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THE NEXT ASIAN TIGER? PROMOTING PROSPERITY IN THE RUSSIAN FAR EAST

INTRODUCTION

As the nuclear belligerence of North Korea threatens to engulf the Korean peninsula in military conflict, the Russian Far East, long the preserve of Stalin's concentration camps, brown bears, and Siberian tigers, may be on the verge of sharing in the growing prosperity of Asia and the Pacific Rim.

The Russian Far East comprises lands stretching from Lake Baikal in Siberia to the shores of the Sea of Japan and the Sea of Okhotsk at the edge of the Pacific Ocean. Major cities include Chita in Eastern Siberia, the industrial center of Khabarovsk, and the port city of Vladivostok on the Sea of Japan. Some of its administrative territories are larger than European states and populated almost exclusively by Russians and Ukrainians.¹

Since the collapse of the Soviet Union in 1991, the Russian Far East has improved its economic ties with Japan, South Korea, and China. Since 1990 the percentage of exports attributed to Russian Far Eastern joint ventures with foreign firms in such industries as lumber, oil and gas, and seafood harvesting has grown from 2 percent to over 30 percent. Moreover, while producing only 5 percent of Russia's Gross National Product, the Far East accounts for 20 percent of its joint venture partnerships between Russian private companies and foreign investors.²

Such growth in foreign trade could transform Russia's backyard into a magnet for investors from Asia and elsewhere around the world, drawing hundreds of thousands, if

1 Vladimir Ivanov, "Federation on the Pacific: Does the Crisis Lead to Collapse?" *Eurasian Reports*, Winter 1993, p. 68.

2 George Rose and Igor Korbatov, "Doing Business in the Russian Far East," *Eastern European Reporter*, Vol. 4, January 31, 1994, p. 106.

not millions, of unemployed Russians from the rust belts in the Ural Mountains and Siberia to a region that may develop closer economic ties with Vancouver, Tokyo, and Seattle than with Moscow and St. Petersburg.

An economic take-off in the Russian Far East would help to integrate Russia and the Newly Independent States (NIS) into the economy of the Pacific Rim, where annual economic growth below 8 percent is considered sluggish. Strong trade with the United States, Canada, Japan, South Korea, and China would provide export outlets for Russian products and offer access by foreign investors to the untapped natural resources of Siberia.

However, this potential cannot be unleashed so long as the region is handicapped by the contradictory and ineffective economic policies of the central government in Moscow. The best way to unleash the forces of entrepreneurship in the Russian Far East is to grant the region more autonomy. If Moscow were to do so, the region could become a catalyst for economic growth throughout Russia.

To realize the economic potential of the Russian Far East, Russia should consider:

- ✓ **Declaring the Russian Far East a free economic zone, opening coastal territories to the free flow of foreign investment and trade.**
- ✓ **Abolishing tariffs, import and export taxes, and customs duties for trade in the area.** This would attract foreign investment from all over the world while facilitating Russia's bid to join the General Agreement on Tariffs and Trade (GATT) and the Asia-Pacific Economic Cooperation forum, a 17-member multilateral trade organization formed in 1989.
- ✓ **Lifting cumbersome restrictions on the movement of hard currency in and out of the area.** Russian banks and enterprises are bound by the unwieldy regulations of the Central Bank in Moscow. Foreign banks operating in Russia likewise are severely restricted in their ability to serve Russian clients. These arbitrary regulations hamper the foreign economic relations of Russian businesses and stem the development of the region and of the country as a whole.
- ✓ **Eliminating regulations on the export of so-called strategic commodities, such as sugar, timber, fertilizers, and plastics.** The Russian government has declared that over three hundred commodities are "strategic goods" requiring export licensing by Moscow bureaucrats. This licensing process not only encourages official corruption, but also stifles economic growth.
- ✓ **Cancelling regulations requiring Russian companies to sell 50 percent of their hard currency earnings to the state.** This measure would reduce the cost of doing business in the area and eliminate the unfair competitive edge now enjoyed by the foreign-owned enterprises and joint ventures that are exempt from these regulations.
- ✓ **Providing a ten-year tax holiday for foreign and domestic investment, abolishing the most burdensome taxes, and introducing a 10 percent consumption tax instead.** This would simplify what is today one of the most

