

# **EVOLUTION OF RUSSIA'S BUDGETARY POLICY IN THE 2000S: IN SEARCH OF FINANCIAL STABILITY FOR THE NATIONAL BUDGET SYSTEM**

BY

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## **ABSTRACT**

This paper deals with 2008-2009 crisis which marked a new stage of Russia's budgetary policy. Although the budget situation in Russia is presently much better than in the majority of the developed countries, reservation of high dependence on oil proceeds, observed trends in in the structure of expenditure obligations indicate the preservation of high risks of an unbalanced budget in long term perspective. Provision of budgetary and macroeconomic balance require adoption of urgent measures both in the sphere of tax policy and budget outlays.

**Keywords:** budget policy, financial stability, tax policy, fiscal policy, national budget.

**JEL:** E62, E52, E58, G01, H61, H68,

# **EVOLUTION OF RUSSIA'S BUDGETARY POLICY IN THE 2000S: IN SEARCH OF FINANCIAL STABILITY FOR THE NATIONAL BUDGET SYSTEM<sup>1</sup>**

## **Pre-crisis stage of budget reform**

Under the influence of the 2008-2009 world crisis and in conditions of worsening debt problems in Greece, Spain, Ireland and Portugal in 2010 the Russian government had to review its policy of increasing public expenditure and obligations. For instance, there was a tendency towards restraining the growth of budget expenditure in the development of the draft federal budget for 2011-2013. The budget projections for the following three years were supposed to ensure stability of the fiscal system by reducing the budget deficit in the fulfillment of previous commitments and to promote innovative development of the Russian economy.

However, the country's budgetary system is still in a state of unstable equilibrium and is heavily dependent on the structure of world energy prices. Despite the reduction of spending relative to GDP, the amount thereof is notably higher than the level in 2008 - a generally good year. In such circumstances an objective view of the risk threat of a budgetary crisis should be considered. In order to prevent it, a record of the balance of the country's financial system should be maintained over the long term. Otherwise, in the case of a sudden change in external conditions, Russia may repeat its experience of 1998, when the primary reason for the crisis was the government's inability to provide for the adoption and, more importantly, performance of a realistic budget. During all the years after the collapse of the USSR: state spending consistently exceeded income from year to year. Consequently, while the external economic situation was favorable up until 2008 this allowed significant improvements in income for the public sector and the development of a considerable surplus (see table 1).

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Table 1

**Implementation of income and expenditure at all government levels in 1999-2008,**  
*% of GDP*

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>Federal budget</b>										
Income	12.7	15.5	17.8	20.3	19.5	20.1	23.7	23.3	23.4	22.5
Expenses	14.0	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.0	18.3
Deficit (-) / surplus (+)	-1.3	1.4	3.0	1.4	1.7	4.3	7.4	7.4	5.4	4.2
<b>Consolidated regional budgets</b>										
Income	13.4	14.1	14.5	15.1	14.6	14.1	13.9	14.1	14.6	15.0
Expenses	13.3	13.4	14.5	15.5	14.9	13.9	13.6	13.6	14.4	15.1
Deficit (-) / surplus (+)	0.1	0.7	0.0	-0.4	-0.3	0.2	0.3	0.5	0.2	-0.1
<b>Budget of extended government</b>										
Income	33.8	38.3	38.4	37.8	37.1	37.5	39.7	39.6	39.8	38.6
Expenses	35.3	34.3	35.2	36.3	36.0	32.9	31.6	31.2	33.8	33.8
Deficit (-) / surplus (+)	-1.5	4.0	3.2	1.5	1.1	4.6	8.1	8.4	6.0	4.8
<i>For reference: the public debt of the RF (as of the end of the year), total</i>	95.4*	57.2*	43.4*	42.1	31.7	23.2	14.3	9.1	7.2	6.5
<i>including: internal</i>	12.0	7.6	6.0	6.3	5.2	4.6	4.1	4.0	3.9	3.6
<i>external</i>	83.4*	49.6*	37.4*	35.8	26.5	18.6	10.2	5.1	3.3	2.9

\* Information according to the Bank of Russia.

