Kalinningrad On Its Crooked Way To Economic Modernization[1]

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The problem of Kaliningrad,[2] in the form it has emerged after the 2004 enlargement of the European Union, stems from the region's ambivalent economic position of being simultaneously inside and outside the EU territory, with no international regulations existing to reconcile this conflict. However, this situation looks puzzling only regarding historical retrospective. In the context of post-modern realities, Kaliningrad just fits into the new type of regionalization based on transborder cooperation and networking with the advancing EU neighbours.

At the moment, the new Federal Law on the Kaliningrad SEZ, in force from April 2006, rather impedes than promotes the prospect of the region's Europeanization and its structural turn to European export markets. Meanwhile, the global competition and the expected Russia's entry into the WTO will objectively make the local economy enter the stage of radical restructuring. In this regard, Kaliningrad is in sharp need of more constructive federal policies which could realize its potential comparative advantages and provide its sound involvement into the post-industrial clusters emerging in the Baltic Rim.

1. Kaliningrad's Import-Led Economic Growth and its Guinness-Record Pathologies

In terms of industrial pattern of development associated with mass production, Kaliningrad's economic system is primordially vulnerable and objectively unable to function in a self-supporting manner. It suffers from narrow sizes of internal market, full dependence on externally supplied power and most of industrial inputs, noncompetitive harbour facilities (as compared with other Baltic ports), and lack of strategic raw materials for mass exports.[3] The region's ongoing large-scale trade with mainland Russia can be maintained only thanks to special government incentives (*Smorodinskaya/Zhukov, 2003)*. As is generally typical for enclave/exclave economies, Kaliningrad needs well-directed federal support (see *Vinokurov, 2007*). However, the system of support that has been shaping the region's economic profile throughout the whole post-Soviet period (up till April 2006), rests on **three complementary pillars** which are a serious departure from regular market-based policies.

The first and foremost pillar is the notorious Special Economic Zone (SEZ) regime, or simply a right for tax-free trading, which was granted to Kaliningrad exclusively in 1992 and reaffirmed by the 1996 federal Law "On SEZ in the Kaliningrad Region". Aimed at supporting Kaliningrad's economic links with Russian mainland, this Law permitted local actors to pay no duties when delivering goods from the SEZ to the rest of the country, which was running counter both to the provisions of the RF customs and tax Codes and to the key principle of building

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[2] In this paper, terms 'the Kaliningrad region' and 'Kaliningrad' are used interchangeably and stand for the whole region.

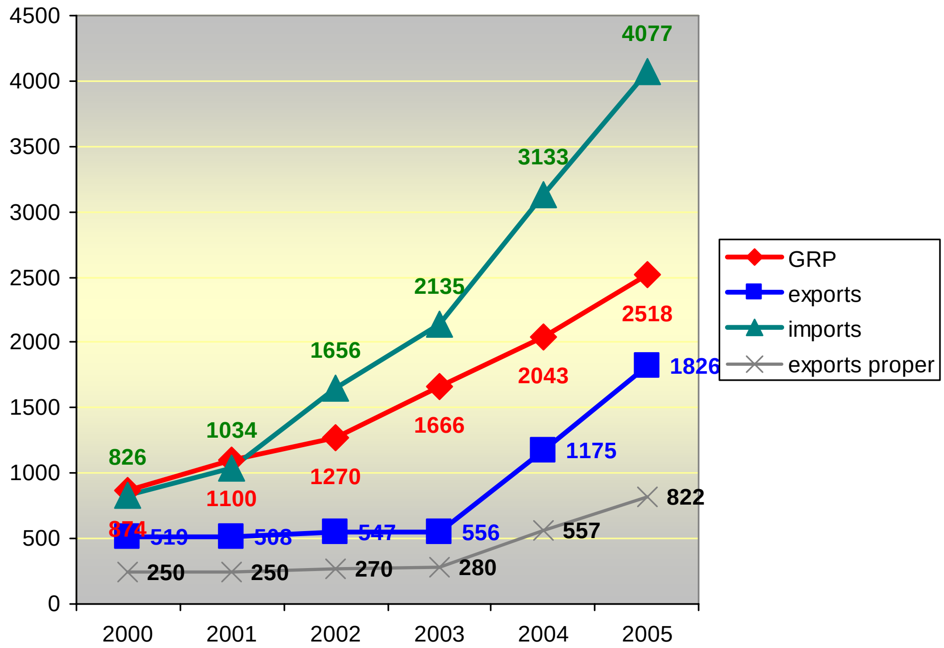
[3] Though Kaliningrad is exporting up to 10.5 m ton of oil and oil-products a year, 90% of this volume is made by Russian export transit flows. Meanwhile, the local oil industry has no development prospects, both in the field of oil-extraction (in 10 to 15 years, the local oilfields will be exhausted) and in the field of trans-shipment (due to high tariff risks for oil transit via Lithuania, as well as due to Kaliningrad's rivalry with Finnish ports). *(Stepura, 2005)*

free economic zones in international practice.[4] ***The second pillar*** concerns special price subsidies for railway cargo transit granted to the region since 2002 by the local branch of the Russian state corporation "Russian Railways" ("RZhD"). These subsidies, combined with a silent duty-free regime for Russian transit oil-exports (a non-transparent measure, applied periodically), enable Kaliningrad's ports to sharply enlarge the volume of trans-shipment. ***The third pillar*** implies additional benefits extracted by geographically remote Kaliningrad's enterprises from lowered level of Russian domestic energy prices as compared to international prices and to export prices of Russian energy suppliers to Europe.

This set of privileges, unavailable to other Russian territories in terms of scale and combination, constitutes **the most outstanding regional case of politically created rents** (*Smorodinskaya, 2001a).* It places Kaliningrad's development under "soft budgetary constraints" associated with abnormal, import-led pattern of economic growth.

Import-led growth is a pathological macroeconomic regime under which imports are increasing much faster than industrial production and may far exceed the value of GRP, while manufacturing exports are practically not developing and thereby, remain incomparably smaller. *Figure1* shows that the curve of total exports, which illustrates the statistically registered outflows from Kaliningrad's customs territory, keeps staying considerably below the curve of GRP (at least until 2004), while the curve of Kaliningrad's exports proper (i.e. the value of total exports, cleared from the oil and other transit export flows) is considerably below than that of total exports. Meanwhile, the curve of imports is sky-rocketing above all others, including GRP, which implies that the local economy is deprived of any objective constraints to limit the growth of trade deficit.

Fig. 1. **Kaliningrad: Growth of GRP, Exports and Imports in Comparison,** US$ m



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[4] As recommended in the International Kyoto Convention on Simplification and Harmonization of Customs Procedures (Appendix D of 1999 on Free Economic Zones), a free economic zone must be considered as outsider of the national customs territory and, therefore, it must pay duties when exporting goods to the mainland. Any violation of this rule is identified as legalized smuggling.