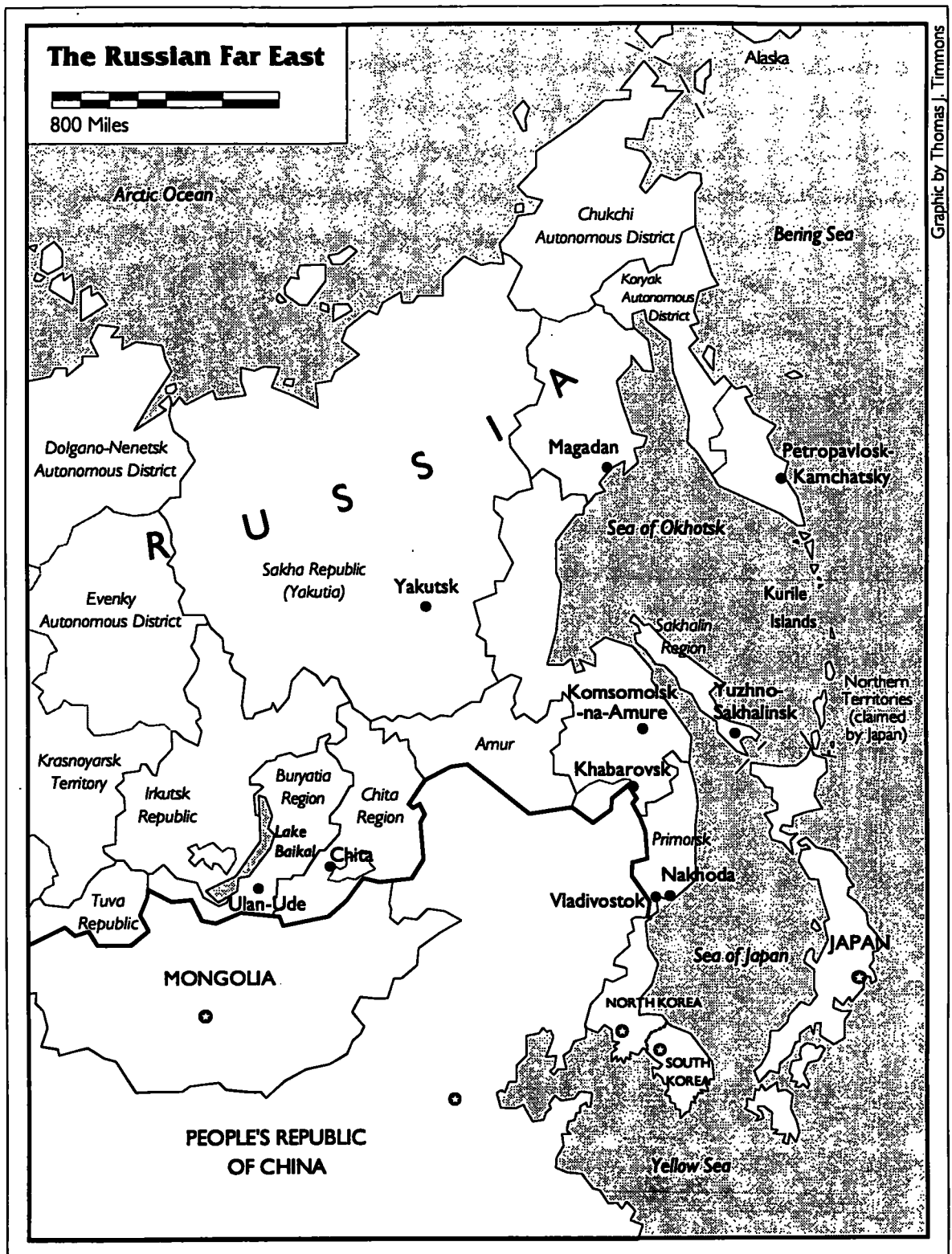
punitive, arbitrary, and complicated tax systems in the world. Lower taxes would stimulate employment, investment, and economic growth.

- ✓ **Establishing economic missions in Japan, Korea, China, Taiwan, the U.S., and Canada to promote investment in the Russian Far East.**
- ✓ **Setting up a privately administered bank for regional development.** Capital could be provided by multilateral lending agencies such as the World Bank and private international investors.
- ✓ **Protecting the environment by developing tourism and running an efficient national park system.** The potential for tourism in the Russian Far East is enormous. Tourism could generate billions of dollars in revenue that could be used to clean up the polluted Pacific landscape and save the Siberian tiger and other endangered species.
- ✓ **Privatizing major infrastructure projects and opening them to Western and Far Eastern investors.**
- ✓ **Devising laws and regulations that allow for the negotiation and enforcement of contractual obligations between parties, regardless of their nationality.**
- ✓ **Boosting law enforcement against organized crime and corruption.** This could be done by creating a professional, highly paid special police force, perhaps with the help of the U.S. and other Western countries. In addition, deregulation of the economy would decriminalize many of the activities, such as import and export licensing, that breed corruption.
- ✓ **Resolving the Northern Territories problem with Japan.** This would remove a major disincentive for increased Japanese investment.

THE IMPERIAL PAST

The Russian Czars brought the Far East under their control during the 17th to 19th centuries. For most of Russia's history, Moscow was interested in the region because of its abundance of such natural resources as furs, fish, and gold. In the 17th century fur pelts accounted for more than half of the Russian empire's hard currency revenue, and the desire to gain access to the furs in the Siberian forests was a strong incentive for eastward expansion. In addition, gaining access to the Pacific Ocean through such naval bases as Vladivostok and Port Arthur was seen as a vital strategic goal.

After the czarist empire collapsed in 1917, the city of Vladivostok and the surrounding Maritime Province declared itself an independent republic. The Russian Far East then became one of the most important battlegrounds of the Russian Civil War. In 1919 a small expeditionary force of U.S. and Japanese troops landed at Vladivostok to assist the White Army against the Bolsheviks. By 1922, however, the Russian Far East was completely under communist rule.