Sources: Federal Treasury, authors' calculations.

With steady growth the budgetary income of the extended government and total expenditure only continued to increase up to and including 2003, after which they started to decrease by 4-5 percentage points of GDP. Such correction of the budget policy was determined by two factors: firstly, further accumulation of budget expenditure conflicted with the task of assuring financial stability in the country by restraining inflation; secondly, a huge burden of social obligations had been built up during previous years, requiring inventory and reduction which was reflected in the tightening of the budgetary allocation, implementation of result-oriented budgeting (ROB) and attempts to optimise the structure of the budgetary institutions.

Budgetary expenses fell sharply in 2004: the share of federal budget spending in GDP decreased by 2 percentage points relative to 2003. This decrease was due to: the creation of the Stabilization Fund, providing for the accumulation of oil rent, and the withdrawal from the economy of the excessive monetary supply and use of conservative forecasts for oil prices and inflation in fiscal planning. However, starting from 2007, due to abnormally high oil prices and the weakening of fiscal policy (in connection with assumption by the government of additional social obligations to the population and the approval ambitious new investment programs) the restraining effect of taking conservative macroeconomic measures could not prevent the growth of federal budget expenses as a percentage of GDP.

Around 2007 the next stage of soft budget policy began in the country, when the growth in spending at all levels of the budgetary system of the RF outperformed the income base. As a result, for the first time in five years, despite the favorable internal and external economic situation, there was a reduction in the budget surplus of the extended government. Due to a sharp deterioration the external economic situation in the second half of 2008, federal revenues decreased considerably (by 0.9 percentage point of GDP). This, again, confirms that the crisis which led to the reduction of oil and gas revenues disturbed the financial stability of the federal budget more than anything else.

In the 2000s there were many attempts in Russia to increase both the stability of the budget system and the efficiency of allocation and use of state funds. The major events in the area of fiscal policy in these years were:

- adoption in 1998 of the Budget Code, effective from 1 January 2000;
- the creation, in 2004, of the Stabilization Fund of the RF (from February 2008 it was divided into the Reserve Fund and the National Welfare Fund);
- implementation of certain ROB procedures;
- improvement of the legal framework for public procurement and municipal needs;
- implementation of priority national projects as an alternative form of a programme management of budgetary expenditure;
- establishment of development institutes for the purpose of creating a unified investment system in the country (Investment Fund of the RF, the Special Economic Zone Open Joint-Stock Company, the Bank of Development and Foreign Economic Affairs (Vnesheconombank), the Russian Venture Company, the Russian Corporation of Nanotechnology (Rosnano), etc.);
- the transition to medium-term budget planning in 2007.

However, the analysis shows that many of the above measures for improving fiscal policies were not implemented properly: ROB was not developed to the stage of being a

spending-efficiency management tool, the establishment of a system of development institutes was not completed, the budget network reform plateaued, etc. This was the result of mistakes made in the choice of setting priorities for the budget reform. From the early 2000s, within the framework of improvements to the budgeting process, complex management mechanisms began to be implemented (ROB, goal-oriented programming). These had proved themselves relatively effective in the UK, USA, New Zealand and Australia but were hardly used in countries with weak institutional environments. Since fundamental budgetary questions were not resolved: the restructuring of the budget network, the creation of incentives for the effective grass-roots use of the budgetary funds and the improvement of the public procurement system, it was hard to expect a rapid improvement in the quality of management of state funds.

## **Essentials of the 2009 fiscal policy**

### *Dynamics of budgetary income and expenditure*

Due to the financial crisis which affected the economies of many countries in the second half of 2008, the mode of operation of the Russian economy changed radically. The key characteristics of this period are associated with relatively low prices and demand for Russian exports, a sharp reduction of output and the growth of unemployment. By the beginning of 2009 the Russian economy had entered a recession accompanied by devaluation of the ruble and the phasing out of investment programs. The worsening situation in the economy was reflected in the state budgetary system: with a considerable reduction of proceedings to the budgets at all levels and, by 2009, the growth of spending commitments within the budget of the extended government had become a deficit for the first time in 10 years (see table 2). The imbalance of the budgetary system and the protracted nature of the world crisis created risks of an increase in the scale of borrowing in the short term.

