

Russia

Macro policy

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New SEZs prove their worth

The 'demonstration effect' of nurseries for direct investment

FDI inflows to Russia seized up in Q4/08, and this year holds scant prospect of a revival. But at the margin there are various means of keeping FDI trickling into the country. Russia's new-generation SEZs are such a vehicle. The infrastructure and, above all, the permitting advantages they offer have already proved effective incentives for European companies setting up production facilities in Russia, especially construction materials and light engineering firms.

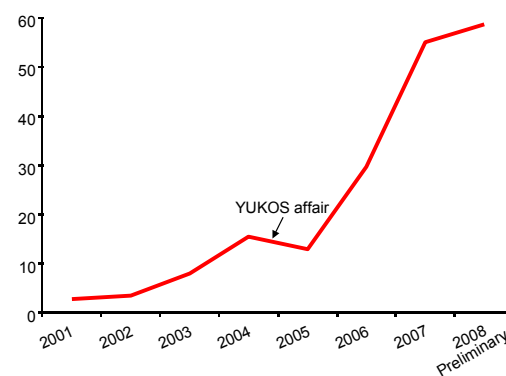
The federal agency responsible for SEZs has come up with a crisis-driven proposal to establish zones without federal funding. This follows the success of various investor-friendly regions, such as Kaluga, that have attracted significant FDI inflows without special zones. The new SEZ model is vindicated by such spontaneous extensions not dependent on Moscow. The appearance – or not – of more foreign SEZ residents this year will be an indicator of the wider resilience of the Russian economy.

Context

Dwindling FDI, resurgent SEZs

After almost five consecutive years in which foreign direct investment doubled annually – the exception was 2005, which saw a contraction in the wake of the YUKOS affair (see chart below) – Russia witnessed FDI growth of just 7 per cent in 2008, according to preliminary figures released by the Central Bank of Russia. The reason for this modest increase was the seizing up of FDI inflows in the fourth quarter as the financial and economic crisis tightened its grip worldwide.

Gross FDI in Russia, 2001-08 (billion US dollars)



While in the short to medium term FDI will remain relatively depressed in absolute terms in Russia – as throughout the emerging markets – a marginal driver of relative economic performance will be countries' success in competing for whatever FDI flows do remain available. Russia's prospects here should be viewed in the light of its fairly recent foray into the establishment of investor-friendly special economic zones (SEZs). While strong arguments have been brought against SEZs in general – the main thrust being that if the investment climate of the zones is beneficial for business, it should be applied to the economy as a whole – and while Russia has already had its own negative experience with SEZs, the Russian government decided in 2004 to make such zones a cornerstone of its policy to diversify the economy and, in particular, promote innovation. As we discuss later in this research note, although the government is reviewing its overall funding approach towards SEZs in the light of the financial and economic crisis, it is continuing to push ahead with the creation of new zones as an essential component of its longer-term economic goals.

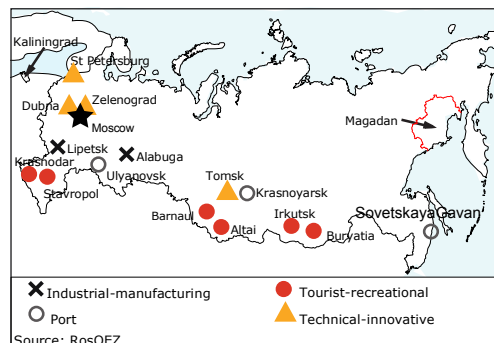
Getting it right second time round: Russia's new SEZ regime

Russia's first stab at making SEZs work on its territory dates back to the final years of the Soviet era. Between 1989 and 2000 a total of 18 free economic zones – as these first-generation SEZs were called – were set up with the primary objective of stimulating the economic development of depressed or border regions. To that end, companies entering these zones were given material tax breaks as well as generous customs and other advantages. However, the zones not only failed to generate any significant new investment

but were also a major drag on the federal budget. In effect, they became either offshore financial centres inside the country – it was these domestic tax havens that became YUKOS’s undoing – or a means of cheap customs clearance, as in the case of the exclave of Kaliningrad. Acknowledging the failure of its first SEZ experiment, the government disbanded all the first-generation SEZs by 2005, with the exception of Kaliningrad and the Far Eastern region of Magadan.

