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Special Economic Zones in Russia
– What do the zones offer for foreign firms?

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Prologue

"Russia's innovation potential is probably greater than that of most other countries at comparable levels of GDP per capita. The country benefits from a substantial science base and a well developed education system in science and technology. Yet indicators of actual innovation activity remain disappointing. There is striking imbalance between the public sources devoted to knowledge creation and the observed outputs in terms of innovation. Closing this gap constitutes one of the major challenges for Russian innovation policy. The other is to stimulate greater private-sector involvement in R&D, which remains limited. ... A healthy business environment may be considered a precondition for boosting innovative activities. Russian innovation policy should therefore be carefully designed, with a balance between general and targeted measures. ... Here the paper identifies two measures that should be considered as first priorities for the government: the reform of the state science sector and the strengthening of the intellectual property rights (IPR) regime. It argues that the authorities should proceed with caution when it comes to targeted initiatives like the creation of special zones and technoparks."

Christian Gianella and William Tompson (2007)
*Stimulating Innovation in Russia: The Role of
Institutions and Policies*, OECD, pp. 1-2.

Executive summary

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.

Despite the slow progress of the Russian SEZs, some indicative findings can be presented. First, the tax privileges offered by the Russian SEZs lower the investment barrier for foreigners but the benefits alone are not sufficient to attract foreign firms to invest in Russia. Furthermore, Russia's poor reputation on immaterial rights, stagnant innovation system, the low-tech image of the country, a lack of R&D-related finance, and administrative inertia downplay the advantages provided by the zones.

The growing role of the military-industrial complex in innovation building distracts both the Russian private companies and foreign firms from the innovation activities. I strongly believe that the adaptation of the military-led innovation system does not start the diversification of the Russian economy, since the military-led innovation systems are by nature expensive, inefficient, and corrupt due to their secrecy, bureaucracy and non-competition.

The ICT collaboration between the Saint Petersburg innovation SEZ and the Nordic companies would be natural, and the close distance may create an additional competitive advantage, if the Nordic companies are not afraid of taking risks involved in Russia's poor

respect of immaterial rights. In order to promote the Finnish-Russian R&D co-operation, some Finnish innovation facilitators, such as Technopolis and Finpro, have already entered in St. Petersburg.

Although the Kaliningrad region is unfamiliar to most of the Finnish investors, I advise that Finnish companies considering an investment exceeding EUR 4 million in Russia would make a feasibility study of the investment possibilities in Kaliningrad. Besides considerable tax benefits, the administration of the Kaliningrad SEZ has a good reputation for being investor-friendly, and furthermore, Kaliningrad is close to Central European markets.

Should Kaliningrad truly manage to become Russia's leisure centre on the Baltic Sea, it is self-evident that high-quality construction companies from the West, including those from Finland, may find additional demand there. A need for wooden summer houses is definitely growing in the region, when the current financial crisis is over. Additionally, if Kaliningrad is serious with its nuclear power plant project, some Finnish construction companies recently involved in building the fifth nuclear unit in Finland might find the project in Kaliningrad worth studying in more detail.

There are no major Finnish companies operating in any of Russia's SEZs for time being, though one company with a Finnish name has been registered in the Saint Petersburg SEZ.

1. Introduction

This report is rather unconventional, since it does not describe the plans, priorities, and privileges offered by Russia's Special Economic Zones (SEZs). As the earlier studies have dealt with the aforementioned issues, a reader is recommended to familiarise themselves with the study conducted by Männistö in 2007 and a short follow-up carried out by Tuominen and Lamminen at the end of 2008. In addition, earlier reports of the Pan-European Institute (PEI) have dealt with the Kaliningrad SEZ (Liuhto 2007; Usanov 2008) and the Saint Petersburg SEZ (Lisitsyn 2007; Zashev 2008).

Instead of the description, this report jumps directly into the SWOT analysis on Russia's SEZs and summarises the opportunities these zones provide for foreign firms, particularly for Finnish ones. In order to aid a reader to comprehend the current state of the Russian SEZs, in the following a brief historical background is given and the main types of the SEZs are introduced.

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. United Russia policy has further emphasised 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. For a

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

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).

more detailed description of the historic development of the Russian SEZs, see Lisitsyn (2007) and Zashev (2008).

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 specialises 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 area), and the Sovetskaya Gavan Port in the Khabarovsk region (Far East). It is interesting to note that Ust-Luga, the colossal sea port to be erected in the Gulf of Finland, has decided not to apply for SEZ status due to the large investments required (over € 100 mn) and non-clarity related to the governance of the port SEZ (Ust-Luga Company 2008)⁵. To sum up, 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.

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).