Table 2

### **Implementation of income and expenditure at all levels of government in 2009**

	2009		Change compared to 2008				
	billion rubles	% of GDP	in nominal terms		in real terms		p.p. of GDP
			billion rubles	%	billion rubles	%	
<b>Federal budget</b>							
Income	7,336.8	18.8	-1,937.3	-20.9	2,159.4	-22.7	-3.6

<i>including oil and gas</i>	2,983.9	7.6	-1,405.5	-32.0	-	1,510.6	-33.6	-3.0
Expenses	9,636.8	24.7	2,070.2	27.4	1,889.0	24.4	6.4	
Deficit (-) / surplus (+)	-2300	-5.9	-4,007.5		-	4,048.4		-10.0
<b>Consolidated regional budgets</b>								
Income	5,927.2	15.2	-271.9	-4.4	-420.3	-6.6	0.2	
Expenses	6,256.3	16	2.8	0.0	-146.9	-2.3	0.9	
Deficit (-) / surplus (+)	-329.1	-0.8	-274.7		-273.4		-0.7	
<b>Budget of extended government</b>								
Income	13,420. 7	34.4	-2,582.7	-16.1	-	2,965.9	-18.1	-4.2
Expenses	15,847. 3	40.6	1,858.1	13.3	1,523.1	10.6	6.8	
Deficit (-) / surplus (+)	-	-6.2	-4,440.8		-	4,489.0		-11.1

*Sources:* Ministry of Finances of the RF, Institute of Economic Policy (IEP) calculations.

The biggest drop in revenue and growth of expenditure occurred at the federal level as this was principally dependent on revenues affected by the prevailing economic situation. Federal budget revenues decreased by 23% in real terms whilst expenses increased by almost 25% and the budget surplus, of 4.1% of GDP in 2008, was replaced by a budget deficit of 5.9% of GDP in 2009.

In a short period (from November 2008) the Russian government took a wide range of anti-recession measures - this was unprecedented both in the number of types and directions of state influence on the economy and in the volumes of resources involved. In the autumn of 2008 “point responding” measures were implemented under tight time constraints, primarily using “manual management” mechanisms, but by March 2009 a complex set of anti-recession measures had been developed by the Russian government.

In order to finance priority areas of the anti-recession program it became necessary to make amendments to the Federal Budget Law. As a result, the budget acquired an expressly anti-recession nature: previously approved budget appropriations were reduced by 2.4% of GDP, where 4.1% of GDP (including the released resources) was allocated, mainly, to support financial stability and the preservation of strategic industries and enterprises and, to a lesser extent, to support vulnerable social groups. The anti-recession measures were financed both from federal budget funds and from non-governmental sources, accounting for over 2/3 of the relevant expenses.

In general, according to our estimates, the cost of the set of anti-recession measures in 2008 was 1.1 trillion rubles (2.7% of GDP) and, mainly, included expenses relating to

supporting the financial system. In 2009, 2.4 trillion rubles of budget and quasi-budget funds were allocated to anti-recession measures (6.2% of GDP).

In Russia the macroeconomic risks of the anti-recession program were partially reduced due to the financial reserves accumulated in the period of economic growth. Oil and gas funds became the main sources of financing the federal budget deficit in 2009. About 3 trillion rubles (7.7% of GDP) were allocated from the Reserve Fund for financing budget expenditure. We should point out three aspects relating to an understanding of the “reserve” nature of these funds.

