PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: AB2147

Project Name	Special Economic Zones Project
Region	EUROPE AND CENTRAL ASIA
Sector	Sub-national government administration (80%); Central government administration (20%)
Project ID	P092213
Borrower(s)	Ministry of Finance of the Russian Federation
Implementing Agency	Ministry of Economic Development and Trade of the Russian Federation; Federal Agency on SEZ
Environment Category	[ ] A [X] B [ ] C [ ] FI [ ] TBD (to be determined)
Safeguard Classification	TBD (to be determined)
Date PID Prepared	February 6, 2006
Estimated Date of Appraisal Authorization	September 29, 2006
Estimated Date of Board Approval	December 25, 2006

1. Key development issues and rationale for Bank involvement

Challenge of Achieving Sustainable Growth

In spite of impressively solid macroeconomic fundamentals—federal budget surplus for six years in a row, balance of payment surplus throughout the whole transition period—Russia still faces the challenge of diversifying economy away from over-reliance on the low processed hydrocarbon exports, increasing productivity, and enhancing competitiveness of the manufacturing sector. Competitiveness of the Russian economy is further affected by appreciation of the national currency (ruble), primarily driven by huge foreign exchange inflows from the hydrocarbon exports. Hence, there is a universal understanding of the urgency of launching innovation-based growth and improving business environment by completing the institutional reforms agenda.

Consequently, the government has attempted to complement and accelerate the institutional reform agenda with elements of the new industrial policy. The government has recently established an Innovation and Investment Fund, funded by a portion of proceeds to the Stabilization Fund, declared its intention to establish Special Economic Zones (SEZ) for manufacturing, in particular innovation-oriented, companies, and embarked on an even broader exercise of facilitating innovative companies by supporting creation of techno parks and business incubators across the country. The SEZs, techno parks and other instruments of competitiveness enhancement strategy are entry points to approach wider issues of institutional reform and improvement of national investment and innovation climate, including liberal trade and investment regime. In other words, initial strategic public investment should serve as a catalyst to future self-sustaining private sector development, not as an instrument for protected development of infant industries. Of course it is neither easy to design such public interventions, not implement them appropriately.

In the past, the Russian government already twice attempted to create SEZs. Yet both previous attempts failed leading to a massive tax abuse, fraud and corruption rather than to growth in technology based investment. Drawing on past experiences the Russian federation adopted a law on establishing SEZs, in July 2005[1]. Unlike previous attempts the recently adopted law puts more emphasis on creating enabling environment and not tax exemptions by streamlining business regulations, introducing a single-window approach, and providing necessary physical and business infrastructure The proposed SEZs shall become innovation and industrial clusters, enterprise incubators and technology parks rather than isolated domestic tax off-shores. Development of local systems for enterprise and technology upgrade by developing venture capital, managerial and marketing expertise, and other business development services that currently are scarce forms the core of the government diversification program. However, any public sector action to stimulate investment should contribute to the efficiency and long-term sustainability of the industrial sector, and not to substitute for private investment. This is why the best results are achieved when the public sector provides incentives to well-managed clusters where only part of the funds raised come from public sources. To provide equal access and promote quality, such clusters are best selected competitively, based upon transparent criteria.

Although government interventions mentioned above cannot substitute for a comprehensive improvement of the investment climate, and hence for the continuation of institutional/structural reforms, there are at least two ways in which SEZ development can help the broader reform effort. First, SEZs will provide entry points to demonstrate how the investment climate and innovation systems can be developed. The SEZ initiative will pilot a diversity of PPP in the areas of enterprise, technology and infrastructure upgrading to accelerate development of relevant sectors in the economy. Second, given the growing sectoral and regional heterogeneity in the country, with emerging innovation clusters in Lipetsk, St. Petersburg, Tomsk, and in a number of cities in the Moscow oblast which have resulted from pro-active and reformist regional administrations, SEZs can accelerate the development of such better-performing segments of the Russian economy.

<u>Rationale for Bank involvement</u>

The key rationale for the Bank to support development of SEZs as a new instrument of public intervention is to finance investments in public goods such as innovation and R&D investment in non-traditional sectors which are severely constrained by the growing economic concentration in resource exporting sectors and the appreciation of the national

[1] **<u>Main restrictions under the new SEZ Law</u>**: (i) 20 year limit on SEZ life-span; (ii) minimum investment requirement for each resident of a manufacturing-type SEZ– Euro 10 million, including not less than Euro 1 million over the first year upon registration as a resident; (iii) no production of excisable goods, with exception of cars and motorcycles; (iv) all SEZs shall be greenfield – no existing enterprise allowed; (v) no discrimination against foreign investors.

<u>Main benefits under the new Law:</u> (i) lower United Social Tax (Wage Tax), with a regressive scale (14% instead of 26%, and gradually going down from 14% to 2% for higher salary ranges: 14% for below $700, and 2% for above $2,000); (ii) higher depreciation rate for equipment; (iii) allowance for transferring losses against revenues of future periods; (iv) import duty exemption for equipment; (v) access to better infrastructure established at the public expense; (iv) more straightforward (one-window) regulation: registration, licensing, inspections.

currency. The government realizes the successful establishment of SEZs is a major challenge and seeks Bank involvement hoping that best practice contributed by the Bank to the SEZ initiative will prevent the risk of degrading the new SEZ initiative into an old-style anti-competitive industrial policy.

The Bank has been chosen by the Russian Government as a key partner in a new attempt at establishing SEZs because of its expertise in establishment of local systems of enterprise and technology upgrading, including SEZs. The Bank is seen in Russia as a source of best practice which could be adopted to the Russian SEZ initiative and help the government to design efficient SEZ management mechanisms with transparent regulation, efficient performance monitoring and evaluation, and wide application of public-private partnership (PPP), .

2. Proposed objective(s)

The Project Development objective will be **to assist the Russian Government in piloting industrial and technological special economic zones in selected Russian regions through introducing:**

- systems of public-private partnership for provision of modern business development services (ICT, marketing, legal support, logistics, certification, skill/management training, etc.), supplier and cluster development and public-private funding of innovation start-ups and spin-offs,
- local business development services (BDS) systems including managerial, marketing, skills enhancement and other business services,
- private-sector led venture capital funds and networks,
- a scheme of partial risk guarantees to reduce policy risks to investors,
- An efficient system for management of SEZs, including monitoring and evaluation systems.
-

3. Preliminary description

Apart from the special regulatory environment that has already been set up, the government program for SEZ development includes major public investment into developing physical infrastructure of SEZ sites. Eight billion rubles were allocated for this purpose as a distinct line in the federal budget for 2006, and this amount has been matched by similar—and in some cases even greater—amounts assigned to this investment in budgets of those subjects of the federation on whose territory SEZs will be created. These locations were determined through a competitive round of site selection which yielded 6 winners (out of over 40 applicants). The winners were: Tatar republic (Elabuga) and Lipetsk oblast for manufacturing SEZs, and Moscow (Zelenograd), Moscow oblast (Dubna), St. Petersburg, and Tomsk oblast for technology and innovation SEZs. The budgets for developing SEZ physical infrastructure committed by the federal, regional (oblast) and municipal governments appear to be sufficient for launching the first batch of 6 SEZs by end-2007, and hence no funding from the Bank loan is required for developing these elements of the SEZs.

Activities proposed under the Bank financed part of the project will organically complement this physical infrastructure development funded by the Government by providing SEZ residents with both on-site and off-site access to a variety of “soft” infrastructure, i.e. business development services and by capacity building in the state and municipal service involved in management of SEZs. In addition, during the project preparation the team will assess a need for mechanisms to mitigate non-commercial risks for private investors.

Finally, the Bank loan will provide funding for designing and implementing efficient Project monitoring mechanisms (focusing *inter alia* on reducing potential scope for rent-seeking and corruption) which should increase efficiency of the investments into physical infrastructure.

The Bank loan will comprise the following three components:

- *Business development.* This would include the specific business services, *services*, cluster development, and venture funding with an emphasis on (i) provision of professional services, technology transfer, and skills development, (ii) development of business synergies for building local production clusters, and on (iii) practical assistance to SEZ start-ups in penetrating new, particularly international markets.
- *Developing supply chains* - matching grant schemes for developing potential local suppliers, in and outside of a SEZ, to enable them to meet the quality, price and technical specifications required by companies-residents of a SEZ.
- *Efficient management of SEZs* – capacity building at the federal and local (both municipal and SEZ) levels to ensure transparent and enabling environment for business development on the territory of SEZs.

4. Safeguard policies that might apply

TBD

5. Tentative financing

Source:		($m.)
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT		50.00
	Total	50.00

6. Contact point

Contact: Gevorg Sargsyan
Title: Sr. Infrastructure Specialist
Tel: 7-495-745-7000 ext. 2043
Fax: 7-495-745-7002
Email: gsargsyan@worldbank.org
Location: Moscow, Russian Federation (IBRD)