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*The review provides a detailed analysis of main trends in Russia's economy in 2009. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.*

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## Russia's State Budget in 2009

In 2009 Russia's economy has completed its journey from the recession noted in the first half of the year to the stabilization with initial signs of revival. The latter phenomenon was mirrored in some improvement of economic indicators vis-à-vis expectations, particularly the ones in the area of public finance. Behind the improvement there had been huge injections of public funds into the economy. Quite illustratively, the enlarged government's aggregate expenditures hit a record-breaking value ever reported in the '2000s. In tandem with a sizeable fall in budget revenues, that had resulted in the budgets of all levels running deficit by the end of the year.

It was the Reserve Fund whose resources in 2009 formed a major cushion ensuring a greater balance of the budget system in 2009. However, it is envisaged that the Fund would be completely run out of its resources this year already. The imperative to pursue an anticrisis fiscal policy in 2010 paired with the necessity to fulfill the earlier assumed expenditure obligations have compelled the RF government to revise their public borrowing program towards its extension. So, with the current correlation between the robustness of the budget system and the situation in the foreign trade area, the state of affairs in the sphere of public finance has remained challenging and far from its pre-crisis fairly balanced state.

### 2.2.1. Overview of the Budget System of the Russian Federation

The slump in the real sector in the late 2008 with a subsequent recession since the early 2009 has had an adverse effect on the state of the public finance, which resulted in the rise of a steady budget deficit at all the tiers of the government. The 2009 volume of revenues to the budget of the enlarged government plunged ay 4.4 p.p. of GDP vs the respective figures of the same period of 2008 (see *Table 1*). Behind the nosedive was chiefly a considerable fall in the federal budget revenues (by 3.7 p.p. of the nation's GDP).

The crisis period made the domestic corporations' survival a critical imperative. That is why the RF government devised a set of measures to support various industries and the social sphere. Within a fairly short time (practically since November 2008) the government introduced a broad package of anti-crisis measures, unprecedented by the variety of forms and avenues of the government's influence on the economy, as well as by the volume of resources deployed. In the autumn 2008, given tight timelines, the anti-crisis measures were more of "pin-point response" ones and required largely the use of "manual- control" mechanisms. The RF government's 2009 comprehensive anti-crisis Program had been developed by March 2009.

The need to finance the Program's priority avenues necessitated amending the act on the federal budget. Subsequently, the earlier approved budget appropriations were axed by Rb. 943.3bn, while as much as Rb. 1.61trln, including thus available funds, was earmarked to stabilize the financial market, support the strategic nationwide and local backbone corporations as well as individual, particularly vulnerable to the crisis, industries in the real sector, and the social protection of the population. The measures, to some extent, had been implemented in the pre-crisis period, but it is in the crisis conditions that they emerged as the priority ones. As a result, the enlarged government's budget expenditures rose at 6.7 p.p. of GDP vs the prior year, with the rise driven primarily by growth in the expenditure volume of the federal budget (some 6.4 p.p. of GDP). With the gap between collection and spending of budget funds widening, 2009 has become the first year over the past decade when the budget deficit of the enlarged government was reported to account for 6.2% of GDP.

*Table 1*

**Execution of Revenues and Expenditures of Budgets of All the Tiers of the Government in 2008–2009**

| | 2009 | | 2008 г. | | Bias as p.p. of GDP |
|---|---|---|---|---|---|
| | As Rb.bn. | As % of GDP | As Rb.bn. | As % of GDP | |
| **Federal budget** | | | | | |
| Revenues | 7336.8 | 18.8 | 9274.1 | 22.5 | –3.7 |
| Expenditures | 9636.8 | 24.7 | 7566.6 | 18.3 | +6.4 |
| Deficit (–) /Surplus(+) | –2300.0 | –5.9 | 1707.5 | 4.2 | – 10.1 |
| **Consolidated budgets of the RF Subjects** | | | | | |
| Revenues | 5927.2 | 15.2 | 6199.1 | 15.0 | +0.2 |
| Expenditures | 6256.3 | 16.0 | 6253.5 | 15.2 | +0.8 |
| Deficit (–) /Surplus(+) | –329.1 | –0.8 | –54.4 | –0.2 | –0.6 |
| **Budget of the enlarged government** | | | | | |
| Revenues | 13420.7 | 34.4 | 16003.4 | 38.8 | –4.4 |
| Expenditures | 15847.3 | 40.6 | 13989.2 | 33.9 | +6.7 |
| Deficit (–) /Surplus(+) | –2426.6 | –6.2 | 2014.2 | 4.9 | –11.1 |
| *For reference: GDP. as Rb. bn.* | *39016.1* | | *41256.0* | | |

*Source:* The RF Ministry of Finance; IET calculations

Notwithstanding the gravity and scale of budget infusions in the domestic economy, the measures not only came late (their real financing and an immediate delivery of the funds to recipients under the auspices of the anti-crisis program kicked off only between May and June 2009), but suffered a lack of consistency and, in certain instances, the absence of the much-needed for their implementation legal base.

### 2.2.2. An Analysis of Main Parameters of Execution of the Budget of the Enlarged Government

A sizeable contraction of the volume of revenues to the national budget system (*Table 2*) took place under the impact of negative ramifications of the global financial crisis and debilitation of the economy against the backdrop of the earlier emerged, extremely exposed to external shocks, mineral structure of Russia's exports. It was revenues from taxes and levies that directly depend on the prices of, and demand for Russian exports – namely, revenues from *the mineral tax* and from *foreign trade*, that plunged most drastically. When compared with 2008, these revenues to the budget of the enlarged government slid by 1.3 p.p. and 1.7 p.p. of GDP, respectively. The main cause for such a fall in revenues became a drastic price downfall for energy sources: the 2009 average price of Urals on world markets was some USD 61/bbl, or down by 35.5% relative to the average 2008 price level. The effect from the price drop was aggravated by the contraction of the physical volumes of production and export of carbohydrates (mostly natural gas). A rapid plunge of revenues from the said taxes and levies was registered in the first half 2009, when contracts concluded in late 2008 by compulsory low prices were due to be exercised. But the depreciation of the Rb. against the USD between late 2008 and early 2009 to some extent mitigated the dynamic of the fall of revenues from the mineral tax to the budget[1]. With the price situation improving between the 1st and the 3rd quarters last year, the dynamic of collection of revenues from the oil-and-gas taxes once again became positive.

*Table 2*

**Dynamic of the Level of Tax Burden and Collection of Main Taxes to the Budget of the Enlarged Government of RF in 2004–2009 (as % of GDP)**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| **The level of tax burden (1+2+3)** | **35.8** | **36.3** | **35.9** | **36.1** | **35.6** | **30.8** |
| 1. Tax revenues, including: | 27.5 | 25.7 | 24.4 | 25.7 | 23.9 | 20.5 |
| Corporate profit tax | 5.1 | 6.2 | 6.2 | 6.6 | 6.0 | 3.2 |
| Personal income tax | 3.4 | 3.3 | 3.5 | 3.8 | 4.0 | 4.3 |
| Uniform social tax* | 3.5 | 2.0 | 1.9 | 2.0 | 1.9 | 2.1 |
| VAT | 6.3 | 6.8 | 5.6 | 6.9 | 5.1 | 5.3 |
| Excise taxes | 1.4 | 1.2 | 1.0 | 1.0 | 0.8 | 0.9 |
| Mineral tax | 3.0 | 4.2 | 4.1 | 3.6 | 4.1 | 2.8 |
| 2. Insurance contributions to the compulsory pension insurance | 2.8 | 2.9 | 2.9 | 3.1 | 3.1 | 3.4 |
| 3. Foreign trade revenues | 5.5 | 7.8 | 8.6 | 7.3 | 8.6 | 6.9 |

*Without regard to insurance contributions to the compulsory pension insurance.
*Source:* The RF Ministry of Finance; IET calculations

The export duty rates for oil were revised following the improvement of the situation with the world oil prices. More specifically, between January and June 2009 the figure has been fluctuating within the range of USD 100-135 per ton of crude oil. Between July and August it was raised up to USD 222/t, while between September and December it was fluctuating between USD 231-271/t. The increase in the export duty rate has inevitably resulted in growing revenues from foreign trade, but failed to attain the 2008 relative volumes of tax revenues, nonetheless.