*Firstly*, the use of money from the Reserve Fund to repay the budget deficit is a simple issue of money being provided by the Central Bank of the RF, because in practice, this transaction means the movement of the liabilities and funds of the special account of the RF government in the Central Bank into the monetary base (in the government’s current account). This transaction could be non-issuing if the Bank of Russia simultaneously sold the currency received during the period of accumulation of the Reserve Fund, however, after falling to their lowest level in January 2009 the international reserves of the Bank of Russia continued to grow steadily. If the creation of the Reserve Fund was not accompanied by a reduction of the monetary base (its funds would have to be accumulated on accounts in commercial banks rather than on the government’s accounts in the Central Bank), its accumulation and expenditure would not be linked to the money issue. Thus, from the point of view of the money policy, the Fund was not some kind of reserve but a separate source of money inflow into the economy.

*Secondly*, the issue-effect described above (of the use of funds from the budget account) is observed every time that the government spends money within the framework of the Treasury System of the RF, which holds budget accounts in the Bank of Russia. In such a system the funds received for the budget account are taken out of the monetary base. Corresponding fluctuations of the monetary base are constantly observed during the year. We should note, for example, a sharp growth of monetary aggregates in December when the budget is actively executing expenditure items, or the reduction of the monetary base within the last days of the month, when taxes are transferred to the budget.

However, by virtue of the fact that the adopted budget period is the fiscal year, as a rule (from the point of view of budgetary policy), only the final influence of the budget transactions on the monetary base is taken into account. If the period of budget planning were to be extended, for instance, to five years, the use of money from the Reserve Fund would cease to be a pure issue because money accumulated therein, within this period, may be considered temporarily withdrawn (as with fluctuation of the monetary base caused by non-



synchronous implementation of income and expenditure of the budget) and then returned to the economy.

*Thirdly*, from the point of view of fiscal and debt policy, money within the Reserve Fund can definitely be considered as the reserve of the RF government because its availability allows for financing the budget deficit without borrowing in the market, which would increase the national debt. This may be performed by the issue, with simultaneous sterilization of the monetary base, through foreign exchange intervention, using external resources accumulated as a counterpart of the Reserve Fund. At the same time, the experience of EU countries, the USA, Japan, UK, etc. shows that it is the growth of public debt for financing anti-recession measures which becomes one of the key problems during recovery. Taking into account the above, Russia's Reserve Fund acts as a factor which allows the avoidance of a build-up of a debt load and the transfer of the burden of current expenditure onto future generations.

Simultaneous with the growth of costs, anti-recession tax exemptions were implemented: income tax rate was reduced, a new procedure for a non-linear amortization, an increased depreciation premium, increased non-taxable price minimum for mineral extraction tax (MET), etc. In 2009, the total cost of the "tax package" for the budget system was about 1.5% of GDP.

The anti-recession fiscal measures taken in Russia in 2008-2009 are similar to equivalent foreign programs in terms of the tools used: unemployment benefits; support of pensioners; assistance provided to strategic enterprises in various sectors of the economy; financial restructuring of banks and support for small and medium-sized enterprises. The differences primarily relate to the financing volumes and are due to differences in the severity of the problems faced by the government and the scale of such problems.

In general, the anti-crisis policy in Russia was successful although it had some shortcomings:

- the retarded nature of decision-making in the implementation of the measures of the anti-recession program;
- a lack of transparency in the governmental support measures, in particular, the absence of rules for the of allocation of assistance to enterprises;
- insufficient attention to supporting the population during the initial stage of the crisis, which reduced the effectiveness of the government measures;
- irregularity of the cash implementation of the expenditure commitments, impeding effective and timely use of budget appropriations.

## Budget policy during recovery from the crisis

Along with the improvement in the macroeconomic situation, the revenues of the budget of the extended government based on the results of the first half of 2010 exceeded the level of the corresponding period in 2009 by 1.9 percentage points of GDP. At the same time, the expenditure, in relative terms, decreased by 2.6 percentage points of GDP, although in absolute terms the growth of such expenses was about 700 billion rubles. As a result, as of 1 July 2010 the budget of the extended government was implemented with a surplus of 1.3% of GDP, whilst in the corresponding period of 2009, its balance had been 3.2% of GDP (see table 3). It should be noted that the considerable difference in balance values for the budget of the extended government and the federal budget observed in the first half of 2010, compared to the corresponding period of the previous year, is explained, primarily, by the change in the procedure for the transfer of money to non-budget funds: whilst in 2009 the unified social tax proceeds were partially transferred to the federal budget income and then to the Pension Fund of the RF, starting from 2010, insurance premium payments were transferred directly to non-budget fund accounts.

