PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: PIDC1237

Project Name	Russia Special Economic Zones Enhancement Project (P147011)
Region	EUROPE AND CENTRAL ASIA
Country	Russian Federation
Sector(s)	General industry and trade sector (50%), Public administration- Industry and trade (50%)
Theme(s)	Export development and competitiveness (100%)
Lending Instrument	Investment Project Financing
Project ID	P147011
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Economic Development, Ministry of Economic Development
Environmental Category	B-Partial Assessment
Date PID Prepared/ Updated	15-May-2014
Date PID Approved/ Disclosed	16-May-2014
Estimated Date of Appraisal Completion	15-Oct-2014
Estimated Date of Board Approval	02-Mar-2015
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

Russia moved to high-income country status in July 2013, with a GNI per capita of US$ 12,700 in 2012. 17.2 million people were below the poverty line in 2012, a record low for the past few decades. This economic performance hides a number of structural weaknesses. Economic growth estimates for 2013 and 2014 are much lower than the pre-crisis rates of around 7 percent. Due to a tight labor market and high levels of capacity utilization, it is unlikely that the difference between these growth rates will be bridged soon. It is also unlikely that oil prices will rise sufficiently to drive a much faster pace of expansion.

The lack of diversity in the Russian economy is a threat to its economic stability and reflects a weak ability to grow new firms and draw on non-oil sources of growth. In 2000, oil and natural gas products constituted less than half of Russia's total exports. Ten years later, this figure had grown to two-thirds of total exports, with an additional 15 percent coming from other extractive commodities and only 9 percent from high-tech exports, mainly in the defense industry.

The investment climate makes it difficult to establish and operate a firm. Russia is ranked 92nd on Doing Business, although it has risen in the rankings in recent years. There are particular challenges in dealing with construction permits (rank 178th), trading across borders (157th) and getting electricity (117th). Overall, red tape and deficiencies in infrastructure, labor and managerial skills, and access to finance make it harder to run a business than it otherwise might be.

A lack of competition in some markets also inhibits the growth of new firms. Recent World Bank research has shown that the Russian economy produces new firms, but that they are unlikely to grow as much as they might and, despite the fact that they might be more efficient than older firms, are more likely to exit a market during a period of economic contraction. This suggests that some firms have unfair advantages or, at the very least, that new firms are in conditions that make it hard for them to compete.

The Russian government is aware of these challenges and has several programs to address them. Efforts to improve the investment climate are high on the agenda of the government. The Russian President has set the country a target of being in the top 20 of the Doing Business rankings by 2020. To achieve this, several organizations such as the MoED and the Agency for Strategic Initiatives have been working on “road-maps” for addressing some of the most serious problems, which have been partly responsible for some Doing Business ranking improvements. Several initiatives are also being undertaken to boost innovation and entrepreneurship.

Sectoral and Institutional Context

A typical special economic zone (SEZ) is an area within a country that has more liberal rules of doing business than those that prevail in the rest of the country, and offers public goods that are superior to those supplied elsewhere. An SEZ tends to offer special conditions to businesses in the hope that they would move to the zone and grow. These conditions generally include infrastructure that is easier to access and more reliable than is normally available domestically, such as serviced land, factory shells, and utilities; a special customs regime that includes an efficient customs administration and, usually, access to imported inputs free of tariffs and duties; and an improved regulatory and administrative regime, including streamlined procedures for company set-up, licensing, and operations.

The Russian SEZs program was established in 2005 with the aim of attracting investment and spurring diversification. Job creation has since become an additional target. There are 28 SEZs in the program and these are divided into four groups: manufacturing (five zones), innovation (five zones), tourism (14 zones), and port (four zones). Twelve of these remain under development and 16 are operational. The operational one are the following:

- Manufacturing: Pskov, Kaluga, Lipetsk, Zelenograd (Moscow), Alabuga (Republic of Tatarstan) Togliatti, Titanium Valley (Sverdlovsk Oblast)
- Innovation: St Petersburg, Dubna, Tomsk
- Port: Khabarovsk, Ulyanovsk
- Tourism: Altai Krai, Altai Republic, Irkutsk, and Buryatia.

