Section 2. Monetary and Fiscal Policy

2.1. Monetary policy[1]

2.1.1. Monetary policy trends

In 2020, the world economy was faced with a large-scale crisis caused by the coronavirus pandemic, a worsening situation in the global oil market, increasing global uncertainty, and capital outflows from emerging markets. The crisis phenomena were experienced, to a varying degree, by every sector of the economy and required the implementation of a set of urgent monetary policy measures. The Bank of Russia's switchover to monetary policy easing became its key decision aimed at sustaining aggregate demand: in 2020, the regulator cut the key rate four times, from 6.25% per annum in February to 4.25% per annum in July, thus sinking it to its historic low.

It should be noted that just before the onset of the 2020 epidemiological crisis, the Russian economy was characterized by a favorable situation in terms of monetary conditions, inflationary processes, the balance of payments, and the foreign exchange market. Low inflation, stabilization of inflationary expectations, high levels of international reserves, a positive current account balance, low external debt, a significant structural surplus of banking sector liquidity, and lower dependence of the ruble exchange rate against major world currencies on the movement of oil prices under the fiscal rule had all contributed to the Russian economy being more secure that before from external shocks.

In February-March 2020, the Russian economy had to deal simultaneously with two major challenges. The slowdown in the global economy resulting from the rapid spread of the coronavirus translated into a sharp plunge in aggregate demand, while the containment measures introduced in the Russian Federation

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triggered a decline in aggregate supply. All this was occurring alongside a growing uncertainty and capital outflows from the developing markets. In addition, the OPEC+ deal failure on March 6, 2020 sharply accelerated the oil price downfall. Following the auction on March 9, prices of Urals crude fell more than 30%, to $33 per barrel. Over the remaining weeks of March, Urals prices continued to slide, reaching a local minimum of $18.64 per barrel on March 18, 2020, which corresponds to their level in February 2002.

An additional downward pressure on the ruble exchange rate was exerted by capital outflows from emerging markets in a situation of uncertainty. Over March, the share of non-residents in the OFZ market shrank by 3 p.p., from 35% to 32%, which corresponds to a reduction in the portfolio held by non-residents by Rb280 bn. The outflow exceeded the volume of OFZ placement in Q1 2020, which amounted to Rb227 bn.

In the short term, these shocks created challenges to Russia's financial sustainability. Thus, over the course of February 2020, the ruble depreciated against the US dollar by 6.3%, to Rb67.0; and in March 2020, it lost another 16.0%, getting to Rb77.7. In view of the sharply deteriorating external situation, the RF Central Bank decided, from March 9 onwards, not to purchase foreign currency in the domestic market within the framework of the fiscal rule mechanism; and on March 10, it began proactive sales of foreign currency, thereby implementing the fiscal rule in order to support the cheapening ruble. Thus, over the period from March 10 to March 31, the Bank of Russia sold foreign currencies to the value of Rb143.5 bn, and the total volume of foreign currency sales under the fiscal rule over the period from March to December 2020 amounted to Rb1.7 trillion.

An additional mechanism applied in order to boost the foreign currency supply in the domestic forex market was the sale of foreign currency reserves from the National Welfare Fund (NWF) to pay for the RF Government's purchase of shares in Sberbank to the value of Rb 2.1 trillion. The daily volume of foreign exchange sales in the framework of that deal varied depending on the fluctuations of the price of Urals crude under $25 per barrel. When the cutoff price was exceeded, no operations were carried out. With due regard for the situation in the world oil market, forex sales were taking place from March 19 through May 12, 2020. The total amount of proactive forex sales and those involved in the Sberbank deal was about Rb0.5 trillion. Note that in August-September 2020, the RF Central Bank offset the remaining unsold foreign currency balance within the framework of the Sberbank deal against the balance of all the foreign currency purchases and proactive sales that had been deferred since 2018. The resulting balance of these operations amounted to Rb185 bn. Over the course of Q4 2020, the Bank of Russia evenly distributed the sales of the forex surplus in addition to its regular forex operations under the fiscal rule. In October 2020, the deal of purchase, by the RF Government of shares in Aeroflot PJSC at the expense of the NWF, was launched. The volume of forex sales completed by the regulator within the framework of this deal until the end of 2020 amounted to Rb50 bn.

In order to boost forex market stability and expand the possibilities for providing banks with foreign exchange liquidity, the Bank of Russia, starting from

10 March, decided to increase the limit of forex swap transactions for providing US dollars with maturity of 'today' from $3 bn to $5 bn. However, there was no demand for this instrument, which confirms the vital function of the fiscal rule as an automatic stabilizer – among other things, of foreign currency liquidity in the financial sector.

The measures implemented by the monetary authorities in order to maintain financial stability made it possible to prevent the development of a forex market crisis. In April-May 2020, the ruble exchange rate fluctuated within Rb70–75 rubles per US dollar. Our calculations demonstrate that over that period, a fundamentally sound ruble-to-USD exchange rate should have hovered around Rb75, if the price of oil remained at around $25-30 per barrel.[1]

Importantly, for the first time in a crisis environment, Russia's macroeconomic policy made it possible to avoid a tightening of its monetary policy. At its meeting on March 20, 2020, the Bank of Russia Board decided to keep the key rate at 6% per annum, although based on the experiences of the previous crisis, many had been expecting it to be raised. It should be recalled that during the currency crisis of late 2014 and early 2015, increasing inflationary expectations coupled with inflation acceleration as a result of a rapidly depreciating ruble necessitated, in December 2014, an urgent key rate increase from 10.5% to 17% per annum. In 2020, there was no national currency plunge of a similar magnitude, and after two short-term inflation surges in March-April and May-June 2020, the inflation rate slowed down, and the ruble strengthened. Thus, while the monthly growth rate of the CPI in March and April stood at 0.6% and 0.8%, respectively, later on, in May and June, its movement slowed down to 0.3% and 0.2%, respectively. It is in this aspect that the situation in 2020 significantly differs from that in 2014, when, as the ruble exchange rate plunged, inflation accelerated to 2.6% in December 2014, and then to 3.9% in January 2015.

As early as the spring of 2020, the RF Central Bank switched to monetary policy easing. On April 27, the key rate was cut by 0.5 p.p. to 5.5% per annum; on June 22, by 1 p.p. to 4.5% per annum; and on July 27, by 0.25 p.p. to 4.25% per annum (the latter, as noted earlier, corresponds to historic low). Thereafter, over the September-December 2020 period, under the influence of short-term pro-inflationary factors, including some recovery in consumer demand and growth in the inflationary expectations of consumers and businesses resulting from the ruble weakening, the regulator temporarily discontinued monetary policy easing.

Note that in the unprecedented crisis conditions typical of 2020, the majority of central banks in the developed and developing economies likewise reduced their key rates. As shown by the year-end results of 2020, the key interest rate in Russia in real terms (based on actual inflation) decreased significantly, and thus became negative (-0.65% per annum), at a level that was comparable to that of Australia (-0.6% per annum) and the UK (-0.5% per annum). The real key rates in the majority of developed economies, as well as some of the developing ones that relied on inflation targeting, also shifted to negative values (-1.4% per annum in

1 The calculations are based on the econometric model of a fundamental ruble exchange rate movement pattern, developed by the Gaidar Institute and the RANEPA.

Norway, -0.45% per annum in Canada, and -2.5% per annum in Chile), while their nominal interest rates hovered near zero, and inflation was low (*Fig. 1* and *Table 1*).

Table 1

Inflation and key rates in some developed and developing countries

	Actual inflation, December 2020 to December 2019, %	Key rate, end of year, % per annum
Developing countries		
Colombia	1.6	1.75
Indonesia	1.7	3.75
Peru	2.0	0.25
Poland	2.4	0.10
Hungary	2.7	0.60
Chile	3.0	0.50
South Africa	3.1	3.50
Mexico	3.2	4.25
Brazil	4.5	2.00
India	4.6	4.00
Russia	**4.9**	**4.25**
Kazakhstan	7.5	9.00
Turkey	14.6	17.00
Developed countries		
EU	0.2	0.00
United Kingdom	0.6	0.10
Australia	0.7	0.10
Canada	0.7	0.25
Norway	1.4	0.00
New Zealand	1.4	0.25
USA	1.4	0.25
Czech Republic	2.3	0.25
Iceland	3.6	0.75

Source: Central banks' websites.

In addition to the measures designed to maintain financial stability that have been discussed earlier, the Bank of Russia proposed a package of anti-crisis measures that included support of the lending market (including lending to SMEs, housing mortgage loans, and lending to businesses operating in the affected industries). Among the most significant measures, we may also point out payment holidays on consumer loans. In addition, the RF Central Bank launched a support program for small and medium-sized businesses to cover the payment of wages to their employees. Besides, it was decided to zero out the risk ratios for housing mortgage loans. Meanwhile, it is worth noting that this measure triggered a rush demand in the real estate market, resulting in a record increase in the volume of new mortgage loans issued and a surge in housing prices, thus giving rise to the risk of a mortgage bubble.

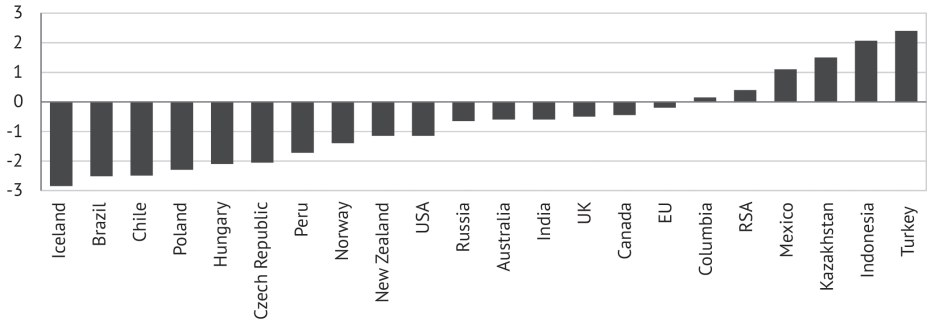

Fig. 1. The real key rates as of the end of November 2020, % per annum (based on the actual inflation patterns over the previous 12 months)

Source: Central banks' websites; own calculations.

The Bank of Russia also decided that, from March 1 to September 30, 2020, no increased risk-based buffers should be applied for foreign currency loans issued during that period to manufacturers of pharmaceuticals, and of materials and equipment used for medical purposes, as well as for their investments, over the same period, in forex-denominated debt securities. Besides, the Bank of Russia decided to grant a preferential treatment to systemically important banks for their compliance with the short-term liquidity ratios, in order to expand their opportunities for lending to the private sector. In addition to reducing the fee for the right to use an irrevocable credit line (ICL) from 0.5% to 0.15%, the Bank of Russia increased the maximum total limit for ICLs from Rb1.5 trillion to Rb5 trillion for the period from April 1, 2020 to March 31, 2021.

In general, having analyzed the actions undertaken by the Bank of Russia during the acute phase of the epidemiological crisis, it can be concluded that the key role in successfully dealing with the crisis period in terms of monetary measures belonged to the inflation targeting regime and the fiscal rule, which made it possible to prevent a dramatic weakening of the ruble, acceleration of inflation, and panic in the markets; in this, the current crisis differs significantly from the global financial crisis and the currency crisis in this country in late 2014 and early 2015.

2.1.2. The money market

In 2020, amid the spread of the epidemic, the higher uncertainty also created certain risks for the money market. The increased demand for liquid funds displayed by economic agents led to a rapid reduction in the liquidity surplus across the banking system. In this connection, part of the Bank of Russia's package designed to maintain financial stability were the measures aimed at providing the banking system with additional liquidity.

To begin with, over the period from March through November 2020, the structural surplus of banking sector liquidity[1] shrank from Rb3.8 trillion as of March 1, 2020, to Rb0.2 trillion as of January 1, 2020 (*Fig. 2*). The liquidity surplus shrinkage occurred in the main due to the increasing cash in circulation volume that resulted from the high demand for it displayed by economic agents. Thus, the amount of cash in circulation in March 2020 increased by Rb0.7 trillion, and the maximum increase (Rb0.2 trillion) occurred on March 27, 2020, the first day of the weekend preceding the non-work week. Note that the growth rate of cash in circulation in March 2020 relative to the previous month turned out to be significantly higher than the average monthly growth rate displayed by that indicator over the past 5 years (6.9% vs 0.8%). A similar pattern was observed in May-October 2020. Although during that time span the monthly growth rate of household demand for cash declined on March 2020, over the period from May through October it amounted on average to 1.7%, while in the previous 5 years it had stood significantly lower, at 0.2%. In November-December 2020, the growth rate of demand for cash stabilized at a level that was comparable to the previous year's values. As a result, at the start of January 2021, compared to the beginning of 2020, the volume of cash held by individuals increased on early 2020 by 26.4%, to Rb13.4 trillion.

Secondly, the liquidity surplus of the banking sector was receding due to the rising correspondent accounts balances of credit institutions with the Bank of Russia, because a number of banks wanted to create additional cash reserves as a safety net against the risk of sudden withdrawals of funds by their clients in face of growing uncertainty. Thus, over the course of March, the correspondent account balances of credit institutions jumped by 26.9%, to Rb2.6 trillion; and in April, by another 16.3%, to Rb3.0 trillion. Between May and December, the correspondent account balances of credit institutions stabilized at Rb2.9 trillion, and the fluctuations of this index were caused by the redistribution of funds between the correspondent and deposit accounts held by credit institutions with the Bank of Russia, which they did in order to meet the requirement for averaging their required reserves.

Thirdly, the liquidity surplus of the banking sector was shrinking in response to the increase in the required reserves of commercial banks as a result of the liabilities of credit institutions being adjusted relative to the changing forex rate of the weakening ruble. This effect was most pronounced in April and September 2020 when, due to the ruble weakening, the required reserves of banks increased by 6.9% and 2.1%, respectively. According to the year-end results of 2020, they stood at Rb0.7 trillion, having gained 15.6% relative to their year-beginning value.

Fourthly, the liquidity surplus shrinkage was associated with budget operations. Over the period from March 1 through May 10, foreign currency sales under the

1 According to the Bank of Russia definition, structural liquidity deficit/surplus is calculated as a difference between the Bank of Russia's aggregated claims on the banking sector and its aggregated liabilities to the banking sector. The banking sector structural liquidity deficit is the state of the banking sector which implies the existence of banks' permanent need of raising funds with the Bank of Russia operations; in case of structural liquidity surplus, it is their permanent need of allocating funds through the Bank of Russia operations.

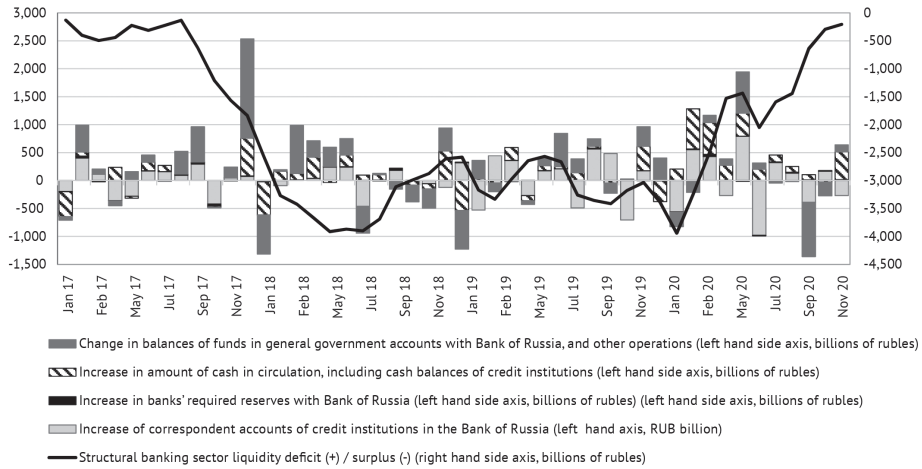

Fig. 2. Structural liquidity surplus of the banking sector and its components, 2017–2020

Source: Bank of Russia.

fiscal rule, increased net government borrowing, cash inflow into bank deposits, and the repo transactions carried on by the Federal Treasury, when taken together, accounted for liquidity absorption from the banking sector in the amount of Rb0.8 trillion; this was in part offset by the excess of budget expenditure over budget revenue, in the amount of Rb0.38 trillion. As a result, a total of Rb0.46 trillion was absorbed from the money market through the budget channel. Over the next period, from May 11 through June 2020, the situation drastically changed, and the budget channel was the source of liquidity for the banking system in the amount of Rb1.2 trillion. Thus, e.g., the operations of the RF Ministry of Finance with financial assets and liabilities (foreign currency sales under the fiscal rule, changes in the amount of net government borrowing, cash inflow into bank deposits, and the repo transactions of the Federal Treasury) absorbed liquidity in the amount of Rb0.3 trillion, but the excess of budget expenditure over budget revenue increased the banking sector liquidity by Rb1.5 trillion. Over the July-November 2020 period, budget operations pushed down the liquidity surplus as liquidity absorption amounted to Rb2.5 trillion, being in part offset by the excess of budget expenditure over budget revenue in the amount of Rb1.3 trillion. In December 2020, on the contrary, the operations of the RF Ministry of Finance with financial assets and liabilities absorbed Rb1.3 trillion, while the excess of budget expenditure over budget revenue added liquidity to the banking sector in the amount of Rb1.4 trillion; as a result, the budget channel supplied liquidity to the banking system only in the amount of Rb0.1 trillion. It should be noted that the liquidity inflow turned out to be rather modest for the month of December (compared with Rb1.8 trillion in December 2017, Rb0.4 trillion in December 2018,

and Rb0.3 trillion in December 2019), and so the liquidity surplus of the banking system in December 2020 remained at a low level (Rb0.2 trillion an average).

