

Russia's Innovation Reform - The Current State of the Special Economic Zones¹

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Abstract

Approximately 20 special economic zones (SEZs) have been founded in Russia. Four of them are innovation zones, two manufacturing zones, seven tourism zones, three port zones and two old zones of the 1990's, namely the Kaliningrad SEZ and the Magadan SEZ. Additionally, four gambling zones are to be opened by July 2009. The Russian SEZs currently produce more plans than results i.e. unrealistic plans characterise the contemporary Russian SEZs. Only the Kaliningrad SEZ and the Magadan SEZ can be classified as fully operational, and therefore, it is far too early to make any firm conclusion on the economic impact of these zones on the Russian economy. On the other hand, it is highly recommendable that a follow-up of the Russian SEZs will be carried out in 3-5 years from now, since the results of today do not necessarily describe the potential of tomorrow.

Keywords: *special economic zone, innovation reform, SWOT analysis*

1 Introduction

The SEZs are no novelty in Russia. The first steps in developing special zones were already taken in Soviet Russia at the end of the 1980's. In the 1990's, some 10-20 SEZs³ operated in Russia. These SEZs received a lot of criticism, since they were accused of having become legalised places for illegal business. As some Russian firms used the SEZs for tax evasion and bribed the SEZ administration to maintain their privileges, the federal authorities decided to terminate the SEZs.

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³ In the 1990's, the special zones were called Free Economic Zones.

United Russia policy has further emphasized that the Russian market should operate under the same legislation, and thus, the privileges granted earlier to some regions of Russia have been taken away⁴.

In 2005-2007, Russia passed several laws related to the SEZs, and hence, there are six main types of SEZs: (1) innovative zones; (2) manufacturing zones; (3) tourism zones; (4) port zones; (5) "old zones" of the 1990's; and (6) gambling zones. Until the beginning of 2009, 22 SEZs have received permission from federal authorities to operate in Russia. Four of them are innovation zones, two manufacturing zones, seven tourism zones, three port zones, two "old zones", and four gambling zones.

The innovation zones have been established in St. Petersburg, Tomsk, and two in Moscow, namely in Dubna and Zelenograd. The Saint Petersburg SEZ specializes in analytical instruments, Tomsk in industrial electronics and biotechnologies, Dubna in information and nuclear technologies, and Zelenograd in micro- and nano-electronics.

The manufacturing zones are located in the Lipetsk region and in the Republic of Tatarstan. The first concentrates mainly on domestic and industry appliances and the latter on automobile industry components and products of the chemical industry.

The tourism zones have been opened in Western Russia (Kaliningrad), Southern Russia (Krasnodar and Stavropol), and in the Asian part of Russia (Buryatiya, Irkutsk, Republic of Altay, and the Altay Territory). All the tourism zones have been placed in extremely beautiful natural locations. However, it seems that these zones have not been developed for mass tourism but rather for elite tourism. One should not be over-optimistic that foreign tourists will find these zones, excluding perhaps the tourism zones of Kaliningrad and Krasnodar. The current financial crisis may postpone the development plans of the tourism zones, and therefore, one should not expect any major macroeconomic results prior to the middle of the next decade i.e. these zones do not create any major cash inflows for the regional administration to solve regional problems often caused by the peripheral location of these regions.

The port zones have been established to develop logistical hubs in Russia. These logistics hubs can be established around sea and river ports plus airports (RIA 2008). These zones offer customs benefits and tax privileges to both the Russian and foreign companies which operate in the privileged ports. Until now, zones have been established in Krasnoyarsk (East Siberia), Ulyanovsk (Volga

⁴ During the Yeltsin era, Russia's regions received various privileges from the federal centre. The Putin period practically ended the era of these regional privileges and introduced the united Russia policy. It is interesting to note that some regions have started to offer foreign investors certain advantages. One could take as an example the Kaluga region, which "*offers tax cuts to investors based on a sliding scale of the total amount invested. Last year, new legislation also introduced subsidies for strategic investors, making them eligible to get back profit taxes for up to nine years. In addition, there are breaks on property taxes for up to four years.*" The region's governor aptly concluded in January 2009 that "*we [Kaluga] have more residents in our industrial parks than Russia's special economic zones*" (MT 2009, 1-2).

area), and the Sovetskaya Gavan Port in the Khabarovsk region (Far East). The ultimate goal of the Russian Government is to attract private capital, including foreign capital with tax privileges, to aid the Russian Government to build modern logistics hubs in the country.

