Supply Chain Strategies in Russia's Special Administrative Regions: Does It Recover the National Economy?

Viacheslav A. Andreev[*1], Tat'ayna V. Varkulevich[#2], Marina N. Arnaut[#3], Lev S. Stavnichiy[#4]

[#1,2,3]*department of economics and management, Vladivostok State University of Economic and Service, Russian Federation*
[#4] *Vladivostok State University of Economic and Service, Russian Federation*
Corresponding author: E-mail: andreev_va@inbox.ru

***Abstract*-Due to the economic sanction the Russian Federation has taken a vigorous attempt to compensate the risk for the national economy stipulated by restriction with access to the capital markets and supply chain strategy by constraints to compete in international markets. Imposition of the special administrative regions is a respond to the sanctions by the United States and a few countries in order to minimize possible financial losses. In an uncertain recovery, supply chain operations need to be more scalable and flexible as they anticipate economic recovery and increase capacity.In practice, a special administrative area appears as offshore financial center. However, its goal is broader – to ensure the repatriation of capital withdrawn off the Russian jurisdiction in 1998-2018. The aim of study is to estimate the capital which will prospectively be returning to Russia until 2025 through the special administrative regimes at Russkiy island and Oktyabr'skiy island in the Russian Federation. The findings show that the capital flight off the Russian economy has amounted to 653.2 billion US dollars for the last 20 years. But viewing the result of sanction's pressure, by 2025, the total return of capital from the offshores at Cyprus and the Virgin Islands could prognostically reach 165.55 billion dollars. Special administrative region's preferences will motivate large foreign holdings, especially those that have fallen under sanctions, to change their registration to the Russia's domicile. Therefore, the special administrative regions could prospectively facilitate investment inflow and stipulate recovering the Russia's economy.**

Keywords; *special administrative regions, supply chain strategy, capital repatriation, redomiciling*

1. Introduction

The economic crisis in Russia in 2008 caused capital flight about $10 billion, led to a sovereign default and revaluation of the public debt to 140% of GDP. That stipulated a jump in inflation by 85% and mass bankruptcy of the banks. After learning the lessons of previous crisis in 1998, due the economic growth in early 2000s when the oil prices were high, Russia's government decided to accelerate repayment of public debt and to establish the Stabilization Fund. Therefore, by the beginning of the crisis in 2008, Russia's debt was the lowest among the G20 countries (about 8% of GDP), and the Reserve Fund that inherited the Stabilization Fund and the National Wealth Fund jointly accumulated more than $170 billion (more than 10% of GDP). This allowed to Russia quickly set a comprehensive package of financial incentives at 5% of GDP.

In the end of 2018, the Russia's Central Bank noted increase in net capital outflow – by 2.7 times in annual terms – from 25.2 billion to 67.5 billion dollars. For comparison, net outflow in 2017 amounted $ 31.3 billion (by 1.6 times in 2016). The trend continued in 2019. For the first two months of 2019, the net export of capital from Russia by the private sector, according to the Central Bank, amounted 18.6 billion dollars, by 2.1 times to same period of 2018. Imposition the anti-Russian sanctions that set restrictive measures on lending to domestic enterprises abroad has led to the fact that a significant number of Russian exporters have been hampered by access to cheap borrowed funds abroad. Within the current structure of the economy, within the current quality of the institution, including the quality of public administration, Russia's economy has no longer opportunity for a serious breakthrough.

To support economic development the government represented a legislative regime so-called "special administrative regions" (SAR), whose residents are able to obtain the status of an "international company" and have various preferences, including accelerated registration, exemption from tax on the profits of their controlled companies, preferential rates on dividend income and some other benefits, including the terms of currency control by supply chain strategy. The goals of the SAR project initially were the capital repatriation and protecting national business from a foreign restrictive pressure.

The legislation set rules for determining a tax basis for assets of companies that have received the status of an international firm, as well as foreign companies which recognized as a tax resident of the Russian Federation. Russia's ministry of economic development, which proposed these special regimes, hopes that such

IJSCM, ISSN: 2050-7399 (Online), 2051-3771 (Print)

preferences will motivate large foreign holdings, especially those that have fallen under sanctions, to change their registration to the Russia' domicile. But opponents are concerned about unequal business conditions in the Russian Federation and a possible mass re-registration of taxpayers, in fact, in the Offshore Financial Centers.

