

## Section 2. Monetary and budgetary sector

### 2.1. Monetary policy

In 2013 inflation exceeded the target range (5-6%) established for 2013 in accordance with the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having reached 6.5%. On average, between January and December 2013 the M2 money supply had grown by 15.3% and as of 1 January 2014 was Rb 31,404.7bn. The international reserves reduced by 5% to \$509.6bn during the year.

In 2013 the Bank of Russia continued to improve its monetary policy within the framework of transition to inflation targeting. In particular, the Bank of Russia introduced the concept of a key interest rate reflecting the course of its monetary policy and, thus, completed the formation of an interest rate corridor.

The Bank of Russia continued increasing the flexibility of the exchange-rate regime by increasing the sensitivity of the boundaries of the operational band to the number of FX interventions performed by the Bank of Russia and adjusting the mechanism of the exchange rate policy aimed at ensuring the neutrality of the Federal Treasury's FX transactions related to accumulation (expenditure) of sovereign funds.

#### 2.1.1. Money market

Based on the results of 2013 the amount of the international reserve assets decreased by \$28bn (5%) and as of the beginning of January 2014 was \$509.6bn (*Fig. 1 and 2*). This reserve amount is more than sufficient for ensuring the stability of Russia's balance of payments, covering 13 months<sup>1</sup> of imports of goods and services in the RF. We should note that in 2012 the international reserves increased by \$38.97bn (7.8%) to \$537.6bn as of 1 January 2013 and the adequacy of reserves reached 14.5 months. In 2013 the volume of foreign exchange reserves decreased by \$16.97bn (-3.5%) compared to the beginning of the year due to implementation by the regulator of FX interventions aimed to smooth the volatility of the ruble exchange rate during periods of its fast weakening. In contrast, in 2012 the foreign exchange reserves grew by \$32.6bn (+7.2%), which was mainly due to transactions performed by the Ministry of Finance of Russia, repo transactions with non-residents and currency swaps, while the number of interventions in the domestic market was insignificant. The monetary gold reserves decreased by \$11bn (-21.6%) compared to the beginning of the year, which was mainly due to their negative revaluation. As a result, as of

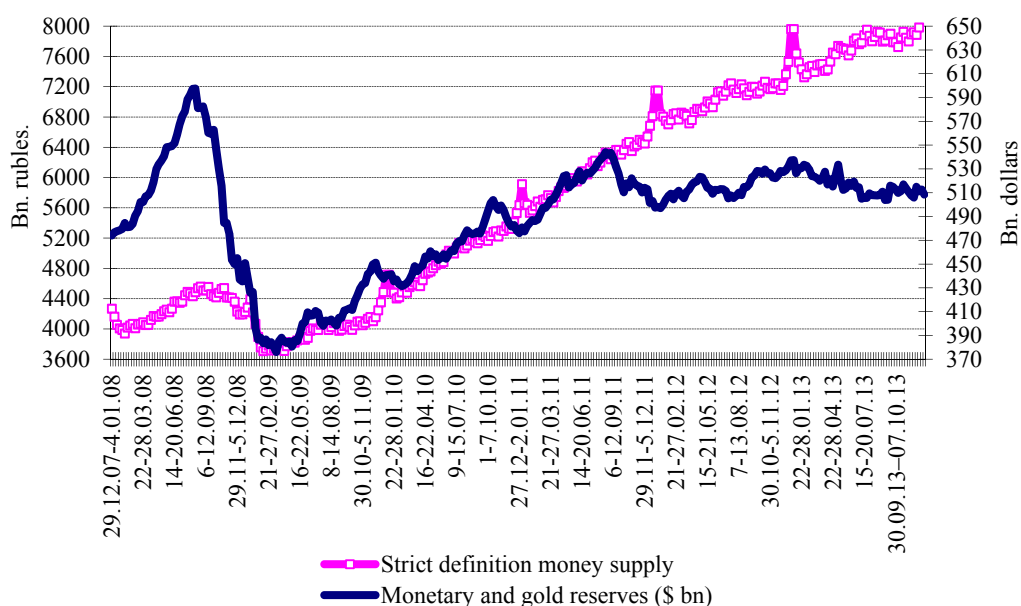
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<sup>1</sup> Calculated on the basis of the monthly average cost of imported goods and services for the period from October 2012 to September 2013.

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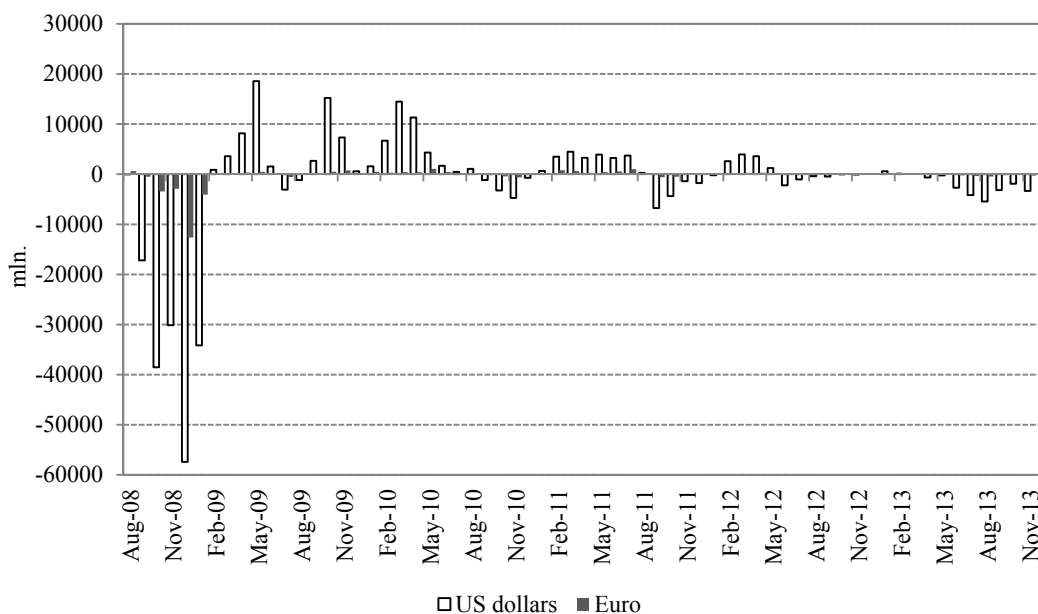
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1 January 2014 the share of currency exchange reserves in the total reserve assets was 92.2% (90.5% in 2012), with the share of the gold component being 7.8% (9.5% in 2012).



Source: Bank of Russia.

Fig. 1. Dynamics of the monetary base (in a strict definition) and foreign exchange (international) reserves in the RF in 2008-2013



Source: Bank of Russia.

Fig. 2. FX interventions (net purchase of foreign currency) of the Bank of Russia in 2008-2013

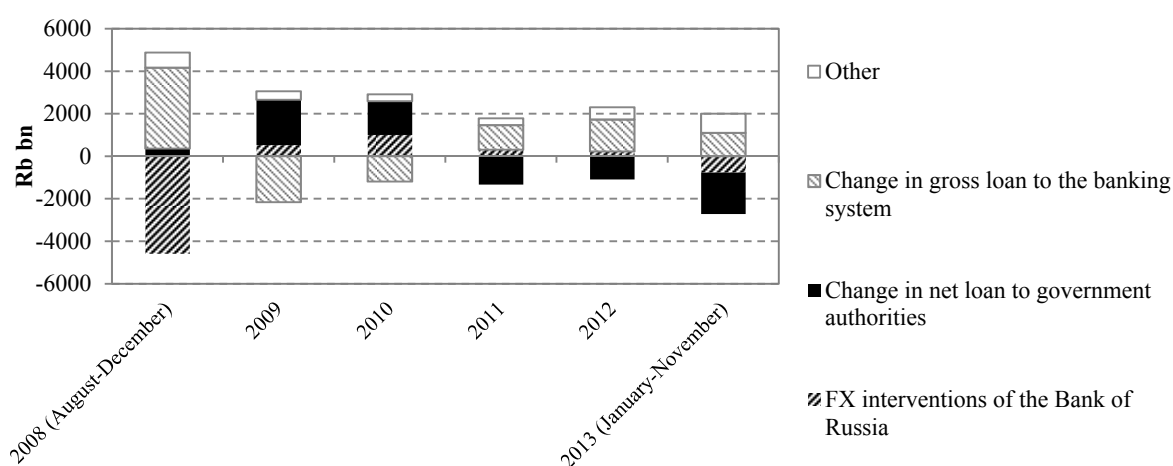
In 2013 the broad definition monetary base had increased by 6.6% and as of the beginning of 2014 was Rb 10.5 trillion. The main factors contributing to the reduction in the monetary

base in 2013 were the Bank of Russia's transactions for the sale of foreign currency in the domestic market and accumulation of the funds of the enlarged government in the Bank of Russia accounts (*Fig. 3*). At the same time, the key factor of the monetary base growth in 2013 was performance by the Bank of Russia of transactions for the provision of funds to commercial banks. We should note that in 2012 the monetary base had increased by 14% to Rb 9,853bn but here the accumulation of funds of the enlarged government in accounts in the Bank of Russia was the main factor restricting this growth.

The amount of the enlarged government's accumulated funds in accounts in the Bank of Russia for the first 11 months of 2013 has increased by Rb 1.9 trillion (38.6%) (*Table 1*).

We should note that despite the Bank of Russia's announcements about transition to an inflation targeting regime and taking measures aimed at increasing the flexibility of the exchange-rate regime, the Bank of Russia, in 2013, increased its presence in the FX market, performing considerable transactions for the sale of foreign currency. For comparison, since 2010, the net sales of foreign currency have been decreasing (in 2010 – \$34.1bn, in 2011 – \$12.4bn, in 2012 – \$7.6bn). However, in 2013 foreign currency net sales amounted to \$27bn. Apparently, such measures of the Bank of Russia were not only due to the necessity to smooth the ruble exchange rate volatility but also due to its intention to slow down the rates of ruble impairment under the conditions of decreasing current account balance and capital outflow from the country.

We should note that such an interventional policy by the Bank of Russia, perhaps, does not conflict with the task of transition to inflation targeting because, due to the effect of transfer of exchange rate into prices, ruble weakening causes a growth of inflation in Russia. At the same time, a considerable expansion of one-way (sale only) transactions of the Bank of Russia in the foreign exchange market appears to be unreasonable under the conditions of the fundamental tendency towards a reduction of the general balance of payments of the RF due to an expansion of the physical volumes of import with simultaneous export stagnation (both in physical and monetary terms) and the acceleration of private capital outflow from Russia.



Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

*Fig. 3.* Key factors of the monetary base change (in a broad definition) in 2008–2013<sup>1</sup>

<sup>1</sup> The period in question (2008-2013) is determined by availability of data on FX interventions of the Bank of Russia and the balance sheet of the Bank of Russia.

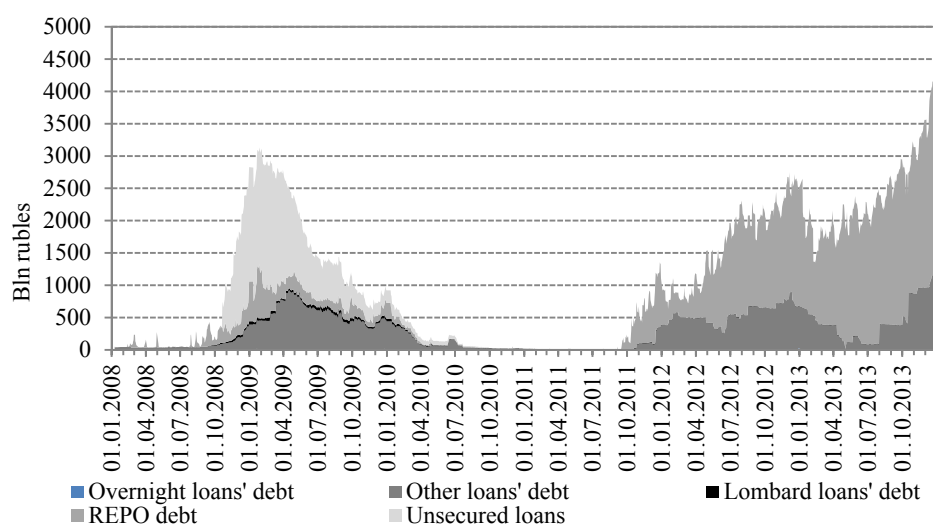
Table 1

Balance sheet of the Bank of Russia in 2012-2013

	1 January 2012		1 January 2013		1 December 2013	
	Rb bn	% of assets/ liabilities	Rb bn	% of assets/ liabilities	Rb bn	% of assets/ liabilities
Funds deposited with non-resident organisations and securities of foreign issuers	14,245,276	76.7	14,525,436	70.4	15,433,355	68.1
Loans and deposits	1,663,280	9.0	3,158,355	15.3	4,259,354	18.8
Precious metals	1,527,545	8.2	1,646,187	8.0	1,429,894	6.3
Securities	426,150	2.3	456,314	2.2	451,833	2.0
Other assets	97,857	0.5	251,549	1.2	451,350	2.0
<b>Total assets</b>	<b>18,562,735</b>	<b>100</b>	<b>20,630,744</b>	<b>100</b>	<b>22,675,450</b>	<b>100</b>
Cash in circulation	6,896,064	37.2	7,667,950	37.2	7,522,845	33.2
Funds held in accounts with the Bank of Russia	7,742,221	41.7	9,404,984	45.6	10,745,922	47.4
<i>including of the RF Government</i>	4,443,546	23.9	4,913,764	23.8	6,811,932	30.0
<i>of resident credit institutions</i>	1,748,402	9.4	2,185,349	10.6	1,616,635	7.1
Accounts receivable	36,217	0.2	158	0.0	23,290	0.1
Securities issued	-	-	-	-	-	-
Liabilities to IMF	472,335	2.5	447,686	2.2	497,885	2.2
Other liabilities	158,612	0.9	138,183	0.7	1,139,868	5.0
Equity	3,235,383	17.4	2,724,457	13.2	2,745,640	12.1
Profit in the reporting year	21,903	0.1	247,326	1.2	-	-
<b>Total liabilities</b>	<b>18,562,735</b>	<b>100</b>	<b>20,630,744</b>	<b>100</b>	<b>22,675,450</b>	<b>100</b>

Source: Bank of Russia.

Fig. 4 shows the dynamics of the debts of commercial banks to the Bank of Russia. Since 2011 there has been an observed tendency towards considerable growth in the provision of liquidity to credit institutions by the Bank of Russian. In 2013 debt exceeded the peaks of the crisis period, having increased by 65% and reached Rb 4.4 trillion as of 1 January 2014. The main source of attraction of liquidity by credit institutions on the part of the regulator are repo auctions, the average debt on which was Rb 1.95 trillion in 2013 (Rb 1.1 trillion in 2012, Rb 0.2 trillion in 2011). The maximum amount of funds is provided through 1-week repo auctions (on average Rb1.6 trillion for 2013).



Source: Bank of Russia.

Fig. 4. Debt of commercial banks to the Bank of Russia in 2008-2013

Provision of liquidity to credit institutions by the Bank of Russia was carried out mainly using short-term repo transactions, the average-weighted interest rates on which were 5.5-5.6% from January to December 2013. Since certain credit institutions lacked securities accepted as collateral on repo transactions and due to insufficiently active redistribution of funds in the interbank market, “currency swap” transactions with a 6.5% rate were used for the ruble part of transactions.

The second half of 2013 saw an increase in debt of the banking sector under loans of the Bank of Russia secured by non-market assets and guarantees. This was partially due to the introduction by the Bank of Russia of a new instrument of bank liquidity provision, a three-month credit auction secured by non-market assets (promissory notes, loans receivable) with a floating interest rate. Within the framework of the first such auction held on 15 October 2013 the regulator provided Rb 500bn at 5.76% per annum. The minimum cost of credit is linked with the key rate of a one-week repo, which was 5.5% at the moment of holding the first auction, plus 0.25 p.p. The advantage of a three-month auction over a similar one-year auction introduced by the regulator in June 2013 is the higher availability of collateral of required term for credit institutions and an increase in the collateral base of the banks by means of reducing the term for disbursement of funds. We should note that before the regulator introduced this instrument banks had shown low interest in refinancing instruments secured by non-market assets due to the high level of the fixed rate (7.5%). Despite the conditions of loan provision at a floating rate being quite favourable, only large banks with a notably higher collateral base can participate in such auctions.

The interest rate on interbank loans<sup>1</sup> has increased by 18.5% in 2013 (from an average of 5.4% in January 2013 up to an average of 6.4% in December 2013). The interest rate on interbank loans has been in the upper part of the interest rate corridor of the Bank of Russia, from time to time coming very close to its upper limit (*Fig. 5*). In general, the annual average MIACR on overnight interbank loans in rubles has increased by 10% from 5.5% in 2012 to 6.1% in 2013. We should note that, given that the key channel of the monetary base growth are the transactions of the Bank of Russia, it is the decisions of the Bank of Russia that determine the dynamics of the interest rates. Furthermore, revocation of the licences of certain Russian banks became an additional factor in the interest rate increase in the interbank market in the IV quarter of 2013.

As of 1 January 2014 the 70% share of total indebtedness of credit institutions to the Bank of Russia was owed by the 5 largest market participants (according to data as of 1 January 2013 a 70% share of indebtedness of banks to the regulator for the total amount of Rb 2.7 trillion was owed by 13 banks). In turn, the high degree of market concentration is evidenced by the fact that as of 1 January 2014 the 70% share of indebtedness of banks to resident credit institutions which accounted for Rb 2.6 trillion was owed by 10 banks (as of 1 January 2013 70% of debt for the total amount of Rb 2.7 trillion was recorded in the balance sheet liabilities sections of 13 banks)<sup>2</sup>.

We should note that prospectively extension of the regulator’s use of long-term liquidity provision instruments (three-month or one-year repo auctions secured by non-market assets) will enable banks to release market collateral and create conditions for additional growth in the volumes and availability of interbank loans.

Let us consider the monetary base structure (broad definition) in more detail (*Table 2*).

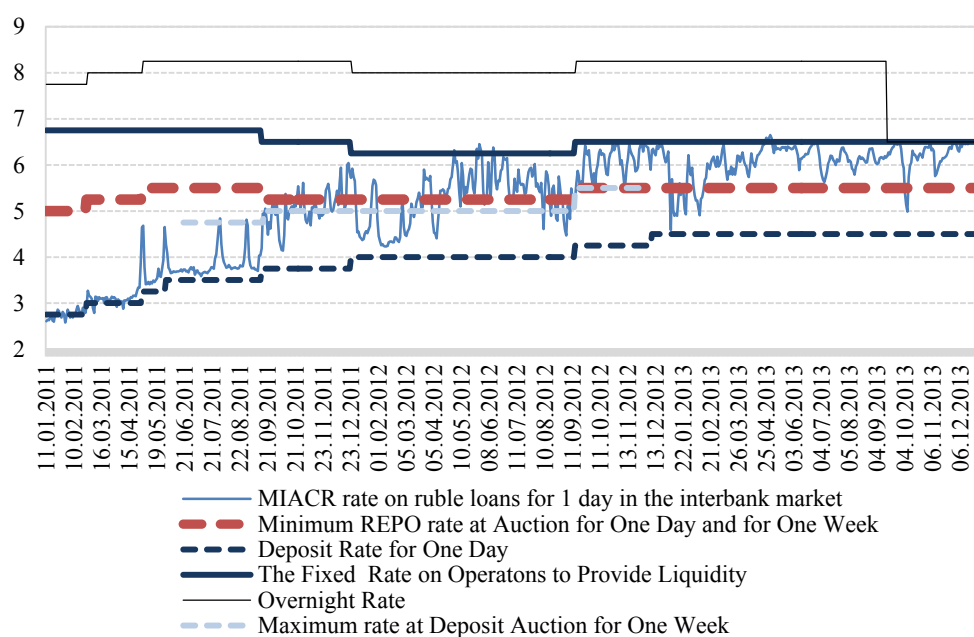
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<sup>1</sup> Interbank interest rate is an average monthly MIACR on overnight interbank loans in rubles.

<sup>2</sup> Based on calculations by the Centre of Structural Research of the Ye.T. Gaidar IEP.

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Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

Fig. 5. The interest rate corridor of the Bank of Russia and dynamics of the interbank market in 2012-2013

Table 2

### Dynamics of the broad definition monetary base in 2013 (Rb bn)

	1 January 2012	1 January 2013	1 April 2013	1 July 2013	1 October 2013	1 January 2014
Monetary base (broad definition)	8,644	9,853	8,628	9,063	9,117	10,504
– cash in circulation, taking into account cash balances on hand in credit institutions	6,896	7,668	7,102	7,420	7,369	8,308
– correspondent accounts of credit institutions with the Bank of Russia	982	1,356	856	1,002	1,098	1,270
– mandatory reserves	378	426	450	498	506	409
– deposits of credit institutions in the Bank of Russia	388	403	220	145	144	518
– bonds of the Bank of Russia in credit institutions	0	0	0	0	0	0
For information only: excess reserves	1,370	1,759	1,076	1,147	1,242	1,788

Source: Bank of Russia.

Among components of the broad monetary base, the number of which has decreased, the following should be highlighted: correspondent accounts (decrease in January-December 2013 by 6.3% to Rb 1,270bn) and mandatory reserves of banks (by 4% to Rb 409bn). Deposits of credit institutions in the Bank of Russia have increased by 28.5% to Rb 518bn and cash in circulation has increased by 8.3% to 8,308bn). For the 12 months of 2013 the total excess reserves increased by 1.6% and amounted to Rb 1,788bn. The decrease in balances of correspondent accounts in the Bank of Russia under the conditions of a growth of interest rates on interbank loans suggests a structural deficit<sup>1</sup> of liquidity in the banking sector.

<sup>1</sup> According to the Bank of Russia's definition, a structural deficit of liquidity means a condition of the banking sector characterised by the existence of a stable necessity for credit institutions to obtain liquidity by means of transactions with the Bank of Russia (from "Guidelines for the Single State Monetary Policy for 2014 and for 2015-2016").

On average, in January-November 2013 M2 money supply increased by 15.3% on an annualised basis. In 2010 the average money supply growth rate was 32.5%, in 2011 – 24.3% and in 2012 – 19.4%. In general, it can be noted that the tendency towards the gradual decrease in the money supply growth rates (compared to the correspondent period of the previous year) that had been observed since 2011 reversed in the first half of 2013, with M2 monthly growth rate stabilising at the level of 15.4-16.7% (on an annualised basis) in the second half of the year. We should note that the average M2 growth rate in the first half of 2013 (on an annualised basis) was 16.8%, with an average increase of the monetary base by 13.5% and of the money multiplier by 3%.

Thus in general, an increase in the rate of growth of the M2 money supply for the 12 months of 2013 was moderate compared to the previous periods taking into account the relatively low basic inflation of 5.6% (on an annualised basis) (5.7% in 2012) and, by itself, does not create any preconditions for a disturbance of price stability as a result of monetary factors.

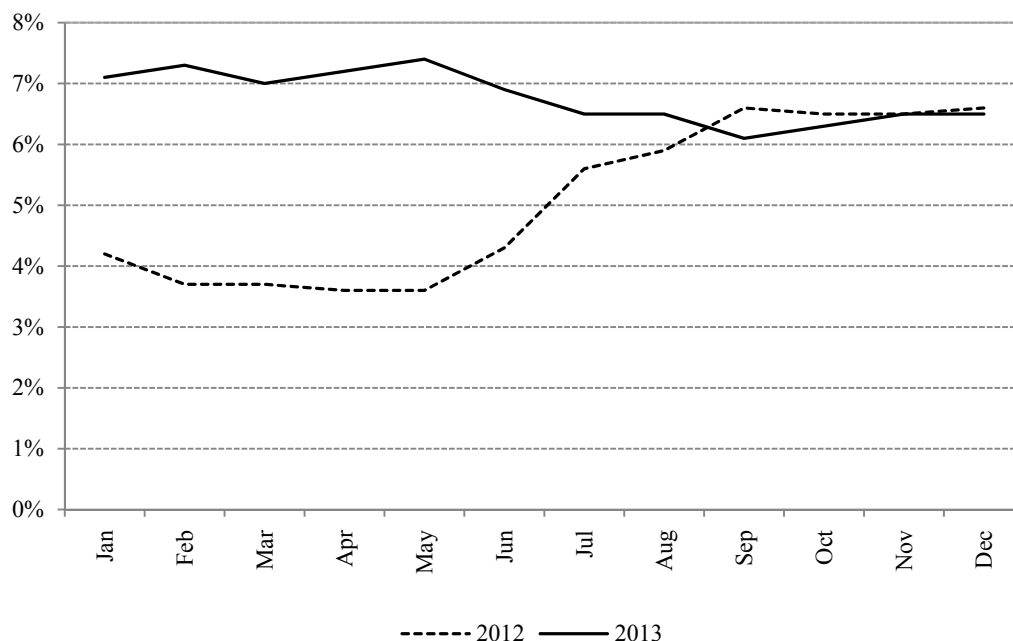
Taking into account that in 2013 the monetary base increased by 6.6% and the money supply grew by 14.6%, the money multiplier growth rate was 7.5%. From January to December 2013 the average money multiplier (M2/monetary base ratio) was 3.2, showing a slight increase compared to 2012 (3.0 in 2012, on average). This value of the money multiplier is typical of emerging economies whilst in developed countries it is usually with the 5 to 8 range. We should note that in eastern European countries during the last 20 years, money multiplier growth was observed as their banking systems developed. For example, in Poland from 1993 to 2013 the money multiplier increased from 3.1 to 6.1.

