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**The economic impact of the EU enlargement  
and forthcoming change in legislation  
of the special economic zone upon  
the Kaliningrad region**

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# **The economic impact of the EU enlargement and forthcoming change in legislation of the special economic zone upon the Kaliningrad region<sup>1</sup>**

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## **1. The main objectives of the study**

The rapid economic transition of the Baltic States and Poland along with their recent EU memberships raises the question, has the Kaliningrad region<sup>2</sup> benefited from the EU coming to its borders or has the region suffered from the EU enlargement? In this short report, the author aims at answering the question, *what is the socio-economic impact of the EU's latest enlargement upon the Kaliningrad region?*

The study focuses on analysing change in the region's foreign trade and foreign investment, due to the fact that the region's external economic relations are likely to experience changes earlier than the rest of the economy. Here, one should keep in mind that major changes in economic behaviour do not occur overnight, and hence, one is only able to analyse the immediate impact of the Union's expansion on Kaliningrad. One should not forget that some immediate reactions to the enlargement are probably only temporary ones. Furthermore, it is extremely important to keep in mind that just a year has passed since the enlargement occurred, and therefore, all the necessary statistical data is not available yet.

Secondly, one may ask *what are the possible economic consequences of the legislative change concerning the special economic zone to the Kaliningrad economy?*

In time of writing this article, only the first reading of the act on the Kaliningrad special economic zone (SEZ)<sup>3</sup> has taken place in the State Duma. Therefore, the analyses have to be carried out on the basis of the draft law. Major changes in the final law may invalidate the analyses made in this paper<sup>4</sup>.

Before one is able to deal with the two aforementioned research objectives, one should have a look at the economic potential of the Kaliningrad region prior to the EU expansion. An overview of the region's economic potential is necessary to comprehend the true impact of the EU enlargement and to better estimate the economic consequences which change in the SEZ legislation may cause to the Kaliningrad region.

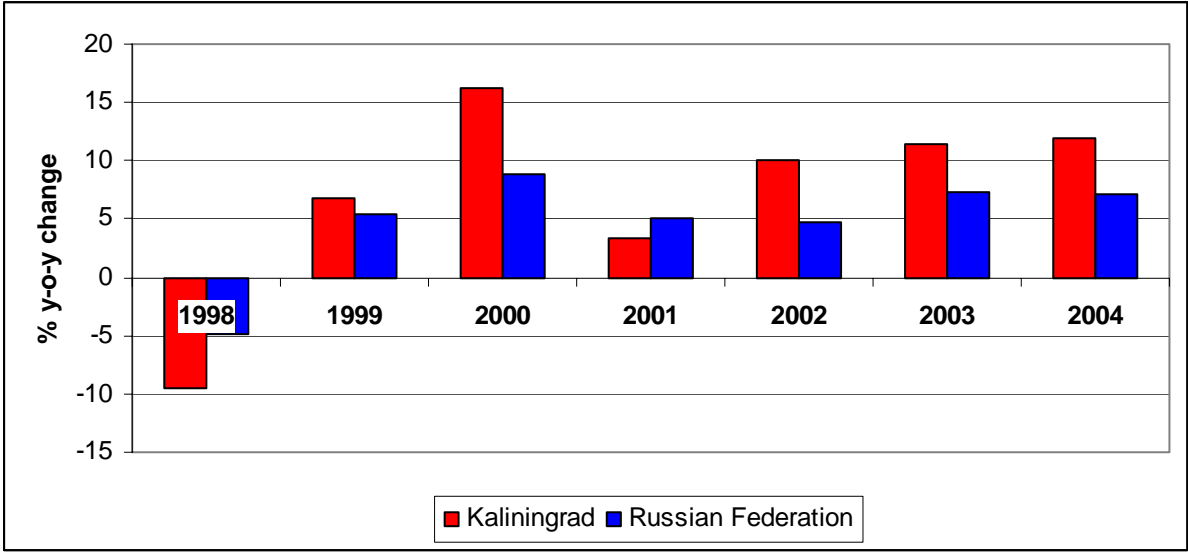
## 2. An overview of the Kaliningrad region’s economy

### 2.1. The economic potential of the Kaliningrad region prior to the EU enlargement

Russia’s economic slowdown in the 1990s had major consequences for Kaliningrad. By 1999, the region’s industrial production fell by over 60 per cent compared with 1990, as old production and trade relations were eroded. Since then the Kaliningrad region has rapidly started to recover.

During the past three years, the Kaliningrad region has grown considerably faster than the Russian Federation as a whole. Annual GDP growth rates in Kaliningrad have exceeded 10 per cent during the period 2001-04, whereas economic growth in Russia has remained between 4-7 per cent. If the Kaliningrad region manages to maintain such a high growth rate, the region is able to meet the ambitious goal of doubling its economic size in 10 years<sup>5</sup>. Should the growth of the 2001-04 continue, Kaliningrad is already able to double its regional GDP by the end of this decade. However, in order to maintain such a high growth rate, the regional companies need more energy, since energy bottlenecks are already currently slowing down the economic growth (see Table 1)<sup>6</sup>.

**Table 1. Annual GDP change in Kaliningrad and Russia, % y-o-y**



Source: Pan-European Institute (2002-2005a)

Despite Kaliningrad’s impressive growth, some statistics produced by the Russian statistical service (Rosstat) suggest that the living standard in Kaliningrad is lower than in Russia on average. For instance, Kaliningrad’s average monetary income in June 2005 was RUR 6571 (€187), approximately 85 per cent of the Russian average. The passenger car intensity and meat consumption per person, however, give an opposing picture of the region’s living standard. When using these material wellbeing indicators, Kaliningrad outperforms many Russian regions. Furthermore, the author’s own observations in various Russian regions lead him to think that the Rosstat data is not fully able to describe the true picture of wellbeing in Kaliningrad, probably due to a large chunk of unrecorded economy, and therefore, the real living standard in Kaliningrad is most likely higher than in Russia on average (Liuhto et al., 2004; 2005).

Kaliningrad ranks as the 37<sup>th</sup> among 89 Russian regions<sup>7</sup> in terms of its investment potential. The region's infrastructure, its transport infrastructure in particular, is highly developed by Russian standards. For example, Kaliningrad has Russia's only ice-free ports on the Baltic Sea shore. In addition, the Pan-European Transport Corridors 1A and 9D go through the region. Therefore, it is not surprising that Kaliningrad ranks 3<sup>rd</sup> after St. Petersburg and Moscow in terms of its infrastructure potential. On the other hand, the region's labour, financial, production, innovation, and consumption potentials are somewhat lower than the Russian average (see Table 2).

**Table 2. The investment potential of Kaliningrad among Russia's 89 regions**

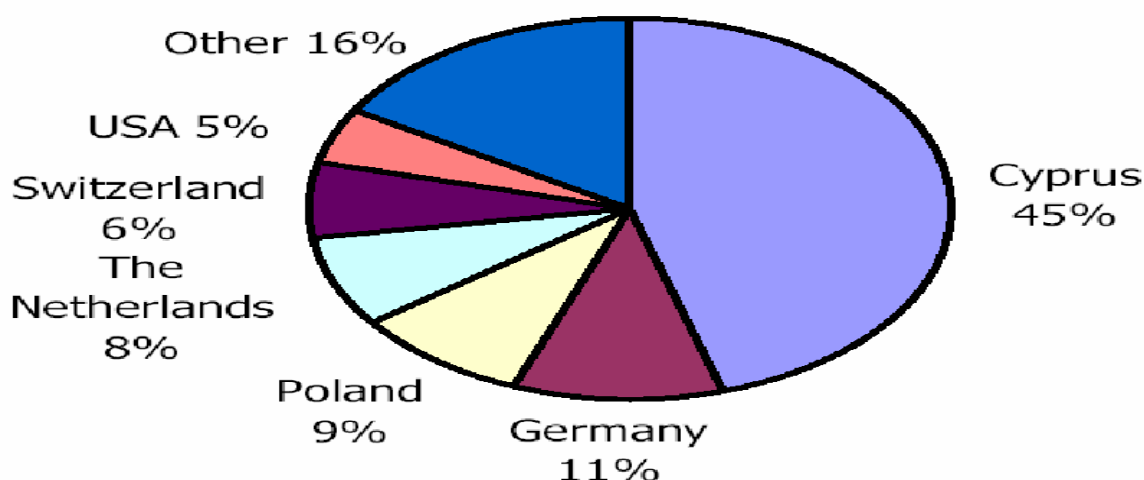
Investment potential 2003-2004	37
Change from previous year (a deterioration of 2 positions)	-2
Infrastructure potential	3
Institutional potential	29
Natural resource potential	40
Labour potential	52
Financial potential	52
Production potential	53
Innovation potential	54
Consumption potential	58
Investment risk 2003-2004	22

Source: Expert 2004

Relatively low investment potential is one of the reasons why the amount of foreign investment in Kaliningrad is relatively modest. The region accounts for not more than 0.2 per cent of the foreign investment stock of the Russian Federation. The aforementioned stake is even lower than Kaliningrad's share in the Russian GDP, 0.4 per cent. This indicator suggests that Kaliningrad does not perform as well as the country as a whole in attracting foreign investment. This implies that Kaliningrad has not succeeded in putting to full use its geographical proximity to the EU or the SEZ to attract foreign investments there.