"The old zones" of the 1990's do not operate under the general legislation on SEZs passed in the middle of this decade, but they follow their own legislation passed in the 1990's. These special economic zones of the 1990's operate in Magadan, situated in the Far-East of Russia and in Kaliningrad, the Russian enclave sandwiched between Lithuania and Poland. Kaliningrad has been extremely successful in getting special economic zones. I assume that the success of Kaliningrad is based on the special location of the region rather than on any personalised criteria, i.e. current Prime Minister Putin's wife originates from Kaliningrad (Liuhto, 2007; Liuhto et al., 2007; Usanov, 2008).

The gambling zones will be the only legal places to gamble in Russia. The gambling law should come into force in July 2009 allowing gambling in only four Russian regions, namely in Altay, Kaliningrad, Krasnodar, and in the Primorie District in Russia's Far East. Even if the gambling zones should commence their operations soon, there are considerable doubts how the law can be executed since the gambling zones are not prepared to accommodate gambling activities, gambling companies are not ready to leave their current sites, and the Russian Government is unlikely to close down a business segment worth USD 8 billion with 500,000 employees (MT, 2008).

Special economic zones in Russia at the beginning of 2009

Table 1

Zone	Type	Some focus areas	Location
Saint Petersburg	Innovation	Analytical instruments	Novo-Orlovsk and Neudorff, St. Petersburg
Tomsk	Innovation	Industrial electronics and biotechnology	Tomsk region
Dubna	Innovation	ICT and nuclear technology	Moscow region
Zelenograd	Innovation	Micro- and nano-electronics	Moscow region
Lipetsk	Manufacturing	Domestic and industry appliances	Lipetsk region
Alabuga	Manufacturing	Components of the automobile industry and chemical industry	Republic of Tatarstan
Altay Valley	Tourism	No data	Republic of Altay
Biriuzovaya Katun	Tourism	Ecological tourism, skiing	Altay territory
Grand SPA	Tourism	Health-related, skiing	Stavropol territory

Zone	Type	Some focus areas	Location
Yutsha			
New Anapa	Tourism	Yachts, maritime sports	Krasnodar territory
Irkutsk	Tourism	Hunting, fishing	Irkutsk region
Buryatia	Tourism	Ecological tourism	Republic of Buryatia
Kurshkaya Kosa	Tourism	Ecological tourism, yachts	Kaliningrad region
Yemelyanovo	Port (air)	Cargo hub between Asia and Central Russia	Krasnoyarsk
Ulyanovsk	Port (air)	Cargo hub, aircraft repair	Volga area
Sovetskaya Gavan	Port (sea)	Ship repair, fish processing	Khabarovsk region
Kaliningrad	"Old zone"	Tax free imports-based assembly & large investments	Kaliningrad region
Magadan	"Old zone"	Tax free imports-based assembly	Magadan
Altay	Gambling	Russians	Altay
Krasnodar	Gambling	Russians	Azov Sea coast Krasnodar & Rostov
Kaliningrad	Gambling	Russians, EU citizens	Baltic Sea coast, Kaliningrad region
Primorie	Gambling	Asian customers	Primorie District

2 Special economic zones (SEZs) in Russia

The current state of Russia's SEZs is here analyzed via a SWOT analysis. The first section of the chapter focuses on the innovation zones, though also manufacturing, tourism, port, and gambling zones are briefly dealt with. The old zones of the 1990's, namely Kaliningrad and Magadan, have not been included in the analysis conducted, since their operational reality differs from those zones established in the middle of this decade.

Strengths

The legislative basis of the SEZs is sufficiently clear and the legislation is on a federal level, which protects the SEZ residents (companies registered within the SEZs) from sudden and unexpected legislative changes on a regional level. As a sound legal foundation was missing in the 1990's, only a few serious companies

started their operations in the SEZs, as they were afraid that these zones will be terminated, which in matter of fact was what occurred.

The SEZs offer customs advantages, tax benefits and other privileges, which give SEZ residents some competitive advantage. According to the Russian Ministry of Economic Development and Trade, the benefits give a SEZ-based company a 20-30% tax advantage. Even if the benefits offered by the SEZs are concrete, the tax benefits alone do not make foreign firms want to invest in Russia, i.e. the SEZs lower the investment barrier for foreigners but the SEZ benefits alone are not sufficient to attract foreign firms to invest in Russia. This can easily be seen when one analyses the backgrounds of the SEZ residents. Leading foreign high-tech firms have not invested in the Russian SEZs, and it is anything but certain whether *the entry boom of global high-tech companies into Russia will happen, unless the SEZ administration seriously starts to attract leading foreign high-tech companies into the zones (stronger marketing activities required) and the general image of Russia as a FDI-friendly country improves.* Russia's investment climate has seriously deteriorated since the middle of this decade as some foreign firms have been treated strangely by the Russian authorities and the Russian Government has started to restrict the operations of foreign firms in so-called strategic sectors (Liuhto, 2008).

The SEZs act on the basis of the "one window" principle, which reduces the bureaucratic burden of investing firms. The SEZ administration can be extremely valuable for a foreign investor, but on the other hand, the administrative special service may leave room for subjectivity in the bureaucracy, i.e. enhance corruption. So far, no corruption cases related to new SEZs have hit the headlines. Though the SEZ administration should be active in attracting firms in the SEZs, some Finnish firms have expressed their dissatisfaction with bureaucracy and a lack of business-orientation in the SEZ administration (Peltola, 2008).

Russia offers an abundant educated workforce, which is cost-competitive compared to the researchers in western countries. Despite the higher wage levels in the West, their better functioning innovation environment has still supported the competitiveness of innovation work in the developed countries. In addition, some Asian tigers, such as China and India, are far ahead of Russia in producing qualified experts with lower salary requests. Furthermore, the brain drain from Russia to the West weakens the human resource base of Russia and the SEZs can hardly stem the intelligence outflow from Russia in either the short or medium term.

The tourism zones have been placed in extremely beautiful natural locations. However, the remote location of the Baikal region and the enclave location of Kaliningrad, continue pushing Russian tourists towards their natural sites i.e. the shores of the Black Sea and the Azov Sea⁵, and the lakes of the

⁵ The travelling and tourism account for 1.2% of the Russian GDP and 1.0% of the total employment i.e. in an international comparison Russia's tourism industry clearly underperforms. Besides, the weak quality-price ratio of the tourism services indicates lacking competition in the field (Accenture 2008; Kommersant 2008).

Karelian Republic, or even those of Finland. Strengthening existing tourism destinations would have been a more rational way to build the tourism zones rather than to create new zones to support regional policies.

Weaknesses

The Russian SEZs remind one more of Soviet-type "plan factories" rather than real activity centers, i.e. *unrealistic plans are a typical characteristic for the Russian SEZs*. The macroeconomic results, such as additional GDP and employment generated, innovations and new patent-applications created, are non-existent. In fact, only a few SEZs have begun their operations as initially planned.

The Russian SEZs do not form an integrated network but the SEZs can instead be regarded as isolated innovation-oriented oases in Russia's low-tech desert. The innovation system of Russia is stagnant, i.e. the interaction between the state, research institutions and universities and private companies is based on bureaucratic collaboration rather than on business-driven goals (Dezhina & Zashev, 2007; Peltola, 2008).

The R&D organisations together with the state agencies form a mammoth research network⁶. The analysis of the Russian innovation system indicates that Russia does not lack innovation-related agencies, but it definitely lacks innovation-related activity. Currently, *Russia's innovation sector reminds one more of Soviet bureaucracy rather than a business-oriented innovation-promoting cradle*. The European Commission (2007) phrases the aforementioned statement a bit differently, i.e. "*R&D system structure and mission as a whole does not correspond to the economic and social needs.*"

When Russia is developing its innovation-related activity, *it should be extremely careful what will be the role of the state in innovation building, as Russia's bureaucracy is notorious for its inefficiency and wide-spread corruption*. In this context, one should remember that only 30% of the Russian R&D expenditure is financed by enterprises. The respective share in the EU is over 50%, in the USA approximately 60% and in Japan close to 75% (Dezhina & Peltola, 2008).

