

Foreign Investment from Offshore Jurisdictions into Russia: An Analytical Overview

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Abstract

Drawing on a dataset from ROSSTAT, the authors investigate foreign investment from offshore jurisdictions into Russia. They conclude that it is reasonable to suggest that corrupt public officials in Russia utilize round-trip schemes via offshore centers for laundering the proceeds of corruption. In addition, they highlight a trend whereby offshore investors choose to invest in the more corrupt regions of Russia within the real estate and financial sectors, suggesting that this is because these sectors are known to be associated with corruption.

A distinctive feature of Russian foreign investment patterns is the correlation of the inward and outward investment flows between Russia and offshore jurisdictions, such as Cyprus and British Virgin Islands (BVI). According to ROSSTAT (Russian State Statistics Service), the key offshore destinations of Russian registered capital outflows—Cyprus and the British Virgin Islands (BVI)—are persistently among the major source countries of foreign investment into Russia. Russian capital stock abroad amounted to 106706 million USD by the end of 2011, 24.6% of which was registered in Cyprus and 5.2% in BVI¹. At the same time, between 2005 and 2011 foreign investment from Cyprus into Russia represented, on average, 13.2% of total foreign investment into Russia, making Cyprus the second largest source of foreign investment after Great Britain (16.5%).² The Central Bank of Russia classifies Cyprus as the largest single source of foreign direct investment (FDI) in the Russian Federation, with a total of 41.7 billion USD in cumulative inbound FDI into Russia's non-financial sector between 2007 and 2010.³ In general data patterns reflect round-trip investment via offshore jurisdictions (in particular, via Cyprus). The drivers for this phenomenon in Russia are widely discussed and mainly include tax avoidance/evasion, laundering the proceeds of corruption and securing the secrecy of an investor's identity from Russia's corrupt and autocratic authorities (reinvesting into Russia via offshore jurisdictions gives Russian businessmen the possibility of hiding their identity as investors: e.g. in Cyprus, the nominees can be appointed on behalf of the registered shareholders, if the true owner wishes to hide their identity).

In our research,⁴ we focus on the second stage of this round-trip investment: foreign investment from offshore jurisdictions into Russia. Our analysis makes use of a ROSSTAT dataset, which provides information on around 20,000 firms with foreign capital registered in Russia during the period of 1997–2011, and which provided financial reports to ROSSTAT in 2011. This dataset includes information on firms with two ownership types: full foreign ownership and joint ventures between foreign owners (foreign entities and foreign citizens) and Russian private owners (Russian entities and citizens).

Patterns and Trends of Offshore Investment Into Russia: Evidence From Rosstat Firm-Level Data

As can be seen in Table 1 overleaf, which lists the main country-investors into Russia, Cyprus is a leading investor into Russia. Other offshore jurisdictions that are large investors into Russia, according to our data, are the British Virgin Islands (BVI), Seychelles and Switzerland.⁵

From Table 2 overleaf and Figures 1a and 1b on p. 4, we can see that genuine foreign investors (defined as investors from all countries except offshore jurisdictions with more than 25% agreement as defined in Palan et al. 2010 study (see note 5) and the Netherlands⁶) tend to invest significantly more in manufacturing industries than offshore

1 ROSSTAT, 2012: <http://www.gks.ru/bgd/regl/b12_13/Iss WWW.exe/Stg/d5/24-24.htm>

2 ROSSTAT, 2012: <http://www.gks.ru/bgd/regl/b12_13/Iss WWW.exe/Stg/d5/24-22.htm>

3 Joseph Cotterill, *Between Greek default and dodgy Russians*, 20.04.2011: <<http://ftalphaville.ft.com/2011/04/20/551141/between-greek-default-and-dodgy-russians/>>

4 1) Ledyeva S., Karhunen P., Whalley J., *Offshore jurisdictions (including Cyprus), corruption money laundering and Russian round-trip investment*; NBER working paper 2013-19019; 2) Ledyeva S., Karhunen P., Whalley J., *If foreign investment is not foreign: round-trip versus genuine foreign investment in Russia*, CEPII working paper 2013-05; 3) Ledyeva S., Karhunen P., Kosonen R., Whalley J., *Determinants of offshore (round-trip) and genuine foreign investment across Russia: A comparative empirical analysis*, mimeo.

5 According to the classification of offshore jurisdictions/tax havens (with more than 50% agreement) in: Palan R., Murphy R., and Chavagneux C., 2010. *Tax Havens: How Globalization Really Works*. Ithaca: Cornell University press.

