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**RESTRUCTURING AND REVITALIZING THE KALININGRAD REGION\*  
(PHASE I-A)**

TF/RUS/94/001 and US/RUS/93/134

RUSSIAN FEDERATION

**Technical report: Study on investment promotion\*\***

Prepared for the Kaliningrad Administration  
by the United Nations Industrial Development Organization

*Based on the work of J. Swiecicki,  
consultant in investment promotion and feasibility studies, and  
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<b>Contents:</b>	<b>Page</b>
1. Introduction	4
2. Executive Summary and Recommendations	5
3. Background	7
4.1 Scope of work	9
4.2 Objectives	9
5. The investment promotion and the development strategy of the local government	10
6. Foreign investment in the transitional economies	12
6.1 Findings on foreign investment up to date in the Kaliningrad Region	14
6.2 Legislation related to foreign investment	15
7. Investment promotion and privatisation	16
7.1 Findings on the state of privatisation in the Kaliningrad Region	17
8. Investment promotion and the financial markets	19
8.1 Findings on the development of the financial markets in the Kaliningrad Region	19
8.2 Existing System of State Investment Support	20
9. SWOT analysis	21
10. Visions and ambitions	25
11. Project Concept	26
11.1 Specific Project Proposals	27

<b>Appendix list</b>	<b>Page</b>
1. <b>Legislation on foreign investment</b>	31
2. <b>Legislation on stock market</b>	32
3. <b>Currency regulations</b>	33
4. <b>Legislation on the Kaliningrad Region</b>	34
5. <b>Main documents regulating the foreign investors activity in Russia</b>	35
6. <b>List of major j.v. in the Kaliningrad Region</b>	37
7. <b>Taxation of foreign investment</b>	38
8. <b>State support of investment promotion</b>	39
9. <b>Project to be financed by EU under the TACIS programme</b>	43
10. <b>Information on international technical assistance (consulting aid)</b>	44
11. <b>Concept of an Off -shore Zone in the Kaliningrad Region</b>	45
12. <b>Scientific-research centre in the Kaliningrad Region</b>	49

## **I. Introduction**

Investors, whether it be domestic or foreign, seek opportunities where the risk is low and potential profits are high. They shun political, legal and social instability. Why do business in Russia? For entrepreneurs with pioneer spirit and inclination to take high risks, it is just a volatile time of great change which offers the best opportunities. For others, reading newspaper reports from Russia about political turmoil and economic free fall, it has not been the time to consider investment. Now it may change. Optimistic assessments of the Russian economy have been published by IMF and OECD. A few recent quotations from international papers illustrate a possible approaching change in attitudes: "After a painful and chaotic slide, the Russian economy appears to be stabilising. Prospects for growth look promising" (International Herald Tribune, Sept. 26, 1995) "Russian tigers. Russia draws the attention of western investors. According to experts from the London branch of the Daiwa Bank, the Russian stock market offers the best profit opportunities in the near future." (Polish daily Rzeczpospolita, Sept. 21, 1995) "The European Bank for Reconstruction and Development has sharply raised its capacity to finance the development of small and medium enterprises in Russia with the approval of a \$300m programme for the Russian Small Business Fund" (Financial Times, Sept. 5, 1995) Even the recent turmoil in the Russian banking sector is taken as a sign of recovery: "Russia's banking crisis, provoked by recent, tentative signs of stabilisation in the economy, is an opportunity to clean up an oversupplied industry and set the country on the path towards sound money. So far, the government seems determined to grasp the opportunity. Such consolidation (hundreds of weak banks may need to disappear) would, in the long run, be good news for the economy." (Financial Times, Aug. 26, 1995)

The Kaliningrad Region may be, using well its strengths and competitive advantages, an outpost of recovery and the investors' gateway to the coming Russian boom.

## **2. Executive summary**

1. As a small enclave, isolated from the markets and suppliers of the Russian hinterland, the Kaliningrad Region offers worse, not better, conditions for investment than many other parts of Russia. Those drawbacks are only partly balanced by favourable geographical location as a Baltic seaport close to the European markets.
2. It is therefore necessary to compensate the disadvantages with special regulations on the central level. The experience of FEZ "Jantar" shows how essential its regulations were for the investment climate, and consequently, how devastating was the cancellation of FEZ privileges in March 1995.
3. The great asset of the region is its reform oriented administration. In the first stages of market reforms, the government (local administration) has a special and irreplaceable responsibility as a initiator and a power engine of change. Any upgrading and amelioration of its functions will have a multiplied positive impact on the economic performance of the Region.
4. It is unrealistic, and not always desired, to expect quick and substantial inflow of foreign direct investment. As the experience of other reform economies shows, the recovery of investment has been achieved through the mobilisation of domestic savings. Most fixed investments are financed by the enterprises themselves, e.g. from increased export revenues.
5. Privatisation is one of the most important parts of the reform programme, but it is not the end in itself. Effective ownership functions, the capital enforcement and the management development has not always been achieved. More attention should be paid to the after privatisation support.
6. New business should have easy access to production means. Free market for premises, land (at least for domestic investors), machines, raw materials, energy etc. should be developed. State owned and privatised enterprises should be encouraged to sell off their excessive assets. Bankruptcy and liquidation procedures should be developed, thus facilitating the necessary process of reallocation of resources.
7. Financial market is almost non-existent and the banking sector is very weak. The administration should on the one hand initiate and stimulate the development of the financial market institutions in the Region, and on the other hand during the meantime fill

the gap by mobilising the available state recourses for financing long term industrial investments.

8. Among the most urgent task of the local government in order to improve the investment climate, reduce the risks, and make the region more attractive for domestic and foreign investors are:

- stimulate the development of financial markets and domestic savings
- develop the infrastructure
- improve the image of the Region
- introduce special local regulations in order to attract domestic investors
- promote business friendly attitude at all levels of the bureaucracy

#### 4. Background

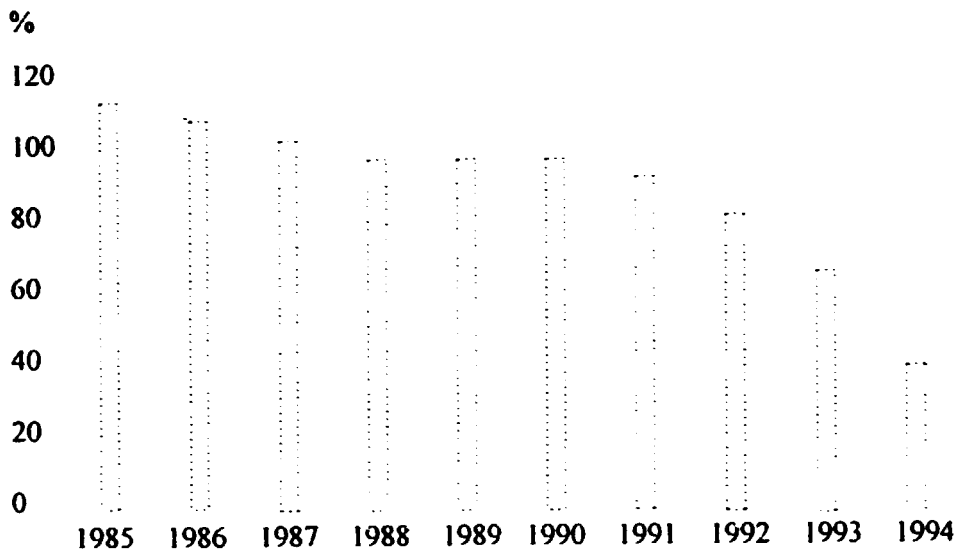
The break-up of the Soviet Union has totally changed the prerequisites of the economic life of the Kaliningrad Region. In decades, it used to be a close, heavily militarised region, to estimated one-third to one half of its budget financed through federal subsidies, closely entwined with the economy of neighbouring Baltic Soviet Republics, and with the Russian economy as a whole. After 1991, it became an exclave of The Russian Federation, cut off from the hinterland, wedged between an independent Lithuania and Poland. The regional administration of Yuri Matochkin, a professor of economy, in a bid to find a new economic basis, has re-opened the Region for foreigners and actively promoted the Region as a Free Economic Zone called "Yantar". A package of trade and investment incentives, on the basis of President Yeltsin's decree from the Dec. 7<sup>th</sup>, 1993, supplemented by various tax and custom regulations, gave the Region a special status designed to attract foreign as well as domestic investment.

The result of this and other development efforts of the regional administration has been a considerable number of joint ventures with foreign participation, but the inflow of capital was very modest, and their impact on the industrial output or employment in the Region was negligible. One of the main reasons seems to be the uncertainty about the political and economical developments in Russia. Especially the legal underpinnings of the Kaliningrad Region's special incentive schemes turned out to be very fragile. A new decree of President Yeltsin in March 1995 without notice cancelled most of the FEZ's privileges for the investors. Following the regional administration's lobbying in Moscow, some of the privileges were restored, but can be very easily altered again. The hope of leaders of the Region is now attached to the draft law on the Kaliningrad Region being processed by The State Duma, which will create more stable legal foundations to the FEZ's special regulations.

The decline of the industrial output in the Kaliningrad Region has been more dramatic than in Russia as a whole. The downward trend was visible already in the late 1980-ties, but the total break down came after 1991.



**Fig. 1 Industrial output in the Kaliningrad Region 1985 - 1994 (1990 = 100)**



Source: "Kaliningradskaya oblast v tsifrakh. 1994". The statistical Yearbook. Kaliningrad. 1995

The break down in the volume of investments was even more dramatic, especially the industrial investments, which have been reduced from 930 million rubel in 1990, to 203 million rubel in 1994.

**Fig. 2 Volume of investments in the Kaliningrad Region (in 1991 year's prices)**

	1985	1990	1993	1994
Investments, totally, in million rubel	918	1241	642	507
In manufacturing	78%	75%	67%	40%
In non-manufacturing	22%	25%	33%	60%

Source: "Kaliningradskaya oblast v tsifrakh. 1994". The statistical Yearbook. Kaliningrad. 1995

As a Russian exclave of great strategic importance, with its central geographic location in the southern Baltic Sea region, with its one of Russia's few ice-free ports, the Kaliningrad Region ranks high in the Russian Government's priorities for federal resources and rights. Its future

and its attractiveness to foreign investors will depend to high degree on decisions taken in Moscow. Continuing its dialogue with politicians on the federal level, the Regional Administration looks for methods and measures being within its own reach, to promote investment in the Region.

#### **4.1 Scope of work**

According to the job description, this subproject in Investment Promotion has to analyse the conditions for foreign and domestic investment, including the legal framework, the capabilities of institutions to assist enterprises and the viability of an investment promotion authority.