Kaliningrad's accumulative foreign investment inflow amounted to nearly USD 300 million by the end of 2003. In 2003, Cyprus, with a 45-per cent share, was the largest investor in the region, indicating that the major part of 'foreign' investment originates from Russia. If one excludes 'Cyp-Rus' investment from the foreign investment stock, the major foreign investors come from Germany, Poland and the Netherlands. The active presence of Cyprus, Germany and the Netherlands in Kaliningrad is not a surprise, since they are also among the leading investors in the Russian Federation as a whole (Pelto et al., 2004). Similarly, Poland's presence in Kaliningrad is anything but unexpected due to her geographical proximity. Lithuania's absence from the list of the main investors in Kaliningrad indicates that Lithuanian firms have concentrated more on less-capital intensive business operations, mainly on trade and services, rather than on industrial production, as the number of Lithuanian firms in Kaliningrad is noteworthy. Here, one has to remember that companies based in the neighbouring countries may utilise the opportunities of the target region without investing there, which may also explain the modest investments of Lithuanian firms in Kaliningrad (see Table 3).

**Table 3. Foreign investment inflow to Kaliningrad in 2003 by country**



Source: Pan-European Institute 2005a

Here, one should not forget that Lithuania and Poland are not major capital-exporting countries. Their combined outward foreign direct investment stock is less than USD 2 billion, i.e. Lithuanian firms have invested abroad only USD 0.1 billion and their Polish counterparts USD 1.8 billion. The outward investments of Lithuania and Poland are clearly smaller than those of the Nordic countries. Denmark, Finland and Sweden have invested USD 77 billion abroad, USD 69 billion and USD 189 billion respectively. Russia's own investments abroad amount to over USD 50 billion (UNCTAD, 2004; Vahtra & Liuhto, 2004).

Kaliningrad's foreign trade has developed extremely positively. In 1992, Kaliningrad's foreign trade amounted to not more than USD 0.14 billion. In 2003, their turnover has become nearly 20 times larger. In 2003, the region's imports were valued at USD 2.1 billion and the exports USD 0.6 billion. The sales of Kaliningrad to the Russian mainland amounted to USD 1.1 billion. Then, Kaliningrad's sales to the Russian mainland were over a half, compared with the region's imports. The aforementioned ratio stresses the great importance of the SEZ in boosting Kaliningrad's sales to the Russian mainland<sup>8</sup>. The region's import structure and the list of the main importers confirm the above conclusion (see Table 4).

**Table 4. The largest importers of the Kaliningrad region in 2003**

Rank	Company	Field of operation	Share of region's total imports
1.	Telebalt	Electronics	5.9%
2.	Avtotor	Automobiles	5.2%
3.	Promexportimport	Household appliances	2.6%
4.	Interfood	Foodstuffs	2.4%
5.	Lukoil-Kaliningradmorneft <sup>9</sup>	Oil business	2.3%
6.	Agerratum	Foodstuffs	1.7%
7.	Stella Plus	Electronics	1.4%
8.	Sodruzhestvo Kargo	Material for fodder	1.3%
9.	Podonit Plus	Black metallurgy	1.1%
10.	Produkty Pitanya	Foodstuffs	1.0%
<b>Total of 10 major importers</b>			<b>24.9%</b>

Source: Liuhto et al. 2005

Kaliningrad plays an important role in the Russian Federation's foreign trade, especially in the country's imports. The region accounts for 4 per cent of the country's total imports, though the population of the region covers only less than 1 per cent of the federation's population and less than a half percentage of the country's GDP.

It is natural that the foreign trade intensity of a small economy, especially when it is geographically located apart from the mainland, becomes high<sup>10</sup>. However, Kaliningrad's current SEZ, based on customs privileges, is a more important factor than its exclave<sup>11</sup> position or small economic size in explaining the region's high import intensity<sup>12</sup>. The aforementioned argument can easily be explained by comparing the region's proportion of the Russian Federation's total imports and exports.

The region accounts for 4.0 per cent of the Russian Federation's imports, whilst merely 0.4 per cent of the country's exports. Such a high import share cannot only be explained by the exclave position or the small size of the regional market. Correspondingly, the region's export share corresponds to its GDP share, suggesting that Kaliningrad is not a particularly export intensive region. The low export intensity refers to the relatively weak competitiveness of Kaliningrad-based goods abroad. Here, one should not forget that improving the external competitiveness of goods via the SEZ is a much more demanding task than that of improving their internal competitiveness, i.e. the competitiveness of Kaliningrad-produced goods inside Russia (see Table 5).

**Table 5. The Kaliningrad region in the Russian economy**

<b>Kaliningrad's share of the Russian total</b>	
<b>Basic facts</b>	
Area	0.1%
Population	0.6%
<b>Economy</b>	
Gross domestic product	0.4%
Industrial production	0.5%
Retail trade	0.5%
Enterprise population	0.9%
<b>External economic relations</b>	
Exports	0.4%
Imports	4.0%
Foreign investment	0.2%
Number of companies with a status of "a firm with foreign capital"	2.0%

Source: Rosstat 2004

## **2.2. Kaliningrad in international comparison**

Kaliningrad's economic recovery seems less glorious when compared to Poland or particularly to the Baltic States, which belonged to the same country less than 15 years ago. The table below shows that the GDP per capita in Kaliningrad is less than a half of that in Latvia, which has the lowest living standard amongst the Baltic States.

Kaliningrad succeeds better with its external economic relations. Its exports per capita are already two thirds of that of the Latvians, and its imports per capita are higher than in Latvia and Poland. When analysing Kaliningrad's high import intensity, one should naturally remember that a great part of the region's imports are finally targeted to the Russian mainland, which distorts the aforementioned comparison.

The weak performance of the Kaliningrad region becomes more obvious, when analysing the region's attractiveness in the eyes of foreign investors. The FDI stock per capita in Latvia, Lithuania, and Poland is 5 times that of Kaliningrad. The gap between Estonia and Kaliningrad is even wider – 20 times (see Table 6)<sup>13</sup>.

**Table 6. A comparison of the Kaliningrad economy with its neighbourhood in 2004 (at current prices)**

	Kaliningrad	Poland	Estonia	Latvia	Lithuania
GDP (€billion)	1.9	195.2	9.0	11.0	17.9
Exports (€billion)	0.9	60.0	4.7	3.2	7.5
Imports (€billion)	2.5	71.6	6.7	5.6	9.9
FDI stock 2003 (€billion)	0.2	42.6	5.3	2.7	4.1
Population (million)	0.945	38.174	1.351	2.319	3.446
GDP per capita (€)	2011	5113	6662	4743	5194
Exports per capita (€)	952	1572	3479	1380	2176
Imports per capita (€)	2646	1876	4959	2415	2873
FDI stock per capita 2003 (€)	212	1116	3923	1164	1190

Sources: UNCTAD 2004; Eurostat 2005; Statistics Lithuania 2005; Pan-European Institute 2005b

The gap between the Kaliningrad region and its neighbours becomes narrower when Kaliningrad is compared with the Lithuanian or Polish regions bordering it. This is mainly due to the fact these Lithuanian and Polish regions do not generally perform as well as other regions in these countries. GDP per capita in Warminsko-mazurskie and Podlaskie, the Polish regions bordering Kaliningrad, is 'only' double that of Kaliningrad. Correspondingly, the Lithuanian regions bordering Kaliningrad – Klaipeda, Marijampole and Taurage – have a GDP per capita 25-150 per cent higher than in Kaliningrad.