Calculated from: Smorodinskaya/Zhukov (2003); Kaliningradstat (2004-2006); Customs Statistics (2004-2006)

Such pathological macroeconomic proportions, actually deserving to enter the Guinness book of records**,** have been generated by Kaliningrad's post-Soviet **specialization on servicing import flows to Russia's mainland.** For many years since introduction of the SEZ regime, the region's massive ruble-denominated deliveries to Russia were officially treated as import substitution and, therefore, highly welcomed in Moscow. But actually, both under the transformational recession of the 1990-s and in the period of economic upsurge of the 2000-s, Kaliningrad was only mediating a tax-free entry of foreign consumer goods to Russian markets, while expanding output just nominally, through winding up its figures with an increased turnover of imported goods (*Smorodinskaya/Zhukov, 2003; Usanov/Kharin, 2006).*

A more detailed picture of Kaliningrad's import-led growth is submitted in *Table1.*

In the 2000-s, when the local economy was growing at accelerated rate of 9-12% a year, Kaliningrad's **total imports** were expanding 1.5 times as fast as GRP to reach an unrivalled level in the global economy of 40-50% above GRP (or $4 billion as for 2005). Similarly, Kaliningrad's **ruble-denominated shipments to Russia** had also trebled in four years to make up 80-88% of GRP, or $2.3 billion by the end of 2005. Meanwhile, the region's **total exports** were almost flat, staying at the level of $510-550 million a year. Only in 2004, due to transit shipments of Russian oil, they started a sharp rising and in a year made up as much as 63% of GRP ($1.8 billion). However, Kaliningrad's **exports proper** (without considering transit flows from Russia), which also began to rise only in 2004 (thanks to enlargement of oil extraction in the region), had reached the level of only 29% of GRP by the end of 2005, with their share in total exports facing even a slight narrowing (from 50% in 2003 to 45% in 2005). As a result, **foreign trade deficit** showed a 4-fold growth in five years, making up from 78 to 96% of GRP, or $2-2.3 billion in value. This means that the local economy continued to face high macroeconomic risks which were automatically damped down by the federal centre with funds arising from oil-export revenues.

Table1. **Kaliningrad's Trade Transactions in 2000-2005**

	2000	***2001***	***2002***	***2003***	***2004***	***2005***
Trade transactions, US$ m						
Foreign trade turnover	1,345	1,542	2,203	2,691	4,308	5,903
• **Total exports (***inc. transit flows***)**	519	508	547	556	1,175	1,826
• **Total imports** (*inc. transit flows*)	826	1,034	1,656	2,135	3,133	4,077
• **Total trade balance**	-307	-526	-1109	-1,540	-1,958	-2,251
Deliveries to mainland Russia *	432	619	759	1,118	1,802	2,295
Trade transactions as share of GRP, %						
GRP at official exchange rate, US$ m	874	1,100	1,270	1,666	2,043	2,877
Foreign trade turnover	154	140	173	162	211	205
• Total exports	52	46	43	33	58	63
• **Total imports**	**94**	**94**	**130**	**128**	**153**	**142**
• **Total trade balance**	**-50**	**-48**	**-87**	**-95**	**-96**	**-78**
Deliveries to mainland Russia	49	56	60	67	88	80
Trade transactions: ratios and cleared figures						

Exports proper,** US$ m	250	250	270	280	557	**822**
• as share of total exports,%	48	49	49	50	47	45
• **as share of GRP, %**	**29**	**23**	**21**	**17**	**27**	**29**
Imports proper**, US$ m	826	1,034	1,656	2,135	3,133	4,077
• **as share of Russia's imports, %**	**1.8**	**1.9**	**2.7**	**2.8**	**3.2**	**3.3**
Cleared trade balance **, US$ m	**-576**	**-784**	**-1,386**	**-1,855**	**-2,576**	**-3,255**
• **As share of GRP, %**	**-50**	**-71**	**-109**	**-111**	**- 126**	**-113**
Total coverage ratio **(**exports **:** imports), %	51.0	39.7	25.9	26.0	37.0	44.8
Cleared coverage ratio orts proper **:** imports proper), %	30.3	24.2	16.3	13.1	17.8	**20.2**

***** Tax-free deliveries of goods 'considered to be produced in the SEZ' (as provided in the 1996 Law on SEZ)

****** "Exports proper" denote the actual volume of export goods produced in the SEZ, i.e. the volume of total exports cleared from transit flows. Kaliningrad's "imports proper" are practically equal (by 95-97%) to the volume of total imports. Trade balance cleared from transit flows (i.e. total trade balance adjusted for "proper" values) shows actual size of Kaliningrad's foreign exchange shortages

Calculated from: Smorodinskaya/Zhukov (2003); Kaliningradstat (2004-2006); Customs Statistics (2004-2006);
Database of the Bank of Russia (2001-2005); Usanov (2005); Usanov /Kharin (2006)

For a more precise picture, we've adjusted Kaliningrad's aggregate volumes of trade for its own-generated volumes (see cleared indicators in *Table1*). Negative figures of trade balance, once cleared from oil transit flows, reveal the actual scale of Kaliningrad's foreign exchange shortages to finance the ongoing expansion of imports, i.e. they show the extent of region's inability to self-support further economic growth. In the 2000-s, Kaliningrad's real value of trade deficit has been enlarging at steady and much greater pace than a corresponding total indicator. By 2002, it had exceeded GRP and thereafter, kept growing further up to $3.3 billion in 2005, making up from 11 to 26 % above GRP. This means that **during the period of accelerated growth the local economy has become still more incredible than under the industrial slump of the 1990-s.**

2. Structural Distortions and Fiscal Shortages under High Economic Growth Rates

In order to transfer imports to Russian markets on beneficial terms (i.e. exempt from customs duty and value added tax) local enterprises had to add, be it formally, only 15 to 30% of value during the processing (as according to the 1996 Law on SEZ) and to receive a Certificate of origin from the local Trade and Industry Chamber. This means that value of Kaliningrad's goods considered as "produced in the SEZ" is formed for 70 to 85% by imported components. However, everything coming from the beltline (after assembly, glue, or packing works done) is registered in full by statistics as the local industrial output.

This is a way **to generate a purely statistical economic growth,** accompanied by a decreased level of added value and a reduced level of tax collection as shares in GRP. The reduction concerns all types of taxes, not only VAT itself but also profit tax (the corporate income tax) and personal income tax. Simply speaking, the SEZ regime has been pushing local producers upon **very specific schemes of tax optimization.**

First, large-sized and the majority of medium-sized companies widely apply *artificial splitting into numerous small and smallest enterprises,* which enables them not only to enjoy a simplified system of taxation granted in Russia to small businesses, but also to avoid any forms of VAT payments now applied in Russia, be that the traditional VAT charged upon producers of the total value of commodity, or the VAT charged upon importers (automatically along with import duties) of the value of imported components only.[5] This practice leads to mass shadow incomes and seriously **distorts the institutional structure** of the local market**.** In particular**,** Kaliningrad's small business sector accumulates only 11% of able-bodied population, but formally makes up to 35% of GRP, which far exceeds its real contribution to economic growth (to compare, the respective Russian average is 12%).