⁵ It could be that the management of the Ust-Luga Company is not particularly willing to form a port zone, since the company management may feel that by establishing a port zone it might lose their decision-making authority to the federal authorities.

Table 1. Special economic zones in Russia at the beginning of 2009

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 Yutsha	Tourism	Health-related, skiing	Stavropol territory
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 analysed 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 Saint Petersburg SEZ is briefly discussed in the second section since this SEZ might be of special interest to Finnish firms.

The old zones of the 1990's, namely Kaliningrad and Magadan, have not been included in the analysis conducted in the first section, since their operational reality differs from those zones established in the middle of this decade. The third section focuses on the Kaliningrad SEZ due to its potential interest to EU-based firms. The Magadan SEZ has been designed for collaboration with Asian companies, and therefore, it has not been analysed in this report.

2.1. SWOT analysis on new SEZs in Russia

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 Sea⁶, and the lakes of the 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 centres, 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 network⁷. 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.*"

⁶ 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).

⁷ Close to 4000 R&D organisations, employing over 800,000 people, operate in Russia (Dezhina & Peltola 2008).

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% (Dezina & 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.***

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 necessary materialise 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 materialise 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. Finland's experience in particular could be useful for the Saint Petersburg SEZ and the Kaliningrad SEZ.

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 firms⁸. 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 Russia⁹. 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 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

⁸ 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).

⁹ At the moment, foreign firms form nearly 10% of all R&D expenditure in Russia (Peltola 2008).

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.***

2.2. Saint Petersburg SEZ

The Saint Petersburg SEZ offers practically the same tax privileges as its three sister zones specialised in innovations. What makes the Saint Petersburg SEZ unique is its geographical location, i.e. this SEZ may develop into Russia's innovation window towards the West, if it manages to attract the leading foreign innovation-oriented companies. So far, the results are meagre.

Less than 30 companies has been registered in the Saint Petersburg SEZ. None of these companies can be classified as a globally recognised innovation company. In fact, they are rather unknown companies outside Russia, and even inside the country. For a closer description of these companies, visit the website of the Saint Petersburg SEZ (www.spb.rosoez.ru).

The zone has not fully started its operations, i.e. the construction process has not been finalised in either Neudorf (the southern part of the SEZ) or Novo-Orlovsk (the northern part of the SEZ). The international financial crisis may slow down the launching of the zone further, since some of the key financiers of the zone have encountered severe financial difficulties.

The Saint Petersburg SEZ has expressed its interest to focus on the production of software, ICT, consumer electronic devices, and military and civil aviation. Software production might be a challenging field since India, for instance, offers qualified experts with lower salary levels, and software production is not dependent on geographical proximity. ICT collaboration with the Nordic companies would be natural, and the close distance may create an additional competitive advantage, if the Nordic companies are not afraid of taking the risks involved regarding Russia's poor respect of immaterial rights. The SEZ's focus on consumer electronics is slightly strange, since the Kaliningrad SEZ is not located far away from St. Petersburg and the Kaliningrad SEZ is considered to be Russia's leading zone on producing consumer electronics, TV sets and vacuum cleaners in particular. The specialisation on aviation offers little, if anything, for foreign firms, since military aviation has been labelled as a strategic sector with a restricted access to foreigners.

As it is not constructive to analyse the plans, promises and hopes of the bureaucrats, one can only conclude that "no progress" means a relative weakening of the competitive position of the SEZ, since their competitors have not been idle for the past four years. To put it differently, Russia's stand-still means that the innovation gap between Russia and the rest of the world widens, as the surrounding world goes ahead, whilst Russia stays relatively unchanged.

Even if the progress in Saint Petersburg is not impressive, one should not forget that the Saint Petersburg SEZ may have a trump card up its sleeves, since Anatoly Chubais, Director General of Russian Nanotechnology Corporation (Rusnano), originates from St. Petersburg. ***It remains to be seen what will be the extent of the future collaboration between Rusnano and the Saint Petersburg SEZ¹⁰***. In this context, one should not forget that Rusnano possesses USD 5 billion funds to be allocated to the development of nanotechnology investments.

Another trump card of the Saint Petersburg SEZ is its western neighbour Finland.

Finland is one of the world's leading high-tech countries, and innovation collaboration between Finland and St. Petersburg would be very natural. In order to facilitate this co-operation, some Finnish innovation facilitators have already entered St. Petersburg.