Though Kaliningrad's GDP per capita is lower than in the surrounding regions, the official employment situation in Kaliningrad is better. The unemployment rate in Kaliningrad is only 6.2 per cent, measured by the ILO standards, whereas the unemployment rate of Warminsko-mazurskie and Podlaskie is clearly over 15 per cent. Lithuania's regions bordering Kaliningrad have lower unemployment rates, 6.9-12.7 per cent, than Poland's eastern parts. Kaliningrad's narrow labour potential, together with these relatively high unemployment rates in the surrounding regions, has created a rather interesting phenomenon, i.e. a labour movement from Lithuania and Poland to Kaliningrad. Kaliningrad companies, particularly those in electronics and other advanced fields, search for qualified experts abroad (see Table 7).

**Table 7. A comparison of wellbeing in Kaliningrad and its surrounding regions**

	Kaliningrad	Warminsko -mazurskie (Poland)	Podlaskie (Poland)	Klaipeda (Lithuania)	Marijampole (Lithuania)	Taurage (Lithuania)
GDP / capita (€)	2011 (2004)	3871 (2002)	3992 (2002)	5039 (2003)	3186 (2003)	2520 (2003)
Unemployment	6.2% (2004)	19.7% (2004)	16.4% (2004)	12.7% (2004)	6.9% (2004)	8.9% (2004)

Such a wide gap between Kaliningrad and its bordering regions underlines the fact that the economic activities across the border are below their potential due to the barriers hampering cross-border business activities from taking place. To put it differently, Kaliningrad would definitely benefit from lowering the economic border between Kaliningrad and its surrounding areas.

To sum up, when comparing Kaliningrad with its neighbours, one should take into account methodological differences in producing statistics between the EU and Russia, the large size of the unrecorded economy in Kaliningrad and the exchange rate issues, which prevent one from producing a precise comparison. The author's own experience in travelling in Kaliningrad and its bordering regions in Lithuania and Poland suggests that the real living standard gap is perhaps not as wide as the statistics may indicate.

### **3. Kaliningrad's new challenges**

#### **3.1. The external economic relations of Kaliningrad after the EU enlargement**

In 2004, the trade between the EU and Russia increased substantially. Particularly the EU15 managed to increase its trade turnover with Russia by approximately USD 25.3 billion. The new members' trade growth was more modest, some USD 5.5 billion. The trade growth can mainly be explained by the high prices of natural resources and increasing consumption in Russia, which has kept Russia's imports going up since 1999. In 1999, Russian imports amounted to only USD 40 billion, whereas 5 years later they were almost 2.5 times higher. During 1999-2004, the country's exports have jumped from USD 75 billion to close to USD 185 billion. The volume growth in the EU-Russian trade and the structural change in trade have been much less impressive.

Even today fuel and metals cover over three quarters of Russia's exports. Machinery and equipment represent less than 5 per cent of the total exports. Correspondingly, consumer goods continue to dominate Russia's imports. Machinery and equipment already account for over 40 per cent of the total imports. Unfortunately, much of the machinery is not investment goods but consumer products, such as passenger cars and cellular phones. In fact, in the first quarter of 2005, the fastest growth was registered in car imports; the number of foreign cars imported into Russia jumped by almost 70 per cent.

In addition to an increase in the prices of natural resources, the enlargement per se has also had a direct impact on EU-Russian trade. The EU's share of Russian foreign trade jumped by

more than 10 percentage points, as a result of their 10 new members. Last year, the EU covered approximately half of the country's foreign trade (see Table 8).

**Table 8. Russia's foreign trade before and after the EU's enlargement in 2004**

	Share before enlargement (% - 1-4/2004)	Share after enlargement (% - 5-12/2004)	Change in trade (USD mn - 2003/2004)
Austria	0,9	0,7	213
Belgium	1,1	1,2	980
<b>Cyprus</b>	<b>2,8</b>	<b>2,0</b>	<b>1198</b>
<b>Czech Republic</b>	<b>1,3</b>	<b>1,2</b>	<b>461</b>
Denmark	0,4	0,5	406
<b>Estonia</b>	<b>0,7</b>	<b>0,7</b>	<b>181</b>
Finland	3,6	3,0	1984
France	2,9	2,9	1659
Germany	9,3	9,3	5342
Greece	0,6	0,5	339
<b>Hungary</b>	<b>1,6</b>	<b>1,5</b>	<b>543</b>
Ireland	0,6	0,3	-261
Italy	5,7	6,0	4354
<b>Latvia</b>	<b>0,7</b>	<b>0,6</b>	<b>325</b>
<b>Lithuania</b>	<b>1,4</b>	<b>1,3</b>	<b>800</b>
Luxemburg	0,0	0,1	99
<b>Malta</b>	<b>0,1</b>	<b>0,0</b>	<b>43</b>
Netherlands	6,6	6,4	6691
<b>Poland</b>	<b>3,3</b>	<b>3,1</b>	<b>1675</b>
Portugal	0,2	0,3	582
<b>Slovakia</b>	<b>1,0</b>	<b>1,1</b>	<b>229</b>
<b>Slovenia</b>	<b>0,3</b>	<b>0,2</b>	<b>58</b>
Spain	0,8	1,1	551
Sweden	1,2	1,3	1033
United Kingdom	2,8	3,1	1342
EU15	36,7	36,7	25315
EU25	(49,9)	48,4	30827
CIS	17,9	18,5	13471
China (excl. Taiwan)	6,5	5,7	3283
Japan	2,9	2,9	3059
USA	3,2	4,0	2605
TOTAL	100	100	66120

Source: Customs Russia 2005

Russia is the fifth largest trading partner for the Union, with a share of 7.6 per cent of the Union's imports and 4.4 per cent of exports (Karaganov, 2005). The enlargement did not cause a strategic change in the geographical division of the EU's foreign trade, since the foreign trade of the 10 new members with Russia is rather modest. Poland with her 3-per cent share in Russian foreign trade is clearly the main partner among the new members. In this context, it is necessary to mention that the share of the EU15 in Russia's foreign trade has remained unchanged after EU enlargement, but the share of the new members has diminished from 13.2 per cent to 11.7 per cent. All in all, despite the strong growth in EU-Russian foreign trade, one should not argue that an immediate strategic shift would have taken place in the trade between the EU and Russia.

The foreign trade of the Kaliningrad region developed very positively last year. Kaliningrad's foreign trade turnover reached in 2004, nearly USD 4.5 billion, a growth of over 60 per cent compared to 2003. The first half of this year shows that the strong growth continues. During the first six months of 2005, the foreign trade turnover of Kaliningrad has increased by nearly 60 per cent. Particularly, Kaliningrad's exports have skyrocketed. In 2004, they doubled and extremely fast growth seems to continue. Imports are growing at a lower pace. In the first half of 2005, they increased by some 35 per cent (see Table 9)

**Table 9. The trade flows of the Kaliningrad region, USD million**

	2000	2001	2002	2003	2004	1H/2005
<b>Exports of goods (A)</b>	475	455	471	574	1264	884
<b>Imports of goods (B)</b>	875	1047	1610	2142	3198	1710
<b>Sales of Kaliningrad goods to the Russian mainland (C)</b>	424	619	759	1118	1802	1048
<b>Ratio A/C</b>	1.12	0.74	0.62	0.51	0.70	0.84
<b>Ratio B/A</b>	1.84	2.30	3.42	3.73	2.53	1.93
<b>Ratio C/B</b>	0.48	0.59	0.47	0.52	0.56	0.61

Sources: Pan-European Institute 2005a, Kaliningrad Statistics 2005

The high peak in exports is not directly linked with the EU enlargement. The growth in exports in 2004 was mainly due to the large increase in the export of oil and oil products (by 2.8 times) and machinery (by 2.2 times). This was chiefly due to companies from other regions in Russia channelling their exports through Kaliningrad so that they were registered as Kaliningrad's exports. The proportion of Kaliningrad's own firms in the value of exports was approximately 50 per cent. One should keep in mind that energy and machinery account for over 60 per cent of the region's exports<sup>14</sup>.

The use of the Kaliningrad region in minimising export taxes and duties casts some shadow over the new SEZ, as it suggests that the artificial exploitation of tax breaks may continue, if the SEZ is not controlled carefully. On the other hand, the impressive growth in machinery exports is a very encouraging fact, as Kaliningrad may show the rest of the Russian Federation a way how to decrease the natural resource dependency in exports.

In 2004, Kaliningrad's imports increased by USD 1 billion, a growth of nearly 50 per cent. Such a tremendous jump is not a novelty in the Kaliningrad region, since the annual growth of imports has remained between 20 and 54 per cent during the whole decade. The EU enlargement has not changed the structure of the region's imports. In 2004, materials linked with machine building and foodstuffs accounted for two thirds of the region's total imports. The structure was practically the same a year earlier.

Last year, Kaliningrad's sales to the Russian mainland reached the record high, USD 1.8 billion, being almost over 60 per cent higher than a year earlier. The sales to the mainland are very concentrated. Three products – TV's, meat and fish products – account for 40 per cent of these sales. It is important to notice that sales to the mainland have increased faster than imports to the region. Therefore, the ratio between the mainland sales and the region's imports reached a record high in the first half of 2005. The aforementioned ratio illustrates the 'old' SEZ is not only a transit region to the Russian mainland, but an increasing amount of value adding takes place in the region.

One should also notice that the region's imports were double the exports in the first half of 2005. In 2003, imports exceeded exports by almost four times. In other words, Kaliningrad's external trade has become more export-oriented. In addition, one should notice that the exports have rapidly caught up with that of sales to the Russian mainland. The ratio between their real exports and 'the mainland exports' is over 80 per cent. This is a great achievement, since in 2003 this ratio was barely over 50 per cent. Though the 'old' SEZ has contributed positively to the increase in the region's exports (e.g. subcontracting with foreign firms in electronics), the SEZ is not the major explanatory variable for increasing exports but rather the increase in energy prices.

Kaliningrad's foreign trade is understandably more orientated to the EU than that of the Russian Federation. Clearly over two thirds of Kaliningrad's foreign trade is conducted with the EU, whereas the EU covers a half of the foreign trade of whole Russia. The geography of Kaliningrad's foreign trade has not significantly changed when one compares the years 2003 and 2004. The leading troika have kept their places, i.e. Germany, Poland and Lithuania were still the region's main trading partners in 2004. Together they formed 37 per cent of the region's foreign trade. A year earlier, their combined stake was three percentage points higher. Last year, France became Kaliningrad's fourth largest trading partner, as its trade with Kaliningrad increased by an impressive 500 per cent. Kaliningrad's trade with the Netherlands, the region's 5<sup>th</sup> largest trade partner, almost tripled, probably due to high oil prices. Despite the EU enlargement, the Kaliningrad region's foreign trade with Belarus jumped from USD 120 million to nearly 150 million, making Belarus the 6<sup>th</sup> largest trade partner for Kaliningrad. Sweden's trade with Kaliningrad collapsed in 2004 when compared to 2003, from USD 140 million to USD 60 million respectively. The collapse has probably nothing to do with the enlargement per se. The trade value of the 8<sup>th</sup> largest trade partner (nearly USD 50 mn), Denmark, remained practically unchanged in 2004, compared to a year earlier.

Non-legal foreign trade activity across the Kaliningrad border, i.e. shuttle trading, was vivid prior to the enlargement. Vinokurov (2004a, 15) wrote prior to the enlargement as follows: *“since Polish and Lithuanian borders have become external borders of the Union, stricter customs regimes will most probably cause lower volumes of black and grey trade on the borders. Certainly, as long as heavy price imbalances exist, this kind of border trade (cigarettes, vodka, spirit, gasoline) will not vanish entirely, but their volume must shrink considerably. In the long run this may be judged to be a positive phenomenon, but in the short and medium term, it will create enormous difficulties for an estimated 20,000 to 40,000 families in the region that currently make a living on shuttle trading. This would create an extremely serious structural problem at the regional level because a disproportionate part of these families live in smaller border towns where other employment possibilities are severely limited.”*

Even if no statistics on shuttle trading exist, it seems obvious that the shuttle trading has decreased after the enlargement due to new regulations and stricter control at the borders<sup>15</sup>. However, it is difficult to believe that the socio-economic impact of decreasing shuttle trading would have been as dramatic as has been indicated by Vinokurov, since the estimation that 20,000 to 40,000 families, i.e. 50,000 to 100,000 Kaliningrad citizens, would have been dependent on shuttle trading prior to the enlargement is indisputably too high. The aforementioned estimate would have meant that 5-10 per cent of the Kaliningrad population would have been involved in this non-legal trading. If this would have been the case, the

unemployment rates of Kaliningrad would have skyrocketed after the enlargement. This has not happened, quite on the contrary, Kaliningrad's unemployment rate at the end of 2003 was 9.1 per cent, whereas a year later it was 6.2 per cent measured by the ILO standards.

Foreign investments in Kaliningrad increased over 90 per cent in 2002, by nearly 20 per cent in 2003, but only 10 per cent in 2004. The 2004 development indicates clearly that the EU enlargement has not started a foreign investment boom in Kaliningrad. The explanation for such a 'low' growth rate in 2004 is not the saturation of the Kaliningrad market, as foreign investments in the region are still extremely modest. The total foreign investment stock in the end of 2004 was less than USD 350 million.

During the year 2004, the Kaliningrad region was able to attract foreign investment of just some USD 60 million. In the first half of 2005, foreign investment inflow has been notably low, only USD 18 million. The slow growth of foreign investments in 2004 and in 2005 is due to the fact that some foreign companies, mainly the 'Cyp-Rus' ones, wait for the new SEZ law to be adopted. The adoption of the new SEZ will probably cause a temporary foreign investment boom in Kaliningrad, as it releases those investments which have been postponed (see Table 10).

**Table 10. Annual foreign investment inflow into Kaliningrad, in USD million**

	1994-99	2000	2001	2002	2003	2004	1H/2005
<b>Total foreign investment of which</b>	<b>114</b>	<b>19.1</b>	<b>24.6</b>	<b>47.7</b>	<b>56.2</b>	<b>61.9</b>	<b>18.3</b>
Direct investment	n.d.	6.6	3.2	5.9	14.0	22.4	8.2
Portfolio investment	n.d.	-	-	-	-	4.9	1.3
Other investments	n.d.	12.5	21.3	41.8	42.2	34.6	8.7
- trade credits and loans							

Sources: Pan-European Institute 2005a, Kaliningrad Statistics 2005

In January-September 2004, some 40 per cent of the foreign investment in Kaliningrad ended up in trade, nearly 20 per cent in communications, over 30 per cent in the paper industry, fuel industry and foodstuffs<sup>16</sup>. Presumably, the foreign investment structure and its geographical composition have not changed considerably due to the EU enlargement. The main change in the geographical division might be the lower share from Cyprus in the foreign investment statistics of 2004, since many of the Cypriot firms have postponed their investments as they await new SEZ legislation to take place. One must bear in mind that the majority of the Cypriot investment in Kaliningrad is Russian in origin. For these 'Cyp-Rus' investors, the enlargement has not been as an important motive to invest in Kaliningrad as the SEZ.

Due to a small amount of foreign investments, one cannot argue that foreign investments are the main driving force in Kaliningrad's economic development, but an important addition to the overall investment activity. The share of all foreign investments from the total investments into the fixed capital in the region was nearly 10 per cent in 2004. It is highly likely that the foreign investment inflow would grow and the role of foreign firms would become much more important in the regional development, when the implementation of the Common European Space begins.

Even if the EU enlargement has not resulted in major change in foreign investment flows into the Kaliningrad region, it has officially made the EU the main foreign investor in the Kaliningrad region due to the fact that Cyprus joined the Union.