But even as it was closing down the first-generation SEZs, the government was drawing up legislation providing for a second generation of zones (under the stewardship of former Minister of Economic Development and Trade German Gref). Half a dozen years in the making, the new law was signed in July 2005 and went into effect six months later, in January 2006. Above all, it was designed to avoid the problems that had arisen with the first-generation SEZs. In its current form (following amendments in 2007), the law provides for the establishment of a total of four types of zone: industrial-manufacturing; technical-innovative; tourist-recreational; and air, river or sea port. (A separate new law has been introduced to regulate the already existing Kaliningrad SEZ, while legislation on the Magadan zone dating from 1999 remains in force.)

Russia's SEZs



There are at least three fundamental differences between the old and new SEZ regimes. First, whereas in the 1990s all manner of opaque deals were negotiated between the federal government and regional authorities intent on having zones on their territory, the 2005 law on SEZs stipulates a uniform procedure for the creation of the zones. (By the same token, the rights and privileges of the zone residents are no longer up for negotiation but are firmly enshrined in law.) This procedure is based on competition: regions or municipalities take part in open tenders which are adjudicated by special committees for each type of zone and which require the applicants to meet strict criteria.

One of those criteria is that the regional or municipal authorities make a significant contribution towards meeting the cost of constructing the basic infrastructure of the SEZs. This ensures that local governments cannot use the zones as a means to lay their hands on significant federal funds without making any commitment of their own, as was the case in the 1990s. At the same time, it underscores the second fundamental difference between the old and new SEZ regimes: development of the regions is no longer the main goal of the SEZs. Rather, it is the wealthier (so-called donor) regions which are now hosting the new SEZs and for which the zones are an important but by no means crucial instrument in further developing their economies.

The third fundamental difference between the old and new SEZs is that tax advantages are no longer the key attraction for residents. Compared with the excessively liberal – and frequently arbitrarily applied – concessions bestowed

on residents of the first-generation zones, the tax privileges offered today are modest. They are also modest compared with the SEZ tax regimes in India and China, for example. At the same time, Russian residents of SEZs enjoy a customs-free zone, unlike their Chinese counterparts. (Subscribers to our China and India services can read about these countries' most recent SEZ initiatives by clicking [here](#) and [here](#), respectively.)

Table 1: Tax and customs incentives in Russia's SEZs

	Inside SEZs	Outside SEZs
Corporate tax in industrial-manufacturing zones (%)	20	24
Unified social tax in technical-innovative zones (%)	14	26
Company property tax (%)		2.2
Land tax (%)		1.5
Customs incentives*	No customs duties on any goods, supplies or machinery that enter the zone. Full VAT refund on all Russian goods, supplies or machinery that enter the zone.	

* Not applicable to tourist-recreational SEZs.

Source: RosOEZ.

Table 2: Tax and customs incentives in China and India's SEZs

China	India
<ul style="list-style-type: none"> ❑ Corporate tax (which is 30% outside special zones): 15% in SEZs 24% in coastal cities 15% in technology development zones* ❑ Tax breaks for manufacturing industries operating for more than 10 years: First two years of profitability: 0% Third-fifth years: 50% ❑ No customs incentives 	<ul style="list-style-type: none"> ❑ Corporate tax (which is 30%+ for domestic companies and 40%+ for foreign companies outside special zones): 15% ❑ Tax breaks for manufacturing industries and services (on income tax on export income): First five years of profitability: 0% Second five years: 50% Third five years: 50% on export income ploughed back into India ❑ The duty free import/domestic procurement of goods for the development, operation and maintenance of SEZ units

* Today, only technology development zones are, in fact, operating as SEZs.

Sources: Chinese and Indian Ministries of Commerce.

For the industrial-manufacturing and port zones, there is an additional fundamental difference between the old and new SEZ regimes – namely an investment threshold that is aimed at keeping out companies interested solely in tax evasion. The mandatory capital investment for residents of the industrial-

manufacturing zones was set at 10 million euros (of which 1 million euros must be invested during the first year of the residency), while the mandatory investment in port infrastructure is 100 million euros. Setting the bar this high, however, has kept out some of the very companies that the industrial-manufacturing zones, in particular, are trying to attract, and a legislative push to lower the bar significantly is now under way (see below).