Secondly, the larger local companies, in order to fit the total amount of production costs into a small 15-30-percent portion of value added, *widely re-register their import contracts in offshore centres and artificially overprice the imported components*. This permits them to conceal part of their profits from taxation under the disguise of production costs and to leave non-taxed delta sums on their offshore accounts. A side effect is **the distortion of price structure** in the regional market: despite the regime of duty-free imports meant purely for the benefit of local population, the local consumer prices are artificially boosted up to and even over the level of Moscow prices.

That is why key "import substitution" businesses with a noticeable share of the Russian market in various consumer items (canned fish and meat, TV sets, electric vacuum cleaners, refrigerators, furniture suits, and assembled motor cars – all products with a 70-85% share of import components)**,** despite showing rapid growth in production, contribute very little to Kaliningrad's economic development in terms of their share in tax payments and total investment.[6] They either evade taxes or operate, on purpose, on the brink of profitability. As a result, Kaliningrad actually keeps **a second economy in the shadow:** for many years the turnover of shadow assets reaches up to 95% of statistically registered GRP (against 25-50% in Russia as a whole), while money turnover in the local consumer market is 2.5 times larger than the officially recorded value (*Samson/Eliseeva, 2003; Smorodinskaya/Stepura,2005*). And the major part of shadow rents is accumulated in trade intermediation and, thereby, is "virtual" by nature, which means that contraction of informal activities may rather diminish than enlarge the recorded value of Kaliningrad's GRP: nearly a half of its real economy will just be blown off like a bubble.

No wonder then that Kaliningrad has **a deeply distorted industrial structure.** The entire manufacturing industry provides almost 90% of recorded industrial output, but makes less than 10 to 15% of the region's net yearly revenue (a balanced aggregate profit of large- and middle-sized enterprises). At the same time, oil extraction, while making only 9 to 11% of industrial output, provides alone up to 70-85% of net revenue, thus serving as the largest taxpayer (*Stepura, 2004; Usanov/Kharin, 2006*).

To conclude, Kaliningrad's consolidated budget rests on tax receipts from oil

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[5] The two forms of VAT are charged alternatively, albeit at a similar rate of 18%. Since Kaliningrad's producers were free from import duties on their deliveries to Russia (according to the 1996 Law on SEZ), they couldn't enjoy paying a reduced, "import" VAT and were demanded to pay "full" VAT (contrary to all the rest Russian importers), which induced them to evade VAT payments at all. The RF Tax Code relieves small enterprises (with turnover less than RUR 1m within 3 calendar months) of paying VAT, except for importers. Meanwhile, the 1996 Law on Kaliningrad's SEZ provides VAT-deferral for importers (till the processed imported components are delivered to Russia's mainland). By combining these provisions, local producers managed to legally avoid any VAT payments.

[6] A typical example is the first half of 2005, when Kaliningrad had remarkably increased industrial production (by 27% on a year-period basis) but simultaneously markedly reduced the share of taxes in total budget revenues (from 72 to 63%), which required additional transfers from the federal budget (*Usanov, 2005*).

industry (not only regarding oil extraction but also oil trans-shipment). Contrary to that, any further expansion of "import substitution" automatically leads to losses in tax revenues, irrespective of the will and efforts of regional authorities. Therefore, a **shortfall in tax receipts and the following frustration of annual budget plans has become in Kaliningrad a typical situation.**

Basically, Kaliningrad has started to run serious fiscal shortages and a growing demand for extra federal subsidies as early as in 1995.[7] In 2001, the Russian Clearing House even declared Kaliningrad bankrupt (since its ratio of budget deficit to own budget revenues had almost reached a critical point of 15%, as set by the RF Budgetary Code).[8] And under the economic boom of the 2000-s, the scale of fiscal shortages only increased (*Table 2),* with the share of tax collection in GRP never exceeding 21-22% (the comparable all-Russian share, cleared from customs payments, is 30-31%) (*Smorodinskaya/Stepura, 2005*).

Table 2. **Kaliningrad Region: Consolidated Budget in 2001-2005, RUR millions**

	2001	***2002***	***2003***	***2004***	***2005***	***(2006)****	**2006**	***(2007)****
Revenues	**5,460**	**7,781**	**9,190**	**11,236**	**15,145**	14,951	**15,096**	17,676
Expenditures	**5,431**	**7,917**	**9,627**	**11,505**	**15,164**	15,861	**14,958**	18,879
Fiscal balance	**29**	**- 137**	**- 437**	**- 269**	**- 19**	**- 909**	**138**	**-1,203**
• as share of expenditures, %	**0.5**	**- 1.7**	**- 4.5**	**- 2.5**	**- 0.1**	**-5.7**	**0.9**	**- 6.4**
• as share of revenues, %	**0.5**	**- 1.8**	**- 4.8**	**- 2.4**	**- 0.1**	**-6.3**	**0.9**	**- 6.8**

* A revised budget draft for the year of 2006 and an initial budget draft for the year of 2007, both adopted by the Regional Duma in the 4th quarter of 2006.
Compiled from: Usanov/Kharin (June 2006); data from the Kaliningrad Regional Government;
Report of the Kaliningrad Ministry of Finance on the 2006 budget performance

In 2005, thanks to a combined effect of several conjuncture factors (spectacular growth in oil-export earnings, enlarged base for property tax after the start up of TETS-2, increased Governor's fight against shadow incomes, increased federal transfers for celebrating the 750th anniversary of the Kaliningrad city), the region enjoyed a significant rise in total budget revenues (34.5%) and as a result, an almost balanced budget (as shown in *Table2*, fiscal deficit went down to 0.1% of total revenues). *In 2006,* Kaliningrad showed **a small budget proficit** (of 0.9% of total revenues), which made an impression that it had started to steeply improve the state of its finance (especially, against the expected budget deficit of 5.7%).

However, a more detailed analysis of budget flows reveals that the 2006 budget surplus is rather **a result of skillful fiscal management under the new Kaliningrad's governor, than a sign of economically backed improvement in the structure of the region's finance.**[9] Under the existing macroeconomic

[7] Federal subsidies for Kaliningrad had risen from the level of 18% in 1994 up to 25% in the late 1990s, and up to 37.8% in 2003 (*Smorodinskaya, 2001a; 2004*). In 2005-2006, they were covering about 30% of the budget expenditures.
[8] Today, the fact of Kaliningrad's bankruptcy of 2001 is not recollected, with the annual budget figures having undergone a retrospective amendment in the official regional database (*see Table2 in this paper).*
[9] The budget performance achievements, as observed in 2005-2006, still couldn't overweight a traditional drop in the region's profit tax returns (usually by 14% nominally against the plan) and other fiscal shortages generated by the import-led economic growth. To

regime, Kaliningrad's authorities are objectively unable to make the region richer and more independent. They can push up nominal budget revenues in this or that way (through periodical resale of state property, or higher tax rates, or additional federal subsidies), but can't provide a stable outstripping growth in tax receipts over demanded expenditure growth.[10] **If not oil export earnings, Kaliningrad's budget would get rapidly shrinking.** However, oil-related income is a very fragile foundation for future stability. If Kaliningrad is deprived of its right to export oil duty-free, as well as of its other individual privileges now contradicting to the WTO rules, it will mostly lose the advantage of trans-shipping the large-scale transit oil-flow, which provides together with local oil about 73% of the region's export earnings (*Customs Statistics, 2005-3Q).*

Moreover, the official fiscal statistics doesn't reflect to the full the real state of weakness of Kaliningrad's finance. A situation, where the region's foreign trade deficit amounts to 80-95% of GRP, while its cleared value ("deficit proper") far exceeds the size of GRP, implies that **for many years Kaliningrad has been in a chronic state of default,** even regardless of its inability to pay off the accumulated external debt. Under market conditions no sovereign territory would survive if it had a zero level of creditworthiness. But as a part of Russia, Kaliningrad enjoys a chance of covering its foreign exchange shortages by the federal centre and, in this way, of concealing its actual insolvency.