Table 3

### Implementation of income and expenditure at all levels of government in January-June 2009 and 2010

	January-June 2010		January-June 2009		Change, p.p. of GDP
	billion rubles	% of GDP	billion rubles	% of GDP	
<b>Federal budget</b>					
Income	3,997.9	19.0	3,172.2	17.9	+1.1
Expenses	4,386.2	20.8	3,893.9	22.0	-1.2
Deficit (-) / surplus (+)	-388.3	-1.8	-721.7	-4.1	+2.3
<b>Consolidated regional budgets</b>					
Income	3,155.7	15.0	2,711.3	15.3	-0.3
Expenses	2,747.6	13.0	2,611.7	14.8	-1.8
Deficit (-) / surplus (+)	408.1	2.0	99.6	0.5	+1.5
<b>Budget of extended government</b>					
Income	7,603.5	36.1	6,042.7	34.2	+1.9
Expenses	7,331.2	34.8	6,619.7	37.4	-2.6
Deficit (-) / surplus (+)	272.3	1.3	-577.0.9	-3.2	+4.5
<i>For reference: GDP, billion rubles</i>	<i>21,073.0</i>		<i>17,679.6</i>		

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

Federal budget income for the first half of 2010 was 19.3% of GDP which was 1.3 percentage points higher than the value for the corresponding period for 2009. Federal budget expenses in January-June 2010 decreased by 0.5 percentage points of GDP compared to the corresponding period of the preceding year, and reached 21.5% of GDP. However, this value is one of the highest compared to the pre-crisis period when federal budget expenses did not exceed 16% of GDP. As a result of multidirectional changes in the parameters of the federal budget for the first half of 2010 this was implemented with a deficit of 2.1% of GDP compared to 4.1% of GDP in 2009.

The consolidated regional budgets for January-June 2010 were also implemented with a surplus of 2.0% of GDP compared to 0.5% of GDP for the corresponding period of 2009. Although in the first half of 2010 expenses decreased by 1.8 percentage points of GDP, the federal authorities recommended that the RF subject states continued to restrain the growth of their budget expenses.

In analyzing the revenues to the budget system of the country, the effect of the low base in the first half of 2009 should be taken into account. The budget receipts then decreased because of the drop in oil prices and the general slow-down of economic growth rates. If we compare receipts for the first half of 2010 and for the corresponding period of 2008, we see that the current level of income is notably lower than the pre-crisis level. Moreover, in early 2009 and 2010 the investment income from the management of oil and gas assets was 275.2 billion rubles and 134 billion rubles, respectively.

The budget income of the extended government (see table 4) consists of income from tax revenues, personal income tax revenues, mineral extraction tax (MET) revenues and value-added tax (VAT) revenues. The increase in income in January-June 2010 was primarily due to the growth of revenues from foreign economic activities, MET revenues and, to a lesser extent, due to an increase of corporate income tax. In general, the level of the *tax burden* on the economy for the first six months of 2010 increased by 2.6 percentage points of GDP compared to the corresponding period of 2009 and reached 32.4% of GDP.

Table 4

**Dynamics of tax burden and revenues from main taxes received to the budget of the extended government of the RF in January-June 2009 and 2010, in % of GDP**

	January– June 2010	January– June 2009	Change, percentage points of GDP
<i>Level of Tax burden (1+2+3)</i>	32.4	29.8	+2.6
Tax revenues (1), including:	20.3	20.9	–0.6

corporate income tax	4.4	3.6	+0.8
personal income tax	3.8	4.2	-0.4
unified social tax*	0**	2.3	-2.3
VAT	5.4	5.4	0
excise taxes	1.1	0.9	+0.2
MET	3.2	2.3	+0.9
Insurance premiums on compulsory pension insurance (2)	5.1	3.6	+1.5
Income from foreign economic activities (3)	7.0	5.3	+1.7

\* Without taking into account insurance premiums on compulsory pension insurance.

