

## A bottomless pit: the costs of Crimea's annexation by Russia

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The annexation of Crimea has brought the Russian authorities significant dividends, in particular on the domestic stage: it has resulted in an unprecedented social and political consolidation, and strengthened Vladimir Putin's position after several years of decline in social support for him. It has provided Russia with strategic benefits, giving it broad access to the Black Sea and the military infrastructure on the peninsula, as well as access to natural gas and crude oil reserves. Russia has also taken over numerous assets (including the tourist infrastructure) previously owned by the Ukrainian state.

However, the decision itself concerning Moscow's annexation of Crimea was taken off the cuff, with no calculation of the costs of integrating it with the Russian legal, political and socio-economic space. Russia took over a region that required subsidies from the Ukrainian budget; moreover, the annexation struck at the most important industry of the Crimean economy – tourism. Crimea's integration with Russia will be a complex process that entails high costs, financial, organisational and social, including multi-billion dollar investments in the modernisation and development of infrastructure, covering the region's budget deficit, and paying out social benefits.

For reasons of prestige and political significance, Moscow is treating Crimea as a showcase region. Russia is determined to prove that the Crimean incorporation will be beneficial for the region's economy and will raise people's living standards. However, the expenses triggered by Crimea's integration will coincide with a deteriorating economic situation in Russia, aggravated by US and EU sanctions, and this may force Russia to postpone or even give up some of its ambitious investments in the peninsula. Some of the integration costs will have to be borne by other Russian regions, even though they already face serious financial problems that have forced them to reduce their own investment programs. Another issue that has come into question is the fulfilment of the Crimean people's' expectations concerning the improvement of their living standards, due to the tourist sector's problems (small-scale tourist services used to be one of the local people's main sources of income), the rising costs of maintenance, and finally, restrictions of civil rights after the introduction of the more restrictive Russian legislation.

### Russia's benefits from the annexation of Crimea

The annexation of Crimea has brought Russia and its government a number of benefits. It has contributed to an unprecedented consolidation of the elites and the general public around

Vladimir Putin. Support for the president has soared to 85-86%, an increase of almost 25% compared with the beginning of 2014<sup>1</sup>. This has

<sup>1</sup> According to a WCIOM survey from 20 July 2014, support for Putin has risen to a record 86% (from 60.9% in January this year.). The Levada Centre poll of 24 July 2014 recorded an increase to 85% (from 65% in January 2014).

reversed the downward trend in support for Putin which had been observed since his return to the presidency in 2012, and yet again reinforced his position as the undisputed political and social leader.

The benefits for Russia include taking control over the sea and air space of the Black and Azov Seas. Russia has taken full control of the Black Sea Fleet base in Sevastopol, along with its military and maritime infrastructure, and gained access to Ukrainian military bases in Crimea. This will translate into annual savings of nearly \$80 million from the abolition of fees for the database lease<sup>2</sup>.

**The annexation of Crimea has resulted in an unprecedented consolidation around Vladimir Putin and reversed the downward trend in public support for him which had been observed since his return to the Kremlin.**

Millions of dollars will remain in the Russian budget due to the abolition of customs duties for supplies for the fleet, as well as for passing Russian ships through the Kerch-Yenikalskiy canal. The Black Sea Fleet is to be modernised (at a cost of \$2.5 billion by 2020) and Crimean plants are to receive part of the orders from the Russian arms industry, which may contribute to their modernisation and a rise in production. Another strategic gain is Russia's access to the Black Sea ports in Kerch, Feodosia and Sevastopol, and those ports' shipping capacities, which will make the planned construction of a port on the Taman peninsula (in Krasnodar *krai*) unnecessary and save another \$2.5 billion. When Russia annexed Crimea, it also took over state-owned enterprises (in the spheres of manufacturing, repair, transport, education, scientific research, culture and others), and

<sup>2</sup> [www.vedomosti.ru/finance/news/26692171/100-mlrd-ne-hvatit](http://www.vedomosti.ru/finance/news/26692171/100-mlrd-ne-hvatit)

part of the peninsula's resort and sanatorium base. These enterprises are to be assigned to the Crimean authorities and Russian companies such as the state-owned Russian Railways<sup>3</sup>. By taking over Chernomorneftegaz (a subsidiary of Naftogaz Ukraine), Russia gained access to natural gas deposits located on the continental shelf of the Crimean peninsula<sup>4</sup>, as well as to its transmission infrastructure and 2 billion m<sup>3</sup> of gas stored in an underground storage on the peninsula. Russia also took over the renowned Massandra winery, which is one of the largest wine producers in the CIS.

