

# **MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:**

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

**No. 18(56) October 2017**

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## MAIN TRENDS AND CONCLUSIONS

The abrupt deceleration of industrial growth in September can be regarded as a local episode that cannot reverse the recovery-based trend in the Russian economy. However, the deceleration was led by fundamental factors such as reduced crude oil production and the deceleration of natural gas production, with gas supplies to Europe being faced with slower pace than before.

The structure, permanent as such, of the national economy makes such 'local episodes' inevitable in the future. However, the principal fundamental challenge in the real sense of the word is the potentially growing structural gap between the Russian economy and the global economy, when the former is faced with minor changes, whereas the latter is changing at a faster than expected pace.

In this context, it is worth looking closely at the 19th Congress of the Chinese Communist Party and at the potential impact it may have on geopolitics and geoeconomics, all the more so as structural decisions in China are implemented consistently, having a diverse impact on other economies (an example is net reduction in steel output, coal production, coal generation, etc.). Oil-producing countries have started to believe, albeit grudgingly, in European plans to discontinue sales of gasoline-driven motor vehicles in the 2030s. China has the same plans, too. Considering the structure of China's economics and politics, the country stands a better chance to do this, all the more so as its intentions are now reinforced ideologically by the Congress (stepping-up of environmental policy). China's mounting motor vehicle fleet has so far been the winning argument that explains the rise in oil demand. However, massive vehicle electrification can dampen the demand beforehand, that is as early as the second half of the 2020s. And this structural challenge is much more serious than the shale revolution, the probability of which was challenged up until the point when it reshaped the global oil market and the national budget of dozens of countries.

When analyzing the draft federal budget bill for 2018–2020, our experts have noticed heavy cuts in expenditure and a conservative enough projection for crude oil price.

Budget expenditure are expected to shrink from 16.0% of GDP in 2017 to 14.8% till 2020 mainly due to the dynamics of oil and gas revenues amid extremely downbeat projections for global crude prices of \$41–42 per barrel in 2019–2020, however, the projected rouble's depreciation cannot offset in full the fall of oil-market quotations. The experts rely on a higher oil price of \$46–48 per barrel amid an exchange rate of 60–63 roubles per US dollar, in which case the volume of oil and gas revenues will exceed the envisaged level (including 0.3–0.4 p.p. of GDP in 2019–2020). According to the draft bill, oil and gas revenues are expected to be stable up to 10% of GDP.

The experts have also noted serious expenditure cuts from 18.1% of GDP in 2017 to 15.6% of GDP by 2020, whereas the federal budget expenditure were never cut less than 18% of GDP in 2011–2017. The effectiveness of budget consolidation has been low over the last few years, according to the experts: in 2013–2017, expenditure dropped just from 18.6% to 18.1% of GDP. Severe

cuts in expenditure that are scheduled in the next three years stem from budget fine tuning in accordance with a new budget rule that was adopted in summer of 2017. However, when analyzing the rule, the experts have concluded that it is not stable enough despite its simplicity, and accumulation of funds in the National Wealth Fund that represents at least 10–15% of GDP will put a heavy political pressure towards increasing the marker crude price (a constant price of \$40 per barrel of Urals crude is set under the rule).

While pointing to the fact that the projected expenditure dynamics is not enough to bolster economic growth and can pose a threat to social commitments, the experts consider it reasonable to maintain non-interest expenses at least at 16% of GDP and budget deficit at not higher than 1.5% while keeping intact the tax burden.

Furthermore, the experts have assessed positively the projected cuts in non-productive outlays and the 2018 projected cuts in confidential and strictly confidential appropriations (up 7%), whereas the proportion of classified expenditures (17.5% of the federal budget) is still by an order of magnitude greater than for public finances of developed countries.

In the draft bill, the National Wealth Fund and public borrowings will be the key source of compensation for a budget deficit in 2018 and in 2019–2020, respectively. The target amount of borrowings (with a real rate of return of 2.5–3% and economic growth rates of 2%) leads to a marginal increase in the public debt and in public debt servicing costs. The public debt will account for 16.1% of GDP rather than 13.6% as expected at 2017 year-end.

In conclusion to the draft bill analysis, the experts have pointed to the fact that retaining the expenditure in nominal terms at the level of 2017 may strengthen budget sustainability. However, the most likely scenario is that budget parameters will be updated substantially (which also can affect the budget 2018) in order to achieve the objectives to be set by political leaders in the context of a new political cycle, as was the case with, e.g., the adoption of the presidential executive orders dated May 2012. Conclusion: underestimated revenue and expenditure leave room for new expenditure commitments, whereas actual budget expenditure despite new budget rules may turn out to be much higher than expected.

When assessing the status of the consolidated budget of subjects of the Russian Federation, the experts has noted the projected continuation of the trend towards stable revenues and expenditure and a budget deficit reduction. Certain concerns have been sparked by a projected downtrend in the real volume of intergovernmental budget transfers to regions by 2020, although the experts have assessed rather positively a decision to restructure publicly funded loans to regions while discontinuing gradually the practice of crediting out of state budget funds.

When analyzing the existing fiscal and financial environment, it should probably be acknowledged that there are no reasons for serious concerns: all these reasons are beyond the national perimeter, being hypothetical and, therefore, weak enough to encourage structural and institutional changes. Most of the indicators are not even close to the red line, and even a moderate deterioration cannot affect the environment.

For example, it is unlikely that the fact that Russia's current account balance continued to contract in Q3 2017 on the back of stabilizing exports amid rising imports could become a reason for concerns. Additionally, there was no big difference between the current account balance (\$1.2bn) of Q3 2017,

Q2, and of that recorded in the same period last year. Moreover, both current account and financial account ran a surplus driven, among other things, by the growth in foreign direct investments (FDIs).

According to our experts, the rouble's real effective exchange rate in Q3 2017 was overestimated 1.5–2% above the fundamentally substantiated level driven by the dynamics of productivity, terms of trade, capital flows. In this context, the rouble has to depreciate in nominal terms by 2.8% so that the rouble's real effective exchange rate returns to an equilibrium pathway, with the Russian inflation rate staying at 3%. With terms of trade remaining approximately at a level similar to what it is now, the current account will again stabilize at around zero if the rouble slightly depreciates (against the background of likely decline in foreign capital inflow into Russian financial assets).

Relatively steady financial performance figures, a declining consumer inflation and a more moderate dynamics of utility rates might have contributed to a record low (down to 4.8%) level of unpaid individual utility bills that was recorded at the end of H1 2017, according to the experts. However, this was caused chiefly by gaining control over the utility sector, enhancing the e-document flow, making the process of utility rates setting more transparent and eliminating defects in accounting, according to the experts.

According to our experts' analysis, there is no visible correlation between the proportion of poor population in regions and the proportion of outstanding utility bills (e.g., indebtedness in North Caucasus Republics is far above the value recorded in the poorest regions such as the Republic of Kalmykia, the Republic of Tyva, Jewish Autonomous Oblast). The proportion of families that are not covered by the statistics representing underpaid utility bills is also of importance. In other words, this is the extent to which the population of subjects of the Russian Federation are involved in relationships with utility companies. For example, 19% and 35%, respectively, of the population of the Republics of Tyva and of the Chechen Republic receive services from such enterprises. The proportion of urban population that fall into this category is above 74% on average across the country. Families of three or more children and single-parent families most frequently fall into the category of outstanding debtors for utility services. Such households fell into the category of debtors more frequently than in the previous year, whereas the situation was getting better across the country.