Therefore, could the special administrative regions, i.e. Offshore Financial Centers, to restore the Russia' economy? Does it facilitate finance's repatriation and business re-domiciliation and under what conditions?

2. Related literature

A model of special administrative region is multidimensional. Special administrative regions (see Offshore Financial Centers) cannot be viewed as tax heavens only. It could encompass minimum formalities for incorporation, existence of an adequate legal framework that safeguard the integrity of principal-agent relations, a proximity of attracting capital to major economies, freedom from exchange controls, safeguarding assets from the impact of litigation. It appears as s financial system with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies. More popularly, a center which provide some or all the following services: low or zero taxation, moderate or light financial regulation, banking secrecy and anonymity [1-4].

The process of globalization by supply chain strategy has brought nations closer together and, apparently, increased the international mobility of corporate activity. Two aspects of globalization have had important and conceptually distinct implications: reductions in transportation and communication costs may make capital more mobile across jurisdictional boundaries, and financial innovation and liberalization may facilitate international tax avoidance by less footloose firms [6-10].

Increased mobility of goods and services is apt to give rise to an erosion of corporate tax bases in high-tax industrialized countries, a decline in tax revenues and a rise in competition among governments. Using special administrative regimes countries attract and retain mobile investment and the associated tax revenues that may be induced to reduce tax rates below the levels that would obtain in the absence of mobility [4, 7]. Increased mobility can lead to a "race to the bottom" driving business tax rates to minimal levels, due to the fiscal externalities that mobility creates. These arguments notwithstanding, there appears to be very little evidence of a general decline in effective tax rates on capital in recent years [5].

A practical meaning of an Offshore Financial Center is a center where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents [1]. The implications of financial mobility are more subtle. When firms may shift income to tax havens and other low-tax jurisdictions through financial transactions, real investment choices of firms and the tax policy environment of governments are changed [6].

Tax planning tends to make the location of real investment less responsive to tax rate differentials, even as taxable income becomes more elastic. While tax planning may reduce revenues of high-tax jurisdictions, therefore, it may have offsetting effects on real investment that are attractive to governments. In principle, then, the presence of international tax planning opportunities may allow countries to maintain or even increase high business tax rates, while preventing an outflow of foreign direct investment [11]. Financial mobility is manifested in the decisions of multinational enterprises to separate research and development and capital financing activities from production and sales of outputs, and so to engage in "tax planning" to realize income from intellectual property and from capital in jurisdictions different from those where real economic activities are located [12-14].

3. Analysis method

The aim of study is to assess a prospect for Russia's special administrative regions, in terms of repatriation of capital due to the trade restrictions and sanctions imposed for business with Russian origin based on the supply chain strategy. It assumes that the special administrative regions cannot be viewed as tax heavens only. It encompasses simpler prudential regulatory frameworks that reduce implicit taxation, sets minimum formalities for incorporation, and, finally, attracts investment.

Object of analysis is the volume of capital flight (i.e. capital outflow) off the Russia's economy from 1998 to 2018. The analysis follows the data according to the Central Bank of the Russian Federation's. Compared the amount of sovereign debt of Russia and the volumes of capital outflows off the national economy. To assess the impact of capital repatriation on the Russian economy used a prognostic projection which tracked the volume of the capital export and repatriation on example of two countries - Cyprus and the Virgin Islands for 2008-2018, and till 2025. It must be noted that both countries are popular offshore zones for the Russian business.

4. Results

The predominance of capital outflow over inflow in natural meaning called "capital flight". In the context of our research, we consider the capital flight as spontaneous, unregulated export of capital by individuals and legal entities abroad in order to make their investment more reliable and profitable, as well as to avoid expropriation, high taxation, and losses from inflation by supply chain strategy. In these areas, the supply chain strategy links the customers to sources and control the process to be clear which improve the economy fluency. In order to estimate the total outflow of capital off the Russia's economy, we analyzed the volume of annual net capital flight from 2008 till 2018 (figure 1).