In addition to external factors, the amount of oil-and-gas revenues in 2009 found itself affected by changes in the mineral tax administration procedures, including the following ones:

– increase of the exempt minimum threshold from 9 USD/bbl to 15 USD/bbl;
– since 2009 for the sake of taxation the volume of the extracted oil was identified in net mass units;
– the list of fields subject to application of zero rate of the mineral tax was extended;
– the subsoil use license write-off procedure was modified for all the oil companies.

As well, the year of 2009 saw adoption and promulgation of a new procedure of collection of the mineral tax-based revenues. The revenues from the carbohydrate minerals, oil and gas condensate in full have now become subject to collection to the federal budget. As a reminder, the tax was previously collected to the federal budget at a rate of 95%. Whereas the respective proportion of revenues from the mineral tax in the revenue structure of budgets of the Subjects of the Federation has recently accounted for a meager 1.5-2%, such redistribution has not entailed any considerable fall in the said revenues. Plus, the increase of rates of individual regional taxes (the transport tax, state levies, excise taxes) effective since 2010 may

[1] The USD/RB exchange rate is used to calculate the coefficient of the oil price dynamic, which is used to set the mineral tax rate with respect to oil.

offset a possible withdrawal of a fraction of regional resources due to the modification of the mineral tax distribution procedure.

Declining revenues, primarily in the oil-and-gas sector and the general slump of business activity in other industries have resulted in a plunge of revenues from *the corporate profit tax*. Between January and December 2009 the revenues to the enlarged government's budget accounted for 3.2% of GDP compared with 6% of GDP in 2008. As of early 2010, financially, most enterprises have found themselves in dire straits, while the government stimulus package was delivered to a limited number of the most critical, backbone corporations and fell short of securing a mass positive effect. Meanwhile, it is worth noting some stabilization of the financial health of corporations in individual sectors over the last months of 2009.

In all, according to the preliminary data, over 11 months of 2009 the real sector posted an aggregate financial result of Rb. 3,639,3bn, or more than 1.2 times lower than the respective figure of 2008, while the proportion of profit-making organizations in their overall number dwindled by 5.8 p.p. and accounted for some 67%.

In addition, the corporate profit tax underwent some reform in 2009. Specifically, its rate slid from 24% to 20%, while the regional component soared to 18% instead of the previous 17.5%. As well, the year of 2009 saw some amendments to Art. 25 of the Tax Code in the part of administering the corporate profit tax levied on organizations and improvement of the taxpayers' situation come in force. More specifically, the following novelties are worth notion:

- simplification of the procedure of payment of the corporate profit tax by virtue of transition from the quarterly-advance arrangement to its monthly payment on the basis of effective profit;
- increase of the bonus depreciation rate (attribution of a part of the initial costs of capital assets to expenses in the ongoing tax period) from 10 to 30%;
- provision of the possibility for amortization of capital assets identified as a result of stocktaking;
- granting organizations the right to factor in costs of training of their staff by major, as well as complementary professional programs;
- possibility to consider individual kinds of R&D costs with the use of an increasing coefficient -1.5.

The above modifications of the procedure of administration and accounting of the corporate profit tax reduce the tax base. But that was counterbalanced by some new modifications, including:

- obligation to restore the bonus depreciation by capital assets which are sold prior to the 5-year deadline of their use;
- payments to members of the Board of Directors are not subject to their accounting as costs.

Overall, the above measures aimed at expansion of the tax base of the corporate profit tax failed to substantially reverse the unfolding in 2009 tendency to contraction of the volume of payments by the corporate profit tax.

On the backdrop of a substantial fall of revenues by main taxes to the country's budget system, the 2009 volume of the *VAT*-based revenues rose by 0.2 p.p. of GDP. But considered in absolute terms, it tumbled. The tax revenues in question slid due to the deteriorated business activity in the domestic and national economies and under an adverse effect of measures devised to improve calculation and administration of the tax. More specifically, they include the abrogation of the obligation to pay VAT in cash equivalent under non-cash kinds of settlements, exemption from VAT of payments for technological equipment, granting the right to deduct VAT from advances.

But in some months the VAT collection rate would outpace the respective figures of the prior year. The trend does not mirror an improvement of its collection - rather, it can be ascribed to modifications of the respective payment and refund timelines. Given that in 2008 VAT was paid on the quarterly basis, ie the whole amount of tax obligations was payable as a single payment in a month following the reporting quarter, in 2009 the taxpayer was able to effect the payments at his discretion - that is, either quarterly, or monthly, in equal installments. The novelty secured some equalizing of revenues from the tax in the span of the year, but, at the same time, has complicated comparison of the annual dynamic of the 2008 with that of 2009.

The 2009 volume of revenues from *excise taxes* did not undergo any substantial changes and remained at the level of 0.9% of GDP, notwithstanding a traditional indexation of its rates. To exemplify, the excise rate on straight-run gas surged up to Rb 3,900 per ton vs. the previous 2,657/t; excise rates on liquors were indexed by the inflation rate on average, while those on cigarettes soared by 20 to 25% relative to the prior year. The excise rates on passenger cars with the engine capacity of over 67.5kW (90 HP) and motorcycles with the engine capacity over 112.5 kW (150 HP) were raised roughly by 9%.

An important move in 2009 became the RF government's decision to drastically index excise rates on low-alcoholic and tobacco products since 2010. Specifically, excise rates on low-alcoholic goods with the volume ratio of up to 9%, alcohol-containing products and wine were indexed at 30% on average, and those on beer – at 50%. As concerns cigarettes (including Russian cigarettes), the ad-valorem component of the respective excise tax on them calculated proceeding from the maximum retail prices is envisaged to rise by 0.5%; meanwhile, the specific component of the excise rate on the filter cigarettes should be raised by 30% on average, while that on Russian cigarettes – by 50%. We believe such a drastic increase of excise rates on low-alcoholic and tobacco goods is a quite timely move and it appears fairly justifiable from the fiscal perspective and from the perspective of promotion of a healthier lifestyle in Russia. But the move should not entail a substantial decline of demand for these excised products, nor should it derail the investment attractiveness of the respective sectors.

The 2009 revenues from *the personal income tax* to the budgets accounted for 4.3% of GDP, up by 0.3 p.p. of GDP vis-à-vis the respective figures of 2008. Meanwhile, the revenue volume declined slightly in absolute terms. Some growth in the PIT-based revenues in relative terms does not at all evidence its collection has improved. Rather, it was driven by a higher dynamic of deceleration of the economy's growth rates compared with revenue volumes from the tax. More specifically, according to preliminary estimates, the 2009 increase in the population's real disposable incomes (incomes less compulsory payments adjusted by the CPI) followed the 2008 dynamic and accounted for 1.9% relative to the prior year. Meanwhile, real salaries and wages tumbled by 2.8% vs. the respective figures of 2008, while a number of benefits reducing the PIT tax base were put in effect, including:

- increase of the child benefit up to Rb. 1,000 and the respective amount of the annual income eligibility threshold (up to Rb. 280,000);
- increase of the upper marginal amount of the social tax benefit by the PIT with regard to expenses on the savings part of the labor pension from Rb. 100,000 up to 120,000;

- calculation of income in the form of interest on Rb.-denominated bank deposits is made using the CBR refinancing rate +5%, which to a significant degree reduces the tax base vis-à-vis the earlier set one;

In addition to the tax novelties associated with individual taxes and levies, the year of 2009 saw introduction of amendments that regulate the basic procedure of provision of a tax credit:

- In September, the RF government approved a bill "On introducing amendments to Section One of the Tax Code of the Russian Federation with regard to regulation of tax, levy, penalty and fine arrears". With the amendments in place, it has become possible to grant the taxpayer determent of payment, installment of date in connection with the threat of the rise of insolvency (bankruptcy), should the tax payment be nonrecurrent. However, the risk of bankruptcy should be proved by documented evidence;
- the credit ceiling of the investment tax loan extended to the taxpayer in the event he runs R&D projects, pilot-plan works, or technical rearmament is increased from 30% of his assets to 100%.

Affected by the domestic and external factors, the 2009 aggregate indicator of tax burden on the economy slid by nearly 5% of GDP and accounted for not more than 31% of GDP (see *Table 2*).

With the revenues to the enlarged government's budget being in decline, its expenditure component demonstrated an opposite dynamic and posted growth equivalent to 6.7 p.p. of GDP (see *Table 3*). Interestingly, in the last months of 2009 budget funds were spent more intensively than in the beginning of the year.