The issue of property tax payment or the practice of collection of taxes in arrears have been considered as part of this analysis. These pressing issues concerning the practice and prospects of tax administration, as applied, in part, to individuals and legal entities as taxpayers, are considered in another survey of our experts on countering tax avoidance, workflow informatization in the Federal Tax Service (FTS), tax control procedures, administration of the personal property tax. ●

## 1. THE FEDERAL BUDGET FOR 2018–2020: AUSTERITY MEASURES

A.Deryugin, I. Sokolov

*At present, the State Duma is reviewing the draft federal budget in 2018–2020, which is characterized by a conservative forecast of the price of oil, dramatic reduction of the expenditures as a result of new budget rules being applied and a high level of state borrowings. In addition, with the start of a new political cycle in 2018 it may be required to build up expenditures for solving the issues set by the country's leadership.*

Late in September 2017, the draft law on the federal budget for 2018 and the 2019–2020 planned period (hereinafter the draft law) was introduced into the State Duma. The draft federal budget for the next three years has the following main parameters – *Table 1*.

*Table 1*

THE MAIN PARAMETERS OF THE FEDERAL BUDGET FOR 2018–2020,  
BILLION RB

| Name                      | 2017<br>(estimate) | 2018<br>(draft) | 2019<br>(draft) | 2020<br>(draft) |
|---------------------------|--------------------|-----------------|-----------------|-----------------|
| Revenues, total           | 14 720.3           | 15 257.8        | 15 554.6        | 16 285.4        |
| % GDP                     | 16.0               | 15.7            | 15.1            | 14.8            |
| including:                |                    |                 |                 |                 |
| Oil and gas revenues      | 5 795.2            | 5 479.6         | 5 247.5         | 5 440.4         |
| % GDP                     | 6.3                | 5.6             | 5.1             | 4.9             |
| Non-oil and gas revenues  | 8 925.1            | 9 778.2         | 10 307.1        | 10 845.0        |
| % GDP                     | 9.7                | 10.0            | 10.0            | 9.8             |
| Expenditures, total       | 16 728.4           | 16 529.2        | 16 373.7        | 17 155.3        |
| % GDP                     | 18.1               | 17.0            | 15.9            | 15.6            |
| Deficit (–) / Surplus (+) | -2 008.1           | -1 271.4        | -819.1          | -869.9          |
| % GDP                     | 2.2                | 1.3             | 0.8             | 0.8             |

*Source:* the explanatory note to the draft law on the Federal Budget for 2018 and the 2019–2020 planned period.

According to the draft law, the total level of *the revenues* of the federal budget in shares of GDP will fall from 16.0% of GDP in 2017 to 14.8% of GDP by 2020. The main factor behind the reduction thereof will be the dynamics of oil and gas revenues on the back of highly pessimistic forecasts of oil prices: \$49.9 per barrel in 2017, \$43.8 per barrel in 2018 and \$41–\$42 per barrel in 2019–2020. Note that the expected weakening of the ruble against the US dollar will fail to make up for completely the depreciation of the price of oil.

According to our estimates, in the period under review the price of oil will be fluctuating in the range of \$46–\$48 a barrel, so it corresponds to the Ruble/Dollar exchange rate of Rb60-Rb63 per \$1. In case such price and exchange rate targets are achieved, the volume of oil and gas revenues will exceed the level set in the budget by 0.1 p.p. of GDP and 0.3-0.4 p.p. of GDP in 2018 and 2019–2020, respectively.

Oil and gas revenues are expected at the stable level of 9.8–10.0% of GDP. In accordance with budget projections, that is related to improvement of the

macroeconomic situation, higher quality of fiscal management and indexation of the rates of excises.

The revenues from the main source of non-oil and gas revenues, that is, the VAT are forecasted to exceed slightly by 0.3 p.p. of GDP the 2017 revenues from this tax during the entire three-year period. The revenues from the profit tax, import duties and excises are projected in shares of GDP for the entire period of 2018–2020 at the level of 2017 which situation is quite justified.

In 2018–2020, the total volume of the federal budget *expenditures* is expected to decrease from 18.1% of GDP in 2017 to 15.6% of GDP by 2020. Note that in 2011–2017 the federal budget expenditures did not fall below 18% of GDP.

Generally, the efficiency of the budget consolidation of the past few years remained rather low: from 2013 till 2017 the federal budget expenditures decreased from 18.6% of GDP to 18.1% of GDP, it is to be noted that they rose by 24% in nominal terms and fell by 9.7% in real terms. The pattern of the federal budget expenditures got much worse: cuts in expenditures affected primarily investments in development of the infrastructure, science and human capital. Such a dramatic reduction of federal budget expenditures (2.5 p.p. of GDP in the next three years) is related to adjustment of the budget to the new budget rule approved in June 2017.

Under the abovementioned budget rule, the ultimate volume of the expenditures is determined as the sum of the following three components: 1) the base volume of the oil and gas revenues calculated on the basis of the price of oil prevailing at the permanent level of \$40 per a barrel of Urals oil and the relevant base price of natural gas; 2) the volume of non-oil and gas revenues calculated in compliance with the baseline scenario of the mid-term forecast of the RF Ministry of Economic Development; 3) expenditures related to debt-servicing. Despite the obvious simplicity and transparency of the above pattern, the new budget rule lacks the required sustainability: with accumulation of funds at the National Welfare Fund at least at the level of 10–15% of GDP, a strong political pressure starts to be exerted to review the base price as it happened in 2005. Further, as all the components of the budget rule behave either in a procyclic or acyclic way it is impossible to maintain expenditures at a permanent level.

In our view, the dynamics of expenditures included in the draft budget does not permit duly to underpin economic growth at the expense of the budget and puts at risk the fulfillment of social obligations (amid preservation of the existing legislation on social issues).

It is believed that the policy of keeping non-interest federal budget expenditures not below 16% of GDP and the federal budget deficit not higher than 1.5% of GDP with the share of non-productive expenditures (on defense, law enforcement, public management, subsidies to state-run companies and financially viable institutes of development and social expenditures) being smoothly reduced and the current level of the tax burden maintained is quite justified. It will permit to ensure the equilibrium between the need, on the one hand, to meet people's needs in education, healthcare, social support, public security and other, while, on the other hand, to maintain quite favorable business environment.

In the context of functional classification of the expenditures, their highest growth in absolute and relative terms by the end of the three-year period in 2020 as compared to the level of 2017 is expected in the following sections:

- “Servicing of the State and Municipal Debt”: growth of Rb 149.9bn or 20.8%;
- “National Security and Law Enforcement”: Rb 163.5bn or 8.3%;
- “Education”: Rb 38.9bn or 6.2%;
- “Healthcare”: Rb 46.9bn or 10.4%.

Also, slight growth in funding volumes in 2020 as compared to 2017 is expected in the “General Inter-Budget Transfers” section and the “Protection of the Environment” section (an increase of Rb 21.5bn and Rb 1.9bn or 2.7% and 2.0%, respectively).

A reduction of expenditures in shares of GDP by 2020 as compared to 2017 is registered in most sections, including: “Social Policy” (a decrease of 1.1 p.p. of GDP); “National Defense” and “National Economy” (0.6 p.p. of GDP); “Federal Issues” (0.3 p.p. of GDP); “National Security and Law Enforcement” and “General Inter-Budget Transfers” (0.2 p.p. of GDP); “Education” (0.1 p.p. of GDP) and “Physical Culture and Sports” (0.06 p.p. of GDP). As regards other sections of the functional classification, in 2020 the expenditures in shares of GDP will remain at the level of 2017. It is to be noted that there is a considerable decrease in non-productive federal budget expenditures.

The share of expenditures distributed by programs in the total volume of budget expenditures in 2020 as compared to 2017 remains unchanged at the level of 51.5%. As regards the lines of state programs, the “New Quality of Living” program and the “Innovative Economic Development” program will account for the highest share of the expenditures in the entire 2018–2020 period (19.6% and 12.5%, respectively). Such major lines of the expenditures as pension provision and maintenance of national defense capabilities are not included as before into the program part of the federal budget.