### The costs Russia will bear

Moscow will treat Crimea as a showcase region. It is determined to demonstrate that the annexation of the peninsula will contribute to the development of the Crimean economy and raise its residents' living standards. This requires multi-billion investments, both from the state budget and other sources. Former Finance Minister Alexei Kudrin has estimated that the investments in Crimea will exceed the total cost of the reconstruction of the North Caucasus republics after the end of the Chechen wars<sup>5</sup>.

The annexation of the peninsula has already absorbed nearly \$4.5 billion from Russia's federal budget<sup>6</sup>. These funds have been used to balance the budgets of Crimea and Sevastopol (\$1.6 billion) to set up the region's executive structures, issue passports, pay pensions, raise public sector employees' salaries (which were much low-

<sup>3</sup> The Ukrainian ministries and agencies had owned approximately 200 recreational and sanatorium facilities and residences used by top government officials.

<sup>4</sup> In 2013, gas production on the continental shelf of the Crimean peninsula reached 1.65 billion m<sup>3</sup>. According to Sergey Donskoy, Russia's minister of natural resources, crude oil deposits in the Crimea total 47 million tons, and natural gas deposits 165.3 billion m<sup>3</sup>, along with 18.2 million tons of gas condensate. Five gas and three condensate deposits were discovered on the Black Sea shelf, and six gas fields on the shelf of the Sea of Azov. [angi.ru/news.shtml?oid=2812305](http://angi.ru/news.shtml?oid=2812305)

<sup>5</sup> [https://www.youtube.com/watch?v=46WN\\_OaiWXs](https://www.youtube.com/watch?v=46WN_OaiWXs)

<sup>6</sup> [www.vedomosti.ru/companies/news/28853561/krym-prisoedinitnya-k-150-mlrd-rub](http://www.vedomosti.ru/companies/news/28853561/krym-prisoedinitnya-k-150-mlrd-rub)

er than those in Russia), to cover the most urgent social needs and to secure transport links (\$2.9 billion)<sup>7</sup>. Part of the budget reserve was used to support Crimea in 2014, as were pension premiums, which were supposed to have been transferred to private pension funds<sup>8</sup>. The draft budget for the years 2015-2017 estimates that the cost of Crimea and Sevastopol's maintenance will exceed \$2.5 billion per year (not counting investments), and that half of this sum will be spent on subsidies to their budgets. The annexation was not preceded by legal and organisational preparations: only after Russia seized the peninsula did President Putin order the Ministry of Regional Development to prepare a 'Programme for Development of the Republic of Crimea and the Federal City of Sevastopol by 2020' which specified the necessary investments in infrastructure and other sectors of the region's economy.

According to the programme, the largest investments from the federal budget will be spent on the expansion and modernisation of Crimea's infrastructure, including:

- the construction of transport links with Russia (the key investment is the construction of a road-rail bridge across the Kerch Strait);
- Crimea's gasification and the construction of an energy infrastructure linking the peninsula with Russia;
- the expansion and modernisation of water supply and sewerage.

However, the Russian budget for the years 2015-2017 lacks sufficient funds to implement these ambitious investment plans in Crimea (\$8.5 billion versus the required \$22.5 billion)<sup>9</sup>, and so additional sources of financing are being sought. To cover Crimea's needs in the coming

years, the government will have to abandon part of the investments in other Russian regions. Among other reductions, the Ministry of Finance proposes to dispense with the strategic project to construct a bridge over the Lena River in Yakutia and roads leading to it, which will save \$1.3 billion<sup>10</sup>.

### **By annexing Crimea, Moscow has taken on the burden of subsidising the region's loss-making economy and restoring its institutional, economic and infrastructural links with Russia.**

Another of the government's ideas to attract investors is the creation of a Special Economic Zone on the peninsula, termed a 'civilized tax haven', that would grant preferential terms to investors. Furthermore, during his visit to China in May, President Putin encouraged Chinese entrepreneurs to invest in Crimea, including by continuing the projects agreed on during the former Ukrainian President's Viktor Yanukovich's visit to China in December 2013.

### **The costs Crimea will bear**

The process of integrating the newly created Republic of Crimea and Sevastopol City with Russia's institutional, political and economic space is complex and entails significant costs, financial, organisational and social, since the annexation has severely affected or even completely severed economic and institutional ties with Ukraine. One of the first stages of this integration was the introduction of the Russian rouble as of 1 June 2014, which replaced the Ukrainian hryvnia.

<sup>7</sup> The average pension in Ukraine is 5700 rubles, while in Russia it is about 10,000 rubles. Social allowances and reliefs that are in force in Russia, such as the maternity capital, are to be introduced in Crimea.

<sup>8</sup> [www.interfax.ru/business/382558](http://www.interfax.ru/business/382558)

<sup>9</sup> [http://1prime.ru/state\\_regulation/20140709/788002223.html](http://1prime.ru/state_regulation/20140709/788002223.html)

<sup>10</sup> [www.vedomosti.ru/companies/news/28921021/lena-bez-mosta-i-dorogi](http://www.vedomosti.ru/companies/news/28921021/lena-bez-mosta-i-dorogi)

Russia's annexation of Crimea has hit all the branches of Crimean economy. It has severed production ties and supply channels, and resulted in the cancellation of many contracts with suppliers and customers in Ukraine and the EU<sup>11</sup>, thus causing problems for industry and agriculture. Customers are suffering from shortages and rising prices of goods<sup>12</sup>. To avoid popular discontent, the Crimean authorities have issued an order to reduce the margin of profit applied to basic groceries to 10%<sup>13</sup>. Many foreign companies and retail chains have withdrawn from the peninsula<sup>14</sup>.

**It is a matter of prestige for Russia to prove that the annexation of the peninsula is beneficial for the Crimean economy and will raise people's living standards.**

Entrepreneurs are also facing problems with customs clearance of goods (because of the differences in sanitary and veterinary regulations between Russia and Ukraine). Information shortages and legislative chaos have accompanied the process of calculating VAT, which has been reduced to 4% (from 18% in Russia) for the next 2 years<sup>15</sup>. Another business issue that needs to be solved quickly is the requirement to re-register the businesses in accordance with Russian legislation. This procedure is likely to

drag on, as in the case of a joint stock company, the consent of all shareholders – including Ukrainian – will be required. Another problem is the ban on exports from Crimea due to the EU sanctions, which has affected the famous Crimean Massandra wines, among other products. Moreover, the winery faces a problem with selling its produce in Russia: due to a specific production procedure, Crimean wine is classified as a 'wine drink', on which a very high excise duty is imposed<sup>16</sup>.

The most acute problem for Crimea is the transport restrictions, which have not been resolved by the addition of ferry and air connections. Transport costs have increased, and trucks have to wait for several days in ports to be transported to Crimea.

Residents are concerned about the supplies of electricity and thermal energy in the peninsula, which is delivered from power plants located in other regions of Ukraine, as well as the increase in tariffs<sup>17</sup>. Similar concerns apply to supplies of drinking water and its price; 85% of the water consumed in Crimea is pumped from the Kakhovskiy reservoir on the Dnieper in Ukraine<sup>18</sup>. The peninsula's agriculture has already suffered significant losses due to insufficient irrigation of the fields. With all the problems that are occurring, no efficient mechanisms for solving them have been created; they are being dealt with by way of *ad hoc* temporary interventions.

A major impediment for business, but also for Crimea's inhabitants and tourists, is the reorganisation of the banking sector. Most of the Ukrainian and foreign banks operating on the peninsula have pulled out, and Russian banks have only begun organising their activities<sup>19</sup>.

<sup>11</sup> Following a decision by the EU Council, a ban has been introduced on imports of goods from Crimea and Sevastopol that do not possess a certificate of origin issued by the Ukrainian government.

<sup>12</sup> Before the annexation of Crimea, 80% of goods were supplied to the peninsula from Ukraine, and only 2% of the demand was covered by local production. The Crimean authorities have had to prohibit the exportation of many food items beyond the peninsula in order to reduce shortages in the shops. Currently, goods are being delivered to the peninsula mainly via ferries across the Kerch Strait. Some produce reaches Crimea illegally from Ukraine, [www.rbcdaily.ru/economy/562949991590590](http://www.rbcdaily.ru/economy/562949991590590)

<sup>13</sup> <http://ru.krymr.com/content/article/25447668.html>

<sup>14</sup> <http://cre.in.ua/news/2014/04/23/iz-kryma-uzhe-ushli-5-setey-i-okolo-50-brendov>

<sup>15</sup> On the other hand, entrepreneurs have been deprived of their previous opportunity to postpone the payment of VAT until their investments begin to generate income.

<sup>16</sup> In Russia, the excise tax on Crimean 'wine drinks' is 50 times higher than under Ukrainian legislation, [http://economics.lb.ua/business/2014/05/28/268077\\_vina\\_massandri\\_rossii\\_sochli.html](http://economics.lb.ua/business/2014/05/28/268077_vina_massandri_rossii_sochli.html)

<sup>17</sup> The tariff on electricity transmission from Ukraine to Crimea has risen from 1520 to 3420 rubles per megawatt as of 1 June, [www.epravda.com.ua/news/2014/06/20/468900](http://www.epravda.com.ua/news/2014/06/20/468900)

<sup>18</sup> The Crimean authorities intend to raise charges for water supply from Ukraine from 0.06 to 0.40 ruble per 1 m<sup>3</sup>.

<sup>19</sup> The Russian National Commercial Bank, Krainvestbank, Genbank, Just Bank and other.

Mostly these are minor Russian banks which are supposed to take over the Sberbank, VTB and Alfa-Bank branch networks; the latter, which hold numerous assets abroad, have withdrawn from the peninsula for fear of US and EU sanctions<sup>20</sup>. This makes it hard for residents to obtain a loan or use credit cards; most transactions have to be carried out in cash.

Another regulation which may severely affect the inhabitants is the extension of the expropriation procedure. The Crimean parliament has adopted a law granting the government the right to carry out compulsory acquisition of property which is owned by legal and natural persons and considered 'strategic' by the authorities<sup>21</sup>. This has fuelled public anxiety about hostile takeovers of attractive property, such as land on the coastline and tourist facilities.

Another acute problem is the collapse of the tourism sector since the annexation of Crimea, which has significantly reduced the residents' income. Previously, Crimea was visited by about 6 million tourists a year<sup>22</sup> (70% of them were citizens of Ukraine), of which only a small part chose an arranged stay (resorts or hotels)<sup>23</sup>. Most tourists rented private lodging from locals; nearly half of the population made money this way, their income being unreported. In the summer season of 2014, the citizens of Ukraine boycotted Crimea<sup>24</sup>, which exposed the residents to large losses. Their losses were not compensated for by an increased inflow of Russian tourists (about 1.1 million people by July),

because the majority of them choose to stay at hotels and resorts.

The tourist industry's problems require Moscow's intervention to compensate for the decrease in the number of tourists. The State Agency for Tourism (Rosturizm) was instructed to provide Crimea with no less than 3,000,000 tourists from Russia in the summer season of 2014. As of 1 June 2014, the government launched additional low-budget airline connections to Crimea from 17 Russian regions.