The monetisation level of the Russian economy (M2 to GDP ratio) for the period from 1999 to 2012 increased by 2.5 times to 51.5% in 2012. For comparison, in Belarus the M2 to GDP ratio for the same period increased by 1.8 times to 30.5%, in Kazakhstan – 2.6 times to 34.7% in 2012 and in Ukraine – 3.3 times to 54.9%. A relatively lower GDP monetisation growth rate in the period from 1999 to 2012 was typical of the majority of the Central and Eastern European countries, for example, in Poland the M2 to GDP ratio increased by 1.4 times to 57.9% in 2012, in France – 1.5 times to 158% in 2012, in Germany this indicator remained relatively stable, having reached 173% in 2012. We should note that the relatively low level of monetisation of the Russian economy was due to the comparatively low level of development of the financial system in the RF.

If we analyse the components of the money supply, we can note that individual saving in 2013 showed an average increase of 18.3% on an annualised basis (19.9% in 2012) and deposits by non-financial organisations and financial organisations showed an average increase of 12% (18.3% in 2012). M0 money supply demonstrated an average growth of 8.2% (on an annualised basis) in 2013 (12.7% in 2012) and its share in M2 was, on average, 22.6% (24% in 2012). Thus, in 2013 the share of cash in the money supply continued to decrease, which reflects the gradual development of the financial system of the RF, however, this proportion is still very high compared to developed countries where, as a rule, it is about 10%.

### 2.1.2. Inflation processes

In 2013 inflation was again above the target range (5-6%) established in the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having come very close to its upper limit in September 2013, and reached 6.5% based on the results of the year (6.6% in 2012) (*Fig. 6*).



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

*Fig. 6. CPI growth rate in 2012-2013 (% per year)*

Inflation exceeded the upper limit of the target range mainly due to non-monetary factors, in particular, the quicker than in 2012 increase in prices for domestic food products. We should remember that the average M2 money supply growth rate on an annualised basis for the 12 months of 2013 slowed down, amounting to 15.3% on an annualised basis. The increase in consumer prices was also pressurised by the indexation of tariffs for services provided by natural monopolies and the increase in excise duties on certain goods. Moreover, taking into account the considerable share of imported goods in the consumption of economic agents in the RF, the ruble weakening also contributed to the accelerated inflation. We should note that the effect of the transfer of exchange rate fluctuations on prices in the Russian economy is incomplete. On average, the one-month effect of transfer of the exchange rate on the CPI is 5% with the major part of the adjustments of the price levels to the ruble exchange rate fluctuations occurring within the following 6 to 12 months<sup>1</sup>.

Meanwhile, we should add that when the Bank of Russia established the inflation target for 2013, it should have been important to take more accurate account of the possible influence of accidental factors (influence of the 2012 harvest on the conservation of fodder to be used in 2013; analysis of the market structure of different food and non-food products; consideration of the effect of the transfer of national currency depreciation into the prices for goods; introduction of new trade restrictions, etc.) and to assess possible deviation of inflation from the target range. Hence, inflation in excess of the target range is an unambiguous failure of the policy of the Bank of Russia.

Let us consider the 2013 inflation process in more detail. As shown in *Table 3*, the growth rate of prices for consumer goods in the period from January to December 2013 was slightly

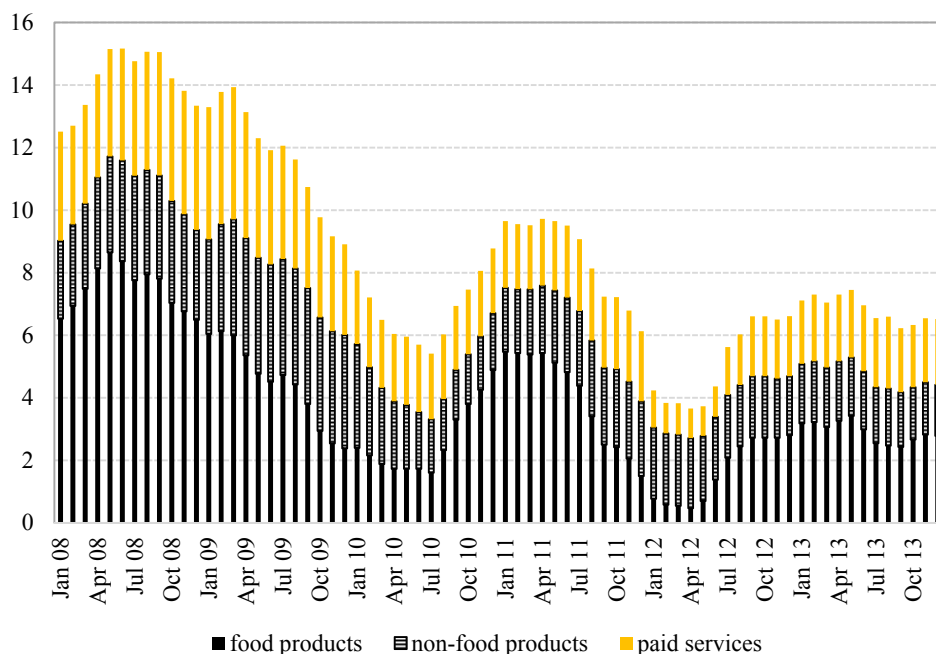
<sup>1</sup> According to estimates of the Ye.T. Gaidar IEP.



lower than in 2012. Growth of the following prices contributed greatly to the increase in prices for food products: eggs (+28.8%), butter (+18.6%), alcoholic beverages (+14.6%), milk and dairy products (+13.1%) and fruit and vegetables (+9.3%). The increase in prices of butter and dairy products as well as of eggs resulted from the deficit of raw materials due to the limited availability of fodder, caused by the poor harvest in 2012. The rise in prices for fruit and vegetables which had begun in October 2013 was associated with the poorer harvests due to heavy rain in the central part of Russia. We should note that restrictions on the import of certain goods to Russia from Belarus, the Baltic countries and Ukraine also contributed to the increase in food prices.

The rate of growth of non-food prices (+4.5%) also slowed down in 2013 compared to 2012. The quickest growth in this product group was observed for tobacco products due to the increase in excise duties. Furthermore, the increase in excise duties and wholesale fuel costs in the second half of 2013, due to the closing of several oil refineries, resulted in acceleration in the growth rates of gasoline prices.

In 2013 the prices for paid services rose by 8% compared to 2012. This was notably due to the indexation of regulated prices and tariffs for the services of organisations providing infrastructural activity. A slight acceleration in the rates of growth of prices for most groups of services should be noted. At the same time, the postponement of indexation from January to July seems reasonable to us, because, when a new harvest goes to market after tariff indexation, it causes a decrease in food prices and partially damps the effect of tariff indexation.



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

*Fig. 7. Inflation structure in 2008-2013 (% per month to the corresponding month of the preceding year)*

Table 3

**Annual price growth rates for certain types of consumer goods and services  
in 2011-2013 (% to December of the preceding year)**

	2011	2012	2013	2011-2013*
<b>CPI</b>	<b>6.1</b>	<b>6.6</b>	<b>6.5</b>	<b>20.5</b>
<b>Food products</b>	<b>3.9</b>	<b>7.5</b>	<b>7.3</b>	<b>19.8</b>
Grains and legumes	-8.0	-7.0	3.2	-11.7
Butter	6.6	3.0	18.6	30.2
Vegetable oil	4.6	3.4	-3	4.9
Pasta	3.4	7.6	4.7	16.5
Milk and dairy products	6.3	4.4	13.1	25.5
Eggs	6.2	5.1	28.8	43.8
Bread and bakery	8.9	12.0	8.0	31.7
Meat and poultry	9.2	8.3	-3	14.7
Fish and shellfish	10.3	1.9	7.6	20.9
Fruit and vegetables	-24.7	11.0	9.3	-8.6
Alcoholic beverages	8.4	12.1	14.6	39.3
<b>Non-food products</b>	<b>6.7</b>	<b>5.2</b>	<b>4.5</b>	<b>17.3</b>
Construction materials	7.9	5.1	2.5	16.2
Petrol	14.9	6.8	5.7	29.7
Tobacco products	21.1	22.6	29.3	92.0
<b>Services</b>	<b>8.7</b>	<b>7.3</b>	<b>8.0</b>	<b>26.0</b>
Housing and utility services	11.7	9.4	9.8	34.2
Early childhood education services	11.3	6.4	9.9	30.1
Recreation and health services	9.0	5.9	5.7	22.0
Passenger transport services	9.1	6.9	8.9	27.0
Culture organisation services	11.3	8.8	10.5	33.8

\* Inflation for 2011-2013.

Source: Rosstat.

To end this section we compare the growth rates in prices for consumer goods in Russia and the other CIS countries (Table 4).

Table 4

**Dynamics of consumer price indices in CIS countries in 2011-2013,  
% per annum**

	2011	2012	2013*	2011-2013**
<b>CIS countries</b>				
Azerbaijan	8	1	1.7	10.9
Armenia	8	3	4.5	16.2
Belarus	53	59	13.8	176.8
Kazakhstan	8	5	4.2	18.2
Kirgizia	17	3	2.9	24.0
Moldavia	8	5	4.4	18.4
Russia	8	5	5.95	20.1
Tajikistan	13	6	3.35	23.8
Ukraine	8	0.6	0.0	8.6
<b>Developed countries</b>				
Germany	2.1	2.0	1.3	5.5
France	2.1	2.0	0.7	4.9
USA	3.2	2.1	1.2	6.6
Netherlands	2.3	2.5	1.5	6.4

\*Data for January-November.

\*\* Inflation for 2011-2013

Source: Interstate Statistical Committee of the CIS (<http://www.cisstat.com/>), OECD database (<http://stats.oecd.org/>).

For the period from January to November 2013 Russia was in second place after Belarus among the CIS countries by growth rates in consumer prices. Based on the results of the 11 months, Ukraine saw a zero level of inflation. Inflation in Russia from January to November 2013 increased 2.5-8.5 times compared with the value for the developed countries (*Table 4*). Thus, inflation in the RF continues to remain relatively high, both in comparison with developed countries and emerging economies.

In 2014 factors restraining inflation could be a slowdown of economic activities, moderate growth of monetary supply, the favourable situation with grains and legumes in 2013, improvements in the worlds agricultural market. Factors which could potentially accelerate inflation in 2014 include a possible continuation of ruble depreciation and the effect of the transfer of the exchange rate into prices, the consequences of the depression in fruit and vegetables yield in 2013 and further increase in excise duties.

In general, the prospects for achieving the inflation target level (5%) in 2014 seem realistic, taking into account the current trends in the Russian economy and modifications of the interest rate policy of the Bank of Russia (the introduction of a key interest rate as a main instrument of the monetary policy, under the conditions of inflation targeting and completion of the interest rate corridor aimed at reducing the volatility of short-term interest rates in the interbank market).

A decision on the “freezing” of tariffs for the services of legal entities having natural monopolies and the use of a decreasing coefficient for the indexation of regulated prices and tariffs for the population in 2014 will also facilitate achievement of the inflation target.

### 2.1.3. Key measures in the sphere of monetary and FX policy

In 2013 under the condition of a gradual transition to inflation targeting, the Bank of Russia made a number of important decisions in the area of improving the system of its interest rate instruments and an increase in the flexibility of its exchange-rate regime.

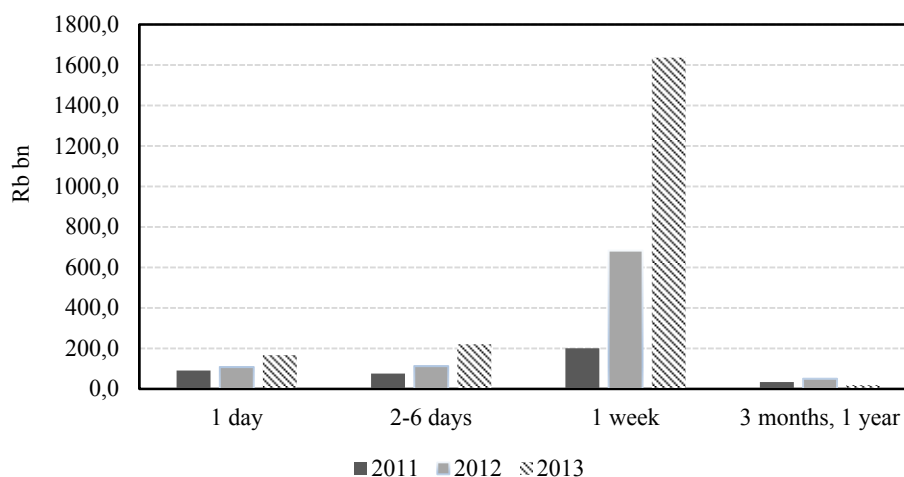
#### ***Decisions in the field of the monetary policy***

The most important decision made by the Bank of Russia in 2013 was the introduction of a key interest rate by unification of the interest rates on operations and the provision of liquidity absorption through an auction for the period of 1 week (5.50% per annum as of 13 September 2013). At the same time, the Bank of Russia completed the formation of the interest rate corridor. Interest rates on continuous transactions of the Bank of Russia for absorbance and provision of liquidity for 1 day constitute, respectively, the lower (4.5% per annum as of 13 September 2013) and upper (6.5% per annum as of 13 September 2013) limits of the interest rate corridor symmetrically in respect to the key interest rate (*Fig. 5*).

The choice of a key interest rate seems reasonable because the main source of attraction of liquidity for credit institutions on the part of the Bank of Russia are auctions for the period of one week (average value for January-December 2013 Rb 1.6 trillion), with indebtedness on overnight auctions (average value for January-December 2013 Rb 0.2 trillion) and long-term auctions (3, 12 months) being considerably lower than on weekly auctions (*Fig. 8*).

The regulator intends to use the key interest rate as the main indicator of the direction of the monetary policy. The Bank of Russia officially recognised the secondary part of the refinancing rate. From 1 January 2016 the refinancing rate will be adjusted to the level of the key interest rate, which will enable an increase in the transparency of the monetary policy, not only for economic agents within the country, but also abroad, increasing investors' trust in

signals from the Bank of Russia. Under the conditions of the inflation targeting regime, the main instrument of the monetary policy is the interest rate affecting the volume of loans, money supply and other macroeconomic indicators. Any change in the key rate may serve for economic agents as a potential signal of softening or toughening of the monetary policy directly affecting their expectations.



*Fig. 8. Average debt of commercial banks to the Bank of Russia on repo transactions of different terms in 2011-2013*

On 12 July 2013 the Bank of Russia announced the introduction of a new instrument of refinancing the banking system – auctions for the provision of loans secured by non-market assets or guarantees for a 12-month term. The introduction of the new instrument was aimed, not at the growth in the volume of refinancing, but at its redistribution in favour of instruments with longer terms. The minimum interest rate under the new refinancing instrument was 5.75% per annum, which is 0.25 p.p. higher than on direct repo auctions for a 1-day term. Based on the results of the first auction, held in late July 2013, the volume of funds loaned was Rb 306.8bn with the maximum allotment being Rb 500bn. One-year loans at the minimum interest rate of 5.75% were issued to the 31 borrowers which participated in the auction. The low level of interest in this new instrument of the Bank of Russia can be explained on technical grounds, since not all the banks willing to participate in the auction have received the regulator’s approval. Another, and, in our opinion, more important reason for the low demand for the auction held, is that most banks lacked collateral of the required term (12 months) and the high alternative costs of the reduction of the collateral value of relevant credit institutions (lost opportunity to obtain short-term loans due to the deficit of available collateral value). We should note that the second of such auctions with the Rb 500bn limit that had been planned for 13 January 2014, did not take place due to an insufficient number of applications.

On 13 September the Bank of Russia announced a reduction of interest rates on overnight loans, and loans secured by non-market assets or guarantees for a 1-day term, to 6.50% per annum and the increase of the maximum interest rate on deposit transactions on an auction basis for 1-week period to 5.50% per annum. Interest rates on the remaining operations of the Bank of Russia and refinancing rates remained unchanged.

The Bank of Russia plans gradually to increase the average terms of liquidity provision, using overnight instruments only in emergency situations. In particular, from February 2014 onwards auction transactions for 1-day terms and transactions with fixed rates for a term longer than 1 day will cease. However, if necessary, the Bank of Russia will use point repo transactions on an auction basis for terms from 1 to 6 days. The regulator points out that interbank lending should start playing a major part in the redistribution of liquidity amongst market participants. Let us consider these measures in more detail.

Firstly, the reduction in the number of short-term transactions in the open market (up to 7 days) may result in decreased control over interest rates. As seen from the practice of developed countries, the regulation of interest rates on overnight interbank loans is possible precisely through one-day maturity repo transactions. The absence of this instrument may result in an increase in interest rates on short-term interbank loans and an increase in their volatility. The cancellation of auctions with fixed rates may also cause interbank loan interest rates to increase, because auctions with a floating interest rate are not limited to any maximum value.

Secondly, we should note that the interbank lending market in the RF is highly concentrated: as of 1 January 2014 the 10 largest market participants accounted for 71%, 20 commercial banks — for 83% and 50 banks — for 96% of the debt to credit institutions, the total amount of which was Rb 2.6 trillion<sup>1</sup>. This means that the major proportion of small banks have very limited access to the interbank lending market.

We should note that an improvement to the system of refinancing instruments of the Bank of Russia is a necessary but not a sufficient condition for further development of the interbank lending market. To that end, measures must be taken to reduce the concentration of the interbank lending market.

However, in the mid-run, an increase in terms of liquidity provision by the regulator may incentivise credit institutions to carry out effective management of liquid assets, which, in the end, will create conditions for a reduction of the volatility of interest rates in the interbank market. At the same time, the formation of “long money” in any economy is not the central bank’s task but that of the entire fiscal system. Hence, issues relating to increasing the depth of the financial sector and the development of the institutional environment, remain relevant for the Russian economy.

In October 2013 the system of monetary policy instruments was supplemented by auctions for the provision of loans secured by non-market assets for a 3-month term with a floating interest rate. We should note that the results of this auction, held in October 2013, showed a high demand for this instrument of the Bank of Russia (the demand was Rb 563bn with a Rb 500bn limit). The benefits of a three-month repo secured by non-market assets are due to a lower floating rate compared to auctions with a fixed rate, and to one-year auctions with floating rate, secured by non-market assets. Participation in a three-month auction, in contrast to an equivalent one-year auction, enables banks to increase their available collateral value and to facilitate the provision of collateral of the required term.

In order to mitigate the shortage of liquidity for individual credit institutions, the Bank of Russia will continue to perform auction based transactions using not only securities but also other types of assets, including non-market ones. However, under the conditions of gradual reduction in the capacity to provide liquidity to banks and which is secured by collateral of proper quality, the Bank of Russia plans an active use of the purchase and sale of assets

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<sup>1</sup> According to data of the Centre of Structural Research of Ye.T. Gaidat IEP.

(securities, gold, foreign currency) as an additional instrument of liquidity regulation. A higher diversity of the regulator's mechanisms for liquidity provision may facilitate stabilisation of the liquidity situation in the banking sector.

Among innovations adopted by the Bank of Russia at the meeting of the Board of Directors held on 13 September 2013, we should note the establishment of a target inflation level as a point, not an interval range, which potentially enables the Bank of Russia to transfer a strong signal regarding its target priorities to economic agents. The Guidelines for the Monetary Policy for 2014-2016 specify that the target change in consumer prices will be 5% in 2014, 4.5% in 2015 and 4% in 2016. However, in the case of unforeseen factors, the limits of tolerance of inflation upwards and downwards from the target value were established at the level of 1.5 p.p. In our opinion, taking into account the current trends in the Russian economy, the inflation range of 3.5-6.5% covers almost all possible scenarios in the next year. In other words, in the absence of global shocks, inflation will remain within this range with almost any course of the monetary policy of the Bank of Russia. We should note that, in 2012, 41% of countries applying inflation targeting used levels of tolerance  $\pm 1$  p.p., 18% of countries were oriented on point values, 11% of countries applied the range  $\pm 1.5$  p.p. and the remaining countries were characterised by a larger range or interval approach to the establishment target inflation values<sup>1</sup>. We assume that the targeting interval in the Russian conditions should be narrower than  $\pm 1.5$  p.p., or the Guidelines should specify in more detail the actions of the Bank of Russia in the case of any notable deviation of the actual inflation value from the centre of the established interval.

In general, this last modification of the system of instruments of monetary policy will facilitate improvement of the functioning of the non-money market, increased control over interest rates, and the mitigation of inflation risks. The created interest rate corridor which, in prospect, can improve the predictability of interest rates in the money market will contribute to the workability of the interest channel. The use of target inflation values with narrower fluctuation ranges, acceptable for the regulator, and an explanation to economic agents of the peculiarities of the application of the instruments of the monetary policy in the mid-term, will increase their trust and stabilise expectations related to interest rates in the money market, which, in turn, will improve the operation of the entire transmission mechanism of the monetary policy.

### ***Decisions in the field of FX policy***

In 2013 the Bank of Russia proposed to improve the mechanism of the exchange-rate policy. All decisions made in the field of the FX policy were aimed at increasing the flexibility of the exchange-rate regime under the conditions of transmission to inflating targeting.

Within the framework of implementation of the exchange-rate policy the Bank of Russia used, as an operational landmark, the ruble cost of the dual currency basket consisting of 45 eurocents and 55 US cents. The range of values of the ruble cost of the dual currency basket acceptable for the Bank of Russia is established as a floating operational band, the boundaries of which are adjusted depending on the amount of FX interventions performed. Since 24 July 2012 the width of the interval has been 7 rubles. On 9 September 2013 the Board of Directors of the Bank of Russia passed a resolution on decreasing the amount of

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<sup>1</sup> D. Hammond. Practice of Inflation Targeting - 2012 // Bank of England. Centre for Central Banking Studies. Guideline 29. 2012.

accumulated interventions resulting in an automatic movement of the boundaries of the operational band by 5 kopeks, to \$400m instead of the \$450m approved in the middle of 2012. From 10 December 2013 the accumulated amount of sale (purchase) of foreign currency by the Bank of Russia resulting in adjustment was again decreased, this time to \$350m.

From 1 October 2013 the Bank of Russia has performed adjustment of the exchange-rate policy mechanism. According to this adjustment, the parameters of the Bank of Russia FX sale and purchase operations in the domestic foreign exchange market are determined by taking account of the Federal Treasury operations for the accumulation or expenditure of funds of the Reserve Fund and National Wealth Fund. In particular, the amounts of the Bank of Russia FX operations on the domestic market, aimed at smoothing the rouble exchange rate volatility, may be increased or decreased by an amount equal to the Federal Treasury FX purchases (sales) with the Bank of Russia, related to the accumulation (expenditure) of sovereign funds in foreign currencies. Such an adjustment will allow smoothing of the ruble exchange rate fluctuations and the maintenance of stability of the FX and money market during periods of Federal Treasury FX operations. In order to increase the transparency of the exchange-rate regime, preliminary information on the volume and date of the performance by the Federal Treasury of its FX operations will be posted on its official website.

We should remember that, in order to smooth the ruble exchange rate volatility, the floating operational band is split into internal intervals, for each of which a particular amount of intervention is established (in \$ mn per day). In the central part of the floating operational band a “neutral” range is outlined, within which the Bank of Russia does not perform FX interventions aimed at smoothing the ruble exchange rate volatility. In 2013 the operational band of the cost of the dual currency basket in which the Bank of Russia performs FX interventions, was supplemented by an inner “technical” range. As in the neutral range, in the technical range the regulator will not implement any FX interventions, including those related to the Federal Treasury operations for the management of sovereign funds. As a result of the introduction of the “technical corridor” the range in which Russian ruble exchange rate is formed only by market factors, was expanded by Rb 0.1. Additionally, on 7 October 2013 the Bank of Russia performed a symmetrical expansion (from 1 to 3 rubles) of the “neutral” range of the floating operational band of acceptable cost of the dual currency basket. Thus, the FX corridor within which the Bank of Russia does not influence the dynamics of the Russian ruble exchange rate was increased to Rb 3.1 in 2013.