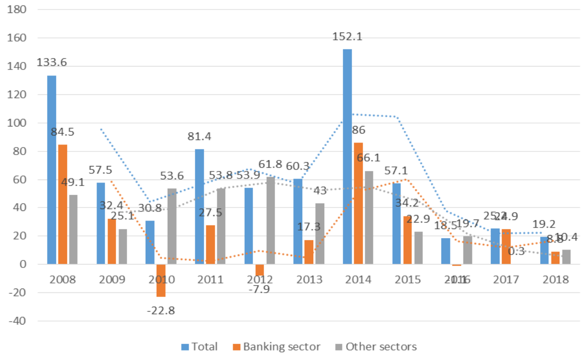

Figure 1. Net Russia's capital outflow/inflow in 2008-2018, billion USD dollars (Source: The Central Bank of Russian Federation https://cbr.ru › statistics › credit_statistics › bop › outflow)

According to results of the analysis for the banking sector and for other sectors, we can make some conclusions. For the whole period the net export of capital off the jurisdiction territory of the Russian Federation prevails. Notably, except for 2006 and 2007 when the capital inflows at $ 43.7 billion and $ 87.8 billion have been observed. These were relatively prosperous years for the economic system when the oil prices were high, and Russia's government established the Stabilization Fund and the National Wealth Fund which jointly accumulated more than $170 billion. Totally for 20 years 653.2 billion dollars have been withdrawn off the national economy of Russia. The share of banking sector accounted by 33.14%, while other sectors accounted by 66.86%.

In order to assume the trends of decapitalization of the economy and estimate stability of the financial system of the Russian Federation until 2025, we compared the volume of sovereign debt of the Russian Federation and volume of the capital outflow from 2008 till 2018 (figure 2). Observing the statistics data of the Central Bank, we can make a few conclusions. The sovereign debt of the Russian Federation as of December 31, 2018 amounted to 454.68 billion dollars. While net capital outflows for 20 years have been amounted to $ 653.2 billion. Notably, over the past 8 years, the total outflow of capital amounted to 467.7 billion dollars, which more than the sovereign debt of the Russian Federation. Despite the fact that the net outflow of capital from Russia in January–November 2019, according to the Central Bank, decreased from $54 billion to $34 billion compared to the same period in 2018, however, the national economy has returned to the model of "flight of money" economy.

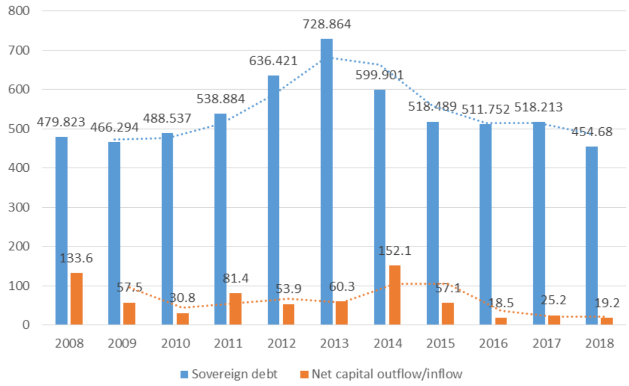

Figure 2. Russia's sovereign debt and capital outflows in 2008-2018, billion USD dollars
(Source: The Central Bank of Russian Federation https://www.cbr.ru/statistics/macro_itm/svs/; https://cbr.ru › statistics › credit_statistics › bop › outflow)

Statistics on the payments balance by the Central Bank of Russia for October 2019 shows that after the capital increase of $ 1.3 billion in early autumn, then the private sector withdrew $6.7 billion off the country. In general, the outflow of capital, as in the crisis years, has become an avalanche (since April, more than 80% of the free currency has left Russia, of the sum which is a residual after import duties exemptions and payments on tax items). It appears as a systematic problem for the economy which is virtually impossible to prevent or stop.

At first glance, the current outflow of capital does not really interfere with the economy. Inflation as a result of 2019 is projected to be less than 4%, and GDP growth is estimated by some economic strategists at 1.5%. On the other hand, there is no more money in the people's pockets for consuming in a long-term period. According to the prime minister the individual's real income at the end of the year has grown, but only symbolically by 0.2–0.3%.

Notably, the Russia's GDP has decreased since the imposition of sanctions, contracting by 2.8 percent in 2015. While it is harder to causally link the impact of sanctions with Russia's decline in economic growth, it appears that decrease in trade will be slowing down the country's economic development. In context of our study it should be noted that establishing of special administrative regions has undertaken in respond to the sanctions to minimize losses and encourage business activities of "the national roots" - for non-residents and for the Russian companies.