\*\* From 2010, instead of unified social tax, organizations pay insurance premiums credited directly to non-budget funds.

Sources: Ministry of Finances of the RF, Rosstat (Federal Service of State Statistics), IEP calculations.

Against the background of considerable growth of budgetary income in the first half of 2010 the relative level of expenditure decreased significantly. Expenses of the budget of the extended government decreased by 2.6 percentage points of GDP (see table 5) whilst in absolute terms the volume of expenses increased by 711.5 billion rubles.

Table 5

**Implementation of budget of the extended government in terms of expenditure for January-June 2009 and 2010, in % of GDP**

	January-June 2010		January-June 2009		Change, percentage point of GDP
	billion rubles	% of GDP	billion rubles	% of GDP	
Expenses, total <i>including:</i>	7,331.2	34.8	6,619.7	37.4	-2.6
general state issues	615.2	2.9	567.8	3.2	-0.3
including for servicing state and municipal debt	131.0	0.62	112.4	0.64	-0.02
national defense	563.2	2.7	527.3	3.0	-0.3
national security and law enforcement activities	578.6	2.8	546.3	3.1	-0.3
national economy	791.0	3.8	1034.5	5.9	-2.1
housing and utilities sector	352.3	1.7	329.2	1.9	-0.2
environmental protection	10.5	0.05	11.6	0.07	-0.02
education	860.5	4.1	817.1	4.6	-0.5
culture, cinematography, mass media	141.5	0.7	132.1	0.8	-0.1
healthcare and sports	705.2	3.4	680.1	3.9	-0.5
social policy	2,713.1	12.9	1,973.5	11.2	+1.7

Sources: Treasury of the RF, IEP calculations.

The greatest relative reduction in public spending was due to decreased financing of the national economy by 2.1 percentage points, healthcare, sports and education by 2.1 percentage points of GDP. Expenses relating to general state issues, national defense, national security and law enforcement activities decreased by 0.3 percentage points compared to the corresponding period of 2009. The financing of social policy considerably increased during the period in question (by 1.7 percentage points of GDP), mainly, due to an increase of 1.5 times in the cost of the pension system.

### Short-term prospects

Recognizing the impossibility of further annual increases in public spending in the future in post-crisis development, and whilst striving to ensure financial stability of the budget system in the medium term, the RF government, in planning the federal budget for 2010-2012, announced a policy to reduce expenditure commitments as a share of GDP, yet to increase their effectiveness. Full performance by the state of obligations undertaken earlier would result in keeping the deficit at the same level of 6-7% of GDP for the next two-three years. Reduction of the budget deficit would not require a partial refusal from the decisions and obligations already made and undertaken. In the Budget Message-2010 the task of assuring macroeconomic and financial stability was made into a cornerstone which required the reduction of the budget deficits which limit government spending. The main parameters of the federal budget for 2011-2013 are laid out in Table 6.

Table 6

#### Main characteristics of federal budget in 2008-2013, % of GDP

Indicator	Fact		Estimate	Law		
	2008	2009	2010	2011	2012	2013
Income	22.4	18.8	17.9	17.6	17.0	16.8
<i>including oil and gas income</i>	10.6	7.6	8.3	8.1	7.9	7.5
Expenses	18.3	24.7	21.9	21.2	20.1	19.7
<i>including nominally approved</i>	–	–	–	–	0.7	1.3
Deficit (–) / surplus (+)	4.1	–5.9	–54.0	–3.6	–3.1	–2.9
Non-oil and gas deficit	–6.5	–13.6	–12.3	–11.7	–10.9	–10.4

Source: Ministry of Finance of Russia.

It should also be noted that in the Federal Budget Law for 2011-2013 the tendency to reduce the level of income remains unchanged. As seen from table 6, the primary reduction of income is observed in 2010 and is associated with the replacement of the unified social tax

with insurance premiums (−1.3%) and a decrease in revenues from the payment of customs duties (−0.3%).