Important parameters in calculating the amount of operations performed by the Bank of Russia in the FX market, which causes movement of the boundaries of the operational band, are the target interventions. Implementation of target interventions is aimed mainly at neutralisation of the expectations of economic agents for ruble exchange rate fluctuations formed under the influence of existing foreign economic conditions. From 21 October 2013 onwards, the Bank of Russia reduced the amount of target FX interventions to \$60m per day whilst in September average daily FX sales amounted to \$104.3m and over 7m euro. This adjustment will result in an increased sensitivity of the boundaries of the operational band of the dual currency basket to the amount of interventions implemented by the Bank of Russia and aimed at smoothing excessive volatility of the ruble exchange rate. These changes, all other conditions being equal, will ensure a reduction of the direct presence of the Bank of Russia in the domestic FX market. From 1 January to 31 December 2013 the boundaries of the floating corridor of the dual currency basket changed 31 times. For example, on

31 December 2013 the boundaries of the corridor of the dual currency basket cost were Rb 33.05-40.05, while, as early as in the beginning of January 2013, their level was Rb 31.65-38.65. For comparison, in 2012 the boundaries of the operational corridor changed only 11 times from Rb 32.2-38.2 to Rb 31.65-38.65.

We should note that gradual increase in flexibility of the exchange-rate regime, and in the sensitivity of the boundaries of the operational corridor to the amount of interventions implemented by the regulator, create conditions for the adaptation of economic agents to exchange rate fluctuations and their learning to use the instruments of FX risk management. Given the above, the intention of the Bank of Russia, to retain the right to perform point operations in the FX market in order to maintain financial stability in the case of any external shock, seems reasonable, and is associated with the considerable dependence of the situation in the Russian economy on the world prices for energy resources and the high sensitivity of the condition of the capital account to the foreign economic and political environment.

#### 2.1.4. Balance of payments and ruble exchange rate

In January-December 2013 unfavourable external conditions in the world's raw materials markets had a considerable impact on the formation of the balance of payments in the RF. The reduction in demand for raw material resources was driven, among other things, by the low growth rates of emerging economies and the implementation of budgetary policy measures by the governments of a number of developed countries. A substantial decrease in the current account balance and an outflow of funds from the financial account resulted in a reduction in the international reserves of the Bank of Russia, and in depreciation of the ruble. As was mentioned above, in 2013 the Bank of Russia, despite to its transition to the inflation targeting regime, increased its presence in the FX market. Based on the results of the 12 months of 2013 the net capital outflow from the country exceeded the 2012 figure, which reflects a high-risk assessment of investing in the Russian economy.

In accordance with the preliminary estimate of the RF balance of payments for January-December 2013 published by the Bank of Russia, the positive balance of the current account was \$33.0bn, having decreased by 54% compared to 2012 (*Table 5*). The positive trade balance decreased by 7.8% (from \$192.3bn to \$177.3bn), with the export of goods decreasing by 1.2% (c \$528bn to \$522bn) and the import of goods increasing by 2.6% (from \$335.7bn to \$344.3bn). The share of export of oil, oil products and natural gas was 66.9% of total exports, having increased by 1.2 p.p. compared to the corresponding period of 2012, despite an observed reduction in oil prices in 2013, on average by 2.8% to \$108.8/barrel (*Fig. 9*).

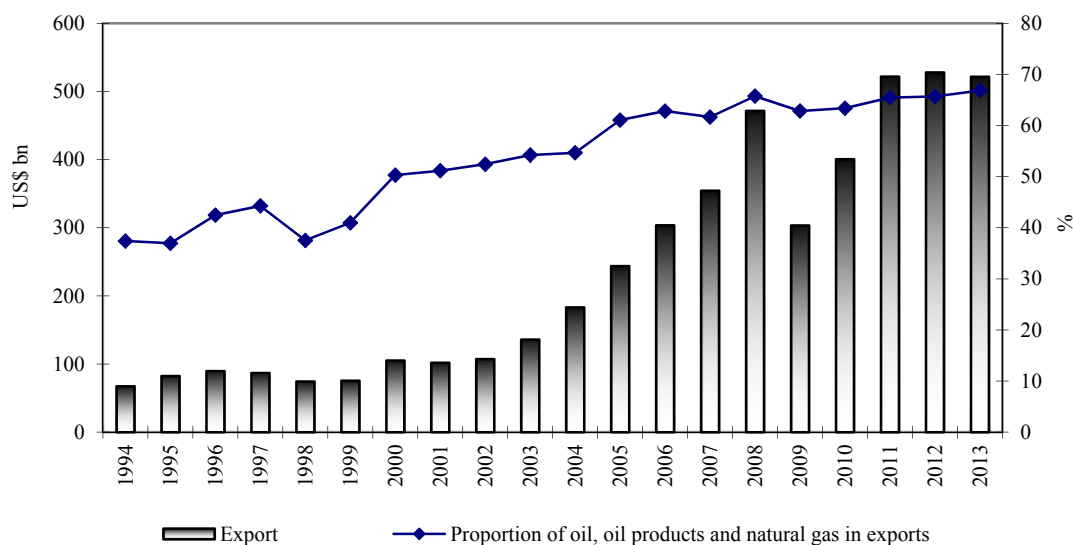
In the 2000s the main factor determining the current account balance in the Russian economy was the trade balance, which, in turn, depended on price fluctuations for hydrocarbons. This tendency continued in 2013 (see *Fig. 10*).

The services balance deficit in 2013 reached \$59.0bn and grew (in absolute terms) by 26.9% compared to the corresponding period of 2012. Services export was \$69.9bn, having increased by \$7.6bn (+12.2%) compared to the preceding year. Services import for the 12 months of 2013 exceeded the corresponding 2012 figure by 18.6% and reached \$129bn, and was primarily associated with the increased expenditure of Russian citizens on international travel. The balance of compensation of employees in January-December 2013 remained almost unchanged, amounting to \$-11.9bn (in 2012 it was \$-11.8 bn). The investment income balance deficit in 2013 compared to 2012 increased by 16.5%, having reached \$66.2bn. Receivable investment income has dropped by 2.8% from \$42.8bn to



\$41.6bn. Income payable to non-financial institutions has increased by 4.6% to \$86.2bn and to banks – by 23% to \$18bn, which determined a growth of total income payable by 8.2% to \$107.8bn. Rent balance<sup>1</sup> for 2013 was \$+0.9bn (\$+1bn in 2012). Based on the results of the 12 months of 2013 secondary income balance<sup>2</sup> was \$(-8.1)bn (in 2012 \$(-6.1)bn) and capital transfer balance was \$(-0.4)bn, (in 2012 – \$(-5.2)bn).

Thus, more than two-fold reduction of the current account surplus in 2013 was not only due to a decrease in trade balance but also to an increase in the deficit of services balance and the balance of primary and secondary incomes.



Source: Bank of Russia.

*Fig. 9. Dynamics of export of goods and the proportion of fuel and energy products in 1994-2013*

In 2013 the financial account deficit was \$-43.0bn (\$-26.5bn in 2012). The increase in the financial account deficit was associated with the outrunning growth of foreign assets against liabilities. The growth of liabilities of Russian economic agents to foreign economic agents based on the results of the 12 months of 2013 was \$141bn, which is 52.6% higher than in the preceding year (\$92.4bn). The external liabilities of federal administration bodies increased by \$11.3bn in 2013. Considerable money inflow in the state administration sector is associated with the acquisition by non-residents of Eurobonds issued by the Ministry of Finance of Russia. The external liabilities of constituent entities of the RF were \$0.2bn. The increase in liabilities of monetary authorities in 2012 was less than \$0.3bn. The liabilities of the banking

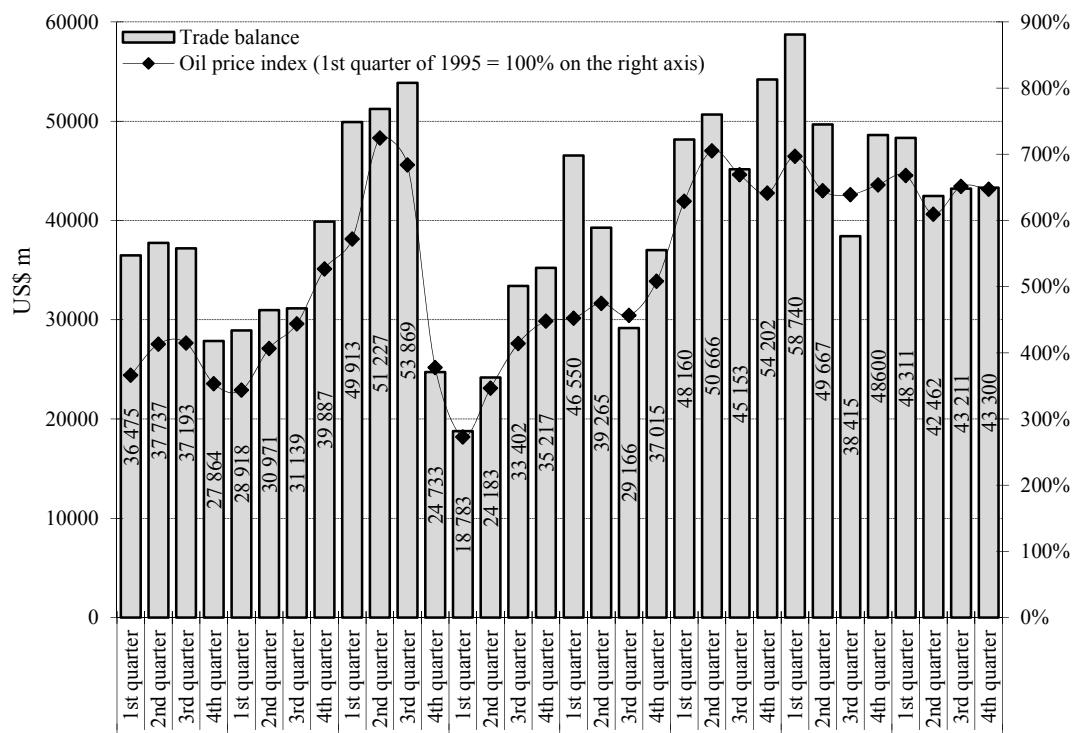
<sup>1</sup> Rent is income receivable for the provision of natural resources and the rights to dispose of any other institutional unit. Rent includes, for example, amounts payable for land use, mineral extraction, fishing rights, forest rights and rights of pasture.

<sup>2</sup> Formerly, current transfer balance. According to the Bank of Russia, current transfers increase the level of available income and consumption of goods and services of the recipient or decrease the available income and potential consumption opportunities of the donor, for example, humanitarian aid in the form of consumer goods and services. Transfers that are not current are, by definition, capital transfers. Capital transfers result in a change in the amount of assets and liabilities of the donor and recipient and are reflected in the capital account. If the donor and recipient are residents of different countries, capital transfer will result in a change in the level of national wealth of the economies which they represent.

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sector to non-residents grew by \$20.2bn in 2013, while in 2012 the banks' liabilities increased by \$33.3bn. The liabilities of other sectors to non-residents in January-December 2013 increased by \$109.4bn compared to \$+39.8bn in 2012, with direct investment in other sectors amounting to \$78.4bn compared to \$42.8bn in 2012. We should note that a considerable part of this amount is associated with the completion of the takeover of TNK-BP by Rosneft in the 1<sup>st</sup> quarter of 2013.



Source: Bank of Russia; EIA; calculations of the Ye.T.Gaidar IEP.

Fig. 10. Trade balance of the Russian Federation and world oil price index in 2006-2013

In 2013 the outflow of portfolio investments from the non-financial sector of the RF in the amount of \$11.3bn was observed (\$-8.1bn in the preceding year). The decrease in portfolio investments in the non-financial sector of the RF illustrates the insufficient attractiveness of investments in it in terms of the risk-return ratio. The amount of loans and credits provided by non-residents grew in 2013 by \$42.4bn compared to \$+6.7bn in 2012.

The foreign assets of residents (the liabilities of economic agents to Russian economic agents) increased by \$184bn for the 12 months of 2013 (by \$118.9bn in 2012). At the same time, the foreign assets of monetary authorities increased by \$4.1bn (decrease by \$0.4bn in 2012). The foreign assets of the banking sector increased by \$26.3bn in 2013 (\$14.8bn in 2012). Capital withdrawal from other sectors compared to 2012 increased by 47.5%, amounting to \$154.1bn. Of this amount, \$97.4bn stood for direct and portfolio investments abroad (\$53.1bn more than in 2012).

The external debt of the RF increased by 15% in 2013 and as of 1 January 2014 was \$732bn. We should note that in 2013 the growth rates of external debt in the private sector continued accelerating (Table 5). Whilst in 2011 the external debt of banks and the non-

financial sector grew by \$58.4bn, in 2012 their debt grew by \$73.8bn and in 2013 – by \$86.4bn. The State external debt increased by \$9bn \$ in 2013, which is considerably less than in 2012 (\$19.7bn). In December 2013 Russia repaid its state external debt to the Czech republic, Finland and Montenegro in the total amount of \$3.6bn, almost entirely clearing “Soviet” debt, and forgave Cuban debt in the amount of \$29bn. In the mid-run we can expect continuing growth of both private and state external debt due to the lack and high cost of financial resources in the country and a deficit of the RF state budget.

*Table 5*

**Main items of the balance of payments and dynamics  
of external debt in 2011-2013 (\$ bn)**

Indicator	2011					2012					2013				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Current and capital account balance	29.8	22.9	17.6	27.1	97.4	34.7	16.1	5.6	10.3	66.8	25.1	2.6	0.4	4.6	32.6
Financial account (excluding reserve assets)**	-17.3	-7.4	-19.0	-32.4	-76.1	-24.8	0.8	-4.0	1.6	-26.5	-12.8	-8.8	-6.6	-14.8	-43.0
Change in FX reserves ('+' – decrease, '-' – increase in reserves)	-10.1	-12.9	1.8	8.6	-12.6	-4.6	-15.0	-1.5	-8.9	-30.0	-4.9	4.4	7.4	15.2	22.1
Net errors and omissions	-2.4	-2.7	0.3	-3.3	-8.7	-5.3	-2.0	-0.1	-2.9	-10.3	-7.3	1.8	-1.2	-5.0	-11.7
Change in external debt of the RF ('+' – increase, '-' – decrease in debt)	20.7	29.2	-11.1	17.4	56.2	18.6	13.1	28.3	37.5	97.6	53.8	15.9	8.0	17.8	95.6
Change in state external debt of the RF	1.3	0.0	-2.7	-0.8	-2.1	1.7	5.1	5.0	7.9	19.7	3.1	-1.5	6.7	0.8	9.0
Change in private external debt of the RF	19.4	29.2	-8.4	18.1	58.4	16.5	8.0	21.7	27.6	73.8	46.8	18.1	2.8	18.6	86.4

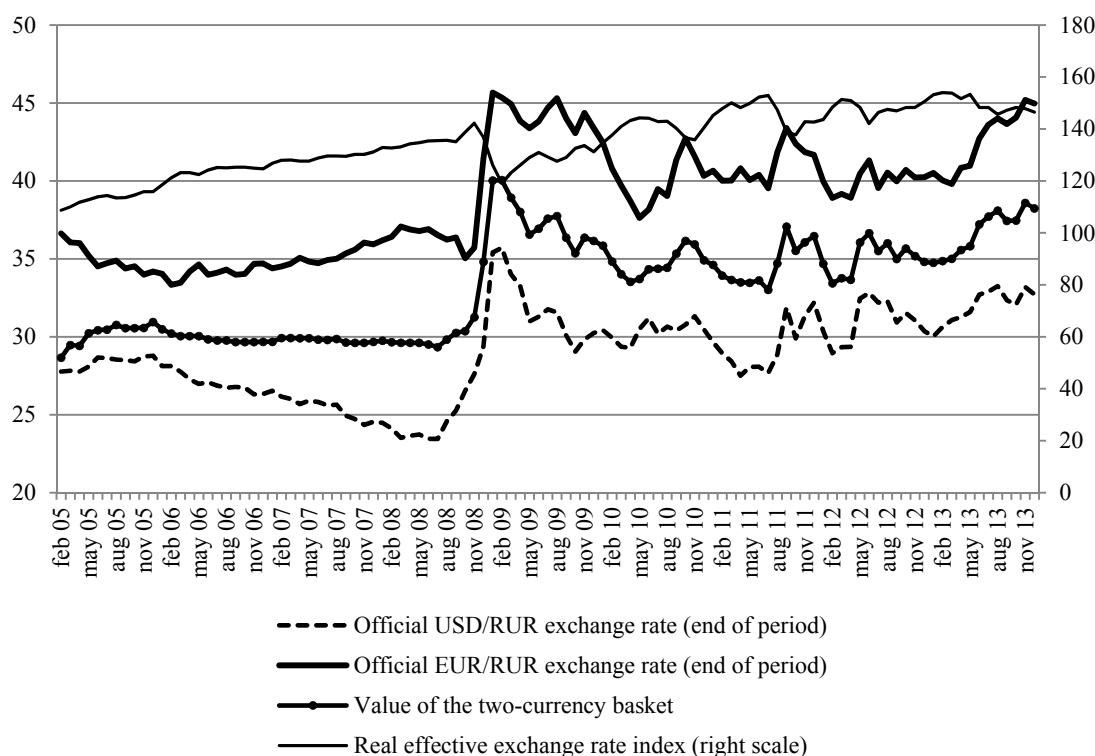
\* – preliminary estimate; \*\* – excluding FX reserves.

Source: Bank of Russia.

The dynamics of the ruble exchange rate in 2013 were similar to those of emerging countries. The tendency of ruble weakening against the main world currencies that had started forming in the second quarter of 2013 continued in the third and fourth quarters due to the substantial decrease in the trade balance of the Russian economy, capital outflow from the country and a reduction of investors' risk tolerance due to the expected wind-down of the Quantitative Easing Program by the Federal Reserve System of the USA (US FRS) before the end of the year. Some ruble strengthening in nominal values at the end of the 3<sup>rd</sup> quarter of 2013 was partially due to FX interventions implemented by the Bank of Russia and the unfavourable geopolitical situation in the Middle East resulting in a rise in oil prices.

Owing to a certain decrease in prices for major Russian export commodities and moderate inflation in the RF the real effective ruble exchange rate decreased by 2.7% based on the results of 2013 (in 2012 a strengthening of 5.3% was recorded) (*Fig. 11*). The official USD to

RUB exchange rate in January-December 2013 increased by Rb 2,31: at the end of December the USD exchange rate was Rb 32.7 compared to Rb 30.4 as of 31 December 2012. The EUR to RUB exchange rate at the end of December was Rb 44.9, having increased by Rb 4.74 for the year. As a result, ruble depreciation against the dual currency basket was observed: the cost of the dual currency basket increased by Rb 3.43 (from Rb 34.8 to Rb 38.2) during the same period.



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

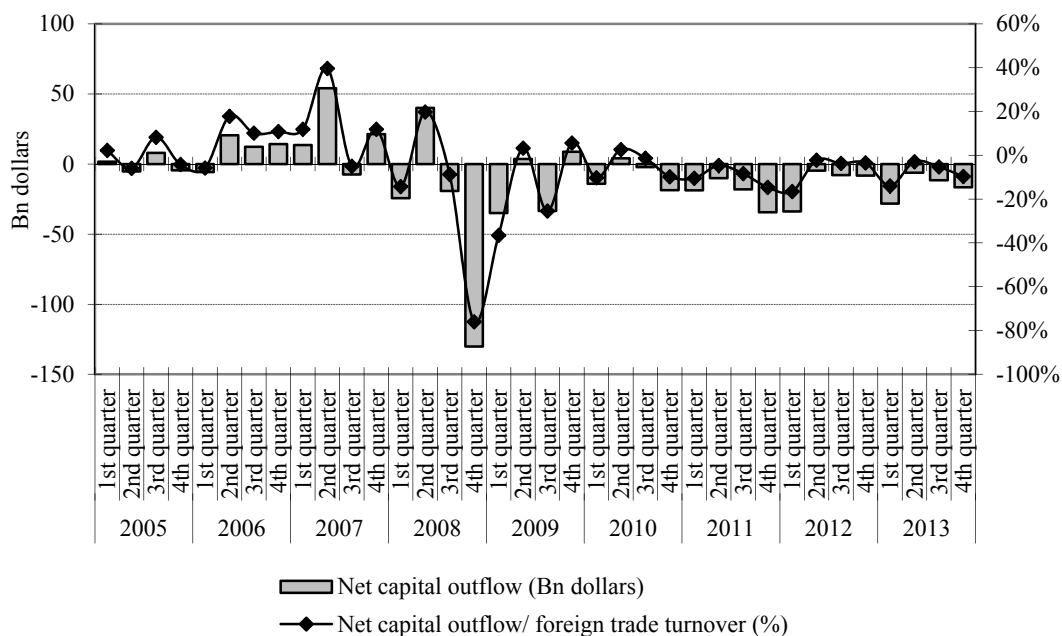
Fig. 11. Ruble exchange rates in the period from January 2005 to December 2013

According to preliminary estimates of the Bank of Russia, one of the critical tendencies in dynamics of the balance of payments figures in 2013 was the dynamics of a net flow of capital from the financial sector, which was \$64.7bn (\$10.1bn more than for the 12 months 2012). Capital outflow was observed during almost entire year, with the exception of June, when a net capital import by the private sector in the amount of \$9.6bn was observed.

For the period from January to December 2013 the net capital income by banks had reached \$5.2bn and by the private non-financial sector – \$59.7bn.

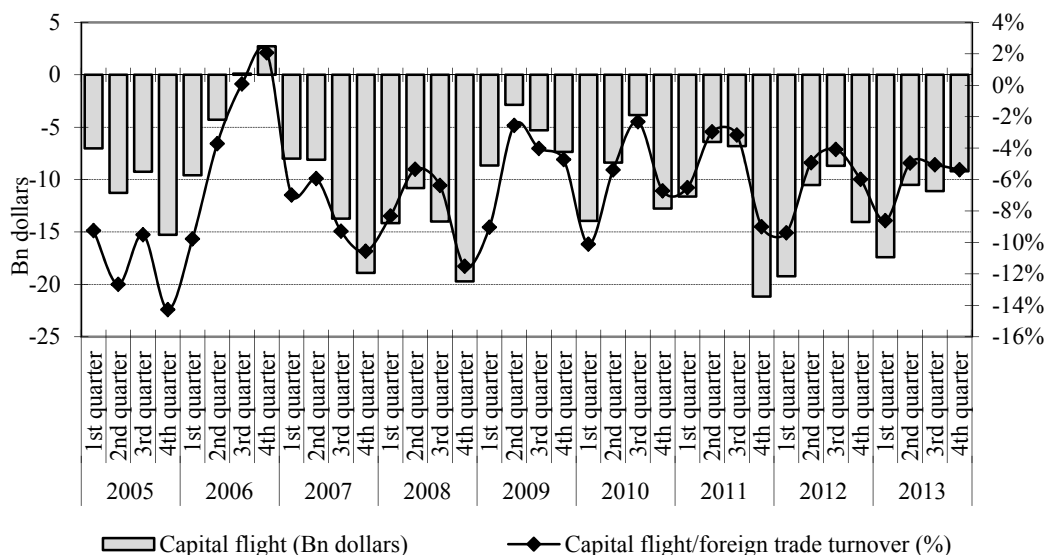
We should note that under the conditions of the unstable global and Russian economic situation, the high dependence of the Russian economy on the export of energy resources and the poor quality of the institutional environment, it is extremely difficult to achieve an increase in investments in the RF by non-residents or a reduction of the outflow of residents’ funds abroad. As was noted before, one of the drivers of capital outflow from emerging markets in 2013 were the expectations of investors regarding the intentions of the US FRS to wind down the Quantitative Easing Program.

The increased capital outflow in 2013 was also associated with the continuing high level of the so-called “capital flight”<sup>1</sup>. Based on the results of 2013 capital flight (see Fig. 12) was, according to our estimates, \$48.2bn (\$52.5bn in 2012) (Fig. 13).



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

Fig. 12. Dynamics of net capital outflow in 2005-2013



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

Fig. 13. Dynamics of capital flight in 2005-2013

<sup>1</sup> Capital flight was calculated by us using the IMF methodology and represents the sum of “trade credit and advances”, “non-receipt of export earnings and goods and services paid but not received under import contracts” and “net errors and omissions”.

We should note that further the prospects of the RF balance of payments are quite ambiguous. On the one hand, it is possible that the tendency towards a decrease in the current account balance that started forming in 2013 will continue in the mid-term. A possible decline in oil prices driven by the slowdown of economic growth in a number of countries that are the main consumers of raw materials, including China; the uncertain prospects for the global economy; a winding down the Quantitative Easing Program by US FRS; and a lower risk tolerance by investors will become the factors having a negative impact on the state of the balance of payments of the RF. On the other hand, a possible decline in the ruble nominal exchange rate will help to increase the trade balance surplus. However, in general, one should hardly expect any considerable improvement in the state of the Russian balance of payments in 2014.

## **2.2. State budget**

In order to mitigate the influence of external factors, the federal budget for 2013, and for the period 2014-2015, had initially been formulated on the basis of budgetary rules aimed at decreasing the influence on it of the volatility of prices within the world market for energy resources. The aim was also to improve the accuracy of the long-term forecasting of revenues and expenditures within the budgetary system. However, in planning the main parameters of the federal budget, the possible changes in domestic factors related to social and economic development were underestimated; it was assumed that the key risks affecting the stability of the fiscal system would be created principally by external circumstances, such as the conditions in the world economy and hydrocarbon prices.

In 2013 the main cause of the reduction in budgetary revenues by 1.0% of GDP, as compared with the previous year, was not the decline in market-determined oil prices on the world markets, but the deterioration of the Russian economy<sup>1</sup>. The shortage of non-oil-and-gas revenues to the federal budget were offset by the growth of oil and gas revenues which exceeded the forecasts and helped to keep the federal budget deficit at the low level of 0.5% of GDP (which was lower than the planned level of 0.8% of GDP) but only due to the reduced transfers to the Reserve Fund. With the difference between the actual average annual price for Urals oil in 2013 (\$107.9 per barrel) and the base price used in formulating the budget within the framework of the fiscal rules (\$91 per barrel), the amount of additional oil and gas revenues planned for transfer to the Reserve Fund in 2013 was estimated at Rb 1 trillion. However, based on the results of last year, only Rb 212.2bn of oil and gas revenues will be transferred to the Reserve Fund. Thus, although the actual share of oil and gas revenues within the federal budget did decrease slightly from 51.2% in 2012 to 50.8% in 2013, the considerable, originally planned change in budget structure, towards non-oil-and-gas revenues, did not take place.

It is also important to note that the increasing tension in budget implementation in 2013 exacerbated the problems related to imperfections in the state forecasting system, which, amongst other things, is supposed to ensure the reliability of budgetary revenue predictions. The first signs of a slowdown in the Russian economy appeared already in the second half of 2012, when federal budget tax revenues and the consolidated budgets of the constituent entities of the Russian Federation, in terms of GDP, began to decrease, compared with 2011<sup>2</sup>. However, in autumn 2012 the Russian Ministry of Economic Development presented a

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<sup>1</sup> For more information on this topic, see other sections of this work.

<sup>2</sup> See IEP's Monthly Overview "State Budget", August-November 2012.

forecast of social and economic development for the Russian Federation for 2013, pursuant to which GDP growth in 2013, according to the moderately optimistic scenario of development, was expected at a level of 3.7%. The ‘Guidelines for Budgetary Policy for 2013 and the Planning Period of 2014-2015’ also predicted an acceleration of growth rates: from 3.8% in 2013 to 4.7% in 2015. In 2013 the Ministry of Economic Development had to review its economic forecasts three times towards a considerable deterioration; and as a result, the expected GDP growth rates declared in December 2013 turned out to be substantially lower than the initial predictions: 1.4% versus 3.7% whilst the initial estimate by Rosstat (Federal State Statistics Service) had been 1.3%.

The manifest tendency towards stagnation of the Russian economy, combined with such factors as the lack of completeness of reforms in the budgetary, housing and utilities sectors, etc. evidences that the next few years may be very difficult in terms of the long term fiscal sustainability of the system.

### 2.2.1. Key trends in the development of the budgetary system of the Russian Federation in 2013

In 2013 the revenues of the budget of the enlarged government were Rb 24,082.4bn (36.1% of GDP), with budgetary system expenditure at Rb 24,931.1bn (37.4% of GDP) while the budgetary deficit was Rb 848.7bn (1.3% of GDP). The five-year dynamics of the key parameters of the budget of the enlarged government, in terms of GDP, show a growth of revenues from 35.0% of GDP in 2009 to 37.2% of GDP in 2011, with a subsequent decrease to 37.1% of GDP in 2012 and 36.1% of GDP in 2013 (see *Table 6*). Initially budgetary expenditure in terms of GDP decreased (in 2010-2011) compared with the previous year, this being mainly due to curtailing of the anti-recession programmes, but then it started to grow, by 1 p.p. in 2012 and by 0.7 p.p. in 2013. Thus 2012 marked the beginning of a new trend towards increased government spending whilst revenues were shrinking, ultimately leading to the budgetary surplus being replaced by a deficit.

*Table 6*

#### Revenues and expenditures of the budgetary system in 2009-2012

	2013		2012		2011		2010		2009		Deviation as p.p. of GDP, 2013 from 2012
	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	
<b>Federal budget</b>											
Revenue	13,019.9	19.5	12,853.7	20.7	11,366.0	20.3	8,305.4	17.9	7,337.7	18.9	-1.2
Expenditure	13,342.9	20.0	12,890.7	20.7	10,935.2	19.5	10,117.5	21.8	9,660.9	24.9	-0.7
Deficit (-)/ Surplus (+)	-323.0	-0.5	-37.0	-0.06	430.8	0.77	-1,812.1	-3.9	-2,322.3	-6.0	-0.4
<b>Consolidated budget of constituent entities of the Russian Federation</b>											
Revenue	8,164.7	12.2	8,064.3	13.0	7,643.9	13.7	6,537.3	14.5	5,926.6	15.3	-0.8
Including inter-budget transfers	1,576.6	2.3	1,679.6	2.6	1,644.0	2.9	1,398.9	3.1	1,487.4	3.8	-0.3
Expenditure	8,806.7	13.2	8,342.7	13.4	7,679.3	13.7	6,636.9	14.7	6,255.7	16.1	-0.2
Deficit (-)/ Surplus (+)	-642.0	-1.0	-278.4	-0.5	-35.4	-0.06	-99.6	-0.2	-329.0	-0.8	-0.5
<b>Budget of the enlarged government</b>											
Revenue	24,082.4	36.1	23,088.7	37.1	20,853.7	37.2	15,715.9	33.9	13,420.7	34.6	-1.0
Expenditure	24,931.1	37.4	22,825.8	36.7	20,004.8	35.7	17,301.0	37.4	15,847.3	40.8	0.7
Deficit (-)/ Surplus (+)	-848.7	-1.3	262.9	0.4	848.9	1.5	-1,585.1	-3.4	-2,426.7	-6.3	-1.7
<i>For reference: GDP, Rb bn</i>	66,755		62,218		55,967		46,309		38,807		-

*Source:* Rosstat, Ministry of Finance of the Russian Federation, calculations by IEP.

In 2013, in terms of the levels within the budgetary system, the revenues of the federal budget and of the consolidated budgets of the constituent entities of the Russian Federation decreased by 1.2 and 0.8 p.p of GDP, respectively, compared with the levels of the previous year, while the corresponding expenditure levels decreased by 0.7 and 0.2 p.p. of GDP. Thus, a major reduction of expenditure occurred within the federal budget while revenues decreased considerably both at the federal and at the regional levels. The result was that the expenditure of the budget of the enlarged government grew from 36.7% to 37.4% of GDP, but this was solely due to expenditure from state non-budgetary funds, primarily, the Pension Fund.

The situation with the cash performance of the federal budget and consolidated budgets of the constituent entities in respect of expenditure remained practically unchanged in 2013, compared with the previous year: the federal budget performance in respect of expenditure was 99.1% (in 2012 it was 98.9%), while the consolidated budget of the constituent entities of the Russian Federation achieved 91.2% (in 2012 it was 90.8%) of the approved annual volumes.

In 2013 the budget deficit of the enlarged government was Rb 848.7bn, being 1.3% of GDP, which was Rb 585.8bn (or 1.7 p.p. of GDP) higher than the 2012 level. However, the deficit had increased both at the federal level (from 0.06 to 0.5% of GDP) and at the level of the constituent entities of the Russian Federation (from 0.5 to 1.0% of GDP). As a result, despite the fact that the deficit in the budgets was still quite a long way from being critical, at the regional level it had already reached a substantial value, based on the results of 2013, and this reflected the tension with the performance of the consolidated budgets of the constituent entities of the Russian Federation.

As of 1 January 2014 the volume of the Reserve Fund was Rb 2,859.7bn (4.3% of GDP) and the volume of the National Wealth Fund was Rb 2,900.6bn (4.3% of GDP). In 2013 the oil and gas revenues contributed to the Reserve Fund amounted to Rb 713.5bn. The exchange differences on revaluation of the funds in the accounts with the Bank Russia for January-December 2013 were Rb 260.5bn for the Reserve Fund, and Rb 216.0bn for the National Wealth Fund. In December 2013, based on a separate resolution of the Government of the RF, \$3.0bn of the National Wealth Fund was placed in the debt obligations of Ukraine, without requiring a long-term credit rating of the issuer.

In 2013 attempts were made to change the approaches to the management and use of sovereign funds, in particular, in respect of investing them in long-term projects. Before 2012 the practice of the accumulation of funds placed in debt obligations in the form of securities issued by foreign governments, or foreign government agencies and central banks, had been maintained in order to create a “safety cushion” for the Russian economy, the social sphere and the entire financial system (Reserve Fund) and to provide co-financing of individuals’ voluntary pension savings thereby ensuring the balance (deficit coverage) of the budget of the Pension Fund (National Wealth Fund). After the end of 2012 proposals were put forward to change the policy of saving in sovereign funds, and areas for the use of the relevant funds were announced. Initially it was expected that Rb 450bn would be used to finance 3 major investment projects: the modernisation and expansion of the Baikal-Amur Mainline and Trans-Siberian railway, the development of high speed rail lines between Moscow and Kazan and the construction of highways in the Moscow region. In the second half of 2013 other proposals for investing these funds started to be discussed, including the realisation of infrastructure projects using the Russian Direct Investment Fund (for the implementation of energy efficiency and information technology, the construction of sea ports, roads and



pipelines and the development of the Moscow air hub). However, none of the projects discussed at meetings of the Russian President or in Government has obtained any funding from the National Wealth Fund. In many respects this situation reflects the fact that the efficacy of investing funds in the proposed projects is still highly questionable. It is also important to understand that, with the further slowdown of Russian economic growth and the uncertain prospects of replenishing the revenue part of the federal budget, it is hardly appropriate to use sovereign funds to initiate large-scale investment projects, which, would then, perhaps, have to be frozen in the case of a sharp deterioration of the situation for replenishing the budget.

### 2.2.2. Analysis of the main tax receipts to the budgetary system of the Russian Federation

In 2013, tax revenue decreased by 1.1 p.p. of GDP, or by 1.8% in real terms compared with 2012 (see *Table 7*), which evidences the deterioration in replenishment of the revenue part of the Russian fiscal system.

*Table 7*

#### **Main tax receipts to the budget of the enlarged government of the Russian Federation in 2008-2013, % of GDP**

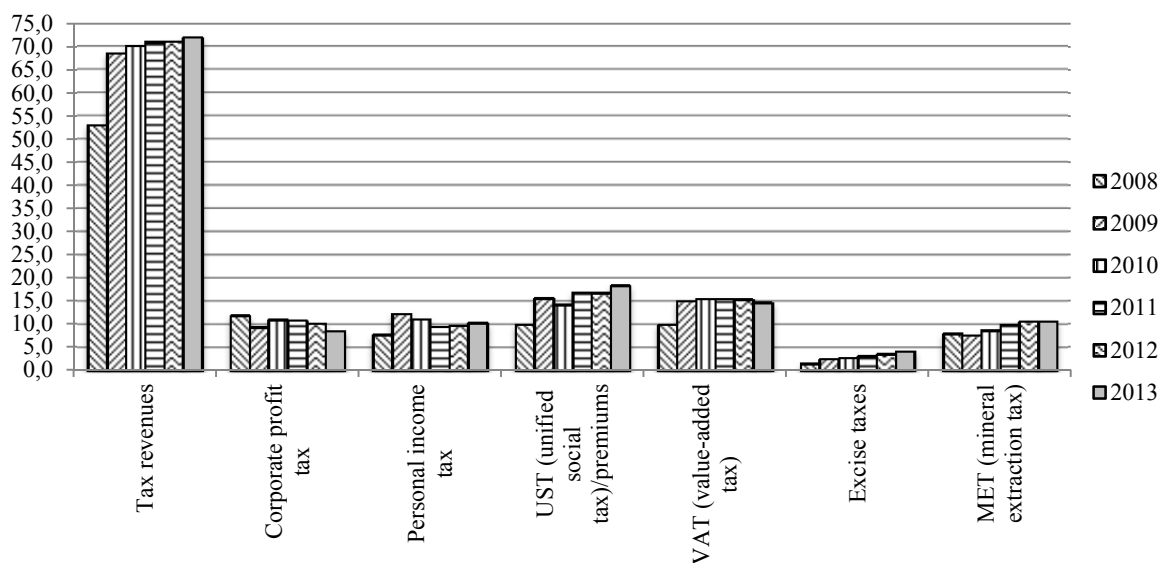
	2008	2009	2010	2011	2012	2013	Change in 2013 relative to 2012	
							as p.p. of GDP	real increase, %
<b>Tax burden</b>	35.7	30.8	31.1	34.9	34.6	33.5	-1.1	-1.8
Corporate profit tax	6.1	3.3	3.8	4.1	3.8	3.1	-0.7	-17.4
Personal income tax	4.0	4.3	3.9	3.6	3.6	3.7	0.1	3.8
UST (unified social tax)/insurance premiums*	5.1	5.5	4.9	6.3	6.3	6.7	0.4	7.7
VAT (value-added tax)	5.1	5.3	5.4	5.8	5.7	5.3	-0.4	-6.3
Excise taxes	0.8	0.9	1.0	1.2	1.4	1.5	0.1	14.0
MET (mineral extraction tax)	4.1	2.7	3.0	3.7	4.0	3.9	-0.1	-2.5
Customs duties and fees	8.6	6.8	6.8	8.3	8.0	7.5	-0.5	-5.2

\* Since 2010 UST has been transformed into insurance premiums paid directly into non-budgetary funds.

*Source:* Ministry of Finance of the Russian Federation, Rosstat, calculations by IEP.

As seen from the data provided in *Table 7*, revenues in terms of GDP have decreased for many types of taxes. So, corporate profit tax collections were below even the crisis level of 2009, VAT collections decreased by 0.4 p.p. and MET collections decreased by 0.1 p.p. The exceptions were receipts from insurance premiums (6.7% of GDP in 2013 against 6.4% of GDP in 2012), from personal income tax (3.7% versus 3.6%) and from excise taxes (1.5% versus 1.4%). The growth in the volumes of insurance premiums was partially due to indexation raising the base, taxable at a rate of 30%, from Rb 512,000 to Rb 568,000<sup>1</sup>. Receipts from insurance premiums and personal income tax were affected by increases in the salaries of employees in the public sector. The increase in excise tax collections was, also due to the indexation of rates. However, of particular concern is the fact that, under the conditions of a slowdown of economic activities, not only have the revenues from one of the most volatile taxes – corporate profit tax – decreased, but VAT receipts, which (together with personal income tax) had been quite stable in terms of GDP during the crisis period of 2009, are also decreasing.

<sup>1</sup> A 10% rate applies above this value and the relevant payments are received only into the Russian Pension Fund.

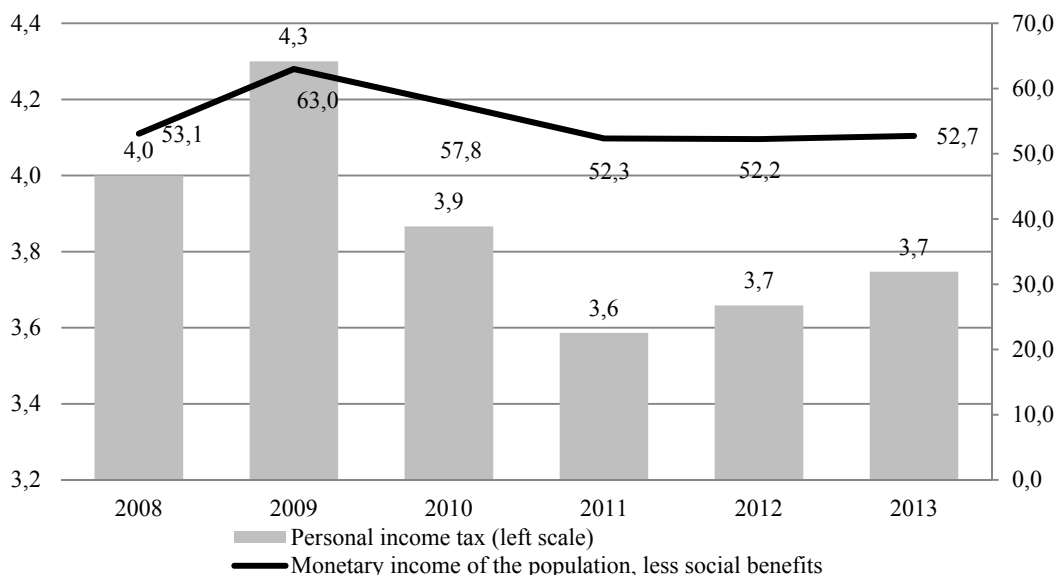


Source: Federal Tax Service of the Russian Federation.

*Fig. 14.* Share of tax receipts in the total revenue of the budget of the enlarged government in 2008-2013, %

As seen from *Fig. 14*, in 2013, the proportions of personal income tax, insurance premiums and excise taxes increased, whilst the proportions of VAT, and especially of corporate profit tax, decreased, compared with 2012. The share of MET remained almost unchanged.

Considering personal income tax receipts, it should be noted that, in 2013, there was a slight growth of monetary income less social payments for the population (see *Fig. 15*). Thus, the increased tax base drove a slight increase in receipts from personal income tax.



Source: Federal Tax Service of the Russian Federation, Rosstat.

*Fig. 15.* Comparison of the dynamics of personal income tax receipts with the dynamics of the monetary income of the population excluding social payments in 2008-2013, % of GDP

In terms of GDP, the oil and gas revenues of the federal budget decreased, compared with 2012 (see *Table 8*). The first component, the MET on hydrocarbons, decreased by 0.06 p.p. of GDP. The slight decrease in oil prices affected MET collections, despite a slight increase in oil production (523.5m tons, including gas condensate, in 2013 versus 516.8m tons in 2012) and a slight weakening of the ruble<sup>1</sup>.

*Table 8*

**Oil and gas revenues and MET in 2008-2013**

	2008	2009	2010	2011	2012	2013
Oil and gas revenues, % of GDP	10.6	7.7	8.3	10.3	10.5	10.0
MET, % of GDP	4.1	2.7	3.0	3.6	3.83	3.77
Oil production, including gas condensate, m tons	488	494	507.2	509.4	516.8	523.5
Average annual level of prices for Urals oil, \$/barrel	94.0	60.7	78.1	109.6	110.7	108.4
Average annual <sup>2</sup> official USD to RUB exchange rate of the Bank of Russia, Rb/\$	24.78	31.90	30.37	29.31	31.05	31.20

*Source:* Rosstat; Bank of Russia; Federal Tax Service of the Russian Federation; calculations by IEP.

The dynamics of the second component, the export duties on energy resources (at about 6% of GDP in 2013 versus 6.5% in 2012), became the decisive factor for the decrease in oil and gas revenues in terms of GDP. At the same time, revenues, mainly from the export of crude oil, decreased (*Table 9*). This was for two reasons. Firstly, in the first half of 2013 oil export duty rates were reduced. Secondly, according to the Ministry of Energy, crude oil exports declined by 5.44m tons, or by 2.3%, in 2013, compared with 2012. Thirdly, there was an increase in the proportion of oil coming from new deposits, which operate on preferential (lower) rates.

*Table 9*

**Receipts of customs duties in 2008-2013, % of GDP**

	2008	2009	2010	2011	2012	2013
Export duties:						
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7
- oil products	1.3	1.0	1.3	1.7	1.8	1.8
Customs duties and fees, total	8.6	6.8	7.0	8.3	7.9	7.5

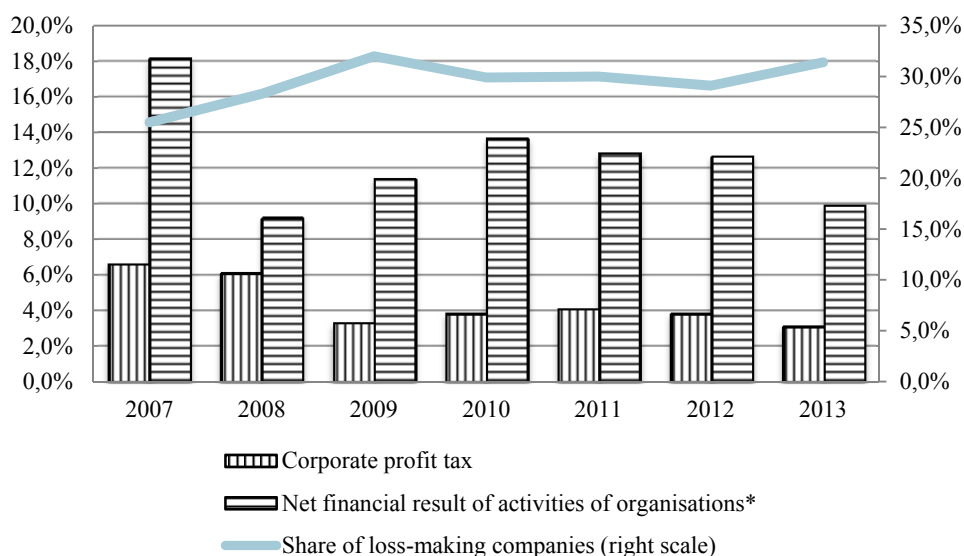
*Source:* Rosstat; data of Federal Treasury of Russia; calculations by IEP.

As noted above, in 2013, the revenues from corporate profit tax, in terms of GDP, were lower than even the 2009 receipts (see *Fig. 16*). The proportion of loss-making organisations in the Russian economy increased to 31.4% while the net financial result of the activities of companies and enterprises (excluding small businesses) reached its lowest level for the period 2009-2013, at 3.1% of GDP.

The decrease in VAT receipts resulted from the reduction in duties on both imported goods and those manufactured and sold in Russia (see *Table 10*). Taking into account, that in 2013, no significant changes in VAT taxation occurred and imports, according to Rosstat, grew by 3% in real terms, conclusions can be drawn regarding the deteriorating situation for VAT collection.

<sup>1</sup> MET rate for oil includes a coefficient characterising the dynamics of world oil prices (Kc) linked with the average USD to Rb exchange rate for the tax period.

<sup>2</sup> Calculated as a yearly average on the basis of the monthly data of the Bank of Russia.



\* According to preliminary estimates of Rosstat.

Source: Federal Tax Service of the Russian Federation; Rosstat.

*Fig. 16.* Dynamics of corporate profit tax receipts to the budgetary system of the Russian Federation, the net financial result of the activities of companies and enterprises and the share of loss-making organisations in 2007-2013, as % of GDP

*Table 10*

**Dynamics of end consumption, import and VAT receipts to the budgetary system of the Russian Federation in 2008-2013, % of GDP**

	2008	2009	2010	2011	2012	2013
VAT revenues (without receipts from YUKOS)	5.2	5.3	5.4	5.8	5.7	5.3
VAT on goods manufactured and sold in the territory of the Russian Federation	2.4	3.0	2.9	3.1	3.0	2.8
VAT on goods imported into Russia	2.8	2.3	2.5	2.7	2.7	2.5
Effective VAT rate <sup>1</sup> , %	8.4	7.6	8.2	9.3	8.3	7.4
Imports*	22.1	20.5	21.1	21.9	22.4	22.6

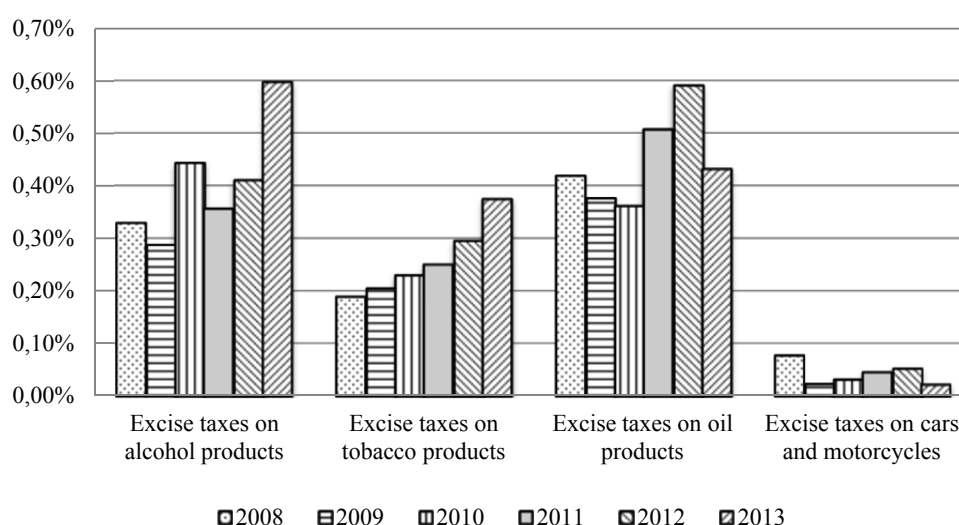
\* The share of imports in GDP was determined as the ratio of import values to GDP, according to Rosstat.

Source: Rosstat; Ministry of Finance of Russia; calculations by IEP.