Therefore, Russia's special administrative regions are considered as Offshore Financial Centers. Their jurisdiction encompasses a relatively large number of financial institutions engaged primarily in business with non-residents. In this research we consider a problem of non-residents with Russia's native origin that suffering excessive external pressure stipulated primarily by risks of sanctions. For political or economic reasons, the United States and several other countries impose trade restrictions and sanctions to protect their own markets. Then, a country against which the restrictions were imposed tends to look for a new market, paying more attention to the national economy, thereby attracting (i.e. returning) capital back to national market.

The most severe restrictions on business activities were introduced in 2018-2019 against companies - metallurgy holding Rusal, IT company Yandex, national finance institution Sberbank, and the aircraft company Irkut.

In order to find out the aftermath of sanction we analyzed these companies by criteria: type of activity, products, sanctions restrictions, consequences on the financial statements, threats and opportunities (table 1).

Table 1. Impact of the sanctions on Russian companies

Company	**Rusal**	**Irkut**	**Sberbank**	**Yandex**
Operation and business activities	Bauxite mining, aluminum production	Aircraft industry/ Civil and defense aviation	Private and corporate banking services	IT, Internet, software and Internet industries
Sanction restrictions	20% duties on rough aluminum, closing of aluminum plant in the USA	Restrictions on supply of engines, spare parts and materials for production and assembly in Russia	Restrictions on purchase of public debt by foreign residents, the risks associated with the default of companies, debtors against whom sanctions are imposed	Ban for foreign companies owning more than 50% (20%) of the capital
Sanction impacts	Decrease in revenues and net profit, increase of costs, shrinking free cash flow	Rapid growth of the expenditures, growth of other expenses, decrease of net profit	Decrease of revenues, low net profit	Decrease of revenues, low net profit
Threats	Sale of the controlling stake by the company's CEO, search for new markets and transfer the assets to Russia	Raise of subsidies from the budget to finance the activities of core Russian enterprise; loss share of market	The decline in assets slows down development	Loss of market

Analyzing the data in the table 3, we should make several conclusions. The core Russian sectors - mining industry, the aircraft assembling, the banking sector and the IT industry are suffering a great restriction on business activities. Being safe at the domestic market, they are under risks in the international markets. As a result, the prospects for development of some core economic sectors are uneven. Russia has adapted to sanctions and partially overcome their effects through a commercial diversification as well through massive budget investments into the public and commercial sectors. However, sanctions will be specifying a long-term effect on the future economic strategy of Russia by holding up a recovery of the economy.

We should bear in mind that the legislation on "Russian offshores" was adopted in August 2018 for domiciling a foreign company - non-resident, at special administrative regions on Russkiy Island in Primorsky Territory and on Oktyabr'skiy Island in Kaliningrad Region. It is worth to note that the rules have frequently been perceived as benefits that are only available to persons subject to international sanctions. It is true that legislation stipulates several special rules for persons that face such "limiting measures". However, companies that have not been affected by the sanctions may also register an international company in a special administrative region, thereby making the regime a universal tax planning tool.

Two further facts should be underlined. Both territories of the SARs are islands which identified as having a special geopolitical significance. However, the law does not limit investments' territorial allegiance by the areas of the two SARs only. So, it permits investing funds within the whole country. Besides, an international company can authorize an affiliated company to handle investments on its behalf. In addition, it is expected to exempt foreign branches of resident firms from taxes. Special administrative region's preferences will motivate large foreign holdings, especially those that have fallen under sanctions, to change their registration to the Russia's domicile.

In order to assume the prospects of special administrative regions, we traced the Russia's capital flows on example of two countries - Cyprus and the Virgin Islands for 2008-2018 (figure 3). It reasonably noted above that both countries are popular offshore zones for the Russian business. The analysis shows that at the end of 2018, \$10.1 billion USD direct investment went back to Cyprus from Russia, according to data from the Central Bank. The negative balance of operations was the largest since 2008. Traditionally, investments from Cyprus and other offshore companies in Russia are financed with money of the Russian origin. Allocation of capital in the Cyprus jurisdiction has become less comfortable for Russians for several reasons. These are increased risks for

Russian money due to possible sanctions that may lead to blocking of accounts. The second reason is increased regulatory pressure in Cyprus.