By the moment**,** Kaliningrad rests upon **an extremely wide package of federal stimulators**, including exclusive customs and tax favours; budgetary subsidies; price subsidies for railway cargo transportation to and from Russia (applied along with overrated federal tariffs for transporting Russian exports to rival ports of Baltic states); VAT exemption for all logistics services in Russia-Kaliningrad communication; budget allocations from the Federal Target Programme till 2010; growing volume of Russia's foreign-currency assets to cover the region's trade deficit; partial exemption of export duties for Kaliningrad's oil-flows, and other benefits. Taken altogether, these favours constitute **an absurdly high price that Russia has to pay** for maintaining an irrational, non-market-based pattern of interaction with Kaliningrad, which makes the local economy still weaker while bringing losses to national economy as a whole.[11]

The aerodynamics of import-led growth swallows any additional federal resources allotted to Kaliningrad, while the territory itself keeps losing its own production and investment capacity.

Kaliningrad's agro-industrial complex is totally suppressed by duty-free imports and exists as a sector of production only nominally, just running zero and even negative growth rates, despite huge and ever growing federal allocations *(Statistical Reference, Jan-Feb 2006*). The region's **transport and port complex** keeps afloat only under immense federal efforts and due to those cargo flows to and from the mainland, which most likely will be cut down in the course of globalization. The local **manufacturing industry** is producing a minimal contribution to the growth of GRP. Kaliningrad's i**nvestment activity** is very

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compensate these shortages, the regional Government had to drastically cut the volume of expenditures (in the 1st half of 2006, at 4.5-fold greater scale than the fall in revenues) and to sharply raise transportation tax. Just this very situation, where an unplanned contraction of revenues was followed by much larger reduction in expenditures and higher tax rates, had created a formal basis for balancing the budget (see *Smorodinskaya, 2007a*).

[10] According to the regional Ministry of finance, the level of federal transfers in Kaliningrad's draft budget of 2007 is lowered down to 22.5% of expenditure. Though Kaliningrad's governor Georgy Boos presents this fact as an achievement ("not more than one-fifth-percentage-share for federal transfers"), he simultaneously claims that "the region's potential demand for additional federal subsidies is far from being exhausted" (*Budget Message, 2006).*

[11] Take, for example, Kaliningrad's enlarging contribution to the Russian 'Dutch disease': by 2005, the region's share in Russia's imports reached a record of 3.3%, which 11 times exceeded its share in Russian GDP (0.3%) (*Smorodinskaya, 2007a*).

volatile and doesn't match with growth rates of either industrial production or GRP, with private capital investment lagging, in principle, far behind the industrial output. While running high rates in total fixed investment (30% as share in GRP in recent years), Kaliningrad fully depends on federal injections. The latter are made either in the form of direct budget allocations, with their share in total investment (14.3% in 2005) far exceeding the Russian average (6.7%), or as investment by state monopolies, such as Gazprom and RAO "UES of Russia" (*Usanov/Kharin, 2006*).[12]

A case, where economy is booming under the diminishing private investment and the enlarging state allocations to compensate this drop, implies that Kaliningrad runs an intensive leakage of capital assets needed for further development. Under any Governor in office, until the existing macroeconomic regime is not amended, Kaliningrad's business sector will be facing dope dependence on state money, while its public sector, a similar dependence on external financial support. This is a typical vicious circle of regional economic growth: **"shortages - federal subsidies – growth – shortages – extra federal aid".**

3. Why the Russian Authorities Are Not Ready to Start Kaliningrad's Reforms

For many post-Soviet years, the relationship between Kaliningrad and Moscow has been shaped by **a trivial rent-seeking game**. The region was successfully profiting by the fact of its remoteness and the risk of its possible separation from Russia to enjoy guaranteed federal assistance, with optimal figures for grants and favours never calculated exactly by federal economic bodies (*Matochkin, 1999; Karabeshkin, Wellmann, 2004)*. On the eve of the EU enlargement, Moscow had suddenly realized that Kaliningrad would objectively need urgent reforms able to prevent its lagging behind the rapidly advancing neighbours. Therefore, upon reaching the 2002 agreement with Brussels on the issue of visas and transit via Lithuania,[13] Kremlin listed the Kaliningrad development problem among its five national policy priorities, with the expert group headed by Putin's Aid Igor Shuvalov commissioned to start working on the new Law on the Kaliningrad SEZ.

Relying on a wide conceptual undertaking on Kaliningrad, which had appeared in 2000-2003,[14] Shuvalov's group **suggested a reasonable economic course:** with the help of a renewed system of favours to softly switch the local economy from servicing imports to producing exports and, by developing non-raw

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[12] For example, the local investment 'boom' of 2003, when total investment increased by 50.5%, was caused by two capital outlays made simultaneously by Gazprom (construction of power station TETS-2) and Lukoil (erection of oil-extracting platform D-6 on the Baltic Sea shelf) under the Federal Target Programme for Kaliningrad's Development. And by 2005, total investment activity has slowed down to 5.6%, with private activity just facing a decline (by 3%), and public activity, on the contrary, a remarkable enlargement (by 87%) (*Usanov Kharin, 2006*).

[13] Introduction of visas by Lithuania made Russia afraid of a possible detachment of Kaliningrad from the mainland. However, in November 2002, after sharp debates, Moscow agreed with Brussels on a wide package of measures to ease transiting across Lithuania, including introduction of Facilitated Transit Documents, both for railway and for cars and buses (*Vinokurov, 2006*).

[14] Since 2000, Kaliningrad's problem has been attracting a growing attention of both Russian and European experts whose research papers have laid a start to "Kaliningrad studies" as a separate research trend. Thereby, Shuvalov's group could enjoy resting upon a whole cluster of findings, including the Pilot region idea that implied the EU-Russian Partnership on Kaliningrad's development, and the prospect of making the oblast' a "region of co-operation" with Europe. See *Joenniemi, Dewar, Fairlie (2000), Smorodinskaya (2001a,b), Kuznetsova, Mau (2002), Kiel (2002), Samson, Eliseeva (2003), Smorodinskaya/ Zhukov (2003), Strategiya sotrudnichestva (2004), etc.*

export items, to insert it into the common European space. However, this course had largely remained on paper, with **the focal idea of Kaliningrad's structural turn to Europe facing a traditional politization,** in other words, being disfigured by considerations of political expediency. Why so?