Besides investments from the countries belonging into the EU, one should not forget the China phenomenon may be taking place in the Baltic Sea region. In other words, it is highly likely that Chinese companies will become more interested in investing in Russia and particularly in a new Kaliningrad SEZ. Those Chinese firms, whose business idea requires proximity to the European market, but nevertheless, which wish to maintain low cost levels, may find Kaliningrad an attractive investment place. Several company managers in Kaliningrad interviewed for this research expressed that the interest of Chinese companies has significantly grown towards the Kaliningrad region during the past 12 months.

Attracting more foreign investments into the region requires a more active investment promotion of the Kaliningrad region, since the possibilities provided by the Kaliningrad region are not familiar to the majority of foreign investors. Therefore, the activities of the Kaliningrad Regional Development Agency should be further supported or a separate unit, the Kaliningrad Investment Promotion ('KalinInPro') should be established sooner rather than later<sup>17</sup>.

Despite the high importance of a foreign investment promotion agency for the Kaliningrad region, one has to keep in mind that larger foreign corporations may find Kaliningrad's labour potential too narrow to make major investments there. At this juncture, one should not forget the fact that in some industrial fields, foreign corporations have already encountered difficulties in finding a qualified labour force in the Baltic States<sup>18</sup>. As Kaliningrad possesses an even smaller labour reserve than her Baltic neighbours, any labour bottlenecks will be reached surprisingly quickly. The narrow labour potential of the region would also create extra pressures to raise salaries at a faster tempo in Kaliningrad than in mainland Russia. Here, one should remember that the unemployment rate of Kaliningrad is already low at the moment, i.e. their unemployed persons do not create an extra labour reserve for industrial companies. In addition, one should keep in mind that the ageing of population and low birth rate negatively affect the future labour reserves of Kaliningrad. Therefore, it can be argued that the Kaliningrad region is able to accommodate only a limited number of major industrial producers.

In this context, one should bear in mind that the Kaliningrad companies, naturally, may use the labour force of close-by countries, such as Lithuania, Poland, Belarus and Ukraine. Even more distant alternatives can be considered. In fact, some of the Kaliningrad companies already at the moment use inexpensive and work-concentrated workers from China. However, their total number is presumably rather modest.

In order to produce a more detailed picture about change in the economic behaviour of Kaliningrad firms after the latest EU enlargement, one should conduct an empirical study among the companies in the region. Special emphasis should be placed on analysing changes in investment behaviour, and in particular, one should analyse whether new investments are linked with the mainland's growing potential or with their expansion aims abroad.

Even if the author does not have statistics on the Kaliningrad companies' investments abroad, one may proffer an educated guess that the investment flows from Kaliningrad abroad are rather modest, as the capital accumulation in the region is not particularly notable<sup>19</sup>. As a

whole, one cannot completely exclude the possibility that some outflows of the Russian capital also take place via Kaliningrad. The EU enlargement per se has very little to do with these outflows, though a great part of these flows have traditionally ended up in Cyprus, now belonging to the EU (Vahtra & Liuhto, 2004).

Tourism is an important source of receiving foreign revenues in many neighbouring countries. The number of foreign tourists visiting Kaliningrad was just 70,000 in 2004, whereas the tourist flow into Estonia, with a comparable population size, is substantially higher. Approximately 960,000 foreign visitors were accommodated in the hotels of Tallinn alone. If one adds to the aforementioned figure one-day tourists from Finland, the total amount of tourists in Estonia can be measured in millions. Therefore, tourism and the shopping related to it contribute a significant stake for the Estonian GDP. This is not the case in today's Kaliningrad.

The development of tourism in Kaliningrad indicates that the number of Russian visitors has doubled in the period 1997-2004. During the same period, the amount of foreign tourists has increased from 50,000 to today's 70,000. On the basis of their tourism development, one cannot argue that foreign tourism, or even domestic tourism, would have significantly suffered from the EU enlargement. On the other hand, one cannot argue that the Kaliningrad region has managed to fully exploit the possibilities provided by its unique nature, history and geographical position.

Various issues slow down the building of the tourism industry in the region, such as undeveloped international transport connections, the small number of Western-standard hotels and visa requirements between the EU and Russia. Kaliningrad in particular would benefit from the visa-free zone between the EU and Russia<sup>20</sup>. As the building of the visa-free zone belongs to the road maps between the EU and Russia, their rapid implementation would support regional development in Kaliningrad (see Table 11).

**Table 11. Tourism and border crossings in the Kaliningrad region**

	1997	1998	1999	2000	2001	2002	2003	2004
<b>Tourism (thousands)</b>								
Foreign tourists	53	65	65	59	60	63	67	71
Russian visitors	112	117	144	164	182	212	224	240
<b>Border crossings (millions) (entry plus exit)</b>								
Persons	n.d.	n.d.	8.6	8.9	9.0	9.1	7.9	7.0
Vehicles	n.d.	n.d.	2.9	3.1	3.1	3.1	3.3	2.9

Source: Kaliningrad Statistics 2005

Though one should not explain the positive development in Kaliningrad's external economic relations by the enlargement per se, one can easily conclude that enlargement has not brought those negative consequences to Kaliningrad's economy which some researchers proposed prior to enlargement, i.e. Kaliningrad has not been economically trapped within the EU.

### 3.2. Kaliningrad and the expected new law on the special economic zone

Some views on the impact of the legislative change have been presented even earlier. In June 2005, the Pan-European Institute's monitoring report on the Kaliningrad region (2005a, 1) suggested that *"customs privileges of the regional Special Economic Zone (SEZ) continued to play a determining role in shaping the economic specialization of the region and in supporting its economic growth, which is based, first and foremost, on import substitution production. The Russian Government, after several years of discussions, approved a new draft law on the Kaliningrad SEZ and submitted it to the State Duma, where it is expected to be quickly adopted. The main idea of the new draft is gradually to replace the existing customs benefits, which are planned to remain intact for existing companies for the next 10 years, with tax breaks for large investors. The existence of the new draft creates some uncertainty regarding the new rules of play in the region, especially for investors who have already undertaken projects in the province. However, this uncertainty is not having a visible effect on the positive dynamics of the main macroeconomic indicators. On the contrary, many companies are seeking to establish a presence in the region in order to capitalize on customs privileges before the new law is enacted."*

In July 2005, **Sergei Yastrzhembsky**, the Russian presidential envoy to the European Union, stated as follows: *"investments in the Kaliningrad region has been insufficient in volume. This has to do with prospects for a Kaliningrad special economic zone that have been unclear until recently. One would expect that, with the adoption of the new law on the special economic zone, the problems that have in the past been slowing down the inflow of foreign investment into the region would be eliminated automatically. Both Russian and foreign investors will be much more active."* (Interfax, 2005).

Should the law be adopted as suggested in the first draft, its core could be summarised as follows<sup>21</sup>:

- The new law provides a full income tax relief for 6 years for new companies, which invest RUR 150 million (some €4,25 mn) or more after the new SEZ law has been adopted. During the 7-12<sup>th</sup> year of operations, the income tax of the eligible company is lowered by 50 per cent.
- RUR 150 million or more has to be invested within 3 years. If the company fails to invest the minimum limit, it has to pay the taxes in full. An interesting legal case appears, if a company eligible for a tax break ceases to exist prior to the end of the third year.
- The following sectors are excluded from the tax break: 1) oil and natural gas production and the services related to them; 2) production of alcohol, tobacco and other goods under the excise (except passenger cars and motor bikes), 3) wholesale and retail trade; 4) repair of household goods; and 5) financial services. It is not clear to the author why the repair of household goods should be excluded from the tax break.
- The customs regime of the former SEZ is kept in place for 10 years. During the transition period the imports of goods are exempt from import taxes and duties. If 30 per cent value added takes place, these goods can be sold to the Russian mainland without paying import taxes and duties. Two major changes will take place. Firstly, companies operating in electronics also have to produce 30 per cent value added to be able to sell their goods to the Russian mainland without taxes and duties. Secondly, the companies operating under the 'old' SEZ are obliged to pay export tariffs and duties.

- The new SEZ law is in force for a period of 25 years from its adoption.

As in time of writing this paper, it is not evident what will be the final form of the law and the date of its adoption, one can only speculate about the economic impact of the change. Though it is too early to predict all the economic consequences of this legislative exercise, several essential issues can be raised.

- 1) The era of two simultaneous SEZ regimes creates, at the beginning, a situation where three types of companies exist: (1) new companies entitled to a full tax break; (2) new companies not entitled to a tax break; and (3) old companies not entitled to a tax break but entitled to customs privileges. After the 6<sup>th</sup> year of the new SEZ, a further new category of companies appears, i.e. those that are eligible to cut their income tax only by 50 per cent. After the 10-year transition period, customs privileges are abolished, and hence, company category number 3 disappears.

History has shown that complicated administrative systems do not usually provide maximum benefit to the State, as companies tend to find loopholes in order to minimise their taxes. Empirical evidence also suggests that firms are faster in finding new loopholes in complex systems than the authorities are able to fill them.

Besides, it should not be forgotten that the two simultaneous SEZ systems require more administrative capacity and more control than the 'old' SEZ system. Complicated administrative systems do not aid in the battle against corruption, quite the contrary in fact.

- 2) The new system discriminates, at least in principle, against small companies, which do not possess enough financial resources to meet the investment limits required by the new law. Putting small firms into a less advantageous position is not in line with Russia's policy, which aims at supporting the development of small and medium-sized enterprises (SMEs), which are generally one of the main sources of economic flexibility and employment.

Although the new SEZ does not directly support employment creation via SMEs, it needs to be kept in mind that unemployment is not a substantial problem in Kaliningrad (6.2%). Kaliningrad's unemployment rate is lower than in Russia on average (7.6%). In fact, the unemployment rate in surrounding countries is even higher – in Lithuania (10.6%) and Poland (18.0%).

The new SEZ supports industrial production instead of services, as companies in the service sector seldom reach the investment limit mentioned in the law draft. In this context, one has to stress that the natural competitiveness of Kaliningrad does not presumably lie in industrial production with low labour costs but rather in sophisticated processes which are based on innovation, highly-qualified labour and proximity to the main European markets. In addition, one should not forget the rapid salary increase in the Baltic States, which has made some of their labour-intensive industries uncompetitive compared with their Asian competitors within a time frame of no more than 10 years. The same competitiveness trap may wait for the Kaliningrad industrialists, if their business idea is based on low labour costs.

Instead of turning Kaliningrad into a new production and industrial centre on the Baltic Sea shore, one should support the creation of various services which are based on wider trends in Europe, i.e. the ageing of the population (with a growing need for health-related services) and the increase of leisure time (tourism). It can be assumed that the future competitiveness of Kaliningrad will be based more on health tourism and the services related to it than upon conventional industry. Therefore, the region should support the strengthening of the service sector via a special policy targeted to the service sector.

- 3) Some foreign firms which already operate in the region may feel that the legislative change weakens their competitive position. We have to remember that the average foreign investment in Kaliningrad is substantially below the limit required by the proposed SEZ law. The legislative change may push these existing foreign firms to increase their investment or, in the longer run, force them to leave the market for larger players.

As the role of foreign investments in the Kaliningrad economy is not extremely large, the forthcoming legislative change is not to bring dramatic economic effect to the regional economy via existing foreign firms. One should not be too optimistic that tax breaks attract great amounts of new foreign capital into the region. International evidence has shown that tax reliefs are not the main motive for companies to invest abroad. One should keep in mind that the clear, free, fair and predictable business climate of the region is a much more important reason for potential new foreign companies to invest in Kaliningrad than the SEZ, based either on customs privileges or tax breaks. The foreign investment development of the Novgorod region is good proof of the aforementioned, underlining the role of the regional administration and the region's investment agency in attracting new foreign investments into the region<sup>22</sup>.

- 4) Tax breaks provided by the Kaliningrad SEZ can theoretically be an additional attraction for some Russian capitalists to return their money to Russia and place it in Kaliningrad. However, the author is not very optimistic that a massive capital return would happen due to the change in Kaliningrad's SEZ legislation. Overall development and the predictability of the country's business climate are much more influential factors in attracting the Russian capital back home than tax breaks or other legislative measures.
- 5) If the tax reliefs decrease through time – six years of a full tax break, and thereafter, six years of half a break – it pushes entrepreneurs to establish temporary firms, not only to maximise their tax benefit but also to be in the same competitive position as new companies, which are eligible for a full tax privilege.

It seems highly likely that companies are established to operate for six years, and thereafter, their operations are closed and moved to new firms, which in practice carry out the same activities, and hence maintain the full tax break. Old firms might be forced to use such a reincarnation method to protect their business against newcomers.

The policy discriminating against old firms over new ones does not encourage long-term investments. Whatever controls are set in place to prevent such an artificial reincarnation, it is evident that the system is vulnerable to misuse.

- 6) It seems likely that Kaliningrad's tax breaks will lead to capital movements within the Russian Federation.

According to the positive scenario, change in Kaliningrad's SEZ legislation attracts companies from other Russian regions to move their operations to Kaliningrad, as they aim at minimising their taxes. Kaliningrad definitely benefits from such enterprise immigration and additional capital inflows. Also the Russian Federation as a whole benefits from capital movements to Kaliningrad, provided that these moves create new business activity instead of merely relocating them from one Russian region to Kaliningrad.

According to the negative scenario, the new SEZ may lead to the superficial registering of units in Kaliningrad, as the companies may aim at avoiding taxes by registering 'artificial' units in the region, i.e. the corporation may only move its headquarters instead of production into the region but still try to benefit from the tax break. Naturally, the State does not benefit from the superficial moves – quite the opposite.

It is impossible to predict what might be the extent of capital movements from other Russian regions to Kaliningrad. What ever the scenario takes place, one can be sure that the legislative change puts extra pressures on control.

- 7) The abolishment of the 'old' SEZ after the 10-year transition period may create some unexpected consequences. For instance, some food producers may find it to be more beneficial to locate their production elsewhere in Russia or in some nearby country, perhaps in Ukraine. Also the relative competitive position of the electronics producers in Kaliningrad worsens already during the transition period, and will continue to do so, particularly after it. This may bring some negative impact to the Kaliningrad economy, when the 'old' SEZ will be terminated. A study concerning the socio-economic consequences of the termination of the 'old' SEZ should be carried out well in advance of its closure.
- 8) The overwhelming majority of the Kaliningrad businessmen interviewed for this research consider that the new SEZ law strengthens the economic stability of the region, since the new SEZ will be in force for 25 years. Earlier, the destiny of the 'old' SEZ was discussed annually in the State Duma, which created enormous problems for local businessmen in planning their future activities and created an extra investment risk.
- 9) Two SEZ systems operating simultaneously stresses the need to clearly define roles between federal and regional authorities. Unclear roles would probably lead to unclear

rules and to an increase in unwanted bureaucracy, and hence, to a lower efficiency of firms due to time losses caused by the extra bureaucracy.

- 10) Despite the indisputably important role of the SEZ in the Kaliningrad economy, it should be stressed that all special administrative arrangements are counter to free competition and they break the economic unity of the Russian market. Although the Kaliningrad SEZ can, in the medium term, be justified, due to the region's exclave position, in the long-term all the actions aiming at the abolishment of the administrative privileges supports the overall market transition in Russia.

In other words, this special zone along with other special zones so designed at the moment break the economic unity of the Russian market, since giving privileges to some regions, which means a relative decline of competitiveness of those regions which have not been granted a special privilege. In that respect, special economic zones and other administrative privileges distort the natural competition within the Russian Federation.

Finally, one should emphasise that the SEZ creates an artificial competitiveness in Kaliningrad, which may, in the long run, distort the creation of natural, and hence sustainable, competitiveness in the region. Therefore, the operation of the SEZ should definitely be re-considered when the period of validity of the new SEZ expires. It is also extremely interesting to follow the future development of other special zones to be established in the country<sup>23</sup>.

To conclude, the Kaliningrad special economic zone has been and will be an important engine for the economic development of the Kaliningrad region. However, any possible delay of the new SEZ law should be avoided, since many local companies have postponed their investments whilst they wait for the new legislation to come into a force. If the new law will not be in force by January 2006, the Kaliningrad region will lose at least one year before the law can be put in place, due to Russia's taxation system. Should this happen, Kaliningrad's economic growth would definitely suffer from the postponement. Therefore, it is of the utmost importance to put this law into place already by the beginning of next year.