During and after World War II, the Soviet government developed a vast military-industrial complex in the region, and Vladivostok became a huge base for the Soviet Navy's Pacific Fleet. The town of Komsomolsk-na-Amure on the Amur river became a nuclear submarine construction center while military aircraft were built in the city of Khabarovsk, the old Russian government center in the region.

Terrible environmental damage was done when decommissioned nuclear reactor cores were dumped into the Sea of Okhotsk in the 1980s, polluting the water and Kamchatka Peninsula's pristine beaches. The fish became contaminated but were sold to an unsuspecting Soviet population. Throughout the Soviet period, Moscow extracted enormous valuable resources from the region while the government remained its major employer and supplier of investment capital.

It is no surprise that after centuries of such abuse, Far Easterners jumped at the first opportunity presented by Mikhail Gorbachev's *perestroika* to gain more freedom. The Russian Federation Supreme Soviet established in 1989 the Nakhodka Free Economic Zone near Vladivostok. Located only a couple of hours drive from Vladivostok, Nakhodka is a huge port capable of servicing 33 cargo ships simultaneously. Last year alone, it handled nine million tons of logs, ores, fertilizer, and other raw materials.

This zone was seen by many Far Easterners as a means to gain some measure of freedom from Moscow. But the zone experienced many of the same problems seen throughout Russia today, including the absence of a workable commercial code and a lack of respect for the rule of law and property rights. The Russian Supreme Soviet delayed passing a Free Economic Zone law, thus stalling legislation that would have encouraged economic development in the Far East and other areas of the Russian Federation.

As the Nakhodka experiment has shown, the existing approach, with the parliament and bureaucracy in Moscow deciding every case, is not working. During 1990 and 1991, the Russian Supreme Soviet authorized the establishment of thirteen Free Economic Zones. They were not very successful. Local governments were denied the power to grant tax exemptions or legislate pro-business customs and foreign exchange regimes.³

The failure of the free economic zones can be attributed mainly to the contradictory and ineffective economic policies of the central government. In May 1994, the Russian government announced export tariff exemptions for foreign enterprises and joint ventures.⁴ Unfortunately, the May 1994 decision covered only businesses registered before January 1, 1992, and after January 1, 1994. Ventures created in 1992-1993 period were not covered by the legislation.

President Yeltsin issued another decree in May 1994 reducing the corporate income tax to 30 percent, simplifying the tax structure, and abolishing some of the numerous arbitrary and punitive taxes. Unfortunately, this was accompanied by a decision to raise taxes on individual incomes of over \$1,000 a month to 50 percent and to increase property taxes. With social security and other payments, Russian workers are paying over 80 percent of their income in taxes.

The Russian Duma, like its predecessor, the Supreme Soviet, is stalling important amendments to laws on foreign investment and natural resources. This precludes greater Western participation in the development of Siberian oil, gas, coal, and diamond depos-

3 Vladimir Ranenko, "The FEZs' Economic Prospects," *International Affairs*, Nos. 11-12, 1993, p. 32.

4 According to the decision, only joint ventures with at least thirty percent of Western participation, or at least ten million dollars of investment, are exempt from the tariff and tax.

its that would benefit Russian Far Easterners. In the absence of a special Free Trade Zone law and a strong legal infrastructure, foreign investment in the Nakhodka Free Economic Zone has been poor, totalling only \$118 million. Industrial production by joint ventures in 1993 was only \$54 million.

The Moscow bureaucracy continues to resist the decentralization that is needed if the Far East region is to reach its full potential. Through stifling regulation of economic activity, bureaucrats are choking economic growth and breeding corruption, inefficiency, and misery. Far Eastern businessmen and their Western counterparts often spend more time dealing with government offices in Moscow than tending to their businesses back home.⁵ Even simple business transactions, such as opening a factory or obtaining a mining license, involve a frustrating permit approval process through ministries in Moscow, often accompanied by bribes at every level of the bureaucracy.

Rich in Resources, Poor in Infrastructure

The Russian Far East is a cornucopia of natural resources and, under the right circumstances, could become a magnet for foreign investment. Oil extraction off the shores of Sakhalin Island would spur economic growth throughout the entire region. Japan's Ministry for International Trade and Industry (MITI) is drawing up plans to turn the port of Niigata on the Western coast of Japan into a major import facility for Russian gas; the Western Japanese Aomori prefecture also is interested in Russian gas; and there are plans to build a huge 5,000-kilometer pipeline to import Sakhalin gas to South Korea and Japan.⁶

Owing to the appearance of the Sakhalin and Nakhodka FEZs, Asian industrial giants—including Mitsubishi, Mitsui, Nissan, Honda, Gold Star, Daewoo, and Hyundai, among others—already have established a presence in the area. Numerous Chinese companies trading in consumer goods and foodstuffs are grossing over \$900 million a year. Indeed, a separate FEZ recently was created on both sides of the Russian-Chinese border adjacent to the cities of Blagoveshchensk and Heihe.⁷

The Russian Far East is important also because it links the Pacific Rim with the Eurasian continent. The Russian Far East is adjacent not only to China, Korea, and Japan, but also to Eastern Siberia, which is rich in such minerals as diamonds, gold, platinum, oil, and gas. Ports at Vladivostok, Nakhodka, and Vostochny serve as terminals for the trans-Siberian railway and as eastern gateways to Russia, the Commonwealth of Independent States, and Europe.

Because of its prime location, and despite the often hostile business and investment climate, the region has begun to attract some Western investors. For example, the U.S. Overseas Private Investment Corporation (OPIC) and the European Bank for Reconstruction and Development (EBRD) in May 1994 announced a gold mining project in the Russian Far East. The project is being conducted by a joint venture called Omolon, which includes U.S. Cyprus Amax Minerals and five regional Russian companies.

5 Personal interviews, January-May 1994.

6 *Intercon's Daily*, March 21, 1994, p. 2, and Ivanov, "Federation on the Pacific," p. 76.

7 "Russia to Build Cross-border Free Trade Zone," *Zinhua General Overseas News Service*, January 4, 1994.

Omolon will develop the Kubaka gold and silver deposits near the city of Magadan. OPIC will provide \$150 million for insurance and \$55 million in investment guarantees,⁸ and the EBRD will provide \$55 million in financing. A feasibility study by Vancouver-based Kilborn Engineering Pacific Corporation concluded that the Kubaka deposit has 2.2 million ounces of proven recoverable gold reserves and 1.7 million ounces of silver reserves. The seven-year project calls for the deposits to yield 326,000 ounces of gold and 255,000 ounces of silver annually.⁹

Increasing the number of such projects, however, is hindered by a lack of infrastructure. The region lacks transportation and communication links, data processing services, hotels, and adequate housing for foreign businessmen and their families.¹⁰ For example, the price of real estate in the two major cities, Khabarovsk and Vladivostok, is skyrocketing because of a lack of adequate housing and office space. In 1992, a standard Russian one-bedroom apartment sold in Vladivostok for \$15,000; it is now twice as expensive, and land in or near the port facility has tripled or quadrupled in price.

The railroads and highways of the Russian Far East are in disrepair. The Soviet-era Baikal-Amur railroad, which runs north of the czarist-built trans-Siberian, is often closed for repairs. For long stretches it consists of a single track. There are no links between the Baikal-Amur railroad and the old trans-Siberian railway and no links with railways in European Russia, Korea, or China. Roads throughout the region are poor and traffic from the Far East into Siberia and European Russia is hampered by the absence of bridges over the Amur and Lena rivers.

Similar problems afflict the region's telecommunications system. Western businessmen accustomed to faxing information from their computer screens and conducting

INVESTMENT OPPORTUNITIES IN THE RUSSIAN FAR EAST

Mineral Resources

Ferrous metals

Non-ferrous metals

Fossil energy resources (oil, gas, coal)

Diamonds

Precious metals

Natural Resources

Fishing and sea products

Farming and agriculture

Timber and lumber

Services

Conversion of military industry

Cargo transit and transportation
(sea, land, air, and ports)

Data processing and telecommunications

Office space

Legal and accounting

⁸ *Intercon's Daily*, June 9, 1994, p. 2. As a part of its plans to boost insurance and investment guarantees to American corporations doing business in the former Soviet Union area, OPIC announced in May 1994 that it will increase its commitment from \$1 billion to \$2.5 billion.

⁹ *Intercon's Daily*, June 9, 1994, p. 2.

¹⁰ Rose and Korbatov, "Doing Business in the Russian Far East," p. 106.

business via cellular telephones in their cars soon learn that telephone service in the Russian Far East is worse even than in the Western parts of Russia around Moscow.

Some of these problems are being corrected slowly. In Khabarovsk, the Marriott Corporation is building a five-star hotel; Japanese companies are developing commercial real estate; and the French Thomson electronics conglomerate is overhauling the air traffic control system at the local airport. Contracts have been awarded to foreign companies for expansion of the airport at Vladivostok, and planning for a much larger international airport has begun.

Feasibility studies also are being conducted for the conversion of some military airfields to commercial use. For example, a military airfield in Yelizovo, Kamchatka,¹¹ which is halfway by air between Hong Kong and the West coast of North America, is being used as a refueling stop by a California-based company. It finds the Kamchatka airport to be cheaper and more convenient than the nearby Narita airport in Japan. Here American ingenuity and Russian defense conversion have combined to create a lucrative business venture.

Some modest progress also is being made in satellite communications, digital exchange networks, and microwave transmission facilities. Joint ventures with American and Japanese telecommunications firms such as AT&T, MCI, and U.S. West are providing satellite telephone connections from hotels, long-distance calling, and E-mail service.¹²

NATURAL SPLENDOR AND THE POTENTIAL FOR TOURISM

Throughout the Russian Far East are large and virgin forests, majestic rivers, crystal-clear lakes, and unspoiled mountain ridges. The Kamchatka peninsula, which protrudes into the Sea of Okhotsk, is as pristine as the American West of the 1860s. With fewer than half-a-million people, and with its geysers, bears, and rivers that run red with salmon, this is an area that could beckon to Japanese, Chinese, and American tourists.