Both Moscow and Brussels are looking for improvement of Kaliningrad's well-being and for its successful adjustment to the challenges of global competition. However, the visions of the two parties of how to reach this goal seriously diverge and even conflict**.** While the EU associates such adjustment with regionalization and more liberalized policies for the exclave, emphasizing the priority of its active self-engagement into European infrastructural and cooperation networks, Russia's attempts are constrained by an old alarmist approach which goes up to the concept of Realpolitik, now completely outdated.[15]

In particular, Moscow continues to build its policy line towards Kaliningrad upon security and geopolitics in their classical sense, disregarding key post-modern shifts. The Russian "enforcement" ministries (Ministry of Defense, Ministry of Home Affairs, Federal Security Service, etc.), as well as the RF Ministry of Foreign Affairs, are demanded to scrutinize economic decisions on Kaliningrad in the light of their possible sovereign-security-risk effects. In focus is Moscow's concern of how not to loose (let alone of not to lose) the levers of economic and political control over the exclave under the supposed extension of the EU presence there. To prevent a rise of local separatism or an enhancement of Kaliningrad's autonomy, Kremlin seeks for avoiding not just a growing social contrast but also a too rapid economic convergence of the exclave with EU neighbours. Thereby, it substitutes the prospect of Kaliningrad's Europeanization either with the principle of its "retaining within the indivisible political, economic and defense space of the country", as proclaimed in the Federal Target Program for Kaliningrad's Development till 2010 (*Federal Target Program, 2001*), or at best by the idea of "making use of the Kaliningrad factor in the interests of creating the EU-Russian common spaces", as stated by Ilya Klebanov, Putin's plenipotentiary in the North-West (*Rosbalt, 23.05.05).*

As a result, **federal policies towards Kaliningrad don't go beyond trivial compromise solutions**, which may formally boost its level of development (in terms of per capita GRP) but avoid fundamental issues of its economic modernisation.[16] For example, since early 2000-s, high-level Kremlin's officials repeatedly confirm their adherence to the prospect of making "the Kaliningrad oblast a pilot region of Russian-European cooperation", emphasizing that this idea has been initiated by Russia herself in 1999, in line with her policy of strategic partnership with the EU.[17] However, such statements keep remaining pure declarations, with no visible interest on the part of Moscow to back them by practical policy steps.

A similar fate of remaining mostly on paper may be shared by many resolute statements of Kaliningrad's Governor Georgy Boos, appointed to this post

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[15] In line with the logic of the Westphalia peace, Realpolitik sticks a sound development of a nation to the strength of the federal centre which keeps tight control over the regions and defends national sovereignty. Meanwhile, a contemporary approach to security, now shared by advanced European and Asian nations, implies an entirely different system of priorities, namely**:** control over time and speed in innovations (instead of control over a territory); transnational clusters and regionalism (instead of defending national sovereignty); flexible horizontal networks (instead of tough vertical subordination); and the principles of creative destruction and reconstruction (instead of attempts to preserve a status quo) (see *Smorodinskaya, 2007b).*

[16] As Raimundas Lopata, a leading Lithuanian political scientist, fairly argues, "Russia in its rhetoric claims that it supports the exclave, but actually Russia's and Kaliningrad's interests often clash, and decisions are taken not in Kaliningrad's favour" (*Lopata, 2006).*

[17] The latest assurances of this sort were officially made by Russia in October 2005, at the 7th Summit of the Baltic Development Forum in Stockholm, and in October 2006, on the eve of the EU-Russian Summit in Helsinki.

in September 2005 directly by President Putin.[18] This refers to Boos's intention to sharply lift the local living standards in ten years (by 2010, up to the levels of Lithuania and Poland and by 2015, to the level of Germany), and to his plans of increasing the region's population up to 5 million by 2015 through attracting Russian compatriots from the Baltic States (*Interfax,28.09.05; Rosbalt,2.09.05*), and to his claims in favour of export-oriented reforms (*Kaliningrad's Programme, 2006*), and even to his belief in making Kaliningrad's cooperation with Poland and Lithuania "a model for shaping Russia's relations with the united Europe" (*Rosbalt, 18.09.05; EUobserver, 2006).*

As early as by the end of 2005, it had become clear that Kremlin would hardly permit Boos to go far with his intention to modernize the region and make it closer to Europe. Rather, Kaliningrad's future development will be largely influenced by the Moscow vested interests aimed at counterbalancing the rent-seeking appetite of the local elite. It is indicative that the local branch of the RF Ministry of Foreign Affairs has taken away from the new Kaliningrad's Government any independent authority for advancing its external economic contacts, including trans-border cooperation with Poland and Lithuania. And in several cases, the last-moment instructions of this Ministry had made Boos to suddenly revoke his planned appointments with high-level European officials.[19] In terms of its own initiatives, Kaliningrad is now locked down by Moscow much stronger than its neighbours in the North-West (let alone the central Russian regions), so that the regional Government has to agree its every step with federal bodies, which makes its economic decisions **fully dependent on Kremlin's logic of policymaking.**

The new Kaliningrad's development Programme for 2007-2016, adopted by the regional Duma, sees one of its key priorities in "expedient integration of Kaliningrad Oblast' into the processes of macroeconomic development in the Baltic Sea Region" (*Kaliningrad's Programme, 2006*). This looks as **a** cautious attempt of the local elites **to enlarge their "window of opportunities" in cooperation with Europe**. However, whatever new European investors would come to this territory, they will hardly help it to make an economic advance unless Moscow starts a well-designed set of reforms here. Unless and until this happens, Georgy Boos will be doomed, alike his predecessors, to concentrate his economic policies around a trivial point: **how to keep the region's finance from dropping into the red, at least formally.** To this end, he will look for further redistribution of the region's property in favour of bigger investors (through buying private allotments by the Government to resell them by auction at better price, with proceeds directed to the budget), or for gaining extra sources of politically created rents (like, say, construction of tax-favoured tourist zones, provided in the 2005 Federal Law on Special Economic Zones in Russia), or for making the region a kind of Russian Las-Vegas, an exclusive and legally admitted location of gambling houses.[20]

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[18] Mr. Boos, member of ruling "United Russia" Party and until September 2005, deputy speaker of the State Duma, has taken up his Governor's post in a way of blitzkrieg - two months ahead the expiry date of the ruling Governor Mr. Yegorov. As the local daily "Evening Kaliningrad" supposed, "the balance of interests between the federal centre and the regional elite was disrupted so badly that the Kremlin determined to change the administration despite the fact that admiral Vladimir Yegorov was by no means the worst Governor" (*Kaliningradskaya Vechorka, 2005*).

[19] Take, for example, a sudden abolishment of planned Boos' meeting with the President of Lithuania V. Adamkus in Vilnius in February 2006, or Boos' not coming to Brussels in November 2006 for planned meeting with the EU Commissioner B. Ferrero-Waldner to discuss ways of joint promotion of Kaliningrad's development.

[20] Since July 2009, all gamble houses in Russia must be relocated in four areas only (as provided in the respective federal law of 2007), namely: the Kaliningrad Region, the Altai Territory, the Primorsk (Maryland) Territory, and the border area between the Rostov Region and the Krasnodar Territory. However, the list of such locations is not finally settled and may be still amended.

4. What Interests Meets the New Law on Kaliningrad's SEZ

The new federal Law on Kaliningrad's SEZ, brought in force in April 2006, constitutes a highly contradictory document that can be implemented only through a dozen of additional by-laws. It concerns legal persons only, dividing them into **two groups**: those who can enjoy the status of a SEZ resident, and those who can not (*Table 3).* The group of **Residents**, with a start-up capital for investment of not less than RUR150 m (4.5 m Euro), is granted vast tax favours during 12 years ahead, upon meeting some requirements to investment projects. The group of **'non-Residents'** is deprived of tax preferences but granted the transitory ten-year-long customs favours, which are, in essence, an amended version of the 1996 set of customs favours.

Table 3. **Key Provisions of the 2006 Federal Law on SEZ in the Kaliningrad Region**

Categories of Actors to Enjoy SEZ Favours (legal persons only):
• **Residents of the SEZ -** legal persons included in the SEZ Register upon meeting a set of requirements to their investment projects (*except financial organizations)*
• **"non-Residents" -** legal persons earlier registered in the Kaliningrad Region (before April 2006), which have been guided by the 1996 Law on SEZ
Requirements to Investment Projects Implemented by Residents:
• **capital total to at least RUR 150 m to be invested within 3 years** in fixed assets in the territory of the Kaliningrad region
• **not to deal with**: extraction of oil or natural gas; production of excisable goods (named in the officially approved List); wholesale and retail trading; repairing; and financial activity.
Favours for Residents:
• over the first **6 years** of operation **don't pay** the profit and property taxes
• during the next **6 years** of operation **pay half** of these taxes
Transitory Ten-Year-Long Favours for "non-Residents":
• "non- Residents" can apply **Free Customs Zone regime within 10 years** (from 1 April 2006) **-** according to the rules similar to that of the 1996 Law on SEZ**, but with account of special provisions**
• **Customs favours:** no duties and taxes on delivering goods abroad or to mainland Russia, provided that goods meet Criteria of sufficient processing
• **Special provisions for customs favours:** modified Criteria of sufficient processing; List of foreign goods never imported tax-free; List of operations for production of goods never meeting criteria of sufficient processing, etc.
• **Tax favours:** none

Compiled from: Law on SEZ (2006)

The amended SEZ regime pretends to suppress import servicing and to stop tax evasion (the remnants of the idea of structural reforms). However, de facto, **the Law has Moscow's political priorities in focus, not vital needs of Kaliningrad's economy**.

*Firstly***,** due to security reasons, the Law looks not for bringing Kaliningrad closer to Europe, but rather for preventing its possible breakaway from Russia. Therefore, foreign investors are actually not so much welcome to the Kaliningrad SEZ as it follows from official announcements**.** Instead, the Law aims at bringing to the region several large-sized Russian companies, meant to counterbalance, if needed, possible Western expansion. Such policy line not only impedes the region's modernization but also **seriously deteriorates the local business climate,** distorting the terms of market competition to the exclusive benefit of Russian majors (by local standards). On the whole, the renewed system of SEZ favours discriminates the position of individual entrepreneurs (who are deprived of any favours at all) to that of corporate entities, and the position of small and medium enterprises (which lack the required size of start-up investment and, thereby, can't obtain a Resident status and the respective tax benefits) to that of large businesses, along with creating disadvantages for the newly formed small firms (which can't enjoy neither "old" customs benefits for non-Residents, nor tax favours for Residents) as compared to the existing ones.

Secondly, the Law cares rather about the SEZ would-be meeting the terms of Russia's fluent joining the WTO than about making Kaliningrad more competitive and export-oriented. For this reason, it aims at formally adjusting the SEZ regime to the standards of a classical local-sized free customs zone, and not at real adjusting the local economy to the WTO-demanded principles of fair market competition. A good example of this purely formal following the WTO rules is **the new system of Kaliningrad's customs favours,** which largely stops Kaliningrad's longstanding practice of legalized smuggling (through obliging all SEZ producers to pay import duties on deliveries to the mainland**)** but **doesn't remove the basic uncertainty in the region's standing**: should the world see Kaliningrad within the national customs territory (as provided by the RF Constitution for all subjects of Federation) or, on the contrary, beyond this territory (as implied by its SEZ status)?

Thirdly, the Law provides some extra administrative control over producers to stop their practice of tax avoidance and to clear the territory from corruption. However, these measures work at best for improving Kaliningrad's image in the eyes of Europe, and **not for real taking the region away from shadow activities.**[21] Indeed, vast tax preferences granted exclusively to the SEZ Residents (i.e. to large investors), together with 'old' customs favours retained for "non-Residents", are encouraging Kaliningrad to further extract monopolistic rents by means of 'import substitution'.[22] Since small business is most likely falling out of this practice, the game is widely played, even more vigorously, on the part of new amalgamated 'assembly' companies which make full use of tax benefits and additional use of customs favours (through shadow schemes of cooperation with the old actors). And those businessmen who lack capital of 4.5 m Euro to meet Resident's criteria simply resort to artificial overvaluing the construction cost of new facilities, which above all provokes the emergence of a new shadow market offering specific financial services.

To conclude, **Moscow is making a hopeless attempt to strengthen the competitive edge of Kaliningrad without launching a well-designed process of its modernisation**. Instead of promoting the vitally important rapprochement of the region with its EU neighbours, the new Law still keeps it under specific rules of the game, which seriously diverge from economic openness and fair market competition. Meanwhile, Kaliningrad's actors are demonstrating a remarkable ability of rapid self-adjustment for any changes and, particularly, high

[21] In compliance with the WTO rules, the 2006 Law obliges local producers to pay VAT only in its normal form (as charged of the total value of commodity), abolishes Kaliningrad's legal right to apply quantitative quotas to duty-free imports, and tightens the criteria of sufficient processing for imported components. At the same time, the Law introduces a new form of direct limitations of local import (which is just another violation of a free trade principle) and supports Kaliningrad's artificial market advantages against foreign producers. (*Law on SEZ, 2006*). For details see *Smorodinskaya, 2007a.*

[22] For example, in order to reach the 30-percent minimum of added value for goods of own produce, as prescribed by the new Law (against the 1996 Law margin of 15 to 30%), Kaliningrad's assembly producers don't need to really deepen the processing of imported components. Instead, they can obtain the lacking value through pure statistical transformation of a part of their shadow rents (hidden in the form of oversized import costs) into legal taxable incomes.

creativity in renewing the schemes of extracting shadow rents.

5. Globalization as a Natural Tool to Stop Inertial Development

Nevertheless, in the not-far future, globalization will destroy the present non-market-based pattern of interactions between Kaliningrad and the mainland, and thereby, make the region enter the stage of radical economic restructuring. At least three factors are objectively nearing this perspective.

The first factor is *the 2004 EU enlargement that has made Kaliningrad's trade with Russia, covering thousands of kilometers distance, still more impracticable by market standards***.** Though the enlargement is no longer creating technical obstacles to Kaliningrad's transit across Lithuania (the value of cargo flows to and from the exclave is steadily growing),[23] this event and, broader, the process of globalization has placed Kaliningrad-Russian interactions into a more competitive market environment and, as a result, has made them relatively more costly. This rising level of costs, whatever forms it is taking (additional region's payments for the new border control and transit services offered by Lithuania as the EU-member, the Russia-Lithuania "war of tariffs" in rail-road cargo transportation to their Baltic sea-ports, a switch of transit export flows over to sea-ports of Finland and the Leningrad Region, etc.), implies that **the region's pattern of ties with Russia is bumping into its objective limits**.[24] Despite the growing scale of federal aid granted to Kaliningrad through the customs, tax and tariff favours, the region's ports keep staying at risk of losing clients and the local "assembly" businesses, at risk of losing their share in Russian outlets.

At this background, a noticeable growth of Kaliningrad's cargo transit to and from Russia, as registered for the whole of 2006, has obviously a temporarily nature and can be explained by a combination of several conjuncture factors, namely: the ongoing expansion of Russian export oil flows under high international prices; a new portion of federal transportation subsidies to cover the enlarged costs of supplying Kaliningrad with more fuel and construction materials; the ability of local "import substituting" producers to find extra ways of rent extraction under the revised SEZ regime.

The second factor is *Russia's forthcoming joining the WTO and the resulting Europeanization of the national economy.*[25] With Russia a WTO member, Kaliningrad will lose its present "import-substituting" niches in domestic markets and hardly obtain any new ones instead. On the one hand, the local producers will

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[23]According to European Commission, Kaliningrad's transit flows have been positively affected by the following measures: introduction in July 2003 of "facilitated travel documents" for transiting of Russians across Lithuania; introduction of simplified administrative procedures by which Russian cargo transit declarations can be submitted directly to the New Computerized Transit System in Lithuania; adoption in April 2004 of Joint EU-Russian Statement on EU enlargement and EU-Russia relations (it confirmed the basic principles of freedom of transit and the objective of keeping its cost as low as possible); substantial financial support offered by the EU to modernize the local border crossings (*EC, 2006*)

[24] In the 1st half of 2005**,** the growth rates in local "assembly" industries sharply plummeted, with their share in all-Russian output having reached its possible ceilings (35% for TV sets, 33% for vacuum cleaners) (*Usanov, 2005***)**. For three quarters of 2005, Kaliningrad's deliveries to Russia enlarged just by 27.5%, which is incomparable with their 61% increase in 2004 *(Usanov/Kharin, 2006*). And in the 1st half of 2006, those industries showed zero and even negative growth rates, starting to increase output only later, upon elaborating new schemes of tax avoidance.

[25] Even small amendments that Russia will have to make to its Customs Code as a candidate WTO-member will lead to serious changes in many rules of the game: the Russian Tax Code will have to be amended, the next is the budgetary legislation, and further, in sequence, the whole system of market regulation will have to be replaced. As a result, Russia may come much closer to Europe than the concept of the EU-Russian common spaces is providing for.

find themselves in an equalized competitive position with actors from other Russian regions, i.e. they will mostly lose their artificial price advantages and, therefore, actually de-privileged. On the other hand, they will face tougher import competition on more liberalized Russian markets. The entire mechanism of usual economic interaction with the mainland will get destroyed and, in consequence, Kaliningrad will be spontaneously driven by market forces toward serious structural shifts.

The following set of liabilities taken by Russia as a candidate WTO-member will objectively bring this outcome near: adjustment of the SEZ regime to the WTO rules (partially done in the 2006 Law on SEZ); Russia's abolishing the economically illogical VAT on imports and applying only traditional VAT since 2007;[26] the bounding of Russian effective customs tariffs with the European ones over 7 years (which, according to estimates, will lower import duties in Russia by 2.5-2.7 times);[27] liberalization of domestic transport, fuel and energy tariffs in Russia (for to raise them up to their average world levels and, thereby, to stop the present Russian practice of applying individual subsidies, as demanded by WTO).

The third factor is *the logic of domestic economic changes in Russia herself.* Even irrespective of agreements within WTO framework, Russia will not be able to maintain for long high price subsidies for gas on the domestic market, especially, in the light of the observed falling volume of gas extraction and the relevant threat of gas deficit in the country. Therefore, it will pass to gradual liberalization of gas market and, as a result, to simultaneous regular jerky raising of regulated Gazprom's tariffs.[28] And the same story awaits tariffs of other natural monopolies, which will no longer enjoy subsidizing. As a result, **the system of supporting Kaliningrad-Russian ties through lowered fuel, energy and transportation tariffs will be ruined.** And exclusive tax preferences for SEZ residents, introduced by the 2006 Law, will hardly compensate to the full this rise in costs for the local companies.

Above all, Russia's accession to WTO can encourage her European partners to launch **antidumping procedures** regarding any federal price subsidies for supporting traffic through the port of Kaliningrad. If WTO-members find this practice discriminating in respect to other Baltic ports, Kaliningrad may lose the major part of its current transit export flow, let alone the prospect of attracting additional cargo traffic from Belarus, which fully rests on the argument of political expediency.[29]

5. How to Better Enter the Post-Industrial European Trajectory

In he case of Kaliningrad, prospects of finding optimal investment

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[26] The "import" VAT, an artificial invention of the RF Customs Service of mid-1997 in concern with replenishing the federal budget revenues, has generated, in parallel, vast rent-seeking and shadow activities in Russia, with Kaliningrad's producers enjoying the largest benefits from playing games around VAT.
[27] This means that despite the formal life of the Kaliningrad SEZ for 25 years (as provided in the 2006 Law), the region's monopoly privileges in import trade will be actually effective for another several years only. By the end of that period, the rent-producing capacity of the SEZ regime will be largely exhausted.
[28] According to German Gref, the RF Minister of Economic Development and Trade, within the next 5 years Russia will be doomed to lift domestic gas prices at outstripping pace for the sake of energy saving (*Rosbalt, 15.07.06*). Forecasts predict that by 2010, the average domestic gas price in Russia will double from present-day $40 to $80 per 1.000 cu m (for comparison: Gazprom's price for the home market is now $56, the average export price for Russian gas is $246) (*Vedomosti, 9.03.06*).
[29] By fair market rules, export trans-shipments of Belarusian products through the port of Kaliningrad are much more costly than through the Lithuanian port of Klaipeda *(Russian Exclave, 2006).*

decisions, including the transport infrastructure and communication projects, depend not just on traditional analysis of cost-effectiveness but in the first place on the general state of the EU-Russian relations. This point makes Kaliningrad **a typical challenge of the age of globalization,** where a local task of reforming a territory calls several groups of international actors for a more close cooperation and networking.

To meet the challenge, the idea of the EU-Russian Kaliningrad partnership (or, originally, the Pilot region idea – see *Kiel 2002; Smorodinskaya/Zhukov, 2003)* has been brought into focus. Since not backed by the moment by Russia's practical policies, this idea may seem overambitious and even misleading, as compared, say, with developing cooperation on Kaliningrad within the framework of the renewed Action Plan of the EU Northern Dimension *(*see *Haukkala, 2005)*. Meanwhile, once substantiated by experts, it has moved both Moscow and Brussels to go beyond the notorious transit problem and start thinking of the only reasonable scenario for Kaliningrad's future development – its turn to European export markets. Though today such scenario doesn't look quite realistic (considering Kaliningrad's inability to broadly rely on traditional items of manufacturing exports), **the concerted EU-Russian actions for reforming the region could create a chance to re-shape its economic profile anew**. In what way?