## 5. Summary

- 1) *The majority of the economic indicators suggest that the EU enlargement of 2004 has not caused a negative impact on the economy of the Kaliningrad region.*

Though the region's foreign trade has developed extremely positively after the enlargement, one should not argue that the enlargement per se has caused the positive development. The main explanation for growing imports in 2004 is the increase in sales to the Russian mainland (*the transit effect towards the Russian mainland*). Correspondingly, the main explanation for growing exports is the increase in oil and machinery exports, which is, to a large extent, due to companies from other Russian regions channelling their exports through the Kaliningrad province (*the transit effect*

*from the Russian mainland*). It is important to note that no dramatic change has occurred in terms of Kaliningrad's foreign trade structure or its geographical scope, though the EU's share has increased significantly, particularly due to the EU membership of Lithuania and Poland.

Despite no precise statistics existing, one may assume that the shuttle trading has considerably decreased between the Kaliningrad region and its surrounding countries after the EU enlargement. Even if the decrease in the shuttle trading has had a negative socio-economic impact on hundreds of families (not on tens of thousands of families) living in Kaliningrad, one should not forget that the abolishment of grey and black cross-border activities is beneficial to the regional budget. Furthermore, the abolishment of non-legal foreign trade activities between Kaliningrad and its neighbours supports legal competition in Kaliningrad, i.e. it supports market reform in the region, which is needed to build up the sustainable competitiveness of firms.

2) *The enlargement's immediate effect to the foreign investment inflow to Kaliningrad is modest.*

In 2004, the foreign investment inflow to Kaliningrad grew 'only' by 10 per cent. The growth rate of 2004 is lower than in 2002 and 2003. After the adoption of the new SEZ law, it is probable that the foreign investment inflow to Kaliningrad will pick up, as some existing foreign-owned companies release their investments, which they have postponed throughout the past 18 months. This naturally does not mean that the enlargement would be the major explanatory variable for increasing foreign investment inflow to Kaliningrad but rather the adoption of the new SEZ.

The EU became the major investor in Kaliningrad due to the EU membership of Cyprus. In reality, the investments from the aforementioned country could be re-spelt as Cyp-Rus, since the overwhelming part of the capital arriving from there is Russian in origin. One could not observe any strategic shift in foreign investment inflow or its industrial division, which could be exclusively explained by the enlargement. Also the country division of Kaliningrad's foreign investment stock has not changed significantly, since the inflow of foreign investment in 2004 was not more than USD 60 million. In the first half of 2005, less than USD 20 million has floated as foreign investment into the Kaliningrad region, indicating that the foreign investment inflow in 2005 will be lower than a year earlier.

It is beneficial to bear in mind that the development of the investment climate in Kaliningrad and in Russia as a whole is a more important factor affecting foreign investment flows than the enlargement per se. Secondly, one should not forget that the role of the foreign investments in the overall investment activity of the region will become more important in the future. The enlargement and the intensifying relations between the EU and Russia, for instance via the Common Economic Space<sup>24</sup>, will most probably increase the movement of factors of production to and from Kaliningrad. Thirdly, *the Kaliningrad administration should be more active in attracting foreign investments into the region, for instance by establishing a special unit – 'the Kaliningrad Investment Promotion' – to carry out this task.*

- 3) *The new special economic zone in Kaliningrad will probably increase investment flows from other regions of Russia to Kaliningrad already in the short run.*

It is difficult to predict the extent of the investment inflows from other Russian regions, but nevertheless, these new investments will definitely aid the Kaliningrad region to develop its regional economy. There is less ground for optimism that the new SEZ would attract a great amount of new foreign investment (apart from those, which have been postponed throughout the past 18 months) or intensify the return of Russian capital from abroad into the region, at least not in the short term.

It is important for both the regional and federal governments that the new SEZ will not be used for tax evasion. This puts extra pressures upon control measures. Furthermore, it is essential that the new SEZ does not relocate the production already inside Russia but instead expands production, as otherwise the federal government and particularly other regions, from where the companies move to Kaliningrad, would lose budget income.

The possible postponement of the new law would definitely slow down the investment activity of all companies, as they would further postpone their investments. Naturally, such investment behaviour would slow down the economic growth of the whole region. Therefore, it is of the utmost importance that the new law will be adopted prior to the beginning of the next year.

- 4) *The new SEZ and the gradual abolishment of the 'old' one will create a dual system, which may cause extra pressures for authorities to control it. It may also create surprising legislative loopholes, which some firms may try to misuse.*
- 5) *Lowering the income tax break after the 6<sup>th</sup> year of business operations may create the artificial termination of these companies after the 6<sup>th</sup> year and the shift of their operations to a new company owned by the same people or interest groups. This part of the new SEZ law seems extremely open to abuse. In addition, one should not forget that the policy discriminating against old firms over new ones does not encourage long-term investment.*

***In order to avoid the likely misuse, the author strongly recommends that the SEZ will be organised as follows: a full tax break for the first 10 years (2006-2015) for all firms investing RUR 150 million or more, and thereafter, a 50-per cent reduction of corporate income tax until 2030. Such a system would be administratively much clearer and push the companies to invest as soon as possible to be able to use the tax benefit in full.***

- 6) *Even if the new SEZ gives privileges to larger investors, and hence, theoretically discriminates against smaller ones, this will not be a major obstacle for the development of small and medium-sized enterprises in the region. By supporting larger investors the new SEZ simultaneously promotes industrial production, not the development of the service sector. As the future of the Kaliningrad region cannot*

solemnly rely on industrial production, services, particularly those related to health tourism, should be supported in the region's economic policies.

- 7) *In the long run, the SEZ arrangements should be abolished in Russia and elsewhere in the world since they are chiefly based on administrative privileges, not on natural competitiveness. Though the SEZ arrangement may aid in building new competitiveness, they may also distort the creation of sustainable competitiveness. Furthermore, the regional policy based on administrative privileges discriminates against other Russian regions, which do not possess such a privilege, and hence, it breaks the economic unity of the Russian market. On the other hand, the special economic zones may prove to be useful provided that they help some Russian regions to become regional growth centres.*

Summa summarum, the immediate economic impact of the EU enlargement on Kaliningrad is relatively modest, though still a positive one. The new special economic zone will play an important role in the future development of the Kaliningrad economy. Similarly, the Kaliningrad region will play a special role in the future development of EU-Russian relations. It has been said that St. Petersburg is Russia's window towards Europe. Similarly, one may conclude that Kaliningrad is Europe's window toward Russia. Open windows are needed for creating a true partnership between Russia and the EU.

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## **Background interviews, discussions and meetings in chronological order**

**Sergey Prihodko**, Executive Member of Board of Directors, Institute for the Economy in Transition, Kaliningrad 22.8.2005.

**Vladimir Mau**, Rector, Academy of National Economy, Kaliningrad 22.8.2005.

**Elena Chernetskaya**, President, Telebalt, Kaliningrad 23.8.2005.

**Yuri Zdanov**, Director, The Federal Agency of Special Economic Zones of the Russian Federation, Kaliningrad 24.8.2005.

**Marina Ovsyannikova**, Adviser to the Minister, Ministry of Economic Development and Trade, Kaliningrad 24.8.2005.

**Vladimir Egorov**, Governov, The Kaliningrad Region, Kaliningrad 24.8.2005.

**Mikhail Tsikel**, Vice-Governor, The Kaliningrad Region, Kaliningrad 24.8.2005.

**Stefan Valhovits**, President, Produkty Pitanye, Kaliningrad 24.8.2005.

**Daimir Imamovits**, Vice-President, Produkty Pitanye, Kaliningrad 24.8.2005.

**Mikhail Pluykhin**, Managing Director, Produkty Pitanye, Kaliningrad 24.8.2005.

**Elena Chernetskaya**, President, Telebalt, Kaliningrad 24.8.2005.

**Vitaly Zdanov**, Head, Department of Economic Development and Trade, The Kaliningrad Region, Kaliningrad 24.8.2005.

**Oleg Danovsky**, Deputy Head, Department of Economic Development and Trade, The Kaliningrad Region, Kaliningrad 25.8.2005.