The specifics of the draft law consists in the fact that it rejects federal target programs (FTP) and five pilot state programs. If in 2017 33 FTPs are financed by means of budget funds, in 2020 it is planned to fund only 14 programs. Note that the measures of the programs which remain still topical are expected to be included in the existing subprograms or integrated into the newly developed subprograms (for example, “The Development of the Pharmaceutical and Medical Industry in the Period till 2020 and Beyond”, a federal target program was transformed into the subprogram: “Comprehensive Development of the Pharmaceutical and Medical Industries”).

Also note that project-based approach which is to become a more effective instrument of implementation of the state policy priorities than FTP is not yet integrated in full in the program based budget. So, according to the data of the Audit Chamber in the 2017 budget Rb122bn are provided for implementation of priority projects and that is equal to 1.3% of the federal budget program expenditures.

In 2018, secret and top secret allocations will fall by 7.0% to Rb 2,896.3 trillion (3.0% of GDP) and amount to 17.5% of the expenditures of the federal budget. Despite a relatively high transparency of the draft budget, the share of classified expenditures still exceeds by times similar public finance indices of developed countries, so this transparency can hardly be deemed as satisfactory.

In 2018, the main *source of funding of the federal budget deficit* will be resources of the National Welfare Fund, while in 2019–2020 it is state borrowings (*Table 2*).



Table 2

## THE SOURCES OF FUNDING THE FEDERAL BUDGET DEFICIT, BILLION RB

| Indices                                | 2017<br>(estimate) | 2018<br>(draft) | 2019<br>(draft) | 2020<br>(draft) |
|--|--------------------|-----------------|-----------------|-----------------|
| Total sources                          | 1 923.8            | 1 271.4         | 819.1           | 869.9           |
| % of GDP                               | 2.1                | 1.3             | 0.8             | 0.8             |
| including:                             |                    |                 |                 |                 |
| State borrowings                       | 1 010.3            | 785.7           | 805.6           | 1 044.6         |
| Resources of the National Welfare Fund | 663.5              | 1 113.7         | 4.5             | 3.8             |
| Resources of the Reserve Fund          | 1 060.8            | –               | –               | –               |
| privatization                          | 42.1               | 13.0            | 12.2            | 11.4            |
| Other sources                          | –852.9             | –641.0          | –3.2            | –190.0          |

Source: The explanatory note to the federal draft law on Federal Budget for 2018 and the 2019–2020 Planned Period.

Such volumes of borrowings (with the current real rate of return of 2.5–3% and economic growth rates of 2%) will lead to some growth in the state debt and expenditures related to servicing thereof. The state debt will amount to 16.1% of GDP against 13.6% of GDP on the basis of the results of 2017. Note that extent of borrowings is almost equal to that of state investments of the public part of the budget and even exceeds it.

As per budget parameters proposed by the RF government, revenues from the privatization are not large (they fluctuate in the range of Rb 11–13 bn a year), which factor contradicts in general the logic of optimization of state participation in the economy.

### Financial Relations with Regions

As seen from the forecast, the trends of stabilization of revenues and expenditures of consolidated budgets of constituent entities of the Russian Federation and reduction of the budget deficit prevail. In the next three years, actual volumes of revenues and expenditures of constituent entities of the Russian Federation will be at the level close to that of 2015–2017. The aggregate budget deficit of the regions should not exceed 0.01–0.05% of GDP.

At the same time, the trend of reduction of the actual volume of inter-budget transfers (from 1.85% of GDP in 2017 to 1.44% of GDP in 2020) causes concern because it may result in a reduction of the total actual volume of regional and local budgets, growth in budget inequality and further decrease in the investment component of regions' and municipal entities' budget expenditures. Regions with the lowest fiscal capacity may suffer the most (the republics of North Caucasus, the Republic of Altai, the Republic of Tyva, the Kamchatka Territory, the Republic of Kalmykia, the Chukotka Autonomous Region, the Republic of Buryatia and other).

In 2017, the centralization of a portion of the corporate profit tax was carried out at the rate of 1% with further redistribution of the relevant volume between the entities of the Russian Federation through allowances on adjustment. This measure has increased the volume of transfers to regions by 0.07% of GDP. Even with the above factor taken into account, by 2020 the volume of allowances on adjustment is getting down to 0.59% of GDP which is below the level of 2016 (0.60% of GDP).

Also, the share of non-target financial aid in the inter-budget transfers is growing (from 44% in 2017 to 50% by 2020) due to reduction of the actual volume subsidies and other inter-budget transfers. That will promote trans-

parency of the system of inter-budget relations and provide higher flexibility to regional authorities in carrying out their fiscal policy.

Addressing the meeting of the Presidium of the State Council on 22 September 2017, the President of the Russian Federation said that a decision was made to restructure the regions' accrued budget loans for the period of 7–12 years. Regions which have a high volume of accrued budget loans may face some problems in this respect as they have to refinance such loans by means of increasing their commercial debt (the Republic of Mordovia and the Smolensk Region). However, despite the problems which may arise the gradual abandoning of budget lending is a solution for some regions because it relieves the budget system from fulfillment of credit functions which are alien to it.

In conclusion, it is worth mentioning that the budget parameters formed on the basis of new budget rules are evidence of the Government's efforts to carry out the policy of austerity measures. Maintaining of federal budget expenditures in nominal terms at the level of 2017 may have a positive effect on upgrading of the budget stability. However, another scenario seems to be more likely: the federal budget parameters can be adjusted considerably in future to solve the issues set by the country's leadership within the framework of a new political cycle. Such an adjustment may affect the 2018 budget. The presidential decrees of May 2012 can serve as example of such a policy in the current political and business cycle. With the above taken into account, the underestimated estimates of revenues and expenditures leave a reserve for taking new expenditure commitments, while the actual level of federal budget expenditures may be much higher than that of the draft budget. ●

## 2. RUSSIA'S BALANCE OF PAYMENTS IN Q3 2017

A.Bozhechkova, A.Knobel, P.Trunin

*Russia's current account balance continued to contract in Q3 2017 on the back of stabilizing exports amid rising imports. A financial account surplus was led by foreign capital inflow (FDI) into other sectors, as well as by non-resident purchases of Federal Loan Obligations (OFZs). A double BOP surplus led to a moderate appreciation of the Russian rouble.*

According to Bank of Russia's preliminary data on the BOP for Q3 2017, the current account balance ran at \$1.2bn, not much less than \$2.8bn<sup>1</sup> of Q2 2017 and not much higher than \$0.4bn of Q3 2016 (Fig. 1). There were changes, however, in the structure of the current account balance, particularly in the following three balances underlying the current account balance.

*The balance of trade in goods* amounted to \$20.7bn, down 18% from \$25.1bn of the previous quarter, adding 13% to \$18.3bn of Q3 2016. This outturn was, first of all, due to stabilized (in value terms) exports of \$84.3bn (\$82.6bn in Q1 2017, \$83.5bn in Q2 2017) on the back of traditionally stable exports (in quantitative terms), as well as because of flat year-to-quarter global prices of the Russian core export commodities such as crude oil, natural gas, metals, fertilizers, coal<sup>2</sup>. Second, imports rose to \$63.6bn, adding 9% to \$58.5bn posted in the previous quarter and 21% to \$52.6bn in Q3 2016 led by an appreciating Russian rouble (according to Bank of Russia's data, the index of rouble's real effective exchange rate against foreign currencies stood at +20.5% YoY in January–September 2017, exhibiting a considerable appreciation leading to a relative price depreciation of imports)<sup>3</sup>.

*The balance of trade in services* deteriorated (-\$9.1bn) in Q3 2017 (-\$7.6bn in the previous quarter and -\$7.1bn in Q3 2016). This dynamics was driven by slow growth in export of services to \$15.4bn (adding 4% to the value recorded in the previous quarter, when export of services ran at \$14.8bn, and +11% from the value of Q3 2016, when export of services amounted to \$13.9bn) amid more accelerated growth in import of services to \$24.4bn (adding 9% to the previous quarter, when import of services ran at \$22.4bn, and +16% from Q3 2016, when export of services ran at \$21.0bn). This was, first of all, due to further growth in individuals' international travel costs.

In Q3 2017, the investment income balance posted -\$7.1bn, which is much less (due to the seasonal factor) than -\$12.6bn of Q2 2017 and close to -\$7.9bn of Q3 2016.

1 This one differs from the central bank's BOP preliminary estimate of -\$0.3bn, refer to A. Bozhechkova, A. Knobel, P. Trunin Russia's Balance of Payments in Q2 2017 // Russian Economic Developments. 2017. No. 9. P. 8–11.

2 Refer to Knobel A., Firanchuk A. Russia's exports in Q1 2017 // Russian Economic Developments. 2017. No. 7. P. 11–18.

3 For more information about the effect of foreign exchange rate dynamics on trade refer also to Knobel A., Firanchuk A. Foreign Trade in 2016 // Russian Economic Developments. 2017. No. 3. P. 8–17.

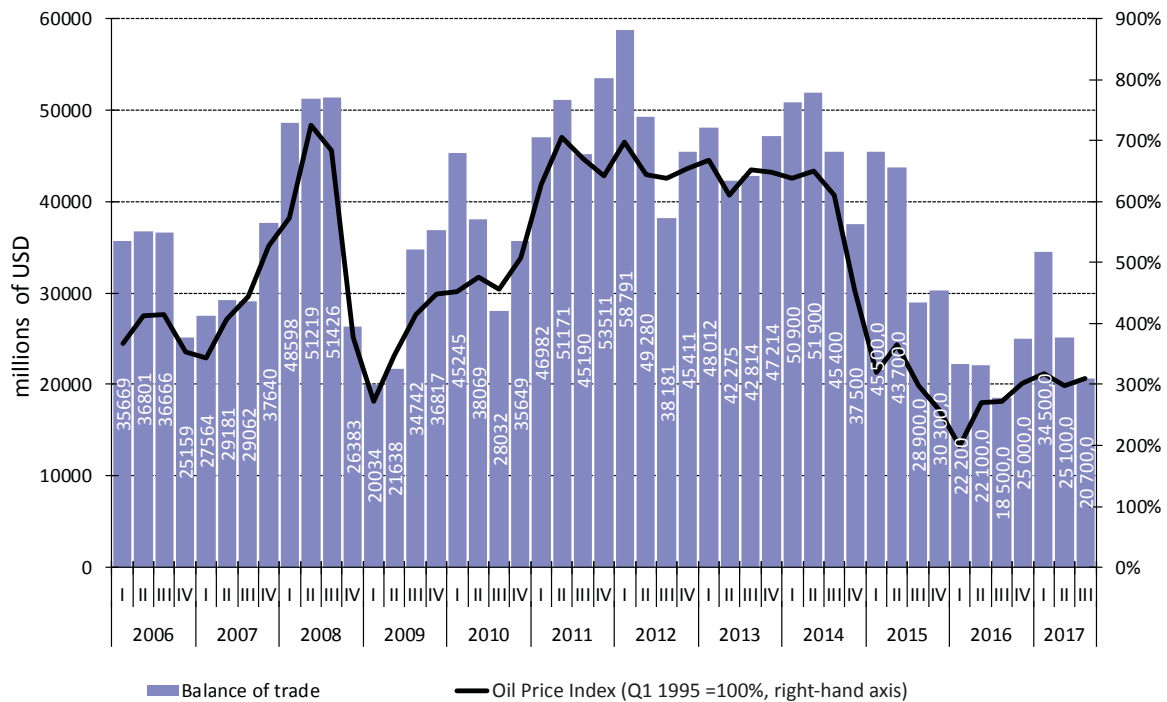


Fig. 1. Russia's balance of trade and the global oil price index in 2006–2017

Sources: Bank of Russia, Gaidar Institute's calculations.

The values of the rest of the current account components (compensation of employees balance, rent balance, secondary income balance) are still way below those of the aforementioned underlying balances, and therefore their dynamics has no significant effect on the BoP dynamics.

Q3 2017 saw both current account and financial account run a surplus, with the financial account balance reaching \$9.5bn (from \$1.0bn in Q3 2016). Russian economic agents' obligations to their foreign counterparts in July–September increased \$5.7bn, whereas they were reduced by \$5.4bn during the same period of 2016. Foreign liabilities were driven up by growth in foreign direct investments in other sectors (\$6.1bn against -\$2.1bn in Q3 2016).

The inflow of foreign direct investments in the third quarter, like in the previous quarter, was presumably due to the reinvestment of dividend income. Moreover, the growth in the portfolio investment of federal government authorities and other sectors (\$4.5bn and \$3.0bn, respectively) contributed heavily to the increase in foreign liabilities. The former's portfolio investment was driven up by the heightened interest of foreign investors in the Russian Federal Loan Obligations (OFZs) amid Bank of Russia's moderately tough interest rate policy. The banking sector continued repaying external loans in the third quarter, reducing foreign liabilities by \$9.3bn (by \$15.5bn in H1 2017).

Residents' foreign asset holdings (foreign economic agents' obligations to Russian economic agents) shrank by \$3.7bn in July–September 2017 (+\$16.5bn in H1 2017, -\$6.3bn in Q3 2016). This was, first of all, due to the fact that banking sector's foreign asset holdings were reduced by \$16.3bn. In Q1 2017, banks' foreign asset holdings jumped to a record high of \$13.6bn, which was most likely due to a bridge loan to non-residents in support of the Rosneft's Privatization Deal. The loan was presumably repaid in the second and the third quarters. In July–September, other sectors' foreign asset hol-

## 2. RUSSIA'S BALANCE OF PAYMENTS IN Q3 2017

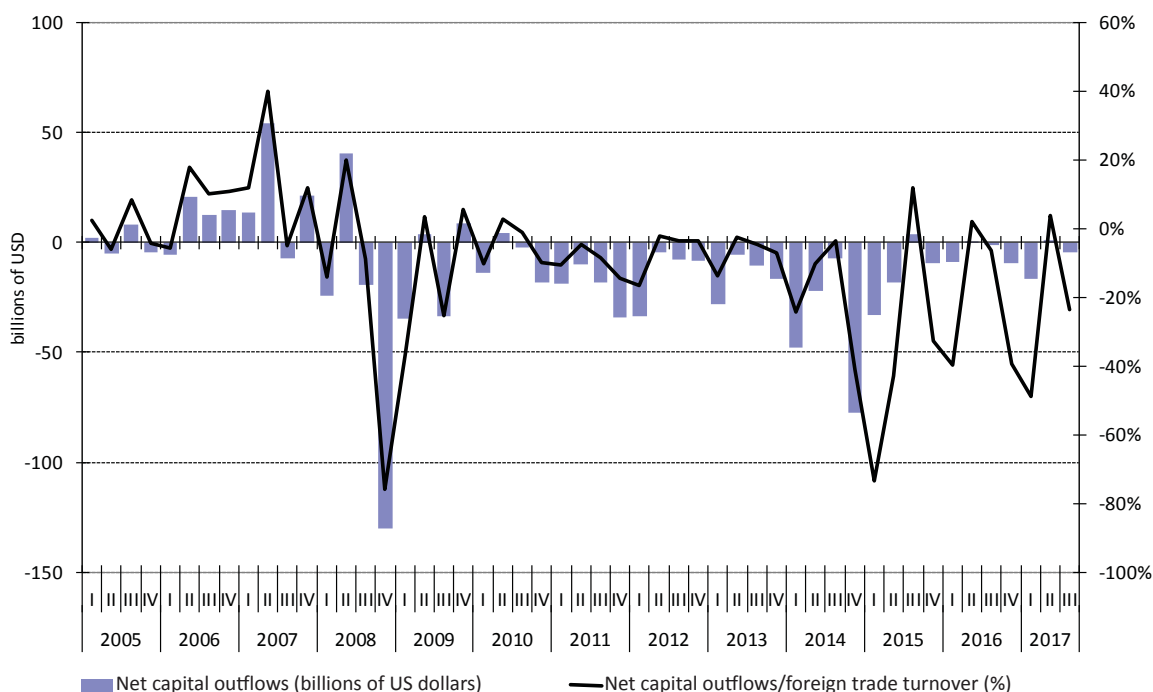


Fig. 2. Private sector's net capital outflow in 2005–2017

Sources: Bank of Russia, Gaidar Institute's calculations.

dings increased \$13.8bn (\$1.9bn in Q3 2016 and \$7.2bn in Q2 2017), driven mostly by outbound foreign direct investments worth \$10.9bn (\$1.8bn in Q3 2016 and \$7.6bn in Q2 2017). Other sectors' portfolio investment increased \$1.7bn (\$0.4bn in Q3 2017).

The net private capital inflow (\$0.9bn) in Q2 2017 gave way to an outflow of \$4.9bn in Q3 (\$1.4bn in Q3 2016) (Fig. 2). For example, \$11.9bn in the net capital outflow in the non-bank sector was partially offset by \$7.0bn in the net capital inflow in the banking sector.

The Bank of Russia added \$6.5bn to its reserve assets in Q3 2017 (+\$18.8bn in H1 2017), which was partially due to the fact that the Finance Ministry purchased approximately \$1.9bn in foreign currency in the local foreign exchange market, and the banking sector repaid its foreign-currency obligations to the Russian central bank (\$1.7bn in Q3 2017). The rest of the increase in the international reserves was due to Bank of Russia's foreign currency liquidity management operations using short-term security-backed foreign currency lending.

Thus, the appreciation (in nominal terms) of the Russian rouble against the US dollar (adding 2.6% to 57.8 roubles per US dollar as at the end of October 2017) through most of Q3 2017 was due to a positive current account balance, as was the case with the same period previous year, as well as due to a financial account surplus (Fig. 3). According to our preliminary estimates, the rouble's real effective exchange rate in Q3 2017 was overestimated 1.5–2% above the fundamentally substantiated level driven by the dynamics of productivity, terms of trade, capital flows. In this context, the rouble has to depreciate in nominal terms by 2.8% so that the rouble's real effective exchange rate returns to an equilibrium pathway, with the Russian inflation rate staying at 3% (September 2017 to September 2016), and with the inflation rate in trade partner countries averaging 1.5–2.5%.

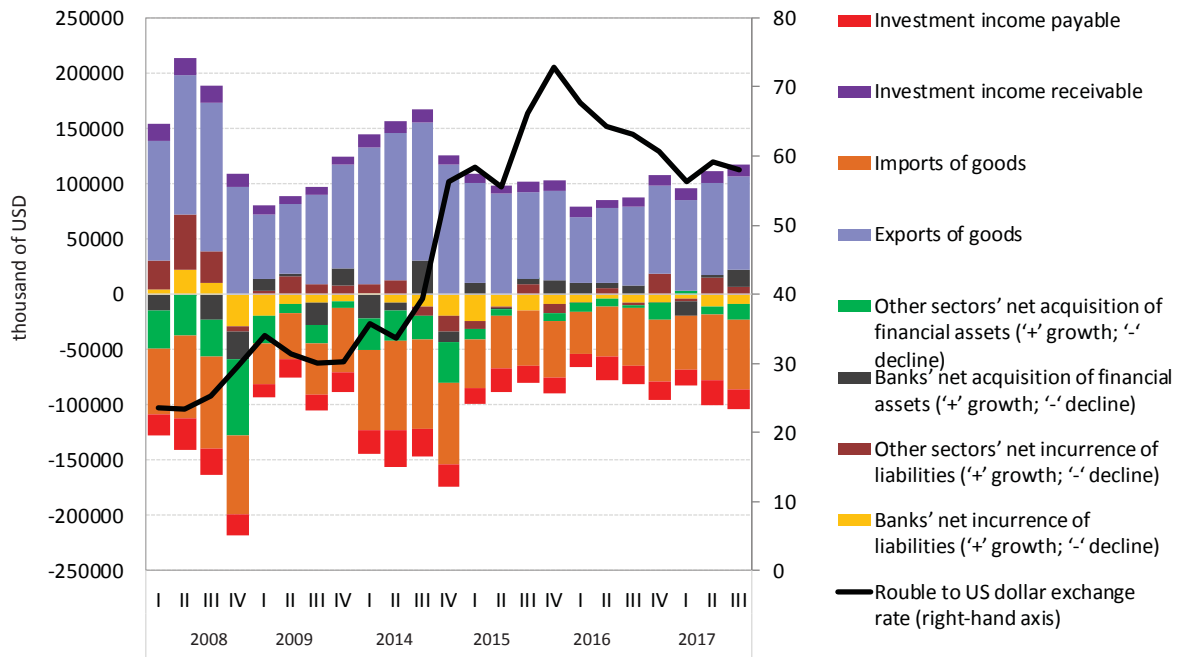


Fig. 3. Principal factors leading to changes in Russia's BoP

Source: Bank of Russia.

In general, with terms of trade remaining approximately at a level similar to what it is now, the current account will again stabilize at around zero if the rouble depreciates somewhat further as foreign capital inflow into Russian financial assets ceases on the back of a narrowing spread between interest rates in Russia and abroad. However, a serious crude price reversal would pose the risk of much stronger rouble depreciation. ●

### 3. HOUSEHOLDS' DEBT ON PAYMENTS FOR HOUSING AND PUBLIC UTILITY SERVICES (HPUS): FOR WHOM IT IS DIFFICULT TO PAY?

A. Burdyak

In H1 2017, the share of households' outstanding HPUS debt decreased as compared to the relevant indices of the last decade. Among Russian territories, the North Caucasian regions have the highest share of HPUS debt. High risks of non-payment of HPUS and electricity bills are specific to families with three and more minor children and single parent families.

In Q1 2017, households' debt on HPUS payments were equal to 10.7% of the total sum of all the payments accrued to households. According to the results recently published by the Rosstat, such debt fell to 4.8% and tensions related to them subsided. Why changes in the debt have occurred so suddenly, what is the nature of this index and how was it changing in the past few years?

The data on the debt is collected on a quarterly basis with cumulative result from the beginning of the year on the basis of the 22-HPU (housing and public utilities) form which is filled in by enterprises. For example, in January–June enterprises specify the amount of bills issued to households in the past six months and the amount of payments received in that period. The difference arises due to a constant growth in tariffs when bills are paid in the next month and also due to a delay in payments for a month or two. Normally, the debt is the highest in the first three months of a year. It used to be very high, up to 18%, in Q1 2009 and Q1 2010. In that period, tariffs on the main public utility services (hot and cold water supply, waste water disposal, power supply, gas supply and heating)<sup>1</sup> rose in nominal terms by 16% a year or more. As until 2012 the tariffs used to be increased from January, in the beginning of the year enterprises rendered services and issued bills to households on the basis of new tariffs, but received payments at lower tariff rates for the past year, so a huge “deficit” was always observed in Q1. After they started from 2012 to raise a larger portion of tariffs in summer, the January–March surges became lower.

In the beginning of 2017, households' outstanding debt on HPUS amounted to 10.7% (a record-low January–March index of the past few years) (Fig. 1). By

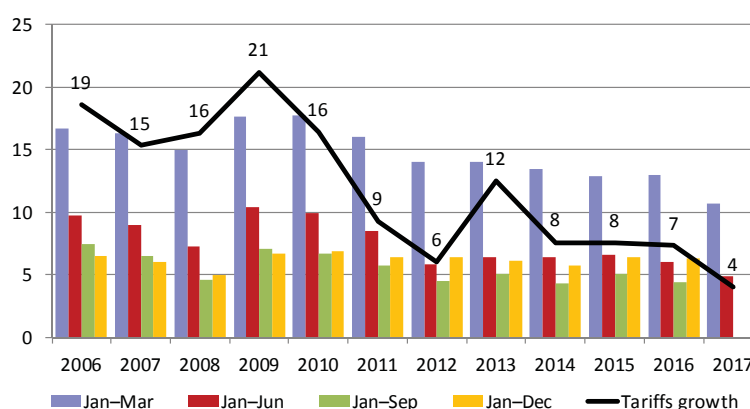


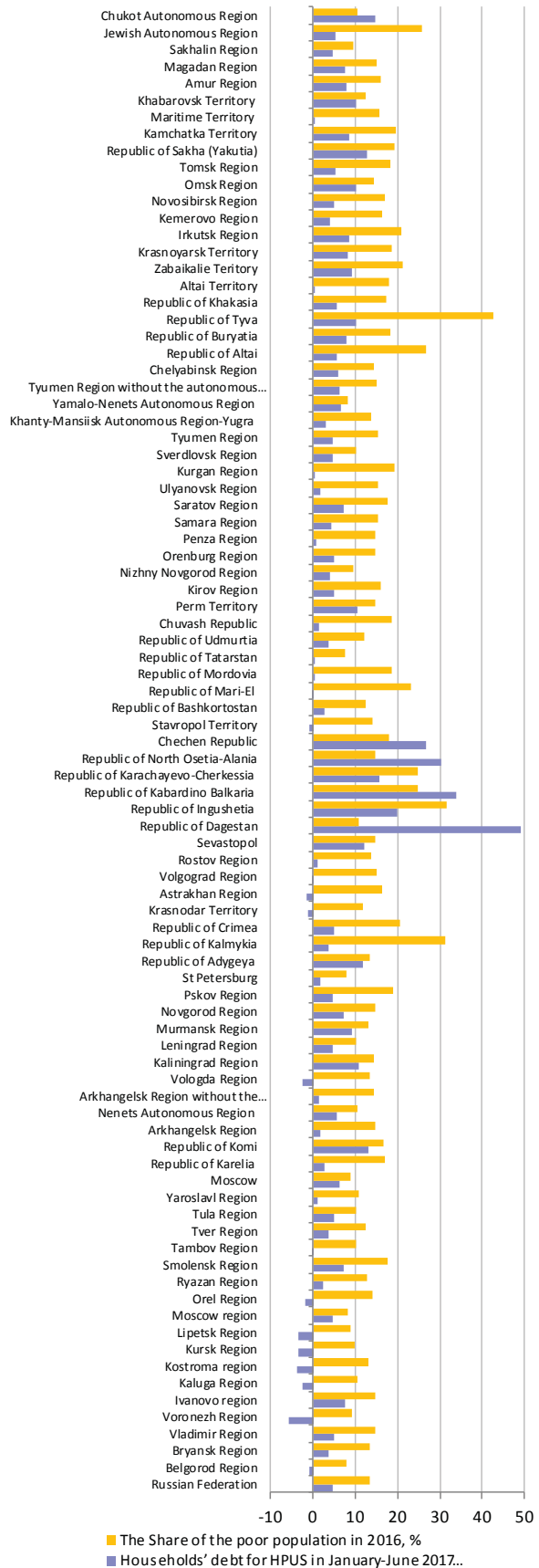
Fig. 1. Households' outstanding debt on HPUS (% of the amount due) and annual average growth in tariffs on HPUS (%)

<sup>1</sup> The weighted average sum is calculated on the basis of the pattern of consumption in accordance with Classification of Individual Consumption By Purpose (CICP) and the information on average monthly consumer prices (tariffs) of goods and services / United Interdepartmental Statistical Information System (UISIS), Rosstat.

the end of the year, the volume of the outstanding debt with a cumulative result for six, nine and twelve months will decrease to 6% of the sum of the bills issued to households in the same period. Such a situation was observed at least in 2011–2016. Also, H1 2017 saw the record low index of households' outstanding payments for HPUS (4.8%) in the entire period of observations. Such a result became feasible thanks to the following factors: sorting out of things in the housing and public utilities sector, upgrading of the electronic document flow, promotion of transparency of the tariff-setting process and elimination of accounting faults.

Is it possible to assert – with respect to concrete situations – that households' high debt to enterprises providing HPU services are related to a region's general welfare, precisely, the poverty rate of the population<sup>1</sup>? No, it is not. No correlation of this kind is observed at the level of constituent entities of the Russian Federation (Fig. 2). In the Republics of Dagestan, Kabardino-Balkaria and Chechnya, the share of the poor population is much lower than that of outstanding HPUS bills. On the contrary, in some other regions (the most disadvantageous ones) – the Republic of Kalmykia, the Republic of Altai, the Republic of Ingushetia, the Republic of Tyva and the Jewish Autonomous Region – there are no serious HPUS debt problems according to H1 results.

Such characteristics of non-payers as the type of the family, families with children, the income level and other are important to the social policy. However, with a transfer from the level of regions to that of families a legitimate question arises to what extent the population of the constituent entities of the Russian Federation is involved in relations with enterprises of the housing and public utility sector and what share of families is not accounted for in the statistics on non-payments for HPUS. The main indicators of the progress of the reform of the housing and public utility sector include



1 Inequality and Poverty / The Rosstat [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/population/poverty/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/poverty/#)

Fig. 2. Households' HPUS debt in H1 2017 and the share of the poor population 2016 across regions, %  
 Source: Authors' calculations on the basis of the Main Indicators of the Progress in the Reform of the Housing and Public Utilities Sector <https://www.fedstat.ru/organizations/?expandd=1292875#fpsr129287>



the cost of housing and public utility services per person a month<sup>1</sup>, on which basis it is feasible to calculate the number of people in the housing fund which receives housing and public utility services. By comparing it with the number of the population of regions<sup>2</sup>, it can be concluded that, for example, in the Republics of Tyva and Altai 19–22% of the population receives housing and public utility services from enterprises of the HPUS sector, while in the Chechen Republic that index is equal to 35%.

Other population of these and other regions is not represented in the statistics in calculation of the average cost of HPUS in regions or the debt volume. It concerns primarily residents of rural areas. The correlation analysis reveals that the higher the share of the urban population in the region, the higher the share of the population which receives housing and public utility services from enterprises of the HPUS sector (Fig. 3). In the Russian Federation, on average, 63% of people lives in the housing fund maintained by HPUS enterprises (in case of the urban population the index is equal to 74%).

The Survey of Households' Budgets (SHB) in which urban and rural residents are evenly represented provides an opportunity to analyze the types or groups of households which have financial problems and fail to pay timely for HPU services. The question about financial difficulties was included in the SHB queries only from the beginning of Q1 2016. As seen from the data on the Q1 2017 results, the situation somewhat improved. The share of those who failed to pay their HPUS bills due to financial difficulties decreased from 9.9% to 9.3% of households. In Q1 2016 and Q1 2017, 6.8% and 6.5% of families failed to pay their electricity bills, respectively.

Note that in the first quintile group (the most disadvantageous one), the share of those who failed to pay for HPU services fell from 16.1% to 15.7% of families of that income group. The number of those who failed to pay their electricity bills due to financial difficulties did not virtually change (11.8% and 11.6%). With income growth, the number of debtors is going down, but even among the representatives of the fifth quintile group (the wealthiest one) 6.8% of families and 5.5% of families failed to pay HPU bills on time last year and this year, respectively, while 4% of families did not pay their electricity bills. So, the level of income is an important factor behind difficulties in payment for housing and public utility services.

Which families become debtors more often? Higher risks of financial difficulties are specific to families with children under 16 years old. Risks of untimely payment for HPUS bills are twice as high with single-parent families and families with three and more minors than on average with all the families (18% against the average index of 9%) (Fig. 4).

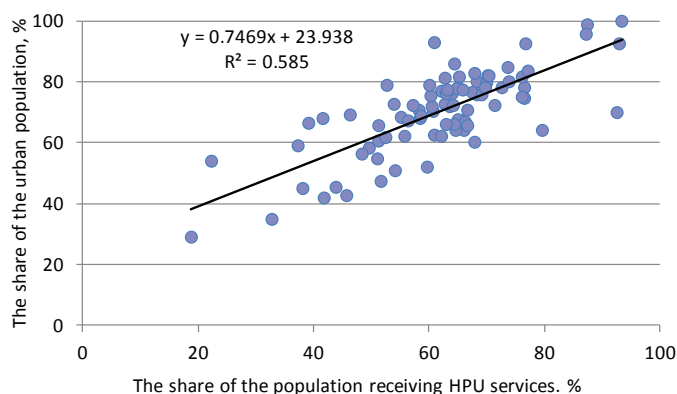


Fig. 3. The share of the urban population and the share of the population receiving HPU centralized services across RF regions, %

1 The value of costs related to provision of housing and public utility services (month/ per person) compensated by households <https://www.fedstat.ru/indicator/33590#>

2 The estimate of the number of the permanent population as of 1 January 2017. [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/population/demography/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/demography/#)

If a household is represented by a single non-working pensioner or a relevant couple or if there is a young family in the composition of the household, such a household runs a high risk of becoming a debtor (12–13%). However, if there is a disabled person of any age group, it does not much influence the risk of non-payments. At present, there is virtually no difference as regards the number of non-payers for HPUS and electricity between urban and rural residents, though a year ago the situation in cities was somewhat worse than in rural areas. In Q1 2017, among families with many children and young families the share of those who failed to pay their HPUS bills due to financial difficulties increased as compared to Q1 2016. At a time when the general situation is getting better, the financial situation of the abovementioned families got worse. ●

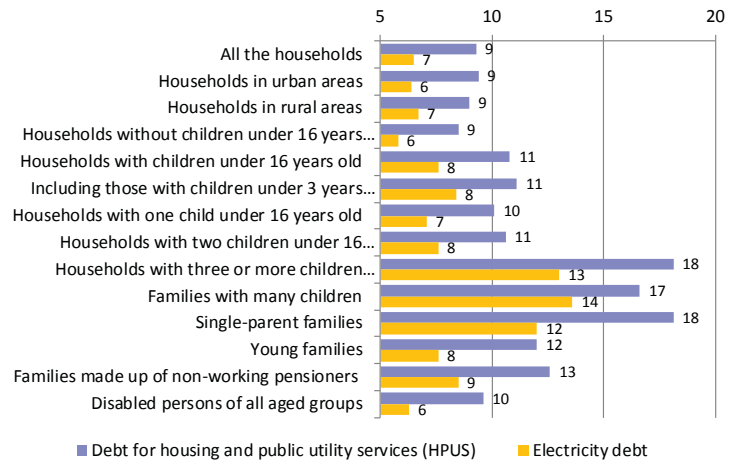


Fig. 4. The share of households having financial difficulties which prevent them from paying their bills for HPUS and electricity in Q1 2017, %

### 4. TAX ADMINISTRATION IN RUSSIA

V.Gromov, A.Korytin, S.Patel

*Material changes in the Russian tax administration have boosted tax revenues on the back of improved tax collection performance, without raising the tax burden. Tax service informatization allows for automatic detection of fly-by-night companies, thereby contributing to the formation of a fair and equitable competitive environment. However, substantial resources are available and yet to be employed to improve tax administration.*

Tax evasion still remains a serious problem facing Russia. In this context, tax administration measures can produce a strong fiscal effect. Control should therefore be enhanced while adhering to the principle of preventing an increase in the administrative burden.

Tax administration measures can be lumped into two packages: counteracting tax evasion and increasing the effectiveness of tax control procedures and forms.

#### **Counteracting tax avoidance**

Tax avoidance leads to lower budget tax revenues and to distortion of fair competition. The solution of these problems urges the state to enhance tax administration and tax legislation, as well as to implement non-tax measures in the context of oversight and compliance monitoring, to reduce the cash-in-hand flow between legal entities.

New transfer pricing rules are in force since 2012 as an effort to reinforce counteracting measures against price manipulation as one of the most popular ways of tax avoidance. Profit tax rules for controlled foreign companies, new rules under which legal entities' tax residence is recognized according to the place of their effective management, as well as a concept of ultimate beneficiary of income have been introduced since 2015 for the purpose of 'deoffshorization' of the economy.

Major contribution to increasing tax administration effectiveness in Russia comes from active **informatization** and computerization of the Federal Tax Service (FTS) workflow.

For instance, an automated control system for VAT refunds (**ASK NDS**) kicked off in 2013. The system is designed for automatic detection of interruptions in the chain of VAT payments and, accordingly, companies that fail to pay VAT to the budget. The second stage of this programme (ASK NDS-2) is underway since 2015, while the third version is under development and testing, which is expected to increase the quality of control using data on cash flow through transaction parties' bank accounts.

A Provision on Nalog-3 Automated and Information System was adopted in 2016, which is designed for building a unified information array and for bulk processing of incoming data to tax authorities, including a function that provides complete and comprehensive information ("profile") about a particular taxpayer.

A prospective line of tax administration development in Russia involves the introduction of **cash register equipment** (CRE) designed for automatic transmission of transactions data to tax authorities. Any CRE registration from 1 February 2017 onwards is supposed to ensure a possibility of fiscal data transmission in electronic form, that is, the data on settlements with buyers are transmitted to tax authorities. Persons who registered CRE under the old rules were obliged to switch over to online cash registers from 1 July 2017.

Owing to a great number of points at issue regarding the application of new rules for electronic payment instruments, a decision has been made to postpone until 1 July 2018 the deadline for the CRE mandatory use of all types of electronic payment instruments, except for payment cards.

Down the road, the data transmitted from online cash registers are supposed to be integrated with the data from ASK NDS-2.

### **Increasing the effectiveness of tax control procedures and forms**

A way to move forward on tax administration is to employ e-services to ease the interaction between taxpayers and tax offices. In particular, using "taxpayer personal account" on the FTS website opens up a wide range of opportunities for users (individuals): electronic filling in and submitting of personal income tax returns (NDFL-3), applying to the tax office without personal visit, obtaining information about accrued and paid taxes.

Another way is to release the administrative burden upon taxpayers when it comes to tax inspections. There are several factors involved in this type of administrative burden: the duration and the number of tax inspections; the period of refund of excess taxes withheld; the number of documents that must be submitted to tax authorities in the course of tax inspections; summons to so-called "loss investigation boards", etc. At present, tax inspections are governed by the rules that were set long time ago, since when tax authorities have improved their technical capacity and competence. Therefore, there are resources available for accelerating and simplifying tax control procedures.