In response to the growing need of banks for liquidity resources, the RF Central Bank reduced its placement of Bank of Russia coupon bonds (COBR). While the offer of COBR in March and April 2020 amounted to Rb490.4 bn and Rb582.0 bn, respectively (vs Rb500 bn each in March and April 2019), in May the volume of new placements of COBR was zero (vs Rb600 bn in May 2019). Thus, on May 12, the auction for the placement of COBR-33 was canceled, and the regulator also decided to stop holding its COBR-32 auctions until the maturity date of COBR-31. As a result, in March-May 2020, the volume of commercial banks' investment in COBR decreased by 41%, to Rb1.1 trillion. Overall in 2020, the volume of COBR placements amounted to Rb5.2 trillion, while in 2019 the same indicator had exceeded Rb6.0 trillion.

In the context of a shrinking liquidity surplus, banks' demand for the Bank of Russia's deposit auctions became less prominent. So, while in 2019 the volume of funding attracted through deposit auctions amounted on average to Rb1.6 trillion, in 2020 it was only Rb1.2 trillion.

In general over 2020, broad money increased by 9.8%, to Rb18,472 bn (in 2019, it increased by 4.7%, to Rb16823.4 bn). Among the fastest-growing components of broad money by the end of 2020, as noted earlier, we can point out cash in circulation, which jumped by 26.4%, to Rb13,180.9 bn, and bank deposits with the Bank of Russia, which increased by 18.9%, to Rb1,220.7 bn. The amount of required reserves increased by 15.6%, to Rb713.6 bn, while the volume of Bank of Russia bonds held by credit institutions shrank by 70.6%, to Rb570.0 bn. The correspondent accounts of credit institutions with the Bank of Russia shrank by 2.9%, to Rb2,548.5 billion. Overall, in face of liquidity surplus, the volume of excess reserves[1] for 2020 decreased by 22.4% and amounted to Rb4339.2 bn (*Table 2*).

Table 2

The broad money dynamics in 2020, billions of rubles

	01.01.2019	01.01.2020	01.01.2021
Monetary base (broad)	16,063.4	16,823.4	18,472.4
cash in circulation, including cash balances of credit institutions	10,312.5	10 616.1	13,419.6
correspondent accounts of credit institutions with Bank of Russia	1,898.2	2,625.5	2,548.5
required reserves	575.3	617.4	713.6
deposits of credit institutions with Bank of Russia	1,903.5	1,027.7	1,220.7
Bank of Russia bonds held by credit institutions	1,373.9	1,936.7	570
For reference: excess reserves	*5,175.7*	*5,589.9*	*4,339.2*

Source: Bank of Russia.

1 Excess reserves of the banking system include deposits of credit institutions with the Bank of Russia, correspondent accounts of credit institutions with the Bank of Russia, as well as bonds of the Bank of Russia held by credit institutions.

The sharp liquidity surplus decline observed in March and April 2020 influenced both the volatility of money market rates and the measures taken by the RF Central Bank by way of stabilizing the situation. The Bank of Russia launched fine-tuning repo auctions to provide liquidity to the banking sector, which had not taken place since February 2017. Over the March- May 2020 period, the RF Central Bank carried out a total of 11 auctions, with the average allotment amount of Rb406 bn. A high demand for these operations persisted over the first ten days of May 2020. Later on, as the situation in the money market stabilized, there was no longer any need for fine-tuning operations to provide necessary cash to the banking sector.

In May 2020, the Bank of Russia expanded the list of instruments that it was using to provide ruble liquidity to credit institutions through one-month and one-year repo auctions. The list of acceptable collateral was reduced as compared to short-term repos. The acceptable collateral included federal government bonds put on the Lombard List and bonds of subjects of the Russian Federation and municipalities with the highest credit rating according to the national rating scale. The 28-day long auction offering up to Rb500 bn, scheduled for May 25, 2020, was recognized to be canceled as it was participated by only one lender. In June-September 2020, alongside a stabilizing situation in the money market, the demand for long-term refinancing likewise effectively dwindled. However, within the framework of 28-to-35-day long repo auctions held over the October-December 2020 period, banks were provided with a total of Rb2.6 trillion. It is noteworthy that the growth in banks' demand for monthly repo auctions is neutral in terms of money supply, because the bulk of these funds is spent on purchasing OFZs. Besides, throughout the year, these operations had neutral effect on money supply, because as early as December 2020, the money received by the budget as a result of OFZ sales went back into the economy in the form of budget spending. The demand for one-year repo auctions was extremely low: banks took part in one-year repo auctions only three times (on June 22, October 12, and December 7, 2020), and the amount of borrowing amounted to Rb5.1 bn, Rb20 bn, and Rb10.5 bn, respectively.

With the liquidity surplus decline in 2020, there was an increase in the debt of credit institutions to the Bank of Russia. By the end of 2020, the amount of loans attracted by credit institutions from the Bank of Russia had soared by 47%, to Rb3.6 trillion (vs Rb2.5 trillion as of January 1, 2020) (*Fig. 3*). The volume of the regulator's claims on banks within the framework of repo auctions at year end 2020 amounted to Rb0.85 trillion (vs zero claims at year end 2019), while banks' debt on loans secured by non-marketable assets reached Rb 0.96 trillion (vs Rb2.0 trillion at year end 2019).

Overall, the situation in the money market amid the epidemiological crisis radically differed from the currency crisis of late 2014 and early 2015, when in face of an increasing structural liquidity deficit, the banking sector's debt to the RF Central Bank nearly doubled the record high reached during the 2009 crisis, having climbed 2.1 times over the previous 12 months and amounting to Rb9.3 trillion as of January 1, 2015.

Another important feature distinguishing the two crises has to do with the banking sector's demand for forex resources. During the March-May 2020 period, the situation with foreign exchange liquidity in the banking sector remained stable. The stability of the required level of foreign exchange liquidity was further sustained by foreign currency sales by the Bank of Russia under the fiscal rule (Rb0.9 trillion in March-June 2020), by additional foreign currency sales carried out when the price of Urals oil plunged below $25 per barrel, and by the increasing de-dollarization of the Russian economy over recent years. One more important factor that determined the low demand of banks for foreign currency was the absence of panic-triggered retail purchases of foreign currency cash. As a result, banks displayed no demand for the foreign exchange liquidity instruments offered by the RF Central Bank. It should also be noted that in late 2014 and early 2015, amid a panic in the forex market, banks were actively taking part in forex repo auctions, and the resulting debt claims rose to $33.9 bn.

Table 3

The Bank of Russia's balance sheets in 2018–2020

	January 1, 2018		January 1, 2019		November 30, 2020	
	Billions of rubles	**% of assets / liabilities**	**Billions of rubles**	**% of assets / liabilities**	**Billions of rubles**	**% of assets / liabilities**
Funds placed with non-residents and foreign issuers of securities	24,496.1	62.2	25,342.9	62.6	30,995.1	60.2
Loans and deposits	3,672.5	9.3	3,305.7	8.2	4,378.6	8.5
Precious metals	6,123.9	15.6	6,952.8	17.2	10,225.2	19.9
Securities	1,038.8	2.6	1,121.6	2.8	1,037.3	2.0
Other assets	2286.0	5.8	2,252.7	5.6	2,861.4	5.6
Total assets	**39,368.9**	**100.0**	**40,513.1**	**100.0**	**51,492.4**	**100.0**
Currency in circulation	10,312.8	26.2	10,616.5	26.2	12,918.0	25.1
Funds in accounts with Bank of Russia	14,526.6	36.9	16,951.7	41.8	17,995.8	34.9
including RF Government	*7,894.7*	*20.1*	*10,734.1*	*26.5*	*10,953.1*	*21.3*
resident credit institutions	*4,381.7*	*11.1*	*4,273.9*	*10.5*	*5,116.5*	*9.9*
Credit float	0.05	0.0	–		–	
Securities issued	1,388.3	3.5	1,952.9	4.8	606.3	1.2
Liabilities to IMF	1,616.4	4.1	1,363.9	3.4	1,648.4	3.2

	January 1, 2018		January 1, 2019		November 30, 2020	
	Billions of rubles	**% of assets / liabilities**	**Billions of rubles**	**% of assets / liabilities**	**Billions of rubles**	**% of assets / liabilities**
Other liabilities	130.6	0.3	190.6	0.5	8,886.5	17.3
Capital	11,394.3	28.9	9,437.5	23.3	9,437.4	18.3
Profit for reporting year	–	–	–	–	–	
Total liabilities	**39,368.9**	**100.0**	**40,513.1**	**100.0**	**51,492.4**	**100.0**

Source: Bank of Russia.

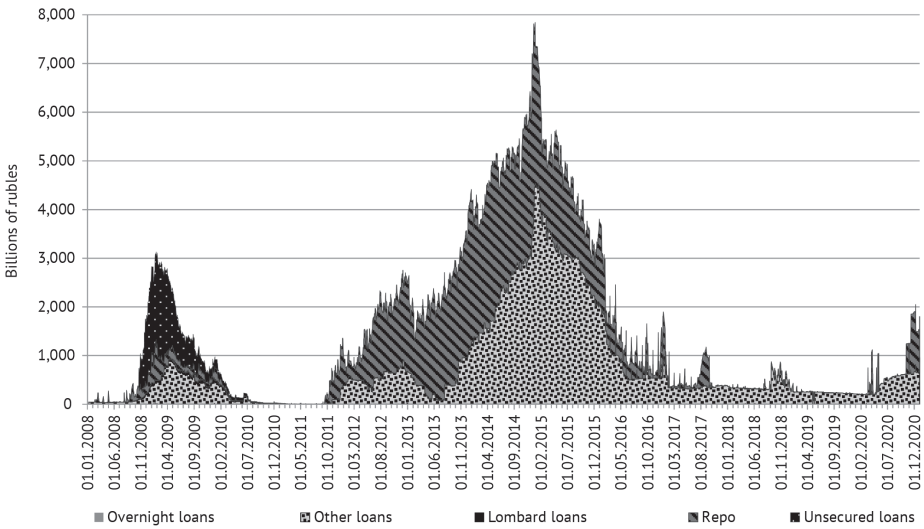

Fig. 3. Debt of commercial banks to the Bank of Russia, rubles, 2008–2020

Source: Bank of Russia.

Note that as a result of the growing tension in the money market, there were days when the short term money market rate rose above the key rate. The spread peaked at the end of April, at 0.5 p.p. Nevertheless, the measures implemented by the regulator made it possible to stabilize the situation in the money market and push the money market rate close to the key rate. As a result, over the May-December 2020 period, the MIACR rate stayed closer to the bottom of the interest rate band *(Fig. 4)*. On average over the January-December 2020 period, the MIACR rate stood at 4.87% per annum, which was significantly lower than its average index for 2019, when it had risen to 7.2% per annum; this is consistent with the Bank of Russia's switchover to monetary policy easing. It is noteworthy that in December 2014, the one-day MIACR rate repeatedly deviated beyond the interest rate band, on some days jumping 1.1–1.3 p.p. above the key rate. Under

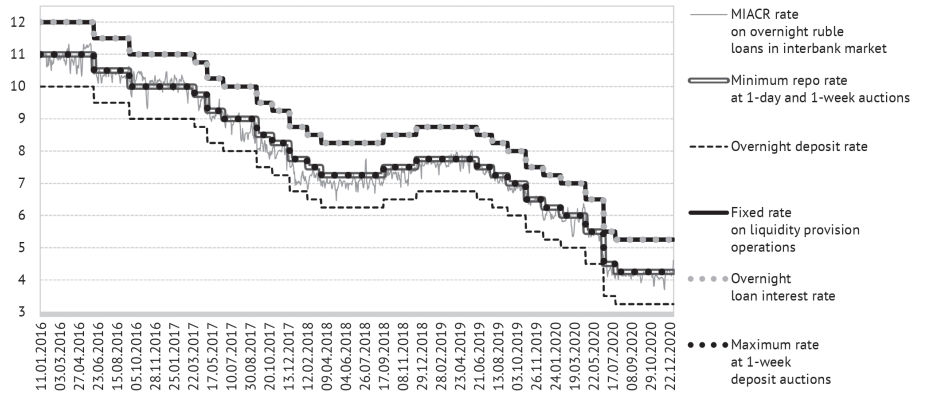

Fig. 4. The Bank of Russia interest rate band and the movement of interbank market interest rates, 2016–2020

Source: Bank of Russia.

such conditions, the instability in the money and forex markets necessitated an urgent raise of the key rate, from 10.5% to 17% per annum. On the contrary, the situation in the economy and in the financial market during the current crisis made it possible to significantly soften the monetary policy. Thus, the regulator's measures launched in the spring of 2020 and designed to stabilize the situation in the financial market and ensure an adequate liquidity level in the banking sector turned out to be effective, and so it became possible to fully achieve the operational monetary policy goal of keeping the short term money market rate close to the key rate.

One of the factors that played a certain role in ensuring financial stability during the crisis situation was the record high amount of accumulated international reserves. Between January and December 2020, international reserves gained 7.5%, increasing to $595.8 bn. In early August 2020, a new historic high of international reserves was achieved, amounting to $600.7 bn (*Fig. 5*). It should be reminded that as far as the amount of international reserves is concerned, its previous historic high was hit in August 2008, when they climbed to $596.6 bn. The movement pattern of forex reserves in 2020 was determined in the main by the ruble exchange rate revaluation and the climbing gold prices in the world market. Note that in 2020, the monetary gold reserves increased by 25.7% to $138.8 bn, mostly due to the positive revaluation of this particular asset over the course of that year. Forex reserves gained 2.9%, and their value as of the beginning of January 2021 stood at $457.0 bn. The shrinkage of forex reserves resulting from the regulator's proactive foreign currency sales in the domestic forex market within the framework of the fiscal rule (the operations over the period of March through December 2020 to the total value of Rb1.7 trillion), and also, in part, from the foreign currency sales from the National Welfare Fund to pay for the government stakes in Sberbank and Aeroflot, was fully offset by the upward revaluation of

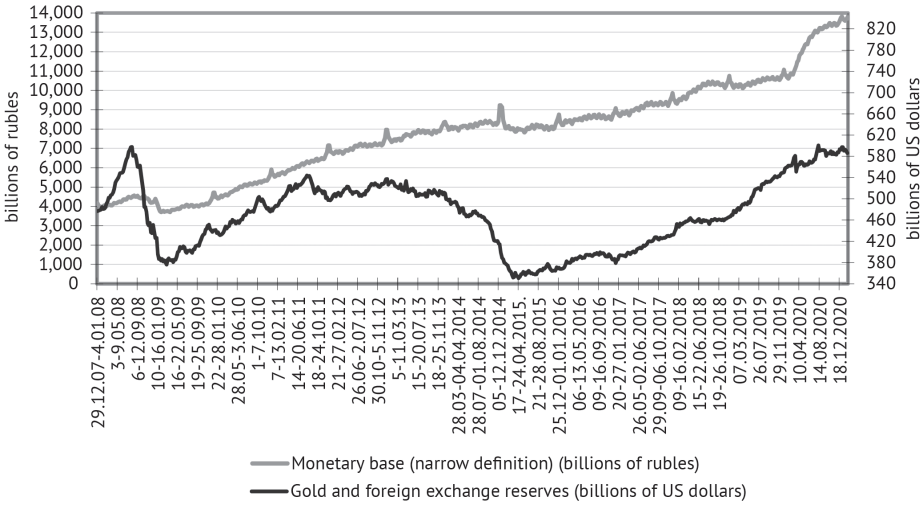

Fig. 5. The movement of the monetary base (narrow definition) and gold and foreign exchange (international) reserves in the Russian Federation, 2008–2020

Source: Bank of Russia.

foreign currency assets based on the exchange rate movement, in particular as a result of the US dollar weakening against the euro.[1] As of January 1, 2021, the share of forex reserves in the total amount of reserve assets was 76.7% (vs 80.1% in 2019), and that of gold was 23.3% (vs 19.9% in 2019). In this connection it is noteworthy that from April 1, 2020, the Bank of Russia discontinued buying gold in the domestic precious metals market, announcing that its further decisions concerning purchases of gold would depend on the evolvement of the financial market situation. It should be reminded that the regulator had been actively buying gold since 2014. The halt in purchases of gold by the RF Central Bank was followed by its export abroad by the banking sector, and this helped sustain the balance of payments of the Russian Federation.