Technopolis, formerly Oulu Technology Park, operates a technology park and an innovation centre in St. Petersburg. Pulkovo Technology Park will be designed as a platform for Finnish and international companies interested in starting their operations in Russia, and vice versa, for Russian companies interested in internationalisation. Similarly, the innovation centre has been founded to serve those Finnish innovation-oriented firms, which need support in their expansion into Russia¹¹. Although the concept of Technopolis seems extremely good, it is too early to estimate the future of Technopolis' technopark and

¹⁰ In December 2008, Rusnano and the City of St. Petersburg signed an agreement on cooperation. Rusnano has signed five similar agreements with other regions of Russia; Tomsk, Sverdlovsk, Tatarstan, Moscow and the Moscow region (Rusnano 2008).

¹¹ Technopolis and Finpro have started a co-operation in Russia to set up a Finnish Innovation and Technology Centre in St. Petersburg. The centre is going to be a part of Finland's international network of innovation centres. This concept of integrating business and development services with modern premises enables Finnish companies to extend their business efficiently to the rapidly growing Russian market. In February 2008, FinNode St. Petersburg was opened.

innovation centre since there is little evidence with regard to Finnish firms' interest in starting their innovation activity in Russia, where respect for immaterial rights is weak. The forthcoming report of the Pan-European Institute may bring empirical evidence on how the Finnish high-tech firms see the opportunities of St. Petersburg (Kaartemo et al. 2009).

In addition to the Saint Petersburg SEZ and the Finnish actors, there are several other high-tech facilitating organisations in St. Petersburg, such as Bonch-Bruевич Technology Park and the university-based innovation units. For a closer description of these units, see Kaartemo et al. (2009).

It remains to be seen how co-existence among several innovation facilitators proceeds. Hopefully, the city administration does not interfere in the competition but allows natural competitiveness to emerge, or alternatively, it has to be prepared to considerably subsidise the public units. ***Free competition is the best way to avoid costly overlapping between the innovation facilitators, and to create a truly sustainable and globally competitive innovation cluster in St. Petersburg.***

Even if St. Petersburg would turn into a high-tech window of Russia (e.g. Matvienko 2007), one should not forget that foreign investors are not just interested in the window but in the whole house, and therefore, Russia should build their country's innovation system and investment climate as a whole. Particularly, Russia should improve their respect for immaterial rights and support free competition.

If the military-industrial complex will take over Russia's innovation industry, it might well be that foreign investors will see only the frames of the window, while the building itself has disappeared during the renovation process. As Russia cannot rely eternally on its current budget revenue generators - oil, gas, and metals, the failure in Russia's innovation policy would bring dramatic consequences for the future wellbeing of all Russians, and therefore, ***the possible adaptation of the military-led innovation system is a genuine threat to the Russian living standard, since the military-led innovation systems are by nature expensive, inefficient, and corrupt due to their secrecy, bureaucracy and non-competitive nature.***

2.3. Kaliningrad SEZ(s)

The Kaliningrad region is a special place due to its geographical location, and therefore, the federal government has always fed the region with administrative privileges. Kaliningrad was granted a free economic zone (Yantar Free Economic Zone) as far back as in 1990-1991. However, already in 1995 this free economic zone was terminated.

A year later a special economic zone was established. This SEZ is based on duty free imports. If a company is able to add 30% onto the value in the imported product and the product's customs classification code changes, the company can sell this product to the Russian mainland without paying import duties¹². Hence, ***Kaliningrad has become a backdoor for a company which wants to legally avoid Russian customs duties.*** The Magadan SEZ in the Russian Far East follows the same operational model, though slight differences in the legislation exist (Lapin 2006; Liuhto 2007).

The most visible impact of the Kaliningrad SEZ is the increase in the imports of the Kaliningrad region. Currently, the total imports of the Kaliningrad region exceed nearly 10 times the level of the mid-1990's. As the citizens of Kaliningrad consume only a fraction of the imports, the majority of the imported goods serve industrial assembly in the region, and hence, assembly has vigorously supported the regional GDP growth (BRE 2009).

The aforementioned SEZ in Kaliningrad is to be closed in 2016. The same will happen with the Magadan SEZ a few years earlier. It is interesting to note that the Kaliningrad region will face another blow to its budget, when the oil field D-6 located in the proximity of Kaliningrad is to become depleted in 10-15 years from now.

As the old SEZ is to pass away in seven years from now, another SEZ law was adopted in 2006. This SEZ allows companies, both the Russian and foreign ones, to have a tax holiday for the first 6 years and a 50%-reduction of the taxes during the years 7-12.

¹² In consumer electronics only 15% of value added is required.

In order to earn these privileges, a company has to invest at least RUR 150 million (some € 4 million) over a three-year-period. The new SEZ is to be terminated in 2031¹³.