Despite this potential, the absence of effective land management and game preserve techniques are threatening the ecological balance of the region. For example, poachers have nearly killed off the Siberian tiger, which is valued for its fur and bones, and used for traditional Chinese medicines. Even the male tiger's reproductive glands are prized by wealthy Chinese for use in aphrodisiac soups. Once the kings of the Siberian jungle, only some 150 of these magnificent cats are left in the forests around Khabarovsk, the administrative center located in the heart of the region.

However, there are signs of hope. In the Kronotsky and South Kamchatka nature reserves on the Kamchatka peninsula, specialized Russian and joint venture companies bring in wealthy Japanese and American clients for safari expeditions and tourism. In some areas, the only transportation for adventurous travellers is by helicopters which are provided by Russian and Russo-Japanese joint venture companies. Westerners are

11 Yelizovo is located near Petropavlovsk-Kamchatsky, capital of the Kamchatka peninsula.

12 Rose and Korbatov, "Doing Business in the Russian Far East," p. 108.

flocking to the largest geyser natural park in the world, and salmon fishermen pay handsomely to spend a week or two on the banks of some of the clearest streams on Earth. Russian experts estimate that the region could generate \$1 billion in tourist revenue by the year 2005.

THE DISPUTE OVER THE KURILE ISLANDS

An economic boom in the Russian Far East would require the participation of Japan. Technically; however, Russia and Japan have never ended the Second World War. The sources of this conflict are well-known. Promising to invade Japan after the victory in Europe, Stalin in July 1945 broke his 1941 nonaggression pact with Tokyo and occupied the southern half of Sakhalin and the Southern Kurile islands (see map).¹³ Despite Japan's willingness to recognize Russia's claims to Sakhalin Island after World War II in exchange for the return of the Kuriles, Stalin persisted in occupying the Northern Territories. As a result, Russo-Japanese relations have been poisoned for the past four decades. Tokyo has never recognized the Russian occupation of these islands.

There have been attempts to resolve the dispute. In 1956, the Soviet government provisionally recognized Japan's claims to the two southernmost Kurile Islands, Shikotan and the Habomais, while Japan promised to give up its rights to Sakhalin. However, the drawn-out peace talks failed because Moscow refused to vacate the Southern Kuriles.

From 1989 to 1992, the Soviet and later Russian governments were close to restoring Japanese sovereignty to the islands in return for economic assistance from Tokyo, but Russian nationalists repeatedly derailed these efforts, arguing that these territories are forever Russian and should never be returned.

Over the last year, the Russian government has sent out mixed signals concerning the Kurile Islands. In March 1994, apparently mindful of the strong showing of hard-line communists and nationalists in the December 1993 elections, Russian Prime Minister Victor Chernomyrdin told Japanese Foreign Minister Tsutomu Hata that the dispute would not be resolved soon: "[i]t is not the kind of problem that can be solved in one leap."¹⁴ In the same meeting, however, Chernomyrdin also called for negotiations to resolve the territorial dispute in Japan and to conclude a Russo-Japanese peace treaty as soon as possible.¹⁵

Japanese economic assistance to Russia, and especially to the Russian Far East, is dependent on a resolution of the Kuriles Islands dispute. Without the nod from Tokyo, vital Japanese investment in the region will not materialize.

13 The Southern Kuriles, referred to as Northern territories by the Japanese, include the islands of Kunashiri, the Habomais (a chain of small islands), Etorfu (*Iturup* in Russian), and Shikotan.

14 *Intercon's Daily*, March 21, 1994, p. 1.

15 *RFE-RL Daily Report*, March 22, 1993, p. 2.

WHAT IS TO BE DONE?

The Russian Far East could become the engine of economic growth for all of Russia. The Russian government should be looking to the example of China, where the introduction of liberal economic policies tripled the living standard of the people in ten years. Pulled along by the southern economic engine, the Chinese economy grew at an average rate of 11.2 percent from 1991-1993, and the forecast for the years 1994-2003 is for an annual growth rate of at least 8.6 percent.¹⁶ Prime Minister Chernomyrdin was so impressed with these bustling zones during his May 1994 visit to China that he declared his full support for the Chinese experiment and he promised to implement such reforms in Russia.