**Igor Kolosnitsyn**, Vice-Director, Bureau of Economic Analysis, Moscow 12.9.2005.

**Vadim Nestrov**, Head, Publications office, Rosstat, Moscow 13.9.2005.

**Andrey Jakovlev**, Vice-Rector, Higher School of Economics, Moscow 13.9.2005

**Natalia Popova**, Ministry of Economic Development and Trade, Moscow 14.9.2005.

**Vladimir Sokolin**, President, Rosstat, Moscow 15.9.2005.

**Alexander Surinov**, Vice-President, Rosstat, Moscow 15.9.2005.

**Ruben Saakyan**, Head, Analytical Department, Federal Taxation Service of the Russian Federation, Moscow 15.9.2005.

**Leonid Gokhberg**, Vice-Rector, Higher School of Economics, Moscow 15.9.2005.

**Reijo Paasilinna**, Member of European Parliament, Bryssels 20.9.2005.

## FOOTNOTES

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<sup>1</sup> This article has been produced, while the author acted as a short-term expert for the Russian-European Centre for Economic Policy (RECEP). The author gratefully acknowledges the contribution of the interviews, discussions and meetings, which took place during the expert period. The author wishes to thank all the persons involved in the research process. Special thanks go to Marina Cherkovets (RECEP), Sergey Prihodko (Institute for the Economy in Transition), Christer Pursiainen (RECEP), and Vitaly Zhdanov (the Administration of the Kaliningrad region). The views expressed in the article do not necessarily represent those of the RECEP, its funding organisation or opinions of those persons, who were interviewed, discussed or met.

<sup>2</sup> In the report, the terms 'the Kaliningrad region' and 'Kaliningrad' are used interchangeably.

<sup>3</sup> The companies operating under the current SEZ may sell the imported goods to the Russian mainland without paying custom duties if 30 per cent of the product's value is added in the region plus change in the Tariff Nomenclature code's 4<sup>th</sup> digit. In electronics and household appliances, 15 per cent value added is required plus change in the Tariff Nomenclature code's 5<sup>th</sup> digit. The companies operating in the SEZ are also exempted from export tariffs.

<sup>4</sup> The second reading is scheduled to take place in the State Duma on the 24<sup>th</sup> of November. The third reading is expected to take place before the end of 2005, thus the law could be in force already in the beginning of 2006.

<sup>5</sup> Note: an annual growth rate of 7.2% is required to double the GDP in 10 years.

<sup>6</sup> The planned North European Gas Pipeline may aid the energy shortage of Kaliningrad. The planned capacity of the two-string pipeline is 55 bn cubic metres per year, and the first 27.5 bn cubic metre string is to be commissioned in 2010. The over 1200 km long pipe will cost approximately USD 4 billion. Offshoots might be built to link the pipeline with Kaliningrad. The timetable of the plan seems ambitious, though not unrealistic. Even prior to the accomplishment of the planned pipe, the growing energy needs of the Kaliningrad companies must be met in one way or another. Here one should stress that the energy producing units of Kaliningrad should not export energy if it results in energy shortages in the region.

<sup>7</sup> The number of the regions in Russia has been reduced since this ranking was conducted.

<sup>8</sup> One of the peculiarities of the Kaliningrad SEZ is the imposition of regional import quotas. Beginning in 1998, about 35 categories of goods are subjected to import quotas (Vinokurov, 2004a).

<sup>9</sup> Lukoil is at the moment Russia's largest oil producer. In August 2005, it produced 1.76 million barrels per day. The volume of Lukoil-Kaliningradmorneft's oil production constitutes 0.7-0.75 million tonnes per year. Most of its production is exported.

<sup>10</sup> The ratio of Kaliningrad's foreign trade over its GDP was 160% already in 2003 (Usanov et al., 2005).

<sup>11</sup> Kaliningrad is a semi-enclave of the EU as it is not fully surrounded by the Union because Kaliningrad has access to the Baltic Sea.

<sup>12</sup> The non-CIS imports per person are clearly higher in Kaliningrad than in any other Russian region (Liuhto et al., 2004).

<sup>13</sup> The FDI figure for Kaliningrad contains all foreign investments, including foreign loans and portfolio investments, in the Kaliningrad region. In addition, one has to remember that a great part of the 'foreign' investments are Russian by origin. This naturally distorts the comparison of Kaliningrad with its neighbouring countries, as it exaggerates Kaliningrad's FDI attractiveness.

<sup>14</sup> A further study on the development of Kaliningrad's machinery exports should be carried out, since it might reveal, how some Kaliningrad-based companies have succeeded in upgrading their exports, while the Russian exports as a whole suffers from the overwhelming dependency on the exports of natural resources. Kaliningrad's success could be copied also elsewhere in Russia

<sup>15</sup> In mid-September, Itar-Tass (2005) reported that as of the beginning of the year, Kaliningrad frontier-guards have confiscated more than 200,000 packets of cigarettes to the total sum of two million roubles. The main part of them was to be smuggled into neighbouring Lithuania.

<sup>16</sup> Kaliningrad's foreign investment division by sector is not dramatically different from that of the whole country. Trade accounted for 32%, industry (incl. fuel industry) 50%, and transport & communication 5% of Russia's all foreign investments gained in 2004 (Finpro, 2005a).

<sup>17</sup> In mid-June 2005, the Foreign Investor Association of the Kaliningrad region was founded. This association may have a positive impact on aiding new foreign companies to adapt to the regional business culture.

<sup>18</sup> The Estonian Investment Agency stopped trying to attract manufacturers years ago, favouring service-based investors instead (Sherwood, 2005).

<sup>19</sup> Forbes (2005a/b) has named 27 billionaires in Russia. None of them lived in Kaliningrad. In fact, none of Russia's 100 richest persons was a citizen of Kaliningrad.

<sup>20</sup> According to Vinokurov (2004b, 1 and 11), "*it is feasible for Russia to introduce visa-free regime for the EU citizens in Kaliningrad Region. On the EU side, visa regime for Kaliningrad may be kept intact, if multi-entry Schengen visas with longer validity will be made available to the residents of Kaliningrad and visa procedures*

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*will be eased up. ... Opening Kaliningrad for Europeans, even if originally a unilateral move, would greatly facilitate doing business in Kaliningrad. It would provide tourism and hospitality business with numerous advantages, on the other hand, and provide investors with powerful incentives to come to the KO [Kaliningrad Oblast i.e. Kaliningrad region], on the other hand.”* Here one should note that only about a quarter of Kaliningrad residents had the external passport in 2004.

<sup>21</sup> Several experts interviewed for this research consider that the new Kaliningrad SEZ would be in line with the WTO criteria. On the other hand, some reports argue that the Kaliningrad SEZ would be against the WTO principles (Finpro, 2005b). Some Russian experts have expressed doubts whether Russia will sign the WTO agreement in December 2005.

<sup>22</sup> Moscow-born Georgy Boos, 42, was elected as the new governor of the Kaliningrad region in September, 2005.

<sup>23</sup> A law allowing the establishment of two special zones was adopted in Russia; 1) a manufacturing zone (not more than 10 sq km) and 2) a knowledge-intensive production zone (not more than 2 sq km). Manufacturing zones would enjoy accelerated depreciation, together with exemption from limitations on loss carry-forward, no property and land tax for 5 years and the waiving of import duties and VAT payments on goods carried inwards. Knowledge-intensive production zones would enjoy a low unified social tax (14%) and exemption from property and land tax for 5 years. Some experts estimate that 10-12 special zones are to be established in the first phase. The first new zones are to be chosen already during the year 2005. RUR 8 billion has been reserved in the federal budget of 2006 for establishing these new zones. The first new zones are expected to start their operations by the end of 2007. The aforementioned law does not have a direct impact on the special zones in Kaliningrad and Magadan. In addition to the 2 aforementioned zones, a law concerning the special zone specialising in tourism and leisure activities is perhaps adopted in September 2005 (Troika Dialog, 2005).

<sup>24</sup> Vinokurov (2004c/d) deals in his articles with the concept of the Common Economic Space in great detail.