When one analyses the FDI inflow to the Kaliningrad region, one can easily observe that FDI inflow has picked up. In 2005, the annual FDI inflow to Kaliningrad was just € 15 million, whereas two years later it was already close to € 120 million (BRE 2009). In the beginning of last year, the number of the residents in the Kaliningrad SEZ was 55. Even if there is some hot air in the pledged investments, one should note that the investment commitments of these companies exceeded € 600 million. The largest investments were pledged to be placed in soybean processing, plastics production and logistics-related projects. These three projects alone cover more than a third of the investment commitments. At first glance, the share of foreign investments among the SEZ residents does not seem to be particularly large.

Besides the SEZ of the mid-1990's and the new SEZ, Kaliningrad has two additional zones i.e. the tourism zone and the gambling zone.

The tourism zone was founded in 2007, and it has been located on the Curonian Spit. This zone focuses on ecological and recreational tourism. Even if the tourism zone has been placed in a wonderful location, one can hardly expect a major tourism inflow. In this context, one should not forget that the number of Russian visitors in 2006 was no more than 275,000 and foreign tourists some 80,000. Germans made up one half of the foreign tourism inflow and visitors from the Baltic States and Poland together formed another 30% (Liuhto et al. 2007).

The fate of ***the gambling zone*** in Kaliningrad is even less bright, since the construction work of the zone has not even started yet though the zone should already begin its operations in July 2009. Kaliningrad would definitely benefit from gambling activities, but it is rather uncertain whether such a zone will be created. On the other hand, one does not need a gambling zone to open a casino in Kaliningrad i.e. a casino could be established in the Kaliningrad region even if the gambling zone were not opened. However, no rational

¹³ It is interesting to note that some companies simultaneously use the benefits of the old and the new SEZ.

company management opens any casino in Russia until the gambling law has been abolished for good.

To summarise, Kaliningrad offers truly attractive tax conditions for investors planning to place more than RUR 150 million in the region. Similarly, the region's proximity to Central Europe is a major advantage for those producers who do not meet the EU's customs barriers. On the other hand, higher logistical costs involved in transporting goods to the Russian mainland are one of the drawbacks of the region. In addition, the region's relatively narrow labour base does not allow the region to compete with low salaries for long.

Should Kaliningrad truly become Russia's leisure centre on the Baltic Sea, it is self-evident that high-quality construction companies from the West, including those from Finland, may find additional demand for their goods and services. A need for wooden summer houses is definitely growing in the region, when the current financial crisis is over. Furthermore, if Kaliningrad is serious about its nuclear power plant project, some Finnish construction companies recently involved in building the fifth nuclear unit in Finland might find the project in Kaliningrad worth studying in more detail.

In innovation competition the Kaliningrad region cannot beat St. Petersburg with its numerous top level universities and research centres. Similarly, the manufacturing base of Kaliningrad is non-competitive compared with St. Petersburg. As the electronics industry¹⁴ in Kaliningrad will decline along with the closure of the old SEZ in 2016 and the oil income will stop a few years later, Kaliningrad is not left with many options for developing its regional economy. Tourism and services related to it might not seem to be a lottery win for Kaliningrad, but the region does not have so many alternatives (e.g. Boos 2006).

¹⁴ At the moment, Kaliningrad produces 99% of TV sets in Russia (Usanov 2008).

3. What do the Russian SEZs offer for foreign firms?

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.

The Kaliningrad SEZ is by far the most attractive zone for foreign investors, which are ready to invest at least RUR 150 million (approximately € 4 mn) in the region. The reason for Kaliningrad's success is the fact that the zone offers better financial benefits than the zones elsewhere in Russia. On the other hand, Kaliningrad's enclave location decreases the competitive advantages the SEZ offers to a company, which targets the Russian mainland.

There are no major Finnish companies operating in any of Russia's SEZs for the time being, though one company with a Finnish name has been registered in the Saint Petersburg SEZ. Although the Kaliningrad region is unfamiliar to most Finnish investors, ***I advise that Finnish companies considering an investment exceeding EUR 4 million in Russia should make a feasibility study on the investment possibilities in Kaliningrad.*** Besides tax benefits, the administration of the Kaliningrad SEZ has a good reputation for being investor-friendly, and furthermore, Kaliningrad is close to Central European markets. If the region starts to attract more tourists, one could estimate that Finnish construction companies might find additional demand for their high-quality goods and services. Though Kaliningrad offers the best financial benefits, it can be predicted that the Finnish companies follow the development of the Saint Petersburg SEZ more closely than that of Kaliningrad or any other Russian region.

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.***

Epilogue

"Khotelos' kak mozžno luchshe, poluchilos' kak vseгда."

We wanted better, but it turned out as always (free translation).

A saying closely affiliated with former Prime Minister
Victor Chernomyrdin, during the election campaign of 1996

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