If Russia wants to achieve similar results, the Russian Far East, with its vast resources and geographic proximity to the successful Chinese model, is a logical place to start. Thus, the Russian government should consider:

- ✓ **Declaring the Russian Far East a Free Economic Zone (FEZ).** The Soviet legislature created the first FEZs in 1989 as a capitalist experiment. One of the first was the FEZ of Nakhodka. Another major FEZ, operational since 1992, is on Sakhalin Island. In the spring of 1994, a huge oil development project off the shores of Sakhalin, known as Sakhalin-2, with estimated resources of over 8.5 billion barrels, was moved one step closer to implementation. The signing of a protocol between a Russian state-owned oil company, Rosneft, and an international consortium known as 4MS will bring Western investments totaling over \$10 billion to the venture during the next ten years. Non-Russian investors include Marathon Oil Co., McDermott International Inc., Mitsui, Mitsubishi, and the Royal Dutch Shell Group. The deal was finally signed by Prime Minister Chernomyrdin during his visit to Washington, D.C., on June 22, 1994.

To sustain the momentum of economic development, the Russian Far East needs foreign investment and free trade zone laws that allow local authorities and the business community freedom of action. Both Russian and foreign observers have called for the passage of such laws to end the climate of economic and investment uncertainty in the area.¹⁷ If Russia's lawmakers continue to stall the needed comprehensive legal reform as they have been doing since 1990, the legislatures of the Russian Far East administrative regions should agree among themselves on a common free trade zone law and pass it simultaneously, thus taking responsibility into their own hands. The future law should incorporate the ideas of economic freedom and practical experience with Free Economic Zones found in China, Hong Kong, Singapore, and Dubai where governments have reduced taxes and regulation dramatically, allowing the free movement of capital, goods, and people. These actions have fostered some of the most impressive economic growth in this century.

¹⁶ World Bank economic forecast, June 1994.

¹⁷ "Nakhodka as a Model for Russian Free Economic Zones," an international conference, *International Affairs*, Moscow, 1993.

The proposed law should also prevent government bureaucrats from turning the Free Trade Zone into a cash cow for themselves through the overregulation of foreign and domestic business, preferential sales of licenses, and other means of corruption practiced elsewhere in Russia. Specifically, the Russian law should privatize port facilities and abolish the current requirements for governmental permission to export goods, with the exception of weapons and military technology items.

- ✓ **Abolishing tariffs, import and export taxes, and customs duties for foreign trade.** To stimulate trade and investment, most government duties, which today are prohibitively high and punitive, should be abolished. Taxes to abolish: a 26 percent oil export tax, a 130 percent automobile import tax, and an 80 percent tax on foreigners' incomes over \$1,000 a month. Such tariffs and taxes impede international commerce and industrial output. They also lead to corruption, as customs and tax officials use their positions as a source of personal enrichment. The only function that should be left to the customs officials should be to prevent unauthorized trade in regulated materials and substances, such as drugs and arms.

Getting rid of export tariffs will facilitate Russia's joining the General Agreement on Tariffs and Trade (GATT) and becoming a full member of the World Trade Organization (WTO), which will issue regulations dealing with trade in commodities and raw materials. It is in Russia's interests to expose its large but inefficient industry to international competition to increase productivity. In addition, Russian consumers will benefit from an abundance of goods from various foreign sources. Harmonizing Russian export policies with international practices would enhance Russia's integration into the international trade system.

- ✓ **Lifting cumbersome restrictions on the movement of hard currency in and out of the area.** Allowing free movement of hard currency into and out of bank accounts will make it easier for investors to conduct business in the Russian Far East. All restrictions on hard currency transactions, such as the forced exchange of half of their foreign currency proceeds by Russian companies, should be abolished. Businesses should be able to move deposits, profits, and investments freely anywhere in the world.

Currently, foreign banks are prohibited from functioning on an equal footing with local banks. For example, until June 1994, international banks were allowed to serve only non-Russian clients. This situation could change because of an impending Yeltsin decree, but it is still unclear whether, when, and how foreign banks will be allowed to operate. Only ten foreign banks, including Citibank and Chase Manhattan, are now permitted to transact business in Russia. Russian banks often provide poor service, make costly mistakes, and leak information to organized crime; therefore, it is in the interest of Russian businesses and private clients to be free to choose whether to invest, borrow, and create partnerships with foreign or domestic banks.

What makes limitations on international banking in Russia even more damaging to commerce is Russian bankers' lack of expertise in internationally accepted banking practices, especially in trade financing and investment. For example, let-

ters of credit are standard tools of trade finance that guarantee payment by the buyer to the foreign seller. But letters of credit are not accepted by Western banks when they are drawn by Russian banks. This slows trade and investment activities and must be remedied by allowing foreign banks and financial services corporations to operate freely. Foreign banks should be allowed to provide a full array of services to their international and Russian clientele.

- ✓ **Eliminating regulations on the export of so-called strategic commodities, such as sugar, timber, fertilizers, and plastics.** The Russian government has declared over three hundred commodities, including sugar, timber, and some fertilizers, to be "strategic goods" that require export licensing by Moscow bureaucrats. Such classification only allows bureaucrats to enrich themselves by selling licenses and taking bribes for their services. Indeed, there is a thriving black market in real and fake export licenses. Especially lucrative are licenses for oil exports, certificates allowing the sale of Russian urea fertilizer to China, and licenses for timber and lumber transactions.