We should note that, according to the forecast of the Ministry of Finance of Russia, in 2013 the federal budget income will be 5.6 percentage points of GDP lower than in 2008, at a comparable volume of real GDP. According to our calculations, about 2.5 percentage points are associated with the change in tax legislation (replacement of unified social tax with insurance premiums and the reduction of income tax), 1 percentage point is associated with the decrease in revenues from the oil and gas sector (MET and export duty exemptions) and 2.1 percentage points are associated with other factors. Among them: changes in the structure of GDP (reduction of the income part of GDP and the level of profitability); a conservative estimate of the level of tax collection and a decrease in revenues from foreign trade duties.

Tax revenues which account for about 55% of the total budget income will remain a primary source of federal budget income during the next three years. At the same time, a gradual reduction in the share of oil and gas income is expected, with a simultaneous increase of non-oil and gas income due to the low growth rates of prices for ‘Urals’ oil and taxable export volumes, compared with the dynamics of GDP and the strengthening of the ruble.

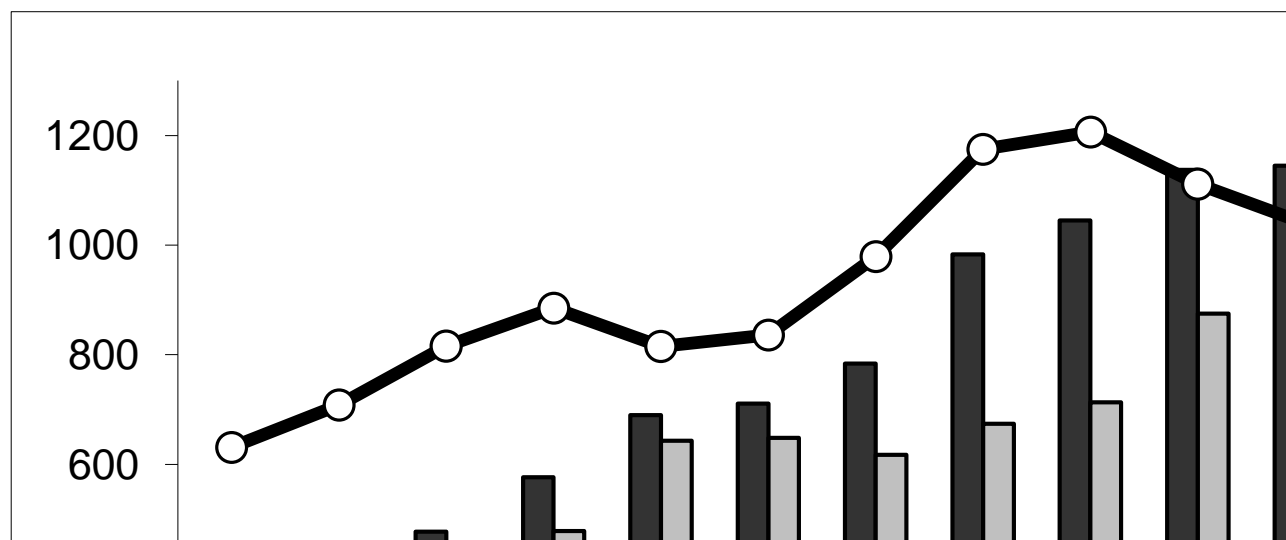
In addition, the projected revenue growth resulting from establishing a set of dividends on the shares of joint-stock companies which are in federal ownership, and part of the income of federal state unitary enterprises has been forecast (49.3 billion rubles in 2011 and 53.3 billion rubles in 2013). In order to cover the budget deficit it is planned to use income from privatisation (298 billion rubles in 2011 and 309 billion rubles in 2013). The Reserve Fund will only be used to finance the deficit in 2011, in the amount of 284.3 billion rubles. As a result it will be completely exhausted by 2012. It is planned to use the National Welfare Fