

# Is Kaliningrad's 'offshore' Status Symptomatic of a "hollowing out" of the Russian State?

Written by Justin Pickard

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JUSTIN PICKARD, JAN 28 2008

In the shift from a Fordist to a post-Fordist international economic system, neo-Schumpeterian theorists have come to anticipate a "hollowing out" of the state, in which sovereignty is displaced 'upward, downward, and, to some extent, outward.' [1] In this transition, subnational entities are afforded an increasing prominence on the international stage; no longer simply an extension of the Keynesian welfare state, tasked with 'offloading fiscal demands from national state treasuries', but 'important partners in promoting exports and attracting foreign direct investment.' [2]

### The Kaliningrad Problem

Kaliningrad's territorial status has, to a great extent, determined the structure and composition of both its domestic economy, and its interactions with the global political economy. Encircled by Lithuania and Poland, theory would suggest that Kaliningrad could have found a 'convenient proximity market' in the European Union. In reality, this strategy was limited by the protectionist barriers which safeguard the integrity of the Common European Economic Space, and which have undermined the capacity of Kaliningrad's goods to compete on an equal footing with those of European producers. [3] Exacerbated by the exclave's comparatively small size, these protectionist barriers had left Kaliningrad in a position where it had no choice but to target the European market, a space in which it cannot realistically compete. Any attempts to remain self-sufficient would, in Karpenko's opinion, inevitably 'lead to ossification and the speedy decline of the region.' [4]

For Kaliningrad, the economies of scale necessary to overcome the burden of Europe's protectionist barriers relied on the pursuit of a substantial level of specialisation within the local economy. This focus has left the region in a position where it is particularly vulnerable to the threat of economic shocks and cyclical fluctuations in supply and demand. [5] The economic instability of the 1990s meant that, by 1998, Kaliningrad's Gross Regional Product represented '30 per cent of the 1990 level, compared with 50 per cent for Russia' [6], and although these statistics fail to take into account the substantial informal economy – estimated to be worth up to 55% of official incomes [7] – they nicely illustrate the economic vulnerability of Kaliningrad's territorial status.

Whether characterised as problem, challenge or puzzle, there seems to be a broad consensus that Kaliningrad represents something anomalous and vaguely threatening. Its peculiar status has led some to refer to it as a 'double periphery', and insist 'that its exclave location should be compensated through direct and indirect subsidies (such as tax breaks) from the federal budget.' [8] Vinokurov comments that this scenario is tantamount to fiscal compensation for Kaliningrad's 'detachment from the mainland' [9], and Berkenback and Wellmen comment that the adherents of such a solution have tended to portray the 'Kaliningrad problem' as a matter of internal relations; something that can be remedied by the support and protection of a strong Russian state. [10]

Others see the problem as inherent in the exclave's territorial status, where a recognition that 'enclaves are made by ... borders' which act as 'an obstacle to communication and the flow of people, good services, capital, and labor' [11], suggests that one could circumvent the problem by surrendering to the forces of globalisation, with the Russian state agreeing to 'liberalize the enclave toward the surrounding state and the rest of the world, thus mitigating the enclave's isolation.' [12] Instead of witnessing a continuous stream of capital or monetary support from core to

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periphery, proponents claim that it would be better to have an abrupt transfer of sovereignty.

## The Special Economic Zone

Kaliningrad is 'the only Russian territory which has been operating as an 'offshore' zone since the introduction of SEZs in the early 1990s.[13] Declared a Free Economic Zone (FEZ) in September 1991, Kaliningrad had been granted preliminary 'special status' shortly before the USSR's collapse.[14] Initially, such a move was not intended as a solution to a specific 'Kaliningrad problem', but was instead cast as a Russian equivalent of the Chinese experiments with capitalism under the 'One Country, Two Systems' doctrine. It was only with the development of the first Special Economic Zone in the mid-1990s that liberalization began 'to be considered as a "compensatory factor" for Kaliningrad's 'detachedness' from the Russian Federation.