Such military goods as radioactive materials, weapons, and sensitive weapons technologies should be regulated, but it is unreasonable and punitive to classify nonmilitary goods and raw materials like sugar as "strategic." In 1992, for example, Russian bureaucrats forced businessmen to "donate" profits from sugar sales to municipal budgets and demanded as much as 10 percent of the value of transactions in kickbacks as a precondition for granting export licenses for ammonia fertilizer.¹⁸

- ✓ **Cancelling regulations requiring Russian companies to sell 50 percent of their hard currency earnings to the state.** Russian businesses are required to sell 50 percent of their hard currency earnings to the National Bank. For example, if a Russian company earns one million dollars, it can keep half, turning the other half over to the National Bank. The law is a relic of the Soviet period, when the hard currency receipts of all government-owned enterprises were expropriated by the state.

This law should be abolished. It represents a burdensome tax on business, as ruble assets depreciate at the rate of inflation (500 percent in 1993) and there is no indexation of savings. Russian companies are punished by having to hold depreciating ruble assets. In addition, this regulation is a major impediment to trade and investment throughout Russia. It prevents businesses from planning their budgets because of the constantly changing exchange rates.

- ✓ **Providing a ten-year tax holiday for foreign and domestic investment, abolishing most burdensome taxes, and introducing a 10 percent consumption tax.** The Russian Far East must compete for international investment with such Asian economic dynamos as Taiwan, Thailand, Singapore, and Vietnam. In all of these countries, there is some degree of tax holiday for im-

18 Personal interviews with members of the California-Russia Trade Association, October 1992.

ported capital; foreign investors do not pay taxes for two to seven years and later pay reduced corporate taxes, often at a rate below 25 percent. Thus, foreign businesses receive an incentive to invest in emerging markets. To attract international financing for regional economic development, and to attract the needed manpower from the European part of the Russian Federation and abroad, tax holidays should be introduced. This should include abolition of the income tax, specifically the high personal income tax (which can reach up to 80 percent) introduced in June 1994. In the U.S., where there is a venerable tradition of paying the income tax, marginal rates are relatively low compared with the rest of the world. In Russia, where the state takes draconian measures to collect income tax, revenues are shrinking. Income tax rates are extremely high, while evasion and corruption of the tax collecting authorities are rampant.

In order to maintain the tax base, the income tax should be abolished and a 10 percent consumption tax imposed.¹⁹ In addition, excise taxes could be placed on alcohol and tobacco, and reasonable fees for using roads, bridges, and airports could be instituted. If the Russian state wants to collect revenue, it should remember that it is much easier to collect taxes from businesses. This proposed tax reform will provide economic stimulus for domestic and foreign investment and for individual work while increasing tax collection by at least 50 percent.

- ✓ **Establishing economic missions in Japan, Korea, China, Taiwan, the U.S. and Canada to promote investment in the Russian Far East.** The government should establish a Far Eastern Foreign Economic Authority modeled on the U.S. Trade Representative's office. This new entity could establish overseas missions as many U.S. states have done to attract foreign investors and promote commerce in those countries. Obvious cites for Russian Far East offices include Tokyo, Beijing, Shanghai, Hong Kong, Seattle, San Francisco, and Vancouver.
- ✓ **Setting up a privately administered bank for regional development.** With capital from the World Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and private investors, a Russian Far East bank could provide the seed money for ports, airports, roads, and telecommunications systems. It also could underwrite investments in oil and gas exploration, diamond, coal, and gold mines, as well as service projects such as hotels and restaurants. The Russian government should allow such investments to be channeled into private rather than government-owned projects.
- ✓ **Protecting the environment by developing tourism and running an efficient national park system.** Sound land and game preserve management is needed to save species and uphold the ecological balance of the region, as well as to make the region attractive for tourism. Experience in Tanzania, Zim-

¹⁹ I am grateful to Joe Cobb, John M. Senior Fellow in Political Economy at the Heritage Foundation, for an incisive discussion of Russian tax issues.

babwe, Kenya, and South Africa shows that large animals can draw huge tourist crowds which generate high revenues. To achieve this goal, national parks must be professionally organized and run by private operators. If unique Far Eastern wildlife is destroyed, potential income from tourism will be lost. In the long run, the region may generate more hard currency from safari tourism than logging and other commercial activities can produce in the short run.

To utilize this potential fully, the management of the Kronotsky and South Kamchatka nature reserves, which between them comprise 3.5 million acres and 22 active volcanos, could learn profitable and safe safari management methods in American national parks. They could look to the examples of the Yellowstone and Grand Teton parks in the U.S. or the Kruger and Serengeti national parks of Africa. Game reserves, with equity ownership by the local villagers, should be created for Siberian tigers and brown bears, both of which are endangered by poachers.²⁰

- ✓ **Privatizing major infrastructure projects and opening them for Western and Far Eastern investors.** The Russian government does not have the billion dollars needed to upgrade facilities and air control equipment at such Far Eastern airports as Vladivostok, Yelizovo, Khabarovsk, Magadan, and Yuzhno-Sakhalinsk. International traffic at these airfields has exploded since the fall of the Soviet Union. These airports should be privatized. A model for this could be the successful privatization of the international airport in Prague.²¹ The Czech example shows that private-public partnerships and outright privatization can build up railroads, highways, and port systems successfully. In addition to relieving the transportation bottlenecks, such development would employ hundreds of thousands of Russian workers and engineers now searching for jobs. Moreover, the central government could encourage the migration of unemployed labor from the rustbelts to development in the Far East.²²
- ✓ **Devising laws and regulations that allow for negotiation and enforcement of contractual obligations between parties regardless of their nationality.** The Russian parliament is stalling on the passage of legal reform that would allow for the enforcement of Western-style contracts. Other legal safeguards missing in Russia include protection for intellectual property and a workable real estate law.

If the central government fails to pass legislation protecting business practices, the Russian Far East should "go it alone." With Western legal assistance, regional legislators could develop and implement a comprehensive package of laws that would allow for successful functioning of the market, leaving the central govern-

20 I am grateful to my Heritage colleague John Shanahan for a useful discussion of game preservation methods.

21 Gerald Shea and Ann Baker, "The Prague Airport Project: Privatization for Infrastructure Development," *BNA Eastern Europe Reporter*, Vol. 4, No. 3 (January 31, 1994), p. 114.

22 For a full discussion, see Ariel Cohen, "Russian Draft Constitutions: How Democratic Are They?" Heritage Foundation *Backgrounder* No. 949, June 30, 1993.

ment to catch up later. Such legislation would include a locally enforced civil code, laws on contracts, a corporate statute, and laws on property rights and land use.

By taking these measures, administrators in the Russian Far East would be serving notice on lawmakers that if they fail in their responsibilities, other means will be found by the regions themselves to create a civilized body of laws to enhance their economic development.

- ✓ **Cracking down on organized crime and corruption.** The most daunting task of all in the Far East is to stem the crime and corruption that have penetrated all facets of business activity. To guarantee economic freedom is to establish and enforce the rule of law; as one attorney with extensive practice in the region put it, however, "the main problem for Western companies is to figure out which part of the mafia is capable of delivering the goods and deal with it."²³

A new, highly professional, and well-paid law enforcement organization is needed to eradicate the gangs and to investigate and prosecute corrupt officials. Such a force could be created with foreign assistance. In addition to a law-and-order approach, the deregulation of economic activities would go a long way toward ameliorating the situation.

- ✓ **Resolving the Northern Territories problem with Japan.** Finally ending World War II by signing a peace treaty with Japan should be a key foreign policy objective for Russia. In order to receive bilateral and multilateral economic assistance from Tokyo, Moscow must move beyond the legacy of World War II and the Cold War. International assistance from Japan is vital to converting the military industries of the Far East to civilian production and finding markets for the region's products in the booming Pacific economies.

There are a number of ways to resolve this dispute. One option is to negotiate a long-term lease of the Kurile Islands from Russia by Japan with sovereignty reverting to Japan at the end of the lease. Alternatively, a United Nations trusteeship could be established over the islands before Japan assumes sovereignty. Another option: a joint Russian-Japanese administration of the islands for a specified period of time could pave the way for the transfer of the territory to its original owner—Japan.

If the efforts of diplomats are not fruitful in the next three to five years, Russia and Japan should call on outsiders to arrange for final and binding arbitration, with neutral and experienced arbiters nominated by both sides. For example, either the International Court of Justice in the Hague or a U.N.- or ASEAN-nominated panel could provide an appropriate forum for resolving Russo-Japanese disputes. Or perhaps the U.S. could offer its own good offices; the Treaty of Portsmouth ended the

23 Interview with Tim Bruinsma, Chairman of the California-Russia Trade Association and a leading legal expert on doing business in the Russian Far East, March 1994.

Russo-Japanese War in 1904 and earned President Theodore Roosevelt the Nobel Peace Prize.

Russian nationalists such as Sergei Baburin, Alexander Rutskoi, and Nikolay Pavlov, will use the Kurile Island question to attack President Yeltsin and Foreign Minister Andrei Kozyrev and to depict themselves as the true Russian patriots. But bold leadership by Yeltsin and Prime Minister Chernomyrdin can overcome the actions and rhetoric of the extreme nationalists, who thus far have prevented a satisfactory solution of the Northern Territory question and forestalled significant economic development in the Russian Far East.

CONCLUSION

With bold and imaginative ideas, the Russian Far East could undergo the kinds of economic growth experienced by California during the decades following the 19th-century "gold rush." The Russian Far East is more than adequately endowed with natural resources. It is located in the booming Asia-Pacific region, and it is capable of attracting foreign investors. Moreover, it could draw millions of the unemployed from the rust-belts of European Russia, the Urals, and Siberia.

In order to fulfill this potential, however, the central government in Moscow would have to pursue policies that unlock the economic potential of the region. Examples abound in the Pacific Rim of how to turn backward areas into economic success stories. If the Russians do it right, American, Chinese, Japanese, and Korean investors and developers will not keep them waiting. And all of Russia will be the beneficiary.

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