A well-managed, efficient SEZs program could help Russia to diversify and offer firms and foreign investors a way of surmounting the investment climate problems that exist elsewhere in the economy, thus helping to boost growth. There are other ways of achieving the same results and, ideally, such benefits would be offered to all firms at the same time through a nationwide program of reform. However, the size and administrative complexity of Russia means that an SEZ program could yield quicker results through targeted reforms and the power of demonstrating the benefits of SEZ pilot projects. Hence, a key motivation for Russia's SEZ program, as with programs elsewhere, is to offer conditions for doing business that are significantly superior to those in the rest of the economy.

The experience of other countries suggests that many of these aims are achievable through an SEZ program. First, SEZs have been credited with accelerating the gains of some of the biggest economic success stories of recent decades, such as China, Korea, Singapore, and Mauritius. Second, countries such as Jordan, the Philippines, the UAE and India have started to use SEZs as a way to generate more diverse economic activities in sectors such as agriculture, tourism, and services. They have also been used to improve national competitiveness and spur structural transformation by being used as pilots for economic reform. Private participation and improvements in public goods on offer in zones were important parts of these programs.

The Masan Free Zone in the Republic of Korea is an example of a successful zone. Its original purpose was to attract FDI into manufacturing export activities, and it offered excellent infrastructure, good zone management and access to support services. It became a strongly competitive cluster of high-value manufacturing and made significant contributions to the diversification of the economy. Hence, there is knowledge and experience from around the world that speaks to the aims of the Russian SEZ program. However, SEZ programs can also face challenges, as described below.

In recent years, the World Bank has analyzed the performance of SEZs around the world and identified a set of problems that are often found in failing SEZ regimes. Some are common to the Russian program, meaning that experience from around the world can be used in the program to both help it improve and to avoid problems. Typical challenges include:

- Poor site locations, entailing heavy capital expenditures
- Uncompetitive policies—reliance on tax holidays, rigid performance requirements, poor labor policies and practices
- Poor zone development practices—inappropriately designed or over-designed facilities, inadequate maintenance and promotion practices
- Subsidized rent and other services
- Cumbers ome procedures and controls
- Inadequate administrative structures or too many bodies involved in zone administration
- Weak coordination between private developers and governments in infrastructure provision.

The MoED is dissatisfied with the performance of the SEZ program. The program has failed to achieve the targets it was set and, as of January 1, 2013, just 323 firms had been attracted to the scheme. These firms have invested about US$2 billion in the zones and created 8,069 total jobs, including 1,814 jobs in 2012. The jobs created in 2012 represent just 49 percent of that year's development target. About US$412 million in federal, regional, and local funds were allocated for the construction of infrastructure in the zones in 2012. However, despite its dissatisfaction with the SEZ program, the MoED is content with the performance of the manufacturing zones.

In early 2013, the MoED asked the World Bank to look at how the performance of the nine nonmanufacturing zones in the 15 that are operating could be improved. The nine zones will continue to receive federal support, and the MoED believes that they are viable. As discussed above, evidence from other countries would suggest that, in principle, such zones could be made to work. The World Bank conducted due diligence on the suggested zones to better understand their viability and how a project could contribute to their development.

During the due diligence process, the World Bank team came to understand that there are a set of challenges in the Russian SEZ program, some of which would suggest remedial action in pilot zones, and others that would require improvements in the structure of the program at the federal level. Identified challenges in the Russia program include:

A. Understanding of zone attributes (by the government and zone management), investor demand, and marketing:

A.i. Assessment of zone strengths and weaknesses: in some cases it is not clear that the attractions of zones are as compelling as they were expected to be during the development of the SEZ program, or that the strengths and weaknesses of such zones are well understood by their management.

A.ii. Promotion of zone attractions to investors: where the strengths of some zones are understood, it is not clear that they are being marketed in a sophisticated manner to investors.

A.iii. Understanding of investor requirements: some zones, and to some extent the SEZ program as a whole, showed an understanding of investor needs that was less sophisticated and nuanced than might be desirable.

