

GAIDAR INSTITUTE FOR ECONOMIC POLICY

**RUSSIAN ECONOMY IN 2010
TRENDS AND OUTLOOKS
(ISSUE 32)**

**Gaidar Institute
Publishers
Moscow / 2011**

UDC 338.1(470+571)
BBC 65.9(2Poc)-04

Agency CIP RSL

Editorial Board: *S. Sinelnikov-Murylev (editor-in-chief),
A. Radygin,
N. Glavatskaya*

R95 **Russian Economy in 2010. Trends and Outlooks.**
(Issue 32) – M.: Gaidar Institute Publishers, 2011. 544 pp.

ISBN 978-5-93255-316-9

The review provides a detailed analysis of main trends in Russia's economy in 2010. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; 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

This publication is made possible by the generous support of the American people through the United States Agency for International Development (USAID). The contents are the responsibility of the Gaidar Institute for Economic Policy and do not necessarily reflect the views of USAID or the United States Government.

UDC 338.1(470+571)
BBC 65.9(2Poc)-04

Sergey Sinelnikov-Murylev, Ilya Sokolov, Tatiana Tischenko

Russia's National Budget in 2010

2.2.1. Assumptions of the 2010 budget policy

An international crisis of 2008 – 2009, ever growing debt challenges in Greece, Spain, Ireland and Portugal in 2010 prompted the Government of the Russian Federation to revise the approach to the policy of irresponsible build-up of government expenses and obligations. A trend to curb budget expenses emerged back in 2010 while the budget was corrected and has continued while a budget was shaped for the next three year- period.

We have to confess, however, that our national budget system remains in an extremely unstable condition and strongly depends on the world market prices on energy carriers. Regardless of the planned cuts in expenses expressed in GDP per cent shares, the level of these expenses is still very high exceeding that of 2008. In this situation, a budget crisis objective possibility should be accounted for as early as possible; to prevent such a crisis, to sustain the balance of the national financial system in a long-term perspective must become an inherent condition of formulating a present-day budget policy. Otherwise a future Russia can as well repeat its experience of the 1998 crisis should external economic parameters change unexpectedly.

A main cause of the 1998 financial crisis was inability of any of the Russian governments during three years after the USSR had collapsed to approve and execute a realistic budget: government expenses exceeded government revenues from year to year manifesting a sustained trend. Impossibility to cover the expenditures by the tax revenues led to monetary financing (up to 1995) and growing borrowings at the internal and external financial markets thus making the national economy vulnerable and sensitive to internal and external shocks.

Restructuring expenses including their serious reduction should have become a key factor in budget balancing. The RF Government being fully aware of political and social implications of such a decision made punctured attempts to streamline expenses of the federal and local budgets; in June-July 1998, Cabinet led by Sergey Kirienko developed a special program in this area that was duly approved.¹ However, these actions were targeted at streamlining of some expenditures only; they looked like attempts to identify and remove inefficient expenditures while the problem was much more complicated: the government had to refuse

¹ Federal Government resolution No 600 “On approval of the program of government expenditures saving” passed on June 17, 1998 in pursuance of Decree of the President of the Russian Federation of May 26, 1998 No 597 “On measures to ensure government expenditures saving” was targeted to cut down inefficient social benefits, state investments and subsidies to certain sectors. According to the assumptions of the program developers, the implementation of the program would have decreased budget expenditures by RUR 41.9 billion (1.6% of GDP). To resolve this issue, Hother governmental resolutions were adopted, among them: RF Government resolution of May 12, 1998 No 438 “On measures to strengthen financial discipline”, Decree of the President of the Russian Federation of May 14, 1998 No 554 “On measures to strengthen financial discipline and implementation of the Budget laws of the Russian Federation”, Resolution of the RF Government of July 17, 1998 No 970-r and others.

implementing a considerable portion of its commitments that were impossible to be executed without a dangerous build-up of government debts; the government also had to seriously reform the budget funding system. No such action was done. As a result of the Government hesitancy to cut down the expenditure obligations, a financial crisis developed, and the national budget system collapsed.

The following years up to 2008 went by in a favorable external market situation; it helped improving budget revenues and running a considerable budget surplus (see *Table. 6*).

Table 6

Implementing budget revenues and expenditures at all the government levels in 1999–2009, in GDP %

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Federal budget											
Revenues	12,7	15,5	17,8	20,3	19,5	20,1	23,7	23,3	23,4	22,5	18,9
Expenditures	14,0	14,2	14,8	18,9	17,8	15,8	16,3	15,9	18,0	18,3	24,9
Deficit (-)/Surplus (+)	-1,3	1,4	3,0	1,4	1,7	4,3	7,4	7,4	5,4	4,2	-6,0
Consolidated budgets of the RF subjects											
Revenues	13,4	14,1	14,5	15,1	14,6	14,1	13,9	14,1	14,6	15,0	15,3
Expenditures	13,3	13,4	14,5	15,5	14,9	13,9	13,6	13,6	14,4	15,1	16,1
Deficit (-)/Surplus (+)	0,1	0,7	0,0	-0,4	-0,3	0,2	0,3	0,5	0,2	-0,1	-0,8
Budget of the enlarged government											
Revenues	33,8	38,3	38,4	37,8	37,1	37,5	39,7	39,6	39,8	38,6	35,1
Expenditures	35,3	34,3	35,2	36,3	36,0	32,9	31,6	31,2	33,8	33,8	41,4
Deficit (-)/Surplus (+)	-1,5	4,0	3,2	1,5	1,1	4,6	8,1	8,4	6,0	4,8	-6,3

Source: Federal Treasury, IEP estimates.

Consolidated expenditures continued growing till 2003 inclusively against the sustained growth of the budget revenues; after 2003, they reduced by 4-5 p.p. of GDP. There were two reasons behind such correction of the budget policy.

First of all, any further step up of the budget expenditures would have been against the task of financial stability assurance in the country by curbing inflation. The task of sustaining macroeconomic stability and further de-regulation of economic relations within the administrative reform could not be implemented because of the previous budget policy. To reduce inflation to 4%-5.5% per year and to maintain stability and predictability of the Ruble exchange rate, a well-thought budget policy was required together with restrained growth of federal budget expenditures (not exceeding 16.5 - 17 p.p. of GDP); besides such policy was to be combined with slower growth rates of tariffs on gas, electricity, railway transportations, utilities (within 5% - 8% per year) that were controlled by the government.

Secondly, there was an acute need in inventory and reduction of the created, in the previous years, enormous burden of social obligations that could never be realized or that inadequately reflected the then social, economic and demographic situations; this manifested in development of tougher requirements to budget allocations, implementation of an end-result oriented budgeting process and attempts to optimize the network of budget funded institutions.

In 2004 there was a major cut in budget expenditures when the share of federal budget expenditures (as a % share of GDP) fell down by 2 percent points. Such major reduction oc-

curred in a situation when the decision to pursue a conservative budget policy (establishment of a Stabilization Fund, among others) coincided in time with a sharp and unexpected improvement of the external economic environment.

Table 7

Federal budget in 1998 – 2009: actual and forecasted parameters

	GDP, in current prices, in RUR bln		Federal budget expenditures, in RUR bln		Federal budget expenditures as a % share of GDP		Inflation, in %		Urals price/barrel, in USD	
	forecast	actual	forecast	actual	forecast	actual	forecast	actual	forecast	actual
1998	2 840	2 629,6	499,9	379,4	17,6	14,4	5,7	84,4	16,0	17,0
1999	4 000	4 823,2	575,0	677,2	14,4	14,0	30	36,5	12,0	20,0
2000	5 350	7 305,6	855,0	1 034,9	16,0	14,2	18	20,2	16,4	27,5
2001	7 750	8 943,6	1 193,4	1 324,1	15,4	14,8	12	18,6	21,2	24,0
2002	10 950	10 830,5	1 947,3	2 046,0	17,8	18,9	12	15,1	23,5	23,7
2003	13 050	13 243,2	2 345,6	2 354,9	18,0	17,8	10–12	12	21,5	27,0
2004	15 300	17 048,1	2 659,4	2 695,6	17,4	15,8	10	11,7	22,0	34,5
2005	18 720	21 625,4	3 047,9	3 514,3	16,3	16,3	7,5–8,5	10,9	28,0	50,8
2006	24 380	26 903,5	4 270,1	4 281,3	17,5	15,9	7–8,5	9	40,0	61,2
2007	31 220	33 258,1	5 463,4	5 983,0	17,5	18,0	6,5–8,0	11,9	61,0	68,4
2008	35 000	41 444,7	6 570,2	7 566,6	18,8	18,3	7	13,3	53,0	89,0
2009	51 475	39 063,6	9 024,6	9 636,8	17,5	24,7	8,5	8,8	95,0	59,4

Source: Ministry of Finance of Russia, Federal Service of State Statistics

One can see from *Table 7*, that in 2004 the revenues of the federal budget were estimated following the macroeconomic forecast estimates that were based on the average annual price of Urals crude for the last 10 years (1994–2004) – 22 USD/barrel. At the same time, the expenditures of the federal budget were estimated from the crude price of 20 USD/barrel. In reality the 2004 price of crude reached its maximum for the previous 30 years hitting an average annual of 34.2 USD/barrel. As a result, the Stabilization Fund that began functioning in January 1, 2004, was considerably replenished reaching RUR 522.3 bln (or 3.1% of GDP) following the 2004 year results.