6 The Netherlands is also a popular location among Russian natural resource companies to set up their financial subsidiaries and, at the same time, is one of the most important source countries of foreign investment into Russia.

investors, while investors from offshore jurisdictions are highly concentrated in the financial and real estate (including related services) sectors. The latter trend reflects the “corruption” component within offshore investment into Russia, as these sectors are often associated with corruption and money laundering.⁷

Table 1: Countries—Main Investors into Russia

Country	Number of firms (registered during 1997–2011)		Cumulative revenues (1998–2011), % of total
	Number	% of total	
Cyprus	6,015	30	54
British Virgin Islands (BVI)	1,688	8	4
Germany	887	4	4
Belarus	740	4	1
Ukraine	627	3	1
Netherlands	588	3	9
USA	488	2	1
Great Britain	473	2	2
Seychelles	420	2	0.38
China	388	2	0.24
Switzerland	370	2	8

Note: The authors' calculations are approximate (due to missing values and the presence of firms with multiple foreign owners (firms in which there are foreign owners from more than one country of origin) in the data).

Source: ROSSTAT and authors' calculations.

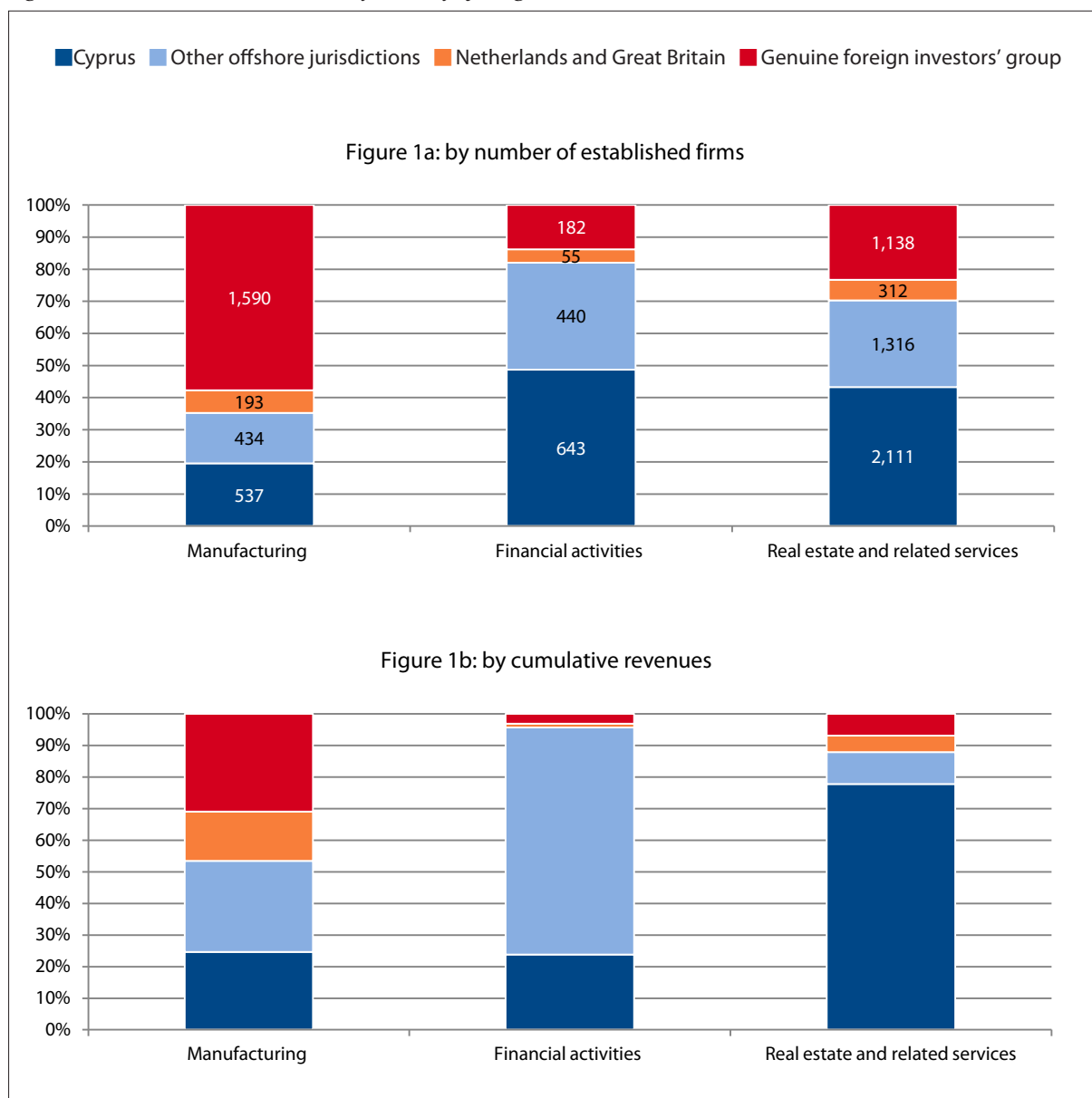
Table 2: Industrial Distribution of Firms with Foreign Ownership