A.iv. Availability of high-quality investors: in some cases, it is not clear what the willingness is of high-quality investors to locate in specific zones. This could be a problem if zones expand rapidly to include primarily lower-quality investors, meaning firms with low viability and low growth prospects.

B. Management of zones:

B.i. Zone management: zone management officials often lack the capacity and incentives to provide world-class services to current and potential investors.

B.ii. Private participation in zones: there are legal obstacles to private companies taking part in the management of zones – all zones are managed by the public sector, while roughly 2/3 of zones in the rest of the world are developed and operated by the private sector.

C. Improvements to zones to overcome government and market failures:

C.i. Planning and development of physical infrastructure: lack of detailed and timely assessments of investor and user demand for investments in infrastructure and facilities means that some structures are inadequate or too sophisticated. Some zones also lack the road, power, and telecommunications connections that are needed to overcome investment climate shortcomings and government failures outside of the zones. Zones also often lack rental opportunities for office space, warehouses, and factory shells of adequate quality for competitive prices. (The lack of such private infrastructure outside of the zones can be considered a market failure.)

C.ii. Value-added services and facilities to stimulate sector development: it is not enough for SEZs to provide infrastructure to jumpstart economic diversification and growth, but the zones in the Russian program appear to have put a lot of emphasis on this. SEZs tend to need services to stimulate innovation, productivity, and entrepreneurship, for which they can serve as a focal point both for firms in and outside the zones. (Innovation, productivity, and entrepreneurship were highlighted as key issues in the Bank's recent Russia report on “Export Diversification through Competition and Innovation”.) This is often particularly important inzones that focus on sectors such as IT. Specialized shared-use infrastructure, such as laboratory space or testing facilities, can also be provided to further such aims. Russia's zones have historically underemphasized such opportunities.

The provision of value-added services and facilities can help address market failures, such as sub-optimal investment in innovation, and coordination failures, such as firms in the same sector not working together to share costs for market research, external promotion, training, high-tech equipment, shared lab space, etc.

C.iii. Business environment: insufficient attention to the importance of fewer procedures and easier licensing systems to make the SEZs attractive relative to the wider business environment in Russia. Red tape is an important deterrent to investment in Russia, but many zones have focused primarily on fiscal incentives rather than the creation of a friendly business environment for investors inside the zone, such as through making it easier for investors to obtain zone residency permits, operating licenses, construction permits, and customs clearance. (Business environment challenges can be considered to be a type of government failure.)

D. Availability of workers with the appropriate skills: in some zones, there could be a lack of available workers with the specific skills that new investors are looking for. This challenge is somewhat mitigated by the fact that several zones benefit from a range of local high quality universities and training institutes that provide workers with a solid foundation of skills.

E. Location of zones: the process of choosing the location of some of the zones appears to have been driven by political rather than economic considerations, meaning that some zones possess inherent disadvantages. Examples include the location of the St Petersburg zone, which is based in two areas and is in close proximity to other technology parks in the region; and the Buryatia zone, which is very difficult to access from large tourist markets.

The MoED is committed to overcoming these challenges and improving the impact of the zones program. Several positive measures have been undertaken in recent years, but much room for improvement remains. The MoED also has cluster initiatives that are linked to some of the zones and involve the World Bank. In some of the components the project will seek to take advantage of the links between the zones and these initiatives, thus seeking benefits for companies outside of the SEZs.

Relationship to CAS

The project will contribute to the growth and diversification of the Russian economy, which is one of the four strategic themes of the World Bank Group 2012-2016 Country Partnership Strategy (CPS) for the Russian Federation. The CPS seeks to achieve these aims through better management of public finances, an improved innovation and investment climate, a stronger financial sector,

better infrastructure, and more effective protection of the environment. The strategic theme has several associated outcomes which, by promoting diversification and helping to improve the investment climate and infrastructure within the SEZs program, the project will assist with. The CPS outcomes are:
- Further streamlined and simplified business procedures and improved capacity to monitor and benchmark business regulations
- Strengthened capacity to design and implement innovation and diversification programs in Russia's regions
- Increased access to quality infrastructure assets and improved infrastructure services.