Another important factor causing the expenditure reduction (as a % of GDP) was an understated forecast of inflation which initially was planned at 10%. In reality the inflation rate was 11.7%. Thus the expenditures reduced both in real terms and as a per cent of GDP.

Due to the understated forecast of the crude price and inflation, budget expenditures in % of GDP could be restrained for the entire period of the 2000's. But beginning from 2007, due to abnormally high prices on crude and the mitigated budget policy, the curbing effect of the conservative macro-economic forecasts could not further prevent a budget expenditures growth (in % of GDP).

The budget policy has been relaxing since 2007; this was related to adoption by the government of additional social obligations to the national community, also within the framework of implementation of national projects of priority; and to the approval of new investment programs connected with the election of President. The year of 2007 actually made a start of a "soft" budget policy when the growth of expenditures at all the budget levels in Russia outpaced the growth rates of budget revenues; as a result the budget surplus of the enlarged gov-

ernment reduced for the first time in the last five years, regardless of favorable internal and external environment.

In 2008, the dynamic trend of the main parameters of the Russia's budget system strikingly differed from those in the previous year. Based on the 2007 year end results, all budget expenditures and revenues grew considerably vs the same indicators of 2006, however, in 2008 changes were multidirectional: in the context of emerging economic crisis and fall of prices on energy carriers, the federal budget revenues reduced by 0.9 % of GDP; simultaneously the revenues of the consolidated budgets of the RF subjects increased by 0.4 % of GDP. This may suggest that a crisis mostly hit financial stability of the federal budget, leading to reduction of oil and gas revenues and indirect taxes revenues.

While the financial crisis was hitting economies of many countries, functioning of the Russian economy radically changed in the 2H of 2008. This period was characterized mainly by relatively low prices and demand on Russian exported goods, by a sharp fall in output and unemployment growth. By the beginning of 2009, the Russian economy entered a recession period, with devaluation of the national currency (Ruble) and cuts in investment programs. Such aggravation of the economy affected the national budget system: given considerable reduction of revenues in the budgets of all the levels and the growth of expenditure obligations, in 2009 the budget of the enlarged government showed a deficit for the first time in the last decade (see *Table 6*). The imbalance of the budget system and the lengthy world crisis created risks of expanding the scale of debt borrowings in the near future.

The largest fall of revenues and growth of expenditures was observed at the federal level which relied largely on market revenues. The revenues of the federal budget reduced by 23 p.p. in real terms while the expenditures increased almost by 25 p.p.; in 2008 the budget surplus of 4.1p.p. of GDP was replaced by a deficit at 5.9 p.p. of GDP in 2009.

The Federal Government managed to implement, under a very tight schedule, a wide range of anti-crisis actions, unprecedented both in terms of a number of forms and directions of the government impact on the economy and the volume of tapped resources. If in the fall of 2008, the measures of "pin-point" responses were implemented under extremely tight time restrictions and by using mainly "manual management tools", by March 2009 a comprehensive Program of Anti-Crisis Actions of the RF Government for 2009 was developed.

To finance the priority areas of this Anti-Crisis Program, changes in the Federal Budget Law were to be made. As a result, the budget acquired a clear recessional character: the earlier approved budget allocations were cut down by 2.4% of GDP; and 4.1% of GDP including the released funds were allocated mainly to support financial stability and maintain strategic sectors and enterprises, and to a lesser extent, to support vulnerable groups of the population. The anti-crisis actions were funded both from the federal budget and off-budget sources which share was estimated at 2/3 of the respective expenditures.

The 2008 anti-crisis package, according to our estimates, valued RUR1.1 trillion (2.7% of GDP) and included mainly investments to support the financial system. In 2009, RUR2.4 trillion (6.2% of GDP) of the budget and off-budget funds were allocated to support the anti-crisis actions.

In Russia, the macroeconomic risks of the Anti-Crisis Program were partially mitigated by using the Reserve Fund: about RUR3 trillion (7.7% of GDP) of the Reserve Fund were allocated to balance the federal budget. There are three aspects specifically related to the "reserve" nature of these allocations.

Firstly, the use of the Reserve Fund to liquidate the budget deficit was a standard issuance of money by the RF Central Bank since practically such transaction means moving the Central Bank liabilities from the special account of the RF Government and including them in the monetary base (using the current account of the Government). Such transaction could not have been considered an emission if the Russia's Bank simultaneously sold the currency received during the period of the Reserve Fund accruals; however the international reserves of the Russia's Bank having reduced to minimal in January 2009 continued growing steadily in future. If the formation of the Reserve Fund were not accompanied by the reduction of the monetary base (its funds would have been accrued not at the Government accounts in the Central Bank but at the accounts of commercial banks), then its reserves and spending would not be associated with the emission. Thus, in terms of the monetary policy, the Fund is not a reserve but a separate channel of money inputs into the national economy.

Secondly, the described emission effect in using deposits from a budget account is observed every time when the government spends money in the current Treasury system that keeps its budget accounts in the Bank of Russia. Within this system, the funds received at a budget account are drawn outside the monetary stock. The monetary stock is fluctuating constantly during a year. There is a sharp growth of monetary aggregates in December when the budget implements its expenditure items, or there is a reduction of the monetary base in the last days of a month when taxes are remitted to the budget.

However, in view of the adopted budget period which is a budget year, in terms of the budget policy, only the final impact of budget transactions on the monetary stock is normally considered. If to extend the term of budget planning to up, e.g. five years, then the use of the Reserve Fund money will stop being a pure emission since the accrued funds during such period can be viewed as temporally drawn from (similar to fluctuations of the monetary base caused by a time asymmetry of implementation of the revenue and expenditure budget items) and returned to the national economy.

Thirdly, in the budget and debt policies perspective, the Reserve Fund deposits can be absolutely considered as a reserve of the RF Government since its availability helps financing the budget shortage with no market borrowings and with no increase of the government debts. This can be done by emission and simultaneous "sterilization" of the monetary stock at the expense of currency interventions and using external reserves accumulated as a counter-part of the Reserve Fund. The practices of such countries as the EU countries, the USA, Japan, Great Britain and others show that it is the growth of the national debt used to finance anti-recession actions that becomes a key issue at the stage of economic recovery. Therefore the Reserve Fund in Russia is a factor that prevents debt burden to increase and to carry the current budget expenditure load over to the next period (generations).

Simultaneously with the growth of expenditures, tax benefits of anti-crisis nature were adopted: a Profit Tax rate was reduced, a new procedure for non-linear depreciation introduced, a bonus depreciation increased, MET non-taxable price exemption increased, etc. In 2009, the "tax package" overall cost was about 1.5 p.p. of GDP.

The list of the budget anti-crisis actions taken in Russia in 2008 – 2009 is very like similar international programs: unemployment benefits, support of the retired, assistance to strategic enterprises in various sectors of economy, financial rehabilitation of banks, support to small and mid-size businesses. The actions differed by scope of allocations dependent on emergency and scale of problems faced by the governments.

In general, the anti-crisis policy in Russia was quite successful though with some deficiencies:

- in implementation of the Anti-Crisis program decisions were often delayed;
- the actions of government support had low transparency, in particular, there were no fixed rules of allocations among the enterprises;
- at the initial stage of the crises, insufficient focus was made on giving support to the community, thus reducing effectiveness of the government measures;
- cash execution of the expenditure obligations was irregular and therefore impeding efficient and timely spend of the budget allocations.