Russia's national image as a low-tech country does not support the development of the SEZs. To illustrate the low-tech image of Russia, one could ask a reader to name three famous non-military-related innovations designed in Russia and used widely in the developed West. Not an easy task, even for an expert.

The SEZ are often located outside the city centres, which decreases the attractiveness of these zones in the eyes of the workforce and companies.

The marketing activities of the SEZs are weak inside Russia, and non-existent outside the country. In fact, it is difficult to find any public information on these zones, even if one would be aware of their existence. *The administration of the SEZs and the federal agency coordinating their activities should take much more active role in promoting these zones both inside Russia and abroad*.

⁶ Close to 4000 R&D organisations, employing over 800,000 people, operate in Russia (Dezhina & Peltola, 2008).

The SEZs do not provide foreign investors with any special advantages compared to the Russian firms operating inside the SEZ.

The earlier references by the majority of SEZ residents are unconvincing, and therefore, *one should not expect any rapid technological break-through in Russia comparable to that of China*, if the SEZ administration acts as Soviet-era bureaucrats instead of business-oriented innovation facilitators.

As a brief conclusion on the gambling zones, one can only state that *it is gambling to support regional policies using casinos*. Casinos will find their Russian clientele even if they would entirely be terminated in Russia. Gambling will transform itself or else go underground, but it does not abandon major Russian cities. Gambling zones, if ultimately opened, may attract sex tourism in Russia, but I doubt whether that has been the original goal of the gambling zones.

The port zones should be located in natural sites, where they may one day survive without administrative privileges. At the moment, only the maritime port placed in the proximity of Japan meets this basic criterion. It is interesting to note that the port SEZs are absent in logical hubs, such in the regions of Kaliningrad, Krasnodar, Leningrad, and Murmansk. *As logistics is an extremely logical sphere of business, supporting anything unnatural with administrative benefits will turn out to be expensive and non-sustainable*. In reverse, supporting something unnatural distorts the evolution of natural competitiveness. Furthermore, large infrastructure public-private partnerships have traditionally been extremely vulnerable to corruption, and therefore, the public-private partnership does not necessarily materialize in the synergistic combination of private effectiveness and the state's strategic vision.

Opportunities

The image of the SEZs has improved among the Russian workforce, companies and particularly among the Russian decision-makers, i.e. the SEZs are no longer regarded as special zones created for money laundering and corruption. However, it will take plenty of time before the Russian SEZs become known among foreign business circles (Giannella & Tompson 2007).

The SEZs may become an additional tool in strengthening regional centres, but this would require that the development speed should be accelerated tremendously. At the moment, the SEZ suffer from a common virus in Russia, i.e. *a good idea at the federal level does not materialize in efficient implementation at the regional level*. The SEZ administration, with a few exceptions, has seldom enough experience on assessing the development of global demand on high-tech goods, the competition involved, and make future visions needed for supporting innovation building. If the regional administration is not fully aware of the global demand and competition, it hardly can create the conditions needed for attracting globally-recognised innovators into Russia. *I doubt that the administrative top-down innovation policy can create any major innovation revolution in Russia*,

unless Russian private firms themselves become more innovation-oriented and start to invest more in R&D.

The collaboration between the SEZs and the state-funded technology centres, regional industrial/innovation parks, and universities is much below potential. *A National Innovation System (NIS) can be a step towards a right direction, as long as the state minimises its own role, since less bureaucracy means more results. The integration of the activities of the Russian Nanotechnology Corporation with some SEZs might give some boost to creating a high-tech network in Russia.* The experience and outstanding leadership skills of the corporation's director general, Anatoly Chubais, are without a doubt major assets for the future development of Russian nanotechnology.

Closer collaboration with the world's leading high-tech countries and the global R&D corporations would benefit the SEZs.