*Table 3*

**Execution of Expenditure Obligations of the Budget of the Enlarged Government in 2008–2009, as % to GDP**

| | 2009 | | 2008 | | Bias, as p.p. of GDP |
|---|---|---|---|---|---|
| | As Rb. bn. | As% of GDP | As Rb. bn. | As% of GDP | |
| Expenditures, total *including* | 15847.3 | 40.6 | 13989.2 | 33.9 | +6.7 |
| General public administration matters | 1290.6 | 3.3 | 1287.6 | 3.1 | +0.2 |
| including the public and municipal debts servicing | 236.6 | 0.6 | 189.3 | 0.5 | +0.1 |
| National defense | 1191.2 | 3.1 | 1043.6 | 2.5 | +0.6 |
| National security and law enforcement | 1245.9 | 3.2 | 1092.1 | 2.6 | +0.6 |
| National economy | 2782.3 | 7.1 | 2253.1 | 5.5 | +1.6 |
| Housing and utilities sector | 1005.9 | 2.6 | 1149.2 | 2.8 | –0.2 |
| Environmental protection | 29.7 | 0.08 | 31.2 | 0.1 | –0.2 |
| Education | 1777.9 | 4.6 | 1665.5 | 4.0 | +0.6 |
| Culture, the motion picture industry, mass media | 324.4 | 0.8 | 310.6 | 0.8 | – |
| Health care and sport | 1653.1 | 4.2 | 1548.6 | 3.8 | +0.4 |
| Social policy | 4546.1 | 11.7 | 3607.7 | 8.7 | +3.0 |

*Source*: the RF Treasury, the IET calculations

As far as expenditure management is concerned, the RF government's budget policy rested upon the "anti-cyclic" principle. With a significant fall in budget revenues, there were no expenditure cutbacks. But already in the beginning of the year the structure of expenditures by directions of their use displayed notable modifications, with investment expenditures being cut vis-à-vis extra funds being earmarked for the sake of financial support of the population and domestic businesses. The funding by the item "Social policy" hit a record-breaking value of 11.7% of GDP vs. 8.7% of GDP reported in 2008. A considerable increase in expenditures was noted by the item "National economy" – up to 7.1% of GDP in 2009 vs. 5.5% of GDP in 2008. As well, substantial funds were earmarked to finance the items "National defense" and "National security and law enforcement activity" – 3.1% and 3.2% of GDP, respectively, each up by 0.6 p.p. compared with the respective figures of 2008.

### 2.2.3. Execution of the Federal Budget of Russian Federation

The global crisis has battered the revenue collection to the federal budget – the revenues found themselves in a steady decline since October 2008. Notably, it was not just oil-and-gas revenues, which directly depend on oil prices, that tumbled considerably, but non-oil-and-gas ones too, due to the general deterioration of business activity indicators in the country.

According to the Federal Treasury, between January and December 2009 revenues to the federal budget accounted for 18.8% of GDP, or down by 3.7 p.p. compared with the respective 2008 figures, while expenditures outran the prior year's level at 6.4 p.p. of GDP and hit the mark of 24.7% of GDP (*Table 4*). Such a drastic increase in expenditures is explained by a large-scale funding of the anti-crisis measures set for accomplishment in 2009, as well as by a far smaller nominal volume of GDP in 2009.

The key cause behind the absolute and relative contraction in the volume of the federal budget revenues in the period in question vis-à-vis the same period of the prior year was the fall of the proportion of oil-and-gas revenues in the budget. At this point, it should be noted that while the volume of revenues from the mineral tax and foreign trade activities are directly dependant on the dynamic of the world carbohydrate prices, the rate of their production and the exchange rate of the Rb., the size of the structural (non-oil-and-gas) revenues is determined by the current state of the national economy.

The federal budget revenues, without regard to investment revenues to the Reserve Fund and the National Welfare Fund (NWF), worth a total of Rb. 205.1bn and 63.4bn, respectively, collected to the budget in January 2009, as well as Rb. 4.1bn-worth interest on the NWF's deposits with the VEB, proved to be substantially smaller than in 2008.

*Table 4*

**Main Parameters of the Federal Budget of RF in 2008–2009**

| | 2008 | | 2009 | | As % to the budget estimate | Bias | |
|---|---|---|---|---|---|---|---|
| | As Rb. bn. | As% of GDP | As Rb. bn. | As% of GDP | | As Rb. bn. | As p.p. of GDP |
| Revenues, including: | 9274.1 | 22.5 | 7336.8 | 18.8 | 109.3 | –1937.3 | –3.7 |
| Oil-and revenues | 4389.4 | 10.6 | 2983.9 | 7.6 | 145.1 | –1405.5 | –3.0 |
| Expenditures | 7566.6 | 18.3 | 9636.8 | 24.7 | 97.0 | 2070.2 | +6.4 |
| Surplus (deficit) of the federal budget | 1707.5 | 4.2 | –2300.0 | –5.9 | 78.1 | –4007.6 | –10.1 |
| Non-oil-and-gas deficit | –2681.9 | –6.5 | –5283.9 | –13.5 | 95.7 | –2628.2 | –7.0 |
| GDP estimate | 41256.0 | | 39016.1 | | | | |

*Source*: the RF Ministry of Finance (preliminary estimates), the IET calculations

As concerns execution of the expenditure part of the federal budget, their financing was extremely uneven and erratic. *Table 5* presents the dynamic of spending of the federal budget funds in 2009 according to the functional classification of budget expenditures. As evidenced by the Table, the rate of spending was lower than in 2008; however, the bias the federal budget funds in spending on the whole was not as significant on average as the one across individual directions of spending. More specifically, the 2009 federal budget expenditures were executed in a proportion of some 97% of the specified budget estimate, or just at 0.8 p.p. lower than the prior year's rate. It was items "General public administration matters", "Culture, the motion picture industry", and "National economy" by which the federal budget spending lagged behind the 2008 figures at most, with the respective cutbacks accounting for 3.1-6.3 p.p. of GDP. By contrast, the advanced rate of spending (by 0.4-5.7 p.p. of GDP vs. the 2008 figures) was posted by financing of items "Housing and utilities sector", "Interbudgetary transfers", and "Healthcare and sport".

*Table 5*

**Cash Execution of the Federal Budget in 2008–2009**
**(as % to the Annual Budget Estimate)**

| | 2009 г. | 2008 г. |
|---|---|---|
| **Expenditures, total** | **97.0** | **97.8** |
| ***Including:*** | | |
| General public administration matters | 85.3 | 91.6 |
| the public and municipal debts servicing | 86.9 | 97.4 |
| National defense | 98.7 | 99.7 |
| National security and law enforcement | 99.7 | 99.9 |
| National economy | 93.5 | 96.3 |
| Housing and utilities sector | 99.3 | 93.6 |
| Environmental protection | 97.5 | 98.8 |
| Education | 100.6 | 101.1 |
| Culture, the motion picture industry, mass media | 97.4 | 100.5 |
| Health care and sport | 99.3 | 98.9 |
| Social policy | 97.7 | 98.4 |
| Interbudgetary transfers | 99.7 | 98.6 |

*Source*: the RF Ministry of Finance (preliminary estimates), the IET calculations

The main cause behind a substantial increase in the federal budget expenditures became the need for implementation of stimulus measures aimed at mitigation of the adverse effects from the global financial crisis and their economic and social consequences. It is particularly worth noting that in addition to the financing of the anti-crisis program out of the budget, the RF government vigorously deployed quasibudgetary sources, including funds of the Central Bank, extrabudgetary funds, public corporations, tax credits, etc. (*Table 6*).

*Table 6*

## Structure of the Financial Anti-Crisis Measures in 2008–2009

| Budgetary anti-crisis measures | Planned for execution in 2008–2009, as Rb. bn | Executed as of January 1, 2010, as Rb. bn. |
|---|---|---|
| ***Measures on securing the economy's financial stability*** | | |
| **Out of the federal budget** | | |
| On balancing regional budgets (subsidies, subventions, budget loans) | 363.4 | 363.4 |
| Vneshekonombank | 175.0 | 175.0 |
| VTB | 180.0 | 180.0 |
| Rosselkhozbank | 45.0 | 45.0 |
| JSC Rosagrolizing | 25.0 | 25.0 |
| AIZHK | 80.0 | 80.0 |
| *Out of the federal budget, subtotal* | *868.4* | *868.4* |
| **Extrabudgetary sources (quasi-budgetary)** | | |
| Subordinated loan to Sberbank of Russia (source- the CBR) | 500.0 | 500.0 |
| Extended to Vneshekonombank to disburse subordinated loans to other banks (14 banks, source -NWF) | 410.0 | 404.0 |
| Placement of funds on deposits at Vneshekonombank for the sake of lending to small and medium-sized (source -NWF) | 30.0 | 30.0 |
| Banks' debts restructuring (source- the CBR and the Deposit Insurance Agency) | n/a | 297.1 |
| *Extrabudgetary sources, subtotal* | *–* | *1 231.1* |
| ***On securing the economy's financial stability, subtotal*** | ***–*** | ***2 099.5*** |
| ***Measures on support of the real sector*** | | |
| **Out of the federal budget** | | |
| Support to car makers | 68.0 | 69.0 |
| Support to aircraft makers | 15.9 | 21.9 |
| Support to shipbuilding | 3.0 | 3.0 |
| Subsidizing interest rates for agrarian and fishery corporations | 18.1 | 60.4 |
| Support of export | 6.0 | 6.1 |
| Development of small and medium-sized businesses | 13.6 | 18.0 |
| Support to the defense and industrial complex | 73.3 | 79.0 |
| Support to transport complex | 53.0 | 56.4 |
| Имущественный contribution to the public corporation "Rostekhnologii" | 1.0 | 1.5 |
| Government guarantees to backbone enterprises | 300.0 | 300.0 |
| *Out of the federal budget, subtotal* | *551.9* | *615.3* |
| **Extrabudgetary sources (quasi-budgetary** | | |
| Support to housing construction (source- the Fund for Assistance to the Housing and Utilities Sector Reform) | n/a | 136.5 |
| ***On support of the real sector, subtotal*** | *–* | *751.8* |
| ***Social measures*** | | |
| **Out of the federal budget** | | |
| Support to the labor market and assistance to employment | 43.7 | 43.7 |
| Raising unemployment benefits | 37.0 | 80.5 |
| Possibility to use the "maternity allowance" to improve housing conditions and for one-time Rb. 12,000-worth allowance for ongoing needs | 44.3 | 44.3 |
| Additional measures in the health care area (combating the A/H1N1 pandemic, provision of necessary medicines, delivery of high-tech medical assistance, etc.) | 9.7 | 9.7 |
| Procurement of housing for veterans | 55.8 | 55.8 |
| Provision of transfers to extrabudgetary funds and the EAEC' s anti-crisis fund | 427.7 | 443.0 |
| ***On social measures, subtotal*** | *618.2* | *677.0* |
| **On anti-crisis measures, TOTAL** | | **3 528.4** |

As evidenced by the Tables, the anti-crisis measures on securing financial stability in the economy were being implemented at the expense of both the federal budget and extrabudgetary sources. The proportion of the latter accounted for over 2/3 of the respective expenditures. Other support measures were financed exclusively out of the budget funds.

In all, between 2088 and 2009 the anti-crisis measures cost a total of some Rb. 3.5 trln.

Main objectives of moves ***to secure financial stability of Russia's economy*** were reduced to combating liquidity shortages, recapitalizing the largest banks, having banks and corporations repay their external corporate debts and regions get their budgets balanced.

The government support to the banking system was exercised by means of boosting the largest banks' capital and providing liquidity in the form of subordinated loans. These measures combined cost some Rb. 2.1trln, with the the federal budget's contribution accounting for Rb. 500bn. In the frame of this bloc of measures the government invested in Vneshekonombank (Rb. 175bn), Rosselkhozbank (45bn), VTB (180bkn), JSC Rosagrolizing (25bn). In addition, the CBR disbursed subordinated loans to Sberbank of Russia (a total of Rb. 500 bn), completed a Rb. 300bn-worth debt restructuring of 18 other banks, which were recognized as being significant for the national banking system or backbone for their respective regions, including: KIT Finans investment bank (JSC), AKB ROSSIYSKY KAPITAL (JSC), Bank Vefk-Sibir (JSC), Gubernsky Bank Tarkhany (JSC), KB Moskovsky Kapital (Ltd, AKB Soyuz (JSC), SEVERNAYA KAZNA (JSC), Nizhny Novgorod (JSC), to name a few.

In the frame of ***support of the industrial and technological sectors*** the RF government employed both a direct aid from the budget and issuance of government guarantees and provision of tax benefits. The volume of funding on support of corporations from different sectors over the crisis period 2008-09 accounted for some Rb. 750bn, including Rb. 300 bn in government guarantees.

The following programs were to be financed out of the federal budget: the technological rearmament of backbone DIC enterprises (to this effect Rb. 50.7bn. was earmarked); innovation-oriented federal target programs on development of the infrastructure for small- and medium-sized business (Rb. 18bn.); automakers' investment projects (a. Rb. 69bn.).

As well, the government practiced a widespread support of corporations by means of *subsidized interest rates.* This form of support was provided for beef and dairy husbandry enterprises, and fishery companies (Rb. 60.4bn), DIC corporations (20.3bn), etc. In addition the government provided for subsidizing interest rates across individual kinds of economic activity, including refinancing of investment loans, interest rates with respect to transactions on leasing of the domestic automobile hardware, for exporters (Rb. 6.1bn), among others.

Additional financing out of the federal budget was exercised by means of *granting subsidies and subventions*: more specifically, to prevent the strategic DIC objects from going bankrupt (Rb. 7.9bn); subsidies to air carriers to continue passenger transportation in the event their licenses had been revoked (5.0bn), etc.

To support individual industries, the government employed the public procurement mechanism, which formed the bulk of funds spent on procurement of motor vehicles for the federal and territorial public agencies and renewal of other special hardware (circa Rb. 15.5bn).

The government also provided *guarantees* on backbone corporations' loans worth a total of Rb. 300bn.

Support to the construction sector was exercised through the Fund for Assistance of the Housing and Utilities Sector Reform, which contributed to the Subjects of the Federation with some Rb. 136bn, to co-finance regional target programs.

As concerns measures on ***support of the most vulnerable strata of the population***, the following ones should be particularly referenced to:

- support to the labor market and assistance to employment measures (some Rb. 44bn);
- increase of unemployment benefits (some Rb. 80bn);
- possibility to use the "maternity allowance" to improve housing conditions and for one-time Rb. 12,000-worth allowance for urgent needs (Rb. 44.3bn);
- Provision of transfers to extrabudgetary funds and the EAEC' s anti-crisis fund (Rb. 443bn);
- Procurement of housing for veterans (Rb.55.8bn)

The social measures also included co-financing of special programs in the housing and utilities sector, that is, restructuring the private individuals' mortgage arrears. This measure is implemented by means of an additional capitalization of the AHML's authorized capital (Rb. 80bn).

The analysis of the system of anti-crisis measures allows one to assert that they have centered mostly on securing the financial stability and support of strategic corporations, while just an meager fraction of them was to be spent on improvement of the situation on the labor market. The target approach to allocation of the budget aid is laudable; however not all the measures were implemented in a timely fashion. Furthermore, some of them latently derailed economic agents' incentives to conduct a more sound policy and more adequately assess risks.

Because of the expansion of volumes of financing out of the federal budget in 2009 and given the persistence of the negative tendency to contraction of revenues to the budget that started yet in 2008, the 2009 federal budget posted deficit amounting to 5.9% of GDP, with the size of the oil-and-gas deficit equivalent to -13.5% of GDP.

The funding of the large-scale measures on support of the economy without attracting external borrowing became possible thanks to financial reserves accumulated in the period of economic growth. It was resources of the oil-and-gas Funds that formed the major pool securing the 2009 federal budget equilibrium. As evidenced by *Table 7*, as much as some Rb. 3.0trln was allocated out of the Reserve Fund alone to finance budget expenditures. This allows to reckon that the concept of formation of the oil-and-gas Funds has been absolutely sound and the current fiscal policy should be given a due credited for that.

*Table 7*

**Dynamic of Formation and Use of the Oil-and-Gas Funds in 2009, as Rb. bn.**

| **Indicator** | **Cash balances as of end-2008*** | **Collected in 2009** | | **Spent in 2009 on:** | | **Cash balances as of end-2009.*** |
|---|---|---|---|---|---|---|
| | | Oil-and-gas revenues | Revenues from capital management | Securing the balanced budget | Securing the oil-and-gas transfer | |
| Reserve Fund | 4027.6 (9.8% of GDP) | 488.5 | 205.0 | 2964.8 | 179.4 | 1830.5 (4.7% of GDP) |
| National Welfare Fund | 2584.5 (6.3% of GDP) | – | 92.5 | – | – | 2769.0 (7.1% of GDP) |
| Total | 6612.1 (16.0% of GDP) | 488.5 | 297.5 | 2964.8 | 179.4 | 4599.5 (11.8% of GDP) |

* balances recalculated using the exchange rate as of January 1, 2009, and January 1, 201, respectively

*Source*: the Federal Treasury.

The year of 2009 saw introduction of amendments to the Budget Code of RF with respect to administration of the Reserve Fund and the National Welfare Fund. More specifically, it was ruled to detest using funds from management of both Funds on their replenishment. Hence since January 1, 2010 and though February 1, 2012 the said funds have become subject to an immediate collection to the federal budget. The measure will enable one to compensate for the fall of the revenue component of the federal budget and narrow its deficit.

### 2.2.4. Main Parameters of Russia's Federal Budget for 2010-2012

The year 2009 has de-facto marked a turning point of trends of main budget indicators and the discontinuation of a long-term policy of boosting expenditures in particular (*Fig.1*). In 2009, the federal budget expenditures hit their peak value both in constant prices and as percentage of GDP (some 24.7% of GDP – for reference, the 2004 indicator did not exceed 16% of GDP). The fact of the matter is that in order to secure the financial sustainability of the budget system in the medium term, the RF government has focused on curtailing volumes of expenditure obligations in shares of GDP together with a parallel increase of their efficacy.

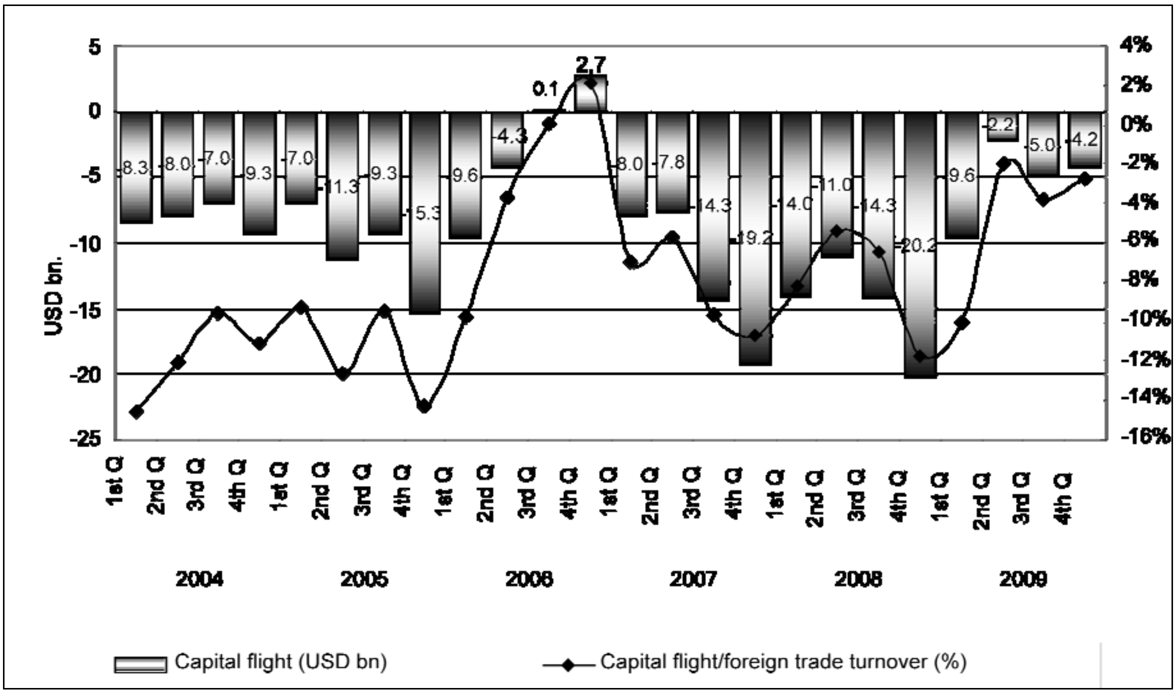


*Fig. 1.* Dynamic of the Federal Budget Revenues and Expenditures
(in the 2006 prices), as Rb. bn.

The volume of revenues to the federal budget is expected to plunge to 15% of GDP by 2012, while the volume of government obligations will be consistently sequestrated from nearly 23% in 2010 to 18% of GDP by 2012.

During the period in question the federal budget revenues should tumble substantially due to the projected relative downfall in the world prices for oil and gas, deceleration of the increase rate of extraction and export of carbohydrates and appreciation of the Rb. against the USD under conservation of the earlier emerged mineral structure of Russia's export. The federal budget act provides for a decline in the volume of oil-and-gas revenues by 0.7 p.p. of GDP over the three-year period concerned. It should be noted that a surge of structural revenues would fall short of duly compensating for the contraction in oil-and-gas revenues. The volume of collection of non-oil-and-gas revenues to the budget would plunge by 1.5 p.p. of GDP over the period in question.

While the volume of expenditure obligations is projected to decline, they would still remain on a fairly high level. Such a structure of the federal budget should give rise to a steady deficit whose size would be fluctuating within the range of 3-5% of GDP. To run a balanced federal budget, the respective act provides for the financing of the deficit out of domestic and external sources, with the Reserve Fund and domestic borrowings constituting major ones. Meanwhile, there has emerged the need for borrowing from overseas – it is planned to attract some USD 18bn already in 2010 alone, while the overall volume of borrowings for 2010-2012 was set at the level of USD 60bn. It may also become possible to introduce some adjustment to the value of annual borrowing in the period in question, should the change in the oil price level display a negative dynamic. In light of the prospective borrowings in 2009 Russia faces a critical challenge of a full repayment of its debt to the London Club and of another USD 400-500mln-worth commercial debt of the former USSR.

### *An analysis of the revenue part of the act on the 2010-2012 federal budget of RF*

According to the federal budget act, the period between 2010 and 2012 would witness a decline in, or a lower dynamic of revenues from most taxes and levies compared with the period of 2006-2008 (*Table 8*). The tendency is characteristic of both the oil-and-gas- and infrastructure-based taxes. The projected decline would be driven chiefly by a relative deterioration of the situation with prices and demand for Russian exports. Specifically, according to forecasts of main macro indicators of the economy's health, through the end of 2011 the world oil prices should not exceed USD 60/bbl, being in a stark contrast with the USD70-120/bbl noted between 2006 and 2008. Likewise the growth rate of production of oil and natural gas should slow down and export of the oil-and-gas complex products should contract. Given that customs duties still account for a fairly substantial proportion in the overall volume of the federal budget revenues, in the medium perspective the level of revenue collection to the federal budget will remain directly correlated with prices for the nation's exports.

*Table 8*

**Dynamic of Tax Revenues to the Federal Budget in 2006–2012 (as % of GDP)**

| Name of tax | Actual collection rate | | | | As per the federal budget act | | |
|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| Revenues, total: | 23.6 | 20.4 | 22.5 | 18.8 | 16.1 | 15.5 | 15.0 |
| Corporate profit tax | 1.9 | 1.9 | 1.8 | 0.5 | 0.5 | 0.5 | 0.4 |
| VAT | 5.6 | 6.8 | 5.1 | 5.3 | 5.1 | 5.2 | 5.3 |
| Excise taxes | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 |
| Customs duties | 8.3 | 7.0 | 8.6 | 6.9 | 6.2 | 5.9 | 5.7 |
| Mineral tax | 4.1 | 3.4 | 3.9 | 2.5 | 2.5 | 2.3 | 2.2 |
| Proportion of the above taxes in the federal budget revenues, as % | 87.0 | 83.4 | 88.0 | 82.5 | 90.5 | 91.6 | 92.9 |

In addition, the global financial crisis has continued exerting an adverse impact on the financial standing and business activity in the real sector. It is still very likely that renewal of their operational performance, that is, bouncing back to the pre-crisis rates of production of goods and services may take long, which does not at all make it certain that non-oil-and-gas tax revenues would be on the rise any time soon.

### *An analysis of the expenditure part of the act on the 2010-2012 federal budget of RF*

As concerns the dynamic of the federal budget expenditures in 2010-2012, the respective act has outlined a consistent capped-spending policy, which contrasts the recent one that would suggest the expenditure increase rate should outpace the economy's growth rate.
Originally, the 2010-2012 federal budget blueprint implied a budget for development; however, presented in the act, main estimates of its expenditure part suggest a continuous policy aimed at social support to the population and target subsidizing of the largest corporations and individual industries vis-a-vis curtailing investment expenditures.

It is assumed that in 2010 the federal budget expenditures should be cut by 1.8% of GDP compared with the 2009 figures. But once the 2010 expenditure volume is compared with parameters of the pre-crisis years, it appears quite significant, and it is going to be 2012 when it will catch up with relative figures of 2007-08.

*Table 9*

**Structure of the Federal Budget Expenditure in 2007–2012 (as % of GDP)**

| | Actual execution | | | The act | | |
|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2011*** | **2012*** |
| **Expenditures, total:** | 18.1 | 18.3 | 24.7 | 22.9 | 19.5 | 18.0 |
| including: | | | | | | |
| General public administration matters | 2.5 | 2.0 | 2.1 | 2.7 | | |
| *of which* the public debt servicing | 0.4 | 0.4 | 0.5 | 0.7 | | |
| National defense | 2.5 | 2.5 | 3.1 | 2.9 | | |
| National security and law enforcement activity | 2.0 | 2.0 | 2.6 | 2.5 | | |
| National economy | 2.1 | 2.5 | 4.2 | 3.1 | | |
| Expenditures on the social policy and social sphere | 2.4 | 2.5 | 3.1 | 2.7 | | |
| Interbudgetary transfers | 5.8 | 6.5 | 9.2 | 8.6 | | |
| Other expenditures (provisionally approved) | – | – | – | – | 0.5 | 0.9 |

* The budget act comprises projections with regard to the 2010 expenditures in a full volume with the breakdown by items of the classifications. Meanwhile, parameters of the 2011 and 2012 expenditure obligations are presented just by marginal values. Let us note that the previous years' format provided for a detailed stipulation in the federal budget act of assumed expenditure obligations for the three-year span, which enhanced transparency and certainty in the sphere of public financing of expenditures for the citizenry. But it is inappropriate to present a detailed breakdown in the conditions of instability of individual macroeconomic indicators in the post-crisis period.
*Source*: the RF Ministry of Finance, the IET calculations

With the decimation of expenditures, the most notable changes vis-à-vis the 2009 budget execution parameters are ascribed to cuts in financing of measures in the national economy sphere and expenditures on the social policy.

More specifically, it is planned to curtail expenditures on *the national economy* by 1.1. p.p. of GDP against their 2009 volume. The cuts can be explained by the fact that the biggest measures on supporting various industries in the frame of the government anti-crisis program were envisaged to be complete in 2009. A certain fraction of the measures is due to be accomplished in 2010, but in a far smaller volume.

The volumes of financing of *the social policy expenditures* likewise are subjected to cuts equivalent to 0.4 p.p. of GDP relative to their 2009 figures. Behind the cuts there is implementation of main measures on pay rises for budget employees and other social monetary allowances in 2009 by means of their advanced indexing.

It should be noted that the 2010 expenditures by item “Interbudgetary transfers” should be cut by 0.6 p.p. of GDP. Such a dynamic is explained primarily by the fall in the volume of transfers to the RF Subjects on balancing their budgets. On this background there should be an increase in transfers to the government extrabudgetary funds (to the greatest extent – to the Pension Fund) to ensure fulfillment of the earlier assumed obligations and conduct the pension reform measures.

Expenditures on general public administration matters (with account of expenditures on the public debt servicing) should also grow from 2.1% of GDP in 2009 to 2.7% of GDP in 2010. The rise is fueled chiefly by growth in newly assumed debt obligations. Relative volumes of financing across other federal budget items should remain unchanged or undergo an insignificant adjustment.

Overall, it can be ascertained that the 2010-2012 federal budget has been formed proceeding from the need to hold the budget system balanced. In the conditions of a substantial fall in budget revenues the government will have to stick to the policy of curtailing its obligations to preclude the budget deficit from rising.

### 2.2.5. The Medium- and Long Term Prospective Avenues of the Fiscal Policy

Next decade, Russia’s tax system will face two major challenges.

First, the effective decisions on the pension reform do not warrant the pension system’s balance, unjustifiably mount pressure on the labor compensation fund and imply the need for its constant replenishment out of the federal budget. Accordingly, the tax system as a whole is in need for a certain adjustment, which should help the public finance adapted to the global process of the population ageing.

Secondly, the national economy’s advancement along the path of innovation implies contraction of the proportion the mining sector holds in the nation’s GDP. But the tax burden on the mining sector has substantially exceeded the one on other sectors. In the medium term Russia will see rental payments to the budgets in decline, which will necessitate revision of the problem of the level of tax burden on the economy and transformation of the revenue structure from main taxes.

Below, we briefly highlight on main measures that may be employed in response to the said challenges.

*Pension reform*

Recent decisions on the national pension system overhaul– that is, federal act №212-FZ of July 24, 2009 “On insurance premiums to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Fund for Compulsory Medical Insurance and territorial funds of the compulsory medical insurance”, in our view, are inadequate, as they fail to solve the problem of securing the pension system’s balance in the long run, but, at the same time, drastically increase the tax burden and complicate the tax administration.

As most developed nations, Russia likewise experience the basic demographic process-namely, the population’s ageing. The negative demographic trend poses a strategic long-term challenge for Russia’s pension system.

The rise in the number of pensioners in Russia from 330 per 1,000 able-bodied people in 2007 to 450 in 2020 will necessitate making a fairly complex choice:

- -either to keep expenditures on pension payments as a percentage of GDP at the 2007 level and yield with the decline of the replacement rate to 16% by 2020 (vs. 23.4% in 2007), or
- to maintain the replacement rate at a socially acceptable level of some 30%, but compromise on a rise of expenditures on pension payments up to 8.2% of GDP in 2020 (ie by 3.4% of GDP vs. the 2007 figures).

As a consequence of the increase of the basic rate of pension contributions from 26% up to 34% most corporations would experience a 1.6 p.p. of GDP rise of the tax burden on the labor compensations fund. By most OECD nations' standards the proposed insurance premium tariffs appear abnormally high. Increase of the tax burden on labor contradicts the general international trend which suggests that to boost an economy's competitiveness, one needs to lower the tax burden on labor and capital and increase the one on consumption.

An increase of the tax burden on the labor compensation fund may result in:

- noncompetitiveness of Russia's economy;
- fall in the official employment rate and, accordingly, in the respective contributions;
- migration of salaries and wages into the grey zone.

The reassignment of administration of pension contribution from the Federal Tax Service to the Pension Fund is explained by the need to update the respective data 4 times a year. But the need to accomplish this technical exercise could justify an increase of the burden on businesses by establishing yet another controlling agency can be questioned.

In the short run an increase of the fiscal burden on the labor market in the time of economic crisis appears a *non-licet* exercise. With the employment problems aggravating, one should not increase the said burden on salaries and wages of the least prosperous strata from the current 26% to 34%. The RF Minzdravsotsrazvitiya maintains it is necessary to secure a steady increase of the insurance tariff from up to 42% by 2047[1], which will make Russia's economy uncompetitive. At this juncture it appears urgent to confine oneself to a moderate indexing of the UST scale, which would not increase the fiscal burden on the labor market in 2010-11.

In the medium term it is imperative to attract financial resources into the pension system to complement premiums on compulsory pension insurance plans. In addition, provided a favorable state of affairs, one should use reserve funds for this purpose. It may also become possible to consider *privatization of public assets*, particularly by means of their transfer to the Pension Fund of RF and non-government pension funds as current contributions by the savings component of pension plans.

To secure a long-term balance of the pension system it is also necessary to *raise the pension age*. While fully appreciating the complexity of the issue from the political perspective, it should be noted that this move constitutes the only solution to the problem of balancing the pension system in the long run, which would enable one to effectively increase the replacement rate.