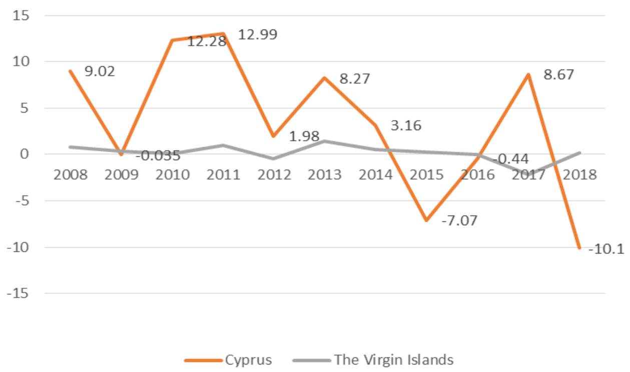

Figure 3. Russia's capital flows in Cyprus and the Virgin Islands, billion USD dollars

To assess the impact of capital repatriation on the Russian economy a prognostic polynomial function used which tracked the volume of capital export and repatriation off Cyprus and the Virgin Islands till 2025 (figure 4). It assumed that repatriation of capital can be carried out in a form of transferring home the capital previously withdrawn abroad, and its profits, as well as the proceeds in foreign currency from the sale of goods and services.

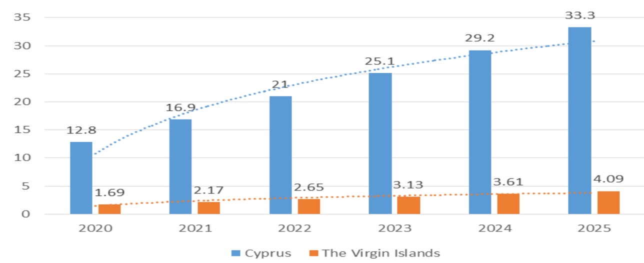

Figure 4. Prognostic outflows from Cyprus and the Virgin Islands, billion USD dollars

The analysis shows, by 2025, if the sanction pressure will be continuing, the total net "back flight" capital from these two countries could reach $ 165.55 billion. Therefore, we can expect an increase in capital investments and enhancing capitalization of the Russia's economy. Some offshore jurisdictions showed an influx of investments into Russia against the background of the outflow of Cyprus's money. These include the Bahamas (plus $923 million), Bermuda (plus $814 million), and the Netherlands (plus $7.9 billion). Investment inflows from the UK (plus $2.5 billion), France (plus $1.1 billion), and Switzerland (plus $1.7 billion) were also recorded. In general, the positive balance of investments in Russia in 2018 amounted to $8.8 billion - more than three times less than a year earlier. According to analysts of the Central Bank, this is due to a decrease in the returning of Russian capital from offshore zones.

In the context of our research, we understand the term capitalization of the economy as a fundamental process, the economic meaning of which is to increase the cost of capital owned by not only non-residents but home companies too. It brings a result in recovering and overall growth of Russian economic system. In this regard, the mechanism of the special administrative region reduces the risks of doing business.

5. Conclusion

More scalable, variable cost supply chain operations have clear advantages over more traditional cost ones, especially when the economic recovery includes a high level of uncertainty and there is a risk of reentering a renewed recessionary period. There may be no better time than now for enterprises in any industry to consider adopting a more variable cost supply chain to limit risk and capture the most revenue growth opportunity. Number of resident-companies at the Russia's special administrative regions in the end of 2019 is not impressive. According to experts the sooner the business is convinced of the absence of risks, the more actively it would use the tool, and the number of residents will be respectively growing. The prognostic modelling for the capital back flow is just an assumption which points at high potential of the special administrative regions as multifunctional financial servicing zones. But the problem is that capital requires not only a safe tax haven, but also profitable returns on investments. In the current situation, when evidently there is a stagnation in the economy, it is quite difficult to find appropriate sectors for large-scale investments in a long-term view. Low consuming due to the low personal incomes remains a constraint factor, therefore, we should not expect a mass influx of investments from the foreign offshores. Another problem is the low efficiency of administration, which can affect delays in registration procedures for non-resident companies. Anyway, the first international companies were registered making the "Russian Offshores" a legally established fact, but time only tell whether these companies will be able to recover the economy in the current conditions.

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