As of year end 2020, the volume of reserves was sufficient to maintain a sustainable balance of payments, because it provided both for 18-month imports of goods and services (vs 16-month imports in 2019) and for the payments due on external debt that were scheduled for 2021.

The economic response measures adopted by the government authorities in 2020 significantly sustained the incomes of economic agents and the lending market. In 2020, the average monthly growth of M2 (relative to the corresponding period of the previous year) was 14.1% (vs 8.7% in 2019), and that of the monetary base was 12.0% (vs 1.9% in 2019). As a result, the money multiplier (the ratio

1 In the structure of forex and gold assets held by the Bank of Russia, the share of the euro is 29.5%; that of the US dollar is 22.2%; and that of the yuan is 12.2% (based on data for Q2 2020).

between M2 and the monetary base) amounted to 3.0 (vs 2.95 in 2019). The accelerated growth of M2 relative to the monetary base occurred in the main due to an increase in the lending volume in a situation of softening loan conditions, both in terms of loan price and otherwise. It is noteworthy that the achieved money multiplier index corresponds to its average value for developing economies (Ukraine, Belarus, Kazakhstan), while in the developed countries it is usually in a range of 5 to 8. It should also be noted that over the past 20 years in the countries of Eastern Europe, as their banking systems developed, the money multiplier was demonstrating an upward movement pattern. Thus, for example, in Poland over the period 1993–2020, the money multiplier increased from 3.1 to 4.9, while in Russia over the same period it climbed from 1.4 to 3.0.

According to preliminary estimates, the level of monetization in the Russian economy (the ratio of M2 to GDP) over the period 1999–2020 jumped 3.5 times to 55.0%, which is still lower than in many other developing countries. For example, in Poland, the ratio of M2 to GDP in 2020 amounted to 82.7% (vs 40.2% in 1999); in Chile, to 84% (vs 52.2% in 1999), in Brazil, to 95.0% (vs 42.8% in 1999); in Thailand, to 122.8% (vs 112.2% in 1999); and in Malaysia, to 123% (vs 122% in 1999). Meanwhile, in Belarus, the ratio of M2 to GDP over the same period increased 2.2 times to 37.5%; in Kazakhstan, 2.2 times to 30.2%; in Ukraine, 2.1 times to 36.0%; in Mexico, 1.4 times to 38.5%; in Colombia, 1.4 times to 49%; and in Peru, 1.4 times to 49.1%. In the developed countries, the index of monetization relative to GDP is even higher, due to a higher level of the financial system development: for example, in 2020 in the UK, this indicator climbed to 145.2%; and in Switzerland, to 193.1%.

2.1.3. Inflationary processes

At the end of 2020, inflation in the Russian Federation amounted to 4.9% (vs 3.0% in 2019), thus jumping 0.9 p.p. above the RF Central Bank's target (*Fig. 6*). The upward movement of the Consumer Price Index (CPI) over the course of 2020 was shaped by the effects of many multidirectional factors. As noted earlier, in spite of the inflation surge in March and April 2020 in response to the increased demand for consumer goods and a sliding exchange rate, the annual inflation rate (as measured during the previous 12 months) in March and April 2020 stood at 2.5% and 3.1%, respectively, while still staying well below the target. Over the May-June period, in face of a weak consumer demand, and also as the exchange rate pass-through effect reached its peak, inflation in annual terms was 3.0% and 3.2%, respectively, which turned out to be slightly below the Bank of Russia forecasts. In view of the current situation, the Bank of Russia switched to a significant easing of its monetary policy.

Over the September-December 2020 period, inflation was accelerated by the ruble weakening once again, the increased inflationary expectations of individuals and businesses, a consumer demand recovery, and rising food prices in the world market. As the pro-inflationary factors prevailed, inflation in annual terms increased from 3.6% in August to 4.9% in December 2020. Under such conditions,

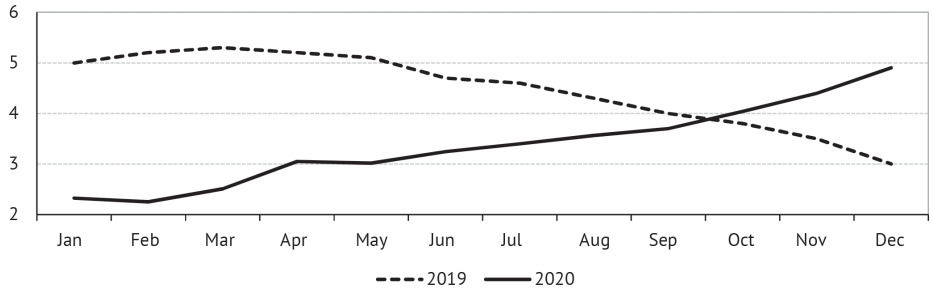

Fig. 6. The CPI growth rate in 2019–2020, % for the previous 12 months

Source: Rosstat; own calculations.

as noted earlier, the Bank of Russia took a pause in monetary policy easing by keeping the key rate unchanged.

Food inflation, after increasing in March and April 2020 to 1.0% and 1.7% in monthly terms, respectively, thereafter slowed down to 0.2% in May and June. In the July-September 2020 period, seasonal deflation was observed in the food sector. In the autumn, alongside climbing world food prices, Russian food products likewise rose in price. The leaders in price growth on the world market and Russia's domestic market were sugar (in Russia, + 64.5% in December 2020 relative to December 2019) and sunflower oil (+ 25.9% in December 2020 relative to December 2019). As a result, at the end of the year, food inflation in annual terms stood at 6.7% (vs 2.6% in December 2019 relative to December 2018) (*Fig. 7*).

In view of such a significant surge in the prices for several socially important foodstuffs, the RF Government decided, in December 2020, to freeze sugar and sunflower oil prices over the January-March 2021 period. According to our estimates, this measure is unlikely to significantly affect the price movement patterns, because it was adopted after the prices of these products had already jumped significantly.

Non-food inflation in annual terms increased from 2.4% in February to 4.8% in December 2020 (vs 3.0% in December 2019 relative to December 2018), which was due, in the main, to the ruble weakening, as well as the consumer demand recovery after the containment measures had been lifted. Over the course of 2020, the highest surge was demonstrated by the prices of pharmaceuticals (9.8%), tobacco products (8.2%), electrical goods and other household appliances (6.4%), Russian automobiles (9.4%), and foreign automobiles (10.3%).

According to the year-end results of 2020, prices for paid services provided to the population rose by only 2.7% (vs 3.8% at year end of 2019), because it was this sector that faced the most significant plunge in demand as a result of the containment measures. At the same time, prices for medical services (+ 4.3%) and resort and spa services (+ 3.8%) grew quite rapidly in response to a surge in demand triggered by the pandemic. The outbound tourism sector, on the contrary, demonstrated a deflation (-0.4% at year end of 2020).

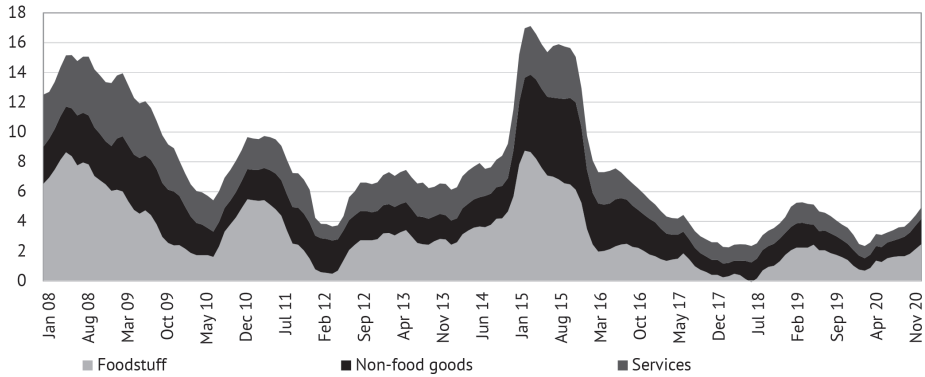

Fig. 7. The structure of inflation in 2008–2020 (%, month to the corresponding month of the previous year)

Source: Rosstat; own calculations.

Thus, core inflation (cleared of the effects of seasonal and administrative factors) grew steadily, to 4.2%.

In 2020, the key factor responsible for the downward pressure on consumer prices was shrinking demand, which resulted from real personal income decline, at the rate of -3.0% in 2020 (vs +1.7% in 2019). As a result, retail turnover likewise decreased significantly: -4.1% in 2020 vs +1.9% in 2019. Meanwhile, inflation acceleration was sped up by the ruble weakening. In 2020, the ruble fell 19.3% against the US dollar, to Rb73.9.

The rise in consumer prices in Russia was also contributed to by the climbing world food prices as a result of reduced supply. The food price index jumped from 91% in May 2020 to 107.5% in December 2020. Over the June-December 2020 period, world prices for dairy products gained 10.7%; prices for grain, 19.6%; prices for vegetable oils, 47.3%; and prices for sugar, 16.2%.[1]

The rapid growth of food and non-food prices pushed up the inflationary expectations of individuals and businesses. The first wave of increasing price growth expectations was observed in March-April 2020. Over the May-July period, the balance between the responses of managers of enterprises and individuals in a survey conducted by InFOM, pointed to the emergence of a downward trend in the expected price movement. However, from August onwards, individual inflationary expectations once again began to climb, rising by December 2020 to 11.5% (vs 9% in December 2019). The balance of responses received from enterprises also indicated a significant shift towards price growth, from 8.3 p.p. in January 2020 to 19 p.p. in December, as a result of a weakening ruble and rising costs. Growth in inflation expectations will contribute to a persistently elevated inflation rate in early 2021.

1 Data released by the Food and Agriculture Organization of the United Nations.

Table 4

The annual growth rate of prices for certain types of consumer goods and services in 2018–2020 (%, December relative to December of previous year)

	2018	2019	2020	2018–2020
CPI	**4.3**	**3.0**	**4.9**	**12.7**
Foodstuffs	**4.7**	**2.6**	**6.7**	**14.6**
Sugar	3.6	-30.8	64.5	17.9
Fish and seafood	3.7	5.2	5.2	14.8
Sunflower oil	1.8	-2.9	25.9	24.4
Milk and dairy products	2.9	6.1	3.6	13.1
Pasta	1.4	5.7	12.1	20.1
Bread and Bakery	5.2	6.3	7.3	20.0
Alcoholic beverages	1.3	1.2	2.8	5.4
Fruits and vegetables	4.9	-2.0	17.4	20.7
Cereals and legumes	1.2	15.2	20.1	40.0
Meat and poultry	9.7	0.2	2.7	12.9
Eggs	25.9	-5.0	15.1	37.7
Non-food goods	**4.1**	**3.0**	**4.8**	**12.4**
Gasoline	9.4	1.9	2.5	14.3
Tobacco products	10.1	11.0	8.2	32.2
Textiles	1.7	1.3	2.0	5.1
Washing and cleaning products	3.1	4.9	6.0	14.6
Footwear	1.9	1.2	1.2	4.4
Knitwear	2.5	2.4	2.0	7.1
Clothes and underwear	2.3	2.2	1.6	6.2
Pharmaceuticals	4.6	6.9	9.8	22.8
Services	**3.9**	**3.8**	**2.7**	**10.8**
Resort and spa services	3.8	3.1	3.8	11.1
Passenger transportation services	4.3	6.1	1.1	11.9
Medical services	4.3	3.8	4.3	12.9
Education services	8.4	5.6	1.9	16.6
Housing and amenities	3.7	4.3	3.6	12.1
Communications	2.4	4.2	3.1	10.0

Source: Rosstat.

Thus, as shown by the year-end results of 2020, under the influence of the pro-inflationary factors discussed earlier, inflation stood 0.9 p.p. above its target value (4%). Nevertheless, in the absence of new fiscal stimulus in 2021, consumer demand will remain at a modest level. Given the positive situation on the oil market coupled with the fiscal rule effects that sustain the ruble, any significant plunge in the ruble exchange rate is unlikely. In this connection we estimate that in H2 2021, inflation will stabilize near the target. In such a situation, the Bank of Russia in 2021 will begin to shift from monetary policy easing to a neutral monetary policy, which corresponds to the real key rate at the level of 1-2% per annum.

2.1.4. The balance of payments and the ruble exchange rate

According to the preliminary balance of payments estimates for 2020 released by the Bank of Russia, the current account balance amounted to $32.5 bn, which is 50% (or $32.3 bn in absolute terms) less than the corresponding figure for 2019.[1]

The goods trade balance amounted to $89.4 bn, which is 46% (or $76 bn in absolute terms) less than in 2019 ($165.3 bn) (*Fig. 8*). A decisive role in this decline was played by a shrinkage of exports by 22% (or $90 bn in absolute terms), from $419.9 bn in 2019 to $329.5 bn in 2020. This decline is primarily due to the downward movement of the average annual export prices of oil, petroleum products, natural gas, metals, and Russia's other main exports (*Table 5*). As a result, the share of fuel and energy complex products in the total export volume shrank from 56.9% in 2019 to 45.2% in 2020, which corresponds to the level of the late 1990s (*Fig. 9*). It should be noted that prices for some of Russia's main exports even increased; this was true of prices for grain, timber and vegetable oil, but the overall picture, nevertheless, remained unchanged.

Table 5

The movement of prices for Russia's main exports, in 2020 relative to 2019

Commodity group	Share in total exports, %	Average export price, USD/t		Price increase, %
		January-November 2020	January-November 2019	
Crude oil	22.0	301	454	-33.6
Petroleum products	13.5	321	471	-31.9
Natural gas *	7.3	123	190	-34.9
Ferrous metals	4.7	399	449	-11.3
Coal	3.7	63	78	-19.5
Wheat and meslin	2.3	209	201	+4.1
Natural gas, liquefied**	2.1	99	124	-19.7
Mineral fertilizers	2.1	203	246	-17.4
Timber	1.3	231	227	+1.9
Aluminum	1.3	1,573	1,691	-7.0
Copper	1.3	5,773	5,900	-2.2
Fish, fresh and frozen	0.9	1,645	1,825	-9.9
Vegetable oil	0.8	743	708	+4.9
Iron ores	0.6	75	97	-23.1
Nickel	0.5	13,119	13,696	-4.2
Synthetic rubber	0.4	1.261	1,596	-20.9

* price in US dollars per 1bn m3
** price in US dollars per 1,000 m3
Source: Federal Tax Service; own calculations.

The goods trade balance shrinkage, in addition to the downfall of exports, was also contributed to by declining imports (at a significantly more moderate rate, both in absolute and in relative terms), which over the course of 2020 lost 5.7% (or

1 *Bozhechkova A., Knobel A., Trunin P.* Balance of payments in 2019 // Russian Economic Development. 2019. V. 27. No. 3. P. 9–12.

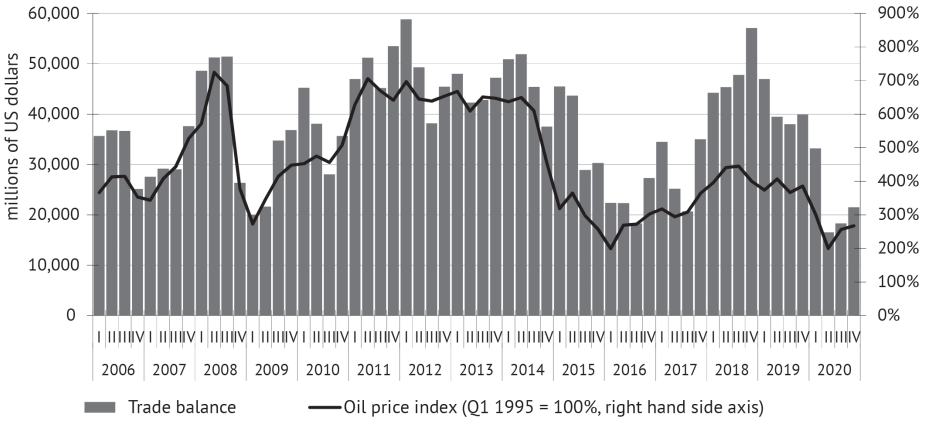

Fig. 8. Trade balance and the movement of oil prices

Source: Bank of Russia; IMF.

14.5% in absolute terms), shrinking from $254.6 bn in 2019 to $240.1 bn in 2020. The decline in imports of goods was caused primarily by the ruble weakening: according to the Bank of Russia data for 2020, the real effective exchange rate of the ruble against foreign currencies lost 7.8% on 2019.[1]

The deteriorating goods trade balance was in part offset by a significant improvement in the balance of trade in services: it amounted to only -$18.3 bn in 2020, which is 50% less in absolute terms than the corresponding index for 2019 (-$36.7 bn). At the same time, services exports fell by 28% (or by $ 5.7 bn in absolute terms, from $ 61.9 bn to $44.5 bn, as a result of a decreased inflow of foreign visitors into Russia and a decline in transportation services); and services imports (due in the main due to the curtailed travel of Russians abroad) shrank by 36%, from $98.7 to $62.8 bn.

In 2020, the balance of investment income and the balance of wages both changed very significantly. The former improved by $19.5 bn (from -$50 to -$30.5 bn), due in the main to a decrease of $32.3 bn in incomes payable (investment income repatriation), alongside a more moderate decline in incomes receivable (by $12.9 bn); and the latter lost $1.9 bn (sliding from -$3.6 to -$1.7 bn). These changes illustratively demonstrate that during a pandemic, when the national currency is weakening, foreign owners of the factors of production (capital and labor) are much less likely to actively repatriate their incomes generated by these factors.

Thus, the year 2020 once again confirmed that the current account balance of the Russian Federation is secure from any significant downfalls, let alone a shift into negative zone, because the national currency weakening in response

1 Concerning the effects of the exchange rate movement on trade, see *Knobel A., Firanchuk A.* Russia's foreign trade in January-August 2017 // Russian Economic Development. 2017. V. 24. No. 11. P. 12–18.

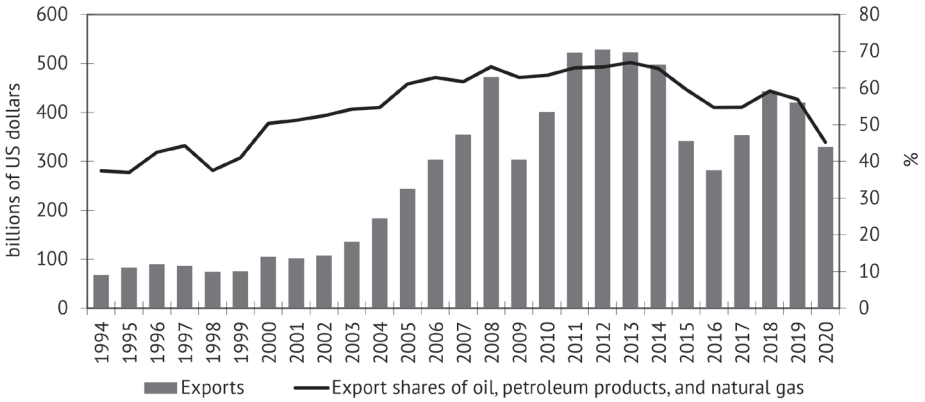

Fig. 9. The movement of goods exports and the export shares of products of the fuel and energy complex, 1994–2020

Source: Bank of Russia.

to declining prices for Russia's main exports translates into a shrinkage in the negative balances of both trade in services and factor income (generated from capital and labor). However, in 2020, it is the closure of borders and the nearly total halt in outbound tourism that contributed significantly to a less pronounced weakening of the ruble and the persisting current account surplus.

In 2020, the financial account deficit reached $49.9 bn, compared with a surplus of $3.9 bn in 2019. Net capital outflow was caused in the main by a shrinkage in foreign financial liabilities, by $43.1 bn in 2020 (while in 2019, foreign financial liabilities increased by $28.7 bn), and by a slight growth displayed by foreign financial assets ($6.8 bn in 2020 vs $24.8 bn in 2019).

The liabilities to non-residents were reduced as a result of operations carried out in 2020 by the banking sector and the other sectors, to the total value of -$25.8 and -$20.3 bn, respectively (vs -$19.8 and +$25.2 bn in 2019, respectively). The amount of foreign portfolio investments in the other sectors decreased by $14.1 bn (vs -$4.2 bn in 2019); the volume of foreign loans and borrowings decreased by $8.3 bn (vs -$6.2 bn in 2019); other liabilities to non-residents increased by only $0.7 bn (vs $6.7 bn in 2019). Foreign direct investment in the other sectors increased by $1.4 bn in 2020 (vs $28.9 bn in 2019).

As seen by the year-end results of 2020, the volume of government bodies' liabilities to non-residents increased by $3.9 bn (vs $22.0 bn in 2019). As of January 1, 2021, the share of non-residents in the OFZ market dropped to 23.3%, while at the beginning of the previous year it had been 32.2%. The reduction in foreign liabilities was due, most likely, to the high uncertainty as to the development prospects of the global economy and Russia's domestic economy: the attraction of non-residents' investment in Russian assets is becoming less rewarding both for Russian and foreign economic agents.

The growth of financial assets of Russian residents abroad occurred predominantly due to operations in the non-banking sector. Thus, for example, in 2020, the foreign assets held by the other sectors increased by $13.9 bn (+$26.5 bn in 2019). The growth of foreign assets in the other sectors resulted from increasing outgoing direct investments ($6.3 bn in 2020 vs $22.6 bn in 2019), outgoing portfolio investments ($10.2 bn in 2020 vs $2.3 bn in 2019), and trade loans and trade advances ($7.9 bn in 2020 vs $9.6 bn in 2019). The amount of foreign assets held by banks shrank by $7.9 bn (vs $2.1 bn in 2019). The foreign assets held by government administration bodies increased by $0.9 bn (vs +$0.5 bn in 2019).

As a result, net capital outflow from the private sector in 2020 fell sharply, to $47.8 bn (vs $22.1 bn in 2019) (*Fig. 10*). At the same time, in 2020, net capital outflow from the banking sector amounted to $17.9 bn, which corresponds to the level of 2019 when this index stood at $17.7 bn. In the non-banking sector, net capital outflow significantly increased, to $30.0 bn (vs $4.3 bn in 2019).

The excess of capital outflow in the financial account over the positive current account balance was offset by a shrinkage in international reserve assets, in the amount of $13.8 bn (vs +$66.5 bn in 2019). The decline in forex reserves was the upshot of foreign currency sales carried out by the Bank of Russia from March 2020 onwards by way of complying with the fiscal rule, because the oil price fell below the cutoff price. Overall for 2020, the volume of foreign currency sales by the RF Ministry of Finance in the domestic forex market amounted to approximately $22.7 bn, including the currency needed to pay for the government stakes in Sberbank PJSC and Aeroflot PJSC. It should be noted that over the August-September 2020 period, in connection with the Sberbank deal, the RF Central Bank offset the foreign currency residuals earmarked for sale against all the foreign currency purchases and sales that had been deferred since 2018. The balance of these transactions amounted to approximately $2.4 bn. The regulator

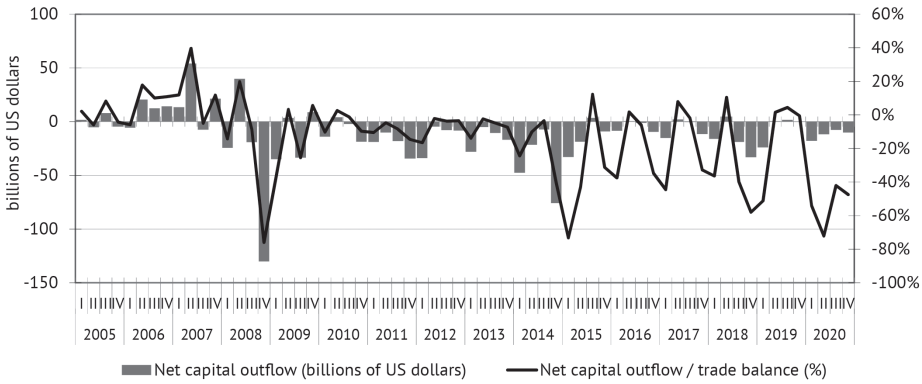

Fig. 10. Net capital outflow from the private sector, 2005–2020

Source: Bank of Russia; own calculations.

then gradually sold this excess currency in equal amounts over the course of Q4 2020 alongside its regular currency sale operations under the fiscal rule.

As mentioned earlier, in 2020 the ruble exchange rate against the US dollar fell by 19.3%, to Rb73.9. The first plunge occurred in March 2020 (16%), it was caused in the main by the sharp drop in oil prices. The ruble's second depreciation peak was observed in September 2020 (6.8%). It had to so with the intensification of geopolitical risks coupled with the diminishing attractiveness of Russia's OFZs for non-residents in the context of a reducing key rate and waning investor interest in the assets available in the developing countries in a situation of global uncertainty. Over the November-December 2020 period, in response to improved terms of trade, the ruble appreciated by 6.9% relative to October 2020.

It should be noted that in 2020, the ruble lost more in nominal terms against the US dollar than the national currencies of many other developing countries where inflation is targeted. Thus, in 2020, while in South Africa and Mexico the decline of the national currency's nominal effective exchange rate amounted to 4.7% and 5.9%, respectively, Russia's national currency plunged by 19.3% (*Fig. 11*). As of year-end 2020, the leaders in terms of national currency weakening were Brazil and Turkey (28.9% and 23.1%, respectively). Meanwhile, the currencies of some other developing countries strengthened slightly (2.1%, Chilean peso; 1.0%, Polish zloty).

In 2020, the foreign debt of the Russian Federation decreased by $21.3 bn, amounting to $470.1 bn as of January 1, 2021. The foreign debt of government administration bodies decreased by 5.5% to $66.1 bn, as a result of foreign capital outflow from the Russian OFZ market. The foreign debt of banks and enterprises decreased by 4.1%, to $391 bn.

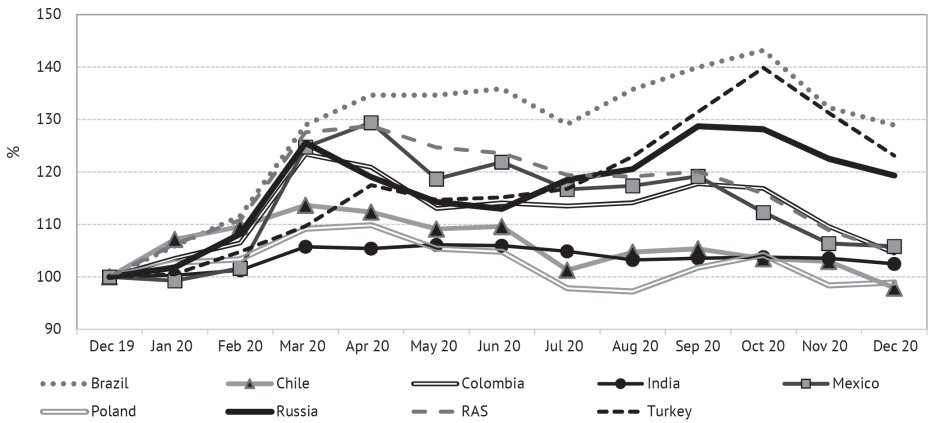

Fig. 11. The movement of nominal effective exchange rates of national currencies in the developing countries targeting inflation (December 2018 = 100%)

Source: IMF; own calculations.

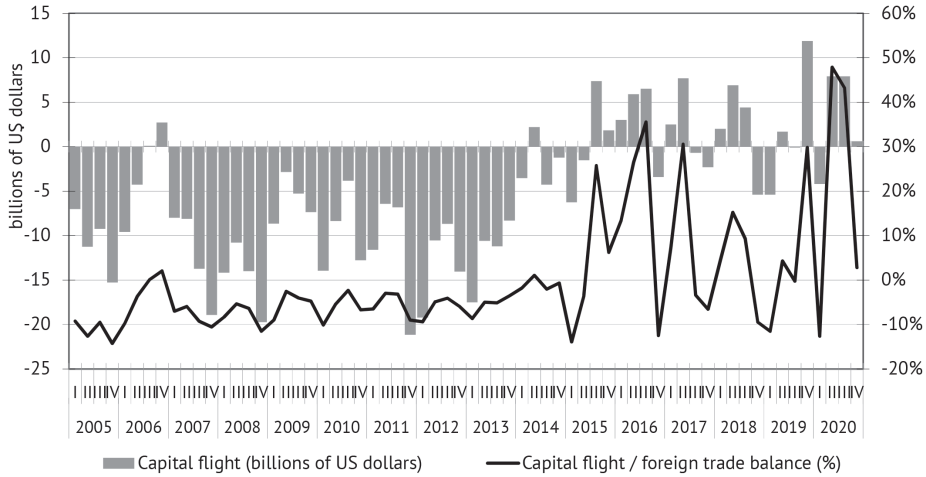

Fig. 12. Capital flight dynamics, 2005–2020.

Source: Bank of Russia; own calculations.

Our year-end estimate of capital flight for 2020 (*Fig. 12*) is $ 12.2 billion, which represents an increase of 50.6% on 2019[1] and reflects the success of Russia's authorities in blocking illegal channels of capital flight.

* * *

For 2021, as the epidemiological risks are expected to recede and the global economy to recover, we predict an increase in the current account surplus following the upward movement of prices for energy carriers, in spite of a possible recovery in imports. In addition, a gradual risk premium decline will conduce to the inflow of capital into the Russian market. As the oil price is expected to climb above the cutoff level in 2021, reserve assets will increase in response to the operations under the fiscal rule. As of the beginning of 2021, the ruble's fundamentally substantiated exchange rate against the US dollar was Rb68–69, which means that it was undervalued by 7–9%.[2] Thus, during 2021, the ruble may strengthen to this level, but this will happen only in absence of new economic and geopolitical shocks.

1 Capital flight is calculated according to the IMF methodology; it is the sum of 'trade loans and advance payments', 'questionable deals', and 'net errors and omissions'.
2 For more details, see *Bozhechkova A.V., Sinelnikov-Murylev S.G., Trunin P.V.* Factors of the Russian ruble exchange rate dynamics in the 2000s and 2010s // Voprosy Ekonomiki., 2020, No. 8, pp. 1–18.

2.2. Fiscal policy[1]

2.2.1. The characteristic features of budgets across the RF budget system

The Basic budget parameters of the RF budget system

The budget system revenues of the Russian Federation in 2020 shrank by Rb3.4 trillion in real terms compared to the previous year, or by 8.6% at constant prices (*Table 6*) on the back of reduced oil and gas revenues. For this reason, the proportion of oil and gas revenues in the total budget revenues of the enlarged government declined in 2020 to 13.1% against 20.9% in 2019. For non-oil and gas revenues, there is a slight increase of Rb118.0 bn or by 0.4% in constant prices, which was achieved during the crisis on the back of the transfer to the federal budget of the Bank of Russia profit obtained from the sale of equity stake in Sberbank (reflected under other income). In the total revenue side of the expanded government's budget, the federal budget revenues decreased to 49.4% in 2020, compared to 51.1% in 2019.

Table 6

Basic parameters of the RF enlarged government in 2019–2020

	2019		2020		Deviation, 2020 to 2019		
	Rb bn	% of GDP	Bn Rb	% of GDP	Rb bn (in 2019 prices)	In constant prices*, %	p.p. of GDP
Revenue, including:	**39 497**	**36.0**	**37 857**	**35.5**	**-3 412**	**-8.6**	**-0.5**
- oil and gas revenue	8 248	7.5	4 950	4.6	-3 530	-42.8	-2.9
-non-oil and gas revenue	31 249	28.5	32 907	30.9	118	0.4	2.4
Expenditure	**37 382**	**34.0**	**42 151**	**39.5**	**2 796**	**7.5**	**5.5**
Deficit (-) /Surplus (+)	**2 115**	**2.0**	**-4 294**	**-4.0**	**-6 208**	**–**	**-6.0**
For reference: GDP, billions of rubles	*110 046*		*106 607*				

* According to the consumer price index.
Sources: Ministry of Finance of Russia, Federal Treasury, Rosstat, own calculations.