Along with the subproject in Regional Development, this study has a general, cross-sector character, unlike the most other subprojects analysing the particular industry sectors.

The focus of this study, following the delimitations agreed with the consultants in the Regional Development and the Infrastructure subprojects, is on the investment promotion aspects of the regional government's development strategy, the role and the conditions of attracting foreign investment, the impact of the privatisation process and the development of the financial markets

The study has been performed during:

- three visits to The Kaliningrad Region: June 5<sup>th</sup> to 15<sup>th</sup>, August 15<sup>th</sup> to 20<sup>th</sup> and planned conclusion visit in October 29<sup>th</sup> to November 3<sup>rd</sup> 1995,
- in Stockholm, the desk research in June and August, and the report writing in September and October.

The local consultant of this subproject was Mr Alexey Ignatiev, until July 1995 Chief of the Department in the Kaliningrad Regional Administration, Free Economic Zone "Yantar" Development Committee, and from August 1995 Director of "Yantar" Fund. He was assisted by his deputy in both institutions, Mr Arthur Usanov .

The list of persons interviewed and institutions visited during the field work is attached in appendix 13.

#### **4.2 Objectives**

The objective of this study is, on the basis of the findings of the field studies and desk research, to formulate the policy recommendations and concrete project proposals in order to improve the Kaliningrad Region's investment climate. Attracting domestic and foreign investors is an important part of the development strategy of the Kaliningrad Region's authorities.

## 5. The investment promotion and the development strategy of the local government

The strategy of the development of the economy of the region is to the high extend the policy of creating favourable conditions for undertaking and conducting economic activities by the private actors, that is to encourage investment in the region, or to attract investment to the region. It might be the rehabilitation, reconstruction and development of existing businesses (in connection with privatisation) , or, in even higher degree, development of a new businesses. These start ups may involve "green field" investments but more likely, the development of a new business on the base of the existing productive resources like premises and machinery of closed down inefficient enterprises. The essence of both investment directions, in old and new businesses, in the transition from plan to market economy, is a *massive reallocation of resources* (from state to private hands and from old to new business). This process of reallocation should be as quick and smooth as possible, thus speeding up the pace of structural reforms, necessary for economic growth.

Creating a favourable investment climate, in a very broad sense, is one of the most important tasks of the government, state or regional.

The role of the government in the market economy is not to be directly involved in, or to conduct the economic activities. Making priorities between the individual industrial projects, and supporting them with the tax payers' money, should not be, in principle, the task of the authorities. This should be left to the market powers to decide. Every investment decision is examined by the actors on the market as to expected gains on the one hand and risks on the other hand.

All investments will be assessed as to risks involved. The higher risks, real or perceived, the less investment will be made. Investment promotion is therefore a matter of risk reducing

However, in the transitional economy, as this in Russia, the role of government can not be limited to what is common in the full fledged marked economies in the West. There several tasks where the state activities can not be replaced by anything else.

Those are primarily:

- creating of legal and institutional framework of the market economy
- transformation of state ownership into private ownership
- provide for a reasonable capital supply in the initial period, until the financial markets are developed enough to take care of this
- promote dissemination of market skills through initiating training, offering advice and different kind of support to the entrepreneurs

The guiding principle of all government activities should be equal treatment of all actors on the market, general character of the rules (for support), neutral approach to the individual enterprises.

Even the usual (in the "normal" economy) regulatory functions of the government, in accordance with the social, ecological and other considerations, have a special importance in the transitional economy.

Since the government plays such an important role in the transition period, it is clear that determination of the leaders, the efficiency of the administration, the adequate organisation, the quality of the bureaucracy, the skills and the motivation of the staff personnel, all that have a direct impact on the success of the transformation process. It is therefore right to conclude that even the small (in terms of money) investments in the improvement of functioning of the government will lead to considerable returns in terms of economic recovery.

The greatest part of the responsibility is located in the central government. However, the regional government's responsibility by no means should be underestimated.

Looking for ways and methods to promote the investment in the region, that is to say to enhance the economic development of the region, we shall concentrate on the measures and actions which can be initiated and performed within the region, by the regional government and by other regional actors.

## 6. Foreign investment in the transitional economies

A great expectations are attached to the inflow of foreign capital. It is the core of the idea of the Free Economic Zone "Jantar". This question is extensively discussed in all development strategies for the Region, worked out by the authorities or by the independent institutes and scientists.

Attracting foreign investment is also explicitly mentioned in the background information attached to the Job Description for the International Consultant in Investment Promotion, whose duty is i.a. to "analyse the conditions for foreign investors". Several conclusions and recommendations in the industry studies made by the international and local consultants within the present UNIDO - project Kaliningrad 2000 mount up to finding foreign partners willing to engage capital and technology in the Kaliningrad Region.

The problem has to be seen in the broader perspective.

The analysis made by the UN Commission for Europe (UN/ECE, *Economic Survey of Europe in 1994*) provides the background to the highly disappointing results of the efforts to attract foreign capital to the Kaliningrad Region so far.

Applying this analysis to the Kaliningrad Region, one can make following conclusions.

The inflow of foreign direct investment (FDI) have been allocated by many Central and Eastern European governments a crucial role in the transition process. FDI would not only help to finance the current account but would play a catalytic role in introducing new technologies and new culture of management and entrepreneurship.

In fact, flows of FDI into the transition economies have been very much less than expected, and far below the amounts flowing into e.g. emerging markets of South East Asia.

The initial enthusiastic expectations concerning the role of the FDI in the Kaliningrad Region was based on couple of assumptions, as that a geographical proximity to western markets, an abundance of cheap skilled labour and a liberal commercial legislation of FEZ "Jantar" would be sufficient to attract foreign investors. The balance after the three years of the existence of FEZ "Jantar" is dismal. Apart from a few investments of some substance, (Vestbalt Telecom, AGA, Baltcran, Neman Pulp and Paper Mill), foreign investment has tended to be very hesitant and on a small scale.

The Russian market, including The Kaliningrad Region, fulfils only a few strategic requirements out of the ranking list of characteristics which is used by the international investors to sort out an emerging market. Those are an educated, industrious population and a commitment to free enterprise. But there is no: political stability, predictability of economic policy, low budget deficit and low level of government spendings, high savings rate, convertible currency, liquid stock market, low and transparent regulations, etc.

Foreign investors pick up the best companies in the Region, in terms of their market (quasimonopolistic) position (case of AOZT "Vestbalt-Telecom", AGA), unique technology (case of AOZT "Baltic Plus") or access to raw materials (Neman Pulp and Paper Mill). The lion's share of foreign investment in whole Russia goes to the exploitation of raw materials.

A general explanation for the reticence of foreign investors is linked to general systemic factors, such as the uncertain legal, political and institutional environment. The frequent, sudden and unannounced changes and sometimes reversals of earlier government decisions, as in case of FEZ "Jantar", on tax and customs regulations, restoring of partial state controls over

already privatised enterprises, etc. have created uncertainty, confused and effectively frightened away foreign investors.

The disappointment with the levels of FDI was due to *unrealistic expectations*. But there was also the disappointment with the effects of FDI due to a misunderstanding of its motives. Much of the foreign investment that has flowed into Central and Eastern Europe has been driven by rent-seeking and has been targeted at obtaining dominant market shares. There can be no presumption that the activities of the foreign companies will automatically contribute to a diffusion of the new technology and management techniques. On the contrary, if the markets are not competitive or the state lacks effective regulatory powers, which by definition characterises the transition economies, their activities may promote the pattern of growth which will not necessarily be the one desired by the local population. The growing hostility towards foreign investors in a number of transition economies may have much to do with that. Too dominant role of FDI in the host economy can provoke social and political problems.

A recovery of *fixed investments* in a number of the reform economies of Central and Eastern Europe is one of most important developments of the recent years. This recovery has been largely financed by the resources of the enterprises themselves, *not* by the intermediation of domestic savings or *by foreign investors*.

Poland has received very little FDI to date - only \$42 per head compared with \$670 in Hungary and \$319 in the Czech Republic - and yet it is showing the most sustained recovery in output and a strong upturn of investment in new machinery and equipment, most of it bought outright from OECD sources and not acquired through joint ventures or outside investors.

Much of the current investment activity is focused on rationalisation and modernisation. The growth of the enterprises' own resources was a function of large productivity gains and a moderate growth of wages. Increased profit margins were an important source of funds for enterprises wishing to invest. In the short run this can be seen as a form of "*forced saving*" in the countries where financial institutions are still very underdeveloped.

FDI is not ineffective or irrelevant to restructuring and restarting growth, but it is not a necessary condition for getting the process underway. There are reasons for doubting whether the emphasis on FDI as having a leading role in the early stages of transition is crucial for recovery of output and investment. There are other ways of obtaining new technology. FDI should by no means be used as a substitute, rather than a complement, to the mobilisation of domestic resources.

Since foreign investment seems unlikely to be available in significant amounts, an alternative strategy suggests high priority should be given to reform of the financial sector, in order to mobilise *domestic savings* to long term industrial investment purposes, and to broad-based *export promotion* programmes.

At the present the insufficient rate of domestic savings, unwillingness to long term investment and lack of proper instruments limit the potential for domestically financed investment. This is due to the low level of per capita income, high inflation and general uncertainty. Policies to encourage more savings and to channel them to desired investment are urgently needed. A variety of incentives should be developed. Real positive interest rates on bank savings is an important but not sufficient one. Others are attractive and secure savings instruments such as mutual funds, pension funds, bonds and equity shares.

Given the need for imports of new technology, an expanding capacity to import will largely depend on the growth of exports. Export promotion efforts should be directed at neighbouring countries, including Germany and Scandinavia. This will require improvements in the trading

infrastructure of the Kaliningrad Region. And this in turn may encourage an "outward-looking" FDI which will contribute to expand exports over the longer term.

## 6.1 Findings on foreign investment up to date in the Kaliningrad Region

Registration of enterprises with the participation of foreign capital is conducted by The Joint Ventures Registration Department in the SEZ "Jantar" Development Committee. Since December 1<sup>st</sup>, 1991 until June 30<sup>th</sup>, 1995, 1024 joint venture enterprises have been registered, which is roughly 1 j.v. per 1000 inhabitants. It can be compared to 15.800 joint ventures in whole Russian Federation (from Jan. 1<sup>st</sup>, 1991 to Dec. 1<sup>st</sup>, 1994), which is less than 1 j.v. per 10.000 inhabitants.

The registration department has noted a considerable slow down in the inflow of new applications after the revoking of FEZ privileges in March 1995. The exact figures was however not yet available.