In terms of GDP, excise taxes showed a growth in receipts in 2013. As seen from *Fig. 17*, this growth was driven by the excise taxes on alcohol and tobacco products (from 0.4 and 0.3%, in 2012, to 0.6 and 0.4% of GDP in 2013, respectively), taking the first place in the overall structure of excise taxes, outstripping those on oil products.

The growth in revenues from excise taxes on alcohol and tobacco products resulted from indexation of rates above the level of inflation while there was a relatively low elasticity of demand, by price, on these goods subject to excise tax. At the same time, according to Rosstat, the consumption of all types of alcoholic products, especially vodka, liqueurs and beer, decreased. According to data from the Tabakprom Association, consumption of cigarettes and filter-cigarettes decreased by 3.8% (see *Table 11*). Thus, the increase in rates fully offset the possible losses from the reduction in the tax base.

<sup>1</sup> Ratio of Vat receipts to end consumption.



Source: Federal Tax Service of the Russian Federation.

*Fig. 17. Excise tax receipts for 2008-2013 grouped by types of goods subject to excise tax, as % of GDP*

*Table 11*

**Volume of consumption of alcohol and tobacco products  
in the Russian Federation in 2008-2013**

Type of product	2008	2009	2010	2011	2012	2013
Vodka and liqueurs, m dL	177.2	166.1	157.8	159.0	159.8	140.9
Grape and fruit wines, m dL	102.9	102.5	103.4	103.0	95.6	91.2
Cognacs, m dL	10.8	10.6	11.1	12.0	12.5	12.4
Champagne and sparkling wine, m dL	26.0	25.5	27.3	29.8	30.1	28.8
Beer, m dL	1,138.2	1,024.7	1,004.0	1,077.5	1,055.7	1,005.6
Cigarettes and filter-cigarettes, bn pieces	393.6	394.3	370.6	366.1	366.8	353.0*

\* Recalculation according to preliminary data from Tabakprom for January-September 2014

Source: Rosstat.

The decrease in excise taxes on oil products was due to a decrease in receipts from “internal” excise<sup>1</sup> taxes. Firstly, receipts of excise taxes on diesel fuel produced in Russia decreased considerably (Rb 48.5bn in 2013 versus Rb 97.2bn in 2012). Secondly, receipts of excise taxes on petrol produced in Russia decreased slightly (Rb 161.7bn in 2013 versus Rb 169.4bn in 2012). Thirdly, excise tax collections for straight-run gasoline produced in Russia also decreased (Rb 6.9bn in 2013 versus Rb 8.9bn in 2012). By contrast, the receipts of excise taxes on oil products imported into Russia increased slightly in nominal terms.

The reduction in collections of excise taxes on transportation vehicles was partially related to the introduction of ‘utilisation duty’ on imported cars. As a result, while “internal” excise taxes, in general, grew from Rb 12.7bn in 2012 to Rb 15.3bn in 2013, “external” excise taxes fell from Rb 20.3bn to Rb 18.0bn.

Considering the dynamics of indebtedness on taxes and duties, it should be noted that in 2013 this grew more slowly than the inflation (*Table 12*).

<sup>1</sup> “Internal” excise taxes mean excise taxes imposed on goods manufactured in Russia and “external” excises mean excise taxes imposed on goods imported into Russia.

Table 12

**Indebtedness on tax and duties in 2008-2013**

	2008	2009	2010	2011	2012	2013
Total indebtedness, as % of GDP	1.35	1.80	1.52	1.21	1.17	1.15
Total indebtedness, Rb bn	559.1	699.0	704.5	675.3	728.2	770.0
Corporate profit tax	107.6	144.8	176.7	160.8	175.0	165.6
VAT	242.9	327.1	313.2	305.0	319.7	333.5
Total indebtedness, real increase, %	85.83	114.91	92.64	90.34	101.15	99.30
In corporate profit tax	92.60	123.75	112.13	85.79	102.07	88.86
In VAT	85.87	123.80	88.01	91.77	98.33	97.96

Source: Federal Tax Service of the Russian Federation; Rosstat; calculations by the Gaidar Institute.

It is also worth mentioning that for such taxes as corporate profit tax and VAT (receipts of which decreased in 2013, both in terms of GDP and in real terms), the volumes of indebtedness also decreased in real terms. Thus, the reduction in relevant receipts to the budgetary system was not related to the growth in tax debt.

### 2.2.3. Budgetary expenditure

Overall, the total volume of budgetary expenditure of the enlarged government increased in 2013 by 0.66% of GDP (see *Table 13*). It is important to note that the tendency towards a reduction of expenditure in terms of GDP (due to a gradual curtailing of the anti-recession programmes and to the growth of GDP itself), outlined in 2010-2011, ceased in 2012. In 2012-2013 a steady increase in government expenditure exceeding the rate of growth of the economy could be observed. The highest growth was recorded in the following areas: “Social Policy” (+0.71 p.p.), “National Defence” (+0.24 p.p.), “Education” (+0.22 p.p.) and “National Security and Law Enforcement Activities” (+0.13 p.p.). Expenditure on social policy increased due to expenditure on state non-budgetary funds, mainly, the Pension Fund. Expenditure on education increased, mainly at a sub-national level due to the necessity to increase the salaries of employees in the basic and pre-school education sector in 2012-2013, in accordance with the requirements of the Presidential Decrees of 7 May 2012. The federal budget continued building up defence expenditure in line with decisions made by the country’s top leaders, while expenditure on law enforcement activities also increased.

In 2013, the enlarged government’s budgetary expenditure on the national economy (–0.34 p.p.), on housing and utilities (–0.15 p.p.) and healthcare and sports (–0.17 p.p.) decreased in terms of GDP. It should be noted, however, that within the “National economy” section there was an increase in some areas and a decrease in others. Expenditure in such large subsections as “Other issues relating to the national economy” (–0.30 p.p.) and “Transport” (–0.18 p.p.) decreased. At the same time, there was an increase in expenditure on road repairs and construction (+0.16 p.p.) and on agriculture (+0.10 p.p.).

If we compare the current structure of expenditure within the budget of the enlarged government with the pre-crisis one of 2008 the following changes emerge. In terms of shares of GDP, there was a considerable increase in expenditure on defence (+0.63 p.p.), on law enforcement activities (+0.59) and especially on social policy (+3.84). Expenditure on education (+0.29 p.p.) and the servicing of state and municipal debt (+0.20) also increased. There was a decrease in funding for the housing and utility sector (–1.21), for overall national issues (–0.37) and the “National economy” section (–0.54). Within the “National economy” section, during the post-crisis period, the volume within the subsection “Other matters relating

to the national economy” decreased substantially (–1.02 p.p.) while expenditure on the public road system and applied scientific research increased (+0.21 and +0.22, respectively).

*Table 13*

**Expenditures of the budget of the enlarged government  
in 2008-2013, % of GDP**

	2008	2009	2010	2011	2012	2013	Deviation of 2013 from 2012	Deviation of 2013 from 2008
Expenditure, total	33.89	40.84	37.36	35.74	36.69	37.35	0.66	3.46
Overall national issues	2.66	2.72	2.54	2.44	2.31	2.29	-0.02	-0.37
Servicing of state and municipal debt	0.46	0.61	0.56	0.59	0.62	0.66	0.04	0.20
National defence	2.53	3.07	2.76	2.71	2.92	3.15	0.24	0.63
National security and law enforcement activities	2.65	3.21	2.89	2.71	3.10	3.23	0.13	0.59
National economy, including:	5.46	7.17	5.02	4.99	5.26	4.92	-0.34	-0.54
agriculture and fishing	0.58	0.72	0.57	0.48	0.44	0.54	0.10	-0.04
transport	0.70	0.96	1.00	0.89	1.00	0.82	-0.18	0.12
public road system	1.54	1.55	1.39	1.28	1.59	1.76	0.16	0.21
applied scientific research	0.18	0.29	0.27	0.32	0.37	0.40	0.03	0.22
other areas	1.91	2.88	1.16	1.45	1.19	0.89	-0.30	-1.02
Housing and public utility sector	2.78	2.59	2.31	2.14	1.73	1.58	-0.15	-1.21
Environment protection	0.08	0.08	0.06	0.07	0.07	0.07	0.00	-0.01
Education	4.03	4.58	4.09	3.99	4.11	4.33	0.22	0.29
Culture, cinematography and mass media	0.75	0.84	0.76	0.73	0.73	0.74	0.01	-0.01
Healthcare and sports	3.75	4.26	3.69	3.74	3.97	3.80	-0.17	0.05
Social policy	8.74	11.71	12.66	11.64	11.87	12.58	0.71	3.84

*Source:* Federal Treasury; calculations by IEP.

In our opinion, to date, the potential to increase government expenditure in the mid- and long-term is almost used up. As a result, the only possible solution is to search for and to create prerequisites for long-term economic growth, both by changing the structure of expenditure and by increasing its efficiency. Measures should be aimed at increasing the volume and quality of production factors (human and physical capital), to increase the factors affecting overall productivity, including the development of infrastructure, transport and communication and by improvements to public institutions. From this perspective it is important to consider the changes in “productive expenditures” (education, healthcare, production infrastructure) which ensure growth, and in “non-productive expenditure” (national defence, law enforcement activities, public administration) which promote little or no economic growth (above a specified limit)<sup>1</sup>. Investments in the fields of education, healthcare and infrastructure cannot be interpreted as expenditure necessary for social reasons or as an addition to the provision of social services in the market. They should be considered as investments in long-term economic growth.

If we analyse the changes in the structure of expenditure in the budget of the enlarged government which occurred in 2012-2013 in terms of the above logic, the following can be noted. In 2013 “non-productive” areas of expenditure such as law enforcement activities and especially national defence have noticeably increased, while there has been a simultaneous reduction in expenditure on healthcare (from 3.67 to 3.47% of GDP, excluding expenditure on sport). At the same time, we must note the outlined increase in the financing of such

<sup>1</sup> For more information see: G. Idrisov, S. Sinelnikov-Murylev. ‘Budgetary Policy and Economic Growth’//Voprosi ekonomiki, 2013, No.8; G. Idrisov, S. Sinelnikov-Murylev. ‘Creation of Prerequisites of Long-Term Growth: How We Should Understand Them?’//Voprosi ekonomiki, 2014, No.3.

“productive expenditure” as that in the public road sector (related, amongst other things, to the restoration of the road fund) and in education (primarily, due to the increased salaries of employees in the pre-school and basic education sectors). However, one has to take into account that the increase in expenditure in the fields of education and healthcare, including the increase in salaries of employees in relevant sectors, should not be purely technical (simply an increase in the funding of the existing network and employees) but should be related to relevant reforms of the sectors in question, and aimed at improving the quality of the services provided. One must also keep in mind that the increase in expenditure on education in 2012-2013 resulted in a higher load on the consolidated regional budgets, while their income base actually declined. In this context, if the federal budget increases its “non-productive expenditure” (defence and law enforcement) the Federation may not have the financial resources to provide additional financial support to the regions.

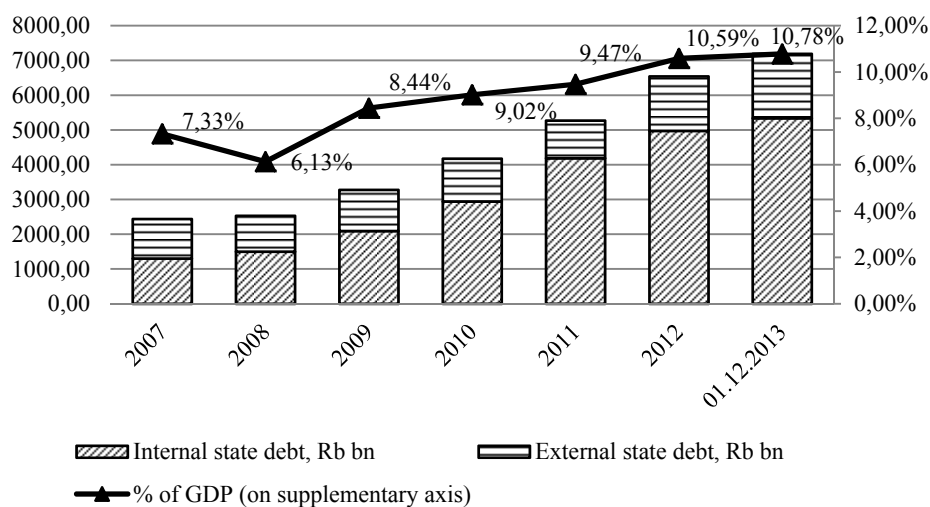
In general, in 2012-2013, the increase in government expenditure occurred simultaneously with conflicting changes in their structure and under the conditions of increasing tension in the respective components of budget execution (especially at the regional level) which calls into question the financial stability of the budgetary system, and makes it difficult to create the conditions needed for increasing economic growth. Taking into account the limitations of the revenue component of the budgets it is necessary to rethink thoroughly the priorities both in budgetary policy and, in general, in the strategy for economic development and the reform of its key institutions.

#### 2.2.4. State debt of the Russian Federation

As of 1 January 2014 the total state debt of the Russian Federation (of the federal budget) was 10.7% of GDP (Rb 7,135bn) (see *Fig. 18*), which is considerably lower than the value of 13.1% of GDP envisaged by the budget for 2013. However, since 2008, the tendency towards an increase in the level of debt has remained. In the total state debt, based on the results of 2013, the share of internal borrowings was 74.8% (Rb 5,338bn), while external borrowings stood at 25.2% (Rb 1,797bn). Since 2011 a trend towards an increase in external borrowings has been observed: in 2011 they were 20.5%, and in 2012, 23.9%. However, in 2013 the growth rates of both internal and external debt slowed down, compared with the previous year: 7.3% (2012: 18.6%) and 14.7% (2012: 45.2%), respectively.

The main driver for the growth of external debt in 2013 was the issue of Eurobonds, the amount of which in circulation increased by 16.5%. As of 1 January 2014 they also accounted for the largest proportion of the structure of state debt, at 72.8% (\$40.7bn). The domination of their share in the external debt structure is the natural result of the strategic objective of market development, and the improvement of conditions for borrowing. The remaining share falls on government guarantees in foreign currency, the rapid growth of which has been observed since late 2011 (\$1bn as of 1 December 2011). However, the volume of state guarantees, after a steep rise in 2012, then remained constant and has not changed much throughout the rest of the year: \$11.4bn as of 1 January 2014 (20.4% of the total external debt). The growth in government guarantees which took place has resulted in an increase in the share of the country's contingent liabilities and, hence, may lead to an additional burden on the federal budget in the case of the execution of guarantees. However, the main volume of guarantees in foreign currency is being provided to support the export of industrial products, which should therefore contribute to an increase in the share of non-oil products in Russian exports.





Source: E.T. Gaidar calculations by IEP on the basis of data from the Ministry of Finance. The average value of the exchange rate over 4 quarters was used in the calculation of annual data. This explains the difference between the amount of external state debt expressed in Rb bn and the data from the Ministry of Finance provided in ‘Guidelines for the State Debt Policy of the Russian Federation for 2013-2015’.

*Fig. 18. Dynamics of Russia’s state debt*

The total volume of internal state debt in securities, as of the end of 2013, was Rb 4,432.4bn, or 6.6% of GDP. The largest share within it is accounted for by federal loan obligations with a fixed coupon yield (OFZ-PD) of 61%. For the last three years the volume of traded OFZ-PD has increased twice: from Rb 1.3 trillion to Rb 2.7 trillion. This trend evidences that these securities are more attractive from the perspective of their non-dependence on the dynamics of the CPI or money market indicators. The remaining share is mainly represented by federal loan bonds with a debt amortization (OFZ-AD) of 24%. The volume of traded government saving bonds with fixed interest rates (GSO-PPS), issued for institutional investors in 2013, was adjusted after their observed continuous growth since 2007. There is also one issue of ruble Eurobonds circulating in the market, and issued in 2011, amounting to Rb 90bn. The absence of new issues of ruble Eurobonds can be explained by the recently observed increased ruble volatility.

In 2013 the main movement in the structure of governmental domestic borrowing was in the following two directions: OFZ-PD (increased by 19.6%) and government guarantees provided in Russian currency (increased by 42.3%). The estimate of the growth in the volume of government guarantees is ambiguous because the mechanism of transparent and objective selection of enterprises receiving the guarantees is not clear.

According to the regulations of various levels, government guarantees are provided to:

- strategically important enterprises;
- enterprises within the defence and industrial complex (OPK);
- commercial investment projects.

It should be noted that most of the companies included in the list of strategically important enterprises to receive government guarantees, are joint-stock companies with the government being, in the best case, a minority shareholder. As for a similar method to support the OPK enterprises, government guarantees are not the main, but rather the supplementary support instruments, along with budgetary targeted subsidies and contributions to the authorized

capital, and these are less orientated towards increased efficiency in the activities of these enterprises. First of all, it is necessary to review the list of strategically important enterprises, and to introduce stricter requirements in the criteria for the determination of the strategic importance of enterprises (for example, the inclusion of a requirement that there must be no offshore companies amongst the founders).

Based on the results of auctions conducted for the placement of government securities, the volume of bids offered by participants within the yield spread exceeded the supply volume, however, the level of placement of securities amongst investors was not high, only 70% of the expected volume. The continuation of this situation may become an obstacle for the implementation of the borrowing plans of the Russian Ministry of Finance for 2014-2016.

In the structure of OFZs with fixed coupon yields, long-term issues (over 5 years) dominate, at 62.8% as of January 2014. The remaining part is accounted for mid-term issues (1 to 5 years). In 2013 no issue of short-term OFZ-PD (up to 1 year) was carried out. The termed nature of the issues is in compliance with the issuance policy of the Russian Ministry of Finance, pursuant to which, the priority area is the issue of mid- and long-term securities, while the issue of short-term instruments is possible only “under very unfavourable market conditions”<sup>1</sup>. This tendency is contributing to the increase of liquidity of government securities, due to which the OFZ yield curve becomes attractive for private borrowers. In 2013 the duration<sup>2</sup> of the OFZ-PD portfolio increased by 7%: from 3.72 to 3.98 years. The maximum value was recorded in April at 4.12 years. It should be noted that the ‘Guidelines for the Debt Policy for 2013-2015’ provide for the “achievement and maintenance of target duration of 5 years for the OFZ portfolio”.

In 2013 the average weighted yield of long-term OFZ issues changed within the range from 6.54 to 8.00% and that of mid-term issues, from 4.55 to 6.57%. In 2013 the dynamics of the long-term OFZ yield was characterized by incremental growth. In contrast, the dynamics of the mid-term OFZ yield in 2013 lacked any pronounced trends: most of the time the yield fluctuated around 6% per annum.

In 2013 the share of non-residents in the OFZ market grew from 19.9 to 23.9%. From July to December their share stabilised at a level of 25%. It should be noted that in the countries of Eastern Europe the share of non-residents in the sovereign securities market is considerably higher (*Table 14*).

*Table 14*

**Participation of non-residents in sovereign debt markets of Eastern European countries in 2010**

Country	Share of non-residents
Slovenia	64.8
Hungary	48.7
Poland	41.8
Slovakia	36.4
Czech Republic	29.7

*Source:* E.T. Gadar calculations by IEP on the basis of OECD data.

In 2013 the sovereign credit ratings of Russia did not change. By Standard and Poor’s scale, Russia’s local currency rating is “BBB+”, and its foreign currency rating is “BBB”. During the year, in both June and December, S&P’s affirmed the sovereign credit ratings on

<sup>1</sup> Guidelines for State Debt Policy of the Russian Federation for 2013-2015, p. 33.

<sup>2</sup> Duration means an average term until payments are made under securities, taking into account coupon payments weighted by the volumes in circulation (Bank of Russia).

the basis of “strong fiscal and external indicators”<sup>1</sup> with a stable outlook. In March 2013 Moody’s agency also affirmed a sovereign foreign currency credit rating at “Baa1” with a “stable” outlook on the basis of “sustainably high budgetary and financial indicators of external debt in comparison to the corresponding indicators of other countries in the same rating category”<sup>2</sup>.

#### 2.2.5. Analysis of the main parameters of the federal budget of the RF in 2009-2013 and for the period 2014-2016

The main parameters of the federal budget for 2014-2016 compared with the corresponding data for 2008-2013 are presented in *Table 15*. For 2014-2016, reductions in both federal revenue and expenditure in terms of GDP are predicted. Revenues will continue the trend in line with the reduction that has been observed since 2013. Revenues of the federal budget decreased from 20.7% of GDP in 2012, to 19.5% of GDP in 2013, with further decreases being forecast: to 18.5% of GDP in 2014 and to 18.3% of GDP in 2015-2016. Expenditure, which has decreased from 20.7 to 20.0% of GDP in 2013, will continue decreasing to 19.0% in 2014, should then grow a little in 2015 to 19.3% but decrease again to 18.9% in 2016. It is planned that the deficit for 2014 will remain at the 2013 level of 0.5% of GDP, with a subsequent increase to 1.0% in 2015 followed by a decrease to 0.6% in 2016.

It is important to note that a considerable change in the structure of the revenues of the federal budget is planned due to a substantial reduction in oil and gas revenues from 9.9% of GDP in 2013 to 7.9% of GDP in 2016, which will result in a decrease in their share from 50.8% in 2013 to 43.2% in 2016. At the same time, non-oil and gas revenues are expected to grow from 9.6% of GDP in 2013 to 10.4% in 2016. It is important to note that the observed reductions in non-oil and gas revenues from 10.1% of GDP in 2012 to 9.6% in 2013, and, in particular, the decrease in VAT receipts, arouses doubts that the above forecast for growth in non-oil and gas revenues to the federal budget will actually take place.

*Table 15*

#### **Actual and expected performance of revenues and expenditures of the federal budget for 2008-2016 (% of GDP)**

	Actual performance						Federal Law on the Federal Budget for 2014-2016			Deviation of 2016 from 2013, p.p. of GDP
	2008	2009	2010	2008	2009	2010	2008	2009	2010	
Revenues Including:	22.5	18.9	17.9	20.3	20.7	19.5	18.5	18.3	18.3	-1.2
oil and gas revenues	10.8	7.8	8.3	10.2	10.6	9.9	8.9	8.6	7.9	-2.0
non-oil and gas revenues	11.6	11.1	9.7	10.1	10.1	9.6	9.6	9.7	10.4	0.8
Expenditure	18.3	24.8	21.8	19.5	20.7	20.0	19.0	19.3	18.9	-1.1
Including nominally approved	0	0	0	0	0	0	0	0.5	0.9	0.9
Deficit (-)/ surplus (+)	4.1	-6.0	-3.9	0.8	-0.06	-0.5	-0.5	-1.0	-0.6	-0.1
Non-oil and gas deficit	-6.7	-13.7	-12.2	-9.5	-10.6	-10.1	-9.4	-9.6	-8.4	1.7
GDP, Rb bn	41,276	38,809	46,308	55,967	62,218	66,755	73,315	79,660	86,837	-

*Source:* Ministry of Finance of the Russian Federation, calculations by IEP.

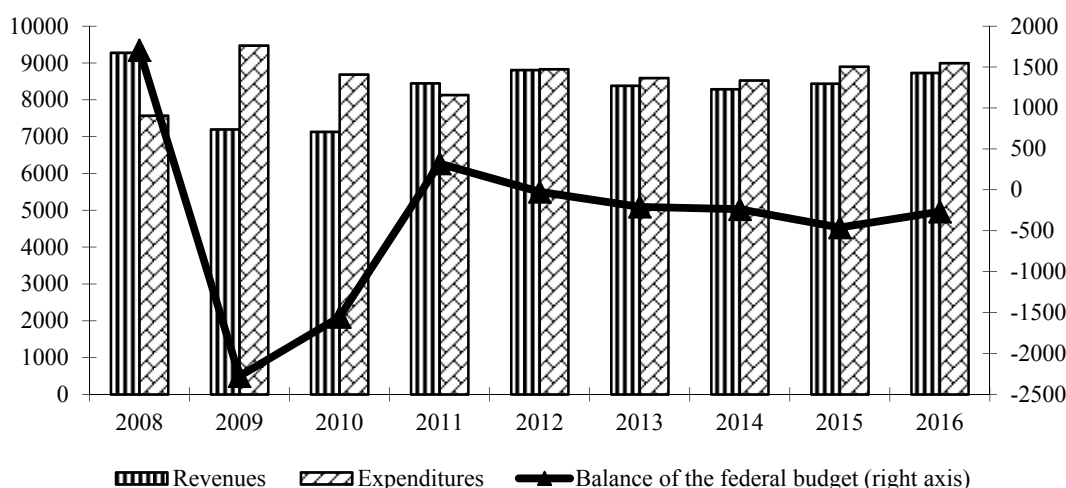
<sup>1</sup> <http://www.standardandpoors.com/prot/ratings/entity-details/ru/ru/?sectorCode=SOV&entityID=308102>

<sup>2</sup> [https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC\\_151971](https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_151971)

Thus, for 2014-2016 a reduction is planned in the dependency of revenues to the federal budget on the foreign economic environment, mainly on the situation in the global oil market. The major part of the reduction in the volumes of oil and gas revenue is accounted for by the reduction in export customs duties, the decrease in which is associated not only with changing macroeconomic indicators (export volumes, USD to ruble exchange rates, etc.) but also, to a large extent, with changes in customs legislation<sup>1</sup>.