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Expenditures of the Russian budget system increased by Rb2.8 trillion in real terms or by 7.5% compared to the previous year. In the total expenditure of the enlarged government budget, federal budget expenditures amounted to 56.6% in 2020 against 51.7% in 2019. The budget deficit of the enlarged government for January-December 2020 increased by Rb6.2 trillion in real terms relative to the budget surplus received at the end of 2019 and amounted to around Rb4.3 trillion, mainly due to the negative balance of the federal budget worth of Rb4.1 trillion.

The Main Tax Receipts in the RF Budget system

Revenues from all major taxes and duties dropped, with the exception of personal income tax and excise taxes (*Table 7*). The largest decrease occurred in customs duties and fees (a drop of more than 60% in real terms), the Mineral Extraction Tax (MET) (by almost 40%), and income tax (by 16%). For insurance premiums and VAT, receipts in 2020 declined slightly.

Table 7

The main tax receipts in the enlarged government budget of the Russian Federation in 2019–2020, RB bn

	2019	2020	Deviation, 2020 to 2019 in prices of 2019%
Corporate profit tax	4 541	4 018	-15,6
PIT	3 900	4 253	4,0
Insurance contributions*	7 292	7 329	-4,2
VAT	7 088	7 202	-3,1
Excises	1 363	1 935	35,4
MET	6 106	3 954	-38,3
Customs duties and fees	3 000	1 148	-63,5

* Minus contributions for non-working population.
Sources: MMinistry of Finance of Russia (operational data), Federal Treasury, own calculations.

Oil and gas revenues. The base rate of the mineral extraction tax (MET) on crude oil was maintained at Rb919 per ton, as in 2019. the dollar exchange rate and the oil price were the main factors of the MET dynamic.

On average for 2020, the price of Urals crude oil demonstrated a sharp drop (*Fig. 13*): in particular, in April 2020, it stood at around $16 bbl, which was due to a drop in oil demand amid the introduction of quarantine measures and an increase in supply owing to the collapse of the OPEC+ deal. Considering the fact that already at $15 bbl, the MET rate (according to the formula for calculating it) becomes zero, in April 2020, an all-time record was set – the minimum value of the ruble MET rate of Rb334 per ton of oil. The weakening of the ruble, which accompanied the fall in oil prices, somewhat smoothed out the loss of oil and gas revenues.

Corporate profit tax. The decline in income tax receipts was triggered by a general decline in business activity during the crisis. According to Rosstat, the income of profitable enterprises in 2020 in 2019 prices amounted to more than

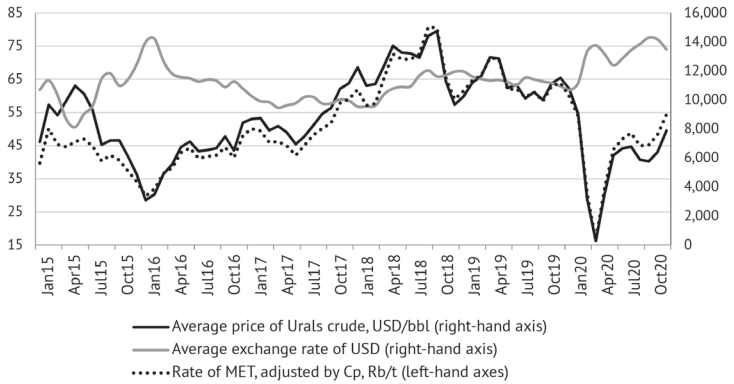


Fig. 13. The dynamic of the actual rate of MET, prices of Urals, and the exchange rate of USD in 2015–2020

80% of the 2019 level. The hardest hit industries in terms of reduced profit volumes were transportation and shipping operations (20-40% of the 2019 profit) and mining (60-80%). This being said, we should not expect a rapid recovery of income tax revenues, since in 2020 there was an accumulation of retained losses of enterprises – its level in constant prices has increased by about 2.5-fold compared to 2019.

Payroll taxes. In 2020, the payroll fund as the main tax base for insurance contributions and personal income tax in 2019 prices did not practically drop. According to the Q1 2020 results, the growth of the payroll fund in comparison with Q1 2019 continued, and the fall in Q2 2020 was recouped in Q3 and Q4 (the payroll fund in these 2 quarters at constant prices was approximately at the level of the previous year).

At end-2020, the payroll fund in construction, tourism and public catering did not fully recover (up to a third of the drop in constant prices), while the payroll fund increased in the sectors related to financial services, information technology and communications, as well as real estate transactions.

Value added tax (VAT). Total VAT receipts in 2020 decreased only slightly relative to the 2019 level. Furthermore, the decrease slightly affected both VAT on imported goods (-1.4% from the level of 2019) and on goods sold in the country (-4.3% from 2019). Retail turnover at comparable prices in Q1 2020 amounted to 104.4% from the level of the corresponding quarter of 2019, in Q2 – 84%, in Q3 – 98.4%. A full recovery in the level of retail turnover did not happen at the end of Q4 (97.2%), so the recovery of VAT receipts should be expected no earlier than the end of 2021.

Excises. Excise tax receipts from tobacco products in 2020 showed a positive trend compared to the previous year, although excise tax rates were increased only by the target inflation rate, and the total market volume continued to decline. In 2018-2019, as a result of a significant increase in the volume and share of the illegal tobacco market (up to 8.5% and 15%, respectively), excise tax receipts decreased for the first time in a decade. In 2020, due to the restrictive

border crossing measures taken to face the COVID-19 pandemic, a significant part of the smuggling channels was "covered up", as a result of which, according to preliminary estimates, the share of illegal traffic decreased to 7.5%. As a result, budget revenues generated by excises on tobacco products have almost recovered to the 2018 level. At the same time, it is worth noting the increase in the proportion of the heated tobacco segment in the total structure of all tobacco excise taxes: if in 2017 it was less than 1%, then in 2020 it reached 5%. The tax collection rate in this segment is almost 100% owing to the full control of this market segment by major players, which is stemming from the technological complexity of the product.

Total revenues from alcohol products increased in 2020, but not in the same way as projected in the context of the expected deviations in the consumption structure induced by the COVID-19 pandemic. That said, the dynamic broken down by segments is ambiguous.

From the point of view of tax collection, the best situation is in the beer market: the consolidated budget revenues from excise taxes on beer in 2020 amounted to Rb173 bn, and the input of beer to the structure of proceeds from excise taxes on alcoholic beverages exceeded 40%.

In recent years, the input of excise taxes from wine to the total income from excise taxes on alcoholic beverages has been growing: if in 2016 it was 3.5%, then by the end of 2020 it was already 6.2%, while budget revenues amounted to Rb26.5 bn. In 2020, the structure of taxation in the wine market changed: rates for wine beverages increased markedly, while domestic wine producers from homeland grapes gained a relative tax advantage. Despite the general increase in the rate, the collection rate remains at a high level.

Budget revenues from strong alcoholic beverages in 2020 remained almost at the 2019 mark and amounted to Rb224 bn. At the meantime, the excise tax collection in this segment fell slightly, but was offset by an increase in the excise rate and an overall increase in the consumption of strong alcohol products.

The Expenditure Side of the RF Budget system

Expenditures of the budget system of the country markedly increase in real terms in 2020 – up by 7.5% or by Rb2.8 trillion compared to the previous year (*Table 8*).

The major growth in expenditures in 2020 compared to the previous year is noted in the sections that provide funding for measures to reduce the social and economic risks associated with the pandemic, including (growth in constant prices): *Social policy* (Rb1,055.5 bn, or 8.1%), *Healthcare* (Rb918.5 bn, or 24.2%), *National economy* (Rb586.3 bn, or 11.3%). In real terms, a slight decrease is observed only in expenditures on financing national issues, housing and communal amenities, culture and cinematography. The real budget execution exceeded the annual budget allocations initially approved for 2020 at all levels of the budget system and amounted to (in nominal terms): according to the federal budget Rb2,780.8 bn, according to the state extra-budgetary funds Rb1,147.5 bn, and according to the consolidated budget of the subjects of the Russian Federation Rb767.4 bn.

Table 8

Enlarged government budget expenditure in 2019–2020

	2019		2020		Deviation, 2020 to 2019		
	Rb bn.	% of GDP	Rb bn	% of GDP	Rb bn (in 2019 prices)	In constant prices, %	p.p. of GDP
Expenditure total, including:	**37 382,2**	**34,0**	**42 150,9**	**39,5**	**2 796,2**	**7,5**	**5,5**
Nationwide issues	2 234,8	2,1	2 251,6	2,4	-88,6	-4,0	0,3
National defense	2 998,9	2,7	3 170,7	3,0	23,4	0,8	0,3
National security and law enforcement activity	2 233,6	2	2 392,4	2,2	46,8	2,1	0,2
National economy	5 171,8	4,8	6 040,8	5,7	586,3	11,3	0,9
Housing and community amenities	1 574,9	1,4	1 590,5	1,5	-58,8	-3,7	0,1
Environmental protection	250,3	0,2	303,9	0,3	39,4	15,7	0,1
Education	4 050,6	3,7	4 324,0	4,1	71,0	1,8	0,4
Culture, cinematography	587,9	0,5	610,1	0,6	-6,4	-1,1	0,1
Healthcare	3 789,7	3,5	4 939,4	4,6	918,5	24,2	1,1
Social policies	13 022,8	11,9	14 769,5	13,7	1 055,5	8,1	1,8
Physical culture and sports	375,4	0,3	400,7	0,4	6,5	1,7	0,1
Mass media	156,1	0,1	173,7	0,2	9,5	6,1	0,1
Government and municipal debt servicing	835,4	0,8	883,5	0,8	6,8	0,8	0,0

Sources: Finance Ministry of Russia (operational data), Federal Treasury, own calculations.

The Russian government relief package in 2020-2021 is worth almost Rb 4.8 trillion[1] or 4.6% of GDP, which is slightly lower than the level of the stimulus support in the OECD and BRICS countries (*Fig. 14*). The Russian practice of using various instruments of state support, with due regard for the real needs of businesses and households, has proved its effectiveness. Thus, the Russian economy ended 2020 with the least losses: Russian GDP for the year contracted by 3.1%, while in the figures presented in *Fig. 14*, GDP in developed countries shrank from 3.7% to 11.2%, and in India, Brazil and South Africa from 4.5% to 9.6%.

The Russian government approaches to the implementation of the anti-crisis policy are generally consistent with the practice of developed economies in prioritizing support areas and individual decisions, while having a fairly

1 The budget allocations appropriated by the corresponding Decrees of the Government of the Russian Federation as part of the stimulus policy implementation, the maximum amount of state guarantees envisaged, the assessment of tax expenditures, and the off-balance-sheet recapitalization of VEB.RF and Sberbank of Russia (by converting credit obligations into equity); excluding deferred income, as well as measures of the National Plan that are not included in the relief packages.

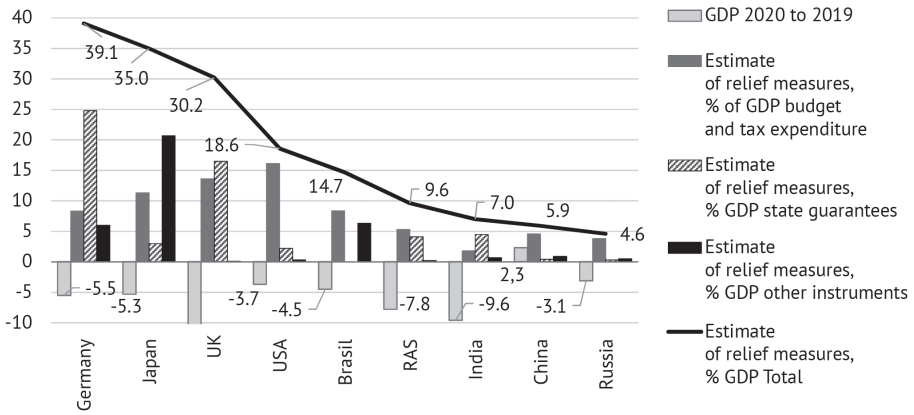


Fig. 14. The volume of relief programs (% of GDP) and GDP growth rates in 2020 in certain countries of the world

Sources: IMF data (January 2021), own calculations.

high social focus of direct budget incentives. A common feature of all national social protection programs is that budget support is provided to a wide range of recipients, not just the unemployed and the needy. In Russia, spending on household income support under the relief measures program accounted for almost half of the total amount of direct budget incentives, and social transfers to households account for one third of the total amount of anti-crisis response tools used by the Government of the Russian Federation. In general, according to the results of the implementation of the enlarged government budget in 2020, expenditures on social security and other payments to the population amounted to Rb16.6 trillion (Rb14.6 trillion in 2019).

No less significant in terms of the amount of budget resources allocated to the anti-crisis policy in Russia was the support of business (slightly less than 30% of the total budget expenditures of all three relief packages). The most "costly" measure of direct assistance to the private sector of the economy in 2020 was the provision of grants to SMEs in the hardest hit sectors for the payment of wages and salaries and other urgent tasks (Rb104 bn). Total expenditures of the enlarged government budget in 2020 for providing subsidies to enterprises of the real sector of the economy[1] and state-owned companies amounted to Rb2.4 trillion and Rb0.8 trillion, respectively (in 2019 – 2.0 and 0.5 trillion rubles, respectively)

Support for the national public health system - an uncharacteristic direction of anti-crisis policy in previous economic crises - was provided in all countries. The main response of the governments was the appropriation of additional budget allocations for the material equipment of public health institutions to combat the spread of COVID-19, the promotion of employees of public health

1 Legal entities (except non-commercial organization), individual entrepreneurs, individuals – producers of goods, works, and services.

institutions (in monetary and other forms), as well as experimental development and research. The scale of fiscal stimulus in this area is diverse: from 1.5% of GDP in the UK and the US to 0.5% of GDP in Australia or 0.3% of GDP in Sweden and New Zealand. The government of the Russian Federation in the context of the pandemic has allocated almost Rb340 bn to support the public health system. Most of these funds went to additional payments to medical and social workers who work with coronavirus patients. As a result, the budget expenditures of the enlarged government in 2020 rose in real terms compared to the previous year in the following areas of the *Public Health* program: for sanitary and epidemiological well-being by more than 2-fold (up to Rb70.9 bn), for providing emergency medical care by 1.8-fold (up to Rb55.0 bn), for inpatient medical care by 53.2% (Rb43.7 bn); the largest increase occurred in the subsection "other issues in the field of public health" by Rb493.8 bn.

The volume of productive spending of the enlarged government budget in 2020 was to the tune of Rb13.8 trillion in nominal terms, compared to Rb11.9 trillion a year earlier. The growth of productive spending in 2020 compared to the previous year is observed in almost all subsections, including (in nominal terms): *Healthcare* (Rb1,149.7 bn), *Public Roads* (Rb193.2 bn), *Transportation* (Rb123.2 bn). In general, the share of productive spending in the structure of the enlarged government budget expenditures showed an uptick up from 31.8% in 2019, up to 32.7% in 2020, which can be estimated as a continuation of the budget maneuver launched since the implementation of national projects.

The Debt of the RF Budget System

The revenue shortfall and the need to finance additional spending on anti-crisis relief measures led to unprecedented public borrowing, carried out mainly by the federal budget. By itself, the level of the debt burden stays at a safe level (less than 20% of GDP), however in the context of the emerging trend towards a reduction in oil and gas revenues of the budget system, the question of fiscal consolidation inevitably arises, which implies either a reduction in the expenditure side of the budget or an increase in taxes. In the absence of fiscal consolidation and while

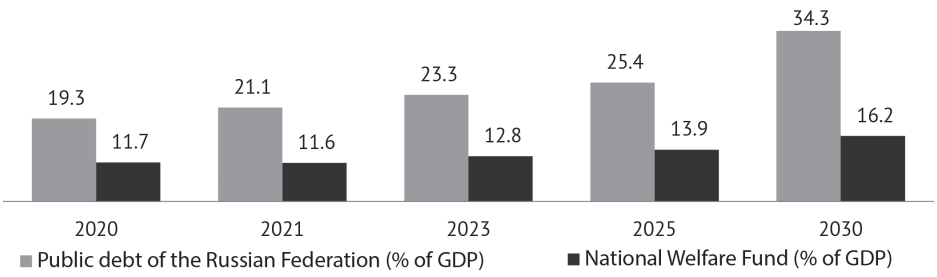


Fig. 15. The volume of public debt of the Russian Federation and the National Welfare Fund

Sources: Finance Ministry of Russia, own calculations.

maintaining the current fiscal policy, the public debt (according to calculations made on the data of the long-term budget forecast of the Ministry of Finance of the Russian Federation as of October 2019) and the "Main directions of budget, tax and customs and tariff policy for 2021 and the planning period of 2022 and 2023" of October 2020) may grow from 19.3% of GDP at the end of 2020 to 34.3% of GDP by the end of 2030 (*Fig. 15*). This being said, there will be an increase in debt service costs from 1.1% of GDP in 2020 to 2.0% of GDP in 2030. Furthermore, the increase in public debt will not be offset by a corresponding increase in the balance of funds in the NWF – the ratio of funds accumulated in the NWF to the amount of public debt will fall from 60% (at end-2020) to 47% (at end-2030).