The project also has a direct link to the World Bank Group's goal of increasing shared prosperity. The project aims to improve business growth and create jobs, which will both directly and indirectly (through spillover effects) improve the welfare of the bottom 40 percent of the population.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The project development objective is to attract investors to, and increase investment in, select pilot zones in the Russian SEZ program.

Key Results (From PCN)

Key Results:
- Increased investments by new and existing SEZ investors and companies, measured against appropriate regional or national benchmarks;
- Increased value of total sales from SEZ investors and companies, measured against appropriate regional or national benchmarks;
- Increased jobs created by SEZ investors and companies, disaggregated by gender and youth, measured against appropriate regional or national benchmarks;

All of the above would be for non-oil and gas sectors, which would contribute toward economic diversification. The key results and the intermediate indicators below will be tracked through monitoring and evaluation that may include the use of control groups.

Examples of intermediate indicators:
- New or amendments to existing federal and subnational law on the regulations, directives, and administrative procedures concerning SEZ regulation, development, operation and management that improve the attractiveness of the SEZs relative to what is on offer in the rest of the economy;
- Capacity built in the MoED, regional and municipal authorities, Russian Special Economic Zone Joint Stock Company (RusSEZ JSC), and RusSEZ subsidiary SEZ management companies to plan, regulate, develop and operate SEZs in accordance with global best practices;
- SEZ infrastructure, business environment and service enhancements in the pilot SEZs prepared and implemented;
- Comprehensive SEZ investment strategies and programs prepared for the pilot SEZs;
- Management efficiency lessons drawn from the pilot projects and successful examples ready to be used outside of the pilot SEZs (meaning either in other SEZs or in the economy as a whole); and
- A SEZ automated information system (under the MoED) developed and functioning, performing as a national database and knowledge center on SEZs and their performance.

III. Preliminary Description

Concept Description

Note: the following is a preliminary description, which will be subject to change over the course of project preparation. The total expected size of the project is US$200 million. The IBRD share of the financing will be US$132 million and the borrower's share will be US$68 million. The project will have three components.

Component 1: Establishing an efficient system for SEZ management and operation and promoting Russian SEZs to international investors (US$47 million).

1.1 SEZ legal/regulatory environment and management systems

This component will improve legal and regulatory norms on SEZs including:

a) Development of appropriate mechanisms and agreements that allow the private sector (non-residents operating within SEZs and in areas adjacent to SEZs) to participate in the development of SEZ infrastructure.

b) Development of frameworks and agreements (including a package of the needed legislative amendments) enabling private sector management of SEZs, as well as deal-structuring advice on the transfer of SEZ management companies' functions to private SEZ operators, negotiating terms and conditions, etc. With the appropriate body, this will include the development of PPP arrangements for SEZ development and operations.

c) Development of a framework for tendering out government land to private SEZ developers for the development, promotion and operation of the SEZ, negotiating terms and conditions, etc.

d) Development of a framework for licensing 100 percent private SEZs.

This component will also review and improve screening procedures for firms interested in locating in the zones. Screening procedures should be investor-friendly and include appropriate assessments of investor quality and growth prospects. The improvement process could include financing of financial and technical advisors to review investor applications.

Development of management capacity for the staff of federal and regional executive authorities, local government agencies, and SEZ management companies, as well as regional executive authorities and local government agency officials who play a role in the SEZs will also be part of this component. Activities in this theme will include developing training and guidance materials, programs, curricula, teaching aids, and activities; conducting training seminars and courses for upgrading thematic skills; and organizing foreign study tours to learn from international experience in SEZ operations. This will include assistance with developing and implementing investment promotion strategies.

Financing of SEZ management contracts may also be part of this component, although as this is not currently included in the budget allocation, funds could be reallocated from Component 2 if the appropriate conditions are in place to award one or more management contracts during project implementation.

1.2 Zone attractiveness and investment promotion

Surveys will be conducted of potential investors, and analysis carried out of investor needs and attitudes with respect to the current incentives and infrastructure offered in select zones. This could be done for pilot and non-pilot zones. Development of the value offered by the different types of SEZs (e.g. innovation, port, tourism) will also be an aim. Pursuit of this aim will include analysis of investor targets, incentives, infrastructure, administrative services, value-added services and programs, and development phasing. There will also be a review of general and specific investment attraction strategies and management models for each type of SEZ. These will be consolidated into an overall piece that presents all of the SEZ options to investors.

