

# **ROLE OF THE GOVERNMENT IN THE DEVELOPMENT OF SPECIAL ECONOMIC ZONES AND INDUSTRIAL PARKS IN RUSSIA**

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## **Abstract**

This paper investigates the process of developing and implementing special economic zones (SEZs) and industrial parks (IPs) in Russia. Russian government used these initiatives to develop and diversify exports, increase employment, attract foreign direct investment (FDI), and launch technology and knowledge sharing processes. The neoclassical approach, political economy approach, heterodox school, and industrial cluster model have been relied on to evaluate the role of the state in the implementation of these initiatives and identify essential factors for sustainable development. This study reveals that government approach in developing SEZs and IPs implied high state interference into the business processes preventing healthy competition and collaboration within the economic zones. Also, lack of funding, political instability and overall business uncertainty were the main prevent factors for the sustainable growth of the economic zones. The paper suggests that for the development of SEZs and IPs in the Russian context, the important factors are personal networks between private investors, regional managers and federal government, as well as appropriate state regulations and general investment climate of the country.

**Key words:** special economic zone, industrial park, Russia, cluster, government

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## **Introduction**

The implementation of SEZ policies is used as an effective tool for strategic planning and infrastructural enhancement by developing countries. These initiatives facilitate export diversification, industrial and economic growth, attract local and foreign investments, increase employment, and stimulate technology exchange and knowledge sharing (Aggarwal, 2012). In Russia, there were several attempts to implement economic zones of different types in the 1990s. After the failure of implementation of Free Trade Zones in Kaliningrad and Magadan regions due to various corruption schemes and legislation uncertainty that resulted in tax

avoidance activities among entrepreneurs, in 2005 the federal government initiated the second attempt of creating SEZs and IPs policies: the President signed the decree №116-Federal Law “Establishment of special economic zones (SEZs) in Russian Federation”, which comprised the formation of four types of SEZs: industrial, innovation, tourist, and port and logistics zones (Yankov et al., 2016). This study investigates the SEZs of industrial type only, as seeking for methods to increase an industrial growth is a vital subject for the Russian economy.

The conception of the IPs did not emerge until the early 2000s. Before, there were merely industrial zones with no administration and delimited territories. First parks appeared in the 2006s mainly in the Tatarstan Republic, Kaluga, Moscow, Leningrad, and Ulyanovsk regions. After the establishment of Association of Industrial Parks (AIPs), which was a public organisation responsible for facilitating the development of IPs in Russia, under the support of the federal government the program was devised under the Act №233 from the 23rd of April 2012, which implied that the regions were granted to receive federal funding on a competitive basis to finance the activities related to the establishment of the IPs. Also, this program implied the provision of funding to small-medium enterprises (SMEs) that became the tenants of the parks (Volkonitskaia, 2015). SEZs and IPs have been predominantly established in the areas with declining economic trend. Local governments have made a decision to reconstruct the existing manufacturing sites with insufficient infrastructure and low production capacity and instead, to build large industrial zones with certain attractive conditions to attract potential investors: individually prepared infrastructure for each potential investor, autonomous customs zone with simplified procedures and duty-free benefits, more liberal economic and juridical regulations, perspective partnerships with other companies, proximity to local companies, labour resources, new potential markets for growth, and fiscal benefits (Sandler & Kuznetsov, 2015; Volkonitskaia, 2015).

**Table 1. Tax differences on the territory of the SEZs and in the rest of the county**

| Tax name      | Country                      | SEZ        | Tax benefits period |
|---------------|------------------------------|------------|---------------------|
| Income tax    | 20%                          | 13,5-15,5% | 49 years            |
| Property tax  | 2,2%                         | 0%         | 10 years            |
| Transport tax | 6-150 rubles per horse power | 0 rubles   | 5 years             |
| Land tax      | 1,5%                         | 0%         | 5 years             |

Source: Yankov et al. (2016)

Fiscal incentives in the forms of reduced tax and customs rates can slightly vary, but, overall, they are lower than in the rest of the country (Table 1). There are stately and privately owned

parks in Russia, but fiscal incentives are offered to investors mostly in the state ones. Although the establishment of the economic zones is typically initiated by the government (Moberg, 2015); in the Russian case, there has not been done any detailed strategic planning in implementing these policies. Due to the absence of precise guideless from the central administration in Moscow, shortage of relevant experience and knowledge, local state officials have made some first attempts to develop the SEZs and IPs in their regions striving to cope with various political, economic and organisational difficulties. Consequently, while some projects succeeded and demonstrated impressive results, others struggled in their development. The contribution of this paper fills the gap in the literature concerning the role of the government and policy-makers in the implementation stages of the economic zones in Russia. It also examines the emerging issues in the establishment process and suggests factors facilitating further development of SEZ and IP initiatives in Russia.