Main developments of the budget policy in the 2000'es

In the 2000'es, regular efforts were taken in Russia to assure stability of the budget system, efficiency of budget allocations and their spending. The budget policy of that period was characterized by the following:

In 1998, Budget Code was adopted and made effective since January 1, 2000, manifesting a considerable success in the area of the budget reform. The new law established legal foundations of the budget system of the Russian Federation, the position of the subjects of the budget legal relations, the procedure for regulating inter-budget relations, the foundations of the budget process in the Russian Federation, and accountability for violation of the RF budget laws.

The Reserve Fund was established in 2004 as a tool of accumulating some of the revenues generated by customs duties imposed on oil and from the Mineral Extraction Tax (oil) when the Urals price exceeded the base price¹. The purpose of the Reserve Fund was to assure the balance of the federal budget in cases where the oil price was lower than the base price and to neutralize extra liquidity by offsetting interventions of the Central Bank caused by increase of external reserves. Thus the expenditure obligations were maintained at a predictable and stable level and did not depend on uncontrolled external situation. As a result of growing prices on oil in 2004–2007, the Stabilization Fund could accumulate sufficient funds that allowed the Fund to perform a priority task of maintaining stability of the Russian state finance and in addition to early repay some of the national external debts. Moreover, due to the application of the Stabilization Fund tool, the budget policy of 2004–2007 acquired features of a counter-cycle. The Stabilization Fund starting February 2008 was split into Reserve Fund and National Welfare Fund. In 2009 – 2010 it was the Reserve Fund that functioned as a main source of financing the federal budget deficit;

In 2003–2004, the introduction of results-oriented budgeting (ROB) began as a tool to improve quality of managing budget funds and allowing distribution of budget funds not by the budget items but by strategic targets and tactical objectives aimed at reaching certain end results. As complex management procedures and processes including target programming and results-oriented budgeting were implemented in the environment where such fundamental budget issues as reforming of the budget network, improvement of incentives at the bottom

¹ Since 01.01.2004, the base price was established at \$20/bbl for Urals (Federal Law No 184-FZ of 23.12.2003, while since January 1, 2006 this threshold price was raised to \$27 (Federal Law of 12.10.2005 No 127-FZ). Regardless of that the oil prices continued growing, further increase of the “cut-off price” likewise the use of funds of the Stabilization Fund inside the country was stopped due to a risk of inflation and larger dependency of the budget on external economic environment.

level to use budget funds more efficiently remained unsettled, no breakthrough in the effective management of the budget funds could be expected. A low quality of the institutional environment considerably discredited the very idea of ROB in Russia regardless of its good potential. As a result, the application of the programmed and targeted planning was actually limited to planning, analysis and monitoring for assessment of efficient use of the budget funds while those mechanisms were designed to become inherent elements of the budget process substantiating the needs of the ministries and departments declared in the Budget Law.

Improvement of the legal foundations for procurement to meet federal and municipal demands was prompted by Federal Law No 94-FZ effective of July 21, 2005 “On placement of orders for supplies of goods, execution of works and rendering services for federal and municipal needs” and a number of amendments thereto. The new procurement system had a lot of advantages vs the previous one: application of direct legal regulation of the procedures for placing orders at all the levels of the budget system, limitation of corruption risks by narrowing the area of application of non-competing procedures (close bids, placement of orders with a sole supplier), introduction of more transparent ways of order placement (auctions, procurement at commodity exchanges, etc.) At the same time these innovations having failed to ensure a considerable reduction of the corruption scope, created certain problems for “fair” providers.

A review of the applicable international experience shows that the government needs in goods, works and services are satisfied more efficiently and adequately if all procedures of a process cycle of a government order (planning, formation and placement) are built into unified institutional environment, aligned with common for all the procedures milestones and streamlined in terms of structure and element composition. At present, however, the Russian legislation does not provide for a unified approach to regulation of the entire cycle of the government order placement. Thus, at the planning stage, the budget legislation is called to ensure targeted and effective spending of the budget funds. Regulation of the implementation of government contracts is limited to the application of general provisions of the Civil Code, and no specific regulation tools are actually applied. Though the stage of placing a government order is most effectively regulated as a result of on-going refinement of FZ-94, the following issues are not settled yet: carry-over of the budget funds allocated to payment for government contracts from the current to a future budget period, broader independence in spending of the saved budget funds generated by effective procurements, application of price monitoring data to justify the start-up procurement prices, prospects of centralization of state procurements, improvement of the procedure for setting prices in construction sector, possibility to engage specialized companies to perform control over contract compliance, in terms of targeted spending of funds, effective work organization, implementation of technologies (banks and engineering companies), methods of procurement of highly specialized services (R&D and pilot), etc.

Implementation of national projects of priority (NPP) as an alternative way of programmed governance of budget expenditures. A new approach to resolve the task of improvement of the Russian community life quality was demonstrated in development of four national projects of priority in the areas of education, healthcare, housing and agribusiness industry. Within each such project problems, objectives and actions were formulated. A specific focus was made on development trends of education and healthcare as these sectors have provided traditionally a wide range access to their services for the citizens and have always been extremely significant in terms of investments into human capital.

A review of the implementation results of NPP shows that the project target indicators have been delivered and over-delivered. However, these deliverables have not been supported by any institutional reform and therefore limited to additional budget allocations to alleviate acute problems in the key social sectors.

As there were no system approach to project shaping, the list of areas and actions of government support had to be extended every year thus leading to additional budget expenditures (to finance new “bottlenecks”, e.g. schools were connected to Internet, later the Internet traffic was paid for, since municipal budgets had no such expenditure items). Besides, the implementation of the national projects created additional expenditure obligations for the regional authorities. It is the regional authorities that are accountable mainly for the areas identified as national priorities. Therefore the national projects being included in the regional scope of competences created for the regions the so called hidden non-financed expenditure mandates:

- in the projects “Education” and “Healthcare” additional benefits and increase of salaries of certain categories of budget employees took place while labor remuneration in the education and healthcare sectors in general have been maintained at the levels planned by the government. Thus a gap in individual revenues was created, and some of the human resources moved to jobs that were highly paid for. The regional authorities had to respond by unplanned increase of salaries of other employees in the education and healthcare sectors.
- as the national projects of priority were implemented, it was found that they did not provide funds for maintenance of high-tech medical equipment, retraining of employees so that they could work with such high-tech equipment, etc.

The process of establishment of development institutions in order to create a unified national innovation system for development began in 2005. For several years, several dozens of organizations were established in Russia with the aim to incentivize investments and transfer to an innovative-performance model of the Russian economy, among them: Bank of Development and External Economic Activity, Investment Foundation of the Russian Federation, OJSC Special Economic Zones, Russian Venture Company, Russian Corporation of Nano-Technologies and other institutions. Each of them enjoyed a sizable support from the federal budget. Budget allocations were granted to organizations called development institutions, mainly in the form of contributions to their charter capital. Development institutions are granted such forms of private business support as loans, insurance of export risks, acquisition of securities of legal entities, participation in their capital and in concession agreements, and direct subsidizing.

The development institutions in spite of the considerable government support have not become catalysts of investment growth of the Russian economy, partially because there were no effective interface system for the institutions, their competences were vague, the applied tools were not aligned with those of established budget support, and the institutions did not have access to main sector strategic documents, etc.

Transition to a mid-term budget planning. In 2007, the 2008 – 2010 federal budget for 2008 – 2010 was formed (for a three-year period) for the first time in the contemporary Russia history. This development indeed was designed to improve predictability of the mid-term budget and fiscal policy of the RF Government, to enhance financial assurance of the adopted expenditure obligations for a three-year term and also to improve requirements to the budget quality and accountability for mistakes made in planning. According to the Budget Law,

budget allocations were approved separately for each year of the three-year period, and chief executives of the budget were granted the right of re-allocation of funds in the course of the federal budget implementation between the current and future years. However, early 2009, as a result of rather high mid-term uncertainties caused by further recession in the world and in the Russian economy, the Federal Government elected not to follow the new practice of 3Y budgeting in 2010-2012. This decision was justified in the then economic environment, and the return to budgeting on a one-year basis was considered a temporary measure, therefore in 2010 the RF Government returned to federal budgeting on a three- year basis.