In the 2006 Federal Law on the Special Economic Zone in the Kaliningrad Region, the Russian government hoped to address the failings of the previous two economic regimes. In 'its efforts to attract strategic investors to the region', a number of tax breaks and associated benefits were promised to those business interests willing to 'invest at minimum 150 million rubles'[15] in the regional economy. Russian discourses have 'always been put forth with the goal of bringing order to Kaliningrad', and the aims of the second Special Economic Zone were no exception. However, it remains to be seen as to whether the new SEZ manages to avoid the fate of its predecessors, where a rhetoric of 'empowerment and institutionalism' fell victim to 'Russia's weak resource base and ... chaotic internal politics'[16].

## Regimes of Legitimacy

Smordovskaya and Zhukov comment on the way in which Kaliningrad's various 'offshore' regimes have transformed the exclave into a 'transit point for channelling to Russia all kinds of imports, regardless of their quality and technological level.'[17] For, while this may have embedded the need for economic openness, it has resulted in a region heavily dependent on redistributive activities, and strong links with the local informal economy. Although such informal economic activity has traditionally been portrayed by analysts of the post-Soviet economy as 'a temporary phenomenon'[18], rooted in a combination of tax evasion and criminal activities, which has tended to accompany the post-Soviet transition, Kaliningrad's 'grey market' has a uniquely ambiguous character. With the SEZ having moved a significant proportion of commercial tax evasion into the open, such evasion cannot be considered an integral part of Kaliningrad's informal economy. This is in stark contrast to 'mainland' Russia, where 'the real scale of business operations are hidden as a means of evading taxes'[19]. Further divergences emerge when one examines illegitimate economic activity. Although Kaliningrad's crime rate is 20% higher than the Russian average[20], Lamande and Vinokurov have shown that illegal economic activities represent only 30% of Kaliningrad's informal economy. They believe that the remaining 70% reflects economic or entrepreneurial dynamism, struggling against 'an inadequate institutional framework.'[21] Indeed, many of the exclave's inhabitants see the 'grey economy' playing a role that the central Russian state was too weak to fulfil, enabling 'entrepreneurs to flourish and local individuals to create their own social safety nets'[22] and, in this, Kaliningrad presents us with evidence of a unique blurring of the legitimate and the illegitimate.

In the broader international context, Palan argues that the development of the 'offshore' economy has been a conscious and strategic reaction to the forces of globalisation. In the face of permeable state boundaries, territorial sovereignty has become a commodity and, with the provision of 'offshore' zones, the state can create 'less regulated and taxed spaces without undermining their claim to regulate and tax other areas of economic activities.'[23] Palan hails that this phenomenon as an ingenious response to the specific 'tension between globalizing tendencies and the state'[24], but when applied to the emergence of a distinctly Russian 'offshore', this explanation seems distinctly incomplete.

The failings of Palan's approach are best highlighted by an analysis of the Autonomous Republic of Ingushetia, in the northern Caucasus. One of the closest analogues to Kaliningrad in the mid-1990s, Ingushetia was afforded 'ofshornaya zona' status by a presidential decree in 1994.[25] Considering the 1990s saw \$10-\$20bn of capital flight per annum, 'leaching away much-needed domestic investment and infuriating foreign aid donors', the creation of an 'offshore' zone would appear to be one of the last things that the Kremlin would have wanted.[26] From this, it is

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logical to assume that the Kremlin must have been convinced of the need for such a zone by someone who would have benefited. In the Russian context, this proves somewhat problematic, as the significant level of capital flight suggests that those who would have normally taken advantage of such facilities – in this case, the Russian oligarchs – were already making use of 'offshore' zones, external to the Russian state. We cannot even attribute such a move to the smaller, less overtly hegemonic business interests, as their enthusiasm for 'offshore' had, to a significant degree, been pre-empted by the existence of Russia's institutionalised 'grey economy'. [27] Indeed, the fact that nobody had previously pushed for a bifurcation of sovereignty within 'mainland' Russia suggests that 1994 must have represented some kind of fundamental discontinuity.

## The Russian Phobia

Freeland comes to the conclusion that, with regard to Ingushetia, this discontinuity was the result of increasing tensions between Chechnya and the Russian state. 1994 saw an unexpected escalation of tensions in the Caucasus, as Chechnya continued to hold out on Yeltsin's Federation Treaty. This legislature would have embedded Russia's peculiar brand of federal asymmetry, and quashed Chechnya's comparative autonomy. Formerly an obscure backwater, this crisis meant that Ingushetia was now firmly on the Kremlin's radar as a borderland, and 'region of strategic importance' [28]. As the Soviets had used promises of autonomy to 'appease local elites and prevent separatist tendencies' [29], Russian business interests convinced the Kremlin firstly 'that a rich Ingushetia would be a loyal Ingushetia' and secondly, 'that it would take an offshore zone to make Ingushetia rich.' [30]

Examining the Russian Federation's federal asymmetry, Holtom commented that one should never underestimate the continuing influence of an embedded 'fear of state disintegration' [31]. Although arguably a concern of all state administrations, this embedded phobia has fundamentally shaped the nature of relations between the Kremlin and its federal subjects. Following the collapse of the Soviet Union, Yeltsin took a comparatively laissez faire attitude towards keeping the various peripheral regions in Moscow's orbit. This led to a gradual burgeoning of regional identities and aspirations of autonomy, both gaining increasing momentum until they erupted in 'open open conflict and full defiance in the middle of the decade when many of the regions maintained secret bilateral treaties with Moscow' [32]. Reinforced by a narrative of fragmentation, crisis, and subsequent recentralisation, it makes sense to speak of 'offshore' being pitched to the Russia's central administration as a panacea for this peculiar obsession; a way of ensuring the loyalty of peripheral, strategically important territories.

This interpretation is led credence by that fact that the aforementioned narratives of Russian federalism were reflected in corresponding discourses on the Kaliningrad problem. Proposals ranged from 'keeping the region as militarised as it was during the Cold War, to proposals directed at developing it as a Free Economic Zone (FEZ) and later as a Special Economic Zone (SEZ), and finally, with the failure of the FEZ/SEZ policies, to the recent suggestions on the EU's more extensive involvement in Kaliningrad's ordering.' [33] This makes it difficult to justify Kaliningrad's 'offshore' status as being the product something solely reactive; little more than a by-product of the growing tension between the forces of globalisation and the Russian state. In both Kaliningrad and Ingushetia, the offshore economy seems to have been a weapon in the Kremlin's arsenal, and the "hollowing out" of the Russian state represents an attempt to tackle specific fears, problems, puzzles or challenges – specifically, economic weakness and a latent threat to Russia's territorial integrity.

## Return of the Iron Fist

Unfortunately, Putin's accession to the Russian presidency throws this argument somewhat off-centre. It is hard to imagine a strategic surrender of sovereignty being approved by a man who openly criticized the post-Soviet transition as an 'epidemic of disintegration' [34], shortly before embarking a systematic campaign of centralisation. [35]

Putin's accession to the Russian presidency represented a dramatic shift in the balance of power, and the most conspicuous onslaught in a protracted struggle between two factions within the Russian political elite. In one corner was the 'old family clan'; those members of Russia's oligarchic business class, who favoured the spread of a more global and deregulated capitalism within the Russian Federation, and who had come to attribute their successes to the actions of former president Yeltsin. Pitted against these neoliberal business interests were 'the siloviki' (derived

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from a Russian word for 'power'). While they may have lacked the economic resources of the oligarchs, they were able to mobilise the instruments of 'state security, law enforcement, and key positions occupied by former KGB people in the federal and regional administrations'[36] to further their aims. Subscribers to a statist, Hobbesian vision of a 'closely administrated Russia'[37], they advocated protectionism and a limited renationalisation of key industries; those very same policies which the oligarchs of Yeltsin's 'family' had most come to fear.

