

## SPECIAL ECONOMIC ZONES IN RUSSIA: A GENERAL LOOK

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The first Special Economic Zones (SEZ) in the history of post-Soviet Russia appeared in the 1990s. They were supposed to stimulate the development of manufacturing and high-technology industries, transport infrastructure, tourism and health services. But these SEZ's were set up and functioned in a chaotic and random manner.

In 1994 the government established two economic zones: a zone of most-favored-nation tariffs in Ingushetia and preferential tax treatment zone in Kalmykia (both republics are in the north Caucasus). These zones were governed by subordinate legislation, no special laws existed, and thus the legal framework did not provide the necessary protection for foreign investments. Gradually these SEZs evolved into offshore zones: companies registered themselves inside these territories, profited from the benefits, but continued their business activities outside. As a result the first SEZs in Russia turned into "black holes" within the national economy. Due to the lack of a legal framework along with constant conflict between the regions and the federal centre for the maximum benefits in the zones as well as control of them, SEZs in 1990s were ineffective and did not achieve their main goal of generating investment.

The second wave of interest in SEZs occurred in 2005 with the adoption of two main laws concerning Special Economic Zones in Russia. These laws laid the legal foundation for such zones and established new principles of "state-business" relations in these territories. Moreover, a fundamentally new administrative system was implemented: the Ministry of Economic Development became the main strategic body responsible for planning and legal regulation, and JSC "Special Economic Zones", founded in 2006, took on the task of managing investor relations.

So Russia passed the early stage – the stage of legislative framework formation and pilot zones implementation (from 2005 to 2009). In 2009 the phase of active infrastructure engineering and construction of the new zones began and at present there are 17 SEZs in Russia, of 4 different types: 3 industrial production zones, 4 technology and innovation zones, 8 tourism and recreation zones and 2 port zones. Still, prospective investors, and foreign investors in particular, are not enthusiastic about SEZs in Russia. What are the main reasons for this mistrust?

It is generally recognized that the effectiveness of special economic zones depends mainly on 3 aspects: geographic position, well-developed infrastructure and the amount of preferences given to investors. If the zone's geographical position is not favorable, the state can support the territory by the means of the other factors. Some experts see the main disadvantages of SEZs in Russia in the lack of benefits granted to investors. Even Russia's nearest neighbors Kazakhstan and Belarus have more favourable treatment inside their SEZs, not to mention China, Singapore and Korea. But the key point is that as a matter of fact Russia considers tax allowances as the main economic stimulus to inflows of foreign capital, while the global experience of SEZs shows that political stability, investment risk guarantees, labor qualification, and lack of administrative barriers are much more significant. So Russia needs to use a more diverse set of tools than simply cutting taxes to attract foreign investors.

Another important issue for prospective investors is the poor level of infrastructure which is supposed to be financed by the state. It appears that on the whole, the federal government's management of SEZs in this regard has not been very effective. It is interesting to note that the most successful examples of SEZ in Russia are located in bolder regions which are constantly pushing the central government to take action in their favor (Kaliningrad, Lipetsk and Tatarstan in particular). These examples of delegating additional powers to the subjects of the Federation are quite positive, as it has allowed investment in these SEZs to increase.

Another discouraging factor for investors is the drawn out and complicated registration process. Submitting an application, writing a business-plan, the decision-making process and concluding an agreement takes several months or even longer and involves struggling through numerous administrative barriers. The main problem is that in Russia the general level of taxes, climate, corruption and inflation risk is so high that even the special conditions for business activities in the zones are not attractive enough, as payback is only possible in the case of potential super profits.

According to the World Bank Group's annual report "Doing Business 2010: Reforming Through Difficult Times" which investigates the regulations that enhance business activity and those that constrain it, Russia is ranked 120 out of 183 economies in terms of viability of doing business. It is in 106<sup>th</sup> position in the ease of starting a business, 182<sup>nd</sup> in dealing with construction permits and 162<sup>nd</sup> in cross-border trading. As long as Russia performs so poorly it will not be able to compete with such acknowledged leaders (in terms of investment appeal) as

Singapore, New Zealand and China. Russia's SEZs, inspite of their simplified conditions for business activities, are far behind them.

Now let us try to analyze the problems of SEZs in Russia in terms of planning and organization, focusing on one particular example. One of the last and most challenging SEZ projects announced by president D. Medvedev is an analogue of Silicon Valley, Skolkovo, which is supposed to be an area of innovation generation and high-tech production. The total amount of financing is estimated at USD \$4-6 billion and the Skolkovo centre will be working in 5 key spheres: energy resources, information technologies, telecommunications, biomedical and nuclear technologies. According to Kremlin officials it will take 3 to 7 years to construct "Russia's Silicon Valley" and in the end Skolkovo will occupy 380 hectares of land near Moscow and employ 40,000 people. This project has aroused great public discussion and severe criticism. The first aspect to be criticized is the chosen location. The area of Skolkovo is quite expensive; it is one of Moscow's most luxurious suburbs (according to some experts one hectare of land costs approximately USD \$1.5-3 million). In California's Silicon Valley office and production site rent is comparatively low and affordable for a start-up company, while in Skolkovo this will not be the case. Moreover, taking into account the well-known problems of over-population and traffic jams in Moscow, a new suburb with 40,000 people working there will inevitably aggravate the situation. Besides, critics point out that in the case of Skolkovo, there is no potential for growth as this area is bordered by Moscow on one side and an elite housing development on the other. Not to mention the great technological gap between Moscow and the rest of Russia, which will only increase with Skolkovo.

Thus the planning of SEZs' location in Russia is quite controversial. Global experience proves that SEZs can be used as a tool for reviving depressed regions, but in Russia the majority of these zones are situated in the more developed areas of the country. To conclude, it seems that the government is underestimating the potential of SEZs and that the zones are mainly centralized, instead of being evenly spread across the territory.

It is important to understand that unless the state can grant convincing investment guarantees to foreign investors, they will not enter the market. Until this is accomplished, SEZs will not function successfully. Lowering taxes and granting favorable labor conditions to enterprises operating in these areas is not enough. A firmer and more far-reaching approach on the part of the public authorities is needed to enhance economic innovation, research and productive activities in general.

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