The Development of Free Economic Zones in Russia

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Free economic zones (FEZ's) are considered to be efficient mechanisms which have been successfully used in many countries. Initiation of FEZ's implies recognition that processors/investors require different, more liberal treatment than they are currently getting in their country. The FEZ policy targets "spot" liberalization of the investment climate for foreign and domestic businesses. FEZ's can also be thought of as reform islands, or specific targets of the reform efforts.

The intention to create an FEZ was announced by the Chairman of the Presidium of the Supreme Soviets of the USSR, Mikhail Gorbachev, in 1986, during his visit to Nakhodka in the Russian Far East. But the real step was taken by the new Russian government only in 1990 after the visit of the first Russian President, at that time the Chairman of the Supreme Soviet of Russian Federation, Boris Yeltsin, to Nakhodka in 1989. In October 1990, the Supreme Soviet of Russia adopted the Decree "On the development of the FEZ in Primorsky Krai in Nakhodka."

After 10 years of attempts to create a true Free Economic Zone in Russia, we have to emphasize *that Russia has never had a Free Economic Zone* in its full capacity and meaning. It is still approaching the understanding of this very important instrument which the country needs so much to facilitate exports, attract advanced business culture and management, develop its own technologies and process enormous resources instead of exporting raw materials. It could help the Russian government to develop and test some of the elements of the new investment policy and methods of cooperation between the government and foreign businesses on the small territory of the FEZ, and then spread it all over the country. Thus, FEZ's can indirectly affect the reform efforts by demonstrating what does or does not work.

Instead, the zones still remain an institutional innovation in Russia. What has happened to the FEZ idea in Russia is the main subject of this article. The Nakhodka Free Economic Zone will be used as a shining example of the entirity of the problems that are faced while developing the FEZ idea.

In Russia there exist 18 areas formally designated as FEZ's. In 1990-91, the status of FEZ was granted to 11 regions with a total population of 18 mln. people (13% of all Russia's population). They had different locations and sizes. For example, FEZ Vyborg (near St. Petersburg), FEZ "Altai" (Siberia) (the whole Altaisky krai), "Kuzbass" on the borders of the Kemerovskaya oblast, "Sakhalin," on the edge of the Sakhalin islands and so on. Almost all these regions did not have an opportunity to use the FEZ status. Nakhodka FEZ was the first to gain FEZ status. It is a strategically important city-port located in the southern part of the Russian Far East, near the borders of China and Korea and close to Japan. Nakhodka was chosen due to its advantageous geographic position and strategic significance for Russia in its Asian policy. For ten years, the Nakhodka FEZ was considered as a real candidate for FEZ development. At the beginning, in 1991-94, partial elements of the zone were used; for example, the tax exemption, customs incentives, special immigration procedures and simplified registration of enterprises. The government provided money for infrastructure development. When the Nakhodka FEZ, together with Korean partners, proposed a new approach to FEZ − implementation of the international project of a Russo-Korean Industrial Complex (RKIC) − it resulted in the signing of an international treaty between the Russian Government and the Government of the Republic of Korea. Nevertheless, the history of Nakhodka is the struggle for real status that has not yet been achieved.

The failure of the FEZ idea in Russia was stipulated for several reasons given below.

1. Concept error and lack of conceptual approach of the Russian Government to the FEZ development in all of Russia.
2. Inadequate and moreover underdeveloped legislation.
3. Unfavorable economic situation.

Concept Problem

The right concept is a core for success, regardless of how complicated the project is. It was very difficult to develop the right concept in the reality of Russia in 1988-90. The initiators of the idea were the part of the post-Soviet economy who knew FEZ's from the books and believed so much that Russia had its own way to develop FEZ's. Some of the important criteria necessary for FEZ development were ignored, such as the global nature of FEZ's, government role, the importance of location and appropriate size and the availability of state-of the art infrastructure.

The global nature of an FEZ presumes that the zone will be part of international competition for investment and market share. When global production networks or chains are constructed, FEZ's can provide a link. FEZ's are one of the main components of the foreign investment-led export-oriented industrialization strategy. It is an aggressive policy of the native government to show the world that it is ready to open its economy to the world, invite foreign investors, follow the "international rules" and support business development in its own country.

In Russia's case, the goals of FEZ development in most regions targeted mostly social problems such as improving housing, goods supply and modernizing municipal infrastructure. The FEZ became a *political instrument to* extract the territory's tax revenue from the federal budget and keep it in the territory.

Although most of the so-called "FEZ" territories copied the main Nakhodka FEZ Decree, setting-up the zones was more about the fight for budget money than facilitating industrial development which measured up to international standards. The financial strategy that the Nakhodka FEZ put into the FEZ through the government decree was to keep part of the tax revenue earned by the city in order *to foster the infrastructure development* and invigorate a less-developed region.

The size of the area plays a crucial role in its financing. Due to international definition, an FEZ is an industrial area. In Russia, it was a mixed area. For example, FEZ Vyborg, with an area of 74.3km², included 6 small towns with a combined population of 200,000. The FEZ's of "Kuzbass" and "Altai" are the whole regions. The area of Nakhodka FEZ included the City of Nakhodka itself and the Partisansk region, with an area of 4,611 km² and a population of 220,000. The area of the City of Nakhodka is 370km² and the other territory is mainly forest. It is substantially different if the host country has to develop and prepare some areas or the entire region with huge social problems like Kemerovskay oblast.

All the FEZ territories have very serious problem in terms of infrastructure. At the end of the 1980s, telecommunications were a problems even in Moscow, not to mention provincial regions. The fax machine was a technological wonder, and in Nakhodka, most of the ports at that time used telex. The government of the host country usually finances the infrastructure development or its improvement, always with huge direct investments. The large size of the FEZ area compelled the government either to put the burden of infrastructure financing on the region or recognize the mistake and abolish previous decrees. As an example, Nakhodka did not receive direct government investment, but investment credit (tax credit later) to develop infrastructure in an area of 4,611km². The responsible Administrative Committee of the Nakhodka FEZ was forced due to the City of Nakhodka and Partisansk region to invest much more money in overall social infrastructure development than it would have if the FEZ had been an area of only several hectares. City projects substantially increased the burden and made the cost of the FEZ expensive.

The mistake of zoning almost 13% of Russia with 18 millions people living there was obvious. *One of the main principles was ignored – a zone is an area or a region, which is set apart or aside and designated for a particular activity (industry, processing or economic).* As a result, the government abolished all incentives it gave to the so-called FEZ's in 1992-93. It also abolished the financing for almost all the region except for the Nakhodka FEZ (Nakhodka FEZ received financing up to 1997).

In 1992, together with the Korean Land Corporation from the Republic of Korea and the American private company SOVCAP, the Nakhodka FEZ Administrative Committee started to develop a new approach to FEZ and proposed to the government the adoption of "spot development" - concentrating efforts on small areas of a few hundred hectares. Bilateral negotiations between the governments of the ROK and the Russian Federation resulted in the implementation of the Russo-Korean Industrial Complex project. This project is an *internationally recognized concept* of a free zone located in an area of 330 ha. It can be used as a model to develop the idea of FEZ's in Russia.

Location is the most important consideration. Good international communications (transport and telecommunication) are essential, as free zones are geared primarily towards firms processing regular (weekly) shipments of imported raw materials for export markets. The experts found that the most favorable and ideal locations are Nakhodka and Kaliningrad. Nakhodka has good access to the markets of America, Northeast Asia and to the Russian market. Kaliningrad is a natural enclave located in the proximity of Germany, Poland, Sweden, and Finland. The goals to set special regimes were thus entirely different than for Nakhodka FEZ, and in 1997, Kaliningrad gained the status of a Special Territory, not a Free Economic Zone, which is absolutely correct.

So we can say that the term "Free Economic Zone" up to 1997 was widely used in Russia for any territory which had more or less different tax or customs treatment or different relationships between the federal and local budgets. However, the FEZ is a combination of natural favorable location, excellent infrastructure, special investment treatment, low bureaucracy and substantial government support. If any of these are low or absent, the success of the FEZ will be problematic. Moreover, the mixture of definitions led to a situation where the FEZ's were criticized widely as illegal. As far as the region had this "brand" (but not the real status) some years ago, all the problems were connected with the FEZ status.

Legislation problems

Legislation is a must for FEZ success. 1990 was the time when the new Russian Government and the Supreme Soviets of the Russian Federation started to develop Russian legislation. The lack of general (basic) legal framework on FEZ's and in relation to foreign investments created the opportunity for different bodies to set up zones. For example, "Sakhalin," "Altai," etc. were granted FEZ status through Decrees of the Soviet of Ministries. The Nakhodka FEZ, "Kusbass," "Sadko" (Novgorodskaya oblast) were created through the Decrees of Supreme Soviets and the Trade Zone "Sheremetijevo" and porto-franko "Vnukovo" (Moscow) by Presidential Decree.

The Decree of the Supreme Soviets and the Decree of the Government on the development of the FEZ in Nakhodka were the first legal documents to regulate the zone and attitudes to foreign investments and investors in Russia. The basic legal acts, such as the Customs Code, Tax Code, Currency regulation Law and the Law on Foreign Investments in Russia, were developed and enacted in the next two years. All these legal acts did not mention the Free Economic Zone, with the exception of the Customs Code, and *the FEZ status became a pure declaration.*

As a result, the FEZ's became illegal and were put "on hold" awaiting a law on FEZ's in Russia. In 1994-95, the government easily abolished its own decrees and the idea of FEZ's was frozen for an uncertain period of time. It became a complete legal vacuum.

A draft of *the Law on Free Economic Zones was* developed and brought to the State Duma in 1993–94, and the law still does not exist. This law was approved in the State Duma twice and twice was vetoed, by President Yeltsin in 1998 and by President Putin in 2000. Both drafts (although conceptually different) legalized FEZ's in Russia and identified the role of government and special procedure to consider zone development. It substantially decreased the size of the FEZ's to several square kilometers and identified tax exemptions and Free Customs Zones as a necessary criteria for FEZ's. But still it did not reveal the full mechanism of FEZ's.

The Administration Committee of the Nakhodka FEZ and its partner, the Korean Land Development Corporation, in order to overcome legal problems, decided to refer to the *International Treaty* between the Government of the Republic of Korea and the Government of Russia on the Development of a Russo-Korean Industrial Complex in Nakhodka FEZ. It contains the major preconditions necessary for FEZ development, such as:

– tax holidays for enterprises located in RKIC;
– simplified bureaucratic procedures (one stop-shop services);
– responsibility of the Russian Government to develop infrastructure and secure Korean and future users' investments.

The implementation of the project of RKIC as a pilot project gives a good opportunity to test the major approaches and develop the correct relationships between all "players of the game," which are federal and local governments, foreign partner-developers and users of the RKIC. The International Treaty has to be supported by a series of instructions, decrees of the government at different levels, and "in-house" acts. All these should be competitive among Nakhodka FEZ's neighboring zones in China, the Republic of Korea (ROK) and the Democratic People's Republic of Korea (DPRK). Transparency and flexibility is of great importance in the first stage of RKIC development.

FEZ "Yantar" (Kaliningrad) was transformed into a special economic territory by the Law "On Kaliningrad Special territory." FEZ "Sadko" refused this idea and did not take a special status, but successfully developed and implemented a special regional investment strategy due to the very progressive governor and Novgorodskaya oblast Administration. To date they have the highest rating among the foreign investors. They cleverly used one of the FEZ criteria – simplification of bureaucratic procedures and regional tax incentives.

Economic Situation

The better the surrounding policy atmosphere, the more beneficial FEZ's will be to the local economy. Of most importance is a stable macroeconomic environment. Inflation should not be a threat, and the exchange and interest rates should be close to their free market values or "market" rather than administratively stable. If the macroeconomic environment is unstable, the direct benefits to the host country from FEZ's will be slight, even if the FEZ's are successful from the participants' point of view. In addition, the better the overall climate for competitive private business in the host country, the greater the direct economic benefits to the host country from FEZ's. Such increased benefits would include greater economy-wide private investment, employment, higher wages and efficiently produced output (which is exportable). This follows from the fact that surrounding businesses will quickly respond to the economic needs of investors in the FEZ's, thus increasing the backward linkages.

In 1990–94, when FEZ's were initiated, the economic situation in Russia was rather unstable, with hyperinflation and political uncertainty, a steep reduction in output and income, political crises and the break-up of the powerful Soviet Union. Russia's reformed government under Boris Yeltsin tried to destroy the old Communist Party command system and establish a rule of law market system. Regional administrations also retained much of the old system's structure and operating procedure. At that time, the privatization process started.

Also at that time, there were no private businesses, *which are fundamental for FEZ development.* The first private enterprises appeared in Nakhodka in the second half of 1990. At that time Nakhodka had 340 state-owned enterprises (for comparison, to date Nakhodka has 4,200 enterprises with 3% being state-owned, and 16,000 individual private businesses). Thus, in the period 1990-95, private business started to develop. The former state enterprises became joint stock companies as a result of privatization. The small businesses were mostly young and inexperienced one-man companies, which could neither compete with foreign businesses nor be equal partners in joint ventures. The Nakhodka FEZ, using at that time tax and customs incentives, attracted foreign businesses, and in 1994 had 460 companies with foreign investments, most of which were joint ventures. Six years later, enterprises wholly owned by foreigners have mostly left. The unstable investment environment and abolishment of benefits promised for the Nakhodka FEZ made the companies shift their focus from processing to simple trade activity, or just leave. The announced share capital in 1992-93 was US$640 mln. This was the amount the *foreigners wanted to invest in* Nakhodka. To date, the registered capital of enterprises with foreign investment is just US$64 mln. The financial infrastructure was poor. The development of the security market also started in 1991. Most of the banks could not accept even a million dollars.

Russia's devaluation of the ruble and default on its debts in August 1998 triggered its most serious crisis and more foreign enterprises left the country. This situation was not conducive for the development of the zone idea in Russia.

Conclusion

Thus, ten years ago, Russia and its government were not ready to start a free economic zone:

– Russia did not have the proper legislation to attract and serve the foreign investments;

– the zones were not regarded as special government policy aimed at integration with the global economy;
– there was an unstable macroeconomic environment and political situation;
– it was the wrong conceptual approach to ignore such important criteria as location, the global nature of FEZ's and the availability of the driving idea on national level;
– there were not enough experienced and reliable Russian private business which could compete.

At present, Russia has a good chance to develop true free economic zones. It has enough experience gained by the territories and State Duma to produce viable and adequate legislature for FEZ's in Russia.

Russians have gained business experience and have started to adjust to international standards of doing business. The young managers can speak English and have studied business abroad. The new strategy of the Russian Government is aimed at attracting FDI to the Russian economy. The personal attention of President Putin to the Sakhalin project and the facilitation of the Production Sharing Agreement shows the importance the government places on its intentions. During two meetings between the Prime-Minister of the ROK and the Prime-Minister of the Russian Government, and President Kim and President Putin, the project of a Russo-Korean Industrial Complex was regarded as one of the most important pilot projects in Russian-Korean economic relationships. RKIC can be a predecessor of more serious Korean investments into Russia and a model for FEZ development.

The new draft of the Law on Free Economic Zones clarifies the definition of FEZ's and the responsibility of the government to develop FEZ's. There is hope that Russia has one more chance to use the FEZ instrument to facilitate the flow of FDI into the Russian economy.

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