Sector	Investors from Cyprus	Genuine foreign investors*
Real estate operations, lease and services	35	15
Trade and repair	22	41
Financial activities	11	2
Manufacturing industries	9	21
Construction	8	7
Transport and communications	6	6
Resource extraction	4	1
Agriculture, hunting, forestry, fishing	2	4
Hotels and restaurants	2	1
Production and distribution of electricity, gas and water	1	0
Others	2	2

* Note: We define genuine foreign investors as investors from all countries except offshore jurisdictions with more than 25% agreement as defined in Palan et al. 2010 study (see note 5) and the Netherlands. The latter is widely recognized as an important channel for round-tripping of Russian capital.

7 FATF 2011. *Laundering the proceeds of corruption*. FATF Report. Paris: The Financial Action Task Force.

Figures 1a and 1b: Firm Distribution by Country of Origin and Industrial Sector



Note: Genuine foreign investors are defined as in Table 2 (see note to Table 2). The group "Other offshore jurisdictions", includes jurisdictions appearing to a sufficient percentage (more than 50%) on 11 tax-haven lists produced by different researchers and compiled by Palan et al. 2010 (see note 5): Malta, Bahamas, Bermuda, Cayman Islands, Guernsey, Jersey, Panama, Barbados, Isle of Man, Liechtenstein, Netherlands Antilles, Vanuatu, BVI, Singapore, Switzerland, Hong Kong, Gibraltar, St. Vincent and the Grenadines, Turks and Caicos, Antigua and Barbuda, Cook Islands, Grenada, Ireland, Luxembourg, Monaco, St. Kitts and Nevis, Belize, Nauru, Andorra, Anguilla, Marshall Islands, Bahrain, Costa Rica, Aruba, Samoa, Seychelles, St. Lucia, Dominica and Liberia.

Source: ROSSTAT and the authors' calculations.

Tables 3 and 4 overleaf provide a more detailed breakdown of industrial structure (using two-digit industrial codes) of investments into Russia from Cyprus (according to our data): by number of established firms and by cumulative revenues, respectively. This data emphasizes the high-concentration of firms owned or jointly-owned by investors from Cyprus in the financial and real estate sector.

Table 3: *Distribution of Cypriot Firms by Industry by Cumulative Number of Established Firms in 1997–2011 (Top 20 Industries)*

Industry (two-digit industrial code)	Number of firms	%
Real estate operations	1,148	20.1
Wholesale trade and commission trade, except of motor vehicles and motorcycles	1,018	17.8
Other services (business consulting, architectural work, engineering, etc.)	661	11.6
Financial intermediation	530	9.3
Construction	433	7.6
Supporting and supplementary transport activities	180	3.2
Retail trade, except of motor vehicles and motorcycles, repair of household goods and personal hygiene items	147	2.6
Activities related to the use of computer engineering and information technology	108	1.9
Production (extraction) of crude oil and natural gas; services in these areas	104	1.8
Activities of hotels and restaurants	98	1.7
Trade of motor vehicles and motorcycles, their maintenance and repair	93	1.6
Manufacturing of food and beverages	92	1.6
Agriculture, hunting and services in these areas	91	1.6
Activities for organization of rest and entertainments, culture and sports	68	1.2
Auxiliary activities in the sphere of financial mediation and insurance	66	1.16
Land transport	62	1.1
Lease of the machines and equipment without operator; hire of household products and subjects of private use	62	1.1
Communication	60	1.05
Chemical production	57	1.0
Publishing and printing activities; replication of the written-down data carriers	46	0.8
Total	5,124	89.7

Source: ROSSTAT and authors' calculations.

Table 4: *Distribution of Cypriot Firms by Industry by Cumulative Annual Revenues (in Millions of Euros) 1998–2011 (Top 20 Industries)*