Thus the review of most important measures to improve the budget policy performed in the 2000'es shows that most of them remained on paper. The results-oriented budgeting was not developed up to a level of becoming a tool of effective management of expenditures; the system of the development institutions can hardly be described as completely developed, the reform of the budget network was slow, etc. A lot of issues remain unattended and unsettled; they can form an urgent agenda to be dealt with in the near future.

We can assume that these insignificant results have been a consequence of mistakes made in selection of priorities of the budget reform. Since early 2000'es, complicated management tools (the results-oriented budgeting, targeted programming) have been implemented to improve the budget process; they proved to be quite effective in such countries as Great Britain, the USA, New Zealand, Australia; however they were hardly used in the countries with weak institutional environment. In a country where such fundamental issues of the budget sphere as restructuring of the budget network, creation of incentives for more efficient use of the budget funds at the bottom level, and improvement of a government order remain unresolved, it is difficult to expect a fast breakthrough in the quality of budget management.

2.2.2. Budget policy at the stage of recovery

In the context of improving macro-economic situation, with a stable growth of oil world prices in 2010, common trends for all budget levels have been: revenue growth, reduction of expenditures against the previous year and consequently reduction of the budget deficit (see. *Table. 8*). In particular, the budget expenditures of the enlarged government fell down by 2.5 p.p. of GDP, of the federal budget by 2.p.p. of GDP, of the consolidated budget of the RF subjects by 1.2 p.p. of GDP. At the same time, with re-calculation into real prices, the saving of the budget funds looks quite modest vs 2009 figures and fluctuates within 2-5% range – thus we can hardly speak of the efficiency of the announced intentions to implement the “responsible” budget policy.

In 2010, the revenues of the budget system changed insignificantly vs the similar parameters of the previous year. Thus the budget revenues of the enlarged government grew by 0.3 p.p. of GDP (equivalent to a 4.8% surplus). This is mainly a result of the change of the procedure of remitting revenues from insurance contributions¹ the federal budget revenues made 18.7% of GDP in 2010 – this is by 0.2 pp. of GDP lower than in 2009.

Table 8

Implementation of revenues and expenditures of the budgets of all power levels in 2010

2010		Change vs 2009		
in bln	in % of	nominal value	real value	pp of GDP

¹ If in 2009 UST revenues were partially remitted to the federal budget and then to the RF Pension Fund, since 2010 insurance contributions have been directed to off-budget funds.

RUSSIAN ECONOMY IN 2010

trends and outlooks

	RUR	GDP	bln of RUR.	%	bln of RUR	%	
Federal budget							
Revenues	8303,8	18,7	966,1	13,2	208,9	2,6	-0,2
<i>Incl. from oil & gas sector</i>	3830,7	8,6	846,7	28,4	538,8	16,4	0,9
Expenditures	10115,6	22,7	455,6	4,7	-541,2	-5,1	-2,2
Deficit (-)/Surplus (+)	-1811,8	-4,1	510,5		750,1		2,0
Consolidated budgets of the RF subjects							
Revenues	6537,0	14,7	610,3	10,3	-1,2	0,0	-0,6
Expenditures	6636,9	14,9	381,2	6,1	-264,3	-3,8	-1,2
Deficit (-)/Surplus (+)	-100,0	-0,2	229,1		263,1		0,6
Budget of the enlarged government							
Revenues	15715,9	35,3	2116,2	15,6	712,9	4,8	0,3
Expenditures	17301,0	38,9	1252,7	7,8	-403,3	-2,3	-2,5
Deficit (-)/Surplus (+)	-1585,1	-3,6	863,5		1116,2		2,8
<i>For reference:</i>	44491,4						
<i>GDP, in bln RUR.</i>							

Source: Ministry of Finance of the Russian Federation, IEP calculations

It should be noted that *the tax burden* in 2010 exceeded that of 2009 by 1.6 pp of GDP reaching 32.4% of GDP. Such increase was substantiated mainly by the positive trend of the tax revenues (see *Table 9*). Thus in 2010, Profits Tax, MET and indirect taxes dominated in their effect on the budget revenues of the enlarged government.

The revenues from the oil & gas sector that secure about one fourth of all the national budget revenues, have fluctuated depending on the world prices trends and demands for the goods of the fuel and energy complex. The main reason of the oil & gas sector revenues growth was the increase of the world prices on oil vs the similar period of 2009 (\$75.9 against \$56.7 \$/bbl), accompanied with monthly indexation of the export duties from \$253,6 per a ton in March up to \$303.8 per a ton in December. As a result of the growth of physical volumes of production and export of hydrocarbons and the growth of world prices on energy carriers, the surplus of oil & gas revenues was 0.9 pp. of GDP vs 2009. A non-zero beneficial export duty on the supplies of oil from the East Siberia fields¹, implemented in July 2010, positively affected the situation; the duty rate is re-calculated monthly depending on the world market prices and the demands for oil on the world markets.

Table 9

Main taxes revenues to the budget of the enlarged government of the Russian Federation in 2007 – 2010 in % of GDP

	2006	2007	2008	2009	2010	2010 change vs 2009		Tax elasticity for GDP in 2010, by times
						in % of GDP	in 2010 prices, in %	
Tax load	35,9	36,1	35,7	30,8	32,4	1,6	9,3	2,4
Profits Tax	6,2	6,6	6,1	3,3	4,0	0,7	27,2	6,9
Personal Income Tax	3,5	3,8	4,0	4,3	4,0	-0,3	-2,6	-0,6
Uniform Social Tax/ /insurance contributions*	4,8	5,1	5,1	5,5	5,1	-0,3	-2,6	-0,7
VAT	5,6	6,9	5,1	5,3	5,6	0,3	10,5	2,6
Excises	1	1	0,8	0,9	1,1	0,2	23,1	5,8
MET	4,1	3,6	4,1	2,7	3,2	0,4	21,0	5,3
Customs duties and fees	8,6	7,3	8,6	6,8	7,1	0,3	9,2	2,3

* since 2010, UST has been converted to insurance contributions remitted to off-budget funds directly.

Source: RF Ministry of Finance, Rosstat, IEP calculations.

¹ The beneficial rate applies to 22 fields of the East Siberia.

The following factors were suppressive for the oil and gas revenues trend in 2010: firstly, the slowdown of oil production growth rates in 2H 2010 vs 2009 and secondly, strengthening of the ruble currency which reduced revenues from external trade in the ruble equivalent.

The Profits Tax and indirect taxes, among other main oil and gas revenue sources, demonstrated a more pronounced trend to increase revenues both in % of GDP and in real prices; the Personal Income Tax revenues and revenues from insurance contributions, however, reduced by 0.3% of GDP.

In particular, the Profits Tax revenues by the year end reached 0.4% of GDP which is by 0.7% higher vs 2009. In real prices, the growth was 27.2% - this is the highest value among the considered taxes. Such positive growth of the Profits Tax revenues was mainly prompted by a better financial situation in the real sector. Thus, for 11 months of 2010, the consolidated financial effect of organizations (without small businesses, banks, insurance companies and budget-funded agencies) reached RUR 5.54 trillion (in current prices); this by 49.6% exceeds the value of this indicator for the respective period in 2009; the share of lossmaking enterprises reduced to 29.7% against 32.0% in 2009.

In 2010, the budget revenues from VAT grew by 0.3% vs 2009 at the expense of the tax imposed on the imported goods only. The VAT revenues from the goods sold inside the Russian Federation in real prices increased by 2.4% only while in the case of imports taxation – by 21.4%. Therefore in 2010, in the VAT revenue structure a continuation of the trend (since 2006) to reduce the share of the internal VAT has been observed in favor of the VAT revenues from the imported goods (if in 2004 the ratio between the revenues from the taxation of the internal sales and the taxation of the imported goods was 70:30, in 2010 such ratio was 53:47). It is explained by two factors mainly: the internal demand has shifted towards consumption of the imported goods (the share of imports in GDP increased from 12.8% in 2004 to 16.9% in 2010) and the legislation regulating internal VAT administration has changed recently; according to our conservative estimates¹, both factors resulted in annual under-receipt of budget revenues in the amount of at least 1.5% of GDP.

In 2010, a considerable growth of *excise* revenues to the budget of the enlarged government by 0.2% of GDP vs the respective value of 2009 was recorded. The reason behind such growth was a sizable increase of the rates on alcohol products, on beer specifically (by 3 times), and indexing for inflation of other groups of excisable goods. If in the 2000's, the growth rates of the tax base were behind the real GDP growth for all the excisable goods besides the alcohol products, since 2010 this trend has become pronounced for the alcohol products as well, which production volume reduced by 2.9% vs 2009 in physical terms.

The revenues from the *Personal Income Tax* (PIT) to the budget of the enlarged government reduced to 4.0% of GDP; this is by 0.3% of GDP lower than the 2009 value. In absolute terms the revenues grew by 7.5% only vs the previous year making RUR1,790.5 billion. In real prices the PIT revenues reduced by 2.6% vs the respective values of 2009. Such reduction of the PIT revenues occurred following the reduction of the taxable base (in GDP shares): in 2010 the growth rates of monetary revenues of the population (less social payouts) were lower than the rates of rehabilitation of the national economy; as a result, their share in GDP decreased by 4.6% of GDP for nine months of 2010 vs the respective period of 2009.

¹ Quality of VAT administration in OECD countries and in Russia/A. Knobel. S. Sinelnikov_murylev, I. Sokolov – M. Journal “Applied Econometrics” No 4 (20), 2010.

Since 2010, UST has been converted to insurance contributions administered by state off-budget funds¹. Before 2010, insurance contributions were paid on the insured and cumulative portion of the state pension and administered by the Federal Tax Service of Russia. These contributions were not a portion of UST, however the UST obligations were reduced by the amount of the paid insurance contributions (the UST portion subject to payment to the federal budget). In 2010, the summary rate of the insurance contributions was maintained at the level of the UST base rate of 26% of the payroll budget, however it was the taxable base that changed. Thus, if before 2010, the UTS was imposed at the regressive scale, and the base rate applied to the annual wage not exceeding RUR280,000, in 2010 the rate of 26% applied to the wage of RUR415,000, and any wage above that level was exempt from insurance contributions (actually two rates were applied: 26% and 0%).

It is important to note that Federal Law No 212-FZ of 24.07.2009 stipulated annual indexing of the marginal base for insurance contributions in line with the growth of the average wage in the Russian Federation². The changes described above should be taken into consideration by comparing the UST dynamics (including the insurance contributions) with the revenues from the insurance contributions in 2010. As *Table 9* suggests, the collection of the insurance contributions made about 0.3% of GDP vs the previous year. It is partially related to the reduction of the payroll fund in GDP by 2.5% of GDP.

Note that more important changes associated with insurance contributions have been effected since January 1, 2011, namely, the increase of the overall rate from 26% to 34%. According to our estimates, this action does not ensure the balance of the pension system of Russia in a long-term period, and there is a considerable negative influence on the pace of economic growth; this may enlarge a scale of tax evasion by the business (the share of the “shade wages” would increase).

With an insignificant growth of revenues to the budget of the enlarged government in GDP shares, in 2010 the budget expenditures reduced vs GDP (by 2.5 pp of GDP) but actually did not change in real terms; this conforms to the earlier accepted concept of their growth restraint (*Table. 10*).

Table 10

Implementation of the expenditure obligations of the budget of the enlarged government in 2009 – 2010, in % of GDP

	2010		2009		Change	
	RUR, billion.	% of GDP	RUR, billion.	% of GDP	in pp. of GDP	%, real assessment
Expenditures, total	17301,0	38,9	16048,3	41,4	-2,5	-2,3
<i>including</i>						
General government issues	1438,9	3,2	1313,8	3,4	-0,2	-0,7
incl. servicing federal and municipal debts	261,0	0,6	236,3	0,6	0,0	0,1
National defense	1279,7	2,9	1191,2	3,1	-0,2	-2,6
National security and law enforcement	1339,4	3,0	1245,9	3,2	-0,2	-2,5
National economy	2323,9	5,2	2782,1	7,2	-1,9	-24,3
Housing and utilities	1071,5	2,4	1006,1	2,6	-0,2	-3,5
Protection of natural environment	28,3	0,1	29,6	0,1	0,0	-13,2

¹ Federal Law of July 24, 2009 No212-FZ On insurance contributions to the Pension Fund of the Russian Federation, Social Insurance Fund of the Russian Federation, Federal Fund of Compulsory Medical Insurance and Territorial Funds of Compulsory Medical Insurance”.

² By Resolution of the RF Government of November 27, 2010, No 933, the taxable base limit was set at RUR463,000 for 2011.

Education	1893,9	4,3	1783,5	4,6	-0,3	-3,7
Culture, cinematography, mass media	353,4	0,8	324,4	0,8	0,0	-1,2
Healthcare and sports	1708,7	3,8	1653,0	4,3	-0,4	-6,3
Social policy	5863,2	13,2	4718,8	12,2	1,0	12,6

Source: RF Treasury, IEP calculations

The reduction of the government expenditures was mostly related to such budget items as “National economy” (by 1.9 pp. of GDP), “Healthcare and sports” (by 0.4 pp. of GDP) and “Education” (by 0.3 pp. of GDP). The only item of the budget of the enlarged government which enjoyed increase of funding was “Social policy”; this is mostly connected with pension indexation, three times during the reviewed year. Thus, from January 1, 2010, social supplementary pays to the pension were established to raise the pension up to the cost of living. Therefore, in 66 subjects of the Russian Federation payouts in the form of federal extra pays to the pension (for 2,403.7 thousand people) and in 17 subjects of the RF in the form of regional extra pays to the pension (2,441.1 thousand people) were made.

From April 1, 2010, work pensions were additionally indexed by 6.3% and social pensions by 8.8%. Besides, from July 1, 2010, social pensions have been increased by 3.41%. With account of all 2010 actions (valorization, indexation) the work pension (old age pension) has grown by 23% amounting to RUR8,177.

At the same time one should mind that such increase of the social obligations requires a well-thought approach since in the context of a sustained shortage of the RF Pension Fund it becomes an extra load on the national budget. Expenditures for funding the additional pension increase in January 2010 were estimated at RUR502 billion (about 1.2% of GDP) while for the April indexation the Federal government had to find another RUR 150 billion. The aggregate pension expenditures grew by RUR1.3 trillion (2.4% of GDP) vs 2009, and a result, the pension system shortage increased to 5.2% of GDP in 2010.

In such context, to revise the current national pension policy is absolutely required. Otherwise, to maintain the replacement ratio at the current level (36%) a choice between the two options will have to be made:

- Step up additional financing (0.5% of GDP for 2011 1% of GDP in 2016, 2% of GDP in 2022, etc) to compensate the pension system shortage; or
- Increase the rates of the insurance contributions by 0.5% on the average every year.

Thus we believe it reasonable to come back to the social tax scale that had been in effect before 2010, to carry our moderate indexation that would not increase the tax burden on the labor market in 2011 – 2012. In a mid-term, to secure the pension system, extra funds should be engaged in addition to standard insurance contributions for compulsory pension insurance. Alongside with the reserve funds, privatization of state property may help, also by way of passing the property over to the RF Pension Fund and non-state (private) pension funds in consideration of current contributions under the cumulative component of the pension insurance.

2.2.3. Main events in the budget area in 2010.

In the last year, in spite of the crisis and the need to cut down budget expenditures, the RF Government continued making transformations that started in the second half of the 2000’s to improve the quality of the budget governance and to implement the social obligations that had been assumed before. In 2010, the following events in the budget area can be considered as significant:

1. Development and approval of the RF Government Program to improve efficiency of the budget expenditures¹. The need to ensure a long-term balance and stability of the budget system in the form of an absolute fair limitation of the “irresponsible” annual increase of the budget expenditures is a fundamental condition for the Program implementation success.

An innovation in the Program is introduction of another program targeted tool - “a government program” designed to set aims, objectives and instruments of the government policy aimed at the implementation of the priorities of the Concept of a long-term social and economic development or large-scale actions of national or international significance. Last August the RF Government approved the procedure for development, implementation and assessment of efficiency of such government programs², while in November the RF Government passed a resolution where a list of the government programs was approved³. All the programs are structured by the following areas:

- New quality of life (13 programs);
- Innovative development and upgrade of the economy (17 programs);
- National security assurance (2 programs);
- Well-balanced regional development (4 programs);
- Effective government (5 programs).

The funds for the programs will be determined during national budgeting for 2012-2014.

Other significant areas of budget governance quality improvement in the Program are:

- Considerable increase of the target programs share (currently the budget expenditures under a targeted program method are covered by about 15%) in the budget;
- Reforming the mechanism of state order implementation;
- Improvement of the budget network;
- Reforming institutions of the federal (municipal) government control;
- Delineation of authorities between various levels of power, etc.

In spite of the fact that the Program is oriented at the improvement of the budget process at the federal level, the success of its implementation depends on the alignment and effectiveness of the efforts at all the levels. Therefore the RF Government recommended the executive authorities of the RF subjects and the local government bodies to develop and implement similar regional and municipal programs for improving efficiency of expenditures of the respective budgets according to the key provisions of the Federal Program. Also a decision was taken to grant federal subsidies to the regional budgets for the implementation of the regional programs⁴.

2. In 2010, amendments⁵ in the RF Budget Code were adopted to be effective since 2011. These amendments primarily changed the structure of functional classification of the budget expenditures and increased the number of budget items from 11 to 14. The following expenditures now have become separate items:

- servicing of the federal government and municipal debts. Before this expenditure item was included in the section “General Government issues”. This innovation aims at the im-

¹ Order of the RF Government of June 30, 2010 No 1101-r

² Resolution of the RF Government No 588 of August 2, 2010

³ Order of the RF Government of November 11, 2010 No 1950-r

⁴ Resolution of the RF Government of December 31, 2010 No 1203.

⁵ Federal Law of 30.09.2010 No 245-FZ.

- provement of control effectiveness over government debts specifically in view of its future increase in the mid-term;
- physical culture and sports expenditures. Earlier this budget item was included in the section “Healthcare”;
 - expenditures on mass media including TV and radio broadcasting; periodical press and publishing houses, applied research in the area of mass media and other mass media issues. Earlier the mass media expenditures were included in section “Culture and cinematography”.

“Inter-budget transfers” section was also modified. Now it is called “Inter-budget transfers of general nature to the budgets of the RF subjects and municipal establishments”. In this section the targeted transfers such as subventions and subsidies are united in item “subsidies for alignment of the budget provision of the subjects of the Russian Federation and municipal establishments”. All other transfers are grouped into– “other subsidies” and “other inter-budget transfers of general nature”. Transfers to off-budget funds are included in other sections. Thus, since 2011 transfers to the national Pension Fund will be included in section “Social policy”; as a result, the expenditures under “Inter-budget transfers” will be considerably reduced in 2011 – 2013 while the expenditures under “Social policy” will grow (see *Table 13*).

“National security and law enforcement” section was supplemented with an item called “modernization of the inferior troops, rescue military crews of a federal executive body authorized to resolve problems of the civil defense and of the law-enforcement and other bodies”. The desire to localize expenditures in the expenditure structure is explained by the coming (since 2012) transition to the program-based budget where each expenditure area will be shaped as a government program.

In July 2010, according to the amendments¹ in the Budget Code, the date of submission of the draft federal budget to the State Duma was moved from August 26 to October 1st. Such decision was made with a view to improve accuracy of the main forecast parameters of the federal budget when it is formed later in the year since by the first of October updated macro-parameters are usually available, main directions of the tax policy approved, and the Federal Target program scope is corrected.

3. Legal framework for road funds activity. In December 2010, the State Duma reviewed the first version (reading) of a bill aimed at development of the legal framework for establishment (since January 1, 2011) of road funds both at the federal and regional levels².

The RF Government initiated creation of a target budget fund for road construction and repair back in May 2010. In particular, the road fund notion was suggested as a portion of the budget funds to be used for financing road activities³, and to set up Federal Road Fund as part of the federal budget.

To create this asset, the following revenues will be accumulated:

- excises on gasoline, diesel fuel and motor fuels;

¹ FZ of 27.07.2010 No 216-FZ “ On amendments in the Budget Code of the Russian Federation with regards to specification of the dates of compiling, reviewing and approving draft budgets and reports on their implementation”.

² Some subjects of the Russian Federation e.g. Tatarstan, Lipetsk and Samara regions announced their intention to set up regional road funds in 2011.

³ The road activity is activity for designing, construction, modernization, capital repair and maintenance of the motor roads (according to FZ of November 8, 2007 No 257-FZ "On the motor roads and the road activity in the Russian Federation, and amendments in separate legislative acts of the Russian Federation”).

- use of property that is part of the motor roads of general use of federal importance;
- tolls on motor vehicles registered in foreign states when they drive by motor ways in the Russian Federation;
- subsidies from the RF budget system to finance roads of general use of federal importance;
- uncompensated receipts from legal entities and individuals to finance road activity;
- other receipts from fines and damage compensations.

With account of increased rates on the said excisable goods, since 2011 this mechanism will help accumulating about RUR500 billion annually, according to the estimates of the RF Ministry of Finance.

The rationale of the creation and functioning of the road funds raises serious concerns by a number of reasons. Firstly, the Audit Chamber of Russia has systematically focused on non-efficient use of the budget funds of the federal and regional road funds that were functioning earlier. Secondly, a road fund having its own fixed sources of revenue does not meet the principle of general consolidated coverage of the budget expenditures stated in Article 35 of the Budget Code. Thirdly, with the creation of road funds, the issue of a single-channel model of financing the needs of the sector remains unresolved: there are still several channels of bringing budget funds to the road sector organizations. In particular, a sub-program “Development of the Russia’s transportation system (2010 – 2015)” of the Federal Target program is still being implemented as well as co-financing of auto-concession from the Investment Fund.

2.2.4. Analysis of the main parameters of the federal budget of the Russian Federation in 2011–2013.

The world economic crisis brought about significant changes in the environment of the formation of the government budget in Russia. First, a sharp reduction in budget revenues took place – from 22.5% of GDP in 2008 to 18.7% of GDP in 2010 (see *Table 11*). Besides, in a long-term perspective a further reduction of the share of oil and gas revenues in the budget is expected which will not be compensated by high oil prices. This will occur due to several factors: non-raw material sectors will have an outrunning growth, greenfields subject to tax holidays will increase in number as well as brownfields (exhausted) that also enjoy tax benefits, the ruble currency is expected to strengthen. A development scenario is likely to happen where budget revenues will decrease while GDP will continue growing. According to our estimates, in the near decade oil and gas revenues may fall down by 2% of GDP as a result of the said factors.

Secondly, during the crisis the federal government has assumed many additional expenditure obligations causing expenditure growth from 18.3% in 2008 up to 22.7% in 2010. Though the implementation of the Anti-Crisis Program was quite justified and successful, currently optimization of the budget expenditure structure and reduction of redundant and inefficient areas of the budget finance has become a priority.

Thus, the Law on the Federal Budget for 2011 and for the planning period up to 2013 was developed in a revised context of the budget system, and this context predetermined the tasks: to ensure financial stability of the budget system, to cut down the shortage of the federal budget and to improve efficiency of the budget expenditures. The main parameters of the said Law are given in *Table 11*.

Table 11

Main parameters of the federal budget in 2008–2013 in % of GDP

	Actuals			Budget Law		
	2008	2009	2010	2011	2012	2013
Revenues	22,5	18,9	18,7	17,6	17,0	16,8
<i>including from oil and gas</i>	10,6	7,7	8,6	8,1	7,9	7,5
Expenditures	18,3	24,9	22,7	21,2	20,1	19,7
<i>incl. tentatively approved</i>	–	–	–	–	0,8	1,3
Deficit (–) / Surplus (+)	4,2	–6,0	–4,1	–3,6	–3,1	–2,9
Other than oil and gas deficit	–6,4	–13,7	–12,6	–11,7	–10,9	–10,4

Source: Ministry of Finance of Russia, IEP calculations

As the Table suggests, the federal budget deficit will reduce to 2.9% of GDP in 2013, however this reduction can be less due to a number of assumptions. Primarily, there are more optimistic estimates of the oil prices in the mid-term (when the budget was shaped, a conservative forecast was used with the prices at 75-78 \$/bbl). A high dependency of the budget revenues on oil and gas revenues remains. Besides, a growth of the budget revenues is possible if the macro-economic situation improves in the mid-term and the world economy revives after the crisis, and the demand for goods on the Russian and international markets will increase together with the growth of foreign investments. Finally, a positive trend of reduction of the budget expenditures as a result of the implemented reforms of 2009 – 2010 may be expected.

It is also obvious that with a less favorable development of the economy and a change of the ratio between the basic parameters of the social and economic development (oil prices, GDP volume, inflation rates, the ruble exchange rate) the budget deficit can become so high that new issues may appear challenging the growth of the economy and the stability of the budget system as a whole.

For the near three years, receipts from the indirect taxes, MET and customs duties will remain the main sources of revenue for the federal budget (see *Table 12*). Note, that according to the forecast of the RF Ministry of Finance, in 2013, with comparable volume of the real GDP, the revenues of the federal budget will be by 5.7 pp. of GDP lower than in 2008. According to our estimates, approximately 2.5 pp. of GDP cuts are caused by changes in the tax legislation (UST is replaced with insurance contributions, and the Profits Tax rate is reduced), 1.0 pp. – caused by reduction of revenues from the oil producing sector (MET and export duty reliefs) and 2.1 pp. – by reduction of revenues from taxes related to a lower (in 2013 vs 2007) level of profitability and changes in the economic activity structure.

During 2012 – 2013, a “pin-point” policy to increase fiscal burden on certain sectors of economy, especially, on the oil and gas sector, will be carried out. Since 2011 the MET rate on gas is expected to increase by 61% - from RUR147 to RUR237 for 1,000 cu. m, in 2012 the rate will be indexed for the expected growth of prices (5.9%) up to RUR251; while in 2013 – by 5.5% up to RUR265/1,000 cu. m. The increase of the fiscal burden on the producing sector the national budget system is going to receive additional RUR50-70 billion every year in 2011 – 2013. (see *Table 12*). As for MET on oil, the MET rate will not change in 2011; however in 2012 it is expected to increase from RUR419 to RUR446 for one ton, and in 2013 - up to RTUR470. This measure will annually bring to the budget about RUR75 and RUR150 billion respectively. However, this measure may negatively affect the sector efficiency.

Abolishment of the reduced rate of the export customs duty on oil produced at the specific fields of East Siberia will ensure a surplus revenue to the federal budget of RUR97 billion in 2011 and about RUR30 billion in the following two years. Besides, last December the increase of the export duty on oil products continued to be discussed. Russia as a member of the Customs Union has reserved this right and can use it as early as in the mid-term period. Two options of the duty increase are considered:

- gradual equation of the duties on light and dark oil products by bringing them to 60% of the duties on crude by 2013;
- increase of the average weighted rate at the external border of the Customs Union.
- If the export duties increase, the government will search for other methods of support of the national “oil refining”, meaning not primary treatment but deep crude conversion.

Regardless of the total increase of the tax burden on producing companies, a gradual reduction of oil and gas revenues (as shares of GDP) is expected caused by objective (lower rates of growth of the Urals prices and taxable exports vs GDP dynamics and ruble strengthening) and sector problems (reduced production volumes and lower profitability rates).

As for revenues other than those from oil and gas, an insignificant growth of the VAT receipts is expected related to the growth of sale volumes at the internal market and receipts from excises caused by the annual increase of the rates on excisable goods (mainly on tobacco and alcohol products) in the coming three years (see *Table 12*).

As for revenues other than from the taxes, their growth is forecasted as a result of setting tasks on dividends generated from the stocks of joint-stock companies being in federal ownership, and a portion of profits of federal unitary enterprises.

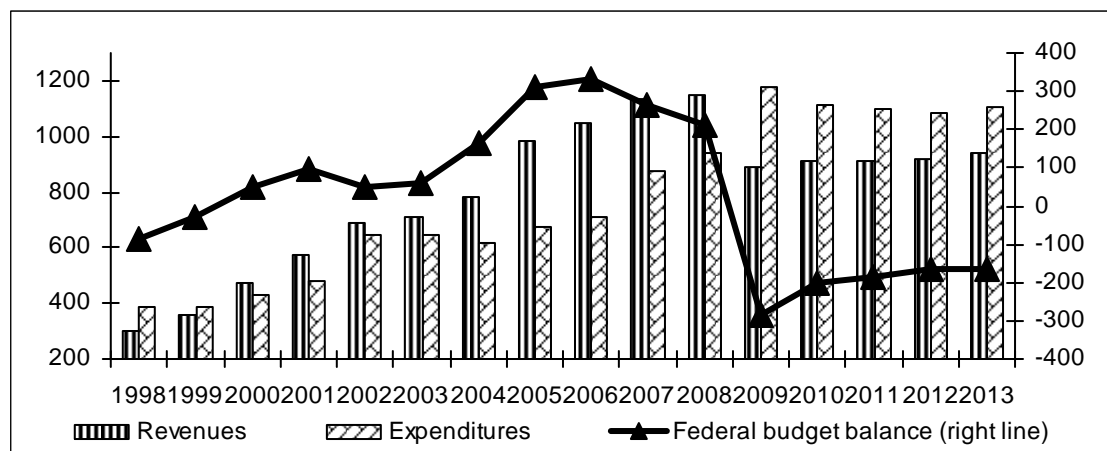
The federal budget expenditures show a tendency for reduction (in % of GDP), but their volumes in constant prices of 1998 and expressed as % of GDP remain at a sufficiently high level that obviously surpass the level reached in the successful 2008 (see *Fig 13*). Besides, in real terms the trend of their reduction will change for the opposite one as early as in 2013.

Table 12

**Actual and expected revenues to the federal budget of the Russian Federation
from the main taxes in 2008–2013 (% of GDP)**

	Actuals			Law on budget		
	2008	2009	2010	2011	2012	2013
Profits Tax	1,8	0,5	0,6	0,5	0,5	0,5
UST/Insurance contributions	1,2	1,3	0,0	0,0	0,0	0,0
VAT– total:	5,2	5,3	5,6	5,6	5,6	5,7
internal production	2,4	3,0	3,0	3,0	3,1	3,1
imports	2,7	2,3	2,6	2,6	2,5	2,6
Excises – total:	0,4	0,3	0,3	0,5	0,6	0,7
internal production	0,3	0,2	0,3	0,5	0,5	0,6
imports	0,1	0,1	0,1	0,1	0,1	0,1
MET	3,9	2,5	3,1	2,8	2,7	2,6
Customs duties – total:	8,4	6,5	6,4	6,7	6,5	6,3
import duties	1,5	1,2	0,8	1,2	1,2	1,2
Export duties	6,9	5,3	5,6	5,5	5,3	5,0
The share of the said taxes and duties in the federal budget revenues in %	93,3	86,5	85,6	92,0	93,4	93,7

Source: Ministry of Finance of Russia, IEP calculations.



Source: Ministry of Finance of Russia, IEP calculations.

Fig. 13. Dynamic trend of the revenues, expenditures and deficit of the federal budget, in RUR billion, and in 1998 constant prices

The growth of expenditures as GDP shares is planned in such sections as “National defense” and “Servicing of the government debt”¹ (see *Table. 13*), while in other sectors the expenditures are going to fall down vs GDP; this can be explained by GDP higher growth rates as compared to the growth rates of expenditures in absolute terms, measures taken to optimize the network of budget institutions, and reduction of the number of implemented federal target programs (43 in 2011 down to 37 in 2012) and the volumes of allocated funds (from RUR 1364.8 billion in 2011 down to RUR1 080.6 – in 2013). The review of the expenditure structure for open federal target programs shows that with a general reduction of the allocations, in 2010 – 2013 an increase in expenditures is observed in “Innovative development and upgrading of economy” only (from RUR436.5 billion in 2010 to RUR 579.3 bln in 2013); this is in full line with the Budget Code provisions.

Table 13

**Dynamics of the expenditure obligations of the federal budget
in 2010–2013 in % of GDP**

	2008	2009	2010	2011	2012	2013	Variance of 2013 vs2010, in %GDP
Expenditures (without tentatively approved) total	18,3	24,9	22,7	21,2	20,1	19,7	-3,1
<i>including</i>							
General government issues							
Servicing municipal and federal debts	0,4	0,5	0,4	0,8	0,9	1,0	0,5
National defense	2,5	3,1	2,9	3,0	3,0	3,4	0,5
National security and law enforcement	2,0	2,6	2,4	2,4	2,1	1,9	-0,5
National economy	2,5	4,3	2,7	3,4	3,0	2,5	-0,2
Housing and utilities	0,3	0,4	0,5	0,4	0,2	0,1	-0,4
Protection of natural environment	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Education	0,9	1,1	1,0	1,0	0,9	0,8	-0,2
Culture, cinematography, mass media	0,2	0,3	0,3	0,3	0,3	0,2	-0,1
Health care and sports	0,7	0,9	0,8	1,0	0,9	0,7	0,0

¹ For the reasons of such growth of expenditures under “Social policy” see above.

RUSSIAN ECONOMY IN 2010

trends and outlooks

Social policy*	0,7	0,8	0,8	6,0	5,8	5,6	4,9
Inter-budget transfers of general nature *	6,5	9,3	9,3	1,1	0,8	0,7	-8,6
Tentatively approved	-	-	-	-	0,7	1,3	-

* Specifics of re-distribution of funds between these two items relate to the changes of the functional classification of the budget expenditures effected in 2011 (see above).

Source: RF Treasury, IEP calculations.

The growth of expenditures is also prompted by some governance decisions which may be considered as doubtful in terms of the budget policy priorities. Thus, e.g. from 2011, five new federal target programs and three state programs will be financed, and part of these are not included in the priorities of the budget policy as set by President of Russia. Many experts believe, e.g. that the “Clear water” FTP developed under the influence of the Parliament lobby, likewise “Development of the domestic and international tourism” can hardly be described as priorities that require additional financing given the budget deficit; moreover the expenditure share for the new FTP makes almost 20% of the FTP general expenditures for 2011 – 2013.

In 2011–2013 the federal budget expenditures will be cut down in the following sections and areas:

- “Healthcare” - from RUR 375.6 billion in 2011 to RUR 356.1 billion in 2013: at the expense of increasing funds for the implementation of the sector modernization project from the Fund of Compulsory Medical Insurance. The major portion of the allocations from the said Fund will be distributed among regions in the form of grants;
- “Housing and utilities” - in 2012 and 2013 there will be a reduction of the budget allocations for the implementation of the federal target programs and a FAIP part not covered with the programs, including the provision of service and permanent housing to the servicemen (RUR125.9 billion in 2010 to RUR25.3 billion in 2013) in connection with completion of the respective efforts. Besides in 2011 there will be budget allocations to finance subsidies to a state corporation Fund of Assistance to the Housing and Utilities Reform in the form of a property contribution to rehabilitate the Fund property that had been transferred to the ownership of the Russian Federation in 2009 in the amount of RUR15.0 billion; no such actions are planned for 2012 and 2013.

More than double expenditures to service the government debt – from 0.4% of GDP in 2010 to 1.0% in 2013 – require special attention. The growth of the government debt (8.3% of GDP as of 01.01.2010 up to 18.2% of GDP as of 01.01.2014 – see *Table 14*) may negatively affect the stability of the national fiscal system. At the same time stepping up the government debt will take place primarily through a growing share of internal borrowings (in 2010 – 2013 the internal debt will grow from 5.4% of GDP to 14.3% of GDP, while the external debt will remain within 4% of GDP) which is quite justified in terms of national security and manageability of the debt.

Table 14

Federal debt of the Russian Federation in % of GDP

	Law on budget*									
	2005	2006	2007	2008	2009	2010	2011	2012	2013	
Federal government debt (as of the year end)	14,3	9,1	7,2	6,5	8,3	9,4	13,7	16,1	18,2	
including:										
internal debt	4,1	4,0	3,9	3,6	5,4	6,6	10,2	12,5	14,3	
external debt	10,2	5,1	3,3	2,9	2,9	2,8	3,5	3,6	3,9	

*top limit of the federal government debt is shown

Source: RF Treasury, IEP calculations.

The period when the Reserve Fund was a key source of financing deficit of the federal budget ended in 2010, when the Fund allocated RUR1,119.5 billion (2.5% of GDP) for the said purpose. The Reserve Fund allocations have not been spent fully as the expected federal budget deficit was reduced; the non-spent funds as of January 1, 2011 amounted to RUR775.2 billion. (*Table 15*).

Table 15

Dynamic trend of the formation and use of oil and gas funds in 2010, in RUR MM

Indicator	Balances as of the end of 2009 *	Receipts in 2010		Spent in 2010 for:		Balances as of the end of 2010 *
		oil and gas revenues	Assets management receipts	Financing of the federal budget deficit	Financing of the budget deficit of off-budget funds	
Reserve Fund	1830.5 (4.7% of GDP)	–	–	1119.5	24.5	775.2 (1.7% of GDP)
National Welfare Fund	2769.0 (7.1% of GDP)	–	–	–	2.5	2695.5 (6.1% of GDP)
Total	4599.5 (11.8% of GDP)	–	–	1119.5	27.0	3470.7 (7.8% of GDP)

* the balances are recalculated at the exchange rate as of January 1, 2010 and 2011 respectively.

Source: RF Treasury.

In 2010, the RF Government elected not to use the National Welfare Fund, and the Fund balance in absolute terms remained at the 2009 year-end level. The Fund's assets in the amount equal to the population's pension accruals (RUR5.0 – 10.0 billion per year) will continue to be further used in 2011 – 2013 thus ensuring safety of the accumulated assets of the Fund. It is worth noting that given the considerable reduction of spending or full spending of the oil and gas funds' assets, by 2012 the national financial system could be exposed to external shocks having no financial coverage.

To cover the budget deficit, receipts from privatization (RUR298 billion in 2011 up to RUR309.0 billion in 2013) will be actively used.

2.2.5. Prospects of the fiscal policy development

In 2010, the structure of the Russian economy (fuel and energy sectors generate up to 9% of GDP) and the exports oriented at raw materials (2/3 of the exports are produced in the fuel and energy sectors) ensured, through the system of oil and gas revenues, up to 46.5% of the federal budget revenues and 24.6% of the budget revenues of the enlarged government. However, world market prices on fuel and raw materials are highly volatile. The issue of such dependency was partially resolved by establishing in the 2000's a tax system with graduated MET rates and export duties depending on oil prices and Stabilization Fund. When in 2009 the federal budget revenues in real terms decreased by 22%, the Government managed to increase expenditures up by 25% by tapping assets accrued in the Reserve Fund. Nevertheless, according to IEP, tax revenues fluctuate in the range of $\pm 3-4\%$ depending on the external market situation; besides, at various stages of the business cycle an additional fluctuation of the tax revenues can happen within $\pm 2-2,5\%$. In other words, with an average long-term price on oil of 70 \$/bbl, the enlarged government budget can receive about 34% of GDP, but this figure may vary from 28% to 40% of GDP.

With account unpredictable generation of budget revenues from oil and gas, a conservative approach is required to define the level of their spend that would ensure budget stability. The current application of the oil and gas transfer which size is linked to GDP does not limit ex-

penditures to a safe level in terms of the budget balance. To reduce the dependency of the budget revenues on the external economic situation, we should abolish the current procedure of the oil and gas transfer and return to the procedure effective in 2004 – 2007: the procedure was based on the cut-off price, and MET contributions to the Reserve Fund and the export duties were in direct proportion to the excess of the actual tax rate over the rate calculated with account of the average long-term price. In other words, the size of the oil and gas revenues open for use should be limited by a certain threshold oil price kept unchanged during the entire period of budget planning (i.e. three years).

All oil revenues above the established limit should be channeled to oil and gas funds. A budget deficit should be funded from the Reserve Fund only if budget revenues are under-received as a result of the oil price being lower than the oil price estimated in the respective macro-forecast which was used as a basis for estimation of the main parameters of the federal budget.

Such approach can assure budget stability since the threshold level of the budget allocations for spending is fixed as early as the budget planning stage. To use the cut-off price would be reasonable (similar to the price used as a basis for establishment of the Stabilization Fund in 2004 – 2007) for estimation of tax revenues from production and export of oil and gas.

In the context of limitation of government expenditures, efficiency of their spending should be improved. The quality of budget governance can be improved by using a comprehensive approach only that will help to cover the broadest range of the applied regulating tools and to align their application in time. With this in view, in the near future a focus should be placed on resolution of the issues of budget system restructuring, higher transparency of the state procurement system and optimization of certain budget procedures. As a favorable institutional environment evolves in the country, any further development of such governance tools as the result-oriented budget, target program activities, state and private partnership can become an important factor of budget expenditures streamlining and improvement of efficiency of the entire budget process.