The minimum equity is 55 million rubel, which is equal to the average wage x 1000. The registration fee is 5 million. Registration procedures are rather costly and time consuming. All submitted documents should be translated to Russian and attested by the Russian notarius publicus. A special group of lawyers assists The Registration Department reviewing the application documents. The staff of the Registration Department agrees that the procedures are too complicated, but cannot see how to simplify them, due to the risk of cheating.

303 companies are 100% owned by foreigners. The Registration Department in the Kaliningrad Region is authorised to register companies with up to 100 million rubel of foreign equity capital. Some 10 companies operating in Kaliningrad with the foreign part exceeding this amount were registered in Moscow.

Total amount of equity capital (declared) is 27,6 billion rubel (=6,2 million US\$); 15,9 billion rubel (3,5 million US\$) of this amount is foreign capital. This has to be, by all standards, described as a negligible amount. Actually introduced capital is even smaller, 15 billion rubel. Full amount of declared capital has to be paid within one year after the registration of the company.

Experts of the Ministry of Economy of Russian Federation estimate the expected volume of inflow of foreign investments in Russian economy in 1995 to US\$ 1.5 - 2.0 billion. The Kaliningrad Region's share of it (1/165 of Russia's population) should be 9 to 12 million US\$. This will be difficult to achieve. While the number of j.v. in the Kaliningrad Region is ten times higher than in Russia as a whole, in proportion to the population, the invested amounts are much smaller. Most j.v. are minimum equity capital companies in services (consulting, procurement agencies, etc.), trade, construction, tourism, transportation. Manufacturing j.v. have all together 300 employees and 235 billion rubel (60 million US\$) value of output.

There are j.v. with 44 countries, 34% j.v. are Russian - Polish

20%	Russian - German
16%	Russian - Lithuanian
8%	Russian - Latvian

In terms of capital invested, the leading investor is France (due to one major investment in AOZT "Vestbalt - Telecom"), followed by Germany and Poland.

The above figures do not include the investment of an American company, Uninvest Paper International, in the Neman Pulp and Paper Mill. The deal was signed after the July 1<sup>st</sup>, 1995. The company from California acquired 62% of the equity of Neman Mill for 1.2 million US\$, after winning the investment competition with the modernisation programme of the mill of additional 16 million US\$. For details about the Neman Pulp and Paper Mill, see the Report "The Pulp and Paper Industry in the Kaliningrad Region" by Börje Kyrklund.

Interviews with foreign investors (German, Polish, American, Swedish), foreign trade representatives and foreign banks indicate that the main reason for their presence in the Kaliningrad Region is (was) its status as a FEZ, combined with the great potential of the Russian market. The small local market is the sufficient reason for establishment only for small trade and construction companies from neighbouring countries. Cheap but highly skilled labour is the reason in a number of cases. Some investors include the Kaliningrad Region in their all-Baltic strategy (for example petrol chains, industrial gas). The geographic location may be important for e.g. shipyard repair services and some transport services.

Several foreign investors air their disappointment with the unstable legal conditions, first of all the abolishment of the FEZ privileges. They continue however their presence on low level manifesting "wait-and-see" attitude in a hope for re-establishment of FEZ-regulations

## **6.2 Legislation related to foreign investment**

See Appendix

1. The legislation on foreign investments
2. The legislation on stock markets
3. The currency regulations
4. The legislation of the Kaliningrad Region
5. The main documents regulating the foreign investors' activity in Russia
6. The List of major joint ventures
7. Taxation of foreign investment



## 7. Investment promotion and privatisation

Voucher privatisation in the Kaliningrad Region, as in whole Russia, is an example of the rapid "formal" transfer of ownership away from the state which is followed neither by effective governance, nor by an inflow of new capital. Even though the state managed to divest itself of a greater part, some 80%, of its industrial property designed for privatisation since the start of privatisation in 1992, the behaviour of enterprises has in fact changed very little, if at all, and not necessarily to the better, because the new owners are either dispersed or, if they hold strategic stakes, are unable to exert the desired influence on managers because the lack of information, conflict of interests or general passivity. Many investors only speculate on reselling their blocks of shares at a profit. The privatised enterprises are thus "non-state", but they are not fully private in the western sense of that term. Moreover, only limited funds have been channelled to the enterprises as a result of this method of privatisation.

The good side of this privatisation method is that it does not fix a final privatisation pattern, with the absence of a single controlling owner. It allows for the evolution of stock market in search for a form of ownership that best suits Russian conditions.

75 % of all enterprises were acquired by the employees under the so called second option for privatisation (an enterprise's employees can, by a two-thirds vote, take over 51% of the enterprise's stock).

The shift in the privatisation policy in April 1995 towards selling enterprises at investment competitions can give a real boost to investment. It has given first positive results in the Kaliningrad Region (Neman Pulp and Paper Mill)

The conversion of existing state enterprises is only one route to privatisation. There are many other ways for shifting state assets into private hands, prior to or beyond the official privatisation plan. "Privatisation of profits" from a still state owned enterprises, starting of several overlapping co-operatives by employees and managers of the one state enterprise, leasing capital goods from the state enterprise are different forms of "*spontaneous privatisation*". It is the name given to illegal or quasi-legal undertakings leading to *de facto* marketisation of the economy, whose fundamental principle is sponging upon public property. Consecutive formal privatisation of such an enterprise could be just an *ex post* confirmation of somebody's common law claim to a piece of state property. One variety of legalisation of private control of state property involves setting up a private bank and selling shares of the enterprise to the bank. The owners of the bank, who thereby become *de facto* stockholders of the enterprise, are typically the managers and higher level officials of the enterprise.

However, it should be clearly stated that the spontaneous privatisation, prior, beyond or in a shadow of official privatisation programmes, has freed a great deal of new economic activity to the benefit of the country. The rational way of eliminating negative features of this situation is no more state control, but establishing clear property rights with explicit ownership claims. The authorities should aim at reducing any ownership uncertainty, prevent any competing claims and limit any informalities of property rights, through, first of all, curbing the administration's own ambitions to exercise influence as the former owner. The new owners should be given the chance to behave as a real owners, with all involved responsibilities and duties. The authorities on their side should concentrate on creating an environment of right market economy incentives.

Potential investors face several difficulties related to the privatisation process, by the economists referred to as high "transaction costs". Continuing state control and restricted or

uncertain property rights after the privatisation (e.g. as to the land) reduce the incentives for investors. The hope for state enforcement of private contracts is very little since the protection offered by contract law is weak and the judiciary system is incapable. Illegal or semi-legal private use of state assets. Corruption. Organised crime. A more detailed analyse of these phenomena is beyond the scope of this report.

## **7.1 Findings on the state of privatisation in the Kaliningrad Region**

The Kaliningrad Regional Property Fund, a regional agency assigned the task of policy implementation of the State Property Committee, the federal privatisation authority, has carried out 737 privatisations of the state owned enterprises. This is 48,8% of all manufacturing enterprises in the Region, and 80% of enterprises intended for privatisation. According to the plan, some 180 enterprises are to be privatised in the near future, and some 550 enterprises will stay state owned.

316 joint stock companies have been established, 120 out of them are 100% private. In the rest the state remains a shareholder to the various degree.

The predominant method of privatisation until the spring 1995 was, as in the whole country, the so called second option, giving the employees and the management the right to take over 51% of the enterprise.

The authorities have no clear picture who were the buyers. There is no central registration of the shareholders (securities). The guess is that the biggest group among the new owners, after the employees and managers, are "fund speculators", more or less anonymous financial gamblers. They have made their money on speculative trade, quick currency operations etc. and have no any experience in the management of manufacturing enterprises. Even having a controlling share packages they are not interested in an active ownership.

Many of the Kaliningrad Region's almost 100 banks are among the new owners. Some of those banks are rather tiny establishments with obscure business idea. The real nature of their relation to the enterprises remains a mystery.

There is a wide spread criticism of privatisation in the Kaliningrad Region, however the critics avoid to reject the whole process on the ideological ground. They point to the disastrous results of privatisation in the particular cases, denouncing the scope, methods and pace, rather than the aims of privatisation. The most criticised privatisation is that of "Russky Jantar" (the Amber Mine). For details see the Report on Light Industries by Jean L. Fabre. Also the privatisation of the fishing industry, including the fishing fleet, the shipyards, the harbours and others are among the most often mentioned warning examples.

The selling of the redundant assets by the state owned and even privatised enterprises is very rare, and discouraged. The private entrepreneurs with expanding business complain that they cannot buy production premises, despite that they are empty or under-utilised. Instead, they are charged high leasing fees or offered to create a joint venture with the state enterprise, with a piece of state property as a share capital.

Privatisation by the liquidation of the state owned enterprise and selling of the assets is not applied. There has been no bankruptcies until now. Bankruptcies and close downs are still sensitive political questions. Also selling of land, forbidden by law, is a very delicate political

matter, which is understandable in the Kaliningrad Region because of historical reasons. There are no plans to change this. A very secure long-term lease would be a solution. Instead, the investors are offered short-term lease with unclear rights, e.g. as to the selling their ownership claims. Taken together, these are very serious obstacles to the transfer of production means from old to new businesses, from the state to private hands

Until the early 1995 there were almost no efforts to support, improve or change management, to enforce the financial restructuring and to draw up reconstruction and modernisation plans in connection with the ownership transformation. Some analyses of the after privatisation processes have been initiated only recently.

The so called "second stage" of privatisation, launched by the Federal Government earlier this year, recommends selling shares at the investment competitions, aimed at the establishment of a balance between the revenues to the state budget and the investment support for the enterprises being privatised. 8 enterprises in the Kaliningrad Region have been sold according to this scheme until now. The most prominent example is The Neman Pulp and Paper Mill.

## **8. Investment promotion and the financial markets**

The reform of the financial system is not only an integral component in the transition to a market economy. The creation of the financial and banking sector, as a heart of market economy, should be initiated at the very beginning of the transformation process. The failure to do so at the start of the transition has a number of serious adverse implications for the economic development.

One can hardly speak about the existence of financial market in the Kaliningrad Region. Many important institutions of financial intermediation (such as pension funds, mutual funds, specialised savings and loans organisations, security firms, equity and bond markets, etc.) are absent or very embryonic. The existing commercial banks have a very small capital base. Their credit operations are very limited, concentrated to the extremely short term lending to trade operations or to a limited number of old clients, mainly large state enterprises. There is virtually no experience in financing long term industrial investments. Due to high inflation and interest rates, most banks deal only with the state treasury bonds and foreign exchange speculations. Prudential regulations and bank supervision is either absent or inadequate. Collateral for credit is also very difficult to find, since property rights are restricted or uncertain.