Additional oil and gas revenues<sup>2</sup>, which could be received if the actual global oil price exceeded its base value, are estimated by the Ministry of Finance at: Rb 615.6bn, in 2014, Rb 384.9bn in 2015, and Rb 381.9bn in 2016. In 2014 a part of the additional oil and gas revenue is expected to be allocated to the Reserve Fund in the amount of Rb 343.5bn whilst the remaining amount of Rb 272.1bn will be used to increase the expenditure part of the federal budget to a maximum volume of Rb 13,869.1bn in accordance with clauses 3-6 of Article 199 of the Budgetary Code of the RF. In 2015 all additional oil and gas revenues will be allocated to the budget and in 2016, to the Reserve Fund.

At 2008 prices, revenues to the federal budget in 2014-2016 are comparable with the revenues of 2013 and are lower than revenues in 2008. Expenditures within the budget in 2014-2016 are comparable with the expenditure of 2013, and lower than the 2009 level but considerably higher than the pre-crisis values of 2008 (see *Fig. 19*).



Source: Russian Ministry of Finance, calculations by IEP.

*Fig. 19.* Dynamics of revenues, expenditures and deficits of the federal budget, Rb bn, at 2008 prices

It should be noted that in the formulation of the key parameters of the federal budget for 2014-2016 the macroeconomic indicators used for the calculation of the key parameters of the budgetary system were reduced, compared with the indicators in Federal Law No.216-FZ ‘On the Federal Budget for 2013-2015’ and formerly used in the ‘Guidelines for the Budgetary

<sup>1</sup> Decrease in the maximum oil export customs duty rate from 60 to 59% in 2014, to 57% in 2015, and to 55% in 2016. Decrease in the maximum export customs duty rate for “light” petroleum products from 66 to 65% of the oil duty rate in 2014, to 63% in 2015, and to 61% in 2016.

<sup>2</sup> “Additional” within the framework of the budgetary rules effective from 2013.

Policy for 2014-2016' (published on the website of the Ministry of Finance in July 2013). For example, Federal Law No.216-FZ forecast GDP growth at 4.3-4.5% in 2014-2015 while the 'Guidelines for the Budgetary Policy for 2014-2016' forecast it at 3.7-4.1% and the new budgetary projections are based on GDP growth estimates of only 3.0 and 3.1%, respectively. However, taking into account the increasing problems in the Russian economy and with GDP growth of only 1.3%, based on the results for 2013, even the relatively low figures of the adjusted forecast seem very optimistic, so this raises questions regarding the execution of the federal budget revenue plan as early as 2014 (especially, with respect to non-oil and gas revenues).

In 2014-2016 some changes are planned in the structure of expenditure of the federal budget (*Table 16*).

*Table 16*

**Expenditures of the federal budget in 2013-2016 (% of GDP)**

	2013	2014	2015	2016	Changes between 2016 to 2013
<b>Total</b>	<b>20.0</b>	<b>19.0</b>	<b>19.3</b>	<b>18.9</b>	<b>-1.1</b>
<i>Nominally approved</i>	<i>0.0</i>	<i>0.0</i>	<i>0.5</i>	<i>0.9</i>	<i>0.9</i>
<b>Total (excluding nominally approved)</b>	<b>20.0</b>	<b>19.0</b>	<b>18.8</b>	<b>17.9</b>	<b>-2.1</b>
<i>Including:</i>					
General national issues	1.3	1.4	1.3	1.2	-0.1
National defence	3.2	3.4	3.8	3.9	0.7
National security and law enforcement activities	3.1	2.8	2.6	2.4	-0.7
National economy	2.8	3.1	2.7	2.3	-0.5
Housing and public utility sector	0.3	0.2	0.1	0.1	-0.2
Environment protection	0.0	0.0	0.0	0.0	0.0
Education	1.0	0.8	0.8	0.7	-0.3
Culture, cinematography	0.1	0.1	0.1	0.1	0.0
Healthcare and sports	0.8	0.6	0.5	0.5	-0.3
Social policy	5.7	4.8	5.1	5.0	-0.7
Physical culture and sports	0.1	0.1	0.1	0.1	0.0
The media	0.1	0.1	0.1	0.1	0.0
Servicing of state and municipal debt	0.5	0.6	0.6	0.7	0.2
General inter-budget transfers	1.0	0.9	0.9	0.8	-0.2

*Source:* Russian Ministry of Finance, calculations by IEP.

As can be seen from *Table 16*, with a general reduction of expenditure in terms of GDP, it is planned to increase expenditure on national defence from 3.2 to 3.9% of GDP and expenditure on servicing state and municipal debt from 0.5 to 0.7% of GDP. The increase of expenditure on defence should result in a growth in the share of this expenditure in the total amount (excluding nominally approved expenditure) from 15.8% in 2013 to 21.8% in 2016. At the same time, the greatest reduction, in terms of GDP, is planned for the sections "National security and law enforcement activities" (-0.7 p.p. of GDP), "Social policy" (-0.7 p.p.), "National economy" (-0.5 p.p.), "Education" (-0.5 p.p.) and "Healthcare" (-0.5 p.p.). From the perspective of the above-mentioned concept of "productive" and "non-productive" expenditures, the reduction in expenditure on law enforcement activities deserves a positive evaluation whilst the increase in expenditure on defence and the reductions in education and healthcare funding deserve a negative one.

In general, one can see that the budgetary projections do not correspond to the "budgetary manoeuvre" proposed by the IEP experts<sup>1</sup> within the framework of the entire budgetary

<sup>1</sup> For more information see: G. Idrisov, S. Sinelnikov-Murylev. 'Budgetary Policy and Economic Growth'//Voprosi ekonomiki, 2013, No.8; G. Idrisov, S. Sinelnikov-Murylev. 'Creation of the Prerequisites for Long-Term Growth: How We Should Understand Them?'//Voprosi ekonomiki, 2014, No.3.

system (with the important caveat, that in this section, only those expenditures of the federal budget have been analysed). The “budgetary manoeuvre” should be conducted within 3-5 years, which would mean an increase in productive expenditures of the budget of the enlarged government by 3 p.p. These additional expenditures would be allocated to increase the quality of the business and investment climate in the country, to improve the human potential and to create a modern transport and engineering infrastructure. At the same time, “non-productive” expenditures should be reduced by 3 p.p. of GDP. It is feasible to increase the expenditure of the budget of the enlarged government on education by 1.2 p.p. of GDP, on healthcare by 1.0 p.p., and on the public road system by 0.8 p.p. of GDP. At the same time, it is necessary to decrease expenditure on law enforcement activities by 0.9 p.p. of GDP, on defence by 1.1 p.p., on the national economy and on housing and public utilities (excluding the public road system) by 1.0 p.p. of GDP<sup>1</sup>.

In accordance with amendments made to the budgetary legislation, the federal budget for 2014-2016 is presented in a programme cost structure that previously had only an “analytical” status (*Table 17*). State programmes are grouped in 5 major directions: “New quality of life” (12 programmes), “Innovation development and modernisation of the economy” (17 programmes), “National security” (1 programme), “Balanced regional development” (5 programmes), “Effective state” (4 programmes).

*Table 17*

**Federal Budget allocations<sup>2</sup> in 2013-2016, allocated for the implementation of state programmes, Rb bn**

	2013 (Law No.216- FZ)*	2014			2015			2016		
		Passport**	Draft Federal Law on Federal Budget	Deviation	Passport**	Draft Federal Law on Federal Budget	Deviation	Passport**	Draft Federal Law on Federal Budget	Deviation
1	2	3	4	5=4-3	6	7	8=7-6	9	10	11=10-9
1	2	3	4	5	6	7	8	9	10	11
<b>Total federal budget expenditure</b>	<b>13,387.3</b>		<b>13,960.1</b>			<b>14,977.5</b>			<b>15,572.6</b>	
Out of which:										
<b>Total expenditure on implementation of state programmes of the RF</b>	<b>7,733.2</b>	<b>7,633.9</b>	<b>8,161.1</b>	<b>527.2</b>	<b>7,723.6</b>	<b>8,422.6</b>	<b>698.9</b>	<b>8,138.5</b>	<b>8,547.9</b>	<b>409.4</b>
Share in the total amount, %	57.8		58.5			56.2			54.9	
Including in the areas:										
I. New quality of life (12 programmes)	3,349.9	3,230.0	3,408.2	178.2	3,196.5	3,410.2	213.7	3,276.5	3,422.5	145.9
II. Innovation development and modernisation of the economy (17 programmes), excluding a closed part	1,872.0	1,896.7	2,034.4	137.7	1,881.3	2,085.8	204.6	1,923.6	2,057.0	133.4

<sup>1</sup> Quantitative parameters are calculated on the basis of the structure of expenditure within the budget of the enlarged government in 2012.

<sup>2</sup> Open part.

*Cont'd*

1	2	3	4	5	6	7	8	9	10	11
III. National security (1 programme), excluding closed part	9.1	7.6	2.3	-5.3	5.7	1.5	-4.2	1.6	1.5	-0.1
IV. Balanced regional development (5 programmes)	678.1	627.8	740.2	112.3	604.4	778.6	174.2	761.4	787.1	25.7
V. Effective state (4 programmes)	1,084.3	1,137.4	1,115.1	-22.3	1,198.6	1,193.8	-4.8	1,205.8	1,239.7	33.8
Expenditure on implementation of state programmes of the RF (closed part)	739.7	734.4	861.0	126.6	837.2	952.7	115.5	969.6	1,040.2	70.6
<b>Expenditure on non-programme activities</b>	<b>5,654.1</b>		<b>5,799.0</b>			<b>6,555.0</b>			<b>7,024.7</b>	
Share in the total amount, %	42.2		41.5			43.8			45.1	
Including:										
Financial support of development of the pension system	2,850.3		2,307.4			2,776.0			3,058.3	
Closed expenditure, including ensuring the country's defence capability	2,242.4		2,556.8			3,028.7			3,310.9	
Other non-programme expenditure	561.4		934.8			750.3			655.6	

\* Analytical distribution in accordance with Federal Law dated 3 December 2012 No.216-FZ (in original revision).

\*\* In accordance with the basic option (without taking into account proposals for additional budgetary allocations)

Source: Ministry of Finance of Russia, calculations by IEP.

Considering the issues of formulating the federal budget for 2014-2016 in accordance with the programme principles, the following should be noted. Firstly, no state programmes have been adopted on such important and large expenditure items as defence and the pension system. As a result, in 2014 the share of programme expenditure is at 58.5% and its share is even planned to decrease to 54.9% by 2016 (if relevant state programmes are not adopted). Secondly, as seen from the data presented in *Table 17*, the parameters of the federal budget for 2014-2016 differ substantially from the corresponding ones envisaged by the passports of the state programmes. As a result, a situation is shaping where the budget is not being adopted on the basis of state programmes, but the passports of the state programmes have to be adjusted in accordance with the adopted law on the budget. As a result of all of the above, an unambiguous conclusion can be drawn: state programmes have not yet become a real tool for the formation of budgetary policy, and the distribution of funds amongst the state programmes still has a rather “analytical” nature.

When considering the other programme-target instruments of budgetary policy one can note that, out of total expenditure, the shares of federal budget expenditure allocated for implementing federal target programmes are to be reduced from 7.5% in 2013 to 6.8% in 2014-2015 and to 5.9% by 2016. In 2014 both the number of federal target programmes and the volumes of their budgetary funding will be reduced compared with the previous year: from 49 to 46 programmes and from Rb 1,009.9bn to Rb 956.5bn, respectively. Furthermore, from 2014, new programmes which have previously been implemented were accepted for

funding, these include: “Scientific and Scientific-Pedagogical Human Resources of Innovative Russia in 2014-2020”, “Research and Development in Priority Areas of the Scientific and Technological Complex of Russia for 2014-2020”, “Sustainable Rural Development in 2014-2017 and in the period until 2020”, together with a number of other programmes<sup>1</sup>. At the same time, the largest volume of funding in 2014-2016 is to be allocated for the implementation of programmes for the development of transport infrastructure and high technology: 39.9 and 29.8% of the total funding for federal target programmes. The volume of investment expenditure in the form of capital investments funded within the framework of the Federal Address Target Programme is Rb 2,419.7bn in 2014-2016, peaking in 2015 at Rb 868.7bn.

According to an estimate by the Ministry of Finance: at the end of 2016, the volume of the Reserve Fund will be Rb 3,710.2bn, or 4.3% of GDP, which is Rb 850.5bn, or 0.1 p.p. of GDP higher than the 2013 figure. The volume of the National Wealth Fund will be Rb 2,990.4bn, or 3.4% of GDP, which is Rb 90.2bn higher than the 2013 level, and by the end of 2016, the volume of the National Wealth Fund will be reduced by 1.0 p.p. of GDP, compared with the 2013 level.

Taking into account the 2014-2016 forecasts for reductions in the growth rates of such indicators as the volume of industrial production, the real disposable income of the population and the possible reduction of import volumes, it can be admitted that the decrease in federal expenditure in terms of GDP for 2014-2016 is a justified measure from the point of view of ensuring the financial stability of the country’s budgetary system. However, the structure of expenditure should be adjusted towards an increase in the “productive” and a decrease in the “non-productive” areas.

#### 2.2.6. Prospects for the fiscal policy in 2014-2016

*1. Budgetary rules and government expenditure policy.* Due to the increasing uncertainty in the world, both geopolitical and financial, together with possible changes in key trends of social and economic development in Russia, it is impractical to revise the budgetary rules in the medium term. It is necessary to continue to restrict the deficit of the federal budget at the level of 1% of GDP and to calculate budgetary revenues based on average annual oil prices. Given the lack of sources of revenue we need to define more clearly the public spending priorities in the light of the concept of “productive/non-productive expenditures” and the above-mentioned “budgetary manoeuvre”.

*2. New public procurement procedures for goods and services.* On 1 January 2014 Federal Law dated 5 April 2013 No.44-FZ ‘On the Contractual System in the Field of Public Procurement of Goods, Works and Services for State and Municipal Needs’ became effective (Federal Contractual System — FCS). The transitional period for certain provisions will stretch as far as 2017. For example, chapter 2 (‘Planning’) will become effective only in 2015. This is, perhaps, the only principal innovation of the FCS compared with the former Federal Law No.94-FZ which the expert community will adopt without major controversies. Law No.94-FZ concerned only the stage of state procurement. Hence, the former purchasing legislation focused on combating the type of corruption which was manifested in overpricing a particular group of goods, works or services. However, this approach does not consider the situation of ineffective (unjustified) expenses where the economic feasibility of the choice

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<sup>1</sup> “Development of agricultural lands in Russia in 2014-2020”, “South of Russia (2014-2020)”, “Development of a unified state system for registration of rights and cadastral accounting for real estate (2014-2019)”.



(ahead of placement of an order) of object being procured, itself, raises doubts. Many stories about the manner in which purchases of executive-class cars or other “luxury articles” have been conducted, can serve as examples of the above situation. Measures which could potentially promote the efficiency of budgetary spending at the planning stage include the introduction of limitations on needs (relevant regulation has not been adopted yet), an almost complete prohibition on purchasing outside of the schedule (the customer places an order with goszakupki.gov.ru), public discussion of purchases (this requirement was optional until the FCS came into force in 2014 when it became obligatory for purchases of Rb 1bn and more), substantiation of the choice of the initial maximum price (the Ministry of Economic Development has developed relevant recommendations) and the type of procurement procedure (Law No.94-FZ did not specify any such constraints whatsoever).

However, in 2014 the FCS is already providing more freedom to customers at the stage of order placement (chapter 3 of the FCS). This is expressed in the extension of the list of purchasing procedures (two-stage tendering, tenders with prequalification, and invitations to tender, were introduced) and in the appearance of a new limit on the cost of ownership as a criterion for bid selection (for the creation of infrastructure objects). Such empowering of the customer, on the one hand, reduces the risk that the tender is won through unfair performance of the state contract procedure but, on the other hand, increases the risk of corruption. However, the expansion of the list of purchasing procedures concerns only a small circle of purchasing objects (*Table 18*).

The lists of goods, works and services which must be placed through an electronic auction and may be purchased from a single supplier have remained almost unchanged (with the exception of the withdrawal of invitations to tender and the inclusion of the purchase and leasing of real estate). The lists for new purchasing procedures appear to correspond with the ideas envisaged when they were introduced. For example, the list of purchases through an invitation to tender is actually a withdrawal of a small part of the grounds for purchasing from a single supplier which were included in Federal Law No.94-FZ. A final aspect worth noting is the potential for criticism of the inclusion of the provision of food services in public institutions into the list where the use of a tender with prequalification (also known as a tender with limited participation) is permissible.

*Table 18*

**New purchasing procedures (Federal Law No.44-FZ)**

Purchasing procedure	Scope	List of goods, works, services
Two-stage tender	Where it is necessary to find out the features of the purchasing object which are the best fit for the relevant need	Creation of culture and art objects Conduct of research and development works
Tender with prequalification	Where improper performance may endanger the life and health of individuals Or where damage can be caused to the property, resulting in irreparable loss of important features of the object	Creation of expensive infrastructure The creation of, and work with, nomenclature related to the atomic industry and energy sector Provision of food services in public sector institutions Preservation of cultural heritage
Invitation to tender	Where criteria which are not included in the list of acceptable criteria may be significant	Sports gear and equipment, sports outfits, necessary for the preparation of sports teams of the Russian Federation for Olympic and Paralympic sports Medical treatment of a Russian citizen abroad Medications for a particular patient Craftwork items Services of professionals in legal proceedings abroad

## 2.3. Inter-budget relations and sub-national finances

### 2.3.1. Analysis of the main features of the consolidated budgets of constituent entities of the Russian Federation

The main trends in the relations between different levels of government are reflected in the structure of revenue and expenditure in the consolidated budget of the Russian Federation. *Table 19* presents data reflecting the shares of tax revenues and expenditure of the constituent entities of the RF in the relevant indicators of Russia's consolidated budget.

*Table 19*

#### Proportions of some indicators in the sub-national budgets within Russia's consolidated budget in 1997-2013, %

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Tax revenues	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9	31.8	33.9	33.2	36.6	37.2	33.2	33.0	33.1
Tax revenues excluding resource payments and customs duty	59.5	59.9	55.0	49.0	42.6	40.1	41.9	47.5	49.1	52.0	50.5	53.7	54.8	57.1	56.9	56.5	56.7
Expenditure	48.1	54.1	51.9	54.4	51.2	49.3	50.0	50.8	49.5	50.0	48.4	49.2	43.4	43.2	45.3	42.6	42.8

Source: Federal Treasury, calculations of the E.T. Gaidar IEP.

The data presented here show that the share of tax revenues of the sub-national budgets in Russia's consolidated budget had grown from 33.2% in 2008 to 36-37% in 2009-2010, but then, in 2011-2013, this indicator returned to its pre-crisis level of 33%. At the same time, the share of tax revenues of the consolidated regional budgets, excluding resource payments and customs duties, having increased from 53.7% to 55-57% in 2009-2010, stabilised in 2011-2013 at a level considerably higher than the pre-crisis one – 56.5-56.9%. The substantial change in this ratio precisely since 2010, compared with the pre-crisis level, was mainly due to the following factors. From 2009 the corporate profit tax rate was reduced from 24 to 20% for the account of federal account component, while 0.5% of the federal rate was transferred to the regions. As a result, in 2009, under the conditions of reduced profits of Russian enterprises, this redistribution of tax income did not have a particularly noticeable effect, however, in 2010 when the Russian economy was gradually recovering, the share of regional tax revenue, excluding resource payments and customs duties, increased considerably. Meanwhile, the share of sub-national budget expenditure in the expenditure of the Russian consolidated budget, having decreased in 2009-2010 due to the accumulation of “anti-crisis” federal budget expenditure, then increased in 2011 (along with the curtailing of anti-recession programmes), stabilising in 2012-2013 at a level of 42.6-42.8%, which is noticeably lower than the pre-crisis level of 49.2%. However, one should bear in mind that the reduction of the gap between the share of income and the share of expenditure of the sub-national budgets in 2012-2013 was largely due to increasing federal budget expenditure and its convergence with the deficit despite the relatively high global oil prices (while in the pre-crisis period a part of the revenues of the federal budget had accumulated in sovereign wealth funds).

Let us consider the revenue part of the sub-national budgets in more detail. The dynamics of the main components of revenues of the consolidated budgets of the constituent entities of the Russian Federation are presented in *Table 20*.

*Table 20*

**Revenues of the consolidated budgets of the constituent entities  
of the Russian Federation in 2008-2013 (in Rb bn)**

	Revenue volume (in nominal terms), Rb bn						Real growth*, %					
	2008	2009	2010	2011	2012	2013	2009/ 2008	2010/ 2009	2011/ 2010	2012/ 2011	2013/ 2012	2013/ 2008
<b>Revenues, total</b>	<b>6,196</b>	<b>5,924</b>	<b>6,537</b>	<b>7,644</b>	<b>8,064</b>	<b>8,165</b>	<b>-12.1</b>	<b>1.4</b>	<b>10.2</b>	<b>-1.0</b>	<b>-4.9</b>	<b>-7.6</b>
<b>Tax and non-tax revenues</b>	<b>4,912</b>	<b>4,243</b>	<b>4,980</b>	<b>5,827</b>	<b>6,385</b>	<b>6,588</b>	<b>-20.6</b>	<b>7.9</b>	<b>10.3</b>	<b>2.8</b>	<b>-3.1</b>	<b>-5.9</b>
including tax revenues	4,384	3,792	4,520	5,273	5,800	5,967	-20.5	9.6	10.0	3.2	-3.4	-4.5
corporate profit tax	1,752	1,069	1,520	1,928	1,980	1,720	-43.9	30.6	19.6	-3.7	-18.4	-31.2
personal income tax	1,666	1,665	1,790	1,996	2,261	2,499	-8.1	-1.2	5.1	6.3	3.8	5.2
tax on aggregate income	161	152	179	215	272	293	-13.6	8.5	13.4	18.4	1.2	27.4
property tax	493	570	628	678	785	901	6.1	1.4	1.7	8.7	7.7	28.0
excise tax	189	246	327	372	442	491	19.2	22.5	7.1	11.4	4.4	81.9
<b>Transfers</b>	<b>1,131</b>	<b>1,486</b>	<b>1,398</b>	<b>1,644</b>	<b>1,624</b>	<b>1,515</b>	<b>20.7</b>	<b>-13.5</b>	<b>10.8</b>	<b>-7.3</b>	<b>-12.4</b>	<b>-6.1</b>
<b>Other revenues</b>	<b>153</b>	<b>195</b>	<b>159</b>	<b>173</b>	<b>56</b>	<b>62</b>	<b>17.4</b>	<b>-25.1</b>	<b>2.5</b>	<b>-69.7</b>	<b>3.9</b>	<b>-71.7</b>

\*Taking into account CPI.

Source: Federal Treasury, calculations of the authors.

As shown in *Table 20*, in 2013 the overall revenues of the consolidated budgets of the constituent entities of the Russian Federation decreased by 4.9% in real terms compared with the 2012 level (in nominal terms there was a growth of 1.2%). The real term reduction in the total level of revenues in 2013 was due to two main factors. Firstly, a slowdown in the growth of the economy<sup>1</sup> and a reduction in the income of Russian companies, which resulted in a reduction of corporate profit tax revenues (-18.4% in real terms compared with the 2012 level). This led to a decrease of tax and non-tax revenues by 3.1%. Secondly, the volume of transfers decreased from Rb 1,624bn in 2012 to Rb 1,515bn in 2013 (a decrease of 12.4% in real terms). This considerable reduction was due to the cessation, in 2013, of the 2011-2012 allocation of transfers from the Federal Compulsory Medical Insurance Fund to the programmes and activities for modernisation of the health care system. Moreover, transfers from the federal budget decreased in real terms (for more information see the following section).

It should be noted that the dynamics of the two main taxes – corporate profit tax and personal income tax (which account for over 70% of the tax revenues of the consolidated regional budgets) – differed considerably. While the growth of revenues from personal income tax in the period in question was 10.5% in nominal terms (3.8% in real terms), corporate profit tax revenues decreased substantially, both in nominal and in real terms (-13.1 and -18.4%, respectively). As a result, the structure of the tax revenues of sub-national budgets also changed noticeably. Whilst in 2012, personal income tax and corporate profit tax accounted for 39.0% and 34.1% of tax revenues, respectively, in 2013 these indicators stood at 41.9% and 28.8%. Corporate profit tax is one of the most volatile taxes, and in periods of worsening macroeconomic situation revenues from it are some of the first to respond the changing economy.

Having considered the dynamics of tax and non-tax revenues in general at sub-national level we shall now consider, in greater detail, the situation with the tax revenues of the constituent entities of the Russian Federation (see *Table 21*).

