

GAIDAR INSTITUTE FOR ECONOMIC POLICY

**RUSSIAN ECONOMY IN 2011
TRENDS AND OUTLOOKS
(ISSUE 33)**

**Gaidar Institute
Publishers
Moscow / 2012**

2.2. State Budget

Throughout 2011, it still was a favorable state of affairs in the foreign economic area which was a major driver of increase in budget revenues: international carbohydrate prices proved at one-third above the projections made while crafting the draft federal budget for 2011-13. As well, the revenue part of the budget found itself under spurred by increasing business activity, which manifested itself in the economy's growth rates notably outpacing the earlier anticipated ones (the 2011 growth in GDP was projected at a level of 3.4%, while Rosstat's preliminary estimates suggest it actually accounted for 4.3%).

There also were other factors fueling the increase in budget revenues: arrears before the budget system were down 12% on a year-on-year basis and hit their lows over the past 7–8 years; wage arrears were also down from Rb 2.4bn in 2010 to 1.8bn in 2011; the registered unemployment rate slid by 10.9%.

At this juncture, even the pre-election boost to expenditure obligations failed to “overweight” the increase in the revenue part of the budget. Thanks to that, at the federal level, the 2011 budget posted a surplus, while the public debt remained under 9.6% of GDP. However, many expenditure obligations are deferred and going to manifest themselves in full only in 2012.

So, on the one hand, against a miserable global economic backdrop (the EU member states sharing a -6.2% deficit of the Eurozone's aggregate budget, the US suffering from a deficit of -9.6% of GDP and Japan a deficit of -10.3% of GDP) and a huge public debt (over 80% of GDP across the Eurozone, 69% of GDP – in the US and 208% of GDP – in Japan¹) Russia's economy appears pretty healthy; however, on the other hand, more and more pre-election obligations and expenditure vows were made (e.g. the decision to raise military and law-enforcement agencies personnel's pay proved very costly; meanwhile, the government is facing the challenge of footing the bill for indexation of the social and the public sectors employees' pay) compels one to reassess risks and consequences of the said managerial decisions from the perspective of the national budget system's sustainability.

2.2.1. The General Characteristic of the Budget System of Russian Federation

The 2011 dynamics of main parameters of the enlarged government budget exhibits retention of the trends launched in 2010 – namely, boosting revenues while constraining budget expenditures relative to GDP (see *Table 5*). The 2011 revenue volume to the enlarged government budget accounted for 38.4% of GDP, or up 2.9 p.p. of GDP vis-à-vis the 2010 level. The volume of federal budget revenues hit 20.9% of GDP, or 2.5 p.p. up compared with 2010. The increase was fueled mostly by oil-and-gas revenues boosted by a favorable foreign economic situation. In 2011, international prices of Urals stabilized at a level of USD 109/b (in 2010- USD 78/b) under a 30.3% expansion of foreign trade turnover calculated by the balance-of-payments methodology². In 2011, the recovery of the industrial output continued to advance, with the index of industrial output accounting for 104.7%. The share of the federal budget revenues in overall revenues to the enlarged government budget posted a slight growth on a year-on-year basis – from c 51.8% in 2010 up to 54.5% in 2011.

Table 5

Revenues to and Expenditures of the Budgets in 2008–2011

	2011	2010	2009	2008	Bias in p.p. of
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• ¹CIA – Central Intelligence Agency.

²At year-end 2010 Russia still was one of the largest exporters, after China, Germany and Japan, in the CIA Sovereignty Rating which is based on assessment of current external balance.

	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	GDP, 2011 vs. 2010
Federal budget									
Revenues	11 365.9	20.9	8305.4	18.4	7337.7	18,9	9275.9	22.5	+2.5
Expenditures	10 935.2	20.1	10 117.5	22.4	9660.90	24.9	7570.8	18.3	-2,3
Deficit(-) / Surplus(+)	+430.7	+0.8	-1 812.1	-4.0	-2322.3	-6.0	1705.0	+4.1	+4.8
Consolidated budgets of RF Subjects									
Revenues	7643.9	14.1	6537.3	14.5	5926.6	15.3	6253.1	15.1	-0.4
including interbudgetary transfers	1644.0	3.0	1398.9	3.1	1487.4	3.8	1132.6	2.7	-0.1
Expenditures	7679.3	14.2	6636.9	14.7	6255.7	16.1	6253.5	15.1	-0.6
Deficit(-) / Surplus(+)	-35.4	-0.1	-99.6	-0.2	-329.0	-0.8	-54.4	-0.1	+0.1
The enlarged government budget									
Revenues	20 853.6	38.4	16 031.9	35.5	13 599.7	35.0	16 169.0	39.2	+2.9
Expenditures	20 004.8	36.8	17 616.6	39.0	16 048.3	41.3	14 157.0	34.3	-2.2
Deficit(-) / Surplus(+)	+848.8	+1.6	-1584.7	-3.5	-2448.6	-6.3	+2012.0	+4.9	+5.1
For reference: GDP, as Rb bn	54 369		45 166		38 809		41 277		-
Increase in Russia's public debt (including issued government guarantees) over the year	+1190.3	+2.2	+921.9	+2.0	+583.1	+1.4	+289.6	+0.7	-

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

At year-end 2011 the RF Subjects' consolidated budgets received Rb 7,643.9 bn in revenues (14.1% of GDP), or 0.4 p.p. of GDP down compared with the prior year (14.5% of GDP), which should be ascribed both to a drop in revenues noted across most tax and non-tax revenues, as well as a fall in the volume of interbudgetary transfers (by 0.1 p.p. of GDP). An alarm bell was the fact that the last year saw the lowest level of collection of tax revenues to the RF Subjects' consolidated budget since 2008. The fall was most intense with respect to the corporate profit tax (by 0.3 p.p. of GDP), PIT – 0.2 p.p. of GDP, property tax - 0.2 p.p. of GDP. Transport tax revenues remained at a level of 0.1% of GDP thanks to greater contributions by private individuals, while amounts collected from corporate taxpayers were down. In all, the share of tax revenues in the aggregate volume of the RF Subjects' consolidated budgets shrank by 1.2% vs. the previous year's figures.

As to non-tax revenues, when compared with the 2010 figures, there was noted a decline in asset management revenues to the RF Subjects' budgets equivalent to 0.1 p.p. of GDP. At this point, exacerbation of asset management problems at the regional level is quite visible, as collection of the revenues in question was supposed to increase due to annual investment by the Subjects' budgets in creation of state property objects equivalent to up to 2.0% of GDP. Meanwhile, the other non-tax revenues remained unchanged since 2010.

Despite a two-year-long tendency to increase in revenues to Russia's budget, the nation failed to clear the pre-crisis bar of revenues to the enlarged government's budget (39.2% of GDP in 2008). Meanwhile, the enlarged government budget expenditures were being trimmed consistently: from 41.3% of GDP in 2009 to 36.8% of GDP in 2011, or 2.2 p.p. below the 2010 figures, but still above (2.5p.p. of GDP) the pre-crisis 2008 level. That said, expenditure cuts were uneven across the tiers of the budget system: thus, in 2011, federal budget expenditures were slashed by 2.3 p.p. on a year-on-year basis and made up Rb 10, 935.2bn (20.1% of GDP), while expenditures of the RF Subjects' consolidated budget slid by 0.6 p.p. of GDP vs. the previous year's figures and accounted for Rb 7,679.3bn (14.2% of GDP).

The decline in the volume of the budget system's expenditures can be partly ascribed to low pace of spending throughout the year. For example, by results for the first 8 months of the year, expenditure-wise, cash execution of the federal budget was 58.4%, while that of consolidated budgets of RF Subjects – 51.7%. The last month of the year saw spending of some 20% of all the federal budget outlays (in 2010 r. – 17.7%, in 2009 – 15.0%).

At year-end, the situation with cash execution of the federal budget and consolidated budgets of RF Subjects was as follows (see *Table 6*).

Table 6

Cash Execution of the Federal Budget and the RF Subjects' Consolidated Budget in 2010–2011

	Federal budget				RF Subjects' consolidated budget			
	2011		2010		2011		2010	
	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %
1	2	3	4	5	6	7	8	9
Expenditures, total including	11 126.0	98.3	10 301.5	98.2	8400.7	91.4	7175.1	92.5
Non-excludable costs	815.0	96.6	990.3	89.4	510.8	91.8	523.1	92.0
National defense	1524.4	99.5	1288.8	99.1	3.6	95.9	3.3	97.0
National security and law-enforcement activities	1258.1	100.0	1094.6	99.2	291.3	96.8	260.5	97.5
National economy	1861.7	96.2	1253.3	97.5	1485.5	88.6	1256.7	87.8
Public utilities sector	282.9	98.9	236.9	99.2	1335.8	72.5	974.4	85.8

cont'd

1	2	3	4	5	6	7	8	9
Environmental protection	17.8	98.9	13.5	100.0	24.0	90.8	16.5	89.7
Education	556.0	99.5	444.8	99.5	1791.3	96.5	1497.5	96.9
Culture, motion picture industry, mass media	86.9	96.0	126.4	99.2	282.9	95.1	240.1	94.9
Health care, physical culture, sports	513.0	97.3	356.8	97.5	1502.0	89.1	853.5	93.4
Social policy, pension system	3185.9	98.2	346.9	99.4	1273.8	93.6	1237.5	94.3

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

Despite the national leadership's regular calls to improve payment discipline, the situation with cash execution of the federal budget remained practically unchanged, while in the case of the RF Subjects' consolidated budget it even exacerbated, with the budget having been executed, expenditure-wise, only by 91.4% (92.5% in 2010). In terms of functional sections the worst performance in executing consolidated budget expenditures over recent years was noted across the following sections "Public utilities sector", "National economy", "Health care, physical culture and sports". Factors behind a low dynamic of spending of budget funds are: inclusion in the Budget Act of costs of construction of objects not backed with necessary documents and materials (approved in accordance with the established procedure design documentation on capital construction objects, decisions to make budget investments in the frame of the approved federal target program, etc.) and, according to the RF MinFin, the launch of the system of open e-auctions in the course of placement of public orders, which required setting up an e-document flow system.³

At year-end 2011 the enlarged government budget was executed with a surplus of 1.6% of GDP thanks to a positive balance of execution of the federal budget (+0.8% of GDP) and budgets of extrabudgetary funds (+0.8% of GDP), including a surplus of the Pension Fund totaling 0.6% of GDP. To ensure the budget balance of the Pension Fund of Russia's budget, during the year, the government injected therein Rb 924.4bn out of the federal budget (1.7% of GDP), while the gap between pension insurance premiums collected into the Pension Fund and payments of the labor and savings parts of pension, less other expenditure items of PFR, accounted for 2.7% of GDP⁴.

The consolidated budget of RF Subjects was executed with a negligible deficit (–0.1% of GDP). According to data as of 1 January 2012, as many as 57 RF Subjects executed their regional budgets with deficit. Atop the list of such Subjects were the Republic of Tatarstan, Samara oblast and Krasnodar krai.

According to the RF MinFin, the volume of the public debt (with account of issued government guarantees) posted an insignificant increase – from 9.2% of GDP as of late 2010 up to 9.6% of GDP as of 01.01.2012. The major driver behind the surging public debt was the

³ <http://bujet.ru/article/121904.php>

⁴ For details, see Section 2.3.

soaring volume of domestic debt – by 1.2p.p. of GDP, up to 7.7% of GDP. By contrast, the volume of foreign debt was down 0.8p.p. of GDP. It should be noted that the ballooning of public debt under a budget surplus (see *Table 5*) is explained by peculiarities of the national budget law. The fact of the matter is that according to Art. 184.2. of the Budget Code of Russian Federation, along with the bill on the budget the government should submit a draft program of borrowings for next financial year. Meanwhile, in accordance with the schedule approved in the beginning of the financial year, a public offer of government bonds is run proceeding from the ongoing situation on financial markets, regardless of an actual securing of current expenditures and cash balances. Hence, focus on the current budget balance does not always seem justified in a situation of a continuous anticipation of the budget deficit by the end of the year.

Meanwhile, in anticipation of revenues above the budget projections and of a budget surplus, the MinFin has the right to make decisions to cut back on volumes of borrowings, which may be implemented in the form of an actual suspension or reduction of volumes of bond placements and redemption of earlier placed bonded loans. The Ministry used the right to implement all the planned bond issuances and, consequently, instead of the set in the budget act marginal debt volume of 13.7% of GDP, as of late-2011, the actual figure remained under 10% of GDP.

During the 11 months 2011, the volume of RF Subjects' public debt shrank by Rb 34.1 bn and made up Rb 1,071.9bn (2.0% of GDP). The biggest contraction in the public debt was noted in Moscow oblast (Rb 50bn), the city of Moscow (Rb 36bn). Meanwhile, the figures were on the upsurge in 40 Subjects of RF, with the biggest one – Rb 23bn – reported by the Republic of Tatarstan.

So, while certain positive trends continued to unfold in the nation's budget system in 2011 (e.g. rise in revenues along with a concurrent slashing of expenditure and the enlarged government budget once again in the black), symptoms of challenges to the budget system's stability exacerbating are there. We believe the most critical risk in this regard is the continuous high reliance of budget revenues on the state of affairs on the global markets for energy sources. As a consequence, the budget surplus becomes attainable only under extremely high oil prices. Our estimates show that in 2011 the structural component of revenues to the budget system of RF which takes place under an average long-standing oil price (USD 67/b.) accounted for 32.4% of GDP. This means that with regard to the amount of budget expenditures (36.8% of GDP) the 2011 structural deficit made up 4.4% of GDP.

A critical challenge facing the budget system is a broad employment of opaque and uncompetitive conduits, as far as channeling budget resources to contractors is concerned, which manifests itself in a high proportion of use of subsidies. By contrast, developed nations vigorously employ more transparent procurement procedures (across OECD nations, an average 18% of GDP is assigned through public procurement procedures vs. 10-11% in Russia). Clearly, given a sizeable budget sector, the use of subsidies as an instrument of financing the public order for public institutions appears a justified move; however, their vigorous employment to support the real sector⁵ is, in our view, an unjustified measure and should be reduced just to individual cases of subsidizing interest rates on loans to agrarian producers and the framework of procedures of rehabilitation or an intense restructuring of backbone corporations.

Another example of employment of opaque budget instruments is contribution to corporate statutory capital (the 2011 spending on boosting stock and other forms of participation in equity capital on the federal level alone accounted for 0.8% of GDP, or 3.7% of the aggregate federal budget expenditures). Not only do investments in a corporation's authorized capital fail to guarantee a target spending of budget allocations for investment purposes, as the state may not directly determine directions of their use, but they engender a conflict between the government's mission to become an arbiter in economic relations and its interests as a stockholder of a given

⁵ More specifically, the volume of federal budget spending on subsidizing commercial organizations under the Section "National Economy" remained on a fairly high level: in 2011 – Rb 166.8bn (0.3% of GDP), in 2010 – Rb 175.7bn (0.4% of GDP).

enterprise. Whereas the main advantage of the instrument in question is acquisition of the right to participate in managing the economic agent's operations, we believe that it should be appropriate to limit the practice of contributing to corporations' authorized capital (i.e. a de-facto irrevocable financing) to economic companies with the 100% government participation. That said, while investing in their authorized capital, the government's interest should lie in control over the economic agent's long-term strategy, rather than in implementation of a concrete investment project.

Another recently noted distinctive feature of the state budget became implementation of huge construction projects (eg. the 2014 Olympics, the APEC Summit 2012, the World Cup-2018). They have put a mounting pressure on the federal budget, while effectiveness of such costs does not appear evident.

Thus, reserves to bolster efficacy of budget spending should be sought in a change of the whole system of budget spending control mechanisms and approaches to selection of funding priorities.

2.2.2. Analysis of Revenues from Major Taxes into the Budget System of RF

In 2011, the tax burden was up 12%, resulting both from a favorable foreign economic environment and, accordingly, increase in the oil-and-gas revenues, and improvement of business activity and rise of consumption in Russia's economy, which entailed an increase in collection of corporate profit tax and VAT vs. the prior year.

Table 7

Revenues from Major Taxes into the Budget of the Enlarged Government of Russian Federation in 2007–2011, as % of GDP

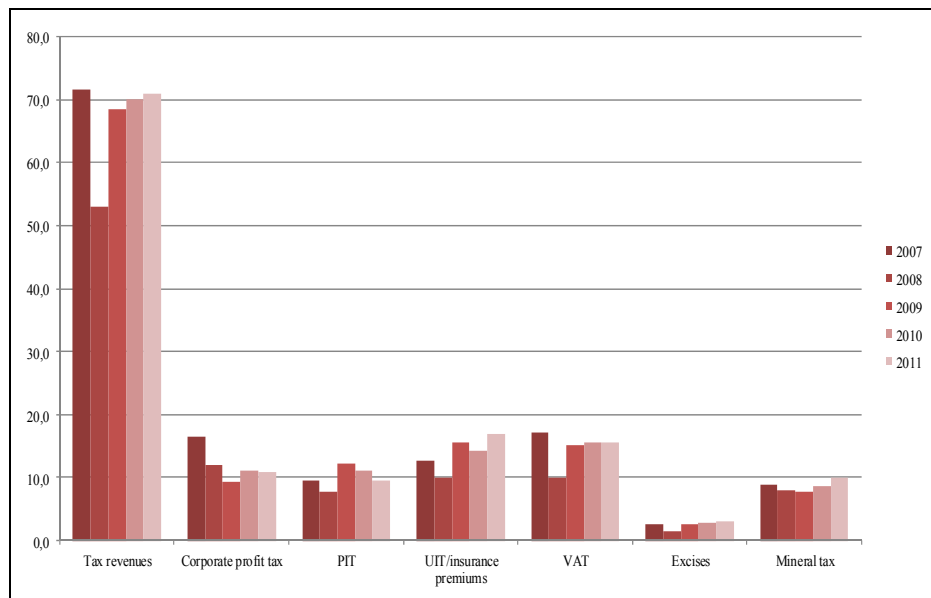
	2007	2008	2009	2010	2011	Change in 2011 relative to 2010	
						As p.p. of GDP	in 2011 prices, %
Level of tax burden	36.1	35.7	30.8	31.9	35.8	3.9	16.9
Corporate profit tax	6.6	6.1	3.3	3.9	4.2	0.3	10.9
PIT	3.8	4.0	4.3	4.0	3.7	-0.3	-3.4
UIT/insurance premiums*	5.1	5.1	5.5	5.0	6.5	1.4	34.2
VAT	6.9	5.1	5.3	5.5	6.0	0.4	12.8
Excise taxes	1.0	0.8	0.9	1.0	1.2	0.2	24.8
Mineral tax	3.6	4.1	2.7	3.1	3.8	0.7	29.1
Customs duties and fees	7.3	8.6	6.8	7.0	8.5	1.5	27.1

* Since 2010 UIT was transformed into insurance premiums collected directly to extrabudgetary funds.

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

The data presented in *Table 7* evidence that in 2011 the level of aggregate tax burden on the economy was practically back to the pre-crisis one. Meanwhile, as far as revenues from individual taxes are concerned, it can be noted that corporate profit-tax and VAT revenues remained at a level notably below the 2007 one, while those from PIT and the mineral tax were close to the 2007 level. In this context, due to the rise of their rates, insurance premiums (earlier known as UST) secured revenues equivalent to 6.5% of GDP vs. 5.1% of GDP in 2007, but posted an disproportionally lesser increase vis-à-vis the rise of the rates, nonetheless. Let us consider in every detail the situation with collection of main taxes.

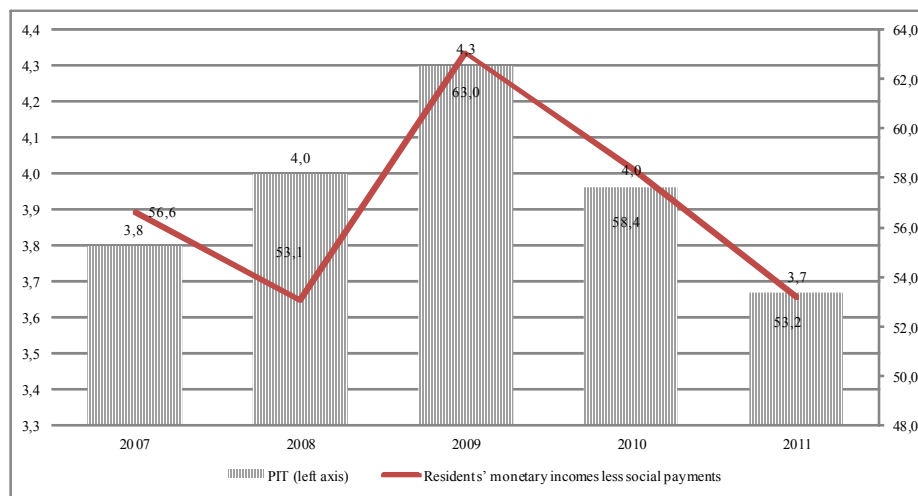
The structure of tax revenues to the enlarged government budget is presented in *Fig. 11*. It was PIT which proved to be the only tax that posted a clearly negative dynamic in 2011.



Source: FTS of RF.

Fig. 11. Proportion of Tax Revenues in Aggregate Revenues to the Enlarged Government Budget in 2007–2011, %

The fall in question should be attributed to its shrinking tax base: the main indicator which characterizes the dynamic of the PIT tax base – namely, the residents’ monetary incomes less social payments – tumbled from 58.4% of GDP in 2010 to 53.2% of GDP in 2011 (see Fig. 12).



Source: FTS of RF, Rosstat.

Fig. 12. Dynamics of PIT Revenues to the Budget System of RF and Residents’ Monetary Incomes less Social Payments in 2007–2011, as % of GDP

The main factor driving the PIT tax base downwards in 2011 became the increase in social contributions rates, including the raising of the basic rate from 26% to 34% in particular.

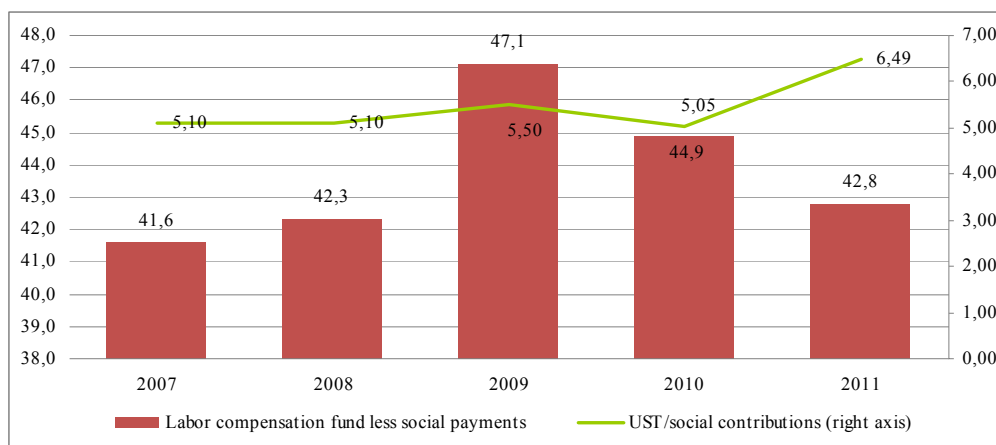
According to surveys run by OPORA Rossii⁶, in 2011, small- and medium-sized businesses responded to the move by:

- 1) using various mechanisms to diminish amounts of insurance premiums (paying a part of salaries “in envelopes”, etc.) (83% of the surveyed);
- 2) abandoning earlier planned pay rises or cutting down salaries (90% of the surveyed);

⁶ <http://opora.ru/legal/analysis/research/polls/#survey/25/>

3) dropping plans to expand operations (equipment modernization, other investment in development) (83% of the surveyed).

As a result, being a major component of the PIT tax base⁷, the labor compensation fund, less social contributions, plunged in 2011 by 2.1 p.p. of GDP (see *Fig. 13*), which in turn explains a 0.3 p.p. of GDP fall in PIT revenues in 2011 vs. the 2010 figures. By contrast, the volume of collection of social contributions surged by 1.44 p.p. of GDP, as the effect from the increase of their rates proved far in excess of consequences from the shrinkage of the tax base.



Source: FTS of RF, Rosstat.

Fig. 13. The Dynamic of Collection of UST/Social Contributions vs. the Dynamic of the Labor Compensation Fund less Social Contributions 2007–2011, % of GDP

Preferential insurance premium rates were foreseen for a closed list of taxpayer categories, which decreased the effective taxation rate on the whole:

- 1) for self-employed, attorneys-at-law and notaries – 31.1%;
- 2) for domestic corporations and self-employed individuals involved in production and publication of printed media, UST payers producing food stuffs, footwear, rubber and plastic items, furniture, means of transportation, equipment, etc. – 26%;
- 3) for corporations operating in IT, economic companies established by public research institutions and universities after 13 August 2009; residents of special R&D economic zones, participants in the Skolkovo project – 14%.

According to the RF MinFin, the overall volume of revenue shortfalls by exemptions and benefits accounted for some Rb 300bn, or some 9% of the 2011 aggregate volume of revenues from insurance contributions.

As to oil-and-gas budget revenues, they posted a notable growth compared with 2010 (see *Table 8*). More specifically, the year of 2011 saw a 0.7p.p. of GDP surge in tax revenues from the mineral tax, fueled both by a notable rise of the tax rate on natural gas and a favorable state of affairs on the global market for energy sources (the 2011 average price of Urals was USD 109.6/b vs. 78.1 in 2010).

That said, despite soaring natural indicators of oil production and a significant price rise for oil, the 2011 level of mineral-tax withdrawals proved to be below the 2008 one. This can be ascribed, first, to the raising in 2009 of the non-taxed threshold with regard to the mineral tax from USD 9/b to USD 15/b and, second, to introduction in the same year of the decreasing coefficient to the mineral tax rate at fields with a high degree of depletion of reserves.

⁷ According to Rosstat data, in 2008-11 the share of labor compensations in residents' incomes less social contributions was steadily at a level of 78–83%.

Volume of Oil-and-Gas and Mineral-Tax Revenues in 2008–2011

	2008	2009	2010	2011
Oil-and-gas revenues, % to GDP	10.6	7.7	8.6	11.0
Mineral tax, % to GDP	4.1	2.7	3.1	3.8
Oil output, including gas condensate, m.t.	488	494	507.2	509.4
The average annual price level for Urals, USD/b.	94.0	60.7	78.1	109.6

Source: Rosstat, FTS of Russia, IEP calculations.

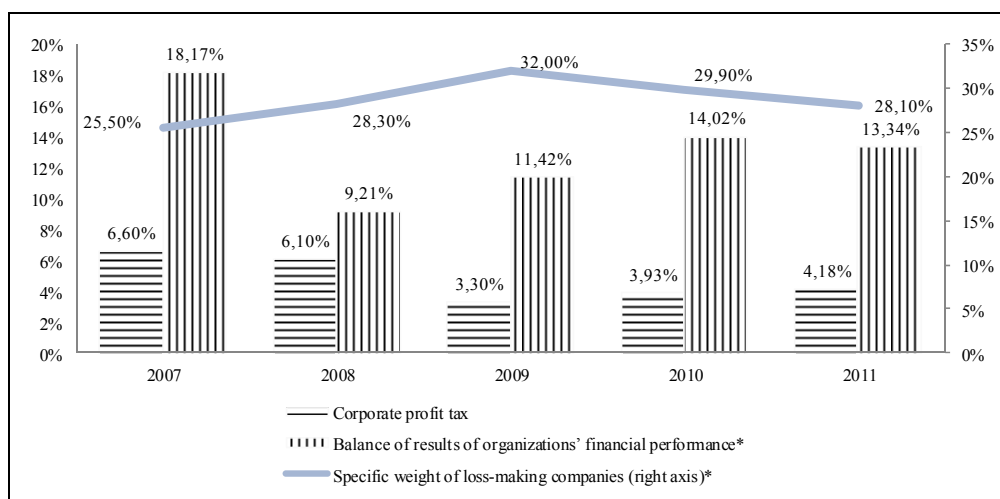
The price rise for energy sources and growth in output had a positive effect on the dynamic of export duties on energy sources. In 2011, the aggregate revenues from export of energy sources practically caught up with their 2008 level (see *Table 9*). The share of export duties on energy sources in the overall amount of tax duties was oscillating around 76-78% over the period between 2008 and 2011.

Collection of Customs Duties in 2008–2011, as % of GDP

	2008	2009	2010	2011
Export duties on:				
– crude oil	4.3	3.1	3.7	4.3
– natural gas	1.2	1.1	0.4	0.7
– goods manufactured of oil	1.3	1.0	1.3	1.7
Customs duties and fees, total	8.6	6.8	7.0	8.5

Source: Rosstat, the Federal Treasury data, the IEP calculations.

As concerns non-oil-and-gas revenues, those from the corporate profit tax were on the rise primarily because of a more robust business activity in Russia. Specifically, the specific weight of loss-making organizations in the economy was down, while net balance of corporate financial performance (less small-sized businesses) in shares of GDP equivalent was up compared with the same period of 2010, thus evidencing the expansion of the corporate profit tax (see *Fig. 14*). As a result, the 2011 corporate profit-tax revenues stood at 4.2% of GDP, or at 0.3 p.p. of GDP above the prior year's level.



* According to preliminary estimates by Rosstat.

Source: FTS of RF, Rosstat.

Fig. 14. Dynamic of Corporate Profit Tax Collection into the Budget System of RF, Balance of Corporations' Financial Performance and the Specific Weight of Loss-Making Enterprises in 2007–2011

Reinvigoration of Russia's economy also led to growth in volume of final consumption which forms the tax base of indirect taxation. Thus, in 2011, the tax base of VAT kept on reviving after its compression during the crisis period. That fueled an increase in collection of

this tax up to 6.0% of GDP vs. 5.5% in the previous year. Yet another explanation of the increased collection of VAT is an improved quality of its administration: specifically, the 2011 VAT collection ratio⁸ posted a 6 p.p. increase vis-à-vis the 2010 figure and hit the 53% level, thus basically having closed the gap with its pre-crisis values (See *Table 10*).

Table 10

**Dynamic of Final Consumption, Import and VAT Collection
in the Budget System of RF in 2005–2011, as % of GDP**

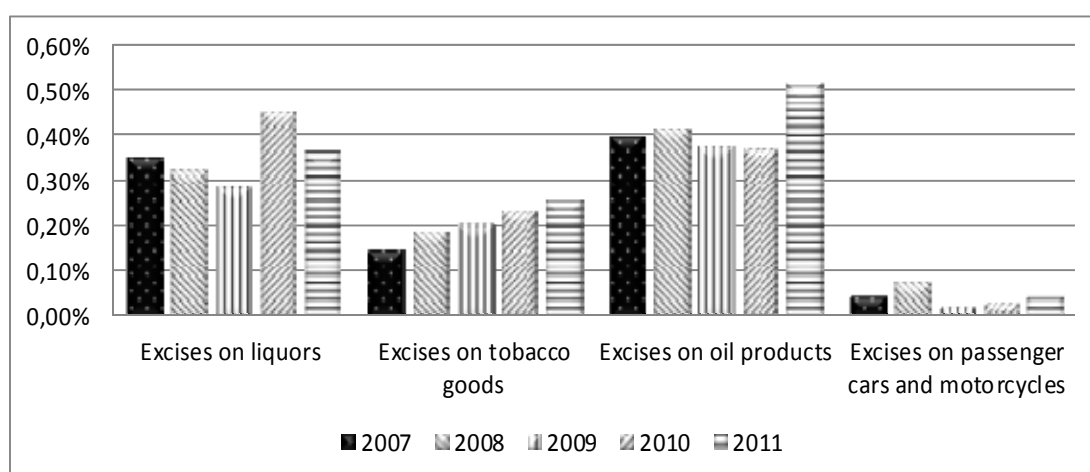
	2005	2006	2007	2008	2009	2010	2011
Revenues from VAT (less revenues from YUKOS)	6.17	5.62	6.13	5.17	5.28	5.53	5.98
VAT on goods sold within RF	4.11	3.44	3.51	2.42	3.03	2.94	3.23
VAT on goods imported in RF	2.06	2.18	2.62	2.75	2.25	2.59	2.75
Tax collection ratio, %	57.0	51.5	56.7	46.6	42.3	47.0	53.0
Import*	12.9	13.9	15.3	16.1	13.7	15.4	16.5

* The share of import in GDP was defined as the value of import data by the customs statistical data to the USD-equivalent GDP value ratio, on the basis of values of the average nominal USD/Rb nominal rate over the respective year.

Source: Rosstat, the RF Ministry of Finance, IET calculations.

It is taxation of imported goods which still secures nearly a half (46%) of the structure of VAT collection. The figure remained at the previous year's level, which evidences a match between the dynamic of revenues from VAT on imported in RF goods and the dynamic of import of goods.

In 2001, revenues to the budget system from excise taxes were on the rise – from Rb 501.5bn to Rb 650.5bn in current prices, which in relative terms secured an increment equivalent to 0.2p.p. of GDP. It should be specifically noted that, as evidenced by *Fig. 15*, the increment in question was driven by soaring revenues from excise taxes on oil products (from 0.37% of GDP in 2010 to 0.52% in 2011). Collection of revenues from liquors and spirits plunged in relative terms (from 0.46% of GDP in 2010 to 0.37% of GDP in 2011), while revenues from taxation of sales of two other excised categories of goods stabilized at the 2010 level: the increase with respect to tobacco goods was negligible (from 0.24% up to 0.26% of GDP) and the same can be reckoned with respect to excise revenues from sales of passenger cars and motorcycles (up from 0.03% to 0.05% of GDP).



Source: FTS of RF.

⁸This index is calculated as $\frac{VAT\ receipts}{VAT\ rate \times (final\ consumption\ less\ the\ tax)}$ and shows which share of the base (final consumption less the tax) is effectively taxed. A more detailed discourse on economic interpretation of the index in question can be found in: *Kazakova M., Knobel A., Sokolov I. The Quality of VAT Administration in OECD Countries and Russia. Reforming the Russian System of Collection of the Tax/ed. by S.G. Sinelnikov-Murylev. M.: IET, 2010.*

Fig. 15. Collection of Excise Taxes over 2007–2011 by Groups of Excised Goods, as % of GDP

The rise in collection of excise taxes on oil products was caused by a fairly considerable raising of their rates – from 30 up to 100%, depending on a specific kind of the oil product, vis-à-vis the 2010 level. The tax base changed insignificantly relative to the 2010 level, while oil-refining plants reported a 1.7% increase in shipments of gasoline, 0.9% – diesel fuel and 4.9% – of fuel oil.

The average value of indexation of excise rates with regard to tobacco products accounted for 17-43%, the one of excise rates for liquors – 12-23%. In 2011, consumption of all kinds of liquors changed insignificantly, while consumption of tobacco goods was in decline (see *Table 11*). The increase in excise rates for tobacco products compensated for the fall in the volume of their consumption, while a poorer administration of excise taxes on liquors, even under indexation of the rates above the inflation rate and the volume of consumption remaining on its 2010 level, resulted in the dynamic of collection falling behind the GDP one.

Table 11

Volume of Consumption of Liquors and Tobacco Goods in RF in 2005–2011

Type of product	2005	2006	2007	2008	2009	2010	2011
Liquors, as decl m							
Vodka and liquors	203.5	197.2	184.6	177.2	166.1	157.8	159.0
Grape and fruit wine	84.9	81.1	94.9	102.9	102.5	103.4	103.0
Cognacs	6.8	7.6	8.9	10.8	10.6	11.1	12.0
Champaign and sparkling wine	19.4	20.6	24.1	26.0	25.5	27.3	29.8
Beer	892.1	1002.8	1155.3	1138.2	1024.7	1004.0	1077.5
(Russian cigarettes), bn. pcs	395.8	424.1	398.2	393.6	394.3	370.6	366.1

Source: Rosstat.

2.2.3. Budget System Expenditures

The year of 2011 saw expenditures contract by 1.7 p.p. of GDP vs. the prior year by section “Social policy” and by 0.1–0.2 p.p. of GDP across each of the following sections: “General public administration matters”, “National security and law-enforcement activity”, “Housing and utilities”, “Education” and “Culture, motion picture industry, and mass media” (see *Table 12*).

Table 12

Expenditure of the Enlarged Government Budget in 2008–2011, as % of GDP

	2011	2010	2009	2008	2011 figures bias from 2010, p.p. of GDP
EXPENDITURE	36.8	39.0	41.3	34.3	-2.2
General public administration matters*	2.5	2.6	2.8	2.7	-0.1
National defense	2.8	2.8	3.0	2.5	0.0
National security and law-enforcement activity	2.8	3.0	3.2	2.6	-0.2
National economy	5.1	5.1	7.1	5.5	0.0
Housing and utilities	2.2	2.4	2.6	2.8	-0.2
Environmental protection	0.1	0.1	0.1	0.1	0.0
Education	4.1	4.2	4.6	4.0	-0.1
Culture, motion picture industry, and mass media	0.7	0.8	0.8	0.7	-0.1
Health care, physical culture and sports	3.9	3.8	4.3	3.7	+0.1
Social policy	12.0	13.7	12.1	9.1	-1.7
Public debt servicing	0.6	0.6	0.6	0.5	0.0

* Except for expenditures on public debt servicing.

Source: The RF ministry of Finance, IEP calculations .

The volume of expenditures across sections “Public debt servicing”, “National defense” and “National economy” in shares of GDP remained unchanged in 2011. The past two years saw volumes of financing by the section “National security and law-enforcement activity” contract

by 0.2 p.p. of GDP annually. Despite that, Russia is still ahead of all the OECD member states in terms of level of spending on domestic security and law-enforcement activity, as well as by the number of law-enforcement personnel (for reference: In Russia, this index is 9.8 per 1,000 residents, while in second to Russia Turkey – twice as low). So, there is a certain potential to further reduce spending by this particular expenditure item.

When it comes to the section “National defense”, the 2011 volume of the enlarged government budget expenditure relative to GDP remained at the prior year’s level – that is, 2.8% of GDP. That said, Russia’s defense spending is one of the highest worldwide and second to the US and Israel’s⁹. A high level of defense spending in the US has been steadily in decline over the past fifty years, except for periods of the US’s military engagement¹⁰.

There was an insignificant increase by 0.1p.p. of GDP in 2011 vs. 2010 by the section “Health care, physical culture, and sports”, which should be ascribed to the bolstering of the volume of funding of objects for the World Student Games-2013 and Olympics-2014. By the Accounting Chamber’s estimates¹¹, the initial budget of the latter event was nearly 4-fold greater than those of the Vancouver Olympics-2010 and Torino Olympics-2006, while the cost overrun exceeded all reasonable limits, as costs surged 3-fold and hit USD 29.8bn (the ultimate budgets of the Vancouver and Torino Olympics were USD 6bn and 3.6bn, respectively). That said, there are grounds to assume that the construction budget and, accordingly, volumes of budget outlays for implementation of the Sochi-2014 project in 2012-13 may likewise be increased more than once.

The 2011 volume of spending on health care per se remained on the prior year’s level and posted some growth vis-à-vis the 2008 figures, which can be explained by a greater spending on financing health care modernization programs. The RF Subjects’ 2011 consolidated budget expenditures on this item posted a 0.07p.p. of GDP increase vs. the previous year thanks to a 0.3 p.p. of GDP increase in expenditures on physical culture and sports, a 0.1p.p. of GDP increase in spending on the ambulance service and a 0.3 p.p. of GDP increase in spending on other kinds of medical assistance. In the structure of the enlarged government spending, the share of expenditures across this item surged up to 10.6% of all the expenditures of the enlarged government vs. the previous year’s 9.7%.

The enlarged government budget expenditures on the section “National economy” in 2011 were on the level of 2010, that is, 5.1% of GDP, but when compared with the 2009 figures, they slid considerably – by 2.0p.p. of GDP, because of scaling back on volumes of anti-crisis support to the economy.

Expenditure item-wise, spending was boosted across the following sectors: the fuel and energy complex – by 0.2 p.p. of GDP, agriculture and fishery – by 0.3p.p. of GDP, forestry – by 0.1p.p. of GDP, the public road system – by 0.1p.p. of GDP and subsections “General economic matters” and “Other matters in e the national economy area” – by 0.2p.p. of GDP. The volume of budget appropriations for applied research in 2011 remained at the prior year’s level of 0.3p.p. of GDP. As to other subsections, including “Exploration and use of space”, “Reproduction of the

• ⁹ In 2010, Israel’s defense spending accounted for 6.7% of GDP. However, in contrast to the RF budget, that section included both defense expenditures per se along with costs of pensions to, and social rehabilitation programs for, the military and their family members, the border infrastructure maintenance costs, and costs of purchasing weaponry from the US at the expense of the latter’s military aid. So, it may well happen that in reality Israel’s military spending does not exceed Russia’s. Source: <http://www.inss.org.il>

• ¹⁰ The US started cutting down its national defense spending back in the Cold War era from 14.2% of GDP in 1953 to 9.2% of GDP in 1962, 6.7% – in 1972, 5.7% – in 1982. The defense spending shrank sizably since the collapse of the USSR: from 5.2% of GDP in 1990 to 3.0% of GDP in 2001 (except for 1992 – 4.8% of GDP due to the War in the Gulf). The figures have been on the rise ever since 2002: from 3.3% of GDP up to 4.0% of GDP in 2005 and further to 4.7% of GDP in 2009 and 5.1% of GDP in 2011, due to financing of military operations in Iraq and Afghanistan. It is planned to scale back on military expenditures post-2011 and bring them down to 3.4% of GDP by 2016. Source: www.whitehouse.gov

• ¹¹ On the basis of data provided by the Accounting Chamber of RF in its conclusions on draft budget acts.

mineral base”, the 2011 enlarged government budget expenditures in shares of GDP equivalent contracted vis-à-vis the previous year.

Expenditures on the section “Education” have been in decline since 2009. In 2010, they shrank by 0.4 p.p. of GDP and in 2011 – by 0.1 p.p. of GDP on a year-on-year basis. The proportion of spending on education in the enlarged government budget accounted for 11.1%, or up 0.3 p.p. vs. the 2010 level.

Since 2008, the volume of financing by the item “Education” has been in decline: in 2010 – by 0.4 p.p. of GDP and in 2011 – by 0.1 p.p. of GDP on a year-on-year basis. The proportion of spending on education in the aggregate volume of the enlarged government expenditures stood at 11.1%, or up 0.3 p.p. vs. the 2010 figures.

The volume of financing by the item “Housing and utilities sector” likewise has been in decline since 2008 by 0.2 p.p. per annum. In 2011, the enlarged government expenditures were cut practically across all the items, except for expenditures on settlements development (up 0.1 p.p. of GDP thanks to the respective increase in regional budgets’ expenditures) relative to GDP on a year-on-year basis. The cuts are associated with a gradual completion of such measures as provision of housing to veterans of WWII and individual categories of residents. Meanwhile, reserves for further cuts in the sector are unlikely to be huge, despite the fact that Russia on average spends on the housing and utilities sector twice as much as OECD member states. More specifically, at end-year 2011, as many as 99.4m² of housing in the country fell under the category of slum and dangerous structures (up 1.5 times over the decade). As it is, as a rule, regions with poor socio-economic performance indicators or those classified as the “Northern” ones (where climatic conditions predetermine high housing deterioration rates) it is inappropriate to cut down the state financing, as availability of adequate housing is a critical component of residents’ living standards. At the same time, given the magnitude of the challenge, development at the federal level of new approaches to assessment of the need in, and provision of, social housing, perhaps, appears justifiable¹².

In 2011, the item “Culture, the motion picture industry and mass media” saw cuts amount to 0.1 p.p. of GDP compared with 2010; however the share of expenditures on culture in the enlarged government budget remained at the level of 2%.

As to the item “Environment protection”, the respective expenditures have remained unchanged since 2009 and accounted for 0.06 - 0.07% of GDP. In its absolute terms (Rb 38bn, or up 10.3bn vis-à-vis 2010) the 2011 spending on environmental programs is comparable to the enlarged government revenues generated by payments for adverse impact on environment (Rb 22.1bn in 2011).

It should be noted that the volume of budget outlays for environmental measures rose 3.5 times between 2009 and 2011 in nominal terms, but shrank more than twice in the shares of GDP equivalent (from 0.16% of GDP in 2009 to 0.07% of GDP in 2011). Individual moves in this area (eg. implementation of a countrywide energy-saving program in the frame of the energy strategy) does bring about some positive effects, but still appear incapable of reversing the destructive trends in the environmental area.

The 2011 appropriations on the section “Social policy” appear impressive – 12.0% of GDP (Rb 6,512.3bn), including those on pensions provision (8.0% of GDP, or Rb. 4,379.6bn), albeit down 1.3 p.p. on a year-on-year basis. The share of the expenditure item in the aggregate volume of the enlarged government expenditure was likewise down 2.5 p.p. compared with the prior year. In the RF Subjects’ consolidated budget, the 2011 social spending was cut down in absolute terms by 28.5% (1.5 p.p. of GDP) relative to 2010, because of cuts in expenditures on the social provision of the population totaling 0.4 p.p. of GDP.

• ¹² Expenditures are incurred both by the federal budget and RF Subjects’ budgets; however the procedure of provision of social housing is established at the latter level. The federal budget does not finance provision of housing; rather, social payments, eg. to young academics, in compliance with Resolution of the RF Government of 17.12.2010 No. 1050.

During last three years, the 2011 enlarged government budget expenditures on servicing the public debt remained at a level of 0.6% of GDP; the RF Subjects' consolidated budget expenditures on this section were down 0.1 p.p. of GDP on a year-on-year basis.

An analysis of recent changes in the structure of the enlarged government budget expenditures allows identification of two negative tendencies:

1. Boosting expenditures on financing public goods (social policy, defense and law enforcement and public order) against cuts in expenditures on ensuring economic growth. So, despite the political leadership's declarations about the budget's modernization nature, actual expenditures encourage public and individual consumption, rather than economic development. At this point, emphasis should be made on government support of backbone national infrastructure objects (meaning investment projects and programs in the innovation development area, such as education, research, technoparks, business incubators, special economic zones, technology transfer centers) and upgrade of the production infrastructure (transport, communications, the FEC infrastructure), which would bolster economic stability, fuel innovation, breakthroughs in the technological sphere and environmental safety. That said, the government should scale back on its participation in business and semi-business investment.

2. A notable surge in the number of public and municipal servants¹³ and public employees, which, first, evidences an excessive presence of the state in the economy and the social sphere. The volume and the number of public functions and services in tandem with antiquated procedures of their delivery exhibit current defects in their organization and, therefore, preserve the problem of huge public costs in the said areas. Second, it must be admitted that in contrast to temporary effects from boosting the financing of individual directions, which serves just as a temporary remedy, it is a funding of institutional transformations that gives a fillip to entrepreneurial activity and attraction of capital into an economy, and its structural diversification on the basis of innovation-driven technological development¹⁴. Thirdly, a high proportion of public employees evidences that by hiring an insufficiently qualified workforce to carry out public functions, a state exercise the "social sponsorship" function. As a result, the state budget is engaged in an implicit "subsidizing" of the populace (ie. the government pays salaries for an inefficient exercise of public functions).

2.2.4. Analysis of main Parameters of the Federal Budget of RF in 2011 and for the Period of 2012–2014.

The budget Act for the upcoming three years does not suggest maintaining the 2011 federal budget revenue increase rates (see *Table 13*): the federal budget revenues should contract by 0.8 p.p. in 2012 and further by 1.3 p.p. in 2013 and 1.5 p.p. in 2014 vs. their 2011 level, with projections of oil-and-gas revenues suggesting their even greater decline – from 10.2% of GDP in 2011 to 7.2% of GDP in 2014.

Table 13

Main Characteristics of the Federal Budget in 2008–2014, as% GDP

	Actual				The budget Act		
	2008	2009	2010	2011	2012	2013	2014
Revenues	22.5	18.9	18.4	20.9	20.1	19.6	19.4
Including oil-and-gas	10.6	7.7	8.5	10.2	7.7	7.1	7.2
Expenditures	18.3	24.9	22.4	20.1	21.6	21.2	20.1
Including provisionally approved	–	–	–	–	–	0.5	1.2
Deficit (–)/Surplus (+)	+4.1	–6.0	–4.0	+0.8	–1.5	–1.6	–0.7
Non-oil-and-gas deficit	–6.4	–13.7	–12.5	–9.4	–9.2	–8.7	–7.9
For reference: GDP	41277	38809	45166	54369	58683	64803	72493

Source: the RF Ministry of Finance.

¹³ The 2010 data suggest that in Russia the number of public employees per capita (108 per 1,000 residents) is greater than across OECD and emerging economies (eg. the average figure across 22 OECD nations is 75, Brazil – 45, South Korea – 29 per 1,000 residents).

¹⁴ According to development priorities established by the Long-Term Development Concept approved by Resolution of the RF Government of 17 November 2008 No. 1662-r.

The 2012 federal budget expenditures should surge by 1.5 p.p. of GDP vs. 2011 and subsequently slide back to the 2011 level again. So, the federal budget for the upcoming three years should be executed with a deficit oscillating within the range of 0.7 – 1.5% of GDP. That said, the value of the basic oil price which ensures a balanced federal budget has been increased for the medium term: while in 2011 the value matching the budget balance was an oil price of USD 115/b¹⁵, already in 2012-13, according to MinFin's estimates, the balance would be secured by a price not lower than USD 120-125/b. So, the budget will become yet more prone to price fluctuations on the global market for carbohydrates.

It should be noted that while crafting main parameters of the 2012-14 federal budget, its authors employed optimistic forecasts of macroeconomic indicators: thus, the forecast with regard to the volume of GDP for 2012 was increased by more than Rb 5bn vs. the figure used while shaping up the 2011-13 federal budget.

Meanwhile, projections of the value of oil-and-gas revenues in the 2012-14 federal budget were based upon a more conservative scenario. On the one hand, that would allow rejecting the need to sequester expenditures during a fiscal year, should budget revenues decline; on the other hand, extra revenues, particularly due to exercising caution while planning them, allow revision of the expenditure part towards increases in individual items, which does not add accuracy to the medium-term budget planning.

Should the 2012 oil-and-gas revenues prove greater than planned, the Budget Act for 2012-14 comprises a clause which holds that extra revenues should be spent on replacement of public borrowings and/or revenues from sales of equity or other form of participation in capital owned by Russian Federation.

In the medium term, main sources of the federal budget revenues should remain collection of indirect taxes, the mineral tax, and customs duties (see *Table 14*).

The data in *Table 14* evidence that the proportion of revenues from main taxes and duties in the aggregate volume of revenues to the federal budget in the shares of GDP equivalent is going to be in decline in the period of 2012-14, because of falling revenues from the mineral tax and export customs duties, which is going to be caused by a downfall in international oil prices and slowdown of growth rate in taxable volumes of oil and oil products.

The budget's reliance on the foreign economic situation can be lowered by stabilizing non-oil-and-gas revenue growth rates. This necessitates maintaining economic growth in the first place, including, in particular, at the expense of reallocation of federal budget revenues from defense and domestic security in favor of economy restructuring programs, providing there are efforts in place to bolster the efficacy of their implementation.

Table 14

Actual and Envisaged Revenues from Main Taxes to the Federal Budget of Russian Federation in 2008–2014 (% of GDP)

	Actual				The Budget Act		
	2008	2009	2010	2011	2012	2013	2014
Corporate profit tax	1.8	0.5	0.6	0.6	0.6	0.6	0.6
VAT – total:	5.2	5.3	5.5	6.0	6.3	6.4	6.5
On domestic produce	2.4	3.0	2.9	3.2	3.2	3.2	3.2
On imports	2.7	2.3	2.6	2.8	3.1	3.2	3.3
Excise taxes, total:	0.4	0.3	0.6	0.5	0.7	0.9	1.0
On domestic produce	0.3	0.2	0.5	0.4	0.6	0.8	0.9
On imports	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Mineral tax	3.9	2.5	3.0	3.8	3.6	3.4	3.3
Customs duties, total:	8.4	6.5	6.8	8.2	7.4	6.8	6.7
Import	1.5	1.2	1.2	1.4	1.4	1.4	1.4
Export	6.9	5.3	5.6	6.8	6.0	5.4	5.3
Proportion of aforementioned taxes and duties in the federal budget revenues, %	93.3	86.5	89.6	91.4	89.4	92.3	93.3

¹⁵ In 2005–2007, the federal budget surplus was secured under average annual nominal oil prices as follows: in 2005 – USD 50/b (surplus equivalent to 7.5% of GDP); in 2006 – USD 61/b (7.4% of GDP); in 2007 – USD 69/b (5.5% of GDP).

Source: the RF Ministry of Finance.

Modernization and restructuring of Russia's economy in the medium- and longer-run are closely associated with abrogation of export duties whose presence means subsidizing domestic consumers of minerals and energy sources at the expense of the rent from the use of state-owned natural resources. Preserving, throughout the new Russia's history, lowered domestic prices of carbohydrates, and export duties on oil products at a level below the one of export duties on crudes has failed to ensure a qualitative modernization of its economy, nor it boosted its competitiveness.

Recent moves to encourage the volume of domestic oil refining and increase exportation of oil products by setting respective export duties at a level lower than the ones on crudes did not help bolster intensity of oil processing which made up just 71.2%, or matched the 2000 level. That is to say, the index in question has posted practically no growth over the past decade (for reference, in developed economies, the oil refining intensity rate is 90-95%).

With revenues from the mineral tax and export duties on energy sources in decline and volumes of collection of the corporate profit tax having stabilized (revenues to the federal budget from the corporate profit tax in 2012-14 should remain at their 2011 level – namely, 0.6% of GDP), reserves for increase in tax revenues should be sought in taxation of consumption.

It is forecast to increase collection of VAT from taxation of imports in 2012 by 0.3 p.p. of GDP on a year-on-year basis and further annually by 0.1 p.p. of GDP in 2013-14. Meanwhile, the volume of revenues from the domestic VAT will be soaring just at a rate equal the GDP growth rate.

The annual increase of collection of excise taxes to the federal budget over the period of 2012-14 is planned at a level of 0.2p.p. of GDP, which should be secured by indexation of their rates and reassignment of revenues from these taxes between the federal and regional budgets¹⁶. Revenues to the federal budget from excise taxes levied on imports in 2012-14 should remain unchanged (0.1% of GDP).

The dynamic of the federal budget expenditures in 2010-2014 in terms of functional classification is presented in *Table 15*.

Table 15

Expenditure Obligations of the Federal Budget in 2010–2014, % BBII

Name	Actual		The Budget Act		
	2010	2011	2012	2013	2014
TOTAL	22.4	20.1	21.6	21.2	20.1
General government matters*	1.5	1.4	1.4	1.3	1.1
National defense	2.8	2.8	3.2	3.6	3.8
National security and law-enforcement activity	2.4	2.3	3.1	3.1	2.9
National economy	2.7	3.3	3.1	2.7	2.3
Housing and utility	0.5	0.5	0.2	0.2	0.1
Environment protection	0.0	0.0	0.0	0.0	0.0
Education	1.0	1.0	1.0	0.9	0.7
Culture, the motion picture industry**	0.2	0.2	0.1	0.1	0.1
Health care***	0.8	0.9	0.9	0.8	0.6
Social policy****	0.8	5.8	6.6	6.4	5.7
Physical culture and sports		0.1	0.1	0.1	0.0
Mass media		0.1	0.1	0.1	0.1
Public and municipal debt servicing	0.4	0.5	0.7	0.7	0.8
Interbudgetary transfers of general nature	9.2	1.2	0.9	0.8	0.7
<i>Provisionally approved expenditures</i>	-	-		0.5	1.1

* In 2010 – without regard to expenditures on the public debt servicing.

** In 2010 – with regard to expenditures on mass media.

*** In 2010 – with account of expenditures on physical culture and sports.

****In 2011 and onwards – this item includes profile interbudgetary transfers, including those across extrabudgetary funds.

Source: Memorandum on the 2012–2014 federal budget.

• ¹⁶ For greater details see Section 2.3.

The year of 2011 saw the biggest increase in federal budget expenditures (by 0.6 p.p. of GDP on a year-on-year basis) with respect to the item “National economy”. One of the drivers of such an increase in budget allocations became financing of projects across five priority avenues: “Energy efficiency”, “Nuclear technologies”, “Strategic computer technologies and software”, “Space and ICT”, “Medical equipment and pharmaceuticals” approved by the Commission on Modernization and Technological development of Russia’s Economy under the RF President. The increase in spending was also fueled by implementation in 2011 of new sub-programs aimed at boosting the domestic production, such as “Development of the domestic machine-tool manufacture and the tooling industry for 2011–2016”, “Establishment and organization of production of industrial diesel engines and their next-gen components in Russian Federation in 2011–2016”.

That said, we believe that budget expenditures on the national economy should ensure much-needed institutional and infrastructural conditions of the real sector restructuring in the first place, rather than substitute for the private sector’s funding. Where there is a direct budget support to backbone and strategic corporations, there emerge risks of preservation of the technological backwardness of manufacture and a low quality of management.

Since 2012 expenditures on the economy should slide by 0.2 p.p. of GDP and further by 0.4 p.p. of GDP in 2013 and 0.4 p.p. of GDP in 2014, on a year-on-year basis. The process should be driven by cuts across individual directions of subsidizing the economy, completion of a string of federal target programs and placement in operation of objects of capital construction.

Since 2012 expenditures on the item ‘National defense’ should be up 0.4 p.p. of GDP vs. 2011 and subsequently up by another 0.4 p.p. of GDP on a year-on-year basis in 2013 and 0.2 p.p. of GDP in 2014. The increase is associated in part with the military’s monetary allowance reform which should result in a more than double rise of the military’s material security, which should also affect the level of pensions of the retired military and persons equaled to them, as their pensions should increase 1.6 times on average.

The increase in spending on the item “National security and law-enforcement activity” is driven by the indexation since 2012 of labor compensation funds of employees with federal public institutions, monetary allowance (salaries) of judges and prosecutors, federal public civil servants, monetary allowances of the military and persons equaled to them (except for employees with the RF Ministry of Defense and the RF Ministry of Interior, as both agencies are facing a monetary allowance reform in 2012), and payments linked to the amount of the military allowance. Between 2012 and 2014 the number of law-enforcement agencies’ personnel should be optimized, with thus freed funds to be spent on the monetary allowance reform.

Specifically, the volume of budget appropriations for the said reform, including compensations linked to monetary allowances and with account of a 15% reduction in the military and law enforcement personnel (except for RF Ministry of Defense and the RF Ministry of Interior) until 1 January 2014, in 2012 alone should account for Rb 389.3bn, in 2013 – 610.7bn, and in 2014 – 679.2bn.

The 2011 public debt servicing costs posted a 0.1p.p. of GDP increase vs. the previous year. The costs in question (Rb 195.0bn in 2010 and Rb 262.7bn – in 2011) were partly compensated by the federal budget interest revenues from placement of cash balances on the single account of the federal budget which form an extra amount to sums spent on securing a current budget balance per the cash budget (Rb 130.0bn in 2010 and 129.0bn – in 2011).

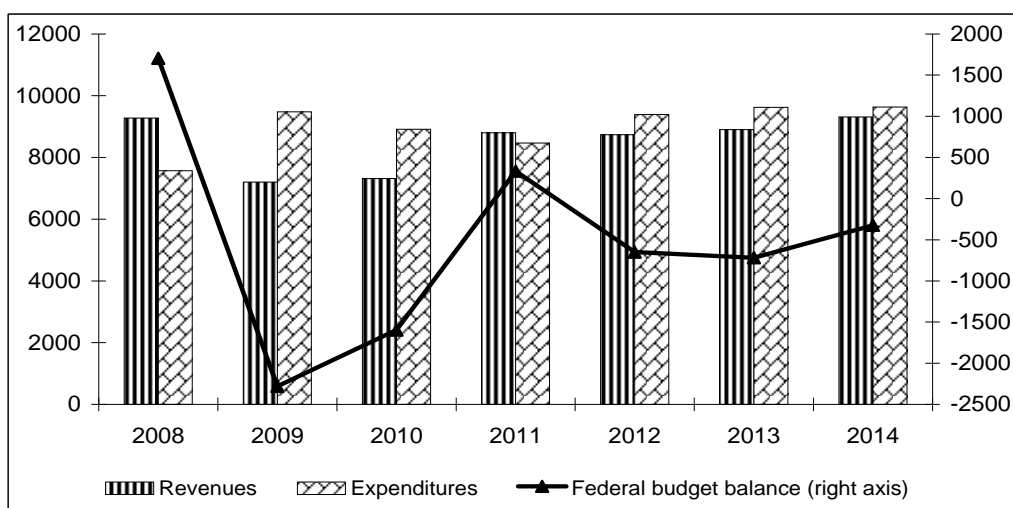
Cuts in spending by the item “Health care” in 2013-14 are associated with reassigning budget funds to implementation of a sector modernization plan out of the RF Ministry for Health Care and Social Development’s budget to the Compulsory Medical Insurance Fund’s.

It is foreseen to scale back on budget appropriations by the item ‘Housing and utilities’ in 2012-2013 with respect to implementation of the Federal Target Program and its non-program part, including providing the military with department and permanent housing.

As to other functional directions of federal budget expenditures, the main factor behind changes in their volume are budget outlays provided for implementation of FTPs and their non-program sections.

The dynamic of the federal budget revenues and expenditures in the 2008 constant prices (see *Fig. 16*) matches the 2008-14 trends of changes in revenues and spending in current prices – that is, substantial revenue cuts in 2009-10 and their annual increase post-2012, and a substantial expenditure increase in 2009, as well as in 2012–14, with a slight decline intermezzo in 2010–11.

The dynamic of main parameters of the federal budget in 2008-14 allows ascertaining that the task to maintain the budget balance is going to fall by the wayside, with priority given to the financial securing of earlier adopted and newly set expenditure obligations. However, a haphazard increase of obligations in a given field of socio-economic development propagates a ripples effect in the form of imbalances throughout other fields, and precise regulation of such imbalances will require extra budget costs. To cite a particular example, the increase in monetary allowance for the military and prosecutors between late 2011 and early 2012 was followed by a debate on the need to raise the university faculty’s pay. In the upcoming future, there cannot help but emerge the need for pay rises for such a low-paid category of budget employees as librarians, museum staff, social employees, etc. Clearly, the 2012-14 budget continues the recent trend and is becoming more and more centered on ensuring the public (defense and law-enforcement spending) and individual (expenditures on education, health care, social support) consumption, rather than on giving fillip to economic transformation.



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

Fig. 16. Dynamic of revenues, expenditure and the federal budget deficit, billion Rb in 2008 constant prices

The share of closed budget items is on the upswing. While in 2006-11 the level of closed expenditures was maintained at the level of 12% of the aggregate budget expenditures (according to IBP, open budget-wise Russia notably trails behind developed nations¹⁷), by 2014 the respective proportion should account for 22%.

The volume of the Reserve Fund posted a slight growth in 2011 (by Rb. 3.63bn), and so did the National Welfare Fund’s (up by Rb. 98.9bn). As of 1 January 2012, cash balances of the Reserve Fund stood at Rb. 811.5bn, or 1.5% of GDP, while those of the National Welfare Fund – at Rb 2,794.4bn, or 5.1% of GDP. The volume of the Reserve Fund is envisaged to gradually increase in 2012-14, with oil-and-gas revenues being a major driver of the process, up to 3.8% of

¹⁷ In January 2012, the International Budget Partnership published findings of the 2010 Open Budget Survey, which evidence that Russia scored 60 out of 100 open budget-wise (for reference: the US scored 82, Germany – 68, Italy – 58, Brazil – 71, China – 13 out of 100).

GDP in 2012, 4.3% of GDP and 5.4% of GDP in 2013 and 2014, respectively. Due to exchange rate differences and co-financing of pension savings, the volume of revenues to the National Welfare Fund should likewise increase in 2012-2014; however, the volume of spending of its resources should be greater, thus resulting in a fall of its volume to 3.9% of GDP in 2014.

The federal budget deficit should be covered by public borrowing and revenues from privatization of federal assets¹⁸. Hopefully, Russia, with its “sound credit record”¹⁹ and credit ratings no lower than BBB and Baa1 (stable or positive²⁰) unchanged since 2010, would face no real problems with placement of debt instruments in the years to come. Plus, a possibility to have extra revenues from privatization (Rosneft, Gazprom, Russian Railways, etc.) should be factored into, too.

2.2.5. Prospects of RF Budgetary and Tax Policy

In recent years, Russia’s budgetary policy has been exhibiting a number of trends pointing to her defiance of the rules that countries with resource-based economies typically abide by. At the same time, the resource dependence factor imposes rigid constraints on this country’s budgetary policy: as the oil and gas sector generates a very considerable portion of budget revenue, the size of budget revenue becomes susceptible to unpredictable fluctuations.

The government’s efforts to mitigate the consequences of the crisis have so far resulted in a higher degree of imbalance in Russia’s budgetary policy. During the 2008-2009 crisis the authorities effectively abandoned the budgetary rules adopted in 2004-2004: budget revenues generated as a result of high current oil prices, instead of being transferred to the Reserve Fund and the National Welfare Fund, were now allocated to current expenditure in the federal budget.

The structure of general government expenditure also demonstrates a rise in the current cost of financing the pension system and in expenditures on national defense, national security and law-enforcement activities. The authorities made some costly political decisions with regard to the financing of a number of large-scale projects implemented within the framework of preparations to the 2014 Winter Olympic Games in Sochi, to the September 2012 APEC Summit in Vladivostok, and to the 2018 FIFA World Cup Russia. Considerable resources, in the form of subsidies and contributions, are allocated to the charter capital of state corporations and companies with state participation.

All these circumstances have significantly increased the existing risks of the budgetary system becoming unstable. The risk factors are as follows:

- the possibility that the federal budget will show a deficit even if current oil prices remain high;
- the impossibility to significantly reduce the existing social liabilities, and the prospects of a further rise in budget expenditures owing to the negative demographic trend and the persisting imbalance of the Pension Fund;
- the inadvisability of any increase in the tax load on the economy, and a possible reduction in budget revenues in a medium-term perspective;
- limited opportunities for a structural maneuver needed in order to achieve the economy’s modernization.

In the context created by these challenges, the key tasks in the field of budgetary and tax policy should be to maintain Russia’s macroeconomic stability, implement the assumed

• ¹⁸ According to Roskomimuschestvo, as of 1 January 2012, the government controlled 2,822 joint-stock companies with state-owned stakes in them.

• ¹⁹ Russia’s sovereign investment rating has been on the rise under a stable since 2005. The nations enjoying a roughly similar rating were Bahrain, Brazil, Hungary, Kazakhstan, China, Latvia, Mexico, Thailand, and South Africa. Despite the fact that due to a considerable contraction of foreign reserves and inflow of foreign investment, in December 2008 and February 2009 two agencies downgraded Russia’s rating to BBB with negative forecast (and one of them changed the forecast for stable in December 2009), the rating is at a level far higher than many developed European economies’.

• ²⁰ Standard&Poor’s, Fitch, and Moody’s.

liabilities in a responsible and most effective manner, and create incentives for stable economic growth through the use of the tax and budgetary mechanisms.

In our opinion, the first-priority task associated with *maintaining this country's macroeconomic stability* should be a return to the 'budgetary rule' that regulates the procedure for the use of those budget revenues which depend on fluctuations in the prices of energy resources, while at the same time imposing restraints on the growth of expenditures and government debt.

The unpredictable character of oil and gas revenues makes it imperative that Russia should adopt a conservative approach to determining the level of allocations from that source that may be safely used in order to maintain proper stability of the state budget. We believe that an adequate estimate of the 'guaranteed' level of budget revenue can be obtained on the basis of revenue calculation at the 'base' price of oil. Accordingly, the federal budget should be balanced at the 'base' price of oil.

We suggest that the 'base' price of oil should represent the settlement price of Urals crude estimated as the moving average price of oil for the past 10 years. For example, in 2012 the 'base' price of oil amounts to about \$ 60-65 per barrel. It is evident that at that level of oil prices Russia cannot achieve a balanced budget in 2012 (according to our estimates, the 2012 federal budget can be deficit-free only if the average prices of oil do not slide below \$ 115 per barrel). However, we believe it possible for Russia to reintroduce the 'budgetary rule' from 2016, when the 'base' price will amount to \$ 90-95 per barrel, provided that the behavior of oil prices entered in the RF Ministry of Economic Development's forecast may indeed be materialized. As regards the transition period, the 'base' price of oil, for the purposes of properly drawing up the federal budget, may be set at \$ 105 per barrel in 2013, \$ 100 per barrel in 2014, and \$ 95 per barrel in 2015.

In that case, the upper limit of expenditure should be determined as the sum of the amount of revenues estimated at an established 'base' price of oil and the amount of net debt financing at a level of no more than 1% of GDP. So, if the actual price of oil becomes the same as the 'base' one, the budget will have a deficit under 1% of GDP, thus making it possible to prevent the volume of state debt from climbing above 25% of GDP. Such levels of state debt can be considered safe from the point of view of the size of the debt load on the budget and the economy in the event of short-term drops in oil prices (a period up to 1 to 2 years) and in Russia's country risk level. We believe that, in order to minimize foreign exchange risks, it would be advisable for Russia to issue bonds exclusively denominated in the national currency, although the form of issuing can vary between federal domestic bonds and ruble Eurobonds.

If there occurs a rise in the actual price of oil and, consequently, in the level of revenues, the proceeds should be primarily allocated to the Reserve Fund until the moment when it reaches its prescribed volume (8-10% of GDP, which will enable Russia to smoothly descend, over the course of three years, to a lower level of budget expenditures in the event of a 20% fall in oil prices). The next steps should be a reduction in net drawings (if deemed necessary by the Government) and a replenishment of the National Welfare Fund.

When the price of oil is relatively low, the loss of revenue should be compensated from the Reserve Fund. At the same time, the amount of funds drawn from the Reserve Fund over the course of one year should be determined with taking into account the total volume of the Reserve Fund and the risk of revenue losses in the following years.

As the alternative 'budgetary rules' one may suggest either the concept of oil and gas transfer (applied in Russia prior to the 2008 crisis), or the rule that the 'base' price of oil should be adjusted when the actual oil prices drop below their forecasted values.

At the same time, we believe that for Russia to return to the concept of oil and gas transfer in the current circumstances, when there exists a strong probability of sharp fluctuations in oil prices, would by no means be an optimal solution because, although the oil and gas transfer is equivalent to the 'base' price of oil (which is constantly increasing so as to compensate for the

continuing shrinkage of the oil and gas sector's share in Russia's GDP), it cannot be adapted to changes in current prices.

However, the adjustment of the 'base' price level in a situation of declining oil prices – for example, if the previous year's price is taken as the 'base' price for the next budget year (when it is below forecasts) – increases the volatility of budget expenditure.

In order to provide adequate financing for the modernization of the Russian economy and a higher level of investments in human capital, it is necessary to alter not only the structure of government expenditure, but also the approaches to the allocation of budgetary funding.

In fact, the majority of the budget-funded public sectors use rather inefficiently the financial resources allocated to them, and so budgetary funding should be allocated to those sectors on condition that they carry out all the necessary transformations. In other words, this means discontinuation of the practice of increasing the size of budget allocations to the items sensitive to the quality of the institutions that act as recipients of those allocations.

In addition to these measures, it is necessary to gradually diminish the role of the federal budget as the principal source for covering the Pension Fund's deficit; to implement a program of further job cuts in the budget-funded sector; to achieve optimization of the expenditures on national defense and national security, rigidly linking this country's foreign policy strategy with the available resources; to abandon the practice of large-scale involvement of budget resources in 'image-making' construction projects; to limit the use of subsidies strictly to the purposes of recovery of or restructuring of strategic enterprises in the real sector, etc.

According to our estimations, altering the structure of financing in the direction of priority treatment of the issues of infrastructure and human capital development, with a simultaneous improvement of the cost-effectiveness of budget resources allocation, will result in an increase in the size of funding allocated to these items by 4% of GDP over the period until 2020. At the same time, reductions in the budgetary system's ineffective and excessive expenditures will make it possible, as early as 2014, to obtain additional resources in the amount of approximately 2% of GDP, resulting from cuts in the expenditures on national defense and law-enforcement activity by 0.9% of GDP, those on the national economy and the housing and utilities system – by 0.8% of GDP, and those on nationwide issues – by 0.3% of GDP.

In order to provide adequate financing for the modernization of the Russian economy and a higher level of investments in human capital, it is necessary to alter not only the structure of government expenditure, but also – and most importantly – the approaches to the allocation of budget funding.

Besides, it will be feasible, *in order to enhance the incentive-creating function of taxes and the reliability of financial coverage of government obligations*, to abstain, for as long as possible, from increasing the tax load on the economy, by expanding instead the structural component of the tax system. As demonstrated by the world's experience, when taxes on consumption are raised simultaneously with a cut in the tax load on labor and capital, it becomes possible for a country to substantially increase the competitiveness of its economy. With regard to Russia's taxes on consumption, acceleration of upward adjustment of the rates of excises on alcohol and tobacco products will be advisable.

In an event of a stable surplus displayed by the general government budget, the best-substantiated measure aimed at achieving a well-balanced budget will be to cut down the rate of insurance contributions – say, to 26%, and to simultaneously increase the revenue margin above which the rate of 5% is to be applied.

Besides, if a truly just and effective taxation system is to be created in Russia, it will be necessary to gradually abolish the export duties on oil and petroleum products and compensate for the resulting loss of revenues by increasing the rate of the Mineral Resources Extraction Tax (MRET), introducing the Tax on Extra Income (TEI) in the oil extraction sector, establishing progressive tax rates in metallurgy, mineral fertilizers production, etc.

The progressivity of income and property taxes should be increased, and the taxation system should be made more environment-friendly (by means of increasing the fines for environment pollution and introducing a tax on carbon emission).

Special attention must be paid to the issues of improving the quality of customs and tax administration. In particular, it is necessary to implement reform of customs administration through introducing selective control based on the results of risks analysis and to complete that process in the sphere of tax administration; and to promote further computerization of the administration procedures and implementation of 'contactless' methods for dealing with taxpayers.

Tables 16 and 17 contain forecasts of the aggregate balances of the general government budget and the federal budget for the period of 2012–2020 if the new budgetary rules are introduced and the aforesaid budgetary and tax policy measures are implemented.

The structural deficit peak (the difference between expenditure and the estimated revenue volume at the 'base' price of oil) will be achieved in 2016 (1.9% of GDP), and then by 2020 it will decline to 0.8% of GDP. This type of deficit is covered by net borrowings from the federal budget. By 2020, the volume of government debt will effectively reach its marginal value of 25% of GDP (22.6% of GDP), which will necessitate balancing the federal budget, from 2021 onwards, at the level of revenue structure.

The aggregate federal budget deficit will reach its peak (1.7% of GDP) in 2013 and then decline to 0.4% of GDP by 2020; it should be noted that between one-third and one-half of this deficit is covered by revenues from privatization of state property. Since the forecasted oil prices are higher than the 'base' ones, and the actual deficit is lower than the structural deficit, part of federal budget revenue is transferred to the Reserve Fund whose size, nevertheless, in 2020 fails to achieve its normative value of 6% of GDP (5.6% of GDP). Consequently, the opportunities for transferring a part of the extra revenues to the National Welfare Fund will emerge only after 2020.

Over the greater part of the period under consideration, the general government budget appears to be properly balanced, with due regard to the estimated size of revenues from privatization.

Table 16

Parameters of the General Government Budget, % of GDP

	2012	2013	2014	2015	2016	2017	2018	2019	2020
1	2	3	4	5	6	7	8	9	10
Revenue, including:	38.1	37.7	37.2	37.0	37.0	36.8	36.6	36.4	36.5
VAT	5.7	5.7	5.5	5.4	5.4	5.4	5.4	5.5	5.5
Tax on profit	6.3	6.5	6.3	6.3	6.1	6.2	6.3	6.1	6
PIT	4.0	3.8	3.8	3.8	3.9	3.9	4	3.9	4.0
Insurance contributions	5.7	5.8	5.9	5.9	6	6	6.1	6.1	6.2

cont'd

1	2	3	4	5	6	7	8	9	10
MRET/TEI (Tax on Extra Income)	3.3	3	2.9	2.8	2.8	2.7	2.7	2.6	2.6
excises	1.4	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9
taxes on property	1	1.1	1.2	1.2	1.3	1.3	1.3	1.4	1.4
customs duties	7.7	7.3	7.0	6.7	6.5	6.3	5.9	5.9	5.9
other revenues	3.0	3.0	3.0	3.1	3.1	3.1	3.0	3.0	3.0
Expenditure, including:	38.0	38.1	37.9	37.6	37.3	37.2	37.1	36.5	35.9
nationwide issues	2.65	2.5	2.5	2.2	2	1.8	1.7	1.6	1.5
national defense	2.8	2.6	2.4	2.4	2.4	2.4	2.4	2.4	2.4
national security	2.6	2.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3
national economy, including	5.8	5.9	6.0	5.9	5.7	5.6	5.2	4.9	4.6
road system	1.5	1.8	2.1	2.3	2.5	2.7	2.9	2.9	2.9
agriculture and fishery	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
communications and informatics	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
national economy, less road system, agriculture, communications and informatics	3.6	3.4	3.2	2.9	2.5	2.2	1.6	1.3	1.0
housing and utilities system	2.2	2.1	2.1	1.9	1.7	1.5	1.3	1.1	0.9
environment protection	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
education	4.1	4.1	4.2	4.3	4.5	4.8	5.3	5.3	5.3

culture, cinematography	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
mass media	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
health care	3.7	4.0	4.2	4.2	4.2	4.2	4.2	4.2	4.2
physical culture and sports	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
social policy, including	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0
aggregate expenditures on labor pensions (less social pensions and budget-funded compensations)	7.9	7.6	7.6	7.7	7.7	7.7	7.6	7.5	7.5
social policy, less expenditures on labor pensions	4.1	4.4	4.5	4.3	4.3	4.3	4.4	4.5	4.5
government debt servicing	1	1.2	1.1	1.2	1.3	1.4	1.5	1.5	1.4
Deficit /surplus	0.1	-0.4	-0.7	-0.6	-0.3	-0.4	-0.5	-0.1	0.6
Revenues from privatization	0.3	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.3

Source: Estimates made by the Ye. T. Gaidar Institute for Economic Policy and the Higher School of Economics – National Research University.

Table 17

Parameters of the Federal Budget, % of GDP

	2012	2013	2014	2015	2016	2017	2018	2019	2020
1	2	3	4	5	6	7	8	9	10
Revenue, including:	20.1	19.5	18.9	18.4	18.2	17.9	17.4	17.4	17.4
VAT	5.7	5.7	5.5	5.4	5.4	5.4	5.4	5.5	5.5
domestic	3.0	3.0	2.9	2.8	2.8	2.8	2.8	2.8	2.8
on imports	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.7	2.7
tax on profit	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
MRET/TEI (Tax on Extra Income)	3.3	3.0	2.9	2.8	2.8	2.7	2.7	2.6	2.6
on oil	3.1	2.8	2.6	2.5	2.4	2.3	2.3	2.1	2.1
on gas	0.2	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.5
excises	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
export duties	6.3	5.9	5.6	5.2	5.0	4.8	4.4	4.4	4.4
oil	3.8	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.4
petroleum products	1.6	1.5	1.4	1.3	1.2	1.2	1.0	1.0	1.0
gas	0.9	0.8	0.9	0.8	0.8	0.8	0.8	0.9	1.0
import duties	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5
other revenues	2.0	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9
Expenditure	21.5	21.2	20.1	19.7	19.4	19.1	18.7	18.4	17.8
Deficit/ surplus	-1.4	-1.7	-1.2	-1.3	-1.2	-1.2	-1.3	-1.0	-0.4
Revenues from privatization	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2
RF government debt	12.4	13.8	14.7	15.8	17.6	19.1	20.5	21.9	22.6

cont'd

1	2	3	4	5	6	7	8	9	10
Revenue at 'base' price of oil (estimate)	21.8	21.5	20.6	19.4	17.5	17.5	17.1	16.9	17.0
Structural deficit	0.0	0.0	0.0	0.3	1.9	1.6	1.6	1.5	0.8
Reserve Fund	2.7	2.6	2.5	2.4	3.3	4.0	4.5	5.1	5.6
National Welfare Fund	4.8	4.4	4.0	3.0	2.8	2.7	2.9	2.8	2.7

Source: Estimates made by the Ye. T. Gaidar Institute for Economic Policy and the Higher School of Economics – National Research University.