Ways of improving the efficiency of administrative and regulatory procedures and controls for SEZ investors and companies will be considered. One way of doing so may be through establishing a single window system that allows potential and current investors to obtain all of the necess ary zone residency permits, operating licenses, construction permits, etc.

Under this component the project will seek to improve investor awareness concerning investment in Russian SEZs through the design and preparation of new marketing collateral, and its presentation through press conferences and presentations, mass media, exhibitions and business fora, road shows, articles in the Russian and foreign media, and awareness-building on the Internet.

Through participation in international workshops and working groups, round tables, professional colloquia, congresses, and fora the SEZ stakeholders will gain more access to international experience and best practices.

1.3 Tourism zones strategy

Given the lack of a sound strategy for developing tourism zones in Russia and the low level of private investment in this sphere to date, the existing operational model of tourism SEZs needs a conceptual revision. The necessary revisions will be reviewed.

1.4 Automated information systems for SEZ operations and monitoring

One or more online systems will be developed and deployed. The federal agencies will be assisted in installing systems that help them to automate some parts of their work, and the publicly-run zones to do the same. These systems would be initiated in the pilot zones and eventually rolled out to the entire SEZ program (if successful).

Component 2. Infrastructure, services, and business enabling environment in pilot SEZs (US$146 million).

This component would help to address challenges related to zone management, private participation in zones, planning and development of physical infrastructure, value-added services and facilities to stimulate private sector development, business environment, and worker skills. The challenges would be addressed in an estimated three pilot zones, whose selection will be approved by an interagency working group (comprising the Ministry of Finance (MoF)) to be established by the MoED.

2.1 Establishment and equipping of shared-use centers and other facilities in pilot zones (US$131 million)

The list of shared use and other facilities will be defined during the project preparation phase, and further refined through detailed feasibility and design studies during the implementation phase. The list will be defined based on well-measured investor demand, as well as considerations of what government and market failures the facilities are addressing and/or what market opportunities they will allow users to exploit.

The MoED would like to construct 4-6 shared use centers across the pilot zones. Based on construction costs of existing facilities in the SEZ program, the MoED estimates that such facilities will cost an average of US$35 million apiece. Equipment purchases for these centers are also envisaged.

2.2 Design and provision of services to firms inside and outside the pilot zones. (US$10 million)

Programs and services to stimulate innovation, productivity, and entrepreneurship are critical for Russia's economic growth and diversification. SEZs can serve as a focal point for new and existing programs and services in such areas, both for firms within and outside the zones. For each pilot zone, an assessment of existing programs and services (offered by the zone and other public agencies) that are relevant to the sectors of interest in the zone would be undertaken. Shortcomings in existing programs and needs for new programs would be identified. This component would then finance the design and implementation of new/improved programs and services. These would likely have a sector focus, e.g. IT or avionics components, in line with the focus of the pilot SEZs. Examples include technology transfer programs, helping firms with commercialization and internationalization of their products and services, market intelligence, specialized training, and other things.

2.3 Worker skills (US$5 million)

This subcomponent could finance on-the-job or other types of training to meet specific demands of zone companies. This subcomponent could receive more emphasis if investor surveys determine that the lack of workers with specialized skills is a key obstacle to attracting investment to the pilot zones.

Component 3: Project management, monitoring and evaluation (US$7 million).

Funds under this component will be used for managing the project implementation process in accordance with IBRD procedures, including procurement, disbursement, financial management, and the monitoring and evaluation of project results.

To coordinate and oversee the preparation and implementation of the project, an Interagency Working Group will be established. It will include representatives of the MoED, MoF, and other relevant federal and subnational executive authorities and organizations.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01	x		
Natural Habitats OP/BP 4.04			x
Forests OP/BP 4.36			x
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11			x
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12	x		
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

V. Financing (in USD Million)

Total Project Cost:	200.00	Total Bank Financing:	132.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	68.00
International Bank for Reconstruction and Development	132.00
Total	200.00

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