There is a number of efforts being taken on the federal level aimed at the development of the financial market and thus attracting citizen's savings to the productive investments. There is a new decree on mutual investment funds. The Central Bank is revising a system of special investment deposits. There are state securities for citizens - savings bonds, and other instruments. Early preparatory steps initiated by the administration of Kaliningrad Region will assure an early, as soon as those legal provisions are effective, introduction of this new possibilities to the advantage of the Region.

### **8.1 Findings on the financial market in the Kaliningrad Region**

- a. Banks
- b. Insurance companies
- c. Investment institutions (broker firms and investment companies)
- d. Pension funds
- e. Investment funds

a. Dominant position on the Kaliningrad Region's financial market, as in Russia as a whole, is occupied by commercial banks. It is typical for most of the developing countries and defined by insufficiently developed financial market, the capital market in particular.

There are 29 commercial banks (on June 1<sup>st</sup>, 1995) and 24 branches of banks from another regions, apart from Savings Bank of Russia's branch network. This is above the average for whole Russia (there are more than 2500 commercial banks in Russia). The branches of a number of Russia's 100 top banks are registered and operating in the Region: "Imperial", "East-West", "Kredo-bank", "Vozrozhdenie", the branches of "Mosbusinessbank" and "Incombank" will be opened soon. The representative offices of two Polish banks have been opened. Relatively liberal position of the Regional Administration and the local agency of the

Central Bank of Russia is conducive to establishing of branches in the Region, which is a rather unique phenomenon in the Russian Federation at present

It should be noted, however, that the financial flows in the Region are limited. None of local banks has been included in the 1994 year's list of the 100 top Russian banks. Assets of Baltvneshtorgbank, the biggest bank in the Region, was roughly 50 million US\$, by the beginning of 1995

b There are 18 insurance companies, 14 are operational, and additional 4 companies got a licence and are under organisation. 19 branches of insurance companies from other regions are registered in the Kaliningrad Region.

The Region's insurance market is typical for whole Russia, with its 2700 insurance companies as a total. The insurance companies' investment potential lags far behind the banks'. Their primary investment strategy is to invest in bank deposits, bills and short-term state securities. "Baltpolis", a branch of Rosgosstrach, the Russian state insurance company, has the leading position on the Kaliningrad market.

c There are 12 investment companies licensed to operate on the securities' market. There were more than 30 such companies before the Russian Ministry of Finance raised the requirements for own capital of the investment companies.

The usual business idea of such companies is to buy shares (vouchers) from employees of the privatised enterprises and form a majority stocks. The reputation of this kind of investment companies has dwindled recently, their power and influence are limited, even concerning their own investment objects. Shares of many industrial enterprises are not liquid now.

d There are 2 local pension funds in the Kaliningrad Region. Their operations, the number of clients and the turn over, are very limited. People prefer to invest in hard currency and short-term bank deposits. The legal base is not sufficient, even if the outline of federal law on pension funds contains some good provisions.

Only in the long run, the Russian pension fund will achieve same position and trust on the financial market, as they enjoy in the western economies, provided that the political and economic stability will be maintained.

e. So far, there is no regular mutual funds in the Kaliningrad Region. The major obstacle is the double profit taxation on the investments in such funds.

The decree of president Yeltsin on establishment of mutual funds, issued this summer, allows to solve this problem without changing the taxation law. One can expect therefore a fast development of mutual funds. Various investment funds, until recently attracting small savers' money, may legally transform itself into mutual funds.

## **8.2 Existing system of State Investment Support**

See Appendix 8 State Support of Investment Promotion

Appendix 9 List of Projects of the International Technical Assistance to the Kaliningrad region

## **9. SWOT analysis**

<b>S - cause</b>	<b>- what to do</b>
<b>1. Determination of the Regional Administration for reform</b>	<b>- continue to develop this attitude through specially designed and well directed projects aimed at making the administration even more professional and market oriented</b>
<b>2. The K-region's history, geographical location, intellectual traditions, european heritage (e. g in architecture), which is unique in Russia</b>	<b>- do not renounce it, protect it and develop wherever possible, use this in the promotion of the region</b>
<b>3 Geographical proximity to the western countries</b>	<b>- improve infrastructure, use in the promotion of the region</b>
<b>4. Tourist attractiveness: coastal line, favourable climate conditions, german heritage</b>	<b>- support SMEs in the tourism sector, based on the german "nostalgia" tourism and domestic tourists, organised groups, conferences etc.</b>
<b>5. Relative social stability and absence of national antagonisms</b>	<b>- use in the promotion of the region</b>
<b>6. Availability of some natural resources, such as amber, oil, raw materials for building industry</b>	<b>- encourage the development of the industries based on these recourses</b>
<b>7. Existing status of the region as FEZ</b>	<b>- make it better known, use in the promotion of the region</b>

8. Relatively large number of market oriented population, entrepreneurship spirit is relatively more common, experience in foreign economic activity of the region's enterprises - support SMEs, make the enter to the legal market more attractive

**W - cause**

**what to do**

1. Uncertain strategy of the Federal Centre as to the future of the Region, lack of stable Russian legislation regarding the Region - increase the efforts in order to make Kaliningrad problems better known and gain allies in Moscow
2. High transport expenses due to enclave position regarding the territory of Russia - use as an argument in Moscow for promotion of the Law on Special Economic Zone in the Kaliningrad Region
3. Insufficient co-ordination between the main power bodies in the Region - consult and if possible get before hand approval for proposed solutions from all major political parties in the region, keep the proposals as expert like and practical oriented as possible, avoiding political affiliations
4. Small internal market - improve access (transport, formalities) to the all Russian market
5. The image of the region as a "military base" - turn it to the advantage: a lot of well educated personnel, high work discipline, low criminality, well developed port facilities etc.
6. Undeveloped public services - use contract system, alternative financial sources and partial privatisation

O - cause

what to do

1. Small size of the region with access to the big market, which should mean: easier to do business; the K-gard region has to be known as more business friendly than other parts of the Federation  
- shorten even more the decision ways, simplify the administrative routines, cut the bureaucratic red tape; introduce several staff training programmes
2. Numerous bank establishments in the region (undeniable existing "power house")  
- develop the concept of the off shore banking ("Trieste of the Baltic Sea")
3. Existing drafts of the Law on Special Economic Zone in the Kaliningrad Region, the Law on Free Economic Zones in the RF  
- develop the drafts of the laws, boost them in the State Duma
4. Intellectual potential in highly specialised research and educational establishments  
- develop the concept of the high tech parks, counteract the disintegration of the research teams and the emigration of the qualified staff from the region
5. Federal financial support to industrial enterprises (soft budget loans for Kaliningrad Region)  
- develop the mechanisms of the effective use of these loans in the Region

T - cause

what to do

1. Political sensitivity of the Region as to relations between the Region and the Federal Centre, Lithuania and Poland  
- use as an argument in Moscow for special treatment, FEZ or SEZ regulations, decentralisation of power to the Region, subsidies, tax privileges, etc. as a necessary compensation
2. Competition from neighbouring Baltic  
- assess the capacity and the market in the



countries and from other regions in Russia

whole Baltic region (market studies); seek an early co-operation, specialise in some niches, avoid direct competition with the stronger players in the same field

**3. Increasing criminality**

- whole range of conceivable programmes; give priority to the less costly ones, encourage grass roots initiatives, self reliance, support NGOs

**4. Unattractive business image of the Region**

- elaborate a positive image programme, promote the Region as the gate to and the part of the great Russian market

## 10. Visions and ambitions

The Kaliningrad Region should be widely known as a business friendly region having a good investment climate offering a significantly better conditions for investors than other parts of Russia. *It has to be easier to do business here than in other parts of Russia.*

The Kaliningrad Region is the most western outpost of Russia and it has to use this advantage. As once in the past St Petersburg was the Russia's gateway for westernisation, Kaliningrad can play a similar role today, being a gateway for modernisation, restructuring, trade etc. Several of the Kaliningrad Region's disadvantages, the small size, the exclave status etc., can be turned to the advantage of the Region through special legal solutions, necessary to compensate for disadvantages, but at the same time placing the Region in the forefront of the all-Russian reform process, making it a sort of experimental field of marketisation.

The region will achieve competitive advantage through:

- special regulations on both federal and regional level,
- consistent and stable economic development strategy of the local government, well-anchored in all major political parties of the Region and supported by the inhabitants,
- initiatives concerning the development of financial markets, privatisation, management development etc.
- export promotion efforts,
- transparent business support policy,
- professional and open attitude in dealings with the business community,
- well designed long term promotion of the region.

## 11. Project Concept

There are several conceivable project concepts, aimed at the investment promotion, based on the above analysis and vision. We shall limit our list of proposals only to the projects already supported by local stakeholders, being discussed with international donors or anchored in some other way.

While the government, central or local, should not be directly involved in commercial activities, it has to create conditions (legal and institutional framework, set of incentives, support and service functions etc.) for the actors on market, in accordance with its political and social preferences. Creation of such framework is the essence of the whole reform process in the transition from planned to market economy.

The local government, Administratsya Kaliningradskoy Oblasti, is a first and foremost power engine of the development of the Region. Its decisions and attitudes have immediate and far-reaching impact on the direction of the development of the Region. It has achieved a lot already.

Many functions, however, can be improved by developing the skills and abilities of key public management leaders. This can be done by participating in specially designed high level seminars, with invited international specialists on regional development, investment attraction and administrative development. Also the exchange of experiences with local leaders from other countries would be useful. (See project proposal nr 1)

The ambition of being *the business friendly region* in comparison with other regions of the Russian Federation implies several changes and improvements concerning the administrative functions and routines on all levels of the administration. An extensive training programme for officials on the middle and lower levels should be carried out. (See project proposal nr 2. See also the Report of Reiner Fölster on institutional infrastructure regarding the SME sector, chapter "General description of actions and Instruments, paragraph 7 "Training program for serviceminded staff at border stations".)

The natural element of the "business friendly" strategy is the institutional adjustment. The purpose will be served by two proposed institutions: "one stop agency", or investment promotion authority, called International Business Support Agency (IBSA), see project proposal nr 3, and the technical assistance centre (TAC) for after privatisation support of medium and large enterprises, see project proposal nr 4. Project proposal nr 5, export promotion and image upgrading activities, belongs to the same category.

An undeveloped financial market is an important drawback to investment: there is lack of capital and/or lack of proper allocation mechanisms. In the Kaliningrad Region there are several ideas and initiatives aiming at the development of financial instruments and institutions. (See appendix 8) They are based on:

- legal opportunities opened by federal legislation
- regional extensions of, or equivalencies to the federal institutions
- state financial resources made available to the regional authorities
- technical and financial assistance of TACIS and EBRD.