For instance, **duration of tax inspections** (a field (tax) inspection normally lasts two months, but it may be extended until up to six months; a single desk audit is normally lasts three months) is objectively long and can be reduced using modern information technologies for data exchange between taxpayers and tax authorities. Not only will this help reduce taxpayers' and inspectors' costs, but it will also speed up the decision-making after inspections, e.g., concerning the refund of excess taxes withheld, tax deductions, VAT refund (which normally takes more than 20 weeks<sup>1</sup>), transfer of the amount to be subtracted from the personal income tax (three months for inspection and one month for money transfer).

Even today, the inspectee can use one of the ways to submit documents, that is document transmission in electronic form, provided that the documents are certified using the enhanced encrypted and certified digital signature. Documents can be submitted in this manner using the taxpayer personal account.

1 M. Papchenkova, E. Bazanova. The duration of VAT refund inspections can be reduced to one month // Vedomosti [E-resource]. – Available at: <https://www.vedomosti.ru/economics/articles/2017/03/16/681381-fns-vozmeshchenie-nds>

Taxpayers (individuals) may be faced with problems if the tax office denies tax deduction as a result of tax return desk inspection. The tax office may **deny tax deduction without giving any reason**, in which case an individual may ask for the reason(s) via his/her personal account opened on the FTS website. In that case the response must be given within a month, and the denial can be challenged in the higher tax authority within one month from the final date of inspection. It is obvious that the applicant will most likely miss the deadline for appeal. Instead of deciding forthwith to deny, it would be reasonable for inspectors to ask, when necessary, the taxpayer to provide explanations and extra documents, and the reasons for the denial should be given.

As to field tax inspections, further work is required to, first of all, streamline the procedure for selecting taxpayers who are subject inspection, and to, second, enhance the list of documents that may be requested in the course of inspection.

A more precise **planning of field (tax) inspections** using a risk-based approach and operations materiality analysis will help release the administrative burden upon good faith taxpayers and focus inspectors' attention on taxpayers whose activities pose a high risk of tax offences.

Field (tax) inspections often suggest that taxpayers should **collect and submit a great deal of documents**, some of which may turn out to be unnecessary. Therefore, documents should be submitted pursuant to a properly arranged procedure, involving only the documents that are really necessary for inspection. Additionally, it would be reasonable to ensure a possibility for requesting (possibly in electronic form) extra documents, when necessary.

A third way is to develop arrangements of voluntary interaction between tax authorities and taxpayers, providing for advanced agreement on the procedure for payment of taxes. These arrangements also comprise tax monitoring and advanced tax agreements.

**Tax monitoring** is a form of tax control requested by an organization, that is distinguished from other forms by its voluntary nature. In practice, this allows for resolving, even prior to the date of tax reporting, all issues in dispute with taxpayers. A tax monitoring institute was enacted in Russia on 1 January 2015 after a pilot project kicked off in late 2012 and proved efficient after testing. The monitoring is based on real-time analysis of the accounting and tax records of an organization by way of permitting tax authorities to have online access to accounting records and data bases. This form of control requires less labour inputs, mitigates the administrative burden on businesses, because no extra inspections are needed due to absolutely transparent accounting.

At present, the right to apply for monitoring is limited by financial performance figures of an organization, with very high lowest values (Rb 300m for VAT, excise duties, profit tax and minerals extraction tax; Rb 3bn for income, Rb 3bn for asset value). With the monitoring in place, labour inputs in administering such taxpayers have been reduced three-fold and the business environment has become more friendly for the taxpayers through, among other things, coordination of complex methodological issues. The practice should therefore move forward towards stepwise lowering the above threshold values and expanding the scope of monitoring to a wider range of persons.

**Pricing agreements** that are voluntarily concluded between the taxpayer and the FTS also play an important part in advanced agreements on tax issues. The agreements define in advance each party's view of the proce-

ture and the methods of pricing concerning specific controlled transactions or groups of homogeneous transactions, including before transactions are closed. Such agreements, when signed, minimize disagreements with tax authorities, reduce considerably the probability of holding persons liable for failure to pay (for incomplete payment) the tax that occurs when controlled transactions are closed, make the assessment of future tax liabilities more predictable.

However, agreements involving methodology, a procedure for estimation of tax implications for future transactions, now can be applied only to transactions between related parties (persons). In our view, it would be reasonable to expand gradually the scope of application of advanced agreements to other categories of transactions.

### **Specific tasks of individual property tax administration**

The transition to the taxation of immovable individual property according to the cadastral value, which took place in 2015–2017 in some subjects of the Russian Federation and will be introduced in other subjects in the coming years, puts relevance to the issues of efficient administration of this tax. The issues have their specifics that relate to the specific features pertaining to real estate registration and appraisal.

Tax losses can be caused by problems arising in the course of the following stages in which government agencies identify tax liabilities of taxpayers:

- When the immovable property and the title thereto are registered with the respective register (Unified State Register of Rights to Immovable Property (EGRP)): tax liabilities do not occur when the property is not registered or the owner thereof has not been identified;
- When cadastral valuation is performed: incorrect entry of property specifications in the registry or inappropriate cadastral valuation can lead to incorrect assessment of the tax base;
- When tax is paid: a situation may occur in which either tax notice has not been delivered, or the taxpayer has intentionally committed a tax evasion.
- With a view to encouraging individuals to provide information on the property they own, a regulation was adopted, under which taxpayers must notify from 1 January 2015 the tax authority of non-delivery of the tax notice on property taxes.

The Federal Agency for State Registration, Cadastre, and Cartography (Rosreestr) is also involved in streamlining the state cadastral registration through troubleshooting and identification of property owners<sup>1</sup>. Local government authorities provide assistance in detecting unregistered immovable property, urging owners to register on a voluntary basis the detected immovable property. However, there is no real tools in place for submission to registration of operating sites whose owners benefit from recognizing these sites as construction in progress, and for obtaining information required for cadastral valuation. In particular, it is impossible to perform tax inspection of living quarters without consent of the persons living in such quarters. To address the issue, the international experience should be considered, including

<sup>1</sup> The Federal Target Program “Development of a unified state system of registration of title and cadastral registration of real estate (2014–2019)” [E-resource]. – Available at: <http://fcp.economy.gov.ru/cgi-bin/cis/fcp.cgi/Fcp/ViewFcp/View/2014/418/>

in Canada, where assessing officers are entitled to have warrantless access in a specified time to real property and to obtain the information required for assessment<sup>1</sup>.

A Federal Law Concerning State Cadastral Valuation was adopted to ensure a uniform approach to the real estate appraisal for taxation purposes. The Law provides for the establishment of state-funded agencies that will perform valuation pursuant to a single methodology, and governs the procedure for challenging cadastral valuations. However, the Law does not consider the quality of valuation as a measure approximating the cadastral valuation to the market value but rather as the extent to which the approved methodology is observed. Application of the statistical criteria provided for by the International Association of Assessing Officers should be ensured in order to control the quality of cadastral valuation<sup>2</sup>. ●

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1 Assessment Act (Amended 2012) [E-resource]. – St. John's, Newfoundland and Labrador, Canada. - Available at: <http://www.assembly.nl.ca/legislation/sr/statutes/a18-1.htm>

2 International Association of Assessing Officers (2013). Standard on Ratio Studies [E-resource]. – Available at: [http://www.iaao.org/media/standards/Standard\\_on\\_Ratio\\_Studies.pdf](http://www.iaao.org/media/standards/Standard_on_Ratio_Studies.pdf)

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