2.2.2. The Characteristic Features of the Federal Budget

In 2020, in real terms the federal budget revenues decreased by 11.7% at constant prices compared to the corresponding period in 2019 (*Table 9*), and cash execution hit 90.8% of the approved forecast volumes for 2020. The largest reduction (2020 to 2019) in real terms is noted for oil and gas revenues of the federal budget by Rb3.5 trillion, or by 42.8%. At end-2020, the basic volume of oil and gas revenues amounted to Rb4.9 trillion.[1]

Table 9

The main parameters of the RF budget system in 2019–2020

	2019	2020			Change, 2020 to 2019	
	Real	Law of FB for 2020*	Law of FB for 2020 with amendments**	Fact	Rb bn (in 2019 prices)	In constant prices, %
Revenue, including:	**20 188.8**	**20 379.3**	**20 593.6**	**18 699.3**	**-2 363.0**	**-11.7**
- oil and gas	8 247.7	7 472.2	7523.8	4 950.2	-3 528.7	-42.8
- non-oil and gas	11 941.1	12907.1	13069.8	13 749.1	1 165.8	9.8
Expenditure, including:	**18 214.2**	**19 503.9**	**19 666.0**	**22 812.7**	**3 532.9**	**19.4**
- interest expense	730.8	896.9	896.9	784.2	16.8	2.3
- non-interest expense	17 483.4	18 607.0	18 769.1	22 028.5	3 516.1	20.1
Budget surplus (deficit)	**1 974.6**	**875.4**	**927.6**	**-4 113.4**	**-5 895.9**	**–**
Non-oil and gas deficit	-6 273.1	–	–	-9 063.6	-2 367.1	–

* Federal Law dated December 2, 2019 No. 380-FZ "On the Federal Budget for 2020 and the planned period 2021 and 2022".
** Federal Law dated March 3, 2020 No. 52-FZ "On Amendments in the Federal Law 'On the Federal Law for 2020 and the planned period 2021 and 2022' ".

Sources: Finance Ministry of Russia, Federal Treasury, 2020 GDP – Rosstat estimate, own calculations.

In 2020, non-oil and gas revenues of the federal budget went up by Rb1.2 trillion, or by 9.8% in real terms compared to the previous year, mainly in consequence of the aforementioned transfer of the central bank's profit from the sale of the Sberbank equity stake.

Federal budget expenditures in 2020 rose by Rb3.5 trillion compared to the previous year, or by 19.4% in real terms (*Table 10*). The cash execution of the

1 Including the reimbursement of excise.

federal budget in 2020, taking into account budget assignments distributed without amendments to the federal law, stood at 95.8% (in 2019 – 94.2%).

Table 10

Federal budget expenditure in 2019–2020

	2019		2020		Deviation, 2020 to 2019		
	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn (in 2019 prices)	In constant prices, %	p.p. of GDP
Nationwide issues	**18 214.2**	**16.5**	**22 812.7**	**21.4**	**3 532.9**	**19.4**	**4.9**
National defense	1 363.5	1.2	1 502.4	1.4	68.7	5.0	0.2
National security and law enforcement activity	2 997.4	2.7	3 167.8	3.0	22.4	0.7	0.3
National economy	2 083.2	1.9	2 225.5	2.1	38.3	1.8	0.2
Housing and community amenities	2 827.1	2.6	3 483.8	3.3	494.0	17.5	0.7
Nationwide issues	282.2	0.3	370.0	0.3	70.5	25.0	0.0
Environmental protection	197.5	0.2	260.6	0.2	50.9	25.8	0.0
Education	826.5	0.7	956.7	0.9	85.5	10.3	0.2
Culture and cinematography	122.4	0.1	143.9	0.1	14.8	12.1	0.0
Healthcare	713.0	0.6	1 334.5	1.3	559.2	78.4	0.7
Social policies	4 882.8	4.4	6 991.0	6.6	1 781.6	36.5	2.2
Physical culture and sports	81.4	0.1	75.2	0.1	-9.7	-11.9	0.0
Mass media	103.5	0.1	121.1	0.1	11.9	11.5	0.0
Government debt servicing	730.8	0.7	784.2	0.7	16.8	2.3	0.0
Intergovernmental fiscal transfers	1 003.1	0.9	1 395.9	1.3	327.6	32.7	0.4

Sources: Finance Ministry of Russia (operational data), Federal Treasury, own calculations.

The largest growth (2020 to 2019) is registered in expenditures related to supporting the economy and social sphere in the wake of the pandemic, including the sections (in real terms): "Social policy" by Ки 1,781.6 bn (36.5%), *National economy* by Rb494.0 bn (17.5%), *Healthcare* by Rb559.5 bn (78.4%), and *Intergovernmental fiscal transfers* by Rb327.6 bn (32.7%).

In 2020, Federal budget expenditures on the implementation of national projects in real terms shot up by Rb446.7 bn, or by 27.9% compared to the previous year (*Table 11*). At the same time, the cash execution accounted for 97.4% of the approved annual assignments, which is 6.0 p.p. higher than the cash execution for the same period in 2019, and the improvement in cash execution of national projects is marked for most of them. At the same time, it should be noted that expenditures on national projects in 2020 were disbursed rather erratically: for example, as of December 1, 2020, the level of cash execution of federal budget

expenditures on national projects stood at only 78%. However, at the year-end, the level of disbursement of funds for national projects exceeded the cash execution for the expenditure side of the federal budget as a whole.

Table 11

The main parameters of the federal budget execution across national projects

	2019		2020		Deviation, 2020 to 2019	
	Rb bn	Cash execution, %	Rb bn	Cash execution, %	Rb bn (in 2019 prices)	In constant prices, %
Expenditure, total, including:	**18 214.2**	**94.2**	**22 812.7**	**95.8**	**3 532.9**	**19.4**
Across national projects, total, including:	*1601.8*	*91.4*	*2149.1*	*97.4*	*446.7*	*27.9*
Demography	498.4	95.5	689.6	98.0	158.9	31.9
Healthcare	157.2	98.0	295.7	96.1	124.7	79.3
Education	98.8	91.0	114.9	86.4	10.7	10.9
Culture	14.0	99.0	15.8	98.4	1.1	7.6
Science	37.6	99.1	40.3	99.2	0.8	2.2
Housing and Urban Environment	98.9	93.8	168.7	99.7	61.9	62.6
Ecology	36.9	66.3	63.1	97.6	23.2	63.0
Small and Medium-Sized Businesses and Support for Individual Entrepreneurs	56.4	93.1	61.7	96.9	2.4	4.3
International Cooperation and Exports	78.2	89.1	70.4	97.5	-11.1	-14.2
Digital Economy of the Russian Federation	73.8	73.3	86.3	97.0	8.5	11.5
Productivity and Employment Support	6.2	87.1	4.0	98.7	-2.4	-38.5
Safe and Quality Roads	138.4	97.1	155.7	98.7	10.0	7.2
Modernization of Infrastructure	306.4	88.0	382.6	99.4	58.3	19.0
Share of spending on NP in the overall volume of federal budget expenditure, %	8.8	–	9.4	–	–	–

Sources: Federal Treasury, own calculations

The share of spending on national projects in the total volume of federal budget expenditures in 2020 rose to 9.4% against 8.8% in 2019, which indicates a slight uptick in the proportion of productive expenditures in the federal budget. In real terms, the volume of funding for projects in 2020 increased: *Healthcare* up by 79.3%, *Ecology* up by 63.0%, *Housing and Urban Environment* up by 62.6%. Reduction in funding in 2020 in real terms compared to 2019 is registered solely

for the projects *Productivity and Employment Support* and *International Cooperation and Export* up by 38.5% and 14.2%, respectively, which is mainly owing to the spending planning features.

The federal budget deficit in January-December 2020 hit Rb4,113.4 bn against a surplus of Rb1,974.6 bn for the same period in 2019, respectively, the non-oil and gas deficit spiked from Rb6,273.1 bn Rb9,063.6 bn. As for the federal budget cash flow taken as sources of covering the budget deficit, one should note that in 2020 Rb5,176.3 bn were raised on the domestic market, with the planned volume of bond placement of Rb2,324.8 bn, the volume of borrowings on the foreign market amounted to Rb180.6 bn and the volume of repayment came to Rb 81.2 bn (planned volumes – Rb207.2 and Rb343.1 bn, respectively).

As of January 1, 2021, the volume of public domestic debt amounted to Rb14,751.4 bn (including state guarantees to the tune of Rb695.2 bn), the volume of public foreign debt amounted to $56.7 bn.

In 2020, the volume of the NWF funds in ruble terms climbed from Rb7.8 trillion (or $125.6 b) to Rb13.5 trillion ($183.3 billion), including owing to the transfer of additional oil-and-gas revenues formed at end-2019 and currency revaluation. The amount of the NWF funds allocated to finance the federal budget deficit in 2020 amounted to only Rb289.8 bn. In other words, the NWF funds were unused as part of the Russian Government's anti-crisis relief package

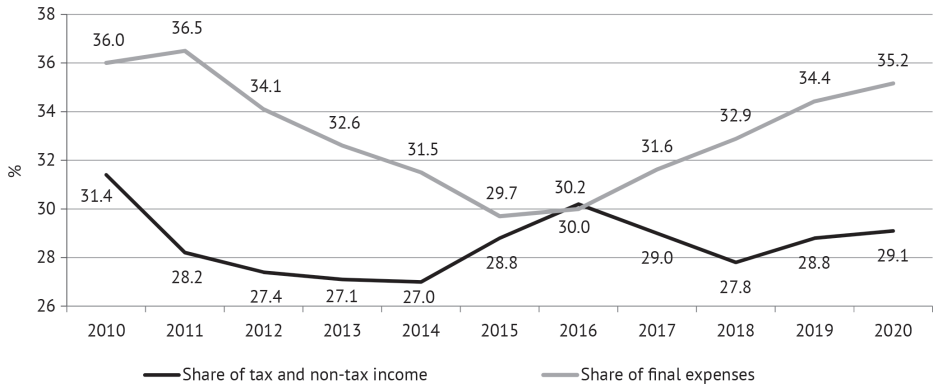
2.2.3. Intergovernmental relations and subnational finance

The Main Parameter of the Consolidated Budgets of the RF subjects

The main trends in relations between different levels of government are reflected in the structure of revenues and expenditures of the consolidated budgets of the subjects of the Russian Federation. *Fig. 16* exhibits the data reflecting the proportion of tax-generated and non-tax revenues and final expenditures of the consolidated budgets of the subjects of the Russian Federation in the total amount of tax-generated and non-tax revenues and expenditures of the consolidated budgets of the Russian Federation and state extra-budgetary funds.

Since 2021, the share of the tax-generated and non-tax revenues of the sub-federal level in the corresponding budget revenues of the enlarged government has varied in the range from 27% to 30%. The relative stability of this index can be explained by the synchronicity of the reaction of federal and regional tax-generated revenues to changes in external and internal factors. The crisis year of 2020 was no exception: the share of tax-generated and non-tax revenues of consolidated regional budgets in the tax-generated and non-tax revenues of the budget system of the Russian Federation in 2020 exhibited a slight uptick compared to 2019 - from 28.8% to 29.1%, which derives from a relatively smaller reduction in regional income compared to the federal one.

The share of final expenditures of regional and local budgets in the expenditures of the budget system of the Russian Federation demonstrated a slight uptick from



Note. In order to ensure comparability of the data for the reviewed period and to avoid double counting, the data on the budget parameters of the budget system of the Russian Federation, as well as the expenditures of the consolidated budgets of the subjects of the Russian Federation, were adjusted granting the insurance premiums for mandatory health insurance of the unemployed population.

Fig. 16. The share of tax-generated and non-tax revenues and subnational budget expenditures in the revenue and expenditure of the budget system of the Russian Federation in 2010–2020

Sources: Federal Treasury, own calculations.

34.4% to 35.2%. This reallocation of expenditures in favor of the regional level stems to the large-scale from an increase in financial assistance to the regions from the federal budget, aimed at mitigating the crisis fallout.

Revenue

The dynamic of the main components of the revenues of the consolidated budgets of the subjects of the Russian Federation in 2020 is presented in *Table 12*.

According to the Federal Treasury data on the regions budgets execution, the total revenue of the consolidated budgets of the RF subjects in 2020 gained 9.8% (up by 4.7% in real terms), amounting to Rb14.9 trillion. In the meantime, the regions own tax-generated and non-tax revenues dipped by 1.8%, and the growth of the total revenue of the consolidated budgets of the subjects of the Russian Federation was secured by fiscal transfers from the federal budget, which soared by 53.9%. It should be noted that the main reduction in tax-generated and non-tax revenues was observed in H1 2020, i.e. during the lockdown period. For the first 6 months of 2020 compared to the first half of the previous year, the reduction in tax-generated and non-tax revenues was 7.2%, while in the second half of the year they increased by 3.2%.

At the year-end, corporate income tax receipts fell the most from large revenue sources of the budgets of the subjects of the Russian Federation, which declined by 12.8%. Tax receipts on total income also dropped by 0.7% and non-tax income – down by 11.7%. Meanwhile, personal income tax revenues increased by 7.5%,

which indirectly indicates that anti-crisis measures helped prevent a reduction in household income and excise taxes (+ 5.6%). Largely due to the positive growth in the transport tax (+6.8%) and the personal property tax (+11.4%), a small final increase was exhibited by the group of property taxes (+ 0.5%).

Table 12

Revenue of the consolidated budgets of the RF subjects in 2019–2020

	Rb bn in nominal terms		Nominal growth, %	Real growth, %*
	2019	2020	2020/ 2019	
Revenue, total	**13 572**	**14 901**	**9,8**	**4,7**
Including:				
Tax-generated and non-tax revenues	**10 993**	**10 798**	**-1,8**	**-6,4**
Including tax-generated revenues:	*10 103*	*10 120*	*-0,9*	*-4,5*
Profit tax	3 358	2 927	-12,8	-16,9
PIT	3 956	4 253	7,5	2,5
Excises	755	798	5,6	0,7
Total income tax	596	592	-0,7	-5,3
Property taxes	1351	1 358	0,5	-4,2
Non-tax revenues	890	678	-11,7	-27,4
Fiscal transfers from budgets of other levels	**2 453**	**3 776**	**53,9**	**46,7**
Other revenues	**127**	**327**	**157,5**	**145,4**

* Income growth in real terms (adjusted for inflation). According to Rosstat, the value of the consumer price index in 2020 (December to December) stood at 104.91%
Sources: Federal Treasury, own calculations.

The contraction of consolidated budgets revenues in 2020 occurred in 5 subjects of the Russian Federation, of which the Nenets Autonomous District, the Tyumen region, the Yamal-Nenets Autonomous Okrug and the Sakhalin region are among the high-income ones, and the reduction in the income of the Chukotka Autonomous District (by 4.1%) is rather a correction after a spike of 56.2% seen in 2019.

Expenditure

The main indexes dynamic of the structure of the consolidated budgets of the RF subjects in 2020 are presented in *Table 13*.

In 2020, expenditures of the consolidated budgets of the RF subjects went up by 14.8% compared to 2019 and hit Rb15.6 trillion. This significantly exceeded not only the inflation rate (the growth was 9.5% in real terms), but also the revenues growth rate. During the fiscal year, expenditures grew unevenly: in the second half of the year, the growth rate slowed significantly compared to the first half – 12.0% versus 18.9%, which was due to the completion of a number of anti-crisis measures, as well as to the regional budgets growing deficit.

Table 13

Expenditure of the consolidated budgets of the subjects of the Russian Federation

	% to total		Nominal growth, %	Real growth, %
	2019	2020	2020/ 2019	
Expenditures, total	100.0	100.0	14.8	9.5
Nationwide issues	6.2	6.0	11.5	6.2
National security and law enforcement activity	1.1	1.1	10.5	5.3
National economy, including:	21.8	20.5	8.0	3.0
Agricuture and fisheries	1.9	1.7	0.1	-4.6
Transportation	5.1	4.9	10.5	5.3
Motor road system (road funds)	9.5	9.1	10.9	5.7
other national economy issues	5.3	4.8	3.7	-1.2
Housing and community amenities	10.1	8.5	-3.4	-8.0
Environmental protection	0.5	0.4	-0.6	-5.3
Education, including:	24.7	22.8	5.8	0.9
pre-school education	7.1	6.3	2.3	-2.5
supplementary education of children	11.9	11.5	10.6	5.4
general education	1.9	1.6	2.0	-2.7
vocational training	1.8	1.6	4.0	-0.9
other education issues	2.1	1.8	-4.0	-8.4
Culture, cinematography	3.5	3.1	1.2	-3.6
Healthcare	8.6	12.9	71.5	63.5
Social policies	19.8	21.3	23.6	17.8
Physical culture and sports	2.4	2.3	13.4	8.1
Mass media	0.4	0.3	0.0	-4.7
Government and municipal debt servicing	0.8	0.6	-5.0	-9.4
Other expenditure	0.0	0.0	8.5	3.4

Sources: Federal Treasury, own calculations.

The reduction in spending was observed solely in two regions – the Sakhalin region (-1.7%) and the Chukotka Autonomous Okrug (-11.4%), but in both cases, this reduction was not the result of fiscal policy rigidity, but a technical correction after a surge in spending in 2019 – by 23.4% and 57.1%, respectively. In two other regions (the Nenets Autonomous Okrug and the Tyumen Region), the increase in budget expenditures in real terms was negative, but given the high level of budget security in these regions, and, as a result, the possibility of reducing a number of lower-priority expenditures, this also did not prevent the implementation of a set of relief measures.

In the structure of expenditures of the consolidated budgets of the RF subjects at end-2020, we can note a substantial increase in the share of spending in the

healthcare sector (from 8.6 to 12.9%) and social policy (from 19.8 to 21.3%), which is due to the implementation of a set of relief measures at the regional level. One should particularly highlight the increase in expenditures under the item *Protection of family and childhood* from 0.9% in 2011 to 4.8% in 2020. The proportion of expenditures in all other sections fell, and in some of them it reached the lowest values since 2011: expenditures on national issues (6.0% with an average of 6.2% for the period 2011-2020), agriculture and fisheries (1.7% with an average of 2.7%), housing and utilities (8.5% with an average of 10.0%) and general education (11.5% with an average of 13.4%).

It is important to note that the share of expenditures of the consolidated regions budget in the sphere of national economy in 2020 (20.5%) remained at a higher level than the average for 2011-2020 (19.9%), which indicates the orientation of the regions' anti-crisis budget policy not only to address social issues, but also to support the economy.

Financial Assistance from the Federal Budget

In 2020, the crisis situation resulted in a significant change in the federal intergovernmental fiscal policy: the volume of fiscal transfers rose markedly, and many requirements for their provision, especially in terms of subventions and subsidies, were temporarily suspended. The total volume of fiscal transfers surged compared to 2019, both in nominal terms (+54.9%) and in real terms (+47.7%) (*Table 14*). All types of intergovernmental fiscal transfers increased, and the increase in subsidies was on the back of additional allocation of equalization transfers. At the same time, subsidies and not equalization transfers were the basis of the federal anti-crisis intergovernmental fiscal policy, as a result of which the percent of non-targeted financial assistance in 2020 decreased by 3.5 p.p. compared to 2019 and amounted to merely 35.2%.

In 2020, 38 subventions were extended,[1] which is 1 subvention more than a year earlier. The volume of subventions spiked (+52.9% in nominal terms and +45.7% in real terms), but the increase was mainly owing to subventions for social payments to the unemployed, so in general, the dependence of regional budgets on the federal budget in terms of delegated powers has not changed.

The increase in subsidies came to 81.7% (+73.2% in real terms), while subsidies for the national economy increased by merely 2.0% (and fell by 2.8% in real terms). The number of subsidies has increased substantially: from 113 in 2019 to 140 in 2020. Similarly, the real growth of other intergovernmental fiscal transfers constituted 45.2%, and the number of such transfers rose from 108 in 2019 to 120 in 2020. For the second year in a row, other intergovernmental fiscal transfers account for about a fifth of the total volume of federal intergovernmental assistance to the regions. Although the increase in subsidies and other intergovernmental fiscal transfers was due to the need to implement anti-crisis measures, it is undesirable in itself, since it reduces the fiscal autonomy of the regions. This being said, the

1 The number of transfers is determined by the number of unique expenditure directions (13-16 numbers of the budget expenditure classification code) provided for in the federal budget execution report.

federal level had another tool at its disposal (equalization transfers), which is more suitable for providing relief support and does not rise the dependence of regions upon the federal level.

Table 14

Federal budget fiscal transfers to the budgets of the subjects of the Russian Federation

	2019		2020			Прирост в 2020 г. к уровню 2019 г.	
	Nominal volume, Rb bn	% to total	Nominal volume, Rb bn	Real volume, Rb bn	% to total	nominal, %	real, %
Transfers to regions, total	**2 387.2**	**100.0**	**3 698.4**	**3 525.3**	**100.0**	**54.9**	**47.7**
Grants	**924.0**	**38.7**	**1 303.7**	**1 242.6**	**35.2**	**41.1**	**34.5**
Including:							
Equalization transfers	675.3	28.3	717.9	684.3	19.4	6.3	1.3
transfers to support measures designed to ensure well-balanced budgets	237.6	10.0	575.6	548.7	15.6	142.3	131.0
Subsidies	556.6	23.3	1 011.5	964.2	27.4	81.7	73.2
Including:							
subsidies to sustain national economy's development	209.9	8.8	214.0	204.0	5.8	2.0	-2.8
Subventions	**396.6**	**16.6**	**606.2**	**577.9**	**16.4**	**52.9**	**45.7**
Other intergovernmental fiscal transfers	**510.0**	**21.4**	**777.0**	**740.6**	**21.0**	**52.4**	**45.2**
Including:							
Other intergovernmental fiscal transfers for development of national economy	305.5	12.8	329.4	314.0	8.9	7.8	2.8

Sources: Federal Treasury, Rosstat, own calculations.

In 2020, as a year earlier, an extensive amount of fiscal transfers was directed to the implementation of national projects at the regional and municipal levels: 44% of the volume of subsidies, 20% of subventions and 32% of other intergovernmental fiscal transfers, and in general - 22% of all fiscal transfers from the federal budget to the regions. Excluding fiscal transfers allocated for the implementation of national projects, the structure of financial assistance in 2020 is as follows: grants – 45.2%, subsidies – 19.7%, subventions – 16.8%, other intergovernmental fiscal transfers -18.3%.

The effectiveness of transfers for the national projects implementation can be indirectly judged by the rhythm of the provision of appropriate funds during the financial year, i.e. by the ratio of the amount of funds transferred for the first

three quarters and the annual amount of funds transferred (*Table 15*). Transfers for the implementation of national projects were extended less evenly during the year than other transfers, which can be explained by the need to prioritize the provision of other transfers in the wake of the crisis.

Table 15

The movement of incoming transfers for the implementation of the national projects

Transfers	Movement, %
Transfers, total	**64.0**
Transfers for implementation of national projects	**54.1**
Including:	
Culture	62.0
The Digital Economy of the Russian Federation	69.8
Education	54.8
Housing and Urban Environment	50.3
Ecology	49.4
Small and Medium-Sized Enterprises and Support of Individual Entrepreneurship	86.0
Productivity and Employment Support	71.6
Healthcare	43.6
Demography	64.6
Safe and Quality Roads	47.5
International Cooperation and Roads	32.9
Comprehensive Plan of Modernization of Trunk Infrastructure	18.4
Other transfers	**66.8**

Source: Federal Treasury, own calculations.

The 2020 crisis had a positive impact on the reduction of the disparity of the fiscal capacity of the regions, which grew during 2017-2019. The growth rates of tax-generated and non-tax revenues of the regions with low fiscal capacity (these can be conditionally attributed to 31 subjects of the Russian Federation, the estimated level of fiscal capacity in accordance with the method of distribution of equalization transfers from the federal budget in 2019 was less than 0.6) exceeded the corresponding indexes of the regions with high fiscal capacity. For example, the correlation coefficient between the growth rates of tax-generated and non-tax revenues of regions for 2020 and the level of their calculated fiscal capacity was equal to -0.4, and due to the fact that the provision of additional financial assistance to the regions from the federal budget in 2020 was primarily focused on regions with low fiscal capacity, the reduction in disparity in total income was even more pronounced: the correlation coefficient between the level of fiscal capacity of the regions and the growth rate of income of their consolidated budgets is equal to -0.63.

The reduction in interregional disparity can also be illustrated by the dynamics of the coefficient of variation of per capita income (*Table 16*). So, if after the equalization in 2020, the discrepancy decreased by the expected 25% (by 23%

in 2019), then after the provision of grants and subsidies – by a notable 45% (by 35% in 2019). This is due to a sharp increase in grants for fiscal equilibrium and subsidies, the distribution of which takes into account the level of calculated fiscal capacity.

Table 16

The variance coefficient of the consolidated regional budget revenues (per capita, with due regard for the budget expenditure index)

Year	Tax-generated revenue	Tax-generated revenue and equalization transfers	Tax-generated revenue, transfers, grants, subsidies
2014	0.590	0.512	0.499
2015	0.661	0.603	0.560
2016	0.556	0.421	0.373
2017	0.558	0.413	0.377
2018	0.586	0.444	0.387
2019	0.603	0.464	0.390
2020	0.561	0.420	0.308

Sources: Finance Ministry of Russia, Federal Treasury, own calculations.

Deficit and Debt at the Regional Level

In 2020, the consolidated budgets of the subjects of the Russian Federation were executed with a deficit of Rb676.5 bn (in 2019 - with a surplus of Rb4.7 bn). Furthermore, the number of regions with a budget surplus decreased to 28 compared to 2019 (*Table 17*). 18 regions had a consolidated budgets deficit of more than 10% of tax-generated and non–tax revenues, of which 7 regions had 20%. Thus, the balance of the consolidated regional budgets for 2020 has deteriorated markedly.

Table 17

Execution (deficit/surplus) of the consolidated budgets of the Russian Federation in 2014–2020

Год	Number of RF subjects that have executed the budget	
	With deficit	With surplus
2014	74	11
2015	76	9
2016	56	29
2017	47	38
2018	15	70
2019	35	50
2020	57	28

Sources: Federal Treasury, own calculations.

In 2020, the volume of RF the subjects' public debt increased from Rb2.1 to Rb2.5 trillion, and in relation to the volume of tax-generated and non-tax

revenues of the budgets of the subjects of the Russian Federation - from 22.5 to 27.3%.

The debt burden on the budgets of certain regions has also changed: the ratio of debt to tax-generated and non-tax revenues decreased over the year in 32 regions, remained unchanged in one subject, and increased in 52. In 15 regions, the growth of the debt burden exceeded 10 p.p. By the end of 2020, the public debt exceeds 100% of tax-generated and non-tax revenues in 3 regions (in 2019, this situation was typical only for 1 region).

The structure of the state debt of the regions changed slightly over the year: the share of budget loans by the end of the year stood at 44.2%, increasing by 2.2 p.p. compared to the end of 2019 (*Fig. 17*), which is owing to the additional allocation of budget loans to the regions to the tune of Rb224 bn. Thus, at the end of 2020, the Russian Federation temporarily gave up policy of not providing budget loans to the regions, which it had adhered to since 2016. The share of securities also increased by 3 p.p., while the share of loans from credit institutions decreased by 4.5 p.p. In general, nominal debt increased on budget loans (by 24.5%) and on securities (by 30.8%).

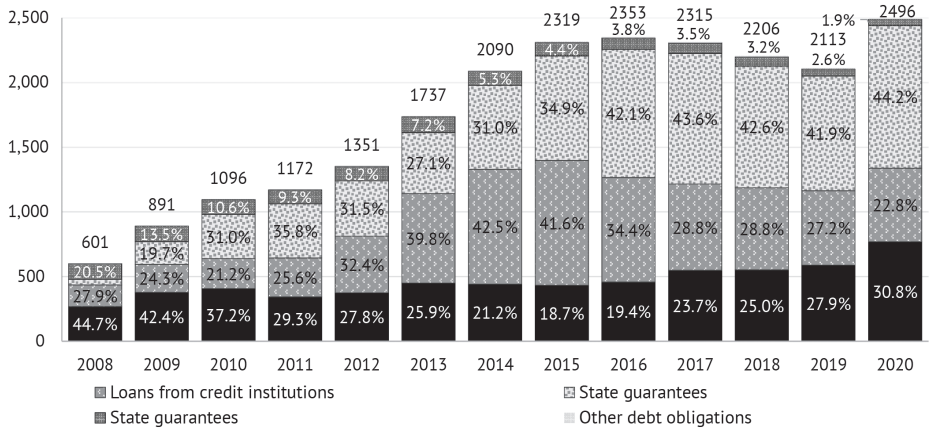


Fig. 17. Nominal volume (Rb bn) and structure (%) of public debt of RF subjects in 2008–2020

Sources: Finance Ministry of Russia, own calculations.

In 2020, the high growth rates of intergovernmental fiscal transfers to the regions, the additional allocation of budget loans to them to the tune of Rb224 b, as well as the reduction in disparity of the level of fiscal capacity of the regions as a result of the distribution of additional volumes of intergovernmental fiscal transfers in 2020 demonstrate that the budget policy of the Russian Federation in relation to the regions in 2020 was countercyclical, aimed at priority support for the worst-off subjects. This made it possible not only to offset for the decline in the regions ‘ own tax-generated and non-tax revenues, but also to ensure the

implementation of relief measures aimed at strengthening the public health system, as well as supporting the economy and the social sphere.

2.3. Challenges of international business taxation in the context of digitalization[1]

The current system of international taxation does not result in a fair distribution of the tax base between countries in a digital environment violating the principle of taxation in accordance with the added value created in the particular country. In the absence of international consensus, countries reform their tax systems aimed to collect taxes in the digital economy unilaterally by imposing Digital Services Tax (DST). By their nature, being indirect, these taxes (DST) are collected on the turnover of foreign digital companies in the market country (the country of the source of income).

Unlike VAT, credited along the entire value chain to ensure its neutrality, these taxes are more like import duties levied on a one-off basis when accessing the local digital market. Due to their specific nature, these taxes do not fall into the system applied by international tax agreements, however, according to some countries, for example, the United States, they violate existing trade agreements and WTO principles.

The introduction of such a tax will result in additional budget revenues, increase the cost of digital services for local users and create a trade barrier for foreign digital businesses. Its goal to ensure neutrality in the overall tax burden between digital and traditional business is an overly complex task that is unlikely to be implemented, given a rather simple and unclear mechanism of this approach, which assumes taxing the attributable profit of foreign digital companies through taxation of turnover at a low rate.

Principles of methodology being the platform for the VAT calculating and levying system in cross-border electronic trade in both goods and services do not generate significant disagreements between countries. The analysis of international experience proves that countries are trying to implement the destination principle to the maximum in relation to international trade as far as the tax administration allows, and, accordingly, ensure equal competition conditions and a neutral shift of the VAT economic burden to the jurisdiction of the product final consumption, including those sold in the electronic form.

These principles were developed and structured by the international consensus back in 1998[2] and further detailed in the context of their introduction owing to certain challenges associated with practical aspects, administration and control over the VAT payment by a foreign company without its physical presence in the

1 This section was written by *Milogolov N.*, Candidate of Economic Sciences, Head of IAES RANEPA Tax Policy Research Department; *Berberov A.*, Researcher of the Gaidar Institute.

2 A Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference, "A Borderless World: Realizing the Potential of Electronic Commerce" on 8 October 1998" Ministers welcomed the report and endorsed the proposals on how to take forward the work as outlined within it. URL: https://www.oecd.org/ctp/consumption/1923256.pdf

country[1]. Thus, the new rules for levying VAT on foreign services in electronic form provided to Russian individuals and enterprises have been in effect in Russia since 2017[2].

However, it should be noted that taking into consideration methodological approaches to direct taxation in the context of digitalization, the relevant international consensus is lacking today, although certain methodological approaches are being developed both by international organizations, primarily the OECD and the EU, as well as by individual countries.[3] The meaning of the mentioned discussion in relation to direct taxation comes down to rethinking of the existing rules for distribution of the tax base of international groups of companies between the country of residence and the country being the source of income, applied amid the current tax architecture, most commonly based on a chain of international bilateral tax agreements built upon the OECD Model Convention concluded by countries.

The reason for the rethinking is that within the current tax architecture, countries being sources of income (market countries) do not have appropriate rights to tax the profits from activities even when foreign companies conduct there a real business without a physical presence, for example, when a fair amount of goods is sold to local population through Internet. Governments and people in these countries consider this situation unfair and thus, stimulate political and expert discussion[4] about particular countries that are creating value and to what extent in the context of new digital business models, and about the tax consequences that should arise hereat. The discussion escalated after the onset of the pandemic when humanity was forced to go digital, and the profits of the largest digital companies significantly increased.

Aiming to maintain competitiveness and fiscal adaptation of the Russian tax system to digital realities, the authors identify *5 key areas* requiring reform in the short and medium term and also put forward appropriate recommendations.

1. Current rules requiring physical presence when creating a "tax liaison" between a market jurisdiction and a foreign company do not meet the demands of digital economy and should be updated in the interests of Russia as a significant market country.

1 Addressing the Tax Challenges of the Digital Economy. Action 1 – 2015. Final Report // OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD Publishing, 2015. URL: https://doi.org/10.1787/9789264241046-en

2 Federal Law «On Amendments to Parts One and Two of the Tax Code Russian Federation «dated 03.07.2016 No. 244-FZ (last edition).

3 Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy / OECD/G20 Inclusive Framework on BEPS. Paris: OECD, 2019. URL: http://www.oecd.org/tax/beps/programme-of-work-to-develop-aconsensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

4 Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Paris: OECD Publishing, 2015. URL: https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en

OECD (UN) standpoint: global reform is critical because users of digital products, including free ones, being residents of large market countries, apparently represent the input resources (providers of user data) for foreign companies without an appropriate physical presence in these market countries.

The unilateral introduction of taxes on digital services (digital services tax - DST) is detrimental, while it is optimal to achieve an international consensus, that is the OECD Pillar One initiative. As a result of its implementation, the market countries will be entitled to tax a share of profits of foreign digital companies whose global revenues exceed Euro 750 mn based on the extent of their digital presence in the country (for example, the level of digital sales or user database in the country).[1]

Situation in Russia: Russian tax legislation lacks effective instruments for taxing local income (profits) of those foreign companies that have only a virtual economic presence in Russia, with a profit tax. However, ignoring the issue leads to unjustified tax losses for the Russian budget and distortion of the competition between foreign and Russian digital businesses.

According to own calculations based on the determination of the Russian users' role in the activities of foreign digital companies through the geographical analysis of their Internet traffic, the introduction of an indirect gross tax on the proceeds from provision of digital services purchased by Russian users from foreign companies (DST) can contribute to the budget about Rb +37.8 bn additional tax revenues.

Russia's accession to the OECD Pillar One initiative has less fiscal potential: according to own calculations, one can talk about Rb 10 bn tax revenues. It is important to emphasize that this amount may be lower, since the list of the largest Russian digital companies includes Mail.Ru and Yandex, operating in the post-Soviet markets, and, therefore, the relevant share of their foreign tax base will not be taxed in Russia and the foreign tax will be credited against the Russian one.

Notwithstanding that the introduction of a unilateral measure is more preferable from a fiscal point of view, the application of this strategy can lead to challenges when increasing the international economic cooperation in the digital sphere with developed countries (OECD countries and, especially, the United States, due to the leadership of this country in the global digital economy).

Amid the actual contradictions and the lack of international consensus, the optimal approach is to introduce a temporary digital indirect tax on digital services purchased from foreign companies (DST). This tax may be canceled after the introduction of the Pillar One mechanism and Russia's accession, taking into consideration a pre-announcement of its national position.

This trend seems preferable, given that ease of administration and fiscal efficiency (typical for DST) currently seem to be more important than fairness in international taxation. Moreover, the introduction of a temporary digital tax is in line with Russia's position as a "market country" and the current needs for

1 Secretariat Proposal for a "Unified Approach" under Pillar One // OECD. URL: https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

fiscal consolidation amid the pandemic economic consequences. Finally, a similar position is now becoming an "international consensus" in developed countries (except for the United States and the "hub countries").

2. Due to the novelty of digital business, revenues from digital operations may fall under several articles of tax treaties and provisions of internal legislation at once (they can be classified as income from business activities, royalties, income from asset disposal). This uncertainty creates opportunities for tax optimization and fiscal risks for the state, as well as increasing risks for entrepreneurs and investors.

OECD (UN) standpoint: the key principle is the analysis of the economic and legal meaning of the transaction based on the scope of rights transferred to the buyer (compared to provisional minimum required standard ("de minimis"). If this threshold is not exceeded, the income received will be interpreted as "income from entrepreneurial activity." Otherwise, the income will be considered a royalty. In a recent initiative, the UN proposes to expand the definition of "royalty" aimed to apply withholding tax to any B2B payments for software.[1]

Situation in Russia: the analysis of the Russian tax legislation shows its current uncertainty regarding the category of income received by a foreign organization from provision of digital operations within the license agreements that fix the "limits" for using the results of the intellectual activity or the means of individualization by the licensee.

The reference to "limits" is shaping the complexity of the reliable definition of the income category. First, in most cases, any transfer of rights can be a transfer of (1) partial or full rights in relation to the underlying copyrights, (2) partial or full rights to using a copy of the program, (3) know-how or a secret formula.

Second, as for mixed contracts, it remains debatable whether the main purpose of the contract should be highlighted to the tax payer when calculating income tax liabilities according to recommendations expressed in the comments to the OECD MC (2017).[2] It should be emphasized that lacking the relevant judicial practice on direct taxes does not allow us to determine the business end of this issue.

In short term, it is relevant to develop a national approach aimed at unambiguous identification of income from provision of digital services (Clause 2, Article 174.2 of the Tax Code of the Russian Federation) for income tax purposes, which should be expressively reflected as Letters of the Ministry of Finance and detailing the provisions of Chapter 25 of the Tax Code of the Russian Federation. In its drafting, one should build upon the principle "de minimis" used in the OECD MC (2017)[3] and tax legislation of various countries (for example, Singapore).[4] In this regard,

1 Discussion draft: Possible Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries Concerning. Inclusion of software payments in the definition of royalties / UN. URL: https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-09/Revised%20discussion%20draft%20final.pdf.

2 Articles of the Model Convention with respect to taxes on income and on capital (2017) // OECD. URL: https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

3 Ibid.

4 Rights-Based Approach for Characterising Software Payments and Payments for the Use of or the Right to Use Information and Digitised Goods // IRAS. URL: https://www.iras.gov.sg/irashome/

we do not share the latest UN initiative[1], since economically different types of transactions should be classified differently for the purposes of tax treaties based on the scope of rights transferred to the recipient.

3. Despite the progress made in the BEPS plan, companies still have the opportunity to avoid paying corporate taxes by redirecting their profits to low-tax jurisdictions, which is especially important for digital businesses.

OECD (UN) standpoint: elimination of unfair tax competition through the introduction of an internationally agreed minimum tax rate (method of calculating is under discussion) and the implementation of the following global rules (OECD Pillar Two)[2]:

- the country of residence of the parent company is entitled to additionally tax the foreign profit of the subsidiary if it has been taxed at a rate lower than the agreed minimum (*income inclusion rule);*
- the country of residence is entitled to switch from the exemption of foreign income from taxation (for example, the income of a permanent establishment) to its taxation at the minimum rate, if it was taxed at a rate lower than the agreed minimum (*a transition rule that will be introduced into tax agreements) ;*
- the country of source is entitled to refuse deducting a payment in favor of a related party or in case of its preferential taxation, if the payment is taxed in the recipient's country of income below the minimum rate (*the rule of compulsory payments* (*including the supplementing tax rule*).

Situation in Russia: the insights of the recommendations related to the second component of the OECD proposals (OECD Pillar Two) indicate that the Russian legislation already has analogues of these rules introduced at the national level. In particular, the *"income inclusion rule"* proposed by the OECD is similar to the CFC rules, which are better adapted to the requirements of Russia's economic policy**.**

The "*transition rule*" is irrelevant for Russian tax practice for the purpose of eliminating double taxation, since Russia already applies the method of offsetting foreign tax in all cases. Finally, the "*rule of compulsory payments*" can also be recognized as not meeting Russia's interests due to the following:

- its implementation may "devalue" provisioning of low tax rates in Russia for foreign investors as a tool to attract foreign investment;
- if increasing the withholding tax rates to 15% is completed in tax agreements with "transit countries", the rule implementation will be irrelevant from a practical point of view, including due to "thin capitalization" rules in Russian legislation;

uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_CIT_rights-based%20approach_2013-02-08.pdf

1 Rights-Based Approach for Characterising Software Payments and Payments for the Use of or the Right to Use Information and Digitised Goods // IRAS. URL: https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_CIT_rights-based%20approach_2013-02-08.pdf

2 Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two // OECD. URL: https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

- the concept of the beneficial owner of income already contains measures aimed at achieving the goals proposed by the second component of the OECD global reform, since the information confirming "lack of tax savings on subsequent transfer of income" can be taken into consideration when identifying the individual having actual right to receive income.[1]

Thus, Russia's accession to the OECD recommendations regarding Pillar Two is premature. First, the second component contains a large number of legal ambiguities (for example, the algorithm for calculating the minimum tax rate is still unclear). Second, its rules may duplicate provisions already included in tax legislation. Third, the accession suggests that Russia renounces part of its tax sovereignty, which is unacceptable in the current environment of intense international economic competition. With regard to Pillar Two, in our opinion, Russia should only monitor now the progress of the discussion related to the OECD initiative.

4. The mechanism for determining the companies' tax residency is not in compliance with digital realities: the criterion for incorporating a company is formal, while the place of effective company management (hereinafter – POEM – Place of Effective Management), being the basis of the economic criterion, can be easily switched to a low-tax country amid globalization and the growing use of digital technologies for communication and management.

OECD (UN) standpoint: notwithstanding that since the 90s, this issue has been the subject of consideration by both the OECD and the UN, the place and role of the concept of the legal entities residence in digital environment is still being discussed.

Situation in Russia: currently**,** according to Article 246.2 of the Tax Code of the Russian Federation, only two categories of companies can be recognized as Russia tax residents: Russian organizations belong to the first category; the second category suggests recognition of a foreign organization as a tax resident when identifying the place of its effective management in Russia[2]. Besides challenges of uncertainty in the interpretation of the existing criteria[3] tending to aggravate in digital environment, following the chosen approach, in our opinion, is against Russia's sovereign interests. This is due to the fact that despite the policy of deoffshorization and establishment of special administrative regions (SAR), the role of foreign companies owning Russian assets remains significant, which is especially important for digital business focused on global markets.[4]

1 Letter of Tax and Customs Policy Department of the Russia Ministry of Finance of April 9, 2020. No. 03-08-05/28323 "On determining the beneficial owner for purposes of taxation// Guarantor. URL: https://www.garant.ru/products/ipo/prime/doc/73927000/

2 To fulfill it, compliance with at least one of the conditions presented is required: governance of organization is maintained "regularly" by an executive body in Russia, or the organization is managed by chief executives mainly in Russia.

3 Both the Tax Code of the Russian Federation and the Letters of the Ministry of Finance of Russia do not clearly answer the question of what is considered "regular" management of a foreign organization. Likewise, there is no answer as to what is meant by "preferential" management of the organization by officials in Russia.

4 Between deoffshorization and globalization // SPARK. URL: https://www.spark-interfax.ru/articles/mezhdu-deofshorizatsiey-i-globalizatsiey

By virtue of Russia's accession to the BEPS Multilateral Agreement, the implementation of a mutual agreement procedure between the competent authorities can become a mechanism for resolving situations of companies' dual residence in the event of a conflict thereof. Such an analysis based on all facts and circumstances most fully meets the sovereign interests of Russia, while its effectiveness may be low without the improvement of Russian legislation in the following areas:

- developing a mechanism for determining the place of effective management aimed to give more weight to the economic functions performed in each country, as well as determining the residence of the majority of top managers or those who make the most important decisions (location of their centers of vital interests), issuing detailed recommendations and analyzing specific situations (a similar trend is particularly typical for South Africa[1]);
- introducing objective criteria into national legislation that would indicate the existence of a stable economic relationship between the company and Russia (for example, analyzing geographical distribution of assets between countries) and the subsequent recoding in the agreements of those factors that will be taken into account in the event of disputes. It should be emphasized that the OECD MC (2017) makes it possible to supplement the corresponding provision by specifying factors that are relevant for determining the residence of a legal entity.[2]

5. The current mechanism for taxing royalties at the source on a gross basis is not economically feasible for a foreign licensor, since the entire amount of paid royalties is subject to taxation, excluding the costs of the licensor for development of an intangible asset.

OECD (UN) standpoint: international organizations note the existence of this problem, however, it is recognized that the solution runs into overcoming the contradiction in economic interests between developed and developing states. The transition to taxation of the calculated value, which would more fully take into account the real fiscal result of the licensor's activities, can be carried out through the following mechanisms[3]:

- "non-final" withholding tax, when a non-resident is entitled to set off all possible or only particular expenses against the income received;
- withholding tax at a rate calculated based on the expected profitability;
- a tax from the legally established part of the gross amount of payment (part of the gross amount).

1 Interpretation Note: No. 6 (Issue 2) [Electronic resource] // South African Revenue Service. – URL: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf

2 Articles of the Model Convention with respect to taxes on income and on capital (2017) // OECD. - URL: https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

3 *Trepelkov, A., Tonino, H., & Halka, D.* (Eds.). 2015. United Nations Handbook on selected issues in protecting the tax base of developing countries. UN.

Situation in Russia: today, gross income is subject to a withholding taxation at a rate of 20% upon payment of royalties to a foreign recipient. The geographical structure of royalties outgoing from Russia is dominated by "transit jurisdictions" with their R&D expenditures vs received worldwide royalties being abnormally high[1], and Russia's tax treaties providing for a reduction of the withholding tax rate to zero.

Thus, it can be assumed that companies of such jurisdictions are integrated into economic chains only to obtain unjustified tax benefits, while the intangible asset benefiting from royalties paid from Russia is established and maintained in other jurisdictions.

Based on the actual regulatory conditions, the taxation of royalties originating from Russia requires an adjustment towards an increase in the withholding tax, which is in line with the fiscal interests of Russia and presents a response to the challenges related to withdrawing profits through royalty payments to low-tax jurisdictions.

Other types of income (for example, dividends) can be paid under the guise of royalties, which is relevant in the context of an increase in the withholding tax on dividends and interest up to 15% in agreements with transit jurisdictions.[2] Growth in the withholding tax rate when transferring royalties to residents of "transit jurisdictions" will increase tax revenues and create a barrier to profit withdrawal. The implementation of this measure also corresponds to the UN MC recommendations[3], as well as to the experience of BRICS countries, where royalties are mainly taxed at a nonzero rate[4].

Such a mechanism can be balanced through offsetting a part of the costs incurred to create an intangible asset in Russia. It is assumed that a foreign taxpayer could deduct all incurred expenses (or part of them) when creating an asset (implementing R&D) in Russia.

Foreign companies may show interest to developing an intangible asset in Russia, knowing that granting licenses to use it in the future will result in a legitimate tax benefit in Russia. This incentive measure can be enhanced by introduction of a mechanism for preliminary disclosure of tax information (according to recommendations of Action 12 BEPS), giving the opportunity to a foreign taxpayer to provide Russian tax authorities with relevant data in advance for tax control purposes "in real time".

1 *Berberov A.*, *Milogolov N.* Assessment of the scope of tax base erosion in Russia // Financial Journal. 2018. No. 6 (46). p. 54.

2 *Milogolov N.* Impact and recommendations analysis for supplementing and implementing measures announced by the President of the Russian Federation in terms of taxation at a rate of at least 15% of dividends and interest paid to "transit" jurisdictions /Monitoring of economic situation in Russia: trends and challenges of socio-economic development. 2020. No. 10 (112). April / Gaidar Institute for Economic Policy, The Russian Presidential Academy of National Economy and Public Administration 211 p. URL: http://www.iep.ru/files/text/crisis_monitoring/2020_10-112_April.pdf, p. 114.

3 United Nations Model Double Taxation Convention between Developed and Developing Countries (2017) // UN. URL: https://www.un.org/esa/ffd//wp-content/uploads/2018/05/MDT_2017.pdf (date of reference 2020-15-05). p. 299.

4 Treaty Rates // Deloitte. URL: https://dits.deloitte.com/#TaxTreatySubMenu