The conceptual and organisational advancement of those initiatives varies. In several cases they need further expert support to materialise. The activities of different administration agencies and committees now controlling the available state funds should be better co-ordinated (instead of today's competition) on the basis of the overall development strategy of the Region and in

accordance with the principles of market economy. Establishment of a new institutions and instruments should be considered. Regional venture capital fund and regional leasing company. The biggest commercial banks in Kaliningrad should be involved, but the initiative from the Administration, soft state loans and organisational support in the initial stage will be inevitable. See suggested project proposals nr 6 and 7. (See also paragraph 6 "Task Oriented Seed Capital", chapter "General Description of..." in Reiner Fölster's report on SMEs.)

Projects 6 (regional bonds) and 7 (investment support strategy) should be co-ordinated with UNIDO "Kaliningrad 2000" project. Expert findings within this project should be the base for selection of priority investment project to be supported and/or financed from these sources (bonds and budget resources).

### 11.1 Specific Project Proposals

1. High level seminar(s) for the development of the public administration functions.
  - Principal subject should be: the role of public administration in the industrial development and investment promotion in the market economic environment.
  - Participants should be 15 - 20 key persons from the Kaliningrad Region Administration, the Regional Duma, the municipal authorities. Invited experts should be top international specialists on regional, industrial and administrative development and on investment promotion. Also regional leaders from other countries (Poland, Sweden) should be invited.
  - 2 - 3 days seminar(s) should take place outside the Kaliningrad Region (e.g. in Gdansk, Poland, in Karlskrona, Sweden) in order to take the officials out of their day-to-day routines, and to ensure at the spot study of foreign experiences.
  - The potential contributors to the funding could be UNIDO, TACIS (Human Resource Development Programme - public administration and training), SIDA. Estimated cost of one seminar: 50 000 US\$. The first seminar should be organised as soon as possible
  
2. "Business friendly" campaign and training programme for functionaries in the regional administration at all levels.
  - The objective of this programme is to simplify the administrative routines, to shorten the decision ways, to cut the red tape, to eradicate remaining bureaucratic attitudes from the planned economy and to introduce a modern, professional service minded administration.
  - The programme will consist of several short term courses in administrative techniques, in fundamentals of market economy (with the stress on the new role of the public administration), in public service functions. It will also consist of informational campaigns (brochures, leaflets, meetings) on needs and expectations of private business, service spirit, etc.
  - Participants should be middle and low level functionaries from the regional and municipal administrations, customs, tax authorities, etc.
  - The programme should be financed to the greatest possible extent from the domestic sources. TACIS (Human Resource Development Programme - public administration and training), SIDA, UNIDO could contribute to

finance foreign experts, first of all to train the trainers. Estimated cost for foreign input in the first phase is 100.000 - 200.000 US\$.

3. Establishment of the International Business Support Agency, IBSA, ("One Stop Agency")
  - IBSA is to be established for the purpose of supporting foreign businessmen and investors who are going to do business in the Region. It will provide all the information and services concerning:
    - investment climate in the Region
    - seeking reliable Russian partners
    - assisting in the registration of joint venture(s)
    - assisting in establishment of contacts with the regional and local authorities.
  - According to the preliminary terms of reference for the first TACIS project in the Kaliningrad Region "Support of the development of the Free Economic Zone in the Kaliningrad Region" this Agency is to be established in 1996 as a department of "Yantar" Fund.
  - The total for the project is ECU 2,5 million. 800 thousand ECU should be earmarked for IBSA (600 th. as a consultancy fee, 100 Th. for technical support and 100 Th. for education).
  - The main beneficiary of the project is to be "Yantar" Fund.
  
- 4 Development of the Technical Assistance Centre (TAC) for support of privatised medium and large enterprises (after privatisation support)
  - Setting up of the TAC is proposed by the second TACIS project "Post privatisation assistance to enterprises in the Kaliningrad Region". The aim is to address after privatisation needs of enterprises over the period of two years and to create the conditions of self-sustained follow up. The more specific objectives of the programme can be formulated as:
    - to provide TA to privatised (or new) medium and large enterprises in need of restructuring of their finances, business plans etc.
    - to identify investment needs and projects, and foster investments
    - to promote contacts and foster long term relationships with EU firms
  - The tender for the project is to be announced in the near future. The total for the project is ECU 1 million.
  - The TAC's activity should be co-ordinated with the phase IB of the UNIDO project concerning the assistance to the concrete enterprises
  - The beneficiary of the project is the Committee for State Property Management of the Kaliningrad Region.
  
5. Export promotion and image upgrading activities (outward directed information campaigns, trade representatives etc.)

- The proposed project, of great importance to the investment promotion, will be elaborated in the Regional Development Subproject by Roy Liff. The idea is also suggested by Börje Kyrklund in his report on pulp and paper industry.
6. Elaboration of the concept of regional and municipal bonds, insurance company, pension funds, mutual funds, collateral fund.
- The objective of this project is to assess the feasibility of these financial instruments and institutions in the Kaliningrad Region (bonds, collateral fund) and support the development of the already existing embryos: (insurance company, pension funds, mutual funds)
  - The project will consist of several subprojects: the expert elaboration of business plans and feasibility studies of each institution. In the second step, the organisational and implementation advisory support will be needed. In some cases, the Administration may decide to commission the implementation from the private firm (e.g. regional and municipal bonds). In that case, the preparation of tender will be needed.
  - Management of already existing embryo institutions, initiators within the Administration and the Municipal Office, in close co-operation with the responsible Administration officials, should form the task groups with the participation of international and domestic (from Moscow and St Petersburg) experts.
  - The financing of the international expert input can be provided by EBRD (the Financial Institution Development Project), possibly also TACIS, UNIDO, SIDA. At this stage, it is not possible to estimate the cost of each part of this project.
7. Elaboration of the investment support strategy based on the regionally available recourses (soft loans and co-financing from "Yantar" Fund, "Budzhetskaya suda", Compensation Fund, Federal Fund for Support of SMEs; see appendix 8 "State support of Investment promotion, paragraphs "Budget Loan", "Compensatory Payments" and "Financial support to SMEs")
- The objective of this project is to elaborate the coherent policy of using available state funds for investment promotion and better co-ordination of the activities of different administration agencies.
  - Establishing of new institutions, such as venture capital fund and regional leasing company should be considered.
  - A task force, consisting of mixed domestic and international expertise, at the request of, and placed directly under the Head of the Kaliningrad Region Administration, should elaborate a general strategy of financial support to the enterprises, including main directions, allocation principles, application procedures and organisational framework. At the second stage, a more detailed policy guidances and statutes of each agency should be worked out and specially designed training programme for the staff personnel assigned this tasks should be carried out.
  - This project should involve all agencies dealing with financial support to the enterprises, including the Financial Unit, the Credit Commission of the Administration, the Committee of the Free Economic Zone "Yantar", Property Management Committee, "Yantar" Fund, banks participating in the

distribution of state resources etc. Some organisational changes and competence shifting between them might be made by the Head of the Administration as the result of the expert task force proposals. On the initial stage of their activities, they may need organisational and policy implementation support.

- The expert task force should be established and start work immediately. The cost can be estimated to 300 thousand US\$. The second stage (detailed guidances, training programme, organisational support) should be a long term programme (one-two years) of 500 thousand to 1 million US\$. Financing can be provided by UNIDO, EBRD, TACIS.

#### 8. Establishment of off shore Free (Special) Economic Areas in Kaliningrad Region

- See Appendix 11. Concept of Creating an Off-shore Zone in the Kaliningrad Region
- EBRD has declared itself ready to assist the Region on how to create an off-shore zone. Also TACIS has offered to work together with the EBRD on such a technical assistance project. However, they will provide the assistance once the law on Kaliningrad has been approved by the State Duma

#### 9 Research and Development Centre ("Technopark")

- See Appendix 12. Kaliningradsky Oblastnoy Nauchno-technichesky Centr (The Kaliningrad Region Technical Research Centre).
- See also paragraph 4 "Converting idle military and other premises into business incubators", chapter "Maintenance sector" in Reiner Foister's report on the SME sector.

### 1. Legislation on foreign investments

The main legal act in this sphere is the law "On foreign investments in the RSFSR" has been adopted in 4 of October, 1991. Foreign investments in this law are accepted as "all kinds of property and intellectual valuables to be invested by foreign investors to gain a profit (benefit)".

The law regulates mainly legal relationships associated with founding and functioning of the enterprises with foreign investments (EFI), more then the half clauses are devoted to activities' regulation of such enterprises. But doing so, some quite common forms to grant the foreign investments are outside regulation (for example, long-term loan agreement).

In general, preferential regime for the foreign investments is pronounced in the law, series of privileges for EFI are defined. However, when in 1992, Russian Government had been reoriented towards the conception of uniform regime of legal regulation for the enterprises and the property of either forms, even whose small privileges and guarantees to be presupposed by above law were virtually abolished.

In particular, in 1992-93, tax holidays presupposed for EFI, duty-free export of own goods and customs privileges to import the goods for own industrial needs, free-use right of currency returns, etc., were cancelled. Only exception was made for EFI to be recorded prior to 1 of January, 1992.

Starting from second half of 1993 (by adopting in 27 of September, 1993, the decree of the president of the Russian Federation # 1466, which submitted to all EFI three years immunity from inflicting the losses acts of Russian bodies) some turn towards preferential regime of foreign investments accepted in many countries, being in need of foreign capital, had appeared. Then, few acts of the President and the Government of Russia were issued, they were oriented towards some liberalisation of foreign investors' activity within Russian market (In particular, these acts presupposed some export tariff advantages for several categories of EFI, partly abolishing limitations on foreign banks function within Russia, prolonging the tax exemption from VAT and special tax for equipment imported for industrial development, including EFI).

However, it is possible to share the opinion of the most experts, considering these means distinctly insufficient for qualitative changing of the situation in positive direction.

The 'rules of the game' for legal regime of foreign investments in Russia being changed every three or four months continue to reinforce more and more the hesitation of serious investors in stability of Russian legislation, which does not guarantee legal protection of their interests even one or two years in advance, what is not sufficient to return on serious investments. The good example in such a field is the story with abovenoted Decree of the President of the RF # 1466. Three years immunity being fixed for EFI with respect to either acts of Russian bodies, who could inflict the losses to foreign investors, remained on the paper thanks to the position of Russian Ministry of Finance. Ministry of Finance refused to follow the decree, which had not been approved by legislative bodies, and the changing in taxation came after that time were imposed to EFI as well.

The basic problems needed to be solved in the immediate future are:

1) the elimination of the contradictions and the harmonisation of the national legislation relevant to the activity of foreign enterprises, their representatives, enterprises with foreign participation;



2) more active work in concluding the agreements on removal the double taxation, on the mutual protection and investment promotion with countries exporting the capital in Russia (recently, such agreements were concluded with Sweden, Hungary and India);

3) the introduction in the law so-called "Grandfather clause" protecting the foreign investors from deterioration of investment promotion conditions during 5-10 years;

4) the laws and legal acts should be expounded in clear and distinct manner to reduce the risk of various interpreting from the party of different state bodies;

5) the introduction of simplified and accelerated procedures to found EFI, especially with small chapter capitals;

6) to refuse the changing in taxation by issuance of instructions, whose acting is put into effect before the approval;

7) solving the issue about land ownership form by foreign investors - the possibility to purchase or rent the land with strong guarantees about stability of rent agreement conditions;

Government carries out some work to solve the above issues. In particular, the law projects "On free economic zones", "On changing the law of "On foreign investments" ( it is supposed in legislative order to fix the introduction of 5 years period, during that, acts of Russian bodies inflicting the losses at enterprise with foreign investments could not be imposed) were forwarded to State Duma for consideration. State Duma has already accepted the law "On agreements concerning the division of production".

## APPENDIX 2

### 2. The legislation on stock market.

Quite numerous quantity of the legal acts (no less then 300, as per different assessments) regulating directly or indirectly stock market were issued by different government bodies (Parliament, President, Government, Central Bank, some Ministries). Accumulated volume of legal acts was not less then 1500 pages by the beginning of 1995.

The problems in this sphere of legislation are:

1) The basic document regulating concrete problems connected with issue of securities and the activity within stock exchange is The statement on issuance and circulation of securities and on stock markets in the RSFSR, confirmed by decision of Government of RSFSR dated 28, December, 1991, #78. This statement was approved when stock market was actually absent, and that is why it is quite old for today and does not reflect the present days. Besides, legal act status of this statement does not promote the stability in stock market regulation.

2) There are some gaps and breaches in the legislation, legal acts themselves do not have the details needed and non-contradictions, these bring traces of the struggle between some government bodies and development conceptions of securities market.

Among undeveloped issues there are following ones could be outlined. The regulation of derivative securities and ownership certificates on the primary securities is virtually absent. The issue about the introduction of clients' accounts to deal with securities (without bank licence) by non-bank investment institutions is not solved. The supervision of financial state of investment institutes through the legislation is not created.

The authorities of Government supervisor bodies and licensing within stock market are frequently crossed in the legal acts.

The insider deals and the legal regime associated with these are not described properly. The legal concept is absent and the regulation of "prices manipulation" is absent correspondingly (it has created the ground for financial scandals, when it is clear that financial fraud exists, but juridically it is absent). There is no list of the deals to be forbidden. There are no standards to control affiliated persons (excluding investment funds).

The special features of foreign investors' acting within Russian stock market and the home companies' dealing with securities within foreign markets are not defined.

The fines system is not developed. Special features of the deals and the information disclosure requirements for directors, officers and chief of stock companies are not developed, if last ones deals with securities of they own enterprise.

3) Russian legislation inclines to formal side (registration, licensing, testifying etc.) but not to content side (sufficiency of the capital, prevention of the bankrupts, financial consistency).

4) Proper supervision of existing rules' use by government bodies is absent (there is "scandals" control instead above), there is not acceleration of such kind supervision and outside "health" monitoring of investment institutions.

Lately, president and government bodies realise the importance of stock market for economic development of the country and pay attention to elaborate the relevant regulative infrastructure (most part of foreign investments in 1994 came to Russia in the form of portfolio investments namely). In particular, President signed several orders on protection of investors rights within stock market, Securities and Stock Commission of President RF in November of 1994 was transformed into Securities and Stock Federal Commission, having status of Ministry and intended to be central regulative body at securities market.

State Duma has adopted the law "On securities market" in 1995, however it has been refused by the President due to series of controversial points. There are law projects on stock companies, on property trust already prepared.

Considering abovementioned, it could be noted that the legislative regulation of stock market is actively being developed and government bodies have made important steps ahead in this field.

#### APENDIX 3

### 3. The currency regulation.

The currency regulation in RF is made as per RF law "On currency regulation and control", accepted in 9 of October, 1992. This law regulates the relationships associated with forming internal currency market, opening the currency account, exchange business. The bodies of the currency control is defined as well.

All exchange businesses are divided into current accounts and capital movements. Last one includes the direct and portfolio investments, granting and receiving the credits above 180 days, remittance to purchase the real estate.

To fulfil the exchange business connected with capital movements, resident needs to get a licence from the Central Bank of the Russia.

Non-resident has a right to open ruble and currency accounts in RF banks. The order how to open the ruble accounts is defined in the Instruction of Central Bank of RF dated 16 July, 1993, #16 "On the opening and keeping the currency of

Russian Federation' accounts for non-residents by authorised banks". To deal with investment promotion (including privatisation) non-residents should open special rubble accounts of "H" type. Non-residents make all kinds of investments and reinvestment within Russia from these accounts and purchase the currency having rubbles in connection with repatriation of benefit to be gained thanks to investment promotion in the Russia.

#### APPENDIX 4

#### 4. The legislation of the Kaliningrad region

Duma of the Kaliningrad region has accepted the law "On condition of investments stimulation in the Kaliningrad region(FEZ "Yantar") in 27 of April, 1995.

In particular, the law provides the exemption from a profit tax in the part of the payment into regional budget during three years for industrial enterprises drawing either Russian or foreign investments (while the following the conditions regarding the amount of investments drawn).

The similar laws were accepted in some other regions of the Russia, for instance in Tatarstan, Komi Republic. However, Kaliningrad one stands out following provisions:

1) Concept of investments is defined quite widely (it comprises not only direct investments into chapter capital of the enterprises, but financial leasing as well as deposits according to co-operation agreements);

2) the privileges granted not only to EFI, but to enterprises drawing Russian investments.

It seems that presence of such law extends the attraction of industrial investments in the Kaliningrad region.

Besides, in accordance with Decree of the President of RF #2117, dated 7 of February, 1993, enterprises being in the Kaliningrad region and having export returns rate no less then 50% in total volume of sale, pay profit tax in amount of 50% from existing tax rates.

## The main documents regulating the foreign investors activity in Russia

4 of July, 1991.

The law "On foreign investments in the RSFSR".

The national regime covers the foreign investments, JV have kept some privileges only in external economical activity. *In connection with acceptance the law "On some issues to grant the privileges to participants of external economical activity" in March of 1995, the JV privileges, which were not mentioned in the law "On customs tariff", were abolished. The basic content of virtually prepared new issue of the law "On foreign investments" is the introduction of 5 years period, during this period, the acts of the Russian bodies, which could inflict the losses to investors of enterprises with foreign investments (at least 30% of foreign participation and no less then fixed amount, there is \$ 100 000 of real contribution of foreign investor in the draft law), should not be imposed.*

21 of February, 1992.

The law "On innermost bowels".

The licenses to use the bowels of the earth were introduced, these cover either concession agreements or agreements concerning the division of production. *The primary problem of law "On agreements concerning the divisions of production" acceptance is the reconciliation of treaty mechanism to define the payment volume of the investor with administrative order of getting the license.*

4 of June, 1992.

The president decree "On some means to develop the free economic zones". The half-reduced tax for raw materials to be extracted within FEZ is being introduced. *The free economic zones need to have much more privileges, special law on FEZ could solely provide these, its preparation is actively being made now.*

8 of April, 1993.

Central bank letter "The conditions to found the banks with foreign investments within the Russia". The conditions are: entrance fee of at least one foreign partner should not be less then \$2 mlns; the license of Central Bank. *In spite of metamorphosis of regulation, the moratorium on activity of foreign banks in the Russia was introduced from the end of 1993 to 1 of January, 1996, then, the part of foreign banks, first of all European ones, was come out from moratorium, the Central Bank conditions stayed the same.*

15 of June, 1993. The order of State Customs Committee "On partial exemption from VAT of imported wares as a commitment in the chapter fund". The exemption covers all the ware, excluding for wares under the excise tax, while the chapter fund is being formed. *There are proposals to introduce new restrictions in the frames of altering the law "On customs tariff", these privileges can use only JV, where real commitment of foreign investor no less then threshold number defined, but there are not a lot of chances to introduce the additional restrictions.*

1 of April, 1994. The statement of the government "On organising the work with foreign investments". The federal centre of project financing and consulting support to foreign investments is established (under the Ministry of Economy). *In essence, new organisations were created instead Russian Agency of International Co-operation and Development to be abolished (RAICD).*

2 of June, 1994. The letter of State Tax Service "On some issues of foreign investments' taxation". The currency credits, to be obtained by taxpayers, should

not be imposed by VAT and a special tax. This is the result of lobbism of Consulting Council of foreign investments in the Russia. *The Council comprises the leaders of 16 big companies of Europe, USA and Japan, its chief is Victor Chienmomyrdin.*

**6 of June, 1994.** The statement of the government "On government registration chamber under the Ministry of Economy". The chamber registries the enterprises with foreign investments. *The substitution of abolished RAICD is being continued.*

**30 of June, 1994.** The statement of the government "On the order to define the production imported by JV for the own needs". The order to define the production for the own needs is confirmed, it is exempted from the import tax according to the law on the foreign investments (except for wares under excise tax). *The same privilege is implied in the law "On customs tariff", therefore, anti-privilege means of the law "On some issues to grant the privileges to participants of external economic activity" do not cover the order presupposed by this decree.*

**29 of August, 1994.** The statement of the government "On activation to draw foreign investments". The structure of Consulting Council of Foreign investments was confirmed.