The main incentives of the zones

While tax incentives may be thin on the ground under the current SEZ regime, there are other, arguably bigger incentives for setting up shop in Russia's special zones. First, alongside modern transportation infrastructure (where this is not already available), the SEZs provide residents with easy access to gas, electricity and water (as well as IT links). As a result of poor infrastructure, opaque domestic tariff structures and general corruption, connections to such amenities remain notoriously hard to come by in many regions throughout the country, and surveys show that this constraint remains a serious obstacle to investment in Russia.

Another incentive is access to land and security of property rights. Like the difficulty in securing power and other basic services, the difficulty of registering title to land and the overall vulnerability of property rights continue to deter investment. Companies that are awarded resident status in Russia's SEZs receive plots of land that they lease from the government for a sum that cannot exceed 2 per cent of the taxable value of the land. Moreover, if the companies fulfil all the conditions of the investment agreement, they have the right to buy the plots of land that they occupy.

Arguably the biggest attraction is the business-friendly regime of the SEZs. The "one-stop shop" principle allows residents to deal with nearly all the relevant federal and regional agencies in one building located in the SEZ. This is not only a huge time-saving measure for the companies entering the zones – having to run from one agency to another and then wait for the necessary permits can take many months, if not longer; it is also aimed at putting a stop to the very widespread practice of extorting bribes from business for the issue of all sorts of permit. This "one-stop shop" principle, which is being applied for the first time in Russia in the SEZs, is eventually to be used for all public services delivered by the bureaucracy (for our recent research brief on the reform of the bureaucracy, click [here](#)).

Proposed anti-crisis measures

The funding conundrum and 'spontaneous SEZs'

At the end of December 2008, the Federal Agency for the Management of Special Economic Zones (RosOEZ) made a pre-emptive move to prevent the financial and economic crisis from slowing down progress on the development of SEZs. Against the background of the government's anti-crisis strategy of prioritising transfers to sustain demand (and the implications of that strategy for public spending on infrastructure, among other areas), the agency has proposed the creation of SEZs *without* federal funding. This measure would not apply to the zones which are already being developed or – as in the case of the three port zones – for which the tenders have already been held. But, according to the agency, it could apply to two SEZs currently under consideration (a titanium and magnesium production zone in Sverdlovsk Oblast and an auto zone in Samara Oblast).

During the period 2006-08 federal funding for the SEZs totalled Rb36 billion (US\$1 billion); and in the 2009 federal budget approved last fall, Rb16 billion was earmarked for this purpose. At time of writing, the spending cuts in the revised 2009 budget have not been finalised, but the RosOEZ initiative on unfunded zones clearly anticipates a large cut in funding. Under the new SEZ regime, whereby regions hosting the SEZs share the cost of constructing basic infrastructure, the aggregate contribution of those regions does not fall far short of total funding from the federal budget. And as RosOEZ points out, there are at least two prominent precedents for regions bearing even more of the burden of attracting FDI to their territory.

The first such precedent (or soon-to-be precedent) is the Alabuga industrial-manufacturing zone in Tatarstan. In the next couple of years, RosOEZ intends to transfer oversight of the SEZ to the Tatar authorities, which have already invested heavily in infrastructure links within the republic and to neighbouring regions. Alabuga was, in fact, the site of one of the first-generation economic zones; by the time of its closure, in early 2003, it had attracted not only leading auto makers such as General Motors but also manufacturers of auto components. Today, the SEZ, combined with the immediate region around it (where many component manufacturers are located), forms virtually an automotive cluster.

Second, other Russian regions have demonstrated that clusters – or what might even be called “spontaneous SEZs” – will emerge if the regional administration is sufficiently investor-friendly. One such administration is Kaluga, located some 200 kilometres southwest of Moscow. Over the past couple of years, Kaluga has succeeded in attracting a raft of major automotive investments; and, unlike Tatarstan, it has done so without any inherited manufacturing base in that sector. The regional administration has offered corporate and property tax breaks, among other incentives – including, a businesslike approach by local officials to property registration and general permitting. Industrial parks – which do not enjoy the same tax and custom benefits as SEZs but do receive funding for basic infrastructure – are being built around the city of Kaluga’s perimeter. Volkswagen, Peugeot-Citroen and Mitsubishi have all signed up to become residents of the industrial parks, while Volvo opened its truck production plant there on schedule, in mid-January 2009, despite the dramatic global destruction of demand for automotive products – from which, of course, Russia has been far from exempt.

For the direct benefit of the SEZ residents

Other measures proposed by RosOEZ are aimed at directly benefitting the residents of the zones. Topping the list are long-term credits from state-owned banks at subsidised interest rates – an echo of the lifeline that the federal government is extending to the 250 companies included on its strategic support list to help them through the current crisis. Some zone residents are struggling to stick to business plans on infrastructure spending because bank loans are now at 25-30 per cent, compared with the 10-12 per cent range of the pre-crisis period. This is affecting, in particular, the development of the Zelenograd zone in the Moscow region, according to RosOEZ.

As for would-be residents of Russia’s SEZs, their number would be given a considerable boost if the capital investment thresholds for the industrial-manufacturing and ports were lowered, so argues RosOEZ and the Tatar authorities. The latter first made such a proposal in the spring of 2008 (that is, well before the current crisis), noting at the time that smaller auto component makers have, in effect, been shut out of the zone because of the minimum capital requirement. A draft law that passed its first reading in the State Duma in December 2008 proposes lowering the threshold for industrial-

manufacturing zones from 10 million euros to 3 million euros and for port zones from 100 million euros to 10 million euros, respectively. Given companies' dire prospects for obtaining credit under current conditions, the bill is expected to sail through the second and third readings.

Crisis fails to thwart SEZ development so far

So far, the financial and economic crisis has not slowed down the development of Russia's SEZs. In the third quarter of 2008, some 110 residents were registered in the two industrial-manufacturing, four technical-innovative and five tourist-recreational zones created to date (see map above). By mid-January 2009 that total had risen to 155 – and appeared to be rising almost daily. If anything, this points to an accelerated rate of increase in the number of residents in comparison with the first three quarters of 2008. But here a note of caution should be sounded: many of the newest residents are to be found in the tourist-recreational zones, whose development is in any case lagging that of the industrial-manufacturing and technical-innovative zones.

As for FDI inflows to Russia's SEZs, these have been – and remain – concentrated in the industrial-manufacturing zones, both of which were officially opened just over a year ago. The ratio of foreign to domestic companies in the zones now stands between one-third and a half – the same as it was in the third quarter of 2008. While this falls well short of the government's goal (dating from early last year) of achieving a 1:1 ratio or even the outnumbering of domestic companies by their foreign counterparts, it is nonetheless a respectable result under present conditions (see table below for a full list of the residents of both the Alabuga and Lipetsk SEZs).

Foreign residents that have entered the zones since the beginning of October include Air Liquide of France (industrial gases) and ALU-PRO and Fentsi of Italy (aluminium window frames and compressors used in glass making, respectively). The latter two have settled in the Lipetsk SEZ, where there was already a relatively strong presence of Italian light engineering companies. This highlights the potential for foreign residents to attract counterparts from their country of origin, creating small country "sub-clusters" within particular zones.

Table 3: Residents of the Alabuga and Lipetsk SEZs

ALABUGA			LIPETSK		
Company	Country of origin	Product	Company	Country of origin	Product
P-D Tatneft-Alabuga Glass Fibre	Russia	Glass fibre	Bekart-Lipetsk	Belgium	Steel wire rods
Septal	Russia	Equipment for sewage systems	LZSK Window Systems	Russia	Plastic windows and other glass objects
Engineering Equipment Factory	Russia	Heat pumps and parts for air-conditioning systems	Mondial Group Ist	Italy	Refrigerator equipment
SeverstalAvto-	Russian-	Medium- to	Ratsional	Russia	Equipment for

ISUZU	Japanese joint venture	heavy-duty trucks	Production Complex		heat and power industry
Rockwool-Volga	Denmark	Mineral wool products	Lipetsk Heat-Insulating Materials Industrial Complex	Russia	Heat insulating materials
Polimatiz	Russia	Synthetic linen and other polymer products	Belon-Metakon	Russia	Metal construction and building materials
SeverstalAvto-Elabuga	Russia	Cars	Bioetanol	Russia	Biofuels
Air Liquide	France	Industrial gases	Sest-Luve	Italy	Heat exchange equipment
			ChSZ Lipetsk	Russia	Glass products
			Fentsi	Italy	Compressors used in glass making
			Solar industrial company	Russia	Solar energy equipment
			ALU-PRO	Italy	Aluminium window frames
			Energotekhnologii Lipetsk	Russia	Energy and heat production technology
			YOKOHAMA R.P.Z	Japan	Tyres
			RTsNT	Russia	Fullerenes and nano-dispersible materials

Source: RosOEZ.

Trusted Judgements

Aleksei Overchuk, former Deputy Head of RosOEEZ and now, as a Director of UFG Asset Management, a member of the special committees overseeing the various types of zone

Improving the overall business environment is the primary (albeit long-term) objective ...

The main idea behind the new-generation SEZs is reducing bureaucratic barriers and creating a better business environment. This reflects the broader discussion that took place in the government during the lengthy period in which the new law on SEZs was debated.

SEZs can be viewed, above all, as pilot projects in which the government tests relationships between the various agencies subordinated to it and seeks to establish an improved climate for companies doing business in Russia. This goal is best achieved in a closed environment, such as exists in the SEZs, where ideas can be tried out and lessons learned that will be relevant for longer-term policies. At the same time, it is important to stress that the zones are real working environments. Eventually, it is hoped, those ideas that have proved their worth in the zones can be applied throughout the country.

... while the development of modern business infrastructure is equally key

Since the 1990s there has been no real government investment in infrastructure – particularly in infrastructure that supports business. The new-generation SEZs are the first attempt to work out mechanisms for developing infrastructure that will directly help companies: substantial federal and regional budget funding has been directed towards this goal, and infrastructure in the zones is now being built in accordance with a schedule approved by former Economic Development and Trade Minister German Gref. This sends a clear signal to business that if you want an environment with modern infrastructure, you will find it in the SEZs.

This state investment constitutes the main – and often overlooked – financial incentive for SEZ residents. The benefits from the tax and customs advantages for the residents of SEZs are nowhere near as significant as the savings that are made on investment into infrastructure.

Clarity of land title is an often overlooked advantage

Another frequently overlooked advantage for residents of the SEZs is access to land. The process is very simple and transparent. All an SEZ resident has to do is to declare just how much land it will need – and the relevant authorities will provide a plot of the required size. Moreover, it has the right eventually to buy this plot – and, no less important, at a price that will be far below the market value bearing in mind the government-funded infrastructure that will have been built around it. This clarity of title to land, guaranteed by law, is a

very important for any company wishing to do business in Russia.

The port zones could have a major impact on the economy

An exciting development is the emergence of the first port SEZs in Russia. These zones have the potential to make a real impact on the economy as a whole. Above all, they could help facilitate the establishment of a transport corridor between the Russian Far East and Europe – which has long been the subject of government discussion. This would give a tremendous boost to economic development in this very underdeveloped and neglected region.

Wrap

The attraction of state-funded infrastructure in SEZs, which our trusted source underscores, will be difficult to maintain as long as the present economic shock persists. That much is clear from the proposal to establish further zones without federal funding. But since the crisis has in any case reduced FDI inflows to a trickle, we believe that spare land and infrastructure capacity in the zones already up and running should suffice to satisfy companies interested in zone residencies at least for the rest of 2009.

Meanwhile, the main attraction of the zones remains immune to the crisis – namely, that they offer an environment in which direct investors can avoid what President Medvedev calls the “nightmare for business” created by the bureaucracy and law enforcement agencies. The “demonstration effect” of this (to borrow some development bank jargon) is real. The ambitions and achievements of Anatoly Artamanov, the FDI-friendly governor of Kaluga, constitute impressive evidence of the SEZ approach germinating outside the nurseries of the zones themselves.

The SEZs are also contributing to the strategic goal of diversifying the economy by providing an environment which is not so necessary (or suitable) for large-scale foreign investors with high-level political access, such as BP, but which can make an important difference for mid-size European companies in sectors like light engineering and construction materials which are aiming to establish a strategic presence in the Russian market.

Of particular interest will be whether during the crisis the incentives offered by working SEZs in Russia can tip the balance in direct investment decisions against the negative factor of deteriorating IRRs. The evidence to watch out for will be the number and quality of new SEZ residents this year.

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