Threats

Most of the SEZs are to be closed in the mid-2020's, or even earlier, if Russia decides to cancel the SEZ laws due to the weak performance of the zones. The fixed tenure reduces the attraction to invest in the zones since the tenure of the privileged period becomes shorter day by day.

Even if Russia's accession to the WTO has progressed very slowly, Russia's possible membership in the WTO might force Russia to close the SEZs, and compensate losses to the SEZ residents. The compensation from the Russian Government does not necessarily cover all the costs incurred by a SEZ resident. In this context, one should stress that Russia's WTO membership is everything but certain.

The role of the military-industrial complex in innovation building distracts both the Russian private companies and foreign firms⁷. There is a substantial risk that some innovation-related industries become restricted, and therefore, natural competition weakens. As the competition forces organisations to innovate, restricted innovation sectors could be damaging for Russia's goal to diversify its economy. The military-led innovation system would mean that competition would be replaced with control and secrecy. If the most advanced parts of the Russian innovation sector will become restricted or closed, it will push foreign innovation-related companies to invest in some Asian countries, where they will find experts with lower salaries (Liuhto, 2008).

The Russian SEZs should not neglect foreign investments for at least six reasons. First, foreign firms bring additional R&D capital into Russia⁸. Second, foreign firms bring advanced technology and introduce best practices, which are even more important than the finance per se, since money can buy the technology

⁷ The development plan 2020 approved by the Russian Government in the beginning of 2009 confirms that Russia has not abandoned the old pattern i.e. the use of the military-industrial complex in its high-tech projects and technological modernisation (e.g. BOFIT, 2009).

⁸ At the moment, foreign firms form nearly 10% of all R&D expenditure in Russia (Peltola 2008).

but not its effective use. Third, without the participation of the leading foreign R&D companies, the Russian innovation network will focus on domestic needs instead of the global opportunities. Fourth, the foreign firms accelerate competition, i.e. they bring dynamism into Russia's stagnant innovation sector. Fifth, the leading foreign innovators have a better view of future innovation development than even best-informed bureaucrats. Sixth, foreign high-tech companies' investment in Russia is a more cost-efficient way to diversify Russia from a raw material producer towards a high-tech country than the acquisition of foreign high-tech companies and bringing their knowledge to Russia.

I recommend that the Russian SEZs would focus on inviting a couple of leading foreign innovators in the zones. Foreign innovation leaders would bring their own foreign clients into the zones, as internationalisation often occurs via business networks (follow-your-client strategy). Since foreign innovation companies cannot act by themselves in Russia, the subcontracting agreements would be a natural way for Russian firms to join the global innovation networks without going abroad. Although the aforementioned recipe sounds easy, one should not assume that the SEZs alone would be a sufficient attraction to bring foreign innovators into Russia. Therefore, *Russia should improve its investment climate and upgrade its innovation system to be able to succeed in a high-tech revolution.*

The current financial crisis slows down the development of the SEZs, since the regions and the companies have to focus on securing their core operations instead of developing innovations.

As the new law on SEZs was passed relatively recently, it is understandable that the results of new SEZs are very modest. In other words, the results of today do not fully describe the potential of tomorrow, and therefore, *it is highly advisable that the follow-up of the SEZ analysis would be conducted in three-five years from now.*

3 Conclusion

One could conclude the progress of the Russian SEZs with a proverb "Much ado about nothing". *At the moment, the Russian SEZs still offer very little for foreign firms.* Even if the SEZs offer certain financial privileges and the Russian researchers are generally very qualified, Russia's poor reputation on immaterial rights, weak innovation system, the low-tech image of the country, a lack of R&D-related finance, and administrative inertia downplay the advantages offered by the zones.

Therefore, it is not surprising to note that foreign firms are a rarity in the zones. In fact, only a few domestic companies have been founded in the Russian zones, since the majority of the zones have not started their operations as initially planned.

If the Russian SEZs do not produce any tangible macroeconomic results by the middle of the next decade, their existence can be questioned, since already by 2025 many of the SEZs are to be terminated.

To sum up, although the results of these zones are meagre, *I recommend the implementation of a follow-up study on the Russian SEZs and innovation-related activities in 3-5 years from now.*

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