## **1 Literature review**

### **1.1 Definitions**

SEZ is a geographic concentration of companies on a certain demarcated area. The common definition embraces different variations of traditional commercial zones that contains some basic essential characteristics: the territory of the SEZ is delimited, it has a single administration, it provides various fiscal incentives (e.g. tax benefits), it offers a separate customs zone with duty-free policies, and it gives more liberal economic and juridical regulations than outside the zone. SEZs typically provide better infrastructure as well: they are commonly established on the basis of the strategic industrial policy to stimulate regional economic development, which involves offering incentives to attract investors to a particular location. Some examples of the SEZ types are Export-processing zones, Free trade zones, Science parks, Industrial parks, Freeport, Single Factory Zone, etc. (Zeng, 2012)

The industrial park is the territory zoned and planned for the purpose of industrial development. It is commonly located in the suburbs of or completely outside a city's residential areas, but it has well-developed transportation connections, such as roads and rails. This concept is predominantly based on two core pillars: establishing the necessary infrastructure in a specifically restricted territory reduces certain expenses for businesses (e.g. roads, rail sidings, electricity, water, and gas), and the distant localisation of industrial zones decreases their environmental impact on urban areas. If SEZs are predominately created for multinational

enterprises (MNEs), whereas the IPs are a sub-type of the SEZs, but a smaller version that is specifically designed for SMEs (Geng & Hengxin, 2009).

The economic zones are expected to loosen the infrastructural complexity that may complicate the inflow of investments into the regional or national economies by offering potential investors established manufacturing sites with prebuilt essential utilities (sewerage, water, electricity, etc.) and leases for long-term perspectives. Besides, the economic zones simplify administrative procedures concerning registration of the enterprise, gaining licences, easier access to vital services, such as construction, outsourcing, etc. Typically, the management of the zone provides “single window” or “one-stop” policy service that involves taking all the duties and obligations to organise administrative processes. Finally, the important service offered to investors is customs administration with fiscal incentives. As a rule, it is located within the zone or at the gate and provides customs clearance services to accelerate and simplify import and export procedures (Aggarwal, 2012; Zeng, 2012).

## 1.2 Theoretical approaches

The neoclassical approach suggests that SEZs are areas providing more open and liberal trade regulations with the aim to promote business operations, and free trade is the best option for the government to employ. However, the economic zones lead to unfair competition between inside and outside companies, reduce government profits and, in case if the rest of the economy is not liberalised, they persist on being manufacturing areas providing small contribution to the economy. The neoclassical approach suggests that SEZs are beneficial when the government uses them as additional stimulative instruments for more complex economic reforms. The role of the zones is temporary assisting the transition period of the economy from import substitution policy to free trade concept with little state participation. They are not a method to liberalise the regime but are the consequences of liberalised economy (Madani, 1999).

The perspective of the political economy approach is based on the theory of ‘minimalist government’, which argues that the best approach for all nations is to liberalise the economy. Free trade along with the little government participation can guarantee the development. But it suggests that implementation of the SEZs involves generating rents to a few investors by easing land procurement and providing fiscal incentives for the cost of the rest of the local population, which results in the reduction of prosperity (Moberg, 2015).

The Heterodox school suggests the combination of state and market interactions, which implies an essential role of the government in investment, human capital formation, technology attainment, institutions establishment and the implementation of relevant policies and reforms.

Local companies do not possess sufficient marketing, technical or managerial capacity, and rarely have access to international markets and distribution channels. So, the government provides this aid through the implementation of SEZ policies by improving the investment climate through well-organised infrastructure, good management, skilled labour, fiscal incentives and more simplified regulatory system. These measures facilitate attraction of FDI, which comes with more sophisticated technologies and managerial experience. The localisation of foreign companies produces significant spillovers, which imply knowledge, skill and technology sharing processes (Chang, 2006).

The success of clusters is based on the following key elements: competition, collaboration, firm structure and strategy, demand conditions, knowledge exchange and innovations, production diversification and the emergence of supplementary industries (Porter, 2003). SEZs have to pursue these factors to achieve growth (Aggarwal, 2012). The benefits of clusters are rooted in knowledge spillovers, resource sharing and labour pooling. Besides, they improve productivity and stimulate innovation through the mutual implementation of technologies, information, specialised labour, competing companies, supplementary firms, research centres and universities, and other relevant organisations (Ketels, 2013). More active and developed interaction of these factors facilitates the productivity growth within the clusters; as well as, the proximity of firms fosters the intensity of this interaction. Some enhanced SEZs are based on the conception of industrial districts suggested by Becattini (2002), which implies social and cultural linkages between firms and people within the cluster that consequently create trust and self-help relations. In general, SEZ policies enable the host country to penetrate the global value chain through offshoring and offshore outsourcing. Hence, they stimulate both local and foreign investments (Zeng, 2012).

## **2 Methodology**

The data collection comprised mixed method approach: interviews, questionnaires, and the usage of financial figures of the organisations. Data has been collected from the managing companies of the SEZs and IPs, their tenants, some policy makers of the regions, in which these economic zones have been established. The data collection process has been conducted from January till November 2016. All six SEZs of industrial type participated in this research: Alabuga SEZ in the Tatarstan Republic, Lipetsk SEZ in Lipetsk region, Kaluga SEZ in Kaluga region, Moglino SEZ in Pskov region and Titanium Valley SEZ in Sverdlovsk region. The list of IPs has been taken from the annual analytics report conducted by the AIPs in Russia in 2015.

The financial data of the organisations that participated in this research has been obtained from the SPARK-Interfax database. Questionnaires were distributed via emails as MS Excel files among the tenants of the SEZs and managing companies of the IPs. Interviews were conducted via the Skype call predominately with the managing companies of the SEZs and other groups of participants mentioned above that had completed questionnaires and additionally agreed to be interviewed. Overall, there were conducted 36 interviews and received 344 questionnaires from the economic zones located in 25 regions of Russia.

The interview and survey questions have been composed according to the relevant five themes, which have been identified as the result of the literature review analysis. Section 1 inquired the data about the establishing process of the SEZs and IPs, some information about the managing companies and the tenants. Section 2 concentrated on the market topic specifically emphasising the linkages with other tenants within the economic zone and the significance of export-oriented activities (Madani, 1999; Moberg, 2015). Section 3 was based on the cluster theory that suggested the importance of three factors (competition, cooperation, and innovation) for facilitating the development (Ketels, 2013; Porter, 2003). Section 4 investigated the role of the state in the development of the economic zones, which is mainly built on theoretical frameworks discussed in the SEZ literature (Aggarwal, 2012; Zeng, 2012). The last Section 5 inquired the general data about success and prevent factors for sustainable development according to the views and perceptions of the respondents. Interview findings and open question responses have been analysed using the thematic method. SPSS software assisted in evaluating results of the questionnaires and the financial data of the organisations.

### **3 Results and Discussion**

The SEZs and IPs have already made some primary positive effects on the Russian economy: attracted FDI into the regional economies, increased employment, enhanced local infrastructure and production capacity, and launched minor collaborative activities between companies inside and outside the zones. On average, the creation of one workplace within the economic zone led to the creation of four to five workplaces outside. Findings outlined the following five core factors that had a significant impact on the development of the SEZs and IPs in Russian business environment.

*Investment climate:* Countries compete to attract new investors, and they must be competitive in their investment costs. In Russia, investment costs are high, and the sales market does not have big potential for growth, local and foreign companies are demotivated to invest

into Russian SEZs and IPs actively. Political and economic instability are also key factors that prevent investors from coming into Russia.

*Political stability:* According to the findings, political stability is essential not only at the federal level but the regional one as well. The regional administration should contain the permanent groups of managers that could work on the SEZ and IP projects. Tenants expect the regional administration to promote local economic zones, meet potential investors and more important – provide a political guarantee in fulfilment of the contractual obligations. Due to political and economic instability and overall uncertainty in Russian business environment, some potential investors (especially, foreign ones) require a political guarantee from the regional governors. Typically, it confirms and proves that the local economic zone is a feasible and reliable project.

*Financial factor:* Political stability provides regular state funding for the projects, which is essential for the establishment of the basic infrastructure. Efficient funding from the government quickens the procedure of the infrastructure preparation. Respondents gave the example of the Sverdlovsk region where initially the idea of Titanium Valley SEZ creation emerged in 2005, but, in fact, the project started operating in full capacity with established infrastructure only in 2013. Such a big gap was due to political instability in the region (local governor had been changed twice); hence, the SEZ didn't receive stable funding for its development. As a result, the economic zone failed to attract many potential investors. However, the importance of the financial capacity commonly depends on potential investors as well, which is an essential consideration for the project's success. Some investors have experienced financial problems in Russia since 2014: because of the economic recession, bank interest rates have increased dramatically. Consequently, businesses don't have enough financial capacity to launch new investment projects and cannot take loans in the banks because of the high-interest rates. Moreover, according to the findings, the government showed a lack of financial support for privately owned IPs. Furthermore, regional governments promoted state-owned IPs more intensively. The state officials claimed that the financial support was provided for all projects through special banking lending programs equally. However, entrepreneurs were not satisfied with these programs, as they involved time-consuming and complicated bureaucratic procedures and the financial support was inadequate.