Industry (two-digit industrial code)	Cumulative revenues	%
Wholesale trade and commission trade, except of motor vehicles and motorcycles	234,236.85	41.32
Other services (business consulting, architectural work, engineering, etc.)	73,050.37	12.89
Trade of motor vehicles and motorcycles, their maintenance and repair	65,539.29	11.56
Construction	26,751.93	4.72
Financial intermediation	20,520.65	3.62
Auxiliary activities in the sphere of financial mediation and insurance	19,027.15	3.36
Retail trade, except of motor vehicles and motorcycles, repair of household goods and personal hygiene items	17,568.37	3.10
Manufacturing of food and beverages	14,087.01	2.49
Production (extraction) of crude oil and natural gas; services in these areas	12,030.78	2.12
Supporting and supplementary transport activities	8,974.90	1.58
Production (extraction) of coal, brown coal and peat	8,893.38	1.57
Real estate operations	6,908.21	1.22
Chemical production	5,621.57	0.99
Processing of secondary raw materials	4,947.18	0.87
Production of coke, oil products and nuclear materials	4,423.24	0.78
Metallurgical production	4,320.20	0.76
Agriculture, hunting and services in these areas	4,265.63	0.75
Production and distribution of electricity, gas and water	2,955.97	0.52
Production of electric machines and equipment	2,951.49	0.52
Extraction of metal ores	2,688.11	0.47
Total	539,762.30	95.22

Source: ROSSTAT and authors' calculations.

Corruption and Foreign Investment from Offshore Jurisdictions in Russia: Empirical Evidence from Firm-Level Data

Corruption has an obvious connection with money laundering. As argued in a 2011 report by the Financial Action Task Force (FATF),⁸ “the stolen assets of a corrupt public official are useless unless they are placed, layered, and integrated into the global financial network in a manner that does not raise suspicion”. The report asserts that corrupt public officials will seek to move the financial proceeds of corruption outside of their home jurisdiction. An examination of their case studies of corruption revealed that in nearly every case foreign bank accounts were being used as part of the corruption scheme. Taking into account the persistently high-level of corruption in Russia, it is reasonable to suggest that corrupt public officials in Russia utilize round-trip schemes via offshore centers for laundering the proceeds of corruption.

According to Simpson (2005)⁹ and Perez et al. (2012)¹⁰ between 7 and 16 billion US dollars of Russian capital flight was allegedly laundered through the Bank of New York from 1996 to 1999. Much of this money was allegedly the proceeds of criminal activity in Russia, and some of it was said to have been looted from IMF loans allocated to Russia. In this context, Shelley (2003)¹¹ also argues that the billions earned through corruption in Russia have been laundered in many countries, including offshore locations. Furthermore, she argues that the true extent of the capital resources of organized crime in Russia will never be known, “because much of it is parked in anonymous bank accounts and carefully masked trusts in offshore locations”. Shelley (2003) names the Caribbean, Cyprus, Switzerland, Liechtenstein, Austria, Marshall Islands and Nauru Island in the South Pacific as common locales for Russian money-laundering.

In our empirical studies (based on the ROSSTAT firm-level data described above)¹² of the differences between the strategies determining where offshore and genuine foreign investments choose to invest across Russia’s regions, we found convincing evidence that offshore investors tend to invest in regions with higher-levels of corruption, while genuine foreign investors have a strong preference to invest in less corrupt regions. This trend among offshore investors for investing in the more corrupt regions of Russia holds both for investment into the manufacturing and combined real estate and financial activities sectors. In the manufacturing sector, this preference reflects the fact that offshore investors are better able to deal with corrupt regional authorities, as we assume that they are Russians by origin. In addition, the more corrupt the region, the more likely it is that local businessmen use round-trip schemes via offshore jurisdictions to hide their identity from corrupt local authorities. Therefore, offshore investors tend to invest in more corrupt regions within the real estate and financial sectors. In our view, this trend might directly reflect practices of corruption and money-laundering via round-trip investment, as these sectors are largely associated with corruption.

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Further Reading

- Svetlana Ledyeva, Päivi Karhunen, John Whalley, *Offshore jurisdictions (including Cyprus), corruption money laundering and Russian round-trip investment*; NBER working paper 2013-19019.
- Svetlana Ledyeva, Päivi Karhunen, John Whalley, *If foreign investment is not foreign: round-trip versus genuine foreign investment in Russia*, CEPII working paper 2013-05.

8 FATF 2011. *Laundering the proceeds of corruption*. FATF Report. Paris: The Financial Action Task Force.

9 Simpson G. R., 2005. Risky Territory: How Top Dutch Bank Plunged Into World of Shadowy Money, *The Wall Street Journal*, Vol. CCXLVI, No. 142, (December 30, 2005).

10 Perez M.F., Brada J.C., Drabek Z., 2012. Illicit money flows as motives for FDI, *Journal of Comparative Economics* 40(1), 108–126.

11 Shelley L., 2003. International Dimensions of Corruption: The Russian Case. Working Paper Series on Russia and the Former Soviet States, August 2003, <http://www.princeton.edu/~lisd/publications/wp_russiaseseries.html>.

12 Studies are listed in note 4.