**25 of January, 1995.** The decree of the president "On additional means to draw the foreign investments in the industrial branches". Foreign companies putting into effect the projects with a cost at least \$ 100mlns with own commitment at least \$ 10 mlns concluding the investment agreement with authorised body, import the wares having paid 50% of import tax rate. *Today, it is hardly single legal import privilege. For the time being, it can use only company "Mars", but the decree is aimed to develop assembling manufactures in the Russia.*

**27 of January, 1995.** The letter of State Tax Service "The explanation about privileges while the forming of the chapter fund". The new thing: exemption from VAT is limited by one year from the moment of JV recording. *Fiscal invasion on foreign investors is being continued.*

**24 of July, 1995.** The statement of the government "On foundation of the statement about the order to conclude and put into effect the investment agreements". The standard investment agreement is confirmed. *Investors being participants of the agreement get a right of encouragement tax to import the own production in the Russia.*

## APPENDIX 6

List of joint ventures acting in Kaliningrad Region  
(to date the October, 1995)

№	Name of enterprise (founding countries)	Branch of industry (field of action)
1.	"AGAKAZ" (Russia, Sweden)	Industrial gases production (oxygen, acetylene etc)
2.	"Cepruss" (Austr., Germ., Ireland, Russia, Switzerl.,)	Pulp and paper
3.	"Baltkran" (Russia, Germany)	Loading cranes
4.	"Lesh-Holding GMBH" (Russia, Germany)	Cars and spareparts
5.	"Vestbaltelecom" (Russia, France)	Communication Service
6.	"Alkatrans" (Russia, Austria)	Trading
7.	"Continel" (Russia, USA)	Office Equipment
8.	"Lemken Selkhoz mash" (Germany)	Agriculture machines repairing, spareparts production
9.	"Roslita" (Russia, Poland)	Trading
10.	"Terminal GMBH" (Russia, Germany)	Trading
11.	"Sov-Hun KFT" (Russia, Hungary)	Fishery & Fishbreeding
12.	"Terminkom Ltd" (Russia, France)	Commercial activity
13.	"Rossban" (Russia, Germany)	Road building
14.	"Trans Reil Vest" (Russia, Sweden)	Dispatching and forwarding
15.	"Baltic GMBH" (Russia, Germany)	Building
16.	"Baltic Plus" (Russia, USA)	Commercial broadcasting
17.	"Baltservice XC International" (Russia, Germany)	Hotelkeeping
18.	"Kaliningradzheldorexpeditcia" (Russia, Sweden)	Dispatching and forwarding

## Appendix 7

### Taxation of foreign investment

The normal level of corporate profit tax rate is 35%. The federal part of this tax is 13% and the local (republican, regional or municipal) part of it is up to 22% (30% for banks, insurance companies, trade organisations). The number of local taxes varies from 17 to 43 in different regions of Russia.

Joint ventures registered after Jan 1<sup>st</sup>, 1994, with foreign participation exceeding 30% and 10 million US\$, are entitled to tax holidays during 2 years after their first profit year.

Joint ventures with 70% of their profit generated in the sphere of material production can enjoy 2 years holidays from federal tax (13%). If their profit from material production is 90%, they pay 25% of the federal tax in the third year and 50% of the federal tax in the fourth year.

The Kaliningrad Region's regulation provides the three years' tax holidays from the local taxes for foreign as well as domestic enterprises engaged in the sphere of material production. Unlike similar regulations in other regions, the Kaliningrad Region's definition of investment entitled to this concessions is rather wide: it includes financial leasing and contributions in accordance with co-operation agreements, and it is alone to cover not only foreign but also domestic investments.

VAT is generally 20 % (reduced from 28% in 1993). This is not a pure VAT but in part a turnover tax of a rather complicated structure. Excise taxes were instituted at the same time as VAT. From Jan 1st to Dec. 31st, 1995 a "special tax (1,5%) for support of vital sectors of national economy" is levied on all goods. In its essence, it is an increase of VAT rate.

There are special export taxes. Export of strategic items, accounting for some 70 % of Russia's exports, is heavily regulated by quotas and licenses. The list includes such the Kaliningrad Region's potential export goods as cellulose, timber, fish, liquor, oil and oil products (along with natural gas, coal, electricity, non-ferrous metals, wheat). The export tariffs are supposed to tax the difference between the domestic price and the world price. There are numerous exemptions from export taxes, discretionary granted to exporters by administrative fiat. The export tax rates are rather high, but frequently adjusted with a downward tendency. But at the same time, new taxes and fees are imposed on trade.

The Russian tax system is usually described (see e.g. Anders Åslund "How Russia Became a Market Economy", Washington 1995) as an inconsistent patchwork. Basic tax rates are high, and allowances for depreciation are far too small. Russian as well as foreign enterprises suffer from the high cost of corruption and extortion, and most of these costs can not be legally deducted. Regional and local authorities add a variety of taxes, in addition to the profit tax: e.g. 1% municipal tax, 3% for garbage collection, 2 % in property tax and 10% in ecological tax, social fees, transportation (road) tax, advertising tax, etc. amounting to a confiscatory taxation levels well over 50% of profit (the construction of these taxes differs and is not necessarily based on profit).

Taxation policies, including tax concessions for foreign investments, in other reform economies vary from country to country. The usual rate of corporate profit tax is 40% (e.g. in Poland). But the stable, consistent and transparent tax system matters more for investors than pure rate levels. Elimination of discretionary decision making, hidden pitfalls and unnoticed frequent changes, free tax inventory activities on all levels of administration, etc. would profoundly improve the investment climate.

### State Support of Investment Promotion

The support and stimulation of investment promotion in the Russian Federation and on the levels of federal and regional executive and legislative branches of powers is implemented in the following main forms:

- legislative;
- financial;
- organizational.

#### Legislative support

The operating Russian legislation in the investment sphere (for more details - see the chapter "Legislation") is at present on the stage of its formulation. At the same time some of already adopted legislative documents and, in particular, the Law "On foreign investments in the Russian Federation", "The Customs Code", "The Civil Code" and also bills which are now under discussion in the State Duma of the Russian Federation "On agreements concerning the division of production", "On concession agreements" create good legal prerequisites for the development of investment promotion. In this respect it is necessary to mention the effort of the Kaliningrad Regional Duma which has adopted the local law "About investment stimulation".

#### Tax credit

The other kind of the state support of investments is so called tax credit which is given to enterprises on the basis of the Law "On tax credits" and adopted on the regional level Procedures of its allocation.

This privilege means the deferment of the profit tax payment in the part which is entered in the Federal Budget (13% of the profit). In 1994 ..... regional enterprises enjoyed this privilege. The total sum of the deferment made up ..... rubles.

According to the President's Decree №2117 from 9 December 1993 "On Kaliningrad Region" regional enterprises 50% of the output of which is exported, have the right for the lessening of the rate of profit-taxation in the part which is remained in the Federal Budget by 50%. The enterprises of the pulp and paper industry enjoy this privilege.

#### Transit through Lithuania

The existence of the comparatively cheap transit through the Lithuanian Republic which, in addition, is legally provided has a special meaning for the economic development of the Kaliningrad Region as a transport junction. At present this problem has been regulated through the adoption of some intergovernmental agreements. It is also necessary to mention that the Ministry of Communication considerably lowered the railway tariffs for the transportation of goods from Kaliningrad to Russia and backwards on the average 25-30% which is to result an increasing of the transportation volumes including conveyance through the Kaliningrad ports.

#### Financial Support

Financial support and investment stimulation are implemented both on the federal and regional levels.

#### The Federal Level

The State Duma of the Russian Federation envisaged in the Budget of Russia in 1995 apportionments an 11 trill. rub of direct state investments. These sums are distributed among final recipients on the competitive basis by two directions:

- as subsidies and soft loans for implementation the most important state socio-economic programmes;



— as soft loans for commercial production projects on competitive base. Competitions are held at the Ministry of Economy of the Russian Federation but every winner can get only 20% of the financing required on that, the rest 80% is supposed to be already available at his/her disposal.

In the Kaliningrad Region there is only one enterprise - the Chernyahovsk Milk Plant which with the Business Development Bank (Moscow) has won the Ministry of Economy competition and got centralized co-financing for the milk processing project implementation.

### The Regional Level

#### Budget Loan

According to the President's decree № 548 (1992) "On some measures for socio-economic support of the Free Economic Zone development" The Free Economic Zone "Yantar" Development Committee in 1995 got from the Federal Government 200 milliard rubbles budget loan in the form of a tax credit for the implementation of the Free Economic Zone infrastructure development projects and for the construction and reconstruction of objects which have a special meaning for the development of the region as a whole. According to the agreement concluded by the Ministry of Finance of the Russian Federation, the Administration of the Kaliningrad Region and The Free Economic Zone "Yantar" Development Committee, the budget loan is granted for the period of up to 7 years with 2 years holidays and the 25% rate re-financing of the Central Bank of Russia at the moment of payment. Compulsory capitalization of the loan into the initial capital of the borrower on behalf of the State is actually a form of deprivatization which is a special condition for granting the mentioned loan. Incidentally the package of shares, at the amount of the loan, becomes the property of the State Property Committee.

At present the decision on financing of 7 projects, including the projects of the airport reconstruction and building of the petrol - filling stations network, restructuring and conversion of the "Kaliningradbummash" and "Yantar" enterprises has been taken (The detailed information is given in the Enclosure). The possibility of granting the loan to the export-oriented pulp and paper enterprises "Cepress" and "Darita" and also to "Yantar" Fund (Regional Development Fund) for cofinancing projects concerning small business is being considered.

The preliminary selection and examination of projects is made at Free Economic Zone Development Committee and "Yantar" Fund and then projects are considered during the sittings of the Expert Council of the Regional Administration.

The final decision on the loan allocation and terms of its granting is taken by the Loan Committee led by the Financial Deputy Head of the Regional Administration.

#### Profit Tax Privilege

According to RF President's Decree № 2117 of 9 December 1993 "On Kaliningrad Region", the enterprises which exports more than 50% have the right to diminution the profit tax rate by 50% of the part passed to the federal budget.

#### Compensatory Payments

After the abolition privileges concerning the external economic activities in the Kaliningrad Region due to the RF President's Decree № 244 of 6 March 1995 the Government of Russia passed the resolution allowing some compensations to the external economic activities participants. The amount of compensations makes up to 75% of the size of losses, including import and export dues, import value added tax and the special tax.

The compensational regime on the territory of this region operates in full. The percentage of compensations is varied from 0 to 75% depending on the range of exported (imported) wares. The compensation is not envisaged for import of a number of exisable wares and export of timber and metals.

Thus the order of compensations adopted by the Regional Administration allows on the one hand to maintain the local consumer goods producers and on the other hand to form the extra-budgetary fund collecting the resources are not liable to returning to external economic activities participants.

At present it is difficult to speak about the amount of capitals will be received in this fund as the mentioned regime exists only 3 months but the Head of the Administration resolution determining the Funds capitals to be appointed mainly for financing projects concerning import-substitutional and export-oriented enterprises has already been prepared.

#### Financial support for Small Business

The Russian Government regards small business as one of the main ways of overcoming the economic crisis and transition to the market relations.

At present the state support of small business is put into practice according to the Law "On the State Support of Small Business in the RF" through the system of state and municipal funds created in the country. In the Kaliningrad Region in June, 1995 in order to reach these goals there was set up the "Yantar" Fund, the fund for business support and FEZ development.

Financial state support of small business will be implemented through the "Yantar" Fund from the following sources:

- Regional Budget resources (10% of the allocation from the regional budget privatization receipts);
- Soft loan from the Federal Fund for Support of Entrepreneurship and Competitiveness Development;
- Part of the Budgetary Loan;
- Allocation from funds of the FEZ "Yantar" Development Committee remaining after customs compensations payments;
- Part of the resources from Fund for Compensations;
- Incomes from the Fund's assets management.

As a rule, the Fund will finance small business projects only partially (up to 70% of total cost of the project). The rest resources are to be non - state origin.

#### Organizational support

The organisational state support of investment promotion is contained in assistance in creation of the "soft" investment-financial infrastructure in the country.

So, on the federal level the Government of the RF has set up, in particular:

- The State Investment Corporation  
(Serves for attraction foreign investments and ensurence the garantes);
- The State Committee of the RF for Small Business Support and Development;
- The Federal Center for Projects Financing  
(Serves for drawing financial resources and promotion the implementation of investment projects);
- The Business Development Bank  
(Serves for financing investment projects and programmes).
- Rosximbank  
(Serves to credit and stimulate export of the processing industry products, particularly mechanical engeneering industry);
- Russian Bank for the Reconstruction and Development.

On the regional level the Regional Administration and Kaliningrad Mayors Office take an active part in establishing and support of investment-financial institutes and usage of market financial mechanisms.

In 1994-1995 in Kalinigrad with the participation of the state level authorities there were established:

- Regional Stock Center  
(Serves to promote the forming of the regional stock market);
- Regional Development Fund — "Yantar" Fund (fund for business support and free economic zone development)  
(Serves to concentrate the resources and use them effectively in the interests of the region development);
- Center (Agency) for Small Business Support  
(Serves for consulting and training small business subjects);
- Baltic Investment -Financial Company  
(Serves for drawing investments into high profit-making industrial projects);
- Municipal Commercial Bank  
(Serves for securing municipal loans).

We can positively evaluate the Housing Loan, held by the Kaliningrad Mayors Office together with the Municipal Commercial Bank. Its floating has already finished. Such an approach could be used on the regional level for attracting the resources into the concrete high profit-making projects.

It is necessary to mention that after the collapse of the big private russian investment companies ("MMM", "Tibet", "RDS" and others) natural persons display their interest for the investment of their funds into securities provided by the real state guarantees. In connection with it we can suppose that realisation of the regional state loan can be successful.

## PROJECTS TO BE FINANCED BY EC UNDER THE TACIS PROGRAM

Project	Organization-recipient	Person responsible	Terms	Cost of the project
Complex program to develop management system in the Kaliningrad region under FEZ conditions	Administration of the Kaliningrad region, Development Committee of FEZ "Yantar"	U.S.Bedenko	3 years	2,5 MECU
Restructuring of the industry and creation the infrastructure to support the enterprises	Development Committee of FEZ "Yantar", Property management committee	U.S.Bedenko E.P.Kuldyshv	2 years	1,0 MECU
Transport system development of the Kaliningrad region	Administration of the Kaliningrad region, Development Committee of FEZ "Yantar"	U.S.Bedenko	1,5 years	1,1 MECU
Complex program to energy-supply the Kaliningrad region	Operative management committee	V.S.Lebedev	1,5 years	1,0 MECU
Technical support for fishery restructuring	Administration of the Kaliningrad region, Fishery department	V.M.Kolesnikov	2 years	1,2 MECU
Eurofaculty	Kaliningrad State University	V.N.Brushin kin	3 years + 2 academic. years	0,8 MECU

Total value is 7,6 MECU

**INFORMATION ABOUT CONSULTING AID FROM  
INTERNATIONAL INSTITUTIONS**

Project	Value	Country/Organi- zation
1. Review on restructuring problems of regional economy	2 000 000 USD	USA
2. Concept to create free customs zone within Kaliningrad port	50 000 USD	Denmark
3. Regional analysis of agriculture structure of the Kaliningrad region	2 000 000 DM	Germany
4. Business-plan of air-port "Khrabrovo" restructuring	300 000 ECU	EC
5. Creation of the agency for the investments projects development	30 000 GBPs	UK
6. Project to provide the port with public services and amenities, 2001	2 500 000 FRF	France
7. Industry restructuring project, "Kaliningrad - 2000"	407 000 USD	UNIDO

## CONCEPT of Creating an Off-shore Zone in Kaliningrad Region

### Abridged

#### *1. The Aims of Creating an Off-shore Zone in the Kaliningrad Region*

Creating of an off-shore zone in the Kaliningrad region is basically aimed at attracting, due to tax and other preferences, financial resources of enterprises and organizations, registered in the Kaliningrad region but operating outside its territory. It will contribute to:

- a. increasing receipts into the profit portion of regional and local budgets,
- b. developing regional financial and banking institutions,
- c. importing of investment climate in the region,
- d. developing foreign economic activity in the region and providing export and import operations of Russia with foreign countries,
- e. providing employment of population.

#### *2. Subjects of Off-Shore Zone Operation in the Kaliningrad Region*

Off-shore companies shall only be owned directly or indirectly by non-residents of the Kaliningrad region, perform their operations outside the region, carry out no profit-making activity and meet all their financial needs at the expense of external sources.

Off-shore companies of the Kaliningrad region can perform their operations outside Russia as well as in the territory of Russia outside the Kaliningrad region.

The basic spheres of activity of off-shore operations can be:

- a. export-import and procurement activity,
- b. consulting and professional services,
- c. operations dealing with property,
- d. financial and banking operations.

### ***3. Taxation within the Off-Shore Zone in the Kaliningrad Region***

Off-shore companies (partial residents) shall be exempted from all the local taxes and only pay their federal part. This is the basic principle, the foundation of the Kaliningrad off-shore zone.

Financial preferences of off-shore companies operation in the Kaliningrad region are as follows:

a tax "harbor" is created which is aimed at 50-70 per cent reducing of taxes. It must attract non-residents of the Kaliningrad region, who must pay for getting preferences:

a. registration fee; b. annual charges for tax preferences; c. annual duty for putting on the list.

In the Kaliningrad off-shore zone the total charges rate can be US\$ 1000 for every enterprise.

### ***4. Off-Shore Companies Management***

Off-shore companies operating outside the region must have a representative company in the region (secretarial, specialized or managing) and perform the following functions:

- a. legal, accounting and banking support of economic activities of off-shore companies founders,
- b. submitting company operating statements to administrative bodies and arranging compulsory auditing check ups,
- c. guarantee of confidentiality regarding clients and their transactions,
- d. secretarial functions.

Services rendered by a representative company on behalf of founders of an off-shore company annually can account for above US\$ 2000.

### ***5. Administrative and Financial Regulation of Off-Shore Companies Activities***

All the off-shore companies shall be registered and shall be on a special list. Off-shore companies shall open their foreign currency and settlement accounts in a special authorized bank which is chosen by local bodies.

Annual auditing checking is compulsory for all the off-shore companies, it must confirm the fact of getting profit of the company outside the Kaliningrad region which is the reason for exempting the company from local taxes.

## ***6. Legal Aspects of Creating and Functioning Off-Shore Zone in the Kaliningrad Region***

The Kaliningrad regional Duma must adopt a special decision on preferential taxation of "partial residents" and on transferring authorities to the Administration which shall set tax rates and compulsory charges.

## ***7. Banking in the Off-Shore Zone of the Kaliningrad Region***

The main form of banking at the first stage of creating and functioning the Kaliningrad off-shore zone is banking through a system of authorized banks. In order to exercise successful control over the process of creating off-shore companies and their activities it is desirable to concentrate all the financial operations in one bank.

Banking activity in the off-shore zone may be implemented in two aspects depending on the status of the bank in the off-shore zone:

1. If a bank or its subsidiary is legally permitted to be registered in the Kaliningrad region as an off-shore bank on condition that their financial activity is outside the region, then economic and legal mechanism of their operation fully fall within general rules of off-shore, and we can speak about creation of an off-shore zone in the Kaliningrad region.
2. If legally full-scale banking off-shore in the Kaliningrad region is not permitted, all the banks in the Kaliningrad region can potentially bank only off-shore companies registered in the Kaliningrad region and operating in other spheres. In this case the institution of authorized banks is required.

The second variant seems to be more realistic. A system of authorized banks serving off-shore companies of the Kaliningrad region is to be created.

Off-shore companies raise a lot of demands to a bank account. The basic of them are as follows:

- the account shall provide the desired tax regime relating to the company's transactions;
- the account shall be managed by the client from any point of the world in the maximum operative regime;
- the account shall be opened in a reliable and a well known bank with good reputation, to support the image of the company;
- the bank shall fully trust to the client, the possibility and cost of different banking operations may depend on it (the operations are mainly risky for the bank).



So an authorized bank shall possess qualities of an up-to-date western bank capable of performing operations of their clients quickly and with high quality.

Both in the first and in the second variants of development of banking in the Kaliningrad off-shore zone it is possible to exempt banks, registered in the Kaliningrad region from local taxes.

## Scientific-research centre of Kaliningrad region

### 1. Purposes and activities:

- a) Participation, together with authorities and institutions, in the forming and releasing scientific-research policy aimed to solve most important social-economic, scientific-technical, ecological, culture-historical, educational and spiritual problems of the region; preparation of the proposals to develop the regional strategy and its priorities.
- d) Evaluation of regional innovative potential. Feasibility study of industries and enterprises in the region being profitable to invest in. The creation of regional infrastructure to incubate the high technologies and promotion of economical mechanisms to put it into effect.
- c) Scientific, information, legal and patent provision of structure changes in the regional economy and the incubation projects within all stages of their implementation: from development till realisation.
- d) Examinations by experts the drafts of regional scientific-research programs, initiative proposals of enterprises, institutions, profit making companies, submission the summaries on these in appropriate authorities and institutions.
- e) Development of high technologies in the system of "High school - Science - Industry" and the manufacture of competitive production based upon it.
- f) Development of international and inter-region links in the education, science and industry spheres.

Making the contacts with Federal bodies and institutions regarding issues to be within competence of the above centre.

### 2. Founders:

Administration of the Kaliningrad region, Kaliningrad State Technical University, Experimental Design Bureau "Fakel" .

### 3. Primary intentions:

The selection and implementation of few prospective projects to develop the region

236000, Kaliningrad (reg.),

Sovietsky prospect, 1

Bank accounts:

c/a 8467313 in Baltvneshtorgbank

General director: doctor of science, professor,  
honored inventor of RF,

Lew Gick