*Personal networks:* The regional administration acts as an intermediary that helps to bring federal funding to the economic zones, promote them, meet potential investors, and assist in developing legislation. It must have a privilege for the federal government to arrange and receive all these benefits for the economic zones. Despite that it is advantageous both for the

SEZ and IP tenants to have personal networks with the regional or federal governments, it is more significant to have these networks for the managing companies because they are mainly responsible for the development of the zones.

*Amended industrial cluster model:* The findings suggest the absence of competition between tenants of the SEZs and IPs. Both the managing companies and tenants strive to avoid a competitive environment within the zone. Some potential investors do not come to a certain economic zone because of the existing rivals in it, or they negotiate with the managing companies to avoid attracting companies that operate in the same industry segment. The managing companies prefer to honour these requests or even do this job in advance without the investors' appeals. Moreover, the respondents did not notice many active cooperative networks among the tenants in the zones. It can be due to the remaining socialist mentality of the Russian entrepreneurs: resistance toward cooperative networks and knowledge sharing processes, as well as avoidance of competition and perceiving it as a threat (Ivanov, 2016; Kuznetsova & Roud, 2014).

## **Conclusion**

The government plays a significant role in the development of the SEZs and IPs in Russia. It has created a vicious circle: it wants to control all the business activities, and at the same time entrepreneurs count too much on the state support as well. It is rather difficult to identify the borderline when state support is necessary and when businesses should rely on themselves only. The findings confirmed that the government approach in developing the economic zones in Russia implied high state interference into the business processes preventing healthy competition and collaboration within the economic zones. According to the cluster concept, the absence of cooperative and competitive environment does not result in innovation activities, the creation of knowledge spillovers, technology exchange processes and production growths (Ketels, 2013; Porter, 2003). Findings revealed that approximately ten years after the implementation of some economic zones, innovative activity was still rather low. Nevertheless, the analysis of the financial results of the SEZ and IP organisations showed that the regions with the active participation of the regional governments in the development of the economic zones were the most successful.

**Table 2. Total 10-year revenues of the managing companies and tenants of the SEZs and IPs, US dollars\*\***



| Managing companies |                         |             | Tenants           |                |    |
|--------------------|-------------------------|-------------|-------------------|----------------|----|
| №                  | Region                  | Total, \$   | Region            | Total, \$      | №  |
| 1                  | Leningrad region*       | 482 506 262 | Kaluga region*    | 56 709 700 672 | 1  |
| 2                  | Tatarstan*              | 277 730 328 | Moscow region*    | 8 079 403 856  | 2  |
| 3                  | Moscow region*          | 56 857 492  | Tatarstan*        | 5 946 807 484  | 3  |
| 4                  | Kaluga region*          | 38 472 164  | Ulyanovsk region* | 4 465 218 721  | 4  |
| 5                  | Vladimir region*        | 24 948 951  | Bashkortostan     | 4 201 727 368  | 5  |
| 6                  | Lipetsk region*         | 21 027 885  | Leningrad region* | 1 881 207 000  | 6  |
| 7                  | Nizhniy Novgorod region | 18 352 984  | Samara region*    | 1 352 745 705  | 7  |
| 8                  | Ivanovo region          | 18 070 590  | Lipetsk region*   | 679 459 000    | 8  |
| 9                  | Pskov region            | 10 089 000  | Voronezh region   | 678 989 873    | 9  |
| 10                 | Belgorod region         | 8 833 426   | Vladimir region   | 538 488 087    | 10 |

Source: data extracted from SPARK-Interfax database and calculated by the author

\* - Active participation of the regional government in the development of the economic zones

\*\* - 1 US dollar equals 61 rubles: average value during 2015 according to Central Bank of Russia

Table 2 shows the ten-year revenues of the ten regions with the most successful economic zones: the regions with the high state support and participation revealed high financial results both among managing companies and tenants of the zones. Regional policy-makers and the governors, in particular, are expected to express the personal interest in developing the economic zones in their regions, promote the projects at all possible levels, arrange meetings with big investors, build warm relationships with them and provide a political guarantee, if necessary.

The Heterodox approach proposes the cooperation between state and private sectors, in which through the SEZ programs the government helps the local companies to improve technological and managerial capacity, build the cooperative networks with foreign firms and obtain access to national and international markets (Chang, 2006). But the financial results of some Russian SEZs and IPs are still not impressive; thus, purely the Heterodox approach is not applicable. This study suggests a different management model in the Russia's context, which implies the significant role of the government in the development of the economic zones. It also comprises the importance of personal networks between private investors, regional managers and federal government, as well as appropriate state regulations, in-time funding, and general investment climate of the country.

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