is the lack of a

functioning financing system for this sector, which impedes investment in new equipment. (Tiusanen, 11 January, 2006) However, from the viewpoint of Finnish food producers the main challenge relates to distribution, since the retailers have a strong bargaining position vis-à-vis producers (Kaipio and Leppänen, 2005).

3.2.3 Metal industry

As noted earlier in this report, metallurgy and machine-building have a prominent role in Northwest Russia. In addition, the production of electro-technical equipment is showing signs of increase although Russia has clearly been a net importer of this equipment. Local manufacturers have not been competitive, but this may be changing fast as foreign manufacturers are setting up factories in St. Petersburg. (Averin and Dudarev, 2003)

Metal industry is here divided into two sub-sectors: metallurgy, and metalworking. Strong regional differences are characteristic of the Northwest Russian metallurgy sector. Most of the R&D and education activities in the sector are concentrated in St. Petersburg, where the products with most added value are also built. Some major enterprises of secondary ferrous metallurgy and metalworking are located in St. Petersburg (such as Izhora Plants and Petrostal), but not those of primary metallurgy and metalworking. All metal industry companies in St. Petersburg face common problems, such as low domestic demand for products with high added value, outdated equipment and deficiency of qualified personnel. The main reason is low demand from metal-consuming industries: the military complex and the machine-building sector. (Boltramovich et al., 2003) However, machine building is currently doing well in St. Petersburg, if not in all other parts of Northwest Russia and it supports some of these companies. The structure of non-ferrous metallurgy and metalworking in Northwest Russia is determined by the location of its ore deposits and power plants (ibid.).

The metal industry in Leningrad Province is not very competitive. The non-ferrous metallurgy in the Province is the most backward segment of metallurgy in Northwest Russia. That said, two of the largest alumina producers in Northwest Russia (Pikalevo Glinozyom and Boksitogorsk Glinozyom) are located in Leningrad Province. They produce approximately 17% of all Russian alumina. (Boltramovich et al., 2003) A new ferrous metallurgy plant may be built in the town of Tihvin, which might change the situation concerning metallurgy in Leningrad Province (ECOMON, 2005). Another probable project is the construction of a primary aluminum plant in Koskolovo with a project cost of $700-800 million by an American company Alutec Corp (Boltramovich et al., 2003). In January 2004 an aluminum can factory began operations in Vsevolozhsk (The Russia Journal). The factory is owned by Rostar, which belongs to RusAl group. The total cost of the investment was approximately

$100 million. Moreover, there is at least one machine-building company in Leningrad Province that produces equipment for the metallurgy industry: Caterpillar-Tosno, which was established in 2000. It assembles Caterpillar tractors, excavators, loaders and other equipment. (Boltramovich et al., 2003) In general, local equipment manufacturers are not very competitive. Even Izhora Plants (located in St. Petersburg), which is the leading equipment manufacturer for metallurgy in Russia, cannot provide products of world quality (Boltramovich et al., 2003).

An important segment of machine-building in Northwest Russia in general and for St. Petersburg in particular is power engineering. Companies in this sector specialize primarily in producing turbines, electrical machinery, technical power equipment, compressors and equipment for nuclear power plants. The largest companies include the Leningrad Metal Plant, Electrosila and the Turbine Blade Manufacturing Plant, which are part of the Silovye Machiny (Power Machines) Group, and the Izhora Plants, which is part of United Machine-Building Plants. The main consumers of this sector's products are domestic electric power companies. However, the products are also exported and used in other domestic industries. (Filippov et al., 2003) In general, the domestic market for power engineering equipment was reduced dramatically in the 1990s and the companies have concentrated now mainly on after-sale and replacement markets. Moreover, although the Northwest region is not Russia's leading concentration of oil and gas equipment manufacturers, there are those as well. Actually, much of this equipment production is done by the aforementioned power engineering companies. Izhora Plants in St. Petersburg is the largest manufacturer of oil and gas equipment in Northwest Russia. (Filippov et al., 2003)

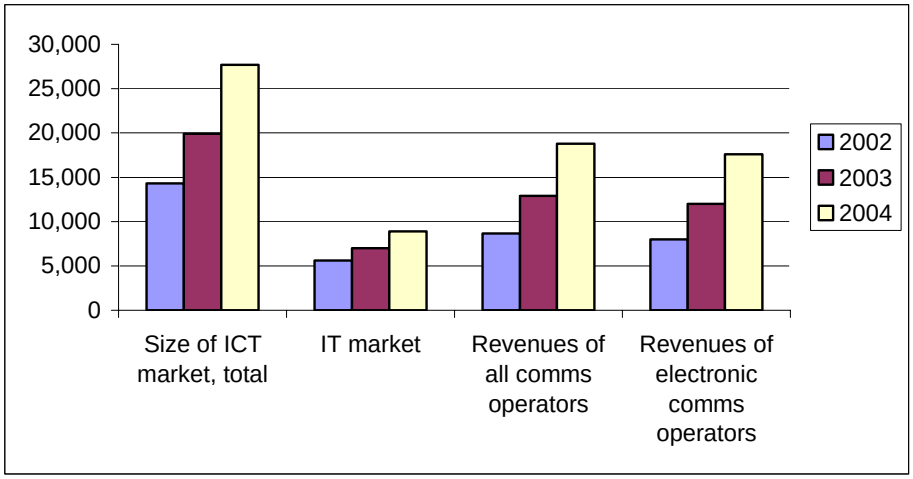
3.2.4 ICT sector

As in Chapter 3.1.4, the ICT sector is here analyzed consisting of both manufacturing and services. As for manufacturing of ICT equipment, producers of telecommunications equipment in North-West Russia can be divided into three categories: (1) old manufacturers with assets inherited from the Soviet period, (2) spin-off companies founded by specialists and focused on smaller niches, and (3) joint ventures or subsidiaries of Western telecommunications companies. The old manufacturers are usually not competitive. The spin-offs, on the other hand, usually exploit their founders' knowledge and imported technologies and are able to offer competitive solutions. Joint ventures and subsidiaries of Western telecommunications companies (such as US Lucent Technologies) typically produce products that are equivalent to those produced in their Western plants. (Averin and Dudarev, 2003 and companies' homepages) However, the main share of FDI in the communication sector of Northwest Russia has been made in services, i.e. foreign investors have acquired shares in

mobile operators. FDI in ICT manufacturing have been made in labour-intensive activities such as components manufacturing, where companies seek for low-cost production locations. The construction of the Finnish Elcoteq factory is an example of this.

In Soviet times, St. Petersburg was the technology centre of the Soviet Union, developing high-tech products mainly for military purposes. When the Soviet Union came to an end, there was no domestic demand for these products. This led to skill and advantage deterioration. Demand for research and development skills in this sector started to take off in the beginning of 21st century along with substantial investments by global companies (such as Sun Microsystems, Motorola, and Intel) in R&D centers or dedicated development centers. (ECOMON, 2001) Today St. Petersburg is the second ICT development centre in Russia after Moscow. Figure 15 below shows the growth of the total ICT services market in Russia and the growth of selected submarkets in recent years.

Figure 15: Size of ICT services market and submarkets in Russia, USD million



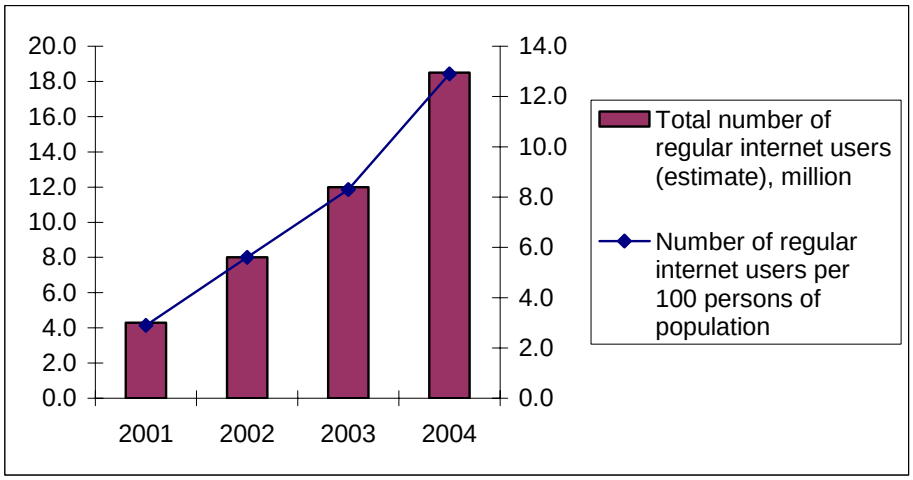
Source: Ministry of information technologies and communications of the Russian Federation (www.minsvyaz.ru)

The Russian ICT services market is still growing at a fast rate, in spite of having grown fast for some years now. Mobile communications is one of the major driving forces behind this growth. Communications has also received a good share of foreign investment in recent years (ECOMON, 2001-2005). For example, teleoperators Megafon and VimpelCom are partially owned by foreigners.

The sub-sectors of the ICT services sector in Northwest Russia have different growth perspectives and enterprise structures. In wire communications, there are both traditional, non-competitive players (former state communication companies) that are natural monopolies

for household clients and new, competitive players (private) that have focused mostly on corporate clients. The development in this field is quite slow due to the need for large investments in infrastructure. Data transmission and Internet access services, on the other hand, have grown very quickly. The northwest region is second in Russia after Moscow in terms of number and penetration of Internet users. The data transmission infrastructure in the region is also quite well developed compared to many other regions. The development of numbers of regular internet users in total and per 100 persons in recent years can be seen in Figure 16 below. (Averin and Dudarev, 2003)

Figure 16: Number of regular Internet users in Russia*.



Source: Ministry of information technologies and communications of the Russian Federation (www.minsvyaz.ru)

* Left scale: Total number of users, right scale: number of users per 100 persons

In mobile communications, progress has been rapid and competition is nowadays intense. In 2000 the total number of mobile operator customers was smaller than the growth in the number of customers in single month in late 2004 (Sotovik.ru). The number of mobile phone subscriptions compared to population is over 100% in St. Petersburg and Leningrad Province (see Table 21 below). In rural areas the penetration is 25.1% on national level (Sotovik.ru). In the Northwest region it is 37%, clearly higher than the national average (ibid.). One reason for the high level of mobile phone subscription penetration in Russia is that many subscriptions are sold as prepaid and with a discount. The consequence of this is that people "collect" more subscriptions than they would otherwise have. In St. Petersburg and Leningrad Province, the leader in mobile operators' market is MegaFon with a market share of 40.8%, MTS is second (32.4% market share), VympelKom third (19.9%) and other operators have 6.9% of the market. The share of MegaFon has been decreasing in recent years and the share of VympelKom has been steadily increasing. (Ibid)

Table 21: Number of mobile phone subscriptions compared to population in Russia

Region	1Q05	2Q05
Moscow and Moscow region	109.6%	118.2%
St. Petersburg and Leningrad Province	94.8%	101.6%
Other regions	50.0%	58.3%
Russia in total	58.9%	67.2%

Source: Sotovik.ru

Information technologies are another fast-growing subfield of ICT services in St. Petersburg. The city is considered to have the most favorable conditions for the development of the IT sector, because of qualified personnel availability and lower cost of living (and lower wages) than in Moscow. The education system in IT, telecommunications and other technical fields is of very high quality. R&D of information technologies dropped dramatically during the transition period. The main institutions, however, survived and continue working. Human capital is probably the major competitive advantage of the ICT sector in St. Petersburg. (Averin and Dudarev, 2003) However, Russia is not yet among the most popular destinations for off-shoring IT functions. In 2003 Russia's offshore IT market was $200 million, while that of India was $7.7 billion and Ireland's was $8.3 billion. But as companies want to spread their geopolitical risk, they might consider St. Petersburg, as the level of education there is superb. (Network World, 2004)

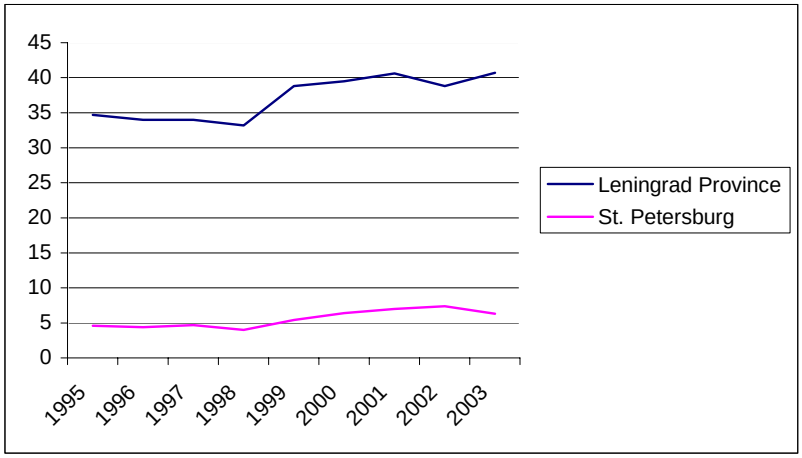
As was mentioned earlier, several sub-sectors of ICT are growing fast. However, the Russian government's nationwide success in promoting ICT, laws relating to ICT, FDI and technological transfers and the collaboration of universities and industries are not at a good level, and are in fact competitive disadvantages. Innovation and quality of math and science education, on the other hand, are perceived as good. (Helanterä and Ollus, 2003) Moreover, according to the IPR legislation, innovations made in state research institutes are state property, which complicates their commercialization (Vähä-Pietilä, 13 December, 2005).

3.2.5 Logistics

Northwest Russia in general has more developed logistics and transportation infrastructure than some other regions in Russia, although it is still not comparable to the infrastructure of Western Europe. Warehouses are one example of this: there is a shortage of them all over Russia (Pekkarinen, 2005). St. Petersburg has at times had higher warehouse space prices than even Moscow (ibid.). Establishing new warehouses, however, is not easy in Russia. There are plenty of difficulties in the way of building a new warehouse, in the form of legal and operational obstacles. St. Petersburg also has one of the main seaports in the region and the fourth largest airport in Russia (Dudarev et al., 2002 and Pekkarinen, 2005)

St. Petersburg is gradually taking back its place as a transport and logistics hub for the Northwest Federal District and for Russia as a whole. Transports grew by 6.6% in 2004 compared to 2003. Marine transport (+140%) and inland water transport (+21.4%) were the fastest growing areas. This was due to an increase in seaport capacity, including the construction of new ports in Primorsk and Vysotsk. These ports serve mainly oil transportation. Ongoing projects are the construction of a port for various cargo transportation in Ust-Luga, the modernization of the Vyborg port and the development of the Greater Port of St. Petersburg[18] to better serve container transportation. However, railroad and pipeline transports are by far the most important when measured in tons of transportation flows, while according to Pekkarinen (2005), the role of road transports will grow in the future. (ECOMON, 2005)

Figure 17: Shipment of cargo on public railroads (millions of tons)

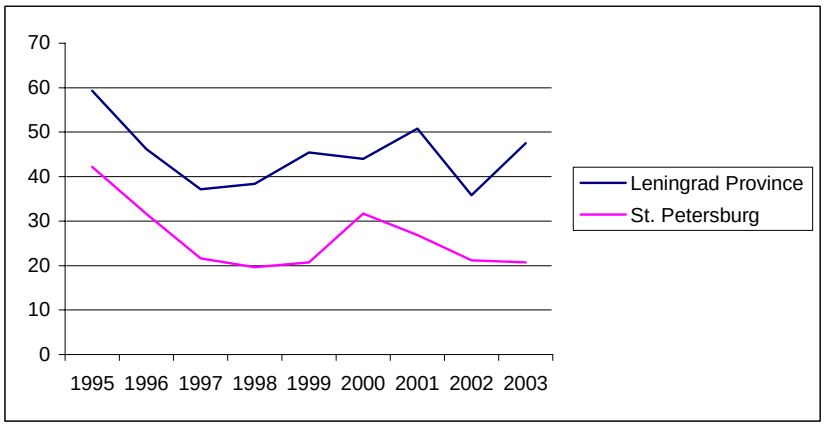


Source: Goskomstat

As one can see from Figures 17 and 18, the transportation and shipment of cargo on road transport and railroads have not grown very much in recent years. There has been an increase in Leningrad Province during the last couple of years, but whether this proves to be lasting remains to be seen.

[18] The Greater Port of St. Petersburg refers to the totality of maritime infrastructure in the city, consisting of independent ports and related transportation and service infrastructure.

Figure 18: Transportation of cargo on road transport (million tons)



Source: Goskomstat

Russian railroads are still a government monopoly. Railroad transport is overall of low efficiency, because of e.g. shortage of specialized rolling stock, inefficient logistics and low level of operations transparency. (Dudarev et al., 2002) Despite its drawbacks, it is the most efficient and extensive form of transport over longer distances, (Hernesniemi et al., 2005). For example, the Trans-Siberian route is very competitive in Europe-Asia transportation (Hämäläinen, 13 December, 2005). The railroad infrastructure in Northwest Russia is owned and controlled by a state-owned company, October Railroads, which is a department of OAO Russian Railroads. OAO Russian Railroads in turn owns basically all railroad infrastructure and most of the locomotives and rolling stock. According to Pekkarinen (2005), the biggest problem in Russian transportation logistics is lack of investments. In August 2004 OAO Russian Railroads adopted a massive strategic development program, which includes 63 million dollars in investments. It also negotiated a loan of $300 million with Citigroup. (Pekkarinen, 2005)

In 2004 growth in the transport sector accelerated in Leningrad Province. The total volume of cargo transportation increased by 20.0%, whereas in the previous year this growth was only 12.6%. The structure of modes of transport changed as well. In 2004 a reform of railroad transport in Russia changed the territorial distribution of transport companies' turnover and revenues. A new state company named "Russian Railways" acquired all railroad infrastructure and carriage parks previously owned by the Ministry for Transport Communications (Ministerstvo Putej Soobshenija). (ECOMON, 2005)

As regards the regional modes of transport, the highest growth (+21.2%) was reported by pipeline transport. Cargo volumes transferred by internal marine transport increased in 2004 by 16.9%. Dynamics of the road transport remained stagnant, as the annual growth was only

0.6%. That, however, might simply have been a levelling out of the impressive rise (+50%) of road transportation in 2003. (ECOMON, 2005) Moreover, road transportation is a sector of heavy competition, due to the large number of transportation companies. On the contrary, the sea and inland water transportation have promising perspectives. In the seaports of Leningrad Province, the exploitation of the ferry line connecting Vyborg and Kiel increased the volume of cargo transportation.

The share of logistics services in mature market economies is normally 7-8% of the final price. The equivalent figure in Northwest Russia is estimated to be 15-20 %. Thus, the logistics system in locations under review is rather inefficient. It can be assumed that increasing competition and improving infrastructure will bring about cost-efficiency in the Russian logistics.

3.2.6 Tourism

The service sector in Russia has developed rapidly since the market reforms. Among the most rapidly developing service sectors is tourism. The tourism industry is seen as significant for St. Petersburg by the local authorities, but there does not exist much accurate economic information on this sector. Moreover, the information given for basic indicators, such as the number of visitors annually varies considerably according to the source. According to the City administration, there are over 1200 firms and approximately 100 000 people employed in this sector of the economy. After private entrepreneurship was liberalized in Russia in the early 1990s, tourism was one of the sectors where small firms mushroomed due to the great demand for travel services and the relative low capital intensity of the industry. Most of these firms served outgoing tourists. The 1998 crisis hit this sector hard when Russian travel abroad diminished drastically. The tourist figures have recovered since then but there has recently been a consolidation tendency in the travel industry where the share of one-person businesses diminishes and firms merge into larger units. There was, however, no statistical data available for this study on this issue. The Rosstat tourism industry statistics do not include the number of tourist firms.

From the viewpoint of Finnish companies, the tourist flows from and to St. Petersburg and Leningrad Province are worth studying. As noted in section 3.1, St. Petersburg especially is an important source of Russian visitors to Finland. In general, the role of Finland as a destination for Russian travel has remained important. In 2003, Finland was the most popular destination of foreign travel (to non-CIS countries) for Russians. However, it should be noted that a considerable part of this travel is private, whereas the share of tourists (as registered by purpose of trip) is relatively smaller than for other popular destinations. (Rosstat, 2004)

Statistics of incoming foreign tourism in Russia show that when registered by purpose of trip, the seven leading non-CIS countries of origin are Poland (34,4%), Germany (10,4%), Finland (8,7%), China (7,3%), USA (4,5%), France (4,2%) and Italy (4,1%). (Rosstat, 2004) In general, the majority of foreign tourists visiting Russia see St. Petersburg and Moscow during their trip. From a Finnish viewpoint, it should be noted that part of foreign tourists visiting Russia, in particular from the US, UK, Australia and Southern Europe, use Finland as a gateway to St. Petersburg. This is mainly due to the competitiveness of Finnish transport infrastructure vis-à-vis direct connection from these countries to St. Petersburg. Also, there is a potential for trips combining Finland and Northwest Russia as destinations. (Karhunen et al. 2003)

The development of tourism demand in St. Petersburg and Leningrad Province can be estimated based on accommodation statistics. Table 22 shows the development of nights spent in hotels for the two regions, and Russia as a whole.

Table 22: Nights in hotels, 1000

	1995	**2000**	**2001**	**2002**	**2003**
Russia	58652.1	46558.8	47342.3	45907.3	45534.9
St. Petersburg	4371.8	3346.9	3429.2	3745.3	3986.6
Leningrad Province	452.0	316.5	359.1	348.8	367.5

Source: Rosstat, 2004

The table shows that despite a positive trend, the accommodation figures have not yet reached the 1995 level. Also, it gives an indication of the magnitude of the tourism industry in the two regions: the number of nights in Leningrad Province is ca. a tenth of those of the tourist centre St. Petersburg. Another factor (not shown in the table) is that the Russian accommodation sector still relies heavily on domestic demand, with the exception of St. Petersburg. The share of Russian citizens in all clients served by hotels in 2003 was in Russia as a whole 81,4%, in Leningrad Province 94,4% and in St. Petersburg 52,3%. (Rosstat, 2004)

In both regions the local authorities have acknowledged the importance of tourism for the regional economy. Also, the private sector has increasingly started to invest in tourism, and in the accommodation sector in particular. In St. Petersburg, foreign investors have targeted the upper end of the hotel industry, whereas local actors have opened a number of mid-class mini hotels in recent years. In Leningrad Province, investors have started to develop recreational facilities to utilize the nature-related tourism potential of the region.

3.2.7 Energy sector

The energy sector is very important for Northwest Russia's economy. It is heavily export-oriented and an important source of revenues for the federal budget. The energy sector is also both an important supplier to other industries as well as their largest customer. Therefore it is not wrong to say that the energy sector is crucial to the whole economy of the country and to that of Northwest Russia. (Filippov et al., 2003)

St. Petersburg and the surrounding Leningrad Province act as hosts to the most important energy cluster agglomeration in Northwest Russia. Located in St. Petersburg is a power engineering complex that provides products for the energy industry. Most of the energy-related education is also concentrated there. In this area (St. Petersburg and the surrounding Leningrad Province) the energy cluster produces products with higher added value than elsewhere in Northwest Russia and there is potential for future development. (Filippov et al., 2003)

Electric power and gas sectors are still monopolies of the companies established in the Soviet period, but in oil, coal and equipment production exist basic prerequisites for competition. Transit trade is also a factor shaping Northwest Russia's energy cluster. St. Petersburg and Leningrad Province are hubs through which energy sector products are exported to Western markets. The growth of this traffic creates opportunities for establishing new industrial facilities. Growth of traffic would be especially beneficial to St. Petersburg, as the largest operating terminal for oil products in Northwest Russia is located there. (Filippov et al., 2003)

The fuel and energy sector forms the foundation of Leningrad Province's industrial base and is vitally important for the needs of the Northwest region. The share of fuel and energy products as a percentage of total production volume in Leningrad Province is 39 percent. The largest oil processing plant in Northwest Russia (KINEF, subsidiary of Surgutneftegaz) and the largest electric power supplier (the Leningrad nuclear power plant) are located in Leningrad Province. Nuclear power is the main form of power production in Northwest Russia and as there are only two nuclear power plants in the region, the Leningrad nuclear power plant is one of the foundation stones of the Northwest region's power supply. There are ongoing projects to prolong the active service life of the reactors to years 2010-2015, but they are clearly at the end of their life span. (Filippov et al., 2003)

Table 23: Production of electric power (in billion kilowatt-hours)

	1995	1997	1998	1999	2000	2001	2002	2003
Leningrad Province	26.4	31.2	27.6	31.4	30.8	35.9	35.4	35.4
St. Petersburg	9.3	7.6	7.8	8	8.2	9.3	10.2	11.1

Source: Goskomstat

Table 24: Capacity of power plants (in million kilowatts)

	1995	1997	1998	1999	2000	2001	2002	2003
Leningrad Province	7.3	7.7	7.8	7.8	7.8	7.8	7.8	7.8
St. Petersburg	2.6	2.1	2.1	2	2	2.5	2.5	2.5

Source: Goskomstat

The most important energy companies are the most prosperous companies in Russia and they have the best access to foreign markets and improved management. Therefore they can afford to invest and pay dividends. In general, the better-off energy companies are those operating in oil, gas and electric power industries. Coal and shale oil companies face difficulties. (Filippov et al., 2003)

The electric power business is a monopoly of RAO UES and its subsidiaries. A restructuring of the company started in 2001 with the aim of creating a competitive electric power market and attracting strategic investments. The reform basically consists of the division of monopoly and competing sectors of the industry. Production and distribution are to be separated to create competition. Implementation of the reform has been postponed and will begin in 2006 at the earliest (EIA). (Filippov et al., 2003) The Leningrad atomic power plant (LAES) produces almost 60 percent of the power that the region needs. Since 1995, the plant has produced 16 to 21 million kWh of power per year. OAO Lenenergo is the operating company. Its largest source of electric energy is the Kirishi Main Regional Power Plant.

In the fuel industry, KINEF alone is responsible for 99 % of the refined oil product exports of the Northwest region. The plant should, however, be modernized to make it more competitive. Still, it is one of the largest and most modern oil-processing plants in Russia. The Baltic Pipeline System, which is an alternative transport route to existing routes through Baltic States, goes through a port near Primorsk in Leningrad Province. The project was established to provide an alternative route for oil transport, which would go through Russia rather than through the Baltic States. The first phase of the project is ready and in use, but the second phase of the project still continues (Kommersant Vlast 17.5.2004). (Filippov et al., 2003)

The Northwest Russian gas-transport infrastructure is not very important for Finland, as Finland has low dependency on gas. As mentioned before, the gas industry is still basically a monopoly in Russia with Gazprom extracting 90 % of all natural gas in Russia. The amount of gas produced in the Northwest region is only 0.7% of all Russian gas production, so it is not a big business there in itself. Northwest Russia is more important as a transit gateway in this field. (Filippov et al., 2003) Natural gas is supplied from the United Gas Supply System of Russia. The gas supplying organization is LENTRANSGAZ, and the distributing organizations are OAO Lenoblgaz and OAAT Gatchingaz, which also provide for liquefied gas supplies.

3.3 Importance of production cooperation for the competitiveness of Southeast Finnish enterprises

The two previous sections gave an overview of the case industries in this study of Southeast Finland and Northwest Russia. This section analyzes the cooperation potential between Finnish and Russian firms in these industries, and its implications for the competitiveness of Southeast Finnish enterprises. The analysis points out promising forms of cooperation in each of the industries, as well as motives for and advantages of cooperation for the Finnish companies.

3.3.1 Forest Industry

The potential of Northwest Russia for the Southeast Finnish forest industry is on the one hand based on the rich forest resources in Leningrad Province, and on the other hand on the demand perspectives in the St. Petersburg market. Also, foreign investors and Russian firms have started increasingly to invest in production facilities in Northwest Russia which investment provides business opportunities to Finnish forest industry technology providers and equipment manufacturers. Here, the competitive edge lies in the technological advantages that Finnish firms have compared to Russian competitors in the forest industry. If and when Russian authorities start to demand reforestation, the Finnish companies have an advantage, as reforestation has been standard practise in Finland for a long time. Another advantage compared to some foreign competitors is that large Finnish forest companies have operated in Russia for many years now and smaller Finnish companies that cooperate with them in Finland can gain Russian contacts and knowledge of the business environment through them.

At the same time, Russian companies are anticipating changes in forest legislation (amendments to the Forest Code), which is going to affect the prices of timber on the markets and therefore will influence future development. The lack of coordinated industrial policy and

weak law enforcement in the forest sector is adding to the problems of the institutional framework and hindering possibilities for cooperation between foreign and Russian SMEs.

Finnish SMEs in woodworking could benefit from subcontracting in Northwest Russia. In more labour-intensive fields of the woodworking sector such as furniture manufacturing, Finnish companies could better utilize the relatively low wage level in Northwest Russia, thereby gaining a cost advantage. Also, the local demand for furniture has been growing and large multinationals such as IKEA have established operations in Northwest Russia. This provides additional opportunities for local production. By subcontracting, the Finnish companies would also learn about conducting business in Russia and could thus prepare for their own investment there. This could be a valuable advantage in the future.

3.3.2 Food industry

The potential of Northwest Russia for the Finnish food industry companies lies in the growing consumer demand. In addition to demand, competition in this field has also intensified in recent years. The 1998 devaluation of the rouble gave a boost to local food production and increased the incentive for foreign food companies to invest in local production. Also, consumer attitudes towards local products have turned more positive after the early 1990s euphoria where all imported goods were considered to be superior. Therefore, the most relevant business options for Finnish food companies have changed from exports to local production. There are already positive examples of investment, such as those mentioned earlier in this report (Fazer, Atria and Hartwall).

It is large enterprises that have made FDI in food production in Northwest Russia. For most Finnish food companies, relatively small size is a problem when entering the Russian market. Although the undervalued rouble provides an incentive for foreign investors, small companies lack resources to utilize this advantage. Therefore, production cooperation might provide a solution for this. In the food industry, which is very localized in many respects, cooperation with a Russian firm with a strong brand would be an advantage. Finnish food producers could bring production technologies to the venture and the Russian partner could use its knowledge of the local market in sales and distribution. Another option for Finnish food producers would be to focus on niche products, positioned in the high-end segment of the market. Finnish food products have traditionally had a good reputation in Russia, and Northwest Russia (especially St. Petersburg) has a large number of potential consumers with incomes high enough to purchase such goods. Also, Finnish food producers could tackle the problem of small size by joining forces in marketing their products in Russia.

3.3.3 Metal-working industry

The sector descriptions of chapters 3.1 and 3.2 reveal that, despite the rapid growth in the ICT manufacturing sector, the traditional metal industry is still an important backbone of the local economies on both sides of the Finnish-Russian border. An emerging problem for the Finnish metal-working industry is the lack of qualified personnel, which could be tackled by Finnish-Russian production cooperation. The wage level in Russia, although rising rapidly, is still considerably lower than in Finland. Therefore, the competitive advantage of production cooperation in the metal industry is mainly in labour cost. It should be noted, however, that there are signs of a lack of qualified personnel in Russia also.

The economic growth in Russia has increased the demand for machinery and equipment, which is also reflected in Finnish export statistics. In addition to exports, this demand could be met by local production. Despite changes made in the Russian legislation during the WTO negotiations, there are still customs barriers that make the imports of especially complex investment goods less competitive than local production. Here, moving parts of the production to Russia would lower the production costs. Also, a local partner could offer its knowledge of local markets and industry standards that often differ from the Finnish ones. It should also be noted that there have recently been large international investment projects in, for example, the automotive industry in Northwest Russia, which provide opportunities to local subcontractors for parts and components.

The metal industry in Northwest Russia has traditionally been based on large production units focusing on military production and has been gradually converted to civilian production. Large conglomerates have been in many cases split into smaller units, with which Finnish SMEs find it easier to operate. However, it should be noted that successful subcontracting in Russia requires close cooperation between the supplier and customer. (Karhunen, 2001) This is due to differences in business practices and the lack of a subcontracting tradition in Russian industry. It is also very important in this business to check the potential partner's true competency in technology beforehand, as there are still uncompetitive companies operating with inherited assets from Soviet times (Averin and Dudarev, 2003).

3.3.4 ICT sector

The cooperation potential in the ICT sector is built on qualified personnel and know-how in Russia on the one hand, and on the large demand for ICT services on the other hand. The demand has grown and seems to be still growing at a fast rate. Despite the high level of education in mathematics and related disciplines, Russia has not yet developed into a main offshore centre in the ICT sector. This is in part due to underdeveloped legislation in the field.

However, Finnish ICT firms could use the know-how in Northwest Russia by joining forces with local companies, which have the knowledge to cope with the local institutional environment. In mobile communications, the operator market is already saturating, but the high mobile phone penetration for its part creates demand for related software.

A common problem in Russia is that fundamental research is at a high level, but the application and commercialization of these results is at an insignificant level. One reason for this is that innovations made in state institutes are state property. However, one avenue of cooperation in the ICT sector would be R & D cooperation with research institutes that are numerous in Northwest Russia. Public funding for this kind of cooperation is becoming increasingly available, as the EU Framework Programs for Research and Development have been opened to third country participants, and national funding agencies such as TEKES have started to put more emphasis on the technology cooperation potential with Russia. St. Petersburg may be considered the most promising IT centre in Russia and, again, the proximity of St. Petersburg is an asset to Finnish companies, as keeping personal contacts with cooperation partners is easier.

3.3.5 Logistics

Logistics is the sector where Northwest Russia and Southeast Finland are competing with each other. So far, Finnish logistics firms have been competitive due to their service level and flexibility, which in Russia are at lower level due to the youthfulness of the sector. The unstable business environment in Russia and underdeveloped infrastructure for logistics services have supported the position of Finland as a safe storage location and route for transportation of valuable items. However, the logistics sector in Northwest Russia is developing very rapidly. This includes investments in transportation infrastructure such as ports, and in warehouse premises. At the moment, distribution of products is still to some extent a problem in Northwest Russia. Finnish companies could now concentrate on creating and offering even better value-added services in logistics with which the competitiveness of transit traffic to Russia via Finland could be protected. Otherwise it is probable that at some point the transit traffic will concentrate more on Leningrad Province's and St. Petersburg's ports, which are being developed and expanded at the time of this writing.

The cost structure in road transport gives a superior competitive advantage to Russian companies. Due to a great difference in fuel prices and drivers' wages companies registered in Finland are not able to compete with Russian firms. Therefore, to take their share in the road transport Finnish companies should register in Russia. Finally, in addition to developing

measures to increase the competitiveness of Finnish firms vis-à-vis Russian firms, the growth of the logistics sector also provides opportunities for Finnish firms. Finnish know-how in logistics could be utilized in warehouse and other projects being implemented in Northwest Russia.

3.3.6 Tourism

As previously noted, tourism is a service branch that has a great growth potential in Northwest Russia. To an extent the situation is similar as with logistics: Leningrad Province is a competitor for Eastern Finland for Russian travellers interested in nature-related vacations. So far the tourism infrastructure in the Province does not meet the needs of demanding customers, but there are several investment projects going on to change this. Instead of competing, Finnish tourism industry actors should focus on the cooperation possibilities with Northwest Russia. Previous studies (e.g. Karhunen et al. 2003) have shown that there is potential demand for package trips combining Finland with Northwest Russia in third countries. This potential could be exploited by developing tourist products jointly with Russian tourist firms. It should also be noted that as the transport infrastructure in Russia improves, Finland might lose its position as a tourist gateway to Russia.

Russian tourists are of great importance for Southeast Finnish regions, both for the tourism industry and retail trade. In the long term, however, the role of shopping tourism is probably decreasing as the selection of goods in Northwest Russia improves and price levels comes closer to those in Fin. Therefore, in order to continue attracting Russian tourists in the future, Southeast Finnish regions should develop tourist products that interest Russian visitors. Here, the traditional strengths of Eastern Finland such as a clean environment are of importance. Also, the tourist flows from Russia to third countries via Finland could be better exploited. At the moment, these tourists use few tourist services while in Finland. Also, a number of Russian tourists visiting Finland would be interested in organising trips to third countries while in Finland which provides additional business opportunities for Finnish tourist firms (for further analysis see Kosonen et al. 2005).

3.3.7 Energy and environment

Russia is practically the dominant primary energy supplier to Finland, supplying currently some 80% of Finnish oil imports and all the natural gas imported to Finland. (Vahtra and Lorentz 2004). On the natural gas and electricity markets, Finland's strategic position could provide the Russian suppliers with considerable strategic incentives. Finnish markets have shown valuable experience concerning the efficient operation of liberalized electricity markets. In addition, Finland is likely to serve as a staging ground for operational expansion

to the other Scandinavian countries. Further development of these strategic relationships is in the interest of both sides.

Finland's strategic dependency on Russian energy supplies raises the need to provide mutual interests for Russia and Finland if sustainable cooperation is to be built. Committing the Russian companies to the Finnish economy through strategic partnerships and investment opportunities would benefit not only the Russian companies' ambitions abroad but also the Finnish counterparts dependent on the Russian supplies.

From the viewpoint of Finnish companies interested in entering Russia, it should be noted that the Russian energy sector has high barriers for entry because of the access to main energy resources is already reserved to a few major players. Also, transport is controlled by natural monopolies (gas pipelines and power transmission lines). Although there are plans to reform the energy sector, one should be cautious when estimating the outcome of such decentralization plans of the Russian economy. The state ownership in the oil industry is increasing and the gas sector is firmly in state hands. Moreover, the splitting of natural monopolies into smaller units does not necessarily result in increased competition if these units are controlled by the public sector. The Yukos case indicates that the state attempts to regain control over the energy sector from the oligarks.

However, there is plenty of potential demand for electricity saving technologies and energy saving equipment in Russia. Since the decentralization of energy supply may advance, the market for small heat generating units and municipal heat distribution networks may emerge. In the sphere of energy saving and environmentally sound technology there are good prospects for Finnish-Russian cooperation.

4 Formal Business Environment in St. Petersburg and Leningrad Province

This chapter will discuss the formal operating environment in St. Petersburg and Leningrad Province, addressing issues such as legislation and administrative regulation of business. Moreover, it briefly discusses initiatives of local authorities and other collective actors that support business development. Most issues addressed in the chapter are common to all enterprises, regardless of their size or country of origin. However, given the nature of Finnish-Russian business cooperation, in which small and medium-sized enterprises (SMEs) are heavily involved, special attention is paid to the SME sector's viewpoint. In addition, the foreign investor's standpoint is taken to better illustrate the investment climate in the two target regions.

4.1 Legislative and regulative environment

In general, the legislative and regulative environment in Russia consists of three levels. First, federal legislation sets the rules for the whole territory of the Russian Federation (RF). Second, regions[19] have their own legislation complementary to that of the federal level. Third, some legislative issues are decided on the municipal level. For example, tax concessions and other support measures are determined to be within the competence of regions by the federal legislation. However, it should be noted that legislative acts of the regional and municipal levels are secondary and should not contravene federal legislation.

In administrative terms, St. Petersburg and Leningrad Province are rather fragmented. St. Petersburg is divided into 111 municipalities, which in turn are controlled by 20 city districts as intermediate territorial divisions. On the municipal level Leningrad Province has 29 cities and towns, and ca. 240 village administrations. These are controlled by 17 districts that implement the policy of the city on its territory. (www.balticdata.info) In practice, the role of the districts is less specific than that of regions and municipalities. From a foreign enterprise's viewpoint, the existence of different levels of administration with their own institutions adds to the complexity of the business environment. It is sometimes difficult to know which authority to approach, for example with questions related to registration of an enterprise. The following sections are intended to illuminate this complexity.

[19] According to the Constitution of the RF (Section one, Chapter 1, Article 5) the Russian Federation consists of republics, territories, regions, federal cities, an autonomous region and autonomous areas, which are all equal subjects of the RF often called "regions". Their total number is 89, including St. Petersburg and Leningrad Province. Here and later in this report we use terms "regions" and "regional" when speaking about subjects of the RF.

4.1.1. Taxation system

Foreign businesspersons often perceive the taxation system in Russia as complex, especially concerning its implementation in practice. Nowadays in Russia there are three main systems of enterprise taxation: General System of Taxation (GST), Simplified System of Taxation (SST) and Unified Tax on Imputed Income for Certain Types of Activity (UTII).

The principles of taxation are defined in the Tax Code of the Russian Federation, which is available online (www.consultant.ru). The general system of taxation is applicable for most enterprises, whereas the simplified system of taxation is for small businesses, and the unified tax on imputed income for certain types of activity concerns mainly consumer services, such as retail trade and public catering. The following sections summarize the main aspects of enterprise taxation in Russia, and the general principles and applicability for the three different taxation systems.

General System of Taxation (GST)

The general system of taxation is the basic enterprise taxation system in Russia, applied for all enterprises that do not fulfil the requirements of the two specific systems. Therefore, in GST all enterprises irrespective of their size pay the same taxes and levies. Unless otherwise stated during registration, an enterprise automatically becomes subject to the GTS at registration. According to this system, the taxable base for the majority of taxes is calculated on the basis of the enterprise's accounting figures. It should be noted, however, that there is a difference between general accounting and tax accounting in Russia. For example, some kinds of income reflected in general accounting are not taken into consideration when calculating income tax. The General System of Taxation has three levels of taxes and levies: federal, regional and municipal.

All the federal taxes and charges are fully detailed in the Tax Code. This includes defining the taxpayers for each tax, the objects of taxation, the tax base, the tax rates, exemptions, and administrative procedures. For the regional and municipal taxes, the Tax Code sets out common principles with the aim of unifying taxation throughout the whole of Russia. Municipalities are left with some discretion to set tax rates, extend some exemptions and decide on other taxation matters within the framework of the Tax Code (Hellevig et al, 2005).[20] The main federal, regional and municipal taxes and levies are presented in Table 25.

[20] The official information sources for regional and municipal taxation in St. Petersburg and Leningrad Province are the regional administrations of the Federal Ministry of Taxation, and the regional governments. They, however, provide information only upon request. In addition, there are commercial

Table 25: The main taxes and duties that have to be paid in each territory of the RF

№	Taxes	Rates	Note
Federal Taxes and levies			
1.	Value-added tax (Tax Code of the RF, Part II, Section VIII, Chapter 21)	18%	Non-taxable (VAT exempt): several types of sales activities; manufacturing equipment are imported on the territory of the RF as in-kind contribution into charter capital of organization
		0%	Export
2.	Excise duties (Chapter 22)	-	Rates vary depending on the type of excisable goods
3.	Personal income tax (Chapter 23)	13%	For residents
		6%	Dividends
		30%	For non-residents
4.	Unified social tax (Chapter 24)	26%	Levied on payroll. Rates vary depending on amount and type of business
5.	Corporate profits tax (Chapter 25)	24%	For residents and non-residents
6.	Tax on mining of natural resources (Chapter 26)	-	Rates vary depending on the type of natural resources
7.	Tax on property to be inherited or transferred as a gift	-	Since 01.01.2006 will be cancelled as separate tax, will be included in personal income tax
8.	Water tax (Chapter 25.2)	-	Rates vary depending on water source
9.	Fee for the right of use of fauna and water biological resources (Chapter 25.2)	-	Rates vary depending on type of the resources
10.	State duty (Chapter 25.3)	-	Rates vary depending on the type of legal operations
Regional taxes			
11.	Corporate property tax (Tax Code of the RF, Part II, Section IX, Chapter 30)	2,2%	Maximum rate used in St. Petersburg and Leningrad Province
12.	Tax on gambling business (Chapter 29)	-	Rates vary depending on taxable base (gambling table, gambling machine, etc.)
13.	Vehicle tax (Chapter 28)	-	Rates vary depending on type of the vehicle and engine volume
Municipal taxes			
14.	Land tax ((Tax Code of the RF, Part II, Section XIX)	0,3%	Maximum rate for agricultural land, land under housing facilities and infrastructure, personal subsidiary plots
		1,5%	Maximum for other land
15	Individual property tax	2%	Nowadays under revision, will be decrease to 0,1%

Source: Ministry of Taxation of the RF

As shown in the table, the majority of the tax burden of the enterprises in Russia consists of Federal taxes, in particular of the value-added tax, the unified social tax, and the corporate profits tax. The rates for regional and municipal taxes, in contrast, are considerably lower and concern mainly property. The basic VAT rate in Russia is 18%. There is also, however, a special 10% VAT rate for items such as basic food, children's products, medicine,

sources such as www.kadis.net, where up-to-date taxation information on the two regions can be purchased.

subscriptions, scientific and text books, and print ads and services. However, there are plans to decrease the standard VAT rate to 15-16% and abolish the special 10% VAT rate. In addition there are a number of taxes with rates which vary depending on the type of business activity. These taxes most often concern industries exploiting natural resources.

Simplified System of Taxation (SST)

The simplified system of taxation exists parallel to the general taxation system and it is specially designed for small businesses. The right to use SST is defined on the basis of the company's sales revenues over a period of 9 months. The current threshold is RUR 11 million, which will be raised to RUR 15 million on 1 January, 2006. It is worth noting that enterprises eligible for the simplified system of taxation may shift from GST to SST and back voluntarily. However, when the sales revenues of the taxpayer reach RUR 15 million[21], the shift to GST becomes obligatory.

The main principle of the SST is that the enterprise pays a single tax, calculated from the gross revenues or gross revenues reduced by expenditures. This tax replaces the company profit tax, the company property tax, and the unified social tax of the GTS. Moreover, enterprises applying the SST are subject to VAT only for import activities. All other taxes and the obligatory pension insurance contribution (14%) are paid in accordance with the GTS rules.

As mentioned before, the taxpayers using the SST may choose the taxable base itself. There are two options. The taxable base is the gross revenue, in which case the tax rate is 6%, or the taxable base is the gross revenue reduced by expenditures, in which case the tax rate is 15%. The shift from GST to SST has pros and cons. The positive side of the SST is the simplified accounting procedure and lower tax rate. Negatively, the list of expenditures that can reduce the taxable revenue is not as long as in the GST. Besides, purchases from SST taxpayers are not included in the calculation of VAT receivable. As a result, SST taxpayers often lose their VAT paying partners.

Unified Tax on Imputed Income for Certain Types of Activity (UTII)

UTII represents a special taxation regime, where the taxpayer is expected to have a fixed level of profitability depending on the type of activity. The income and income tax of the enterprise are then calculated based on this imputed level of profitability using adjusting factors, which are established by federal and regional legislation.

[21] From 1 January, 2006 RUR 20 million

UTII exists parallel to the two other taxation systems. It is brought into force by the laws of the subjects of the RF[22], and it is valid only for activities like personal service, veterinary service, repair, technical service and washing of vehicles, retail trade, parking, public catering, automobile transportation services and outdoor advertising. Enterprises engaged in such activities are obliged to use the UTII and are not allowed to use another system of taxation. The Tax Code does not set restrictions on the size of enterprises subject to the UTII, but in practice it is usually small businesses that are involved in the various activities.

Like enterprises eligible for the SST, UTII taxpayers are exempted from the company profits tax, the company property tax, the unified social tax and the VAT (except the VAT on import). Instead, the UTII taxpayers pay a flat income tax of 15%. Moreover, the subjects of the UTII pay all the other taxes and the obligatory pension insurance contributions in accordance with the general rules.

The UTII has several advantages over the other two systems. The calculation of the income tax itself is very easy, and it is fixed for the whole year, which facilitates planning. The tax on enterprises using the SST or the UTII is much lower than for enterprises subject to the GST. For example, the general company profits tax rate alone (24%) is higher than the unified tax rate of the SST and the UTII (15%). Also, the social payments for enterprises using the SST or UTII comprise only 14% obligatory pension insurance contributions while in the general taxation system companies have to additionally pay a 26% unified social tax. Finally, taxpayers using the SST and UTII are exempted from company property tax (2.2%) and VAT (18%). Nevertheless, the number of enterprises meeting the requirements for the simplified taxation schemes is still rather small. This is in part due to the RUR 15-20 million threshold for annual revenue, which is very low.

4.1.2. Rent and other non-tax costs of business

In addition to taxes, there are several other costs associated with establishing business operations in Russia. These are related to the production premises, various documents related to the start-up of operations, and the launching of products on the Russian market. This section discusses production premises, their availability, and the costs for their rent and maintenance.

[22] In focus regions UTII is implemented by the Law of St. Petersburg № 299-35 of 17.06.2003 (with changes as of 30.05.2005) and the Law of Leningrad Province № 49-оз of 21.11.2002 (with changes as of 26.11. 2004)

The real estate market

In any market, the availability of land and premises is one of the main conditions for a successful start-up and further development of business activity. In St. Petersburg and Leningrad Province, the real estate market is still at a development stage and its depth is not yet sufficient to supply all the required premises at a reasonable cost (Yegorov, 2004). It is fairly common for enterprises to have their administrative office with marketing and sales functions in St. Petersburg, whereas production and storage facilities are located in the territory of Leningrad Province.