To minimize political costs engendered by the move, it should be implemented in a gradual fashion and concern just relatively young residents.

*Export duties*

[1] According to the RF Minzdravsotsrazvitiya's documents

Russia's economy restructuring in the long run is interwoven with abrogation of export duties whose existence means subsidizing the domestic mineral and energy sources producers at the expense of the mineral rent, with mineral inventories being owned by the state. Compensated by an increase of the mineral tax, the abolishment of export duties should entail a rise in domestic prices for minerals and energy sources up to the international levels. As a consequence, domestic producers will be compelled to boost resource efficiency of their production to the level of nations that import minerals and energy sources. Without this, an efficient consumption of natural resources and environmental protection would appear an unlikely prospect.

Selling their products on the domestic market under the present system, the national mineral producers pay the mineral tax, export duties and incur losses equivalent to the difference between international prices for their products and domestic ones. Accordingly, an increase of the mineral tax under the abrogation of the duty should be sufficient to compensate for the value of the export duty and benefits corporations consuming minerals and energy sources enjoy from the difference between the domestic and world prices adjusted by the fall in the volume of domestic consumption caused by contraction of demand fueled by rising domestic prices.

But, at the same time, it is understood that any drastic changes in this area are highly unlikely. Transition to taxation of mineral producers on the basis of the mineral tax should be implemented fairly gradually, so that to give mineral- and energy-source consuming corporations, as well as their consumers, a chance to modify their behavior, particularly, by means of introducing innovations.

*The mineral tax*

In the conditions of the forecasted change in the structure of oil output, primarily an increase in the share of new regions subject to the tax holiday regime, as well as in the proportion of "exhausted" wells subject to a reduced rate, revenues from the mineral tax may fall. This should be taken into account while pursuing a long-term fiscal policy.

*The VAT*

1. Regulation and simplification of the VAT refund procedures in the conditions of application of zero rate and other cases. More specifically, to prove the fact of export it is necessary to set a sole attribute - that is, the good's crossing the customs border of RF.
2. In the countries practicing VAT, most taxpayers not engaged in complex transactions find this tax easy to calculate and pay. To this effect, one needs to modify procedures for filling out invoices and unify procedures with regard to granting the right for tax rebate.
3. It is appropriate to introduce a uniform VAT rate at a level which would ensure that the budget revenues would remain unchanged or grow. Transition to the uniform rate would help simplify administration of the tax, albeit lower progressiveness of distribution of the tax across the population income groups (in an assumption of shifting of the tax on consumers). Compensation for such groups' losses should be secured at the expense of the respective budget expenditures.

In the conditions of the post-crisis development and, accordingly, given the need for maintaining the financial stability, the public expenditure annual increase model is far from being effective. That is why it is the objective of fiscal deficit cutbacks in tandem with the need to bolster return on each Ruble out of public funds that have come to the front burner. In its quest for attaining such ambitious goals, the government focuses primarily on organizing most agencies' budgets on the basis of program-target methods, which suggests a substantial increase in the proportion of target programs in the budget and transition to a program-wise classification of budget expenditures. Another vector of improvement of the quality of budget management lies in reforming the public procurement program and its fundamentals, particularly towards a substantial increase in the proportion of public expenditures on the innovational sector.

We believe main avenues of increasing efficacy of the budget expenditures have been picked quite adequately; meanwhile, the overall progress in the quality of control over budget resources may become possible only under a comprehensive approach to the problem, which would enable one not only to embrace a maximum broad array of the employed regulative instruments, but structure their employment in time. More specifically, in the nearest future (2010-2011), it appears mandatory to center primarily on problems of increasing accessibility of the public social services. The objective is realistic and achievable through restructuring the budget network. As well, a focal point will remain incentivizing the grass-root level of the government to consume budget funds more efficiently, improving the public procurements system, optimizing individual budget procedures (introducing assessment of the regulating impact into the technology of managerial decision-making that bear budgetary ramifications).

Once the respective institutional conditions arise in the country, a further improvement of such fairly sophisticated managerial mechanisms as result-oriented budgeting, program-target operations, public-private partnership may evolve into a critical factor of the rationalizing of budget expenditure and increasing of the budget process on the whole. This bloc of measures should be implemented between 2010 and 2015.

As concerns ***the medium-term fiscal policy priority avenues,*** it is worth noting the following ones:

*Reforming the budget institution network in main sectors of the budget sphere*.

The ultimate objective of the budget institution network reform should be bolstering its operational efficiency by introducing fundamentals of competition and assiduity in public spending, which arises thanks to liquidation of duplication of functions and discontinuation of delivery of similar services by different public agencies. Meanwhile, those institutions which, by their nature or operational conditions, appear unadapted to survival in the market environment or whose reorganization may entail unfavorable socio-economic effects, should not become subject to restructuring.

To attain the ultimate reform objective, the whole budgetary network should be restructured. But there exist objective challenges associated with updates on the state of the regional and municipal budget institutions sub-networks, as well as with the absence of inter-level coordination and the subfederal networks reorganization procedures, etc. That is why an appropriate mission for the upcoming 2-3 years would be centering on the federal element of the budget institutions network.

We believe the main mechanism of optimization of the federal budget institutions (FBI) network lies in the necessity of modifying the legal status of the existing budget organizations. The modification process can be two-fold – either the budget organizations keep their newly affirmed status that would suggest they are granted with the right for a non-restricted control over their income and assets acquired using that, or their transition into treasury enterprises that are subject to estimate-based financing, while their proceeds are to be collected to their founders' budgets.

In tandem with the aforementioned optimization procedures, wherever possible, one should also complete:

- amalgamation of small-sized institutions into larger ones;
- liquidation of poorly performing institutions or those with a thin contingent of customers, with their powers reassigned to peer institutions operating within a given or neighboring territories;
- reassignment of a string of FBIs for the sake of observance with the sectoral operational profile principles;
- reassignment of FBIs, which exercise powers falling under the mandate of public administration agencies of the RF Subjects or under local self-governance bodies' mandate, under control of the RF Subjects' public administration agencies or local self-governance bodies, respectively;
- privatization of FBIs that do not fall within a given department's mandate (e.g. sanatoria, etc.) or their reassignment to respective ministries and agencies (e.g. medical and educational institutions.

While pursuing optimization procedures, one should consider sectoral peculiarities of the FBI network and care to develop a performance monitoring system for restructured institutions.

*Increasing efficiency of the public procurement management procedures*

In order to shape a uniform integrated cycle of planning and placing of the public order, and executing of public contracts which should secure a peremptory fulfillment of the government's obligations, an adequate to the state needs quality of supplied goods, works and services, an efficient consumption of resources, a reliable management of technological, economic and corruption risks, it appears appropriate to accomplish the following moves:

- optimization of the technology of awarding the public order and conditions of selection of qualified suppliers by means of extending the use of e-auctions. That would allow one to abandon the routine "paper" procedures, give entrepreneurs a chance to take part in such auctions via remote access, substantially lower bid-rigging schemes. These measures should be complemented with the fine-tuning of order placement procedures with regard to complex R&D, development or technological projects that should enable the customer to enjoy the possibility for specifying the subject of a contract with account of alternative technological solutions put forward by bidders;
- -consideration of a possibility for centralization of procurement under the aegis of the general manager of budget funds (to secure economies of scale) and development of a system of incentives to securing an even cash execution of limits granted to customers;
- Fixing with customers the right for an independent spending of funds they have received as a payment of a fine (penalty), as well as funds they have received due to the public agency's failure to honor its obligations with regard to securing a customer's auction bid and fulfillment of the public contract;
- Improvement of procedures of monitoring of, and control over the progress with execution of the public contract by optimizing the inventory system with regard to conditions of concluded public contracts; development of procedures of auditing of efficiency of public procurements and recommendations on bringing to account public customers (penalties, lowering their volume of budget funding, suspension of the contract, etc.), introduction of an automated monitoring system (AMS), which should allow one to evaluate the progress in execution of a public contract in real time, supply necessary information to all the participants and make decisions on correcting measures.

*Improving the budget decision-making technology and other result-oriented budgeting instruments*

Today, particularly challenging became the problem of organization of assessing the potential impact a regulating act has on the economy and society on the whole yet at the stage of its development. That is why in order to enhance the quality of managerial decisions it appears justifiable to obligate agencies, which are engaged in development of normative documents, to run a comprehensive evaluation of prospective and ongoing socio-economic policy measures. Methodological fundamental of the measures should be formed by the cost-benefit analysis method as the most acceptable vehicle that takes into consideration all significant effects from a proposed regulatory measure.

The need to increase the efficiency of the interdepartmental planning system makes it appropriate to undertake the following steps:

- to form a report on budgeting agents' operational results and main avenues (BA Report) in a hierarchical fashion, by setting objectives for BA as an upper target margin for their subordinated agencies of executive power;
- to include in the final version of the Report only the budget programs underway. Unapproved (under development) programs may be enumerated in the limits of the budget of assumed obligations only until the budget law for next year has been passed; afterwards a program either is granted with the status "in progress", or it is excluded from the Report;
- to modify the form of the register of expenditure obligations by adding margins hereto, to reflect BAs' objectives and programs;
- one should consider departmental target programs (DTPs) as a grouping of measures implemented by BAs to tackle tactical tasks stipulated in the Report, with specification of the aggregate volume of expenditures, the program's control system and possible risks associated with failure to attain performance benchmarks;
- to establish that executive agencies form DTPs on their own, without an external evaluation and approval. It is the agency's performance results fixed in the Report that should become subject to the external evaluation (and control); meanwhile the right to select a mechanism of its implementation - that is, the DTPs' composition and substance, is assigned to the executive agency. Fixing simpler procedures with regard to development, coordination and, essentially, organization of implementation of DTPs (due to their smaller scale vis-à-vis (long-term target programs (LTTPs) will enable one a in the nearest future to formulate a maximum possible number of programs and ensure a faster transition to the program-target principles of budget execution;
- to fix approved DTPs in the register of expenditure obligations as a target budget expenditure item (while individual measures under the aegis of a program are to be fixed as kinds of budget expenditures);
- to form model methodologies of evaluation of a program implementation efficiency of and the respective budget spending by providing for respective forms in the composition of budget reports;
- to specify the role and designation of an agency's analytical programs in order to preclude the civil service from their use only for allocating of the available funds.

*Improving the public investment management mechanism, particularly in the frame of development of the public-private partnership.*

It is imperative to enhance the operative management of investment projects that have been already selected and are currently financed out of the investment Fund of RF. More specifically, this should imply tightening responsibility for failure to meet the respective timelines. But as with its peculiar procedures for the possibility of transfer of unused cash balances to next year the Investment Fund forms an exception from the general procedures of public finance administration set by the Budget Code of RF, it appears appropriate to relinquish this instrument of organization of the government's investment activity in favor of budget target programs.

It seems appropriate to introduce amendments to the federal act "On special economic zones in the Russian Federation" and the respective bylaws in order to simplify procedures of selection of regions aspiring to have special economic zones within their territories, revise the amount of co-funding of projects on creation of such zones to increase the proportion of regional and municipal budgets in them, bolster incentives for (obligations of) investors with regard to transfer of rights for the use of technologies developed by them upon the 5-year period of their residence and scale of their operations in Russia's territory.

It is imperative to organize training and retraining programs on public private partnership for civil and municipal servants and specialists from the private sector.

Whereas budget resources for encouragement of investments into individual sectors are scarce, an alternative to direct budget expenditures is a mechanism of provision of government guarantees. In order to develop this mechanism, it is necessary to:

– create reserves for the whole term of effect of the guarantee, albeit not in a full volume, but with a due account of risks of a rise of a guarantee event;
– create a reserve fund at the expense of appropriations from the National Welfare Fund;
– exercise flexibility with regard to provision of a collateral for guarantee by the principal on obligations underwritten by the government.

It is equally important to promote the practice of engaging commercial banks in funding and managing investment projects in the infrastructural sphere. More specifically, it seems plausible to more vigorously engage the largest commercial banks in the process of monitoring of implementation of state-funded investment projects and, in the future, to commission the public customer functions to them. It is envisaged that this would allow a greater efficiency of the public investment management and lower construction costs coupled with a greater quality of implementation of such projects.

*Dividing expenditure powers between the Russian Federation, its Subjects, and municipal entities*

Numerous regions and municipal entities have found themselves in a situation when a sizeable proportion of their budget revenues are formed by subventions on exercise of their respective mandates. The subsequent jeopardy to efforts to increase the quality of control over the state and municipal finance is two-fold. First, regional and municipal authorities may not be keen to ensure a maximal efficiency of exercising a de facto someone else's mandate, while the respective monitoring mechanisms are far from being perfect. Second, funding the delegated mandates inevitably gives rise to certain challenges: there primarily exists a certain information asymmetry, i.e. data that directly affect the volume of subventions is supplied to the federal agencies by the RF Subjects. In addition, in the process of execution of the budget it may well happen that a given RF Subject (municipal entity) has received from the federal budget (the RF Subject's budget) an excessive amount of financing to exercise some delegated powers, while other powers have remained underfinanced. Given rigorous conditions of using subventions strictly to fund a certain delegated power, this results in an inefficient consumption of budget funds and the need in an urgent introduction of amendments to the RF Subjects' law in the end of a fiscal year.

The division of powers between the tiers of the budget system has recently been revised literally every year. This lowers predictability of the fundamental parameters of the budget system in the eyes of regional governments and local authorities and has an adverse effect on the quality of management of the public and municipal finance.

At this juncture it seems inappropriate to introduce amendments to the division of expenditure powers in 2010. Meanwhile, it is appropriate to use this period to monitor and evaluate efficiency of the effective system of division of powers.

It is imperative to provide for a possibility for revision of the effective system of division of powers for the sake of reducing the number of delegated powers and to fix with each tier of government those powers it is able to exercise in the most efficient way. This move should be completed as early as in 2011-2012. As the decision has been made to finance the Interior Ministry's bodies exclusively out of the federal budget, there arise ample opportunities and room for a "trading of powers" between different tiers of government.

Optimizing mechanisms of management of financial support to the RF Subjects

According to the draft 2010-2012 budget, there are 87 more transfers in the Russian Federation (4 ones – in the subsection on budget transfers per se, 43- in the subsection on subsidies, including federal programs and sub-programs, 21- in the subsection on subventions, and 19 ones- in the subsection on other interbudgetary transfers). Notably, the volume of funding of as many as 35 transfers has been under Rb. 1bn, which means that an array of programs run by given RF Subject are eligible for just a meager financing. Given a strictly targeted nature of most of them (funded by means of subsidies and subventions), the costs of evaluation of the targeted spending of the respective funds, let alone evaluation of efficiency of such a spending, may overweigh their prospective benefits.

Hence the growing appreciation of the need for systematization of interbudgetary transfers, including a rigorous observance with the fundamental principle, which implies that financial aid should be allocated with account of the RF Subjects' budget sufficiency rate.

This problem can be partly resolved by improving the expenditure powers division procedures. At the same time, the need for integration of a big number of small-volume target interbudgetary transfers into blocs has become evident.

The bottom line is that the concept of bloc transfers implies that financial resources in the frame of a given interbudgetary transfer can be spent by several directions, with the level of government from whose budget they are allocated enjoying the right for setting both the formula of their allocation and conditions of their spending by each direction of financing. The said level of government should have the right to opt for certain proportions of spending of the received bloc transfer by each direction included therein.

This should increase the quality of management of public and municipal finance in the course of implementation of the national priorities, particularly by taking into account, to a maximum degree, the local population's preferences. It seems appropriate to gradually replace after 2010 a considerable fraction of funding in the frame of the national projects, as well as the bulk of versatile subsidies to regions, with bloc interbudgetary transfers. Because of a high degree of differentiation of the fiscal capacity and costs of delivery of budget services in the RF Subjects, it appears appropriate for the federal level to allocate bloc subsidies with account of the regions' budget sufficiency rate. But the equalizing progressiveness rate should be substantially lower than the one of transfers earmarked from the Fund for Financial Support of Regions. It is proposed to grant bloc transfers in proportion to the size of the gap between the regions' budget sufficiency rate and the one of the most prosperous Subject of RF.

As concerns possible directions that may be integrated into bloc transfers at the regional level, those may be: capital refurbishment of public schools; capital refurbishment of blocs of apartments whose owners have established condominium; upgrading the quality of municipal motorways; population relocation from hardly accessible settlements; the health care reform, to name a few.