A strategic option for Kaliningrad's modernization is dictated both by **the objective constraints and the comparative advantages** of its economic potential**,** as seen in terms of contemporary sources of growth.

Regarding the constraints, we must admit that for a wide range of reasons (including narrow sizes of the local market, local energy-supply problems, number and quality of the local labour force) **this territory is of little use for dislocation of large-size industrial enterprises relying on the economy-of-scale effects**. *First,* such entities, while never profitable here by market standards, are lacking natural outlets and any development prospects in today's European environment, even on applying the newest production technologies.[30] *Secondly,* despite a relatively low unemployment rate (5.9%, as by the end of 2006), the region faces acute structural unemployment, with workforce adequate in quality for big industrial plants totally lacking. *Thirdly,* Kaliningrad suffers from acute energy and fuel shortages, with annual consumption of local firms individually rationed by state monopolies and the recently constructed TETS-2 providing only 70% of the rising energy demand (*Westrus,31.10.06*). Meanwhile, the prospect of its full-scale supply is under question in principle: on the one hand, Moscow does not permit Kaliningrad to use non-Russian fuel sources for security reasons, on the other hand, the perspective of constructing a pipeline to carry Gazprom's gas to TETS-2 is troublesome.[31]

All the three varieties of economic constraints exclude any positive scenario of pushing the region along the path of traditional industrialization, which means that the 2006 Law's stake on capital-intensive industrial projects is a dead-end. On the contrary, the objective market rules demand Kaliningrad **to lighten its industrial structure** (by lowering the share of primary-intensive or power-

[30] For instance, the Autotor assembly plant considered one of the most successful projects in the region, can stay keeping on the surface only under guaranteed government procurements and large-scale SEZ preferences. The same will be true for huge mining or steel plants that the region's Government plans to launch in respond to Kremlin's political appeal. For example, an oil refinery may reach here a normal production capacity (3 mill. tons of oil a year) only if a wide transit flow from Russia is available and export duties on petroleum non-existent, otherwise, the oil-flow will choose other ports.

[31] Gas deliveries to Kaliningrad across the Baltic States or Poland are concerned for Russia with a tariff dependency and transit costs. An alternative option, to lay the Kaliningrad branch of the future North-European Gas Pipeline, is hampered by a lengthy payback period. Gazprom is reported to consider this idea only on condition that the RF Government introduces the European-level prices for gas deliveries to the exclave.

consuming production) and **to focus on flexible and relatively small forms of business activity.** If Moscow really wants to see Kaliningrad strong and prosperous in the European environment, it should go beyond the mere idea of promoting manufacturing exports and start cultivating in this territory **a diversified cluster of small and middle-size entities, able to effectively operate in tertiary sector and in service-based export industries,** including any types of incoming tourism.

Regarding potential comparative advantages, as seen in terms of post-modern and post-industrial realities, Kaliningrad can rely on **three basic assets** which run either a zero or negative value at the moment, but will clearly acquire their natural investment attractiveness as soon as the local economy starts moving towards integration into Europe. *The first asset* is the region's rich natural landscape, its advantageous geographical location in the centre of Europe, and its unique cultural and historical heritage. *The second one* is its dynamic neighbourhood of rapidly growing Baltic states, its geographical proximity to Scandinavian countries as technological leaders of the new Europe, and its natural chance to get linked to numerous infrastructural and communication networks in the Baltic Sea Region, an envisaged global frontrunner in innovations. *The third asset* is high market adaptability of the local population, deriving from its massive involvement in the small-business and individual entrepreneurial activities. Such experience, accumulated in Kaliningrad under many years of the SEZ regime, is a unique human resource that could be renewed and substantiated today with more productive economic functions.[32]

Under a thoughtful structural policy, all the three assets can be effectively capitalized in a way that will help Kaliningrad to engage oneself in a broad range of cooperation projects in the Baltic Rim and find a sustainable niche in European markets. It is this very way of promoting local small-business and service-based activities that would offer Kaliningrad **a chance to get organically involved into the European technological set-up, and, in a broader sense, into the development trends of the 21st century.**

To obtain sustainability in the globalized world economy, Russia will need to link her industrial complex to European post-industrial potential, as well as to pass to contemporary security thinking, focused on promoting innovations, transformation and multidimensional trans-border networking. The growing pressure of these interrelated challenges is now felt both at the federal and at the regional levels. But Kaliningrad, the Russian outpost in the EU, is facing them most directly. This is an additional argument **to discuss Kaliningrad's development prospects in terms of the emerging post-industrial clusters in the Baltic Rim**, not in terms of launching individual industrial projects in the enclave territory as such.

Concluding Remark

Though federal plans of reforming the exclave have never been clearly announced, while the concept of 2006 Law on Kaliningrad's SEZ fails to ensure its economic sustainability, Moscow obviously seeks for raising the region's competitiveness and well-being up to average European levels. This purpose must encourage all the parties involved to be more particular in helping the region to move closer to Europe, while trying **to adjust this move with objective demands and opportunities of globalization.**

Globalization and transition to knowledge-based economy, let alone the growing regionalization and the emergence of innovation clusters, are forming an absolutely new world order, able to give a sudden chance for rapid rising to

[32] This transformation will clearly need a certain government assistance (building industrial and technological parks for small business, extending preferential loans to start-ups, funding of retraining programs, etc.), aimed at promoting innovative activities.

different currently under-developed areas. This opportunity, as laid by Brussels in the foundation of the European Regional Policy for 2007-2013, concerns in the first place European regions.[33] Meanwhile, it is no less true for border territories of the Russian North-West. And regarding the case of Kaliningrad, **the new global realities are simply a key to shaping successful modernization strategies.**

The prospect that the EU and Russia decide on joint elaboration of such modernization strategy for Kaliningrad looks today rather unlikely. Nevertheless, the reality may promise more.

Firstly, Russia's anticipated joining the WTO will inevitably accelerate its economic Europeanization, and all the more so, regarding Kaliningrad. *Secondly,* for the nearest years, the problem of Kaliningrad's economic modernization will be remaining on the agenda of the renewed Action Plan of the EU Northern Dimension. *Thirdly,* as time passes by, Kaliningrad is objectively becoming a more and more provoking challenge not only for Europe, and not only for the EU-Russian cooperation, but for Russia herself. As Pertti Joenniemi, a leading Danish expert on the Kaliningrad problem, fairly notes, "**Kaliningrad invites and mandates Russia to view itself in increasingly post-modern terms with a piece of it being simultaneously linked to the EU"** (*Abelsky, 2006*).

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[33] As Danuta Hübner, EU Commissioner for Regional Policy, puts it, "Technological progress and social and economic pressures stemming from globalisation, have an impact on the very concept of peripherality. Traditional support policies have often failed to fully address these challenges. Today, we do not need policies that support, we need policies that dynamise" **(***Hübner, 2006).*

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