The total non-residential area of St. Petersburg is about 67 million sq. m., of which 88.5% is located in detached buildings and 11.5% in non-residential premises in residential buildings. The suppliers of the commercial real estate in St. Petersburg are divided into two groups – public and private. The city is one of the main players in the real estate market. As of 01.01.2005, the number of city-owned non-residential buildings offered for rent was about 20,000 with the overall floor area about 4 million sq. m.: 50% office space, 30% sales premises, and 20% industrial and warehouse premises. Until recently, leasing has been the prevalent contractual form in the commercial real estate market. Its share in the total amount of real estate operations reaches 80-90%. However, the development of long-term crediting has created new opportunities for enterprises willing to buy real estate. Nevertheless, there are still complications related to the purchase of real estate. For example, the legal status of premises is often unclear. After the disorderly privatisation it is sometimes difficult to determine the real owner of the premises. Moreover, city-owned buildings offered for sale are seldom empty – they are occupied with tenants, such as public sector organizations or private residents, who are reluctant to leave.

The leasing of city real estate is not without complications, although the City Property Management Committee of St. Petersburg (KUGI) (the manager of state real estate belonging to the city) has taken steps to improve the situation. For example, the procedure of offsetting tenants' expenses for capital repairs was simplified, and the responsibilities of district agencies of KUGI were broadened so as to localize decision-making and reduce bureaucracy. Also, tenants who paid their rent through 2009 have received additional guarantees of saving tenant-right till the end of contract validity. Nevertheless, a set of problems questioning the predictability and stability of existing rent relations remains. The major problems are first, that the KUGI can unilaterally reconsider the rental rate and second, that the KUGI does not take into account tenants' expenses for capital repairs while reconsidering the rental rate. Thus, it is disadvantageous for tenants to make improvements and capital repairs in rented premises.

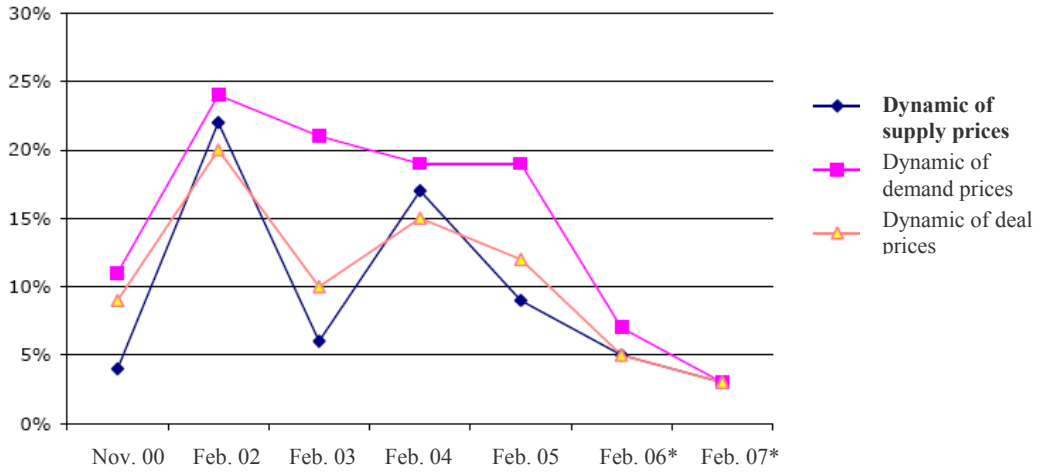
The new leasing system introduced in 2004 has recently caused increases in rents of city-owned premises. This system makes it so that the only practical way to rent city real estate is by auction. As a result, the final rental rate frequently exceeds twice the initial rental rate. Also, as in the case of city-owned premises offered for sale, premises to be rented out are often occupied by tenants that do not agree to leave even after the end of their rent contracts. Thus, small enterprises, especially start-ups, in St. Petersburg are hardly able to rent any premises belonging to the city.

The situation is expected to improve, when the commercial real estate market develops. According to expert estimations, the total area of the constantly growing commercial real estate supplied in St. Petersburg by private companies is now over 13 million sq. m. A similar situation can be observed in Leningrad Province, where the state authorities are still the main suppliers of non-residential premises but the private sector share is gradually increasing.

Office space market

The volume of the office space market in St. Petersburg is more than 3.1 million sq. m., of which ca. 50% still belong to the city and are managed by the KUGI. Quality office buildings satisfying modern requirements appeared in St. Petersburg only some 10 years ago. In the early 1990s, many foreign businesses operated on the premises of hotels that converted part of their room capacity to modest-level business centres. Modern business centres started to emerge in the mid-1990s and at present there are more than 220 of them available on the market, with a total floor area about 850 thousand sq. m.. The rents in the St. Petersburg office space market were in rapid growth (25-30% annually) until 2003 (see Figure 19). However, the growth in rents has now stabilized to a monthly level of 0,5-1%.

Figure 19: Annual dynamic of rental rates on the office space market.



Source: City Department of Inventory and Real Estate Evaluation (GUION)

As the figure shows, there is a tendency of slowdown in the annual growth of rents. The growth comprised 12 % in 2004 as compared to 16% in 2003. If this tendency continues, it is expected that the annual growth of rents in 2005 will be 5% and in 2006 – ca. 3-4%. This tendency is supported by an expected increase in the supply of office space in St. Petersburg in the short-term. This is due to the decision of the Legislative Assembly of St. Petersburg to move the Soviet built industrial enterprises in the near future from the city centre to Leningrad Province. The territories of those enterprises will then be converted into residential, business and service infrastructure areas.

The rent level and the occupancy rates in the business centres of St. Petersburg in 2005 are given in Table 26. Here, a classification of the St. Petersburg Guild of Managers and Developers is used. According to the classification, office premises of "A" and "B" classes are business centers located in detached new or reconstructed buildings in the historic city center. These premises have high quality interior decoration and layout, and support infrastructure such as conference halls, cafés or restaurants, and parking. Class "B" offices are usually located in districts with good transport infrastructure close to the city centre. Offices situated in administrative buildings comprise class "C".

Table 26: The range of the rental rates and occupancy rates in business-centres of St. Petersburg in II quarter of 2005

Class	Range of the rental rates, RUR[A] per sq. m. annually, before VAT, including maintenance cost	Level of unoccupied space, %
A	11 469-19 497	1
B	6 308-12 902	6
C	4 301-7 168	5

Source: GUION

A. End of period exchange rate RUR/USD = 28,6721 has been used to convert dollars to roubles in this table.

As can be seen from the table, there is a high demand for office space of all classes. There is almost no free space in class "A" buildings and the average occupancy rate of those business-centres is about 99%.

Market of industrial and warehouse premises

The market of warehouse and industrial premises in St. Petersburg and Leningrad Province has been growing for the past couple of years, but has not yet matured (Yegorov, 2004). This concerns the variety, quality as well as quantity of premises. Therefore, enterprises willing to lease industrial or warehouse premises have to expend great effort to find a suitable location.

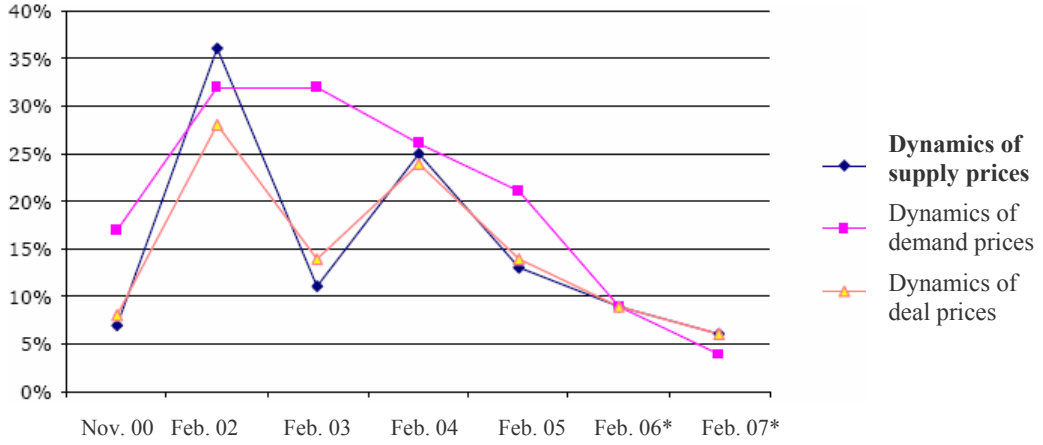
More specifically, the market for industrial and warehouse real estate in St. Petersburg and the surrounding parts of Leningrad Province can be characterized as follows (Yegorov, 2004).

- Low diversification of supply (small share of high-quality premises in the overall supply);
- High demand for reasonably-priced renovated and/or new facilities;
- Overriding tenant preference for leasing premises, not purchasing;
- Growing requirements for building and infrastructure quality;
- Large proportion of small and medium-sized companies on the demand side;
- High demand for relatively small premises;
- Short term lease contracts (usually one year or less);
- Unclear legal status of many facilities.

At the same time, growth of the retail sector and an increase in the number of foreign companies requiring modern production and storage facilities contribute to a progressive qualitative restructuring of the industrial premises market in St. Petersburg. According to GUION, the total area of storage facilities in St. Petersburg is 5.7 million sq. m. However, good quality warehouse premises account for only six per cent (340 thousand sq. m.) of the total storage capacity. This 6% is warehouses meeting modern requirements, i.e. they are professionally managed, meet modern technical specifications, offer a wide range of services, and are properly equipped and well located. In addition to storage facilities available on the market, there are many quality warehouses (about 1 million sq. m.) that are not leased out but used by their owners to support their business operations.

In addition to leasing, the acquisition of premises and/or land for production or storage purposes is an alternative. The average cost of the industrial and warehouse premises put up for sale in St. Petersburg varies between USD 150-400 per sq. m. In Leningrad Province it is between USD 100-200 per sq. m. The price range, however, is rather wide depending on the type of premises. Unheated premises cost less than USD 150 per sq. m. in St. Petersburg and USD 30-50 per sq. m. in Leningrad Province, whereas new high-quality premises are offered at the price of USD 1 000-1 100 per sq. m. Moreover, in St. Petersburg and Leningrad Province the average cost of land plots with a complete infrastructure necessary for industrial and warehouses construction is USD 200 thousand per 1 ha. Figure 20 shows the main changes and forecast annual dynamics of the rents of industrial and warehouses premises.

Figure 20: Annual dynamics of rents in the industrial and warehouse premises market



Source: GUION

As can be seen from Figure 22, since the beginning of 2004 growth in rents for industrial and warehouses premises has slowed down. This tendency is expected to continue, implicating a growth rate of 9% for 2005 and of 5-7% for 2006. The rents for different classes of industrial and warehouses premises, and their occupancy rates are given in Table 27.

Table 27: The range of the rental rates and occupancy rates of the industrial and warehouses premises in St. Petersburg and Leningrad Province in 2005

Class	Range of the rental rates, RUR[A] per sq. m. monthly, before VAT, including maintenance cost	Level of unoccupied space, %
A	258-344	1
B	201-287	5
C	86-1207	n/a
D	29-143	n/a

Source: GUION

A. End of period exchange rate RUR/USD = 28,6721 has been used to convert dollars to roubles in this table.

According to the GUION classification, industrial and warehouse premises of class "A" are high quality premises up to 8 meters high with modern equipment, usually located on the ground floor. This kind of premises includes office space for the tenants, and full service including, for example, loading and discharging operations and recording. Class "B" premises are renovated industrial premises up to 8 meters high with infrastructure and equipment. They can be located on the first or second floor. Former industrial premises without renovation comprise the Class "C" premises, while unequipped in-built warehouse premises usually requiring capital repairs are labeled class "D".

Experts estimate that the majority of the industrial and warehouse premises in St. Petersburg and Leningrad Province fall into the lower quality categories. The share of class "A" and "B" (high and good quality) premises in the overall supply is about 5% (270 thousand sq. m.) and their deficit is approximately 15-20%. As stated before, there is a tendency for enterprises to locate their production facilities in Leningrad Province rather than in St. Petersburg. The main reasons for this are high prices of land plots and associated maintenance costs, high administrative barriers, problems with transport access and irregular behavior of renters and monopolistic companies providing energy, heat, gas, water, etc. (Cherednichenko, 2005).

In contrast, Leningrad Province is interested in new enterprises because they provide jobs and bring income to the region in the form of tax and non-tax revenues. To attract enterprises to its territory, the government of Leningrad Province grants company property tax and company profit tax privileges to enterprises registered or that re-register in the territory of the region. In addition to financial incentives, Leningrad Province's attractiveness is due to lower administrative barriers. It is easier to deal with local authorities and the bureaucracy level is lower than in St. Petersburg.

The growth in investment in Leningrad Province during recent years is reflected in site availability. In the best industrial zones, located along transportation routes, there is now an apparent lack of industrial sites with infrastructure. An emerging problem is also a shortage of qualified personnel. However, in more remote parts of Leningrad Province there are still good sites for production, as well as a surplus of electricity supply.

Experience shows that the best way to find a land plot for greenfield production or premises for lease is to approach the regional administration. Usually, the administration requires an official letter (via fax), indicating the type of planned manufacturing activities, approximate size of investment, desired location of the land plot, monthly and/or annual need for water, electricity, gas supply, requirements for access to railway/other transportation routes, maximum distance to port and other relevant criteria (Yegorov, 2004). When discussing the costs of premises, extra-rental costs have to be taken into account. In St. Petersburg, the maintenance costs and service fees for communal infrastructure are growing (Table 28).

Table 28: Growth in rent and maintenance costs in 2004

Expenditures	Since	Growth rate, %
Rent	01.01.2004	10.1
Electric energy	01.01.2004	6.2
Heat power	01.01.2004	11.5
Water supply	01.06.2004	24.7
Telephone (subscription fee)	01.10.2004	2.6

Source: Committee on Economic Development, Industrial Policy and Trade of St. Petersburg¨

All in all, in 2004 the non-tax financial burden on businesses in St. Petersburg grew 1.5 times (accounting for the rise in the cost of services, raw materials and fuel). A similar tendency can also be observed in Leningrad Province, except that the growth in rents there is not so fast as in St. Petersburg.

4.1.3. Registration issues

The complexity of legal formalities, such as the registration of the enterprise or licensing and certification of products, is one of the most common issues mentioned as characteristically problematic in the Russian business environment. However, the authorities have made some attempts to improve the situation. Beginning from 01.07.2002 the Russian legislative authorities significantly simplified the procedure of state registration of all enterprises in Russia, including foreign ones. Moreover, the registration rules were standardized for all subjects of the RF.

According to the current procedure, the state registration of enterprises and individual entrepreneurs, as well as their registration as taxpayers, is provided by a single executive body – the Ministry of Taxation of the Russian Federation (a so called principle of "one window"). In compliance with this principle, the local tax authority not only registers an enterprise as a taxpayer but also implements its registration in all extra-budgetary funds (the Social Insurance Fund of the RF and the Pension Fund of the RF) and the Committee for Statistics. The main issues of the state registration procedure in Russia are presented in Table 29.

Table 29: The main issues of the state registration procedure in Russia

State authority responsible for the registration	The Ministry of Taxation of the Russian Federation (via its regional representatives)
Documents required for the registration	1. Standard application for a state registration with the notarised signature of the applicant (often the founder of the enterprise) 2. Decision about the establishment of the legal body (a record, agreement or other document complying with the Russian legislation) 3. Constitutive documents of the legal body (originals or notarised copies)

	4. Extract from the registrar of the foreign legal entities of the country of origin, or other document that proves that an applicant has a status of foreign legal entity 5. State duty payment document
Duration of the registration procedure	5 working days (after all the required documents are received)
Cost of the registration	RUR 2 000

Source: Federal Law of the RF № 129-ФЗ of 08.08.2001 "On State Registration of Juridical Bodies"

From a foreign enterprise's viewpoint the main benefits of the new procedure are the unification of duties, the simplification in registration, the shorter duration of the process, and the elimination of the need to record in Moscow enterprises with a founding capital of more than RUR 100 000 (Heusala-Pushnov, 2003). However, as in the case of many progressive legislative initiatives, the practical implementation of the simplified registration procedure leaves room for improvement. Often, on the regional level there is no coordination in the actions of tax authorities, representatives of extra-budgetary funds and the committees for statistics. As a result, the principle of "one window" does not work properly.

An additional problem is that it is often not clear which tax authority (municipal or district) enterprise founders should address,[23] and which door they should knock on and when. This is especially difficult for foreigners not speaking Russian, because the information about working hours, account details and other important announcements of those authorities are usually available only in Russian. Moreover, the 5-day term of the registration procedure is often exceeded. In October 2003 the World Bank published a report on business climates for small and medium-sized enterprises (SMEs) in different countries. For Russia, it was concluded that registration of a new enterprise takes on average 29 days and requires 12 steps (Beac.st, 2004).

The city authorities of St. Petersburg have made an attempt to rectify the above-mentioned shortcomings by establishing the Unified Centre of the Registration of Legal Bodies and Individual Entrepreneurs in 2004. Nowadays in St. Petersburg all new enterprises and individual entrepreneurs, regardless of their legal address, are registered by this center. In Leningrad Province there are no similar initiatives so far.

[23] According to the rules, the regional authority should be chosen in accordance with the legal address of the enterprise

Establishment of foreign operations in Russia

The selection of the legal form for foreign business operations in Russia depends on the scope and nature of operations. The registration procedure for a representative office or branch of a foreign enterprise is somewhat different than for wholly owned subsidiaries or joint ventures between foreign and Russian partner. For example, representative and branch offices have to be registered and accredited by the Chamber of Commerce instead of local registration authorities. Subsidiaries and joint ventures for their part can take any of the legal forms available for enterprises registered in Russia. The main difference between the legal forms lies in the scope of rights, liabilities and risks associated with each of them (Yegorov, 2003). The comparison of the main characteristics of the representative and branch offices of foreign companies in Russia is given in Table 30.

Table 30: Main characteristics of foreign company representative and branch offices in Russia

Representative Office	**Branch Office**
Activities	
Represents & assures interests of a foreign company in Russia: 1. Assists in realization of trade, commercial and other agreements 2. Provides an accumulation, analysis and exchange of relevant market information 3. Ensures the fulfilment of commercial and other deals concluded by a parent company	Conducts all the activities of a representative office as well as carries out all or part of the core activities and businesses of a parent company: 1. Manufacturing 2. Distribution and selling of products 3. Other commercial activities
Registration	
1. Both forms have to be registered and accredited by the Chamber of Trade and Commerce 2. A standard set of documents is required: certificate of registration, company constitutive documents, recommendation letter of the bank that serves parent company, document that confirms the company legal address (draft lease agreement or a letter from a future landlord). The foreign documents should be translated and notarised 3. The accreditation fee is approximately USD 1 000 per each year for which registration will be valid 4. Both have to be registered by tax authorities & extra-budgetary funds 5. If company plans to employ foreign citizens, the permission to hire foreign labour force and work permits for every foreign employee should be received	
✓ The accreditation term is 1-3 years	✓ The accreditation term is 1-5 years ✓ Has to register estimated cost of capital ✓ Is allowed to receive certain kinds of licences (e.g. publishing activities)
Liabilities & Reporting	
1. Parent company is liable for all obligations of its representative or branch offices 2. Bookkeeping is simplified compared to Russian legal entity	
✓ Is not considered a legal entity (needs authorization from the parent company) ✓ Is not subject to income tax	✓ Is a subject to income tax and other taxes and fees according to the Russian legislation if carries out profit-generating activities ✓ Pays profit tax once a year

Source: modified from Yegorov, 2003 and Cliff.ru

As can be seen from the table, the branch office has more rights and more liabilities compared to the representative office. At the same time the registration procedure is almost the same for both enterprise forms.

These two enterprise forms are not independent legal entities according to the Russian legislation. If the nature and scale of operations require that the Russian unit operate independently, it shall be established as a subsidiary. Also, joint ventures between Finnish and Russian partners are legal entities of their own. A subsidiary or joint venture can be established as a limited liability partnership (OOO), or an open/closed joint-stock venture (OAO/ZAO). The main advantages and disadvantages of these enterprise forms are presented in Table 31.

Table 31: The main advantages and disadvantages of different organizational forms

Limited Liability Partnership (OOO)	**Joint-stock company (OAO/ZAO)**
Advantages	
Provides greater control of ownership and management Is easier to register and has to comply with fewer rules and regulations than a joint-stock company	When leaving a shareholder has right to sell his stocks, but has no right to demand the company must buy his share. Thus, in AO there is no financial risk for the company if one of the participants decides to leave
Disadvantages	
When leaving the company a partner's share should be paid back. Thus exit of one of the partners may cause significant losses and even lead to bankruptcy	Within 30 days after the company registration the stock issue should be registered in accordance with stock market legislation In OAO there is less control over ownership because shares can be sold freely to outsiders

Source: modified from Bisnis.doc.gov, 2003 and Flexa.ru

The most popular organizational form for a subsidiary company in Russia is a limited liability partnership (OOO). The closest alternative to OOO is a closed joint-stock company (ZAO).In both cases the registered capital minimum is 100 monthly wage rates (MROT), the partners have a pre-emption right and the maximum number of partners should not exceed 50. A major difference between these organizational forms is that the ZAO is not obliged to buy out its partners wishing to exit the company, as is the OOO. Finally, the open joint-stock company (OAO) represents an organizational form, which is more appropriate for large businesses aiming to be listed on the stock exchange. In OAO the registered capital minimum is 1 000 monthly wage rates, the number of shareholders is not restricted and its shares can be sold freely to outsiders. Hence, from a foreign enterprise's viewpoint, the risk of losing control over the operations is greatest in OAOs.

It should also be noted that the current registration procedure is almost the same for Russian and foreign enterprises. The difference lies in minor details, such as translation and

confirmation of statutory documents and setting up accounts in national (RUR) and foreign currency. Besides, the legislative requirements for the registered capital minimum are equal for enterprises organized with and without participation of foreign capital. Moreover, after registration in Russia the subsidiary or joint venture acquires full legal capacity in accordance with Russian legislation. It is required to conduct accounting in full compliance with the Russian laws and regulations and is subject to all customs, foreign exchange and other rules.

To cope with registration foreign companies are usually advised to seek professional consultants. Their fees for registration of a legal entity generally vary between USD 1.000 – 10.000. This wide variation depends on how much consultation a client requires and how many amendments to the standard documents are needed. In the end, the price also depends on how much time a client wants to spend collaborating with a law firm on preparation of the documents. (Yegorov, 2003)

Usually, law firms with international experience charge USD 60-160 per hour for pro-legal work and USD 100-450 per hour for the work of a lawyer. Although it is possible to find offers to register a foreign company for USD 300-500, firms offering such terms usually lack international experience, which is reflected in the quality of their work. For example, it may even be necessary to re-write the charter and re-register the company afterwards. In addition to the actual legal consultation, law firms usually charge for additional (such as courier, notary, and document translation expenses). Finally, it should be noted that the registration of a representative office or a branch office takes approximately one month, and the registration of a legal entity ca. 1.5-3 months (Yegorov, 2003).

4.1.4. Licensing and certification system

In addition to registration, some types of business activities require a license before they can be started. Also, a large number of products and some services need to have a certificate, either issued in Russia or recognized by the Russian authorities. This section will discuss the main principles related to licensing and certification issues.

Licensing of business operations

Licensing is one of the main methods of public monitoring of commercial activity in Russia. In practice, a license permits an enterprise to undertake a certain type of activity. Though the

list of activities requiring a license has been shortened recently[24], there are still a large number of activities that are subject to obligatory licensing by the appropriate government authority.

The consequences of neglecting the licensing of activities are rather serious. In case a company undertakes any kind of regulated activity without obtaining the appropriate license, state tax authorities may apply to the court for an administrative penalty and the confiscation of income received from such activity. Apart from that, if the company is found guilty of undertaking a regulated activity without a licence, criminal proceedings against the company's officials may be initiated.

Licensing is often mentioned as one of the main problems faced by foreign enterprises in Russia. One reason for this is that the Russian legislation in the field of licensing is constantly changing. The new licensing law 25 came into force in the autumn of 2001, replacing the one of 1998, which in turn had replaced earlier rules set forth by the government. Altogether, the licensing law has been corrected 11 times since its introduction in 1998, with the most recent changes in the law introduced in July, 2005.

Most activity licensing rules are set by the Federal licensing law. However, there are exceptions: licensing rules exist in other laws for certain activities, such as those of banks and credit institutions. Aside from these exceptions, the licensing law seeks to set forth an exclusive list of activities for which licenses are required. However, this list is not entirely clear, so it can be difficult to determine whether a license is required for a certain activity or a set of activities. Legislative acts including the principles of regulation are also published for certain activities, but even these regulations may not provide conclusive information (Malloy, 2002/2003).

For certain activities, the state regulation may involve more than one authority. Therefore, an activity may require licenses from more than one regulator, justified by different aspects. Besides, the regulatory authority may overlap levels of government as well as ministries. Although changes to the licensing law have placed the lion's share of the licensing authority in the hands of federal ministries and agencies, regional and local authorities still have significant permitting and licensing authority concerning specific activities and aspects of

[24] According to the Federal Law of the RF №80-ФЗ of 02.07.2005, the list of regulated activities will be even more shortened – from 103 to 89 items. Thus from 01.01.2007 14 types of activities, including tourism and construction, will not require licensing any more.
[25] The Federal Law of the RF № 128-ФЗ of 08.08.2001 "On Licensing of Certain Types of Activity".

projects. Therefore, one should always check at all levels of government to ensure that all issues for licensing, permitting, and similar requirements are covered (Malloy, 2002/2003).

To conclude, the best way to find out if a specific activity requires licensing is to first look at the Federal law and regulations and then pay a visit to the relevant regulatory authorities, the License Chamber of St. Petersburg or the Leningrad Province Committee on State Licensing. The main issues of licensing procedures in Russia are given in Table 32.

Table 32: The main principles of licensing in Russia

Main rules	License is activity-specific. License cannot be passed to any other organization
Area of validity (depends on the licensing authority)	A license issued by a Federal authority is valid throughout Russia, whereas a license issued by a regional authority is valid only on the territory of the corresponding subject of the RF
Period of validity	5 years
Documents required for licensing	1. Application for a licensing of the certain activity, including the company's details 2. Constitutive documents of the applicant (originals or notarised copies) and registration certificate 3. Certificate of tax registration (copy) 4. State duty payment document (for the consideration of application) 5. Other documents required for certain types of activities in accordance with regulations and federal laws
Term of decision-making	45 days maximum (after all the documents received)
Costs	State duty for the consideration of application – RUR 300 State duty for issuance of a license – RUR 1 000 (with some exceptions) State duty for re-issuance of a license – RUR 100 (if needed) Cost of a copy – RUR 10 (if needed)

Source: Federal Law of the RF № 128-ФЗ of 08.08.2001

As summarized in the table, the licensing procedure itself is not very complicated, and the costs involved are rather moderate. Therefore, the main challenge for foreign enterprises seems to be to know whether a license is needed for their activity in general, and/or for some parts of it in particular.

Certification

In addition to licensing, certification is another administrative issue found problematic by many foreign enterprises operating in Russia. Certification is the major state mechanism for ensuring the quality and safety of products and services in Russia, and it is rather multifaceted. The classification of different types of certification in Russia is given in Table 33.

Table 33: The classification of different types of certification in Russia

According to the principle:
✓ Mandatory certification ✓ Voluntary certification
According to system membership:
✓ Hygienic certification (Ministry of Health) ✓ Product quality certification (GosStandart) ✓ Ecological certification (State Committee on Nature Protection) ✓ Forest certification (Federal Forestry Agency) ✓ Certification in construction (RF Construction Committee) ✓ Other

Source: modified from Megasert.ru

Mandatory certification in Russia was introduced as a part of the consumer protection legislation in 1992[26] in order to ensure the safety of consumer life and health, to prevent damage to private property, and to provide for environmental protection. It was a response to the post-Soviet inflow of substandard goods from overseas that sometimes caused significant damage to Russian consumers. Certification law introduced mandatory certification for a list of goods according to established standards. It also stated that this list of products and public works subject to mandatory certification had to be approved by the Russian government.

A more specific law concerning certification was introduced in 1993[27], detailing the basic principles of mandatory certification, terms for certification of imports, and prescribing that *certificates of conformity* for imported products have to be submitted together with customs declaration to the customs authorities. For retail trade, certificates of conformity (or their authorized copies), are also required by trade inspectors and other controlling bodies (Lapina, 2003). The list of products subject to mandatory certification is long, including items such as pharmaceutical drugs and medical devices, food products, machinery and electrical products, products of light industry, raw materials, wood-derived products and personal safety products. A complete list is available from local certification centres. Russian goods produced and sold domestically are subject to the same certification standards as imported products. In contrast to products, it should be noted that services in Russia are subject only to voluntary certification.

The commercial impact of certification and product branding makes it increasingly common for manufacturers to seek testing and certification for Russia on a voluntary basis, even for those products that are not included in the mandatory list. According to companies' experience the availability of a certificate simplifies the custom procedure and gives

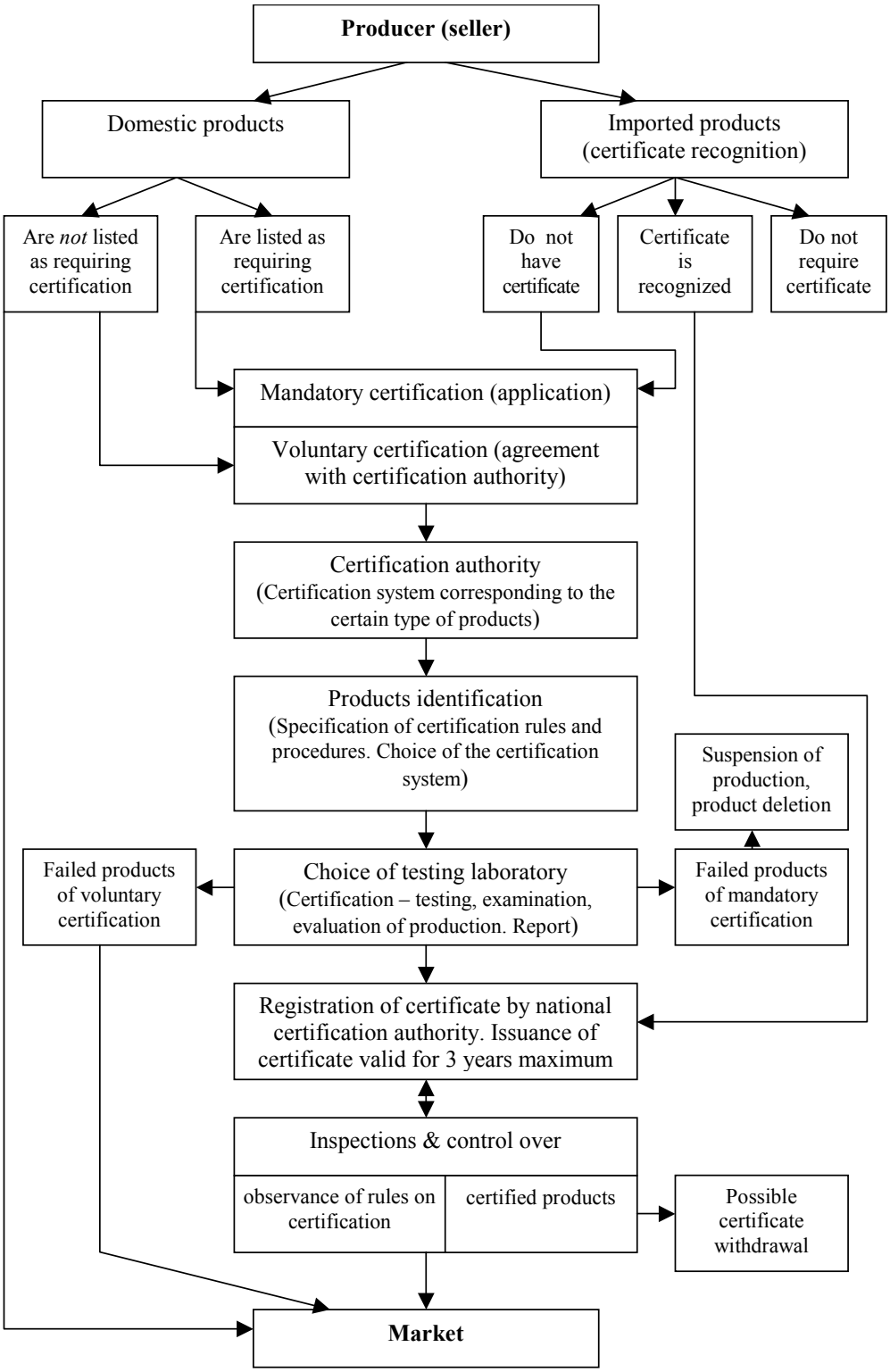
[26] The Federal Law of the RF № 2300-1 of 07.02.1992 "On Consumer Rights Protection"
[27] Federal Law of the RF № 5151-1 of 10.06.1993 "On Certification of Products and Services"

additional competitive advantage because Russian consumers usually prefer products with proven quality (Heusala-Pushnov, 2003).

The basic certification schemes used in the official Russian quality and safety certification system (GOST-R) have been adopted in accordance with the International Organization for Standardization (ISO) classification. Using this ISO classification, additional schemes for self-declaration of conformity[28] and schemes prescribing a product assessment have been introduced. The certification of products is conducted in accordance with rules and procedures specific to every group of products (Lapina, 2003). The main principles of the certification procedure are shown in Figure 21.

[28] In 1999, a *declaration of conformity* as a form of conformity assessment was introduced by an amendment to the Law № 5151-1. As a result, approximately 25% of products subject to mandatory certification were transferred to the list of products whose compliance to established requirements could be confirmed by the declaration of conformity

Figure 21: Russian product certification procedure



Source: Smesupport.spb.ru

According to the Russian legislation, the following authorities can issue certificates: the GosStandart of the RF[29], its regional centres of standardization, metrology and certification, and their testing laboratories. Moreover, registered non-commercial organizations accredited by the GosStandart of the RF can also act as certification bodies and testing laboratories. Certificates issued by any accredited certification centre are valid throughout Russia.

To initiate the certification procedure, a domestic or foreign producer (seller) sends a standard application to the corresponding authority. Against the application, the applicant receives information on the terms of certification, a list of required documentation, and a list of accredited testing centres for the given product. Documents required to support certification may include, but are not limited to: certificates of origin, certificates of quality, test results, and other documents pending on the product. Russian agencies and laboratories involved in certification and testing emphasize the importance of submitting all documents in Russian. All standard forms should be filled out as accurately and correctly as possible as well. Russian officials point out that the engineers and technical personnel who process such documents may not know English, and that customs officers are more likely to simply reject incorrectly completed forms, rather than try to make sense out of them (Robinson; Robinson and Kamayeva).

Sometimes, applications for a certificate may be accepted without preliminary tests, if the applicant provides the manufacturer's certificate of quality or a certificate of conformity with the ISO standards. However, those certificates should be approved by the GosStandart or a body called “Sojuzekspertisa” under the Chamber of Trade and Commerce of the RF. The only exception is certificates issued by foreign certification agencies that have mutual recognition agreements with the GosStandart (e.g. DIN GOST TUV (Germany), SGS (Switzerland), Mertcontrol (Hungary)). However, product-specific requests for information are still advisable.

A typical certification procedure should not last more than one month, and in the case of perishable products – a couple of days. However, in practice those terms are often exceeded. A valid certificate includes the signatures and seals of the certification authority issuing the certificate, and the numbers and dates of registration in the State Register. The term of the certificate’s validity does not exceed the product’s expiry date. If the shelf life of the product is not defined, the certificate is usually valid for one year.

[29] Gosstandart - the Russian Federation State Committee for Standardization and Metrology – the main certification authority, sets and administrates GOST-R. Web-address: www.gost.ru

It is worth noting that in addition to the actual issuance of a certificate, the stability of the certified characteristics of production is the subject of supervisory control, provided by consumer associations and trade inspections. When importing goods to Russia, the required certificates are presented to the Russian Customs by the declarants and verified, if necessary, by the GosStandart representatives.

Additional certificate-type documents required for certain products

An important factor to be taken into account when importing goods to Russia is that many types of products require approval in addition to the GOST-R certification system. These are issued by other federal executive bodies and include, for example Hygienic Conclusion (issued by the State Sanitary and Epidemiological Supervision) for items such as foodstuffs, agricultural products and kitchen appliances, Certificate of Registration (issued by the Ministry of Health) for medical devices, and Certificate of Communication System (issued by the Ministry of Communication) for means of communication. (Lapina, 2003)

Moreover, no product stated as "ecologically safe" or "ecologically pure" can be sold in Russia without a special certificate confirming the statement. Ecological certificates are issued for most consumer goods and food products by independent, nongovernmental and non-profit certification agencies accredited by the GosStandart. An example of such agency is the Test and Certification Agency of the Foundation for Consumers Protection. (Kuzmichenko, 2001)

Ecological certification can be conducted only for products and goods that already have the obligatory certification (safety certification, veterinary certification, or hygiene certification). The certification period lasts from 10 to 30 working days for consumer goods and 5 to 30 working days for food products. The cost of ecological certification is USD 100 to USD 1 000 for consumer goods (depending on test complexity and the volume of goods to be certified) and USD 50 – USD 200 for food products (depending on the consignment volume) (Kuzmichenko, 2001).

When considering the costs involved in certification, it should be noted that currently Russian agencies involved in testing and certification are seriously under-funded and increasingly view these activities as sources of revenue. Therefore, testing in Russian labs is quite expensive. Also, fees for original and follow-up certificates, as well as for safety and health approvals are rather high. Additionally, expense-paid inspection visits (including the wages of the Russian personnel involved) are often imposed on foreign production sites.

The Russian legislative authorities have acknowledged the complexity of the certification system and are working on improving the situation. They intend to go from strict methods of conformity assessment to more flexible ones. For example, a new technical regulation law[30] was introduced in 2003 as a result of joint efforts by the Russian government and technical entities within Russia. One of the main principles of this law is the adaptation of unified rules for establishing product requirements, production processes, and conditions for exploitation, storage, transportation, sale and utilization which are given in the technical regulations. In accordance with the technical regulation law, mandatory conformity assessment shall be carried out only when it is determined by appropriate technical regulation and only for meeting the requirements of technical regulations. A declaration of conformity is be the main form of mandatory conformity assessment.

The introduction of all details of the technical regulation should be completed within 7 years. From an international standpoint, the technical regulation law and normative documents developed for implementation of this law harmonize the Russian technical legislation with the technical legislation of European Community member nations (Lapina, 2003).

4.1.5. Labour relations

In addition to getting the necessary documents for the enterprise and its production, finding competent personnel to carry out the operations is essential when establishing business in Russia. This section gives an overview of the main issues around relations between the enterprise and its labour. It discusses the main features of the Russian labour legislation in general, and questions such as recruitment channels and regulation related to foreign employees, in particular.

Main principles of labour legislation

Labour relations in the Russian Federation are governed by the Constitution of the RF, international treaties to which the RF is a party, federal constitutional laws, by the labour laws (including the occupational safety law), and other normative legal acts comprising the labour law norms. The Labour Code[31] of the RF, effective since February 1, 2002, is the mainstay of the Russian labour legislation. The labour law norms contained in other laws must comply with the Labour Code.

[30] The Federal Law №184-ФЗ "On Technical Regulation" was approved in December 2002 and went into effect on July 2003.
[31] http://www.ilo.org/dyn/natlex/docs/WEBTEXT/60535/65252/E01RUS01.htm

Understandably, Russian labour legislation must be observed by all employers, including foreign companies' subsidiaries, representative offices and branches. In addition, the Labour Code expressly provides that Russian labour legislation will apply to employment relations with all foreign nationals working in Russia (e.g., employees of foreign legal entities and international organizations hired to work in Russia), unless a specific regulation is applicable pursuant to a federal law or an international treaty.

Labour relations between the employee and the employer shall accrue on the basis of a labour contract in accordance with the principle of social partnership. The employees are represented in the social partnership by labour unions and their associations, or other representatives elected by employees. Employers are supposed to take into consideration opinions of the trade union when making decisions that concern core interests of employees, and solve disputable cases by means of conciliation. However, in comparison with the Soviet times, the role of the labour unions in the labour relations has diminished. For example, actions such as dismissal of an employee being a member of a labour union or substantial changes in the operations of the enterprise do not require permission from the labour union as was case until the current labour code came into force. However, the current labour code also states that "the opinion of the labour union has to be heard" in such cases. (Palkkatyöläinen, 2001).

The right to strike is a constitutional right in the Russian Federation, with the exception of certain groups of workers such as the army and law enforcement agencies. The decision to declare a strike can be made by a general meeting of the workers of an enterprise, by a trade union or by a trade union association. A written notice about the forthcoming strike has to be submitted to the employer at least ten calendar days in advance. Participation in a legal strike may not be considered as a breach of labour discipline or as grounds for termination of the contract of employment. Participation in an illegal strike, however, may. During a strike workers participating in it retain their jobs. The employer has the right not to pay workers their wages during their participation in a strike, except those workers who keep the minimum essential services operational. Payment for idle time is due to the workers not participating in a strike and not having the opportunity to perform their work in connection with it. The employer has the right to transfer such workers to other work for the period of the strike.

The employer has a right to apply a court decision on the legality of the strike. In practice, most strikes are declared as illegal by court decision. Therefore, the right for a strike is difficult to exercise in practice in Russia. In majority of cases there is psychological pressure on workers and their leaders or the workers were being prosecuted later. Usually strikes in

Russia were always done suddenly, without giving a warning to an employer, so the employers couldn't apply to court.

During the 1990s strikes mostly have been taken places in the spheres, which had state debts for wages, mostly among teachers, doctors, miners. In the recent years, most strikes have taken place in the educational sphere. In the enterprise sector, among the most visible strikes during the recent decade were the 1997 Dockers trade union strike asking for increase in wages and social guaranties. The strike did not yield results and it is currently being processed in the European court for human rights. In 2000 AvtoVas had a trade-union organized Italian strike, where workers refused to work overtime asking for guarantees of the wages after the reorganization of the factory. This strike was considered illegal in court. A recent example is the on–going case in Ford Motor Company (Vsevolozhsk). In the end of September 2005 Trade Union of the company put out the request of wages increase of 30%, which they motivated with an expected doubling of production in January and the work load increase for workers. Company's management agreed to change the wage system and develop a system of bonuses. But the main requirement of 30% increase of wages the management refuses to undertake. As a result the workers held a one week Italian strike and now at least some requirements are negotiated: leveling the wages of the workers of the same skill group, which will be about 1-2 thousand of roubles for 600 people. This was a first significant negotiation between workers and management, which could, according to experts, become an example for other trade unions of large machine building companies, if the management will not care for the workers requests.

Legislation on foreign workers

Number of foreign companies in St. Petersburg and Leningrad Province are increasing and the issues with hiring the foreigners are becoming very important. However, there are certain legislative and bureaucratic issues which make it very difficult for a company to hire a foreigner.

According to Russian legislation, if an employer decides to invite a foreign employee, it has to obtain a permission to hire foreign employees and ensure the employee obtains a work permit. It is not enough for the employer just to have the right to engage foreign employees, but also the employer has to obtain a work permit for every foreign employee. Moreover, the employer has to show that no Russian citizen can fill the post. The work permit must be obtained before the potential foreign employee comes to the Russian Federation. The permission to hire foreign nationals and individual work permits are issued for the

employment entity for a period of one year. Failure to fulfill this requirement may result in sanctions on the employee.

The Russian labour laws apply to all labour relations in Russia, notwithstanding the legal status or origin of the employer and the employee. Thus, a labour relation involving a foreign company and a foreign individual working in Russia is primarily regulated by the Russian law (if in some cases an international treaty of the Russian Federation would not rule otherwise). Even the employment of a foreign chief executive (CEO or General Director) would fall under the Russian rules. The legislative changes made in 2005 introduced new rules and requirements that make it more difficult for foreign business people to obtain work permits and register their places of residence. These include new regulations as to mandatory medical testing and residence registration, neither of which appears to have a strong basis in substance. (Babich, 2005)

Recruitment issues

Generally the personnel are found through the advertisement, recruitment agencies, and personal recommendations. Sometimes the big companies have agreement with University of Institute to have student's internships and this way the company grows their own personnel. In many cases a worker is found by personal contacts or recommendations. Nowadays the blue-collar workers are lacking on the labour market and in certain professions there no professional education available, so it is important for companies to provide own training.

Legislation concerning employment contracts in Russia (Labour Code of the RF, Chapter 10, Article 56), is rather standard in view of international practice. Some details are, however, worth noting here. First, in case an employee starts working before the employment contract is officially concluded, the employer shall draw up the agreement in writing within 3 days. Second, the employment contract can be concluded either for an indefinite time period or for a definite one, but not over 5 years (so called fixed-term labour contract). The labour code defines groups of employees, with whom the employment contract has to be for a fixed term. These include, for example, persons engaged in small business, heads of organisations and their deputies, chief accountants, people working after their retirement age, freelancers, researchers, and scientists. Also, fixed-term labour contracts may be concluded with people employed to perform jobs not characteristic for the organisation's usual activity. Third, general reasons allowing the employer to terminate an employee's contract include liquidation of the organization, redundancy, employee's poor state of health or poor qualification, and employee's repeated failure to perform job duties without valid excuses.

A legacy of the Soviet Union in the labour relations is a document called the job record book (trudovaya knizhka). It is the major document certifying the employee's work history. The employer (except for employers – physical bodies) is obliged to keep a job record book for each employee having been on the payroll for more than five days. The employer returns the employee his or her job record book on the day of dismissal. A job record book contains relevant information on the employee's job, transfers to other permanent jobs, dismissals and their reasons, and entries on the employee's rewards for efficient work. However, information on penalties imposed on the employee for poor work performance are not included. An employer is entitled to see the job record book when recruiting a person, that is, before concluding the job contract.

Working time, holidays and wages

The labour code specifies the working time, which normally cannot exceed 40 hours in a week. An employer is responsible for keeping a record of the actual working time of each employee. The working time is reduced under certain conditions, such as on the day preceding a non-working holiday and at night (22.00-6.00). In these cases the working time is reduced by one hour. Also, employer and employee can agree on a shorter working time. Here it is worth noting that working on terms of incomplete working time does not result in any limitations of length of annual paid leave, record of working experience or other labour rights. Requesting overtime work is allowed with written consent of the employee and with consideration of the opinion of the organization's elected trade union authority. Overtime work cannot exceed 4 hours in two days and 120 hours in a year for any employee.

The labour legislation also regulates the time of rest that an employee has to have, from breaks during the working day to holidays. During the working day (shift) the employee should be given a break for rest and food, not more than two hours long but not shorter than 30 minutes, which is not included in the working hours. As in any country, Russia has its country-specific non-working holidays. It should be noted, however, that Russians often combine their personal holidays with the official days off to have a longer break around the New Year, for example. An important detail is that if a day off coincides with a non-working holiday, the day off is shifted to the next working day after the holiday. The non-working holidays are currently the following:

- 1 and 2 January - New Year;
- 7 January - Christmas;
- 23 February - Day of the Defendant of Motherland;
- 8 March - International Women's Day;

- 1 and 2 May - Spring and Labour Holiday;
- 9 May - Victory Day;
- 12 June - Day of Russia;
- 7 November – Anniversary of October Revolution, Day of Agreement and Reconciliation;
- 12 December - Day of the Russian Federation Constitution.

The duration of the main annual paid leave granted to employees is 28 calendar days. During the first year of work the employee acquires the right to go on leave after six months of continuous work in the given organization. The employee may be granted a paid leave before the six months' period expiration as well, under the agreement of the parties. The employee may be recalled from the leave only with his consent. Moreover, if temporarily disabled the employee is entitled to paid sick leave. In accordance with federal law, the sick leave allowance for the first 2 days of temporary disability is paid at the employer's expense, and then beginning from the third day by the Social Insurance Fund of the RF. The sick leave allowance is calculated on the basis of the monthly wage of the employee. However, there is a maximum level, currently RUR 12 480.

Upon request and in accordance with medical reports, females are to be granted maternity leave of 140 calendar days. Since January 1, 2005 the maximum monthly level of maternity allowance paid at the cost of Social Insurance Fund of the RF is RUR 12 480. In addition, females can be granted a child-rearing leave up to when the child reaches the age of three years. In that case they will be paid RUR 500 per month by the Social insurance fund. The employer is obliged to take the person back to her position after this period.

Wage

The minimum wage amount is established for the whole territory of the RF by federal law, and it cannot be lower than the amount of the cost of living of an able-bodied person. The current minimum wage is RUR 720. The wage of an employee is defined on the basis of collective agreements defining the wage level for the respective job on the one hand, and on the basis of the employee's personal qualifications and the enterprise's own payment policy on the other hand. Pursuant to the Labour Code, working conditions and pay levels above the legal minimum standards are determined by negotiation, collective agreements and individual employment contracts. Trade unions have been experiencing greater difficulty in finding partners for industry-wide contract negotiations as economic structures were denationalized and democratized. Russian and foreign companies use differing techniques for creating workers' compensation packages. Foreigners operating in Russia tend to emphasize health

care, while companies run on local capital prefer to present their workers with credit and to pay for transportation expenses. In addition to the basic wage, the employer has the right to establish different premium systems, stimulating extra payments and allowances considering the opinion of the employees' representative body. The above-mentioned systems may be established by collective agreements as well.

As to payment of wages, they are to be paid at least once a fortnight. According to the legislation, payment for overtime work should be 1.5 times the normal wage for the first two hours of overtime work, and not less than two times for the subsequent hours. Moreover, an increased wage is to be paid for work performed at night. However, the concrete amount of payment for overtime work and work at night may be defined considering the opinion of the employees' representative body, collective agreement, or the labour contract. Work on a day off and on a non-working holiday is to be paid not less than in the twofold amount. The employer is obligated to pay compensation (including interest) for delaying the payment of wage and other employment-related payments to an employee. The Criminal Code of the RF establishes responsibility for an employer delaying remuneration more than 2 months.

Labour protection

The labour legislation also contains requirements for labour safety, which are obligatory for juridical and natural persons performing all kinds of activities. To assure compliance with the labour protection requirements and exert control over their implementation, a labour protection service shall be set up in every organization over 100 employees performing production activities. In other enterprises, the position of a labour protection expert with appropriate training or work experience in this field shall be established.

In organizations with 100 employees or less the employer takes the decision about the formation of the labour protection service, with regard for the features characteristic to the organization's activities. If there is no labour protection service or expert in the organization, the employer shall conclude an agreement with experts or organizations rendering services in the area of labour protection.

The structure of the labour protection service in the organization and the number of employees in the labour protection service shall be determined by the employer with regard for the recommendations from the federal executive power body for labour. The Labour Code introduces detailed workplace health and safety regulations. It also defines the role and the authority of state labour inspectors and procedures for collective labour disputes and strikes.

4.1.6. Administrative control of business

In addition to formal rules and requirements, the actions of authorities also draw criticism from foreign enterprises operating in Russia. These actions include, among other things, frequent inspections by varying administrative agencies. According to a March 2005 study conducted in 80 regions of the RF by the All-Russian Public Opinion Research Centre (VCIOM) and a public organization "Opora Rossii" ("Anchor of Russia") , the greatest risks for entrepreneurs in Russia are connected with unreasonable fines, violations during the inspections of controlling authorities (the list of the main types of control is given in Table 34), increases in rent payments, illegal attempts to liquidate businesses, the activity of monopolists, and changes in regional legislation. The main results of the study are summarized in Tables 35 and 36. The study focused on small business, but its results are informative in general for enterprises operating in Russia.

Table 34: The main types of control over entrepreneurship in St. Petersburg and Leningrad Province

Police control
Control by Committee of the RF of Standardization, Metrology & Certification
Control by State Inspection of the RF of Trade, Quality of Goods and Protection of Consumers
Control over fire safety by State Fire-Fighting Service
Control over licensing bodies over observance of requirements and conditions of license agreement
Customs control
Tax control
Control by Territorial Department in St. Petersburg and Leningrad Province of the Russian Federation Ministry for Antimonopoly Policy and Support of Entrepreneurship
Currency & Export control
Control by the RF Oversight Committee for Sanitation and Epidemiology (Sanepidnadzor)
Control by Federal Labour Inspectorate
State ecology control

Source: www.smesupport.spb.ru

Although the Russian business environment is often viewed as mafia-ridden, according to the afore-mentioned study small business entities more often face illegal action from bureaucrats (67.7% of respondents) and law-enforcement agencies (58.2%), than from criminal elements (48.7). Interestingly, while during the previous two years police were the most disruptive authority for SMEs (50% of respondents complained about police inspections), nowadays law-enforcement agencies bother only 17.5% of respondents. "Today tax administration plays the role of the main hurdle for business", claims Valery Fedorov, Director General of

VCIOM. As in 2003 10% of respondents criticized tax authorities, in 2004 the number reached 40.2 %. (Businesspress.ru, 2005)

Table 35: The most disruptive controlling authorities in Russia, %

	Police	Fire-fighters	Tax authorities	Sanepid-nadzor	Inspection on quality	No one
All Russia	*17.5*	*16.4*	*40.2*	*21.7*	*12.9*	*27.0*
Moscow	28.0	16.7	42.3	41.0	19.7	10.3
Central Federal District	17.8	12.6	37.2	17.3	11.6	31.5
North-West Federal District	*17.2*	*15.0*	*36.9*	*19.6*	*11.5*	*30.7*
Southern Federal District	21.2	15.3	41.3	20.2	15.6	27.7
Privolgskiy Federal District	12.3	23.6	43.8	23.4	13.0	26.5
Ural Federal District	25.7	21.9	39.0	23.0	14.4	26.2
Siberian Federal District	14.7	14.6	41.9	20.9	9.7	27.5
Far East Federal District	9.0	11.6	37.7	15.1	11.6	22.1

Source: Ekonomika i zhizn', 2005

As the table indicates, the opinions of enterprises in Northwest Russia (including St. Petersburg and Leningrad Province) are rather similar to the all-Russian average. Concerning the tax authorities, the situation is slightly better. However, it should also be noted that a third of the respondents of the study did not find any authority disruptive. This indicates that the situation is substantially better than, for example, in Moscow.

Table 36: Occurrence of illegal payments to bureaucrats, %

Region	Frequent	Rare	Almost no	Difficult to answer
All Russia	*43.4*	*21.2*	*12.9*	*22.5*
Moscow	67.0	15.7	7.0	10.3
Central Federal District	36.7	28.8	12.5	22.0
North-West Federal District	*43.2*	*16.8*	*10.7*	*29.3*
Southern Federal District	52.3	16.4	9.8	21.4
Privolgskiy Federal District	39.5	24.7	14.9	20.8
Ural Federal District	36.0	17.0	16.0	31.0
Siberian Federal District	43.2	19.2	14.1	23.5
Far East Federal District	30.7	21.6	25.1	22.6

Source: Ekonomika i zhizn', 2005

Here again, the results for Northwest Russia fall rather close to the all-Russian average, and demonstrate a considerably better situation as compared to Moscow. However, the results of the study indicate that small businesses, especially those in large cities, have to struggle. "Free competition there is almost impossible and risks of entrepreneurial activity are high", notes President of "Opora Rossii" Sergey Borisov. "Administrations themselves prevail in certain markets and that is why it is difficult to rely on legal protection in those regions". (Businesspress.ru, 2005)

Additional evidence of administrative pressure on business in St. Petersburg and Leningrad Province is given by the Territorial Department of MAP. According to its data, in the 1st quarter of 2004 alone 113 calls, claims, and complaints from juridical and physical bodies were considered by the Administration of Federal Antimonopoly Service in St. Petersburg and Leningrad Province (later – *the Administration of FAS*). Most of the calls were in regard to complaints against monopolistic enterprises abusing their dominant positions, such as imposition of disadvantageous contracts. At the same time, SMEs working in retail trade, housing and public utilities, advertising services and those involved in activities requiring licensing were the most frequent targets of illegal regulatory activity by executive authorities. The following case studies illustrate well the excessive and haphazard nature of entrepreneurial regulation in St. Petersburg and Leningrad Province.

Case №1 (Cedipt.spb.ru)

Nowadays 1.500 small businesses in St. Petersburg working with products of animal origin pay RUR 90 million per month for certification by the City Veterinary Station. According to entrepreneurs, these certificates are senseless since they make redundant other required certificates. Every small company involved in activities such as meat, fish, or milk processing, or delivery of dried animal food, spends RUR 15-60,000 monthly for veterinary certificate №4. In accordance with the legislation that certificate must be issued for every lot of goods sent to the shop, regardless of the volume – 1 kg or 1tn. Moreover, every company has to have a veterinarian on staff (whose wage is ca. RUR 7,000 /month) and must also conclude a service agreement with the State Service on Sanitation and Epidemiology Control (ca. RUR 30,000/month). In the end, various payments for permits and accompanying documents constitute approximately 50% of the production cost, thus significantly increase the non-tax financial burden on enterprises.

As Case 1 illustrates, the administrative pressure on business can considerably increase production costs in certain industries. In addition to the time spent dealing with bureaucracy, enterprises also have to invest financial resources to comply with authorities' requirements. Additional support from a foreign enterprise's viewpoint is given in Case 2.

Case №2 (Source: Sptimes.ru)

Despite the fact that Leningrad Province is not a quarantine zone, according to the international convention exported pinewood should undergo sanitation control that checks the health of timber and whether it was populated by insects or not. Until now, the Federal Service for Veterinary and Fytosanitary Control in St. Petersburg and Leningrad Province

(Rosselhoznadzor) provided this service. However, since September 1, 2005 the procedure for obtaining the sanitation certificates was changed by the Federal authorities. Certificates should now be obtained for all types of wood while earlier they were required only for pinewood. Not only Rosselhoznadzor, but also two commercial organizations ZAO "Greenway Neva" and ZAO "Lesnoi Karantinnyi Broker" are allowed to issue certificates. The period for issuing the certificate was extended and the cost of certificates grew significantly. According to Nils Skaerbaek, vice president of Swedwood[32], the process previously took a couple of days and the cost was RUR 30 per document. Nowadays, a direct application to the state authorities can take as long as 15-30 days, which forces many to use faster but more (10-20 times) expensive private certification. As a result, the profitability of wood export businesses decreases and some of them, for example Swedwood, are considering stopping their activity.

Moreover, in addition to costs for obligatory documents enterprises often have to pay fees resulting from inspections by various controlling authorities. As revealed by the results of a study completed at the St. Petersburg State University of Economy and Finance by Dmitriy Ushakov, the average costs of inspections for small business entities in St. Petersburg reach RUR 32 000 annually (see Table 37). These costs take the form of penalties imposed for non-compliance with official requirements and often depend on the inspector's personal interpretation of the norms and legislation.

Table 37: Amount of "penalties" paid by small business to controlling organizations in St. Petersburg

Controlling organizations	**Amount of "penalties" paid by small business (RUR/6months)**						Average for all respondents (RUR/ 6 months)
	Trade		*Public catering*		*Industry*		
	average	max	average	max	average	max	
Policy	2 000	3 000	-	-	500	1 500	4 000
Tax administration	2 500	4 000	-	-	-	-	3 500
Fire-Fighting Service	2 000	6 000	-	-	2 000	2 000	4 000
Sanepidnadzor	3 860	5 000	5 200	10 000	-	-	4 500
Total	10 360	-	5 200	-	2 500	-	16 000

Source: Ushakov, 2005

According to the study, the share of taxes averages 4.04%, while the share of so called "penalties" reach 3.33% of enterprises' revenues. Thus, the tax burden on small business in Russia is comparable with the cost of administrative barriers. However, the Russian legislative authorities have made some attempts to improve the situation by introducing

[32] Swedwood is an industrial division of Swedish furniture retailer Ikea. It has a factory in Tikhvin, Leningrad Province and exports wood by-products to European Union.

certain changes into legislation regulating the activity of controlling authorities. For example, the inspection authority of police was significantly restricted. In accordance with the new regulation (adopted in August, 2005) police inspectors cannot initiate inspection without special resolution and have no right to stop the activity of an enterprise. Also, the term of inspection should not exceed 30 days. Moreover, the Prosecutor General of the RF in his order 17.08.2005 obliged all the regional prosecutors to tighten control over the administrative pressure on businesses and to immediately respond to the complaints of entrepreneurs. However, the current federal legislation still does not contain the concept of "administrative barriers", thus on the state level there is no unified systematic approach to their elimination.

4.1.7. Customs regulation

From the viewpoint of Finnish-Russian business cooperation, customs is a major authority influencing the operations. Foreign entrepreneurs operating in Russia often criticize the actions of Russian customs officials as inefficient and arbitrary. The problems with customs are often caused by the imperfect legislation, which leaves too much room for interpretation by individual officials. However, the new Custom Code of the RF (effective January 1, 2004) basically fulfils the World Trade Organization and World Customs Organization requirements, and aims to improve the situation in the field of custom relations.

The Customs clearance time is now limited to three working days after customs has received the complete set of documents. The Code sets pre-declared requirements on organizations like customs brokers, forwarders and customs terminals that sell customs operations further. The amount of customs bonds is set at RUR 20-50 million (about EUR 0.6-1.5 million). This is estimated to decrease the number of customs operators considerably, which is speculated will decrease criminality associated with customs operations (Kilpeläinen and Lintkangas, 2005).

However, foreign investors and Russian companies involved in foreign economic activities often still face problems imposed through customs procedures. For example, according to Russian legislation, foreign investors are granted exemptions from customs duties for goods that are imported into the customs territory of the RF as a contribution by a foreign founding party to the registered capital of a Russian entity. Since equipment brought into Russia is usually subject to duty at the rate of 5 - 10%, the saving achieved through the use of this exemption is about 5 - 10% of the value of the equipment. To receive that privilege the investor should prove that such goods meet the following conditions:

- The goods are non-excisable;
- The goods are classified as fixed "production" assets;

- The value of the goods does not exceed the maximum value of the foreign investor's contribution to the authorized charter capital indicated in the founding documents;
- The goods are imported within the time limits set by the founding documents for the formation of authorized capital;
- The goods are imported from the foreign investor indicated in the founding documents.

Despite having the detailed list of requirements, the new Customs Code leaves significant practical power to the border posts and customs terminals. Thus the acceptance of a foreign investor's application for customs duty exemption still depends on the personal decision of the customs officer. It is often the case that customs officers try to avoid excessive responsibility and transfer the right of decision-making to higher authorities. Also, different customs officers have their own requirements in addition to the pile of documents necessary to receive customs privileges. That means additional difficulties and costs for investors.

To conclude, despite recent positive moves, Russian legislation regulating enterprise activity remains rather contradictory and mercurial. Thus, either a legal department with Russian professionals inside the enterprise or strong connection with legal consultants often becomes necessary for a foreign company doing business in Russia. Also, there are state structures and associations of entrepreneurs that work to support businesses. The following chapter discusses these organizations and their actions.

4.2 Support infrastructure for enterprise operations

As illustrated in the previous sections of this report, political power in Russia greatly influences business. Continuous changes in legislation, frequent new resolutions, orders, instructive letters and other governmental requirements all stump entrepreneurs. To cope with this situation, business tries to negotiate with power. The interaction between enterprises and the authorities in Russia has traditionally been based on personal relations between managers and public sector officials. However, as the market economy develops, industry associations and other business organizations increase their role as lobbying instruments. Also, they provide information and other support for their member organizations to cope with the changing business environment. The public sector is also making attempts to improve the conditions for business. An administrative reform is taking place, in which all layers of the power structure are being revised to speed up the implementation of state policy at the regional level.

Currently, the support infrastructure for enterprise operations in Russia is rather complex and consists of a number of actors, including different levels of state authorities. Also, industry associations are still at an institutionalisation stage. In many sectors there are several competing associations and it is difficult to say which one has the most power as a lobbying instrument towards the public sector. This chapter discusses the support infrastructure focusing on two groups of enterprises: SMEs and foreign investors. The importance of supporting SME development was recognized in Russia during President Putin's first term, and respective legislation, policies and institutions are under development. In St. Petersburg and Leningrad Province, public sector support for Russian and non-Russian small businesses is provided by both local governmental institutions and regional representatives of federal ministries and administrations. At the same time, the improvement of business climate for foreign investors depends mainly on the decisions of regional authorities.

4.2.1 SME support

Support for SME sector is provided by federal and regional authorities. *The Territorial Department in St. Petersburg and Leningrad Province of the Russian Federation Ministry for Antimonopoly Policy and Support of Entrepreneurship* (hereafter the Territorial Department of MAP) is the main authority implementing federal policy on the restriction and elimination of monopolistic activity, unfair competition, policy on the development of entrepreneurship, and stimulation of commodity market competition in the two regions. Moreover, it creates and implements small business support programs , takes steps to improve legislation regulating entrepreneurship (including issues of taxation, infrastructure formation, stimulation of investment and innovative activity), and guarantees the protection of the legitimate interests of entrepreneurs.

In practice, the Territorial Department of MAP supports entrepreneurs in different ways. It engages them in the creation of programs for small business development and helps entrepreneurs in attracting external investments and loans. Besides, it gives recommendations for the creation of preferential conditions for organization and operation of business units in certain areas of activity, and controls the existing entrepreneurial regulatory system for certification, licensing, registration, etc. Foreign enterprises may also approach the Department when having problems with the above-mentioned issues.

In addition to the departments of the federal authorities, the regional governments have structures for implementation of federal policies. In the field of small business support, these authorities are the *Committee on Economic Development, Industrial Policy and Trade of the Government of St. Petersburg* and the *Committee on Development of Small and Medium Sized*

Business and Consumer Market of the Government of Leningrad Province. Both organizations have special departments for small business development and are responsible for issues such as small business development strategies and creation of instruments to improve SMEs access to private credit and public financing.

Moreover, to improve interactions between entrepreneurs and governmental authorities *the Small Business Public Expert Council* in St. Petersburg and *the Expert and Consulting Council of Entrepreneurs* in Leningrad Province were created in 2004 by the shared initiative of entrepreneurs and regional authorities. They have the right to request drafts of regulatory legal acts concerning entrepreneurial activity from governmental authorities with the aim of their public evaluation. The members of the Councils are leaders of large public associations of entrepreneurs, leaders of small business support infrastructural organizations, small business entities, and representatives of banks, insurance companies and other interested organizations. Foreign businesses are not involved in those organizations so far.

The aforementioned structures are mainly serving the interests of Russian enterprises. From the viewpoint of foreign enterprises, authorities dealing with investment issues have more relevance. Investment activity of enterprises operating in St. Petersburg and Leningrad Province is mainly coordinated by the respective governmental committees: the *Committee for Investments and Strategic Projects* in St. Petersburg and *the Committee for Economics and Investments* in Leningrad Province. The latter implements the principle of "one window" for investors acting in the territory of the region. It provides all the necessary information and assists investors in the realization of their investment projects. Its activity is widely recognized as an example of a mutually beneficial cooperation between the public sector and investors. In contrast, in St. Petersburg the situation with public sector support for investors is not so clear. The specially created *Committee for Investments and Strategic Projects of the Government of St. Petersburg* is not the only authority whose door a potential investor should knock on. On average, in St. Petersburg the approval process for investment projects connected with industrial, trade and entertainment or hotel construction involves tens of different committees and administrations and lasts from 9 months to 2 years (Arhipov, 2005).

4.2.2 Support for investors

As mentioned before, subjects (regions) of the Russian Federation have great power in the field of investment policy. Therefore, some regions are considered to be more favourable investment targets than others. In general, St. Petersburg and Leningrad Province as subjects of the Russian Federation are entitled to independently grant tax concessions to investors with respect to amounts payable to the local budget as well as adopt their own normative and

legislative acts regulating investment activities. Therefore, Russian and foreign companies investing in the territory of St. Petersburg and Leningrad Province may apply for certain privileges from the local governments (see Table 38).

Table 38: Measures of investors' support in St. Petersburg and Leningrad Province

St. Petersburg	Leningrad Province
✓ Guarantees from St. Petersburg on loans attracted by investors for the implementation of investment projects; ✓ Tax concessions within the amounts payable to the city budget; ✓ Concessions on profit taxes granted to banks and other lending institutions granting loans for investment activities within the amounts payable to the city budget; ✓ Concessions on leasing St. Petersburg real estate; ✓ Deferments and instalment plans with respect to payments for granting real estate objects owned by the city (for a term of up to 5 years); ✓ Investment support from the city budget; ✓ Granting investment tax loans.	✓ State guarantees of investors' rights; ✓ State guarantees with respect to loans for investment purposes; ✓ Preferential treatment regime; ✓ Tax concessions; ✓ Investment tax loans.

Source: Law of St. Petersburg № 185-36, Law of Leningrad Province № 24-оз

Leningrad Province is often considered to be a more favorable investment environment than St. Petersburg. As mentioned earlier in this report, the main governmental authority providing support for investors in Leningrad Province is the Committee on Economy and Investments[33]. The investment policy of the region includes sectors where investment is especially encouraged. In Leningrad Province among these are the energy complex and power-consuming industries, wood processing, tourism, research and development, and high-tech industries.

In St. Petersburg, regional bodies dealing with investment issues include the Committee on the Economy, Production Policy and Trade, the Committee for Economics and Investments, the Committee on Finances, and branch committees[34]. According to Yuriy Molchanov, the vice-governor of St. Petersburg, the most preferable targets for investments in the city are high-tech and innovation production, transport and logistics, trade and tourism.

In their efforts to attract more investments, the governments of both St. Petersburg and Leningrad Province are constantly working on the creation of new incentives for investors. One of them is system of tax concessions, which is different in each place. According to the

[33] The full list of participants in the investment process in Leningrad Province can be found on the official web-site of the regional Government: http://eng.lenobl.ru/economics/investment/

[34] The responsibilities of different governmental committees in St. Petersburg are described on the official web-page of the Government of St. Petersburg: http://eng.gov.spb.ru/economics/invest

new law of Leningrad Province effective since July 2005, an investor has the right to apply for tax concessions on profit and property tax. Moreover, investors involved in the realization of projects in industry, infrastructure or information technologies are 100% exempted from the property tax for the complete pay-off period and the 2 subsequent years. However, this tax concession is valid only for property that is directly used in an investment project. The profit tax rate for investors is set at 20% (instead of 24%) for the complete pay-off period, and in the event the investor company receives not less than 90% of its profit from realization of the new project – for 2 more years. In addition, an investor may receive subventions (financial aid) for special purposes from the regional budget. If an investment is USD 10-50 million, the subvention equates 33% of the company profit tax in part paid to the regional budget. In case of bigger investments the subvention is 100%. Tax concessions and privileges may also be granted to companies involved in trading activity if their annual revenue exceeds RUR 1.2 billion.

According to Grigoriy Dvas, vice-governor of Leningrad Province, the difference between concessions and subventions is that subventions are planned in advance in the regional budget - in 2006 RUR 1.2 billion will be spent for subventions (Mokeicheva, 2005). Therefore, an investor may not be granted subvention if the respective budgetary funds are already exhausted for the given year.

According to the St. Petersburg law effective since January 2005, investments totalling RUR 150-300 million entitle a company to have a 2% tax concession on the profit tax, and larger investments get a 4% concession. Thus, the profit tax rate will be 22% and 20% respectively. Moreover, companies occupied with high-tech production may obtain 2% tax concession when their investments equal RUR 50 million. In addition, for companies investing more than RUR 150 million the property tax rate is lowered from 2.2% to 1.1%. The specific feature of tax concessions in St. Petersburg is that investments should be completed in one calendar year. This requirement is problematic for large projects involving a great amount of bureaucracy that stretch out for several years.

Comparison of the tax concession systems in Leningrad Province and St. Petersburg

Both systems of tax concessions have their advantages and disadvantages. The main strengths of the Leningrad Province system are that there is no minimum level for investments, the possibility to lower the tax burden is higher and the term of the tax concession is longer. From the other side, to receive privileges an investor should conclude an investment agreement with the authorities of Leningrad Province, which implies the risk of bureaucratic delay.

There is an inherent contradiction in the tax concessions granted by the investment agreements in Leningrad Province and the Federal Tax Code. The Tax Code ranks higher than regional laws and represents a closed system of provisions aimed for direct implementation. A regional law cannot change or add anything to the provisions of the Tax Code. The Tax Code definitely restricts the possibilities of granting tax concessions by region. Thus, the Tax Code of Russia directly prohibits granting individual tax concessions by means of an investment agreement concluded with the taxpayer. Each region is allowed to grant tax benefits within its competence by setting laws of general character. The Tax Code (article 56) explicitly forbids granting any company-specific tax concessions (Hellevig et al, 2005). The discrepancy between the regional tax concessions for investors and the Federal tax code may cause problems for foreign investors. For example, the Ford factory in Leningrad Province is facing substantial tax claims from the federal tax authorities who revoked the profit tax break granted by the regional authorities (Smolchenko, 2005).

It should also be mentioned that even when a relevant investment agreement is concluded there are still a lot of issues that can de facto hinder the receipt of the subventions. Such issues are usually beyond the control of the taxpayer. For example if the region fails to annually adopt, on time and in due form, the regional budget law, then the subventions might be at risk (Hellevig et al, 2005).

In its turn, the St. Petersburg investment legislation also contains many points that are not agreed with tax authorities subordinated to the federal government, and thus the risk of applying tax concessions that contradict the federal law lies with the investor. In this case the investor could be liable not only to pay back taxes, but also penalty interest on them and fines (Hellevig et al, 2005). It should be noted, however, that St. Petersburg authorities do not see tax concessions as the main incentive for investors. They view administrative support as more important than financial incentives, and also place emphasis on the normalization of land relations, provision of territories with developed infrastructure, and the creation of special economic zones.

The creation of special economic zones is based on a new Federal law adopted in July 2005. The Law “On Special Economic Zones in Russia” envisages the creation of technological innovative and industrial production zones, which will have a free customs regime: foreign goods will be sold without import duties, and Russian goods without export duties. There will also be a special land use regime. The zones shall be created for 20 years and cannot be extended. The city government of St. Petersburg plans to apply for the creation of 2 special economic zones in the southern part of the city: a technological innovation zone and an

industrial production zone[35]. Most probably the latter will specialize in the production of components of different equipment, as it will give new companies entering the region a possibility to localize the delivery of components. Nowadays in St. Petersburg there are hardly any producers able to satisfy the demand for components.

In contrast, the authorities in Leningrad Province emphasize that all the privileges granted to special economic zones are already now available for investors on the whole territory of the Region.

4.2.3 Support organizations

In addition to the federal and regional authorities, there are many other support organizations (commercial and non-commercial institutions) providing hands-on assistance to local and foreign enterprises working in St. Petersburg and Leningrad Province. Some of them are established on initiative and with the financial participation of public sector institutions, while others are self-organized entrepreneurs. In St. Petersburg, information resources of different business-promoting organizations are united by *Information Analysis Centre "Small Business Support in St. Petersburg"* (www.smesupport.spb.ru), which represents the network of business cooperation and provides entrepreneurs with much business information. In Leningrad Province the *Small Business Support Fund "Retsept"* (www.recept.813.ru) plays the role of a unified informational centre, but it mainly unites the resources of publicly owned organizations.

In St. Petersburg, the city administration has initiated a number of business-incubators, innovation and technology centres, and subcontracting centres in the city. In practically every district of St. Petersburg there are Centres of Business Development (www.bdcspb.ru), where entrepreneurs can get competent consultations on all aspects of business activity. All those organizations are open for cooperation with Russian and foreign businesses[36] that are already active in business or willing to establish operations in St. Petersburg.

In Leningrad Province, public sector support for entrepreneurs is provided on the regional and municipal level. On the regional level the main support organizations are the Fund "Retsept", the Small and Medium Business Support Agency in Shlisselburg and the Public Agency "LenUrBuro".

[35] The information about development of these plans can be found on the web-page of the Committee on the Economy, Production Policy and Trade http://www.cedipt.spb.ru

[36] St. Petersburg and Leningrad Province organizations actively promoting international cooperation are described later in this Chapter

The Fund "Retsept" (www.recept.813.ru) actively promotes cooperation between small and large enterprises. It offers a large database of enterprises looking for cooperation and existing orders not only in Leningrad Province but also throughout Russia. *The Small and Medium Business Support Agency in Shlisselburg* (www.lenobl.siora.ru) provides information and analytical consulting and helps entrepreneurial start-ups with company establishment. Its databases include information about more than 40,000 enterprises in St. Petersburg and Leningrad Province and more than 2,000 different commercial offers from Russian and foreign companies. *The Public Agency "LenUrBuro"* (www.lenurburo.spb.ru) provides small business with the necessary legal consultancy and holds free seminars on the most important legal issues.

In addition to public support organizations, there are also enterprise associations protecting interests of entrepreneurs. According to entrepreneurs the most influential organizations protecting interests of enterprises in St. Petersburg are the St. Petersburg Association of Entrepreneurs and the Merchant Club of St. Petersburg. The former is an influential actor in the sense that it has a working relationship with the city government of St. Petersburg. The leader of the Association is a member of the Small Business Public Expert Council under the Governor of St. Petersburg. The latter became the first self-organized group of entrepreneurs consistently lobbying the interests of small business through the Legislative Assembly of St. Petersburg and the State Duma (parliament of Russian Federation). It makes proposals concerning the improvement of laws regulating entrepreneurial activity, and actively participates in city and federal actions of small business support. In Leningrad Province, the field of enterprise associations is more fragmented and there are no organizations that have such an established role as the two previously mentioned associations in St. Petersburg. A list of business support organizations acting in Leningrad Province can be found at http://www.lenobl.ru/economics/smallbusiness.

The aforementioned organizations mainly serve the interests of local enterprises, as well as foreign enterprises to that extent that they provide information on the development of the formal business environment. In addition, there are structures specialized in promoting cooperation between Russian and foreign enterprises. The *Committee on External Relations and Tourism of the Government of St. Petersburg* and the *Committee for External Economy and International Relations of the Government of Leningrad Province* are the public sector authorities responsible for the promotion of international relations in the region. They coordinate the development and implementation of international technical assistance and business partnership initiatives, including projects targeting public works, human welfare, education, culture and healthcare in St. Petersburg and Leningrad Province. As for other

organizations, the Leningrad Province Chamber of Commerce and Industry (CCI) together with the St. Petersburg CCI are the main support organizations assisting entrepreneurs in establishing connections with Russian and foreign partners. Interests of foreign companies operating on the territory of St. Petersburg and Leningrad Province are represented by *the St. Petersburg International Business Association* (SPIBA, www.spiba.spb.ru). SPIBA, established in 1995, is a non-profit, independent organization that provides a networking platform for the exchange of views and ideas on business matters in Northwest Russia. It cooperates closely with regional policy making institutions.

Finally, there are also organizations focusing on the promotion of Finnish-Russian cooperation. These include the Finnish-Russian Chamber of Commerce (www.finruscc.ru) and the Group of Finnish Advisors (GFA) under the governor of St. Petersburg. GFA, created in March 1997, represents an informal group of representatives of the biggest Finnish companies. The main task of the GFA is assisting in the creation of a favourable investment climate in St. Petersburg. In St. Petersburg, there are also representative offices of the specialized Finnish financing company FINNVERA and the Finnish expert and service organisation FINPRO. Among the other organizations actively promoting Finnish-Russian relations and offering support services to business cooperation, the Representative office of Eastern Finland in St. Petersburg (www.eastfinland.spb.ru) and the St. Petersburg Centre of Business Contacts "BIZKON" (bizkon.frinet.org) should be mentioned.

4.3 Conclusion

The changes affecting the Russian Federation in the years since the market opened continue, as the very definitions of 'business' and the rules of exchange are hammered out. The different levels of legislative and administrative operation (federal, regional, and municipal) are not always consonant and are at times redundant. This makes room for exploitation by local authorities, which can hamper the unfettered growth of SMEs through the imposition of excessive fees, requirements for licensing and inspections, etc. These penalties and fees required of businesses are almost equal to the burden of taxation. The greatest threat of illegality comes not from the mafia but from bureaucrats and law enforcement agencies, though according to one study a third of businesses do not experience any disruptions at all. Still, entrepreneurial control often appears to be excessive. Customs regulation, though improved, still leaves a lot of individual discretion at the border posts and customs terminals, which can mean additional costs and difficulties.

The taxation system is another area that is changing and coalescing, with possibilities for SMEs now defined according to the size of the business and what type of activity it engages in. Under the General System of Taxation (the default) the majority of the tax burden consists of Federal taxes, in particular of the value-added tax, the unified social tax, and the corporate profits tax. The rates for regional and municipal taxes, in contrast, are considerably lower and concern mainly property. In addition there are a number of taxes with rates which vary depending on the type of business activity, most often concerning industries exploiting natural resources.

The real estate market in St. Petersburg is still developing and at present its depth is not yet sufficient to supply all the required premises for business at a reasonable cost. Also, SMEs find it almost impossible to rent any properties from the city itself. Rental rates increases in the area are expected to continue their decline for the next year. Enterprises willing to lease industrial or warehouse premises have to expend great effort to find a suitable location, as good quality warehouse premises account for only six per cent (340 thousand sq. m.) of the total storage capacity in St. Petersburg. There is a tendency to locate production facilities in Leningrad Province rather than St. Petersburg proper, as there are benefits associated with doing so.

Although company registration has been simplified, it is still complex, and though estimated to take 5 days, a World Bank report claims it takes an average of 29 days and requires 12 steps. Part of the problem is not knowing exactly to whom to go for what. The various forms of incorporation (limited liability partnership, etc) each have their own configuration that should be examined for suitability. From a foreign enterprise's viewpoint, the risk of losing control over operations is greatest in open joint stock companies, and professional consultation is recommended in all cases.

Licensing is often mentioned as one of the main problems faced by foreign enterprises in Russia, because legislation in the field of licensing is constantly changing, and licenses may be necessary from various levels of government. The main challenge for foreign enterprises seems to be to know whether a license is needed for their activity in general, and/or for some parts of it in particular. Certification is required for many products (but not services) and usually helps with customs and consumer trust in the product.

Labour is governed by the labour code, trade unions (which are not as strong as in Soviet times), and remaining peculiarities of the Soviet times like the job record book. Russian labour legislation must be observed by all companies, foreign and domestic.

There are a variety of federal and local infrastructural business support systems which domestic and foreign businesses have access to. There is a "one window" theory of streamlining business processes, and regional financial support for support systems has been increasing. As for investment, some regions of the RF are more suitable than others, since the regions have great power to determine their characteristics. Leningrad Province is often considered to be a more favourable investment region than St. Petersburg, because various tax concessions and privileges, for example, apply. St. Petersburg plans special economic zones characterized by a free customs regime, while this already exists in Leningrad Province. Other support is provided by many local support organizations, offering everything from online support to help with documents and incorporation. These include self-organized groups of entrepreneurs and organizations with direct political connections working for the improvement of SME business opportunities.

5 Enterprise Views of Finnish-Russian Production Cooperation

This chapter is based on interviews with managers of Southeast Finnish and Northwest Russian companies. Interviews were carried out with 41 enterprises, of which 21 were Finnish and 20 Russian. 13 of the Finnish companies and 11 of the Russian companies already had cooperation with the other nationality, and the rest, at the time of interviewing, did not (8 and 9, respectively). Table 39 summarizes the enterprises by industry, and whether they have cooperation or not (referred in the table as "Yes" or "No", respectively).

Table 39: Interviewed companies by industry

Industry	**Finnish companies**		**Russian companies**	
	Yes	No	Yes	No
Forest industry	1	2	1	1
Food industry	2	-	1	1
Technology industries (incl. ICT)	2	2	1	4
Logistics	2	1	2	1
Services	3	3	4	1
Energy and environment	2	-	2	1
Multi-industry	1	-	-	-
Total	**13**	**8**	**11**	**9**

Managers interviewed represent the case industries of in this study. The sample includes one Finnish group of companies involved in several of them. The service companies interviewed for the study represented tourism, consulting, and support services to logistics. As for the size of the interviewed companies, the majority of them are SMEs. Large enterprises interviewed represent mainly forest and technology industries in both Finland and Russia. Most of the Russian companies interviewed are private and have been established during the transition period. Three companies are associated with state ownership. Two of them are former Soviet enterprises. During the 1990s the role of the state in these enterprises has changed. Now it is limited to formal relations with administration. One company was established by city administration in the 1990s.

The data analysis was made qualitatively without statistical methods. The following sections first discuss the findings of the interviews separately for Finnish and Russian companies, and then draw them together in a comparative manner.

5.1 Views of Finnish enterprises

This section discusses the interview results of Finnish companies separately for those companies that already have cooperation with Russian firms, and for those that don't have it at the moment.

5.1.1. Views of Finnish enterprises with no cooperation

Although the companies that were interviewed for this section did not have cooperation with Russians at the moment, some of them had had cooperation with Russians or exports to Russia earlier. In some cases the interviewee had worked in Russia on an earlier work assignment.

The expected advantages of Finnish-Russian cooperation

Most of the companies thought that the main advantage of cooperation would simply be increased turnover. Of course, growth in turnover is a positive development in itself and some companies believed that the growth potential is very large. However, many saw practically no competitive advantages through prospective cooperation. This depends on the field of business that the company is in. In general, the importance of cooperation to Southeast Finnish companies was considered either important or very important although some doubts were presented about South-Eastern Finns' overconfidence in their ability of doing business with Russians.

"If we consider a situation where the border becomes more closed than it is now, it would mean that there would be no more butter on bread in this neighborhood [South-East Finland]."

A clear advantage for South-Eastern Finnish production companies compared to companies elsewhere in Finland is the geographical proximity of Northwest Russia: the distance to St. Petersburg with five million citizens is the same as to Helsinki. Service companies do not gain the same advantage from proximity as production companies. Otherwise the situation is the same as elsewhere in Finland, considering cooperation with Russians or exporting to Russia. Via railways the products can be transported straight to Eastern Russia. Also the travel distance to St. Petersburg is very small for, e.g., visiting business partners. Other mentioned advantages from cooperation were that Finnish companies would gain better ability to work locally in Russia in accordance with local culture and local business practises.

One company in the consulting industry thought that the industry in general could benefit from cooperation by gaining a more international perspective. It was also thought that Russian

consulting companies would be advantaged by working with their Finnish counterparts. Some service companies could possibly lower their costs by using more Russians in the workforce.

Future advantages from cooperation were difficult to predict. It was thought that things change slowly in Russia, so the current advantages from cooperation would stay unchanged for some years. Some of the companies considered that in the future the Russian economy will probably continue to develop and thus there will be greater demand for more sophisticated products, an opportunity for some Finnish producers.

Forms of possible cooperation

In order to gain a better insight into this matter, the answers in the analysis below are categorised in two groups according to whether the interviewed company belongs to the production or service sector.

All of the interviewed production companies were interested in cooperation in principle and some of the companies were actually seeking cooperation partners in Russia at the time of the interview. The main interest was towards cooperation in selling products. Cooperation in engineering and/or production would come only after that. The main motive for cooperation was increasing sales volumes. Secondary motives were lower production costs and penetrating the Russian market. The last motive was related to the need for increasing Russia-expertise in the company. It was felt that all of the large international players would go to Russia "as soon as they dare" and it would not be good to be left behind.

None of the service companies was currently actively seeking cooperation partners in Russia. Only one was interested at the moment, if it could find a suitable partner, but it had no time to seek for cooperation partners. Some of them were practically not interested at all in cooperation, and others were interested only under some strict conditions. However, a couple of the interviewees had previous experience working with Russians.

For those service companies that had at least some interest in cooperation, the most probable form of cooperation would be such that they would follow some large Finnish company to Russia. That way they would not have to use resources in seeking cooperation partners or clients. Some interviewees said that it is enough for now to concentrate on the domestic market, either because they are trying to establish themselves here or because they have already established themselves and are busy with the orders from domestic clients. Some companies did not have motives at all, as they were not interested in cooperation at the

moment. For those that had a motive, it was money. Expectations of possible cooperation were also quite pessimistic.

Barriers to cooperation

For both production and service companies barriers to cooperation included lack of time (seeking a partner and trading with Russia was considered to be very time-consuming), orders in Russia being too large (companies do not have enough capital and human resources to fulfil orders), and the quality of business in Russia, or, in other words, finding a suitable cooperation partner. None of the companies thought to start seeking for cooperation partners in Russia by themselves, as it was either too expensive or too difficult for a small enterprise to find a suitable partner:

"It's no use for a small company to go there alone."

The first two barriers could obviously be overcome through increased resources or through sheer luck, if suitable clients would approach the Finnish company themselves. The last barrier is such that it is related to the whole of Russian society. According to an interviewee, the only solution to that was just to seek for the best possible cooperation partner. Almost all of the companies had at some time sought for partners or clients in Russia by visiting several prospective companies, but the trips have not yielded much result. For a specialised logistics company the main barrier was the entrepreneur's own prejudices, as he explicitly stated. However, the same entrepreneur also stated that it is improbable that there would be demand for their services in Russia, as there are skilled workers with lower pay available in the same field of business there. The language barrier was also mentioned.

Business parks could be one way of overcoming some of the barriers described. Business parks (where there are rented facilities for several companies as well as common business services available) were considered useful by the production companies, as they could situate either a Russian partner to sell their products there or their own people as representatives of the company. However, a company should have a real need for such and arrangement, as otherwise it is just too costly. On the other hand, the Russian companies that can afford the services of Finnish companies, can also come to Finland to make deals. The services that would be used in business parks would probably be all the normal business services, like facilities and Internet connections. The kinds of service companies that could in principle use business parks were interested in using them, if the situation would demand their presence in Russia. It was suggested that a company could rent facilities in a business park for a short time period and see how things proceeded. Note, however, that this runs counter to some

other recommendations that say that a company should invest a large amount of time in developing business in Russia (see e.g. Kaipio and Leppänen 2005).

5.1.2. Views of Finnish enterprises with cooperation

The length and intensity of cooperation varied widely among this group of interviewed Finnish companies, as did their experiences of it. For some, the experience has been very positive, but there are also negative examples. On the whole, however, the companies were quite happy with the results of cooperation up to the time of interviewing.

Experiences from Finnish-Russian cooperation

The questions that were asked in this context concerned the form and length of cooperation, problems encountered during cooperation, and the motives for cooperation. The answers of production and service companies are divided again, as there are some differences between them.

There were basically two different cooperation forms in use in the interviewed production companies: cooperation in production and cooperation in marketing. Some companies already had both forms, while some had cooperation only in marketing, but were aspiring to also include production cooperation in the future. The time that the companies had been cooperating with Russians was generally long. The most respondents had cooperated for over five years.

Many service companies had cooperation that was somehow related to their core operations, but not all of them had Russian companies as clients. Others had Russians as clients and providers of some non-core services. Also, all of the companies that had invested in Russia and had an office there had native workers, some having as much as 99 % of their workforce in Russia. The length of cooperation varied a lot between companies. Most of the companies had cooperation that had lasted for over 10 years, while one had just started dealing with Russia.

The motives of companies for initiating cooperation varied. The main motive that was mentioned by both production and service companies was sales growth. For production companies there were other important motives: lower wages and the fact that earlier (in Soviet times), it was impossible to do business in Russia without an official cooperation partner, as foreigners were not allowed to wholly own a company. To categorise the answers more formally, it can be said that there were market-seeking and factor-seeking motives. The third

motive (obligatory cooperation partner) belongs to factor-seeking motives, as the need for investment in Russia was dictated by production factors available there. An interesting motive for one pioneering company in its own field (consulting) was that it wanted to create a new kind of business. Another motive besides something more than growth was that one company (in consulting) wanted to be able to provide the same services to their Finnish clients abroad as in Finland without having to invest abroad: they had seen their competitors invest in Russia and the results had not been good, so a more cautious strategy was needed. Some of the companies could not give an accurate description of their motives at the time, either because the respondent was not working there at that time or because they had no definite recollection of them.

Expectations of cooperation varied, but were usually positive or at least neutral before starting the cooperation. Overall, the expectations had been met or exceeded positively with some exceptions. The most dramatic of these was a fraud by a Russian key employee in one company. In another case, one company that had been established with a Russian partner (a factory) had been bought out to complete Finnish ownership because the cooperation partner was a former state company and did not have similar views as the Finnish owners about how the company should be developed. However, the Finnish company still had different forms of cooperation with Russians and thus could be included in this sample of companies.

On the whole, both production and service companies had had surprisingly few problems with their cooperation partners and clients. The most dramatic case was the earlier mentioned fraud by an employee, who was also a shareholder. According to the interviewee, suing the employee would not have helped, as in these kinds of cases the courts tend to favour the Russian party. Now the company in question has taken measures to control things more carefully. One of the problems mentioned was cultural difference in the attitude of the owners towards profit. At least in the forest industry, Finns would usually like to develop the company further with profits, whereas Russians more often would like to share the profits quicker between the owners. One reason for this might be that Finnish forest industry companies are public and listed companies, whereas Russians more often are not. Yet, there are more and more directors and companies in Russia with a longer perspective on doing business.

Service companies have also experienced some general problems with delivery times and disruptions in payments. Security issues also came up in some interviews of the service companies, but there had been no major problems in this field either. The reason given was that most service companies do not move around large amounts of money. Also, they do not

usually have store windows that could be easily broken as a threat. One company had had some issues with their security company earlier. The security company tried to raise their fees steeply based on "the increase in prices of bullets that were spent practising". However, the Finnish company saw through this and managed to renegotiate the fees to a lower level without further problems.

However, it should be noted once again that most of the companies had had no major problems at all and said that cooperation had been this far easier than expected. Yet, a need for control in order for the business to run without major problems was stressed in the interviews. The companies also seemed on average very prepared to solve problems, which may be one reason why they did not count minor misunderstandings as problems. As one of the interviewees said, misunderstandings are bound to appear when two companies with two different backgrounds and cultures cooperate. That is why these have to be taken into account beforehand so they will not become problems. Also there have to be people with an ability to solve misunderstandings running projects like these. Another thing that was mentioned as helping to solve the problems was Finnish mentality.

"We may have had good luck on our side, too. But often luck is on your side, if you try to do things well and not be naïve, but start doing things with a positive mindset, be open, then maybe things start happening. We have had - maybe luck is the right word - luck in the sense that we have had good people with us since the beginning, people that we could trust very much. That is the key."

The experienced advantages of Finnish-Russian cooperation

As in the previous section, here the answers of the interviewees are divided into two groups: those from production companies and those from service companies. The only exception to this is the question concerning the importance of cooperation to Southeast Finnish companies in general, as the answers did not depend on the company field of business .

Most of the companies thought that the cooperation between Southeast Finnish and Northwest Russian companies in general is very important for Finnish companies. Compared to Western Europe, the Russian markets are growing fast. There are almost five million citizens in St. Petersburg, which is very close to Southeast Finland, and there are almost 15 million people in Moscow. There are large markets for Southeast Finnish companies that have not been sufficiently taken advantage of. However, a counterargument says that, although Southeast Finland is located well considering trade with Russia, production and service companies that want to operate in Russia on a larger scale need to invest in local operations.

Production companies have gained many advantages from cooperating with Russians. One of the main advantages was access to large Russian markets and increased turnover. Another important advantage was that Russian partners could take care of the relations to authorities, a role more emphasized in Russia compared to many other countries. A long-term advantage is learning, which takes place in these operations. The companies gain experience on international management, cooperation with Russians and working in Russia. For those companies that have not invested in Russia, it can act as preparation for investment. It was thought that a company that wants to develop its business should think about how to conduct business with Russia.

"If you do not take some kind of risk and thus participate in the development, you will drop out."

Also the service companies felt that they gained advantages from cooperating with Russian companies. For some, the whole question was irrelevant, as it would not be rational e.g. to buy business services from Western countries, as they cost a lot more and the quality of service in Russia might be even better. Concentrating on the core business and outsourcing other services was seen as a good strategy in Russia also, as it is more cost-efficient. For the service companies, as well as for the production companies, the main advantages were learning to operate in the local context and internationally in general, since St. Petersburg resembles some other international environments more than any place in Finland. In some cases, expanding operations to Russia via cooperation with a local company may be a matter of keeping existing Finnish clients, as Finnish companies internationalise and invest in Russia. An alternative to finding a cooperation partner to provide the services in Russia is investing in Russia to establish a subsidiary, but this may be too risky.

Concerning changes in future advantages, those interviewed thought that at least Russia's role as an economic power is growing. This creates possibilities for more trade. It is important to create long-term contacts with Russian companies, as it is easier to operate there if you have those kinds of contacts. This is so, because Russians value personal contacts very highly and trust between partners is very important. As one interviewee mentioned: *"If someone has promised you something, it is a matter of honour to him that it will be done as promised. That is why they [Russians] often change the contact person, if they need to change something [in the contract]."* However, the issues concerning authorities will not change for some time and Russia will remain a peculiar country in this sense.

Also, some industries could gain more advantages in the future concerning access to raw materials. At least the forest industry could gain more advantages concerning the supply of

raw materials, as there are many Russian companies that control forests. There could also be some kinds of changes specific to the energy industry. At the moment, the growth in Russia's energy exports has been in the Baltic Sea, which is advantageous to Finland, but it could change. There are also lots of human resources available for IT business in Russia at the moment, but the situation is changing, and the job market in this business might very well be overheating as international companies compete for talent. This makes it less appealing to outsource functions in this business to Russia. For the service sector one of the future advantages of cooperation could be better access to a cheaper workforce and large markets, but most of the companies did not have any strong opinions concerning future advantages.

Partner selection

For non-cooperating production enterprises the criteria for cooperation partners depended on whether the cooperation would concern mainly selling products or actual production. If the cooperation would concentrate on selling, the main criteria would be reliability (e.g. in payments), integrity and ease of conducting trade, i.e. it should not take too long to make a single trade. The criteria for production partners would be their track record in engineering and preferably that there would be no competing products in their portfolio. Also the prospective partner's references were mentioned as well as the requirement that a partner should be able to fulfil the same environmental and quality criteria as the Finnish company seeking a partner in its own production. For service companies, criteria for cooperation partners were as follows: transparency of administration and the company in general; reliability; and good financial standing. Fear of the mafia was one reason for the need for transparency. One company actually said that they had no criteria for cooperation partners, as they would not go there alone, but along with some larger Finnish company that would seek cooperation partners.

For those companies already cooperating with Russian partners the criteria for a partner choice varied widely and at least one reason for this was the wide range of industries that the companies were in. Some criteria that are not industry-dependent are that the directors of both companies should have common interests and goals, as well as a similar mindset. Other common criteria were financial soundness of the partner, reliability, long existence, credibility and obedience to the law. For the service companies additional criteria were good reputation, client orientation, overall professionalism and proficiency in the English language. In the food industry some criteria that emerged were that the partner should be a market leader or at least very close to it, they should be situated in a good location. In addition, there are some special criteria for the facilities (i.e. they should be hygienic). A Finnish production company that had at the moment only marketing cooperation with Russians had as criteria that the Russian

company should have a need for products such as the Finnish company produces and that the partner should be able to sell them in the Russian market. The criteria had not changed since looking for a Russian partner for the first time. However, in one case the Finnish company had decided that it does not seek cooperation partners in production anymore, but rather established wholly owned companies. This was because of past bad experiences with a state-owned company as a partner. However, the same company had partners in other areas of business than production.

The criteria for cooperation partners had not changed during the years and thus the companies would use the same criteria if they would search for a new cooperation partner now.

The search methods for cooperation partners were not very surprising as such. They, however, seemed to depend somewhat on the structure of the industry in question. In some industries there are only a few eligible players that are potential cooperation partners and the Finnish company can thus fairly easily make a contact by themselves. In other cases, the use of consults may be necessary. Of course, there were also special cases: in one case the cooperation started in Soviet times and a Soviet ministry assigned a partner to the Finnish company in question, so there was no choice to be made. In another case the Russians made contact to the Finnish company and the Finns decided to start cooperation with them. Most of the companies had searched for their cooperation partners either alone or with the help of their interest groups. One had used the services of Finnish-Russian Chamber of Commerce. This naturally depends also on the resources that the company has available to use in Russia. The companies that had invested in Russia seemed to have quite good abilities to search for partners, either through using internal knowledge or external services. Generally, it can be said that the search for partners is a very important phase in starting cooperation. As one interviewee mentioned, *"the key issue is finding the right people and creating confidential relationships with them."*

Concerning the use of business parks as one form for seeking a cooperation partner and starting cooperation, the larger production companies were not interested at all in them, as they would have no use for them in their business. The smaller companies were interested in locating to business parks. One way of doing this would be hiring a Russian employee and situating her/him in a business park. The services that would interest companies in business parks were all the normal business support services, such as accounting, law services and billing. The service companies were not very interested in using the services of business parks. An interviewee from one of the smaller companies thought that it would be possible in the future, but they did not have a need for an office-worker in Russia at the moment. The

companies that had invested in Russia had no need for business parks anymore, as they had their own offices in Russia. The companies that had not invested in Russia did not see a need for investment yet, but rather relied on cooperation that was conducted from Finland and thus had no need for business parks in Russia.

5.1.3. Views and experiences from the business environment in Northwest Russia

In this section the views of production and service companies are not separated, as there were no identifiable differences between their views. The views of the companies that already had cooperation and the companies that do not have cooperation with Russian partners at the moment are separated, however, as the cooperation experience seems to impact companies' attitudes on this topic.

In general, most of the companies with no cooperation with Russians had very little to say about this topic. Also, some of the companies that did have something to say on this confessed that these are mostly opinions, not necessarily facts. According to the interviewees, business environment has not developed very much from their companies' viewpoint. Of course, economy has developed, but business practices have not changed very much. In the future it is expected that the economy will continue growing and the demand for more sophisticated products for businesses will continue. Negative tendencies were seen also: corruption has grown in recent years, although it should decrease as society develops. Another cause for grief was that social order was not increasing as fast as it should.

"When the society becomes stable enough … that Russian investors dare to repatriate their money and invest it to Russia, then the progress will really start."

The interviewees had heard that authorities cause problems for business. The slowness of decision-making, additional costs and the amount of work that dealing with authorities causes were thought to be the main problems. In practice, a company needs a Russian professional to deal with the authorities, as well as the influence of the company's director in order for things to proceed smoothly. Additional problems were thought to be caused by various inspections, work permit procedures etc. Also, it was known that legislation and taxation systems were cumbersome. They tie up a lot of money and human resources, as it takes a lot of judicial work to run a business. One interviewee, who had been working in Russia before, told that his previous employer went to court against tax authorities four times in two years. The company won every time. *"The style there is such that they [the tax authorities] try whether we would pay"*. It is then up to the taxpayer to fight back.

Companies that have already had experience in cooperation with Russians see positive developments in the economy of Northwest Russia during recent years. Problems and risks have decreased, and today it is even possible to obtain credit insurance for a Russian client. Operating a company has become easier, taxes have decreased and the possibilities for authorities to interrupt company's operations have been decreased. The judicial system works reasonably well. There have also appeared more opportunities for smaller companies, as large (public or private) projects are now split into smaller projects, as is usual in Western economies, which has made it easier for smaller companies to take part in the projects as subcontractors.

The economy of St. Petersburg was seen to have grown a lot especially, but also the economy of the whole of Northwest Russia in general was seen to have developed. The society was also seen to have stabilised during the 21st century. Infrastructure had developed as well, at least in St. Petersburg, albeit at a slower pace than the economy in general.

However, there have been also negative developments in the business environment. Competition has grown, as the markets have been liberated. In some industries the competition is already quite intense. Another negative development is that prices have risen. The influence of authorities on business is still strong (more on this in a later paragraph) and while the rules everywhere in Russia are the same, local authorities interpret the rules in different ways. Changes in regulations seemed sometimes arbitrary. The corruption of authorities is also seen to have grown, which was thought to be an untenable situation: Russia is growing wealthier but the wages of civil servants are very low, which gives them an incentive to ask for bribes.

The influence of authorities is still very strong. In the industries that operate under license, the influence of authorities is naturally larger, as the company cannot operate without a license. It was thought to go without saying that one must have good relations to local authorities in Russia. Otherwise operating a company is a lot more difficult. The city and regional authorities are the most important levels of authority considering business on a daily level. However, the influence of tax authorities was seen to be higher on the federal level than on the level of the city or municipality. Especially the custom authorities and custom policies were complained about. They were seen to make exporting and importing overly difficult. But, on the other hand, there was an opinion that a company's own attitude towards authorities makes a lot of difference in terms of smoothness of relations and e.g. inspections by authorities (this was not related to paying bribes). The importance of local Russian employees in relations to authorities was seen to be high. Especially the role of a local

Russian director was seen to be of very high importance. But, in the end, Russia is a more bureaucratic country than Finland and the various inspections and administrative procedures take sometimes a lot of time irrespective of how cooperative the company is.

The opinions on the administrative procedure for acquiring documents (such as for registering a company) were divided. The interviewees were from several different businesses and therefore had to apply for different documents with different procedures, which may be one cause for the difference in opinions. Nowadays some documents can be applied for during a larger project (such as building a factory), whereas before they had to be applied for before starting the project. Another positive development is that now the officials have an obligation to give information on e.g. why applications are filled in a wrong way and what to do to correct them. Before they might not have disclosed that kind of information and rather just waited that the applicant would pay them to process the applications. However, the different procedures still take time and are sometimes very difficult.

The official prices of documents have not changed significantly during recent years. However, in order to obtain some documents, companies have to apply for them from several different authorities, and every step in this chain makes it possible for the authorities to "milk" the companies. Dissolving this would be a large step in the right direction. When all the unofficial prices are taken into account, a document's price may be a lot higher than the official price. Most of the Finnish companies said that they are prepared to wait longer for a document, but they will not pay any unofficial payments. For example, a construction company may have to wait for a construction license for six months, if it is done strictly officially, while paying a "stimulation payment" of € 2000-3000, it can be done in a month.

The various inspections that the officials do to companies were considered to take a lot of time. The inspections did not make operating a company impossible, but human resources were needed to comply with the demands of the authorities. There are rules governing the inspections and when they need to be done, and a company usually just needs to take them into account beforehand. However, there were also more dramatic examples of e.g. tax inspections and it seems that authorities can cause a lot of trouble for a company if they want to.

Some of the companies had encountered corruption in their relations to the public sector, but none of them had paid any direct bribes. The most common policy of the companies was that bribes are not paid under any circumstances. However, some of the companies have made payments to the civil servants, of which they are not certain, whether they are official and

whether the money will end up with the State or the civil servant even though the companies demand that they will be given a receipt for the payment. But, it was mentioned, that if a company chooses to start paying actual bribes, it would start a vicious cycle that would not end.

The jurisdiction and taxation system have been improved and they are now quite well defined, although this still seems to remain a matter of some debate. There are now laws governing all the different areas of business activity, and although they are still not at the level of EU laws, they are going in the right direction. The big problem is that their application on a local level still varies. A company can ask for a prejudgement, but in practise the authorities do not always give them, even though they are required to do so by law.

Getting refunds on value added tax is difficult and is a common problem for exporting companies. The degree of difficulty of getting a refund depends on the current financial situation of local authorities. However, in general the tax system seems to work also in practice quite well. Usually companies can get an authority's wrong decision rectified in court, but it demands work and time. So the judicial system is seen as working, albeit slowly.

Most of the interviewees had no knowledge of whether public sector measures, such as programs to support SME development, are effective. One company's own Russian experts were of the opinion that the measures are "more words than actions". There is not enough long-term thinking in this respect and it seems that these kinds of public sector measures are still in their beginning phases.

The opinions on Special Economic Zones (SEZs) varied. Part of the interviewees, mostly production companies, thought that SEZs would be very important for accelerating Russia's economic development and would be interesting to some Finnish companies also concerning off-shoring of some of their production. Special Economic Zones would act as "hubs", which would also accelerate the economic development of neighbouring regions. However, it was considered to be important to create the laws that would safeguard foreign investments and establish homogeneous rules in all the regions. Another group of the companies had a sceptical attitude concerning the SEZ, but the degree of scepticism varied. It was thought that the current plans for them are too heavy and cumbersome to meet the interests of a market economy. They might be good for the economy and accelerate growth, but it is improbable that Russian decision-makers will manage to create them. Concern about investing in a SEZ was also voiced, as the rules governing them might change and take the tax-benefits of the

SEZ away, and then a company that has invested there might realise that they are located in the wrong place.

The main problems in financial terms for production companies' business development were the difficulty of estimating the rise in production costs and finding suitable facilities. An added problem is that finding out the real owner of facilities may be difficult as compared to Western economies. The inflation is quite high in Russia, but the cost advantage compared to Finland is still considerable in raw materials and energy. The price of energy is also growing fast, but as the starting level was very low, the prices will be lower than in Finland for some time. Wage inflation is a problem that concerns both production and service companies, but service companies to a larger extent. Wage inflation is higher than general inflation in Russia, and experts' wages can be quite high (more discussion on this later). For some companies, getting refunds on value added taxes was considered the most difficult problem. Also the outsourcing of some functions does not work the same way in Russia as in Finland, because some of the services are not yet available externally, but have to be done inside the company.

The main problem related to personnel was how to make experts stay in the company. It was considered that the easiest way to do it in Russia is money, i.e. higher wages and other benefits. In the future there will probably be a shortage of experts and other employees. Especially important was considered the finding of a good local Russian director with integrity and motivation. Some companies already had trouble finding qualified experts with language skills. The personnel costs in general are still lower in Russia than in Finland, but experts and key employees have wages at least as high as in Finland. In some cases it was thought to be easier to bring an employee from Finland. This was especially true in the ICT business, where there were signs of job market overheating the same as in Finland in the very beginning of 21st century. Foreign companies in general are in demand as employers as they pay wages and the different social expenses on time every month. Other problems related to personnel were the lack of long-term thinking in some Russian employees and making sure that the company does not hire the "wrong people". This does not mean criminals, but rather wrong people in leading posts, where they may do harm. Firing employees in Russia is not as easy as is sometimes thought.

Interviewed company representatives generally trained at least their key personnel on a continuing basis. Industrial employees are in many cases already more qualified than in Finland, so there is not a very pressing need to train them continuously, but training was provided to help employees work more efficiently and to reduce cultural differences.

The main problems related to other local enterprises and production companies were with logistics, which were difficult to effectively arrange. Therefore, companies had to keep larger buffer stocks of raw materials and other supplies than those in Finland. Some companies solved this by at least partly using their own logistics equipment. Of course, this is not an option for small companies and they have to outsource this. Larger companies, too, were intending to outsource this function (depending on the industry) as soon as effectively possible. Service companies did not have any significant problems specific to them. The logistics problems related to other local companies can be mitigated by carefully choosing the cooperation partners and suppliers.

Some of the interviewed companies had encountered unfair competition in their industry. Mostly this was related to other companies not paying their taxes fully or cheating on customs payments, which gives them an unfair competitive advantage. The customs problem could be mitigated with the admission of Russia to the WTO, which would lower customs tariffs.

Almost none of the interviewed companies belonged to any industry associations in Russia. The reasons for this were e.g. that there were too many competing associations that bicker amongst themselves, or that they are poorly organised (in the forestry and consulting industries), or it was not known whether there is an association (in various industries). For the most part the companies did not believe in the benefit of industry associations as lobbying instruments in the near future. However, some companies belonged to some non-industry-specific associations, such as the St. Petersburg International Business Association.

5.2 Views of Russian enterprises

The report now moves on to describe the results of interviews with companies in St. Petersburg and Leningrad region. First, the views of companies with no cooperation yet are analysed, including expectations from, and barriers for, cooperation. Second, experiences of companies already involved in Finnish-Russian cooperation are reviewed. Finally, the interviewees' perspectives on the Russian business environment and their criteria for the choice of Finnish partners are discussed.

5.2.1. Views of Russian enterprises with no cooperation

To start with, the Russian respondents of this group pointed out several competitive advantages of their companies which allow them to have successful performance on the market. These include high product and service quality and qualified personnel, experience and knowledge in dealing with administration, good location (i.e. logistics), technology, equipment and low production costs.

The expected advantages of Finnish-Russian cooperation

Companies already having cooperation and those without any cooperation shared views about the advantages of cooperation between Southeast Finland and Northwest Russia. Among the main advantages and reasons for cooperation were for example the common border, geographical proximity, and similar climate as something that should be advantageous for cooperation. Geographical proximity allows for quick product deliveries and similar climate makes possible use of specific technologies, innovations and products for cold weather, which is not possible to obtain from any Southern partners.

The companies are looking to increase their competitiveness through their cooperation with Finnish companies, which have modern technology, equipment, experience, and education/training. This would in turn allow Finnish partners to find new niches in the Russian markets, because some niches that are already taken in Finland are still available in Russia. It is especially true for technology/equipment and small innovation companies. Therefore the cooperation was supposed to increase competitiveness of Russian companies and at the same time bring benefits to Finnish companies.

Russians respondents also think that Finns can benefit from cooperation because they can offer Finnish partners knowledge of the markets, mentality, and the business environment for market entry or promoting Finnish products.

"We [Russians] must be interesting for Finnish companies because we may offer cheap and quality services, as well as knowledge of Russian mentality and Russian opportunities".

In the food, energy, engineering and environment industries, Finnish technologies, "*know-how*" and experience were noted to be very important for possible cooperation. In services, such as consulting and logistics, Finnish education and experience is valued as well as better knowledge of world standards. Also, especially in logistics Finnish roads and ports were pointed out to be an important advantage for cooperation. Russian companies from all sectors noted that Finland's possibility of receiving EU funding through different EU projects as well as funding directly from Finnish investors could be very valuable for Russian partners. In addition, Russian companies see established trade networks in Finland as another advantage for cooperation. Russian companies are just entering the international markets, while Finland has a lot more international experience and business contacts, from which both partners could benefit. When Russian respondents were asked about the role of Finnish–Russian cooperation the majority stated that it is significant and it will continue growing in importance, as there is geographical closeness and a lot of business possibilities.

"At the Russian –Finnish border there are dozens of timber processing plants with million ton outputs, I don't think anything will change in the near future. They all need raw materials".

"There is an expectation of increasing transportation in the Baltic region. We forecast the Russian cargo volume processing will increase through Finland and not through the Baltics".

Also, as Russian markets are stabilizing, domestic demand is growing and cooperation between domestic companies is increasing, Russian companies become more competitive and therefore, they are looking forward to cooperation on a different level.

"…If earlier Finns could provide a lot of interesting products, now the domestic production picked up and there is no such demand for Finnish products. So, something has to change drastically".

As the Russian economy is continuously developing and local competition is getting tighter, Russian companies suggest that Finnish companies should not miss the moment and opportunities, as they will be quickly taken by domestic or other foreign companies.

"I invite Finnish colleagues: please, come as long as we have these capacities. Because if they come to me in half a year, in a year, I'll tell them: "Guys, you are late again, I don't have any spare capacities".

The role of Russian-Finnish cooperation is also growing because of the increasing Russian-EU relations. Finland has more experience in the European markets, in trade networks, and in working according to world standards and therefore could be used as a gateway to the EU for Russian companies as was noted by the majority of respondents. However, several respondents shared a different view: *"I don't consider it necessary. Russia must develop it's economy independently, avoiding middlemen".*

Forms of possible cooperation

Companies without cooperation with Finland yet pointed out the following ways for cooperation, of interest to them. The type of cooperation depends on the company's sphere, size and orientation.

Beginning from the times of Soviet Union, traditional trade has been very common way of cooperation between the two countries. It involves both selling Finnish products in Russia, and Russian products in Finland. This is done either directly between the companies or through middlemen/trader companies. In metals there has been a trend of exporting the materials and now there is a trend of importing the equipment and exporting the products. In

the forest industry Russian companies supply timber to Finnish processing companies and different Finnish trader companies. In energy and technology, a traditional form of cooperation has been purchasing equipment and technologies in Finland. However, now there is an interest from the Russian companies to cooperate in technological innovations and maybe to promote some innovations in the Finnish markets.

Most of the companies mentioned that they would like to have cooperation in production. They would need certain investment from the Finnish side. Investment in the form of equipment and training was often mentioned as an interesting option. Many Russian companies note this way of cooperation, because it is very hard, especially for the small business, to obtain bank loans and the interest is very high. Russian companies in turn can offer their land/facilities/labour/marketing, which will allow for mutual benefit. In tourism, in addition to organizing the tours, Russian companies are now also looking for cooperation in building cottages in Finland and Finnish-quality cottages in Russia.

There is also an interest in education in certain qualifications. Almost all the companies noted that there is a lack of qualified professional labour force especially in the production sphere (metallurgy, engineering and etc.), as well as in logistics, since in the last 10 years the emphasis was on getting training and education in management and marketing. Thus, several respondents pointed out that professional training between the companies would be a good possibility for cooperation.

Services: Russian companies see possibilities in cooperation in consulting and marketing services with Finnish companies in Russia, including exhibitions and seminars, promoting Finnish products on the Russian markets. Particularly in logistics Russian companies can offer their expertise and experience, warehouses facilities with good locations to railways, highways and ports. The development of industrial parks and logistic hubs is going quite quickly now and there is the same problem of getting investments from the banks, so cooperation in this area would be very beneficial.

Barriers to cooperation

Although there are a lot of advantages and interest in cooperation between companies in Southeast Finland and Northwest Russia, there are certain barriers to initiating cooperation. The companies which don't have partners in Finland noted that among the main barriers for beginning cooperation are the problems with information about interesting and suitable partners and with making business contacts. In this respect, Russian respondents in all the sectors noted that lack of language skills creates barriers for beginning a cooperation

partnership. Still, many Russian directors and/or managers don't have a good working knowledge of English and even fewer people can speak Finnish. The interpreter services are not always available and affordable.

"…in the Soviet Union we were not taught foreign languages well, and now, maybe because of the age, it is difficult to learn a new language"

Some companies mentioned that it is very beneficial when Finnish companies, which come to Russia, speak Russian. Many respondents also mentioned that they feel it would be beneficial for them to have Finnish language skills and not use a third language for communication, since the two countries are located so close. Another problem that several Russian firms mentioned is the difficulty of initiating cooperation due to reluctance of Finnish firms to answer 'cold requests':

"One problem in the beginning of cooperation: Finns are not keen on replying to cold requests through Internet. Finns are not very open when approached for the first time."

Along these lines, contacting the right person for initiating partnerships also makes a difference on how smooth the process will go according to some of Russian respondents:

"Usually the first contacts do not start from the people that have a responsibility to take decisions. For example representatives were coming to us some three times. First there was just an engineer, then his manager, then someone else. Maybe that's the way it should be, but it takes a lot of time".

Lack of information is especially felt by small and medium Russian companies that look for partners in Finland, while there is plenty of information on corporations and holdings. It might be that the information is available in Finnish, which makes it difficult for Russian companies to access. There are also not many centers that provide such information.

Another barrier to cooperation is created because Finnish companies were historically getting lower prices for raw materials (i.e. timber and metals) from Russian suppliers. According to interviewed companies, now there are still expectations of cheap prices from the Finnish side, and often the cooperation doesn't start because Finns want to have the same cheap prices. Russian companies cannot offer as cheap prices anymore, because of the taxes and oil prices, which trigger transportation costs, and also because of the domestic competition. Also, domestic markets are developing and there is an increasing demand from domestic companies. Because of this Finns may lose the opportunities for partnerships and the timing advantage.

"The biggest misunderstanding and problem is that Finns who come to Russia now think that everything is cheap here. Russians don't have cheap timber or cheap products anymore. Everything is determined by business, custom taxes and transport tariffs. And if Russians suggest some kind of cheap products – it means that it is for sure a fake and Finns will just lose money."

Another barrier, which Russian respondents pointed out is in the unequal attitude towards Russian companies:

"All these 10 years Russian industry was considered to be a second-class industry. And the same is today, when there comes a Finnish entrepreneur, he considers you as a potential worker, not a partner, but a worker, when he wants to profit on you without giving anything in return. First proposals were almost offensive: they were proposing very low price for our products, referring to the fact that we have cheap prices for energy. What does energy have to do with it in our situation?"

Sometimes there is a good idea for a partnership, both sides are eager to start working together, but the barrier arises from not being able to carry out the project due to limitations of capacity or technology. However, this leads to understanding of limitations and allows for adjusting the capacities in the future.

Respondents also mentioned that Finns are usually very careful about entering the market and want to get some guarantees on their investments, which the Russian side is often not able to provide.

"Finnish investors and foreign investors in general require guarantees for their investments. In Russia it is difficult to offer such guarantees, although this project in particular already has all the permissions, approvals etc. There is a prejudice, a mistrust from the Finnish side."

Respondents who try to start cooperation with Finnish companies, mentioned that their possible cooperation failed because of unreasonable ambitions of a prospective partner concerning the pricing of Finnish goods that he sought to market in Russia, or because of a Finnish partner trying to get some benefits from a Russian company like help in the company registration giving nothing in return.

"...prospective Finnish partner wants to enter the market with a skimming price, whereas the situation on the market is much tougher than in the 90s… the partner wanted to participate in an exhibition together, but didn't want to share the costs."

So, a lot of barriers for starting cooperation were attributed to lack of information and language skills, difficulty in initiating contacts, and finding the right partner. Business parks

(or centers) are supposed to solve these problems by providing information services, language support, and organizing seminars where possible partners can meet. The majority of the respondents think that business centers are good idea in general, but many don't see benefits from them in their current form. However, interviewees pointed out that they would be interested to get the following services from the business parks: information services, business contacts, organization of exhibitions and seminars.

"Business centers are mostly seen as managers of the buildings, where companies can rent space and leave after a couple years, because the space rent is very high. There are not many services provided besides a basic office and Internet."

According to some responders, techno parks/developers' zones, where the companies from the same industry and with the same problems would work together, could be a better alternative to business parks. Special economic zones were also supposed to help in overcoming some barriers and in attracting foreign investors. However the opinions gathered in the interviews about the special economic zones showed that there is no common opinion concerning this. Some respondents are sceptical about implementation of the economic zones.

"Special Economic Zones are the black holes of the economy. It looks fine on paper, but when implemented the money is gone".

The other group of respondents believes that special economic zones are beneficial, but they need to be more targeted. For example, innovation centers are considered beneficial for an economic zone with a special regime, which is not permanent, but only for some time until this sector is developed.

"For example if there will be a SEZ on the border of Finland and Russia with a 3% tax discount, may be some companies will go. But if communications and infrastructure will be built there and it will be targeted at for example the forest industry, it will decrease the number of companies overall, but it will increase the interest of the targeted group of companies and thus will be more effective."

5.2.2. Views of Russian enterprises with cooperation

This section first reviews the experiences of the Russian companies that already have cooperation with Finnish companies. Then it discusses the views of Russian companies concerning the business environment of Northwest Russia. Views of the companies that have cooperation and do not have cooperation with Finns are considered together, as the fact of cooperating or not cooperating with foreign partners usually doesn't influence the attitude of Russian companies about their business environment.

Experiences from Finnish-Russian cooperation

The cooperation of interviewed Russian companies with Finnish firms can be divided into the following types. Some companies combine several types of cooperation:

- Importing Finnish products (including technologies, equipment, goods)
- Performing certain production as subcontractors
- Selling Russian products to Finland (timber, stainless steel, metals)
- Assisting in market entry for Finnish companies
- Education/consulting
- Services (tourism)

Many of the companies have been cooperating with Finns for more than 10 years and have discovered new ways of cooperation in recent years. Several companies have had cooperation with some Finnish companies, and now use those contacts to find new cooperation opportunities. In general, Russian companies already working with Finnish partners have an overall positive response about their experience, which corresponds with their expectations.

Interviewees value Finns as partners for their reliability and precision. Also, Russian partners highly value the quality of Finnish products and technologies. A lot of respondents pointed out good personal relations and trust that has been established among partners, which helps to solve everyday problems and creates a successful partnership in the long run. Also, Russian partners highly value organizational and management skills of their Finnish partners, learning new ways from them.

"Working problems exist. But we receive professional growth from each project, starting with the contract: the extent to which it is worked through, the way of following it up – we have been lacking this all… We were simply writing down everything at each meeting"

Understanding the Russian concerns and being flexible to the needs of Russian partners were noted as a positive experience. In particular, companies working in the tourist sector described the situations when their partners were even flexible in equipping the cottages:

"…When we asked to install a washing machine in her new cottage, as there was a family with a small child coming there for 3 weeks, they bought it, and they wouldn't ask for any extra money, and they wouldn't change the price of the cottage. It was her investment into the development of her own infrastructure".

Despite generally positive experiences in cooperation with Finnish companies, there were several problems that Russian companies pointed out during the interviews, related to differences in mentalities, business environments, and industry-specific issues, as well as the cases of dishonest practice in certain companies.

The first problem is the specific conditions of the Russian business environment[37]. Working in a different business environment, with different language and different mentality often can create problems in cooperation:

"…we [Russians] work very spontaneously. Finns plan everything for next half a year. We get an idea and want it to be implemented in a week."

"For example, we proposed to the Finnish company our assistance in negotiations [with other parties]. Now they are trying to do it themselves and face very serious problems in negotiating with Russian colleagues. Because… they understand a word said one way, Russian colleagues understand it another way… As a result there are difficulties in further cooperation, up to misunderstanding of the agreements made… Finnish companies need either partners here or employees there that understand the difference in mentalities."

Also, several respondents mentioned that Finnish partners sometimes are being too careful about entering the market and making decisions.

"…Finnish companies are careful when taking decisions. Sometimes this means a very long decision making process. During this time it could be possible to do something already, to get an order etc. This is a problem: while Finnish colleagues think, it is possible to lose all the opportunities. In the Russian market we are used to work somehow more quickly".

According to the respondents, another problem is a lack of understanding of certain customs and financial and administrative requirements in Russia from the Finnish side. For example, customs seems to be known as one huge problem that must be dealt with.

"A Finnish supplier cannot provide product codes for Russian customs, which makes customs services more expensive. They don't understand the use of that, the importance of that."

"The biggest problem with timber is that volume of cargo is measured in two ways – geometrical in Russia and by weight in Finland …claims for the difference between products shipped and products received must be paid in Russia. This creates a headache for both countries. Either Russian or Finnish companies break the law or the money is being transferred through offshore zones, with which both our countries are struggling."

The difference in accounting systems makes the situations even more difficult. Financing is expensive is Russia, it results in shortage of working capital for companies and it creates

[37] See more on business environment in the "views from the business environment" section of the report

limitations when selling the products to Finland, as Russian companies cannot afford to offer deferred payments of 90 days. Also, dishonest practices from both sides create problems in cooperation, such as distrust, and create a necessity for prepayment for products.

Many companies which have had some kind of cooperation with Finns in the past recall the cases of non-payment and other dishonest practices. Such past experience influences the way Russian companies choose the partners now.

"A Finnish company comes and wants to buy timber from us – I have to ask for a prepayment just because of these small incidents when small companies didn't pay."

"We have worked once with the Finnish railways… We produced a batch of these items for the railways. Finns came and said: yes, yes, we will take them now to try; we will see how it will work. Two tonnes of this foundry iron was taken to Finland. The only thing they did – they said that this product doesn't satisfy the requirements of the Finnish railways. That's it, there was no payment, they didn't even return the product."

Also, some Russian respondents complained that in the case of non-payment from the Finnish side it is very difficult to get the payments through some legal measures because *"…contracts are made so that it is possible to avoid the responsibility on Finnish territory."*

Several respondents in the production and service sectors experienced situations when promised conditions were not fulfilled by their Finnish partner.

"The Finnish side invited Russian constructors to participate in the exhibition. Finns assured that there are no barriers for the entrance of Russian firms to the Finnish market… Later on, when the work has already been started, it appeared to be that there are problems with the Finnish trade unions in construction. There was black PR. Promised financial support wasn't offered"

In the service sector, companies also experienced problems of a similar character.

"There was a case when a cottage was reserved and partly prepaid for three weeks in a row. These three weeks were sold to a client. When the owner was contacted it appeared to be that the he sold one week in the middle of the reserved time [to a different client]. The owner was warned that the firm is going to cancel its reservation for the entire year if he doesn't change his mind. He did."

Also, respondents noted that cooperation through middleman might be problematic due to high middlemen's margins, as well as delays in responses and processing requests from the

Russian side. Therefore many companies preferred to work with their Finnish partners directly.

"*…there are problems when collaborating with Finnish [middlemen] firms. When working directly with the cottage owners everything is done quickly"*

"Price on my products, after they go through all the middlemen, grows by up to 80%"

Finnish railways changed their way of working with the Russian tourist agencies: previously they worked directly, now they cooperate only through their Russian middlemen. As a result the process of reserving and purchasing railway tickets is more complicated and more expensive for the Russian firms.

Partner selection

Russian companies generally share a positive opinion about working with Finnish partners. When looking for partners, all of the Russian companies mentioned the importance of having similar interests, trust, experience, expertise, quality, serious long-term intentions and mutually profitable project as the main criteria for partnerships.

Among the first criteria for partners are the expertise, quality and experience in the field for both production and services. Here, Russian respondents also noted that the relationship between the quality and the price of the product provided by a partner is important. Also, all of the respondents noted that long-term intentions are necessary for a successful partnership.

Reliability and credibility of partners, and trust are very valuable for Russian companies when looking for a possible partner, since many of them had a negative experience with one-day companies and dishonest behaviour of Finnish companies in the past. For this reason personal contacts are very valuable, just as mentioned in the Finnish interviews.

"In our industry personal relations mean a lot. Also, the pay ability of the company and the long-term intentions are important"

Also, stable development and mutual profitability were pointed out as necessary grounds for a partnership. The cooperation is successful if it is mutually benefits both sides:

"...the economic criteria come first, if it profitable then there will be a positive partnership."

"...we are expecting normal cooperation, which cannot be without problems, but problems can be solved when needed. What's important is the firm's readiness to invest time, energy, etc."

Views and experiences from the business environment in Northwest Russia

Before getting to the discussion of the respondents' opinions about the business environment in Northwest Russia it must be recognized that the interviewees might be reluctant to sincerely answer some of the questions posed, such as the question about their experience with corruption and their taxation-related problems. Therefore, the situation in business environment might appear to be somewhat more optimistic than it is. Another issue is that some of the interviewees' answers depend on the business they are in and on the size of their company. For example, the firm's size seems to influence respondents' opinions about the tax system: small businesses have problems with the taxes more often.

As majority of respondents note, during the last 5-10 years the Russian business environment has been improving. Business practices became more civilized and less criminal: business disputes today are being solved through negotiations or in courts, and the number of the "one-day" companies with their practice of not paying or failing to provide their services is diminishing. Russian business increasingly demonstrates a long-term orientation: Russian companies seek to develop long-term partnerships with other companies, to build a reputation of reliability and quality. This change was mainly ascribed to the toughened competition.

"There has been a transition from a Wild West to more civilized business. There appeared the notion of reputation, which leads to development of civilized, long-term, partnership-like relations between companies".

In general, most of the interviewees evaluate the state of Russian business today as stable. Russian managers have become more professional, they have been actively learning about the market economy and its mechanisms, and they have been adopting Western management patterns and practices

"…The business relations are getting healthier as well. The epoch of romantic criminals is over. But profitability is going down."

Yet, there are certain fears about the future, which are related to political uncertainty. This is caused, first, by the upcoming presidential elections in 2008. The current president wouldn't be able to participate in these elections according to the Constitution and there seems to be no strong alternative candidate. On the other hand, as some respondents believe, there are forces such as extremists and certain oligarchs aiming to destabilize the political and economic situation in Russia.

"There are fears related to the new presidential elections in 2008. There are different forces that try to take over power, which would of course influence the economy".

As a positive trend some of the respondents note that as business becomes more transparent, financial flows get properly reflected in official documentation.

"…there is a process of "whitening" of business. It used to be very "grey", but now it is getting more transparent".

However, according to some of the respondents, the situation is still far from ideal due to different problems related to the legislative and tax systems.

"The tax system is problematic. Laws don't work. The economy is entirely "grey", salaries are half "grey". No slogans will help making economy "white" while there are such tax and legislative systems".

Yet, during most of the interviews, legislation was not considered to be a major barrier for business development. It was sometimes mentioned that the legislation is improving. The majority of the respondents admitted that the legal system is still problematic, but it is accepted as "rules of the game", which are equally troublesome for everyone and which have to be followed by all the companies acting in Russia. Respondents believe that being familiar with the legislation and following the changes in it help in coping with problems.

"Legislation is problematic, but is manageable".

"We live in Russia, and we have to work with the legislation we have".

However, there were mentioned certain problems with the legislation that the companies have encountered. According to some of the respondents, Russian legislation is deficient, especially when thinking about new business fields, such as logistics, which sometimes suffer because there are no regulations or legal definitions that would support their activities. For example, there is no legal definition of multimodal transportation.

Inconsistency and vagueness of the legislation represent another serious problem for Russian business. Laws and decrees may be contradictory. Language in laws may be so unclear that it allows reading a law in several different ways. Furthermore, legislation is constantly changing. This makes it difficult for businesspersons to be confident about the legitimacy of everything they do. This situation, in turn, creates settings for corruption in public offices and even in courts of law.

"One difficulty is that laws can be read and understood in different ways…A customs officer, because of his position, is always right [in how he reads the law]. This often serves as a ground for obtaining certain material values, or for corruption".

"Many friends of mine are lawyers. They had to quit courts because, according to them, courts' decisions are not made according to laws. Laws are just papers there. Personal contacts, personal relationships influence the decisions a lot".

"If there was clear legislation, there would be no basis for corruption".

So, corruption and bureaucracy, related to various inspections and permissions, still appear to be a problem in the Russian business environment. Interviewees offered two major solutions for avoiding corruption and dealing with bureaucracy. Many of the interviewed companies have good reputations and contacts in administration, which allows them to avoid certain corruption situations and solve their problems without extra difficulties (although personal contacts, of course, may lead to bribery as well). Such contacts may vary from personal contacts to formal relationships (e.g. due to mixed ownership a public officer sits in the company's board of directors). Many companies choose to deal with the situation by carefully studying the legislation under concern, accurately following it, having all the financial documentation transparent, and preparing all the possible documentation that could be demanded by a public officer in certain situations. If, despite all measures taken, an inspector or another public officer finds out a discrepancy, one can always ask for an official fine statement instead of paying a bribe. This solution proves to be effective. However, practically no respondent could say that his or her company has never had to pay a bribe.

"There are many inspections. Many licenses, permissions are needed. What helps is the experience with these procedures and established personal contacts in administration".

"Why people pay bribes? Because they are afraid that they [different authorities] would come and close them, arrest them. It is necessary to know the legislation. (...) It is necessary to know why they could come and close or arrest. And the next thing is that of course one needs to work honestly".

"When someone is directly asking me for a bribe, I tell: "Please, write me out a fine statement according to the Russian legislation. (...) Yes, first year I have been diligently paying fines…Furthermore, I have been paying fines, but I have been also taking measures according to their instructions, as long as they were reasonable".

Sometimes dealing with the public administration gets extremely complicated, as, for example, in the case of getting permission for building a production facility. Getting such permission without use of special agents and getting involved in corruption requires significant skills, efforts and familiarity with the regulations and the legislation. The inflexibility of some public officers in their decisions makes it necessary for businesspersons to resort to certain non-standard solutions.

"In order to get permission for any kind of a project one needs to go through 65 administrations. Because of the administrative reform some administrations responsible for certain permissions do not exist anymore. If to do everything according to instructions, no one would build anything. (…) From the very beginning we defined those state agencies, which have an authority to close our company, which can come on a tank, who have such a right. We took care of those agencies first, got permissions from them… We took care of all the permissions ourselves; it required a lot of time and persuasion skills."

The underlined reason for the problems that exist in relations with the bureaucrats is that Russian public officers' mentality is "clients exist for public officers" and not "public officers exist for clients", like in other countries. So, corruption in Russia can be attributed to the cultural legacy. It appears that companies often have a choice of not being involved in giving corruption. However, they do offer bribes for example in order to get certain documentation done urgently. On the other hand, at least for some people this is the way to demonstrate their power and wealth.

"Corruption is also caused by the people who offer bribes straight away, as they need certain documents to be ready quickly, or they need to demonstrate their power. Therefore this is a cultural issue."

Positive developments were noted in relation to licensing and certification. It appears that the related legislation has been well developed and the application process is not so complicated. Therefore many companies take care of licenses and certificates themselves, as they know where to go and which documents are needed.

"There are no problems with licensing; legislation in this field is already well-developed."

Also, now there are companies that offer help with licensing, certificates, or opening a company. They have their experience and, depending on how fast you need it, this will cost about 10-20% on top of the fees one would usually pay, but it will be done quickly and without those administrative-bureaucratic barriers.

Companies working in Russia also have to face other problems related to state control. For example, one of the respondents described the procedure of transferring a payment for a service to a foreign partner. The procedure is complicated, first, due to the amount of paperwork: the Finnish partner needs to provide the Russian company with an original contract and an act on the services provided. Then every international contract, no matter the size, needs to be checked by the Currency Control, and the company needs to pay for this service.

Nevertheless, some positive developments in public administration were also noted. For example, it was mentioned that in the new city government there appeared a new post: vice-governor for investments, who is managing the newly-created committee for investments and strategic projects. Prospective investors may address the committee to get information they are interested in, legal advice, or support for their investment projects.

When asked about the financial problems they face in conducting their business, most of the respondents mentioned the underdeveloped credit system. In most cases banks require full guarantee for their loans, which is possible only for companies that possess some valuable property. The interests for the loans are very high. The system of getting credit is overly bureaucratic and complicated, despite the proclaimed programs of the small business support. As a result, most of the small firms cannot afford the financing they need for their development. One solution could be some kind of investment agreement with Finns.

Another problem is high rent. It constantly goes up and the majority of respondents (of those who don't own their space) mentioned it as one of their biggest financial difficulties.

"...it is difficult to get a good and not so expensive piece of land from the [city] administration, because good land has been already distributed."

"The most serious threat for business today is represented not by the tax administrations, but by the excessive appetites of the real estate owners. They are our major enemies".

Taxes were not seen as much of a problem for the bigger companies:

"Taxes are not as high in Russia in comparison with the rest of the world. It is more the euphoria of the transition period when you know you could get 100 % profitability that makes people want to go around taxes."

Yet, it may be implied that the responses received were at least partly due to interviewees' unwillingness to talk about the problems related to the level of taxes and to admit using certain "grey" schemes to avoid too high of taxation on their business (existence of such practices was also mentioned in one quote at the beginning of this chapter).

Another problem for the companies working in Russia, especially for the ones involved in technology-related business, is that it is very difficult to find qualified employees, especially engineers. There is also a serious problem with qualified blue-collar workers. For example in logistics there is a growing demand for lower level personnel, but there is no educational setting which prepares such specialists.

"…it is difficult to find qualified employees: good ones are either doing business themselves, or are already hired and it is difficult to get them using the monetary motivator".

The previous Soviet education system worked so that students in technology would be sent to real production for several internships to get practical experience. Now a lot of respondents note that "freshly graduated people cannot do much: they have little practical experience." One solution is to recruit directly from universities and to train and develop the specialists further within the firm. Many companies surveyed do this. Another option is to look for specialists through friends' recommendations. This may help solving another important problem: employee reliability.

"It is difficult, first of all, to find a person whom you can trust, which is really important for business in Russia".

Finally, when asked about their relationships with other companies in Russia, respondents mentioned both positive and negative developments. As already mentioned, many Russian companies have a longer-term perspective in their work today and care about their business reputation. Many respondents did not report any significant problems regarding payments or other obligations from the side of their partner companies. However, problems in getting payments could appear, especially from state-owned enterprises, which often have financial shortages. In general, talking about relations with other Russian companies, a clear majority of the interviewees stressed that it is important to know the companies one is going to work with. Previous experience and friends' recommendations help in choosing reliable business partners.

Another issue concerning relations with other Russian companies is unfair competition. Several companies admitted that such practices exist.

"There is [unfair competition]. It works through different resources: money, personal contacts, family ties".

Large companies are usually members of certain industrial associations, trade chambers, etc. They consider such membership valuable for their work. The benefits mentioned include creation of business partnerships, sharing know-how, and support in dealing with different administrations. Then, respondents representing large companies also believe that membership in such associations helps them in lobbying their interests in government.

The SME companies, on the other hand, often don't belong to any associations, because they are not such serious players to have a significant influence as members. However, many of the respondents mentioned that in the future, when they grow, they would look into

membership. On the other hand, some of the interviewees representing more mature companies consider the potential benefits from the membership in associations to be too small in comparison to the commitments they would have to accept, such as paying membership fees and offering assistance to other companies.

Concerning the state support for SME, respondents were unanimous. They believe that state help exists only on paper. None have seen any practical help. Furthermore, it appears that some of the state initiatives are negative for SMEs. For example, one new legislative project, which has not been accepted by the Parliament yet, would require each tourist agency to allocate a certain amount of their capital for obligatory insurance deposits. The reasons for this kind of measure are understandable. However, if accepted, this law would lead to the demolition of most small tourist agencies.

Many companies note that there is a trend towards company consolidation. This is one of the ways to solve the problems of SMEs. Some of the respondents noted that, by participating in holdings, they manage to optimize their tax payments, as well as the overhead costs.

5.3 Comparing the views of Finnish and Russian enterprises

The analysis conducted in sections 5.1 and 5.2 reveals that there are similarities in the views of Finnish and Russian enterprises, but also divergent views. Table 40 summarizes the main findings of the interview study.

Table 40: Views of Finnish and Russian companies on cooperation

	Finnish companies	**Russian companies**
Motives	Market potential	Access to resources and know-how
Partner criteria	Company performance	Company reputation and personal relationships
Barriers	Lack of resources	Access to information, language
Problems between partners	No major problems	Different mindsets
Problems of Russian business environment	Legislation, administrative control	Lack of financing, rising operation costs, corruption

The table shows some interesting implications for Finnish-Russian cooperation. First, it seems that most Finnish companies are interested in Russia due to its market potential, whereas lower production costs are of secondary importance. Russian companies seek financial

resources, new technologies and know-how from the cooperation. Obtaining funding is very critical for Russian companies now, because the banking system is underdeveloped and it is almost impossible for a firm to obtain the necessary amount for carrying out a business project. When selecting a partner, Finnish companies put more emphasis on "hard" criteria, such as company's reputation, technical knowledge and ways of conducting business. Russian companies also consider the company's reputation and technology as important criteria for finding partners, because of previous negative experiences. However, they also stress "soft" criteria, such as long-term commitment and mutual trust, which is thought would help avoid the problems in cooperation. Finnish companies also want the Russian company to have directors that have a similar mind-set to their own and similar views on business and how to develop it. Some Finnish companies had had bad experiences due to too different views on these issues between the companies. The main barriers to cooperation are the lack of time and other resources for Finnish companies (especially SMEs) and difficulties in finding information on potential partners due to e.g. language barrier for Russian companies.

When analysing problems between partners currently cooperating, it is surprising that Finnish companies hardly mention any problems. It seems that Finnish companies take problems between partners as inevitable when enterprises from two different cultures cooperate, and are therefore prepared for them. Russian interviewees were more informative in this respect. Interestingly, remarks were made about Finnish companies' dishonesty. Also, Finns outdated views of the Russian business environment (such as unreasonably low cost level) and the expertise of Russian firms were criticized. Finally, both groups of enterprises share that the Russian business environment has been developing in a more "civilized" direction. Here, Finnish companies mentioned problems related to the general institutional framework like legislation, whereas Russian companies stressed operational aspects, such as lack of financing and costs of premises, as the main problems in the business environment.

Finnish companies saw as especially problematic the difference between legislation as written and law enforcement, which may vary a lot by region and time. This difference in views between Russian and Finnish companies (operational aspects vs. institutional framework) may reveal something about the way companies think about doing business. For Finnish companies, it is important that an institutional framework is in place and works like it does in Finland, but for Russians the institutional framework has never operated as well as it should and it is therefore "natural" that it is problematic. For them, it is a feature of the business environment that just needs to be taken into account. Their main worries therefore differ, concentrating more on the operational aspects business. However, it deserves mention that some Finnish companies also mentioned operational aspects as their main worries. While the

business environment in Russia is not perfect, Russian companies have to deal with it in their everyday business and, thus, there is a need for more understanding from Finnish companies of certain customs, financial and administrative requirements, which could make business operations run with fewer complications.

6 Concluding Remarks

This report gave a comprehensive overview of the development of the economy and business environment in Northwest Russia, and its implications for the cooperation potential between Southeast Finnish and Northwest Russian enterprises. To conclude the analysis, some remarks can be made.

In general, the business conditions in Russia are developing in a good direction from the viepoint of Finnish companies. The general economic growth is showing in an increasing demand for consumer and industrial goods, which has also benefited Finnish exporters. However, competition in the market has also intensified. In some industries, such as the food industry, it is already almost necessary to establish local production in order to stay competitive. The increased economic activity, together with an increase in energy costs, shows in a growth tendency in production costs. Wages, for example, are ascending rapidly. This is influenced by a relative lack of qualified workers, which is in part due to the collapse of the state professional education system. In addition, analysis of the market for industrial and office premises shows that the demand for quality premises is exceeding supply, especially in St. Petersburg.

The institutional environment shows signs of stabilization, although administrative control of business (inspections etc.) is still a major problem for businesses. However, legislation has been developing and attempts have been made to simplify the procedures of, for example, company registration and licensing. Despite the positive developments, it is still often difficult for foreigners to cope with Russian bureaucracy, and a local partner is an asset.

The cooperation potential and implications for Finnish companies' competitiveness vary. In general, a cautious conclusion can be drawn, in that the cost factor is losing its importance as the production costs in Russia grow. Moreover, the possibilities to use Russian labour at Russian wage level in Finnish operations are restricted by the Finnish legislation. Therefore, for example logistics enterprises operating on both sides of the border have to register in Russia to be able to use the cost advantage for labour. Also, there is an emerging lack of qualified blue-collar workers in Northwest Russia in industries such as metal-working. Therefore, foreign companies investing in industrial production have to put a great emphasis on training, which increases the labour costs.

In contrast, the importance of the market potential in Russia increases. In addition to product exports, the analysis shows that there is a growing demand for cooperation based on technological and other know-how. New industries, such as logistics and tourism are developing rapidly in Russia, which provides business opportunities to Finnish firms with high levels of experience and know-how in these sectors. Also, the increasing investment activity provides demand for upgrading production technologies. For some industries, such as the forest sector, the former emphasis on raw material imports has gradually been shifting towards local production as the Russian economic and political environment stabilizes. In the energy sector there are good cooperation possibilities because of upcoming deregulation of industry and the state of communal housing, so partnerships in innovation technologies and know-how, which are developed especially for the Northern climate will have good potentials.

Also, the general suggestion for all sectors is to take into account the importance of the time factor. Since the markets are developing quite quickly it is important to act on the situation. In order to secure access to good locations and facilities it is important to start strategic partnerships and get involved before it is too late and the desired place is taken by a domestic or other non-Russian company.

Managerial implications and policy recommendations

The analysis shows one important aspect: Russia is developing so rapidly that Finnish managers should constantly update their knowledge of the market. For example, the interviews with Russians reveal that many Finnish companies have an outdated perception of the Russian business environment. Finns may believe that "everything is cheap in Russia", which is no longer true. Also, the Russian companies are developing, so they would like to be treated as equals in the cooperation. The situation of the early 1990s, where the Russian companies were often the dependent party in the relationship, has changed. First, their technological and managerial knowledge has improved and second, there is increasing domestic demand that makes Russian firms less dependent on foreign orders.

The study also has implications for public sector actors. Despite all ongoing initiatives to foster Finnish-Russian business cooperation, companies still call for more support in establishing business contacts. This is in part due to the limited resources of Finnish SMEs, which don't allow a thorough partner search in Russia, and the problems of Russian companies in searching for Finnish partners due to, e.g., the language barrier. The interviews show that in addition to cooperation in core business functions, there is an increasing demand for cooperation in supporting functions such as professional education. Here, the public sector

could have a role in drawing up initiatives to stimulate such cooperation. So, in general Russian business is growing up and becoming more competitive and professional, as over time companies care more about quality and reputation rather than immediate profit.

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