### **Russia's deteriorating economic situation and the US and EU sanctions will make the costs of integration a significant burden on the Russian budget.**

The Crimean and Sevastopol city budgets received funding to organise leisure activities for children from the Russian regions<sup>25</sup>. The government has also launched a campaign to promote a 'patriotic' holiday in Crimea, which often involves putting pressure on Russian officials, regional authorities and public sector employees to spend their summer vacations in Crimea. To help with attracting tourists, a gambling zone is being created in Yalta, on the initiative of President Putin<sup>26</sup>.

Meanwhile, the attempts to direct Russian tourists to Crimea are likely to affect the prosperity of what has hitherto been the most popular Russian resort, Sochi. During preparations for the Winter Olympics, the tourist facilities, sanatoriums and spas in Sochi were developed, expanded and thoroughly modernised. However, Moscow's current efforts to support the Crimean tourism sector must inevitably lead to a reduction in the role of Sochi as a major Russian centre of tourism, international confer-

<sup>20</sup> The Rossiya Bank, controlled by Yuri Kovalchuk, which is a subject of US sanctions, is to take over servicing payments for electricity supplies from Alfa Bank. This should help Rossiya to increase its turnover and thus cover part of the losses suffered.

<sup>21</sup> The law was passed on 9 July 2014. [www.rg.ru/2014/07/09/reg-kfo/vikup.html](http://www.rg.ru/2014/07/09/reg-kfo/vikup.html)

<sup>22</sup> Data provided by the Crimean Ministry of Tourism.

<sup>23</sup> In 2013, only 1.1 million visitors opted for organised tourism, of whom 900,000 stayed in sanatoriums, and 200,000 in hotels. <http://svpressa.ru/economy/article/85472>

<sup>24</sup> The Crimean authorities claim that so far in 2014 the peninsula has been visited by 200,000 Ukrainian citizens (15% of the previous number of visitors). <http://ru.krymr.com/content/article/25457232.html>

<sup>25</sup> <http://itar-tass.com/obschestvo/1253511>

<sup>26</sup> Putin signed the law on gambling zones on 23 July 2014. Apart from Crimea, gambling zones are to be established in Krasnodar krai (in Sochi), Primorsky krai, Altaysky krai and Kaliningrad oblast.

ences and business, as well as its status as the 'gambling capital' (as already mentioned, Yalta has also gained this status). Moreover, the Russian campaign promoting Crimea has indirectly, and unintentionally, struck at Sochi; it emphasises how low the prices in Crimea are (and this contrasts with Sochi's ill-famed costliness), and depicts Crimea's numerous monuments and places of interest (while Sochi's architectural merits are rather modest, to say the least). All this causes concerns in Sochi, which is losing its status as the main Russian holiday centre on the Black Sea<sup>27</sup>.

### **The Russian budget for the years 2015-2017 lacks sufficient funds for the implementation of its ambitious investment plans concerning Crimea.**

The annexation of the Republic of Crimea and Sevastopol by the Russian Federation and their integration with Russia's constitutional and political space will entail serious political changes, and result in the reduction of their political autonomy in comparison with their former status in Ukraine. Crimea was an autonomous parliamentary republic; the president's office existed only in 1994-1995. The highest authority was exercised by the parliament of Crimea, the Supreme Council, which was constituted in general elections, and appointed the government and a Prime Minister<sup>28</sup>. Russia pushed through a Constitution of the Republic of Crimea and a Statute of the federal city of Sevastopol<sup>29</sup>

<sup>27</sup> <http://ru.krymr.com/content/%D1%81%D0%BE%D1%87%D0%B8-vs-%D0%BA%D1%80%D1%8B%D0%BC/25355751.html>

<sup>28</sup> The Constitution of the Autonomous Republic of Crimea, Chapter 3, <http://www.rada.crimea.ua/bases-of-activity/konstituciya-ARK>

<sup>29</sup> The Constitution of the Republic of Crimea as a region of the Russian Federation: [www.rada.crimea.ua/content/uploads/files/konstituciya.pdf](http://www.rada.crimea.ua/content/uploads/files/konstituciya.pdf), the statute of Sevastopol: [sevastopol2011.ru/news/ustav\\_goroda\\_sevastopolja\\_prinjatyj\\_tekst/2014-04-19-7455](http://sevastopol2011.ru/news/ustav_goroda_sevastopolja_prinjatyj_tekst/2014-04-19-7455)

(hastily adopted on 11 April 2014, with no discussions or consultations). These documents state that the heads of the two new Russian regions are designated by their legislatures from among candidates put forward by the President of the Russian Federation. In practice, this means their direct appointment by the Kremlin. Symptomatically, Crimea and Sevastopol have been 'assigned' a procedure for appointing the governor which is only valid in several republics of the North Caucasus, instead of by general election, as in all the other regions of the Russian Federation. New parliaments in Crimea and Sevastopol will be elected in regional elections on 14 September 2014, despite numerous doubts concerning the organisation of elections, such as whether Russian passports can be issued to all residents<sup>30</sup>. Until that moment, the peninsula will be managed by Vladimir Putin's appointees: the acting Governor of Crimea Sergey Aksyonov (a politician and businessman with a criminal record), and the acting Governor of Sevastopol Sergei Menyailo (a retired Vice Admiral of the Russian Black Sea Fleet). Crimea will also have to adapt to the more restrictive Russian legislation regulating the political and social sphere, which may lead to restrictions in civil rights for Crimean residents, in comparison with the Ukrainian period. Greater restrictions will be imposed on the activities of NGOs, organisation of referendums and rallies<sup>31</sup>, and on the media (both online and offline). Several newspapers and online portals have already been closed<sup>32</sup>, which has raised fears of further restrictions for journalists.

<sup>30</sup> The issue of Russian passports to residents of Crimea who adopt Russian citizenship was extended till the end of 2014 (the original deadline was set for 18 June 2014). After the annexation of Crimea, all registered residents automatically received Russian citizenship; non-registered residents had to go through the application procedure

<sup>31</sup> In April 2014, the Russian police dispersed a rally in Sevastopol, even though it did not require notification to the city authorities (under the transitional period, when Ukrainian legislation still applied).

<sup>32</sup> AN-Crimea, *Sobytiya Kryma, Krymskoye Vremya, Respublika* and other media have been closed.

## Forecast

Russia's annexation of Crimea has already entailed significant expenses from the Russian Federation budget for the institutional and socio-economic adaptation of the peninsula. Part of these expenses are temporary, but most of them will also have to be borne in subsequent years. The largest investments, spanning over many years, will have to be made in the construction of transport, energy, water and gas infrastructure. However, the deteriorating economic situation in Russia and the economic sanctions imposed by the US and the EU will make it a significant burden on the Russian budget. Private investors, including those from abroad, will be unlikely to take financial risks in a situation where most countries do not recognise the annexation of Crimea, which in turn will make it difficult to obtain loans and investment insurances. It seems clear even today that the costs of Crimea's integration with Russia will be much higher than the initial assumptions, as was the case with Russia's most prestigious investments in recent years, namely the APEC summit in Vladivostok and the Winter Olympics in Sochi.

A significant part of Russian society seems to be unaware of these costs<sup>33</sup>. This is largely due to the efforts of the government, which is doing its best to reinforce the social consensus on the Crimean issue, transmitting a propaganda of success and camouflaging the costs of the integration. Nevertheless, rumours are circling in regional communities about the possible cuts in social benefits and transferring these funds to Crimea<sup>34</sup>. In the future, when the 'Crimean euphoria' falls away, the social perception of Crimea may resemble that of the North Caucasus, whose reintegration with Russia has entailed enormous financial and social costs. Today the attitude to this region is best captured by the popular saying: "Stop feeding the Caucasus!"

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<sup>33</sup> A Levada Centre poll from 6 May 2014, [www.levada.ru/06-05-2014/rossiyane-ob-ukrainskikh-sobytyiyakh](http://www.levada.ru/06-05-2014/rossiyane-ob-ukrainskikh-sobytyiyakh)

<sup>34</sup> Such questions were raised during Vladimir Putin's annual online conference on 17 April 2014.

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