<sup>1</sup> According to preliminary estimates by Rosstat (Federal State Statistics Service) GDP in 2013 increased only by 1.3%, whilst in 2012 it had grown by 3.4%.

Table 21

**Grouping of regions on the basis of changes in the main types of tax and non-tax revenues of the consolidated budgets of the constituent entities of the Russian Federation**

	Number of constituent entities of the RF showing changes in their main types of tax and non-tax revenues in the consolidated budget of the Russian Federation					
	increase by more than 25%	increase by 10 to 25%	increase by less than 10%	decrease by less than 10%	decrease by 10 to 25%	decrease by more than 25%
<b>in nominal terms</b>						
Tax and non-tax revenues, total	0	16	52	12	1	1
Corporate profit tax	3	3	10	16	31	19
Personal income tax	1	54	26	0	0	1
<b>in real terms</b>						
Tax and non-tax revenues, total	0	3	28	44	5	2
Corporate profit tax	1	2	7	13	36	23
Personal income tax	0	5	69	7	0	1

**Note:** Arkhangelsk region and Nenets Autonomous District are presented in calculations as a single constituent entity.

*Source:* Federal Treasury, calculations by the authors.

As the above data show, in the majority of the Russian regions the situation with regard to the tax revenues of the sub-national budgets was quite unfavourable. In 51 constituent entities of the Russian Federation, based on the results for 2013, a reduction of income in real terms was recorded, although in 44 of these the reduction did not exceed 10%. Corporate profit tax revenues, in real terms, decreased by more than 25% in 23 regions. Those with the greatest reductions in this tax were: the Chukotka Autonomous District (–60.4%), the Kamchatka region (–41.4%), the Tyumen region (–41.5%), the Republic of Ingushetia (–51.5%), the Vologda region (–48.8%) and the Republic of Karelia (–61.0%). Personal income tax revenues increased in almost all regions. The exception to this was the Republic of Kalmykia (–56.3%). This can be explained by the fact that, in 2012, one major taxpayer contributed a relatively high tax amount to the budget of Kalmykia, which caused significant fluctuations in the personal income tax revenues of the region in 2011-2013

Overall, personal income tax currently ensures relative stability of tax revenues in almost all the Russian regions. In contrast, the dynamics of corporate profit tax revenues remain a destabilising factor. Of greatest concern are the regions which are drivers of the Russian economy – those with a high level of fiscal capacity where corporate profit tax accounts for a significant proportion of the total tax revenues.

Let us now consider the changes which have occurred in the expenditure component of the consolidated budget of the constituent entities of the Russian Federation in 2013 (*Table 22*). In 2013, total expenditure decreased compared with the previous year, both in real terms (–0.9%) and in shares of GDP (by 0.29 p.p. from 13.50% to 13.21%).

In analysing the changes in regional budgetary expenditure in particular areas the following should be noted. The biggest reduction of expenditure in 2013, compared with the previous year, was observed in the field of “Healthcare” (–7.9% in nominal and –13.5% in real terms). As a result, the proportion of total expenditure on healthcare for the year decreased from 16.3% to 14.2%. However, this reduction was mainly associated with a redistribution of costs between the budgets of the constituent entities and territorial CMI (Compulsory Medical Insurance) Funds, due to the transfer of emergency medical assistance

to the CMI system. The reduction of expenditure on housing and public utilities (by 3.9%) and on social policy (by 3.2%) in real terms also should be noted.

*Table 22*

**Expenditures of the consolidated budgets of the constituent entities  
of the Russian Federation in 2012-2013**

	% of the total		% of GDP		Increase, %	
	2012	2013	2012	2013	in nominal terms	in real terms
General national issues	6.1	6.2	0.83	0.82	7.0	0.5
National security and law enforcement activities	1.1	1.2	0.15	0.16	12.7	5.8
National economy, including:	19.2	19.6	2.60	2.59	7.8	1.2
agriculture and fishing	2.9	3.4	0.39	0.45	23.5	16.0
transportation	3.5	3.4	0.48	0.45	0.8	-5.4
public road system (road funds)	7.7	8.3	1.05	1.10	13.1	6.2
other aspects of the national economy	2.9	2.5	0.39	0.32	-11.4	-16.8
housing and public utility sector	10.6	10.2	1.43	1.35	2.3	-3.9
environmental protection	0.3	0.3	0.04	0.04	13.6	6.7
Education, including:	24.5	26.5	3.31	3.50	14.0	7.0
pre-school education	5.6	6.7	0.75	0.89	27.6	19.8
primary and secondary education	14.1	15.0	1.90	1.98	12.2	5.3
vocational education	1.5	1.6	0.20	0.21	11.6	4.8
other aspects of education	1.7	1.6	0.22	0.22	4.5	-1.9
culture, cinematography	3.1	3.3	0.42	0.43	12.1	5.3
healthcare	16.3	14.2	2.20	1.88	-7.9	-13.5
social policy	15.3	14.9	2.06	1.97	3.0	-3.2
physical culture and sports	1.9	1.9	0.25	0.26	9.3	2.6
the media	0.5	0.5	0.06	0.06	5.8	-0.6
servicing of state and municipal debt	0.9	1.0	0.12	0.14	22.2	14.7
<b>Expenditure, total</b>	<b>100.0</b>	<b>100.0</b>	<b>13.50</b>	<b>13.21</b>	<b>5.6</b>	<b>-0.9</b>

*Source:* Federal Treasury, calculations by the authors.

At the same time, again based on the 2013 results, certain sections of expenditure within the consolidated budgets of constituent entities of the RF showed increases. Expenditure on the large “Education” component increased considerable (by 14% in nominal and 7.0% in real terms). The expenditure on education increased in all key areas: “Pre-school education” (27.6% in nominal and 19.8% in real terms), “Primary and secondary education” (12.2% in nominal and 5.3% in real terms) and “Vocational education” (11.6% in nominal and 4.8% in real terms). This growth was primarily caused by federal requirements, as early as in 2012-2013, to increase the salaries of employees in the educational field to the average of the region’s economy<sup>1</sup>. Given the necessity to increase salary-related expenditure, the regions had to decrease investment expenditure (in fixed assets and shares in capital) in the face of shrinking revenues. Whilst in 2011 investment expenditure increased by 19% in real terms during the post-crisis recovery of the economy and the improvement of the situation for regional finances, during 2012 they decreased by 5.6% and in 2013 by 8.7% in real terms compared with the previous year.

In 2013 expenditure on national economy increased by 1.2% in real terms. As a result, the share of this section in total expenditure increased by 0.4 p.p. to 19.6%. The growth in expenditure aimed at developing the national economy was the result of increases in expenditure in areas such as: “Agriculture and fishing” (increase by 16.0% in real terms compared with 2012) and the “Public road system (road funds)” (by 6.2%). A considerable

<sup>1</sup> Decree of the President of the Russian Federation dated 7 May 2012 No.597 on Measures to Implement State Social Policy.

growth in real expenditure was also observed in “National security and law enforcement activities” (by 5.8%) and “Culture and cinematography” (5.3%).

The growth of expenditure on servicing state and municipal debt should also be noted. Over the year, expenditure on debt servicing increased by 14.7% in real terms (from 0.12% of GDP to 0.14% of GDP)<sup>1</sup>. In general, however, despite their growth, the expenditure volumes are still far from critical levels.

It is also important to consider the shares in GDP of the consolidated budgets of the constituent entities of the Russian Federation and the principal features of their dynamics (see *Table 23*).

*Table 23*

**Revenue and expenditure of the consolidated budgets of constituent entities of the Russian Federation in 2007-2013, % of GDP**

	2007	2008	2009	2010	2011	2012	2013
<b>Revenues</b>	<b>14.56</b>	<b>15.02</b>	<b>15.27</b>	<b>14.12</b>	<b>13.74</b>	<b>13.05</b>	<b>12.24</b>
including:							
Corporate profit tax	4.60	4.24	2.76	3.28	3.46	3.20	2.58
Personal income tax	3.81	4.04	4.29	3.87	3.59	3.66	3.75
Transfers from the Federal Budget	1.88	2.65	3.81	2.98	2.60	2.33	2.23
<b>Expenditure</b>	<b>14.45</b>	<b>15.15</b>	<b>16.12</b>	<b>14.33</b>	<b>13.80</b>	<b>13.50</b>	<b>13.21</b>
<b>Deficit (+)/Surplus(-)</b>	<b>0.12</b>	<b>-0.13</b>	<b>-0.85</b>	<b>-0.22</b>	<b>-0.06</b>	<b>-0.45</b>	<b>-0.96</b>
For reference only: GDP, Rb bn	33,248	41,277	38,807	46,309	55,644	61,811	66,689

*Source:* Federal Treasury, calculations by the authors.

The above data show that, since 2009, the revenues of the sub-national budgets of the constituent entities of the Russian Federation have been tending to decline in relation to GDP. Whilst, in 2009, the revenues of the sub-national budgets were at a level of 15.27% of GDP, in 2013 they had fallen to 12.24% of GDP. There are several reasons for this trend.

Firstly, the structure of the revenues is changing. Before 2009 corporate profit tax revenues had been the main source of income (2007: 4.6% of GDP, 2008: 4.24% of GDP), and this was higher than personal income tax revenues by 0.79 p.p. and 0.20 p.p., respectively. Then, in 2009, the situation changed. Personal income tax, being more stable, has become the main source of tax income for the sub-national budgets. This tax has been increasing in the last three years — from 3.59% of GDP in 2011 to 3.75% of GDP in 2013, particularly as a result of the growth of salaries in the public sector. By contrast, corporate profit tax revenues in this period have been decreasing, from 3.46% of GDP to 2.58% of GDP, which is a negative signal for the Russian economy that seems to have exhausted all the possibilities of the former growth model. Secondly, in the period in question there was a decrease in the volume of inter-budget transfers allocated from the federal budget. Whilst, in 2009, the constituent entities of the Russian Federation received transfers amounting to 3.81% of GDP, in 2013 the transfers were by 1.58 p.p. less, at 2.23% of GDP. It is important to note that, in 2010-2011, federal aid declined as own revenues of the constituent entities of the Russian Federation recovered, thereby reducing their budget deficits, however, in 2012-2013 the continuing trend towards reduction in the transfers drove an increase in the deficit of the consolidated regional budgets.

Next, we shall consider the situation regarding the performance of the consolidated budgets of the constituent entities of the Russian Federation (*Table 24*). In general, based on the results of 2013, the consolidated budget of the constituent entities of the Russian

<sup>1</sup> For more information on the situation with debt see section 2.3.3 of this overview.

Federation was reduced, so that there was a deficit of Rb 642bn (0.96% of GDP), which is considerably greater than the 2012 indicator (0.44% of GDP).

*Table 24*

**Performance (deficit/surplus) of the consolidated budgets  
of the constituent entities of the Russian Federation in 2008-2013**

Year	Numbers of constituent entities of the Russian Federation performed their budgets in:	
	deficit	surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16
2013	77	6

*Source:* Federal Treasury.

The above data show that the performance of the consolidated budgets of the constituent entities of the Russian Federation turned out to be worse than in 2012. Whilst in 2012 only 67 regions performed their budgets with a deficit, in 2013 there were 77 such regions. In 2013 twelve constituent entities of the Russian Federation which had had a surplus in 2012 converged their budgets with a deficit. In 11 out of those 12 regions the observed growth in expenditure exceeded the average Russian level (5.6% in nominal terms), which casts some doubt on the effectiveness of the budgetary policy conducted in these regions. However, not all constituent entities of the Russian Federation showed an increase in expenditure when compared with 2012. By contrast, in 9 regions the expenditure decreased even in nominal terms compared with the level of the previous year level: Moscow (−0.4%), Krasnodar krai (−3.1%), Volgograd region (0.6%), Chechen Republic (−15.3%), Republic of Mordovia (−7.0%), Republic of Tatarstan (−2.2%), Tyumen region (−12.7%), Yamal-Nenets Autonomous District (−4.8%), Kemerovo region (−0.3%). The constituent entities of the Russian Federation that have reduced their expenditure can be divided in two groups of regions. The first group includes regions with a sufficiently high fiscal capacity (above or close to 1), for which corporate profit tax is one of the key revenue sources (Moscow, Krasnodar krai, Republic of Tatarstan, Tyumen region, Yamal-Nenets Autonomous District and Kemerovo region). The second group includes those constituent entities of the Russian Federation where their structure is characterised by a considerable proportion of transfers from the federal budget and significantly high level of state (municipal) debt (Chechen Republic, Republic of Mordovia). This grouping does not include the Volgograd region, characterised by low fiscal capacity but a relatively small proportion of transfers in its revenues.

In general, when summing up the results of the analysis of the key features of the sub-national budgets in 2013, the following should be noted. The situation in the field of regional and municipal finances has become even more tense, compared with 2012. The number of regions with budget deficits and the volume of borrowings have increased while own revenues have been reduced with no additional financial assistance from the federal budget. Special concern is aroused by there being a reduction in investment activities on the part of the sub-national governments, where the expenditure in their budgets is under pressure due to the necessity to increase salaries in the public sector.

### 2.3.2. Financial assistance from the federal budget

In 2013 the total amount of funds transferred from the federal budget to sub-national budgets decreased in real terms by 3%, compared with the level in 2012 (*Table 25*).

*Table 25*

#### Transfers to Russian regions from the federal budget in 2008-2009 and 2012-2013

	2008		2009		2012		2013		Increase in 2013 on the 2012 level, %	
	Rb bn	% of the total	Rb bn	% of the total	Rb bn	% of the total	Rb bn	% of the total	nominal	real
<b>Transfers to regions, total</b>	1,094.7	100.0	1,480.3	100.0	1,440.2	100.0	1,487.9	100.0	3.3	-3.0
<b>Non-targeted subsidies</b>	390.4	35.7	578.3	39.1	524.0	36.4	609.1	40.9	16.3	9.2
Including:										
non-targeted subsidies to align fiscal capacity	328.6	30.0	374.0	25.3	397.0	27.6	418.8	28.1	5.5	-0.9
non-targeted subsidies to support measures to ensure balanced budgets	46.0	4.2	191.9	13.0	117.2	8.1	177.8	12.0	51.7	42.5
<b>Targeted subsidies</b>	435.9	39.8	530.0	35.8	570.9	39.6	515.6	34.7	-9.7	-15.2
Including:										
targeted subsidies for development of the national economy	181.2	16.5	214.3	14.5	276.2	19.2	268.3	18.0	-2.8	-8.8
<b>Subventions</b>	153.2	14.0	284.4	19.2	284.2	19.7	273.7	18.4	-3.7	-9.6
<b>Other inter-budget transfers</b>	115.2	10.5	87.6	5.9	61.1	4.2	89.5	6.0	46.5	37.6

*Source:* Federal Treasury, calculations of the E.T. Gaidar IEP.

However, for certain types of transfers oppositely directed dynamics could be observed, leading to a restructuring of financial aid. For example, there were increases in 2013, compared with 2012, for transfers such as non-targeted subsidies (increased by 9.2%) and other inter-budget transfers (37.6%). At the same time, the volumes of targeted subsidies and subventions decreased by 9.7% and 3.7%, respectively. It is important to note that non-targeted subsidies grew mainly due to their use to support measures to balance the budgets (increased by 42.5%). The increase in this type of transfer was mainly associated with the necessity for constituent entities to implement the Decrees of the President of the Russian Federation dated 7 May 2012. Meanwhile, the volume of non-targeted subsidies used to align fiscal capacities decreased in real terms by 0.9%.

As a result, by the end of 2013 the structure of transfers has changed. The share of non-targeted subsidies in the total volume of transfers had increased, reaching 40.9% (in 2012 it was 36.4%) and the share of other inter-budget transfers was 6% (in 2012 it was 4.2%). By contrast, the share of targeted subsidies decreased from 39.6% in 2012 to 34.7% in 2013 and the share of subventions decreased from 19.7% to 18.4%.

In general, the tendency to increase the share of non-targeted transfers is envisaged by all key documents in the field of fiscal policy, including the adopted law on federal budget for 2014-2016<sup>1</sup>. For example, in 2016 the share of targeted subsidies is expected to decrease to 18.5% of the total volume of transfers with the proportion of non-targeted subsidies rising to

<sup>1</sup> Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016'.



50.8%. However, it should be noted that the share of non-targeted transfers is currently increasing, mainly due to the use of non-targeted subsidies to balance budgets and this instrument is one of the least transparent mechanisms in the system of inter-budget relations in Russia. It should also be borne in mind that the share of non-targeted subsidies allocated to implement the Presidential Decrees of May (2012) in reality does not constitute non-targeted subsidies but actually represents targeted subsidies. As a result, such changes in the structure of federal financial aid only distort the inter-budget relations and make them less transparent.

When analysing the process of the allocation of federal government transfers to the regions it is important to consider how federal aid affects income inequalities of constituent entities, i.e. to evaluate the levelling properties of financial assistance provided from the federal budget (*Table 26*).

*Table 26*

**Coefficient of variation of the revenues of consolidated regional budgets  
(per capita, taking into account BEI\*) in 2008-2013, %**

Year	Tax revenues	Tax revenues and non-targeted subsidies to align fiscal capacity	Tax revenues, non-targeted subsidies and targeted subsidies
2008	90.6	80.4	71.5
2009	78.3	66.5	54.5
2010	74.2	63.9	57.8
2011	77.8	68.4	61.6
2012	66.1	57.8	51.9
2013	63.7	55.3	48.1

\*BEI – budgetary expenditure index calculated using the method of distribution of non-targeted subsidies to align fiscal capacity.

Source: Federal Treasury, calculations of the E.T. Gaidar IEP.

As can be seen from the data provided in *Table 26* the allocation of non-targeted subsidies to align fiscal capacity in 2013 continued influencing the reduction of income inequalities in the sub-national budgets. However, it should be noted that the extent of this influence has been gradually decreasing since 2010. This has mainly been due to the declining proportion of non-targeted subsidies used to align fiscal capacity in the total amount of transfers allocated from the federal budget. Whilst, in 2008, the share of these non-targeted subsidies had been 30.1%, in 2011-2013 it was already 27-28%. We can also note a considerable decrease in the share of non-targeted subsidies to align fiscal capacity in shares of GDP from 0.86% in 2010 to 0.63% in 2013 (in 2008 it was 0.80%). The volume of tax revenues of the consolidated budgets of the constituent entities in terms of GDP also decreased in the period in question but at a lower rate: from 9.8 to 8.9% of GDP (in 2008 it had been 10.6%). As a result, in 2013, the coefficient of variation of regional revenues after the allocation of non-targeted subsidies to align fiscal capacity decreased only by 8.4 p.p., although in 2008-2010 this indicator was consistently greater than 10 p.p. Thus, one can conclude that it is necessary to increase the volume of non-targeted subsidies in order to align the fiscal capacity of the constituent entities of the Russian Federation. The total of the non-targeted subsidies (including non-targeted subsidies used to align fiscal capacity) and of targeted subsidies ultimately reduced the differentiation of regional revenues by 15.6 p.p., which is better than in 2012 (14.1 p.p.) but much lower than that of the pre-crisis level of 2008 (19.1 p.p.).

It should be noted that in 2013 there was a decrease in the uniformity of provision of transfers to sub-federal budgets. For example, for the first 9 months of 2013 the approved annual plan was performed only by 71.6%, which is 3.6 p.p. lower than the performance of the cash plan in the corresponding period of 2012 (75.2%) (*Table 27*).

Table 27

**Transfers to regions from the federal budget  
for the first 9 months of 2012 and 2013**

	For 9 months of 2012		For 9 months of 2013		Plan, Rb bn		Changes compared with the plan, %
	Performed, Rb bn	% of performance	Performed, Rb bn	% of performance	2012	2013	2013
<b>Transfers, total</b>	<b>1,023</b>	<b>75.2</b>	<b>1,036</b>	<b>71.6</b>	<b>1,360</b>	<b>1,446</b>	<b>2.8</b>
Non-targeted subsidies	377	75.0	441	73.8	502	597	2.0
Targeted subsidies	360	70.2	319	63.1	513	506	1.9
Subventions	246	83.3	226	80.4	295	281	-2.7
Other inter-budget transfers	40	81.4	50	80.6	49	62	30.7

Source: Federal Treasury, E.T. Gaidar IEP.

In general, the slowdown in the provision of financial assistance was observed for all types of transfers. Targeted subsidies were characterised by the greatest lack of uniformity. Whilst 70.2% of all targeted subsidies were provided in the first 9 months of 2012, in the corresponding 9 months of 2013 the figure was only 63.1%. Moreover, 23% of the targeted subsidies were allocated in December 2013, which rendered impossible their full utilisation by the regions. As a result, in January 2014 Rb 176.9bn of remaining targeted transfers were returned to the federal budget, which accounted for about 12% of the total volume of the transfers provided to regions in 2013. Thus, on average, the provision of transfers in 2013 became much less uniform than in 2012, with subventions and other inter-budget transfers being the most uniformly distributed during the financial year, just as in the year before.

The experience of 2013 once again showed that the actual volumes of transfers from the federal budget could differ considerably from the initial plan. So, by the end of 2013 total transfers had increased by 2.8% compared with the plan, with the allocation of targeted subsidies being 1.9% greater than initially planned, non-targeted subsidies 2.0% greater, other inter-budget transfers 30.7% greater. By contrast, the volume of subventions decreased by 2.7% compared with the plan.

Note that, in 2013, additional funding (not envisaged by the plan) was provided to 23 regions in the form of non-targeted subsidies<sup>1</sup>. However, the total amount of this funding was relatively small, only Rb 13bn, out of which:

- Rb 529.9m aimed at partial compensation of the reduction in the volume of non-targeted subsidies, to align the fiscal capacities of the constituent entities of the Russian Federation, where there will be a greater than 20% reduction in the volumes of specified non-targeted subsidies in 2014 compared with 2013 and the share of non-targeted subsidies in the forecast volume of tax and non-tax revenues of the consolidated budgets of the constituent entities of the Russian Federation in 2013 exceeded 10% (Stavropol krai, Amur region);
- 6 Rb bn aimed at partial compensation for the reduction in corporate profit tax revenues to the budgets of the constituent entities of the Russian Federation, where such a reduction in tax revenues for the first 10 months of 2013 exceeded 10%, with negative dynamics of both tax and non-tax revenues (Republic of Karelia, Republic of Komi, Republic of Khakassia, Krasnoyarsk krai, Arkhangelsk region, Belgorod region, Bryansk region,

<sup>1</sup> <http://government.ru/announcements/8892> — Official website of the Government of the Russian Federation.

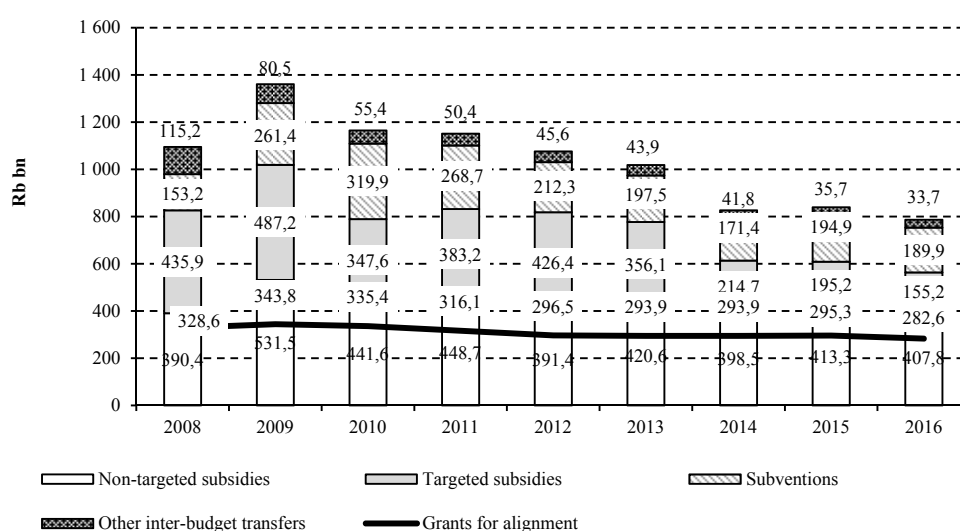
Vologda region, Irkutsk region, Kemerovo region, Novgorod region, Orenburg region, Saratov region and the Chukotka Autonomous District);

- 6 Rb bn aimed at partial compensation for the reduction in corporate profit tax revenues to the budgets of the constituent entities of the Russian Federation (due to the creation of consolidated groups of taxpayers) where this reduction exceeded 1% of the tax and non-tax revenues (Republic of Karelia, Krasnoyarsk krai, Perm krai, Belgorod region, Bryansk region, Volgograd, Nizhny Novgorod region, Samara region, Tambov region and the Tomsk region);
- Rb 400m aimed at providing a non-targeted subsidy to the Vladimir region in relation to a reduction in its tax revenues.

The remaining constituent entities of the Russian Federation were not included as recipients of the non-targeted subsidies, because, according to federal government estimates, they had lower risks of unbalanced regional budgets based on the results for the year.

It is important to note that since 2010 a gradual reduction in the volume of federal transfers allocated to sub-national budgets has been observed (*Fig. 20*).

As shown in *Fig. 20*, in real terms, the total volumes of transfers are tending to decrease. Whereas, in 2008 Rb 1,094.1bn was allocated, in 2013 the figure was Rb 1,018.1bn, and by 2016 it is expected to be only Rb 786.5bn for transfers from the federal budget (at 2008 prices). The targeted subsidies will be reduced the most. It should be noted that the reduction in the number (consolidation) and the decrease in the share of targeted subsidies in the total volume of federal financial aid is, in principle, a reasonable goal, aimed at improving the structure of inter-budget transfers and the efficiency of the process of allocation of financial aid. However, the reduction of targeted subsidies makes sense only if there is a corresponding increase in non-targeted financial assistance, mainly, in the form of non-targeted subsidies to align fiscal capacity. The reduction in the total volume of transfers in real terms, where there is a reduction in own revenues, in fact discredits the process of reforming targeted subsidies, as perceived by regional governments: consolidation becomes a synonym for the reduction of financial support from federal government.



*Source:* Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations of the authors.

*Fig. 20.* Transfers to regions from the federal budget for 2008-2016 (at 2008 prices)

Therefore note that, in 2013, taking into account the non-uniformity of provision of financial assistance during the financial year, the increase in the volume and share of non-targeted subsidies to align fiscal capacity, meant a decrease in the efficiency of the mechanism of provision of transfers to regions from the federal budget. Questions are also raised regarding the further planned decrease in the volumes of financial assistance where there is increasing tension over the performance of the consolidated budgets of the constituent entities of the Russian Federation.

### 2.3.3. Analysis of state and municipal debt

Data on the dynamics of the volumes of state debt of the constituent entities of the Russian Federation and of municipal debt from 2010 to 1 January 2014 are laid out in *Table 28*.

*Table 28*

**State and municipal debt of the sub-national budgets in 2010-2014**

	as of 1 January 2011	as of 1 January 2012		as of 1 January 2013		as of 1 January 2014	
	volume, Rb bn	volume, Rb bn	increase (%)	volume, Rb bn	increase (%)	volume, Rb bn	increase (%)
Total for regional budgets	1,096.0	1,171.8	6.9	1,355.0	15.6	1,737.5	28.2
Total for regional budgets (excluding Moscow and the Moscow region)	649.9	831.6	28.0	1,068.7	28.5	1,474.1	37.9
Total for municipal budgets	169.8	215.5	26.9	245.3	13.8	288.9	17.8
Volume of regional debt as % of GDP	1.64	1.76	7.3	2.03	15.3	2.61	28.6

*Source:* Ministry of Finance of Russia, calculations by the authors.

As can be seen from *Table 28*, the situation with the volume of debt of regional and municipal budgets in 2013 has changed substantially, showing a considerable increase in the amount of debt. The increase in the level of state debt of the constituent entities of the Russian Federation was 28.2%, whilst, excluding Moscow and the Moscow region, it was 37.9%. However, in general, the total volume of debt is not yet large, being about 2.6% of GDP. At the same time, as in the previous year, a considerable volume of borrowing occurred in December. So, in just that one month the volume of state debt increased by 16.5% in nominal terms (by Rb 245.9bn, from Rb 1,491.5bn to Rb 1,737.5bn) and municipal debt increased by 15.8% (by Rb 39.4bn, from Rb 249.4.2bn to Rb 288.9bn). In December 2012 state debt increased by 16.4% (by Rb 190.7bn, from Rb 1,164.2bn to Rb 1,355.0bn) and municipal debt by 14.8% (by Rb 31.7bn, from Rb 213.2bn to Rb 245.3bn).

It should be noted that whereas the major part of regional debt had previously been accounted for by only 2 constituent entities of the Russian Federation – Moscow and the Moscow region (with 40.7% of the total volume of regional debt, as of 1 January 2011), on 1 January 2014 they accounted for only 15.1% of the total debt. In 2013 data on the constituent entities of the Russian Federation showed a decrease in the level of state debt by 8% (principally by the of Moscow region).

At the moment, the main borrowers (by volume of accumulated debt) are Moscow (Rb 179bn), Krasnodar krai (Rb 119bn), the Republic of Tatarstan (Rb 85bn) and the Moscow region (Rb 84bn). It should be noted that Krasnodar krai has become the first constituent entity of the Russian Federation after Moscow, whose debt obligations have increased above

Rb 100bn. In 2013 this region increased its debt obligations by 61.3%, compared with its debts at the beginning of the year.

In general, the increase in debt burden in many constituent entities of the Russian Federation is evidenced by the regional data (*Table 29*).

*Table 29*

**Dynamics of changes in state debt of the budgets of constituent entities  
of the Russian Federation in 2008-2013**

	Numbers of constituent entities of the Russian Federation with respect to the dynamics of state debt (in nominal terms) in the corresponding periods of different years					
	increase by more than 50%	increase by 15 to 50%	increase by less than 15%	decrease by less than 15%	decrease by 15 to 50%	decrease by more than 50%
2008	21	20	10	6	12	9
2009	37	18	11	6	4	2
2010	29	24	8	11	7	0
2011	21	27	13	14	6	0
2012	18	29	14	8	10	1
2013	31	36	8	6	1	0

*Source:* Ministry of Finance of Russia, calculations by the authors.

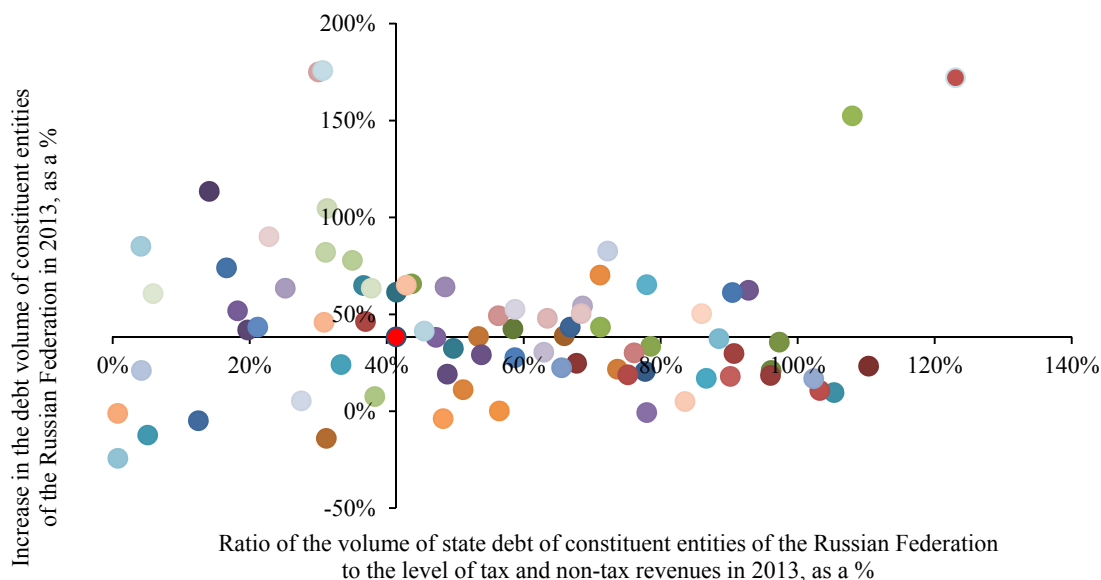
In 2013, the volume of state debt increased in 75 out of 82 constituent entities of the Russian Federation, with a considerable increase in the volumes of debt (by more than 15%) being observed in 67 regions. In 31 constituent entities of the Russian Federation the debts increased by more than 50%. A considerable increase was observed in the Vladimir region (114%), Republic of Ingushetia (152%), Khanty-Mansi Autonomous District (431%), Yamal-Nenets Autonomous District (175%), Novosibirsk region (105%), Primorsky krai (1867%), Khabarovsk krai (176 %) and Chukotka Autonomous District (172%).

Of particular concern are those constituent entities of the Russian Federation which, in 2013, not only considerably increased debt volumes but also substantially raised their debt burden (the ratio of the volume of state debt to the level of tax and non-tax revenues of the constituent entity of the Russian Federation<sup>1</sup>) (*Fig. 21*). In 2013 the average debt burden for the Russian regions was 41.4% (excluding Moscow and the Moscow region), whilst in 2012 it was 30.4%.

*Fig. 21* shows that 23 out of 82 constituent entities of the Russian Federation are in the “troubled sector”: here the growth of state debt and debt burden are higher than the Russian average. It should be noted that in 7 constituent entities of the Russian Federation the level of the debt burden exceeds the amount of their tax and non-tax revenues: Republic of Mordovia (172.1%), Chukotka Autonomous District (123%), Belgorod region (110.3%), Republic of Ingushetia (108%), Vologda region (105.3%), Republic of North Ossetia-Alania (103.2%) and Saratov region (102.3%). A few other constituent entities (Kostroma region, Ryazan region, Smolensk region, Republic of Karelia, Pskov region, Krasnodar krai and Republic of Mari El) are close to the critical level (with debt levels over 90% of their own revenues). Among the above constituent entities particularly alarming situations exist in the Chukotka Autonomous District (the debt burden as of the end of 2013 was 123%, an increase during

<sup>1</sup> Before 1 January 2017 the maximum volume of state debt of a constituent entity of the Russian Federation (municipal debt) can exceed the limitations set forth in clauses 2 and 3 of Article 107 of the Budgetary Code of the Russian Federation (100% of budgetary revenues excluding non-repayable transfers) within the limit of the state debt volume of the constituent entity of the Russian Federation (municipal debt) in the form of budgetary loans (Federal Law dated 9 April 2009 No.58-FZ (as revised on 30 November 2011)), the provision of which is determined at federal government level.

2013 of 172%), Republic of Ingushetia (108% and 152%), Pskov region (93% and 62%) and Krasnodar krai (90% and 61%).



**Note:** 1) The axes intersect at the point where the debt burden and the increase in the debt volume of the constituent entities of the Russian Federation in 2013 are equal to the average Russian values (excluding Moscow and the Moscow region) (41.4% and 38.4%, respectively).

2) The diagram does not include: Khanty-Mansi Autonomous District (9.6%, 430.7%), Primorsky krai (16.7%, 1867%) or Republic of Mordovia (172.1%, 10.1%).

Source: Federal Treasury, Ministry of Finance of Russia, calculations by the authors.

Fig. 21. Debt burden and changes in state debt of the constituent entities of the Russian Federation in 2013 (%)

In general, one can say that the situation with regional and municipal debt is continuing to worsen. However, in most regions which are actively accumulating borrowing the debt burden has remained at a relatively safe level.

#### 2.3.4. Conclusions with regard to the allocation of inter-budget transfers to other levels of the budgetary system provided by the Federal Law dated 2 December 2013, No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’

The total volume and dynamics of inter-budget transfers from the federal budget to the budgets of constituent entities of the Russian Federation in accordance with Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’ are laid out in *Table 30*.

In parallel with the total volume of inter-budget transfers, it seems reasonable to include the indicator of the total volume of inter-budget transfers excluding subventions in the analysis, because it reflects the financial performance by the relevant authorities of their own powers.

*Table 30*

### Inter-budget transfers in 2013-2016

Indicator	2013	2014		2015		2016		
	Rb bn	Rb bn	as % of the previous year	Rb bn	as % of the previous year	Rb bn	as % of the previous year	as % of 2013
Inter-budget transfers	1,488	1,233	82.9	1,308	106.1	1,281	98.0	86.1
Non-targeted subsidies	609	594	97.5	644	108.4	664	103.1	109.0
<i>including non-targeted subsidies to align fiscal capacity</i>	419	440	105.0	462	105.0	462	100.0	110.3
<i>non-targeted subsidies to support measures to balance budgets</i>	178	141	79.2	170	120.5	190	111.8	106.7
Targeted subsidies	516	320	62.0	304	95.0	253	83.1	49.0
Subventions	274	256	93.4	304	118.9	309	101.8	112.8
Other inter-budget transfers	89	62	69.7	56	89.2	55	98.6	61.8
Inter-budget transfers excluding subventions	1,214	977	80.5	1,004	102.8	972	96.8	80.1
<i>For reference: Inter-budget transfers as % of GDP</i>	<i>2.23</i>	<i>1.68</i>		<i>1.64</i>		<i>1.48</i>		<i>66.4</i>

*Source:* Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations by the authors.

With the exception of slight growth in 2015, the total volume of inter-budget transfers has a generally downward trend for 2014-2016: over the 3 years the volume decreases to 80.1% of the 2013 volume excluding subventions. This overall decrease can be seen in the targeted subsidies (from 2014-2016 the annual decreases will be 38%, 5% and 16.9%, respectively), the increase in subventions (–6.6%, 18.9% and 1.8%), the non-targeted subsidies and support measures to balance the budgets of constituent entities of the Russian Federation (–20.8%, 20.5% and 11.8%) and in the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation (5.0%, 5.0% and 0%).

The decrease in the total volume of inter-budget transfers is not offset by the transfer of additional sources of income at regional or local level or by the transfer of expenditure obligations from regional or local levels to the federal level.

As shown in *Table 31*, the decrease in the nominal volume of financial assistance to the lower level budgets is not the result of the forecast of negative GDP growth rates nor the general decrease of revenues and/or expenditure in the federal budget. Indeed, the ratio of the total volume of inter-budget transfers (both including and excluding subventions) to GDP and to the total volume of expenditure of the federal budget monotonously decreases over the period in question. The same conclusion is true for main inter-budget transfers unrelated to the transfer of particular powers of the Russian Federation to the regions: the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation, and the targeted subsidies.

It is unlikely that the decrease in the volume of inter-budget transfers to the constituent entities of the Russian Federation will be offset by a faster growth of tax and non-tax revenues for their budgets (*Table 32*). Indeed, the increase in revenues of the consolidated budgets of the constituent entities of the Russian Federation in 2012-2013 did not exceed the corresponding indicators of the federal budget. In particular, in 2012 the increase in revenues of the federal budget exceeded the increase in revenues of the consolidated budget of the

constituent entities of the Russian Federation by 7.6 p.p., and in 2013 the growth rates of the revenues of both were almost equal at 1.2-1.3%.

Table 31

**Dynamics of inter-budget transfers in 2013-2016**

Indicator	Measurement unit	2013	2014	2015	2016
GDP	Rb bn	66,689	73,315	79,660	86,837
Expenditure of the federal budget	Rb bn	13,343	13,960	15,362	16,392
Inter-budget transfers, total	Rb bn	1,488	1,233	1,308	1,281
Non-targeted subsidies	Rb bn	609	594	644	664
Non-targeted subsidies to align fiscal capacity	Rb bn	419	440	462	462
Non-targeted subsidies to balance budgets	Rb bn	178	141	170	190
Targeted subsidies	Rb bn	516	320	304	253
Subventions	Rb bn	274	256	304	309
Other inter-budget transfers	Rb bn	89	62	56	55
Inter-budget transfers excluding subventions	Rb bn	1,214	977	1,004	972
Inter-budget transfers, total	% of GDP	2.23	1.68	1.64	1.48
Non-targeted subsidies	% of GDP	0.91	0.81	0.81	0.76
Non-targeted subsidies to align fiscal capacity	% of GDP	0.63	0.60	0.58	0.53
Non-targeted subsidies to balance budgets	% of GDP	0.27	0.19	0.21	0.22
Targeted subsidies	% of GDP	0.77	0.44	0.38	0.29
Subventions	% of GDP	0.41	0.35	0.38	0.36
Other inter-budget transfers	% of GDP	0.13	0.09	0.07	0.06
Inter-budget transfers excluding subventions	% of GDP	1.82	1.33	1.26	1.12
Inter-budget transfers, total	% of expenditure	11.15	8.83	8.51	7.82
Non-targeted subsidies	% of expenditure	4.57	4.26	4.19	4.05
Non-targeted subsidies to align fiscal capacity	% of expenditure	3.14	3.15	3.01	2.82
Non-targeted subsidies to balance budgets	% of expenditure	1.33	1.01	1.11	1.16
Targeted subsidies	% of expenditure	3.86	2.29	1.98	1.54
Subventions	% of expenditure	2.05	1.83	1.98	1.89
Other inter-budget transfers	% of expenditure	0.67	0.45	0.36	0.33
Inter-budget transfers excluding subventions	% of expenditure	9.10	7.00	6.54	5.93

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016', calculations by the authors.

Table 32

**Revenues of the federal and consolidated budgets of the constituent entities of the Russian Federation in 2011-2016**

Indicators	Measurement unit	2011	2012	2013	2014	2015	2016
Federal budget	Rb bn	11,368	12,856	13,019	13,571	14,565	15,906
	As % of the previous year	-	113.1	101.3	105.2	107.3	109.2
Consolidated budgets of constituent entities of the Russian Federation							
Revenues, total	Rb bn	7,641	8,061	8,164	8,765	9,491	10,310
	As % of the previous year	-	105.5	101.2	108.3	107.6	108.5
Revenues excluding inter-budget transfers	Rb bn	5,874	6,382	6,649	7,532	8,183	9,029
	As % of the previous year	-	108.7	104.2	111.3	108.6	110.3

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016', calculations by the authors.

It should be noted that the reduction in the volume of targeted subsidies corresponds to the goals of the State Programme of the Russian Federation "The Creation of Conditions for Effective and Responsible Management of Regional and Municipal Finances and Increase of



Stability of the Budgets of the Constituent Entities of the Russian Federation” approved by Decree of the Government of the Russian Federation dated 18 March 2013 No.376-r. As development priorities the Programme indicates a reduction in the share of targeted transfers and a transition to predominantly non-targeted financial support in the system of inter-budget relations. Therefore, one of the indicators of achievement of the goals set in the Programme is the proportion of non-targeted subsidies in inter-budget transfers. *Table 33* demonstrates the simultaneous reduction of the share of targeted subsidies and the increase in the share of non-targeted subsidies, with the proportion of non-targeted subsidies actually being considerably higher than the one specified in the Programme (according to the Programme the share of non-targeted subsidies in 2014-2016 should be 38%, 39% and 40%, respectively).

*Table 33*

**Structure of inter-budget transfers in 2013-2016, Rb bn**

Indicator	2013	2014	2015	2016
Inter-budget transfers	1,487.9	1,233	1,308	1,281
including:				
Non-targeted subsidies, including:	41.6	48.2	49.3	51.8
<i>non-targeted subsidies to align fiscal capacity</i>	28.1	35.7	35.3	36.0
<i>non-targeted subsidies to balance budgets</i>	12.0	11.4	13.0	14.8
Targeted subsidies	34.7	26.0	23.3	19.7
Subventions	18.4	20.7	23.2	24.1
Other inter-budget transfers	6.0	5.1	4.2	4.3
Inter-budget transfers excluding subventions	1,214.2	977.0	1,004.0	971.7
including:				
Non-targeted subsidies, including (%):	50.2	60.8	64.2	68.4
<i>non-targeted subsidies to align fiscal capacity</i>	34.5	45.0	46.0	47.5
<i>non-targeted subsidies to balance budgets</i>	14.6	14.4	16.9	19.5
Targeted subsidies	42.5	32.8	30.3	26.0
Other inter-budget transfers	7.4	6.4	5.5	5.6

*Source:* Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations by the authors.

However, the non-targeted subsidies to balance the budgets are, essentially, almost indistinguishable from targeted subsidies, because they have a particular purpose and are provided on condition of co-financing. These can include the following (within the framework of a sub-programme “Sustaining the Performance of the Budgets of the Constituent Entities of the Russian Federation and Local Budgets” within the aforementioned State Programme):

- a non-targeted subsidy to balance the budget of the Omsk region;
- a non-targeted subsidy to balance the budget of the federal city of Saint-Petersburg;
- non-targeted subsidies as partial compensation for the additional expenditure arising from the increase in salaries of public sector employees.

Hence, referring to inter-budget transfers which have a particular purpose (in this case the ‘target’ does not relate to the destination of the transferred funds but to achieving targeted quality results) as non-targeted subsidies is very questionable and casts doubt on achieving the stated aims related to the proportion of non-targeted financial assistance provided to the budgets of constituent entities of the Russian Federation.

One of the indicators of the quality of the three-year budgetary planning is the extent of deviation from the newly approved budget parameters found in the next financial year and in the first year of the planning period when compared with the corresponding values approved for these same years in the previous budget Law. A comparison of the volumes of the inter-budget transfers (*Table 34*) shows that the volumes of all types of inter-budget transfers have been adjusted upwards: for non-targeted subsidies and targeted subsidies in 2014 the average

adjustment is 3-6%, for 2015 it is 10-13%. The positive adjustment of the volumes of inter-budget transfers has helped to avoid further imbalance in the consolidated budgets of the constituent entities of the Russian Federation. At the same time, the considerable adjustment of the volumes of subventions and other inter-budget transfers shows that the parameters of the regional budgets for the planning period are highly dependent on newly made federal decisions, and this therefore does not eliminate the issue of the stability of regional finances.

*Table 34*

**Inter-budget transfers approved in the federal budget  
for 2013-2015 and in the federal budget for 2014-2016, Rb bn**

Indicator	2014			2015		
	216-FZ	349-FZ	Increase, %	216-FZ	349-FZ	Increase, %
Inter-budget transfers	1,184	1,233	4.1	1,168	1,308	12.0
Non-targeted subsidies	592	594	0.3	582	644	10.6
<i>including non-targeted subsidies to align fiscal capacity</i>	419	440	5.0	419	462	10.2
<i>including non-targeted subsidies to balance budgets</i>	161	141	-12.5	151	170	12.6
Targeted subsidies	300	320	6.8	287	304	5.9
Subventions	244	256	4.7	254	304	19.4
Other inter-budget transfers	47	62	31.4	44	56	26.0

*Source:* Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, Federal Law dated 3 December 2012 No.216-FZ ‘On the Federal Budget for 2013 and the Planning Period of 2014 and 2015’, calculations by the authors.

The major part of the volume of non-targeted subsidies to balance the budgets (Rb 120, 130 and 150bn for 2014-2016, respectively, which represent about 30% of the total volume of non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation) is related to the financial support for implementation of the Presidential Decrees of 7 May 2012. In this case, it constitutes additional financial support for the current expenditure obligations of a permanent nature. At the same time, financial support of the current expenditure obligations is being performed by the provision of non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation. The difficulty in application of this mechanism under the current conditions is due to its failure to provide transfers to constituent entities of the Russian Federation, whose fiscal capacity level is in the interval from 1 to 2, and due to the fact that the method of distribution of non-targeted subsidies to align the fiscal capacities was not adjusted to take into account any need to increase salaries across a major part of the public-sector funded organisations to the average level for the economy of the respective constituent entity of the Russian Federation. However, it could be possible to provide relevant assistance to regions-donors in the form of targeted subsidies while the remaining regions receive non-targeted subsidies to align their fiscal capacities.

Among the priority goals for development within the system of inter-budget relations set in the State Programme of the Russian Federation “The Creation of Conditions for Effective and Responsible Management of Regional and Municipal Finances and Increase of Stability of the Budgets of Constituent Entities of the Russian Federation” are the reduction of the number of targeted subsidies that will take place through their consolidation within the framework of Russian Federation state programmes (the target values for 2014-2016 are 80, 70 and 60, respectively) and the increase in the share of targeted subsidies from the federal budget to the budgets of constituent entities of the Russian Federation, the distribution of which amongst

these entities has been approved by annexes to the Law on Federal Budgets for the next financial year and the planning period (the target values for 2014-2016 are 25%, 30% and 35%, respectively). Based on the number of target items for which it is planned to provide targeted subsidies to the budgets of constituent entities, in accordance with the Law on Federal Budgets in 2014-2016 the number of targeted subsidies is 82 for 2014, 73 for 2015 and 62 for 2016. In turn, the estimated proportion of distributed targeted subsidies for 2014 is 20.7%. Thus, the decrease in the number of targeted subsidies to the budgets of constituent entities of the Russian Federation and the increase in the share of distributed targeted subsidies are a little behind the target values, so additional effort will be required in this direction.

In general, in respect of the provision of inter-budget transfers Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period of 2015 and 2016' shows a general commitment of state budgetary policy to the set priorities. At the same time, there exist high risks that real financial support for the budgets of the constituent entities of the Russian Federation will decrease and that lack of achievement of the overly-optimistic estimates of revenue growth rates for the consolidated budgets of the constituent entities will have a particularly unfavourable effect on the total balance of budgets at the sub-federal level and will cast doubt on the possibility of implementing the Presidential Decrees of 7 May 2012. There are still some reservations over the opportunity to increase the efficiency of the structure of the inter-budget transfers and to improve the method of distribution of the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation. It also seems necessary to intensify work on the consolidation of inter-budget targeted subsidies and to increase the share of targeted subsidies, the distribution of which amongst the constituent entities of the Russian Federation has been approved by an annex to the Law on Federal Budgets for the next financial year and the planning period.