Thus it was that the early 2000s saw Russia trapped in a situation where wealth was pitted against administrative power in a struggle for control of the state apparatus, and If Putin's appointment was one of two turning points in this campaign of covert warfare, then the events surrounding the 'Yukos affair' were definitely the second. 2004 saw Yukos Oil, a major petroleum company, charged with allegations of tax evasion. Accused of misusing the Russian 'offshore' in the 1990s to reduce corporate tax burdens, Yukos was said to have maintained an de facto tax rate of eleven percent, as opposed to the thirty percent imposed by the Russian state. And whilst Yukos claimed that its activities were legitimate at the time, Mikhail Khodorkovsky – Yukos's CEO and an active participant in the 'old family clan' – was convicted for fraud, share ownership was frozen by the government, and the company assets were auctioned off, in a symbolic triumph of state over business.[38] In the following months, 'the distribution channels of property and power [were] monopolized'[39] by the siloviki, as Putin's government replaced a number of large private businesses with state-controlled companies, and the Yeltsin-era oligarchs were marginalised in favour of 'a new category of ... 'bureaucratic oligarchs', or 'oligarchs inside the regime'[40]. State power was consolidated, 'both vertically (from small and medium sized businesses) and horizontally (from their counterparts in the West)'.[41]

In 2007, Kaliningrad's 'offshore status' is no longer a matter of strategic compensation. Alongside a continuous stream of budgetary support, which has arguably constituted 'serious divergences from market-based principles of economic development'[42], the SEZ has become firmly entrenched, almost taking on a momentum of its own. Medvedev's analysis suggests that Kaliningrad's ability to cling onto 'offshore' status can only really be attributed to the Russian oligarch, but reality suggests otherwise. In the wake of Putin's brutal suppression of the 'old family clan', this analysis is clearly flawed, as the oligarchs no longer possess the necessary influence. In fact, in the context of the Russian state, Kaliningrad's continuing autonomy is utterly inexplicable. If Kaliningrad can be said to have escaped Putin's attempts to "rebuild the vertical power structure", then we will have to look beyond domestic interest groups for an explanation.

## Conclusion

Moses suggests that, over the course of the 1990s, an entrenchment of Kaliningrad's 'offshore' economy means that, despite its many failings, the inhabitants of Kaliningrad have come to identify with their unique territorial and economic situation. To all intents and purposes, the SEZ has assumed the role of 'a virtual political compact', which unites the region's 'political-business elite and the public', regardless of political leaning or socio-economic class.[43] Conversely, the EU tends to represent Kaliningrad as a veritable 'black hole in northern Europe'[44]. In their view, Kaliningrad's problems pay no attention to borders, and Poland and Lithuania are in the direct firing line of a number of socio-economic externalities, 'emanating from Kaliningrad in the sectors of crime, health, illegal migration and the environment'[45]. In this, Kaliningrad poses as much of a problem to the EU, as it does to the Russian Federation.[46] European pressures may limit Russian attempts at recentralisation, but even they have come to regard the SEZ as little more than an interesting failure, churning out a tide of minor 'soft' security threats and 'trade distorting effects'[47].

By playing these two interest groups off against each other, Kaliningrad may have managed to delay the inevitable. But, regardless of whether this constitutes an intentional strategy on the part of Kaliningrad's administrative apparatus, such a deadlock can only be temporary. In the international political economy, multilateral policies of trade liberalization threaten the so-called 'onshore offshore' – reducing the 'general effectiveness of SEZs in attracting investment'[48] – and Kaliningrad's current status will only be able to safeguard the exclave's competitiveness in the immediate future.

So, whilst it may be tempting to treat Kaliningrad's tenacious grip on sovereignty as the manifestation of a progressive, irreversible "hollowing out" of the Russian state, recent studies suggest that the actions and rhetoric of

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the Putin administration have confounded such claims. In my opinion, Kaliningrad's unique territorial status and geographic isolation may have enabled it to continue along a historical trajectory that was reversed in 'mainland' Russia by the Putin administration. In this, we can interpret Kaliningrad as a disjunctive space – somewhere where effects play out in expectation of a cause, the oligarchs enjoyed victory over the siloviki, and the Kremlin fell victim to a Schumpeterian "hollowing out".

[26/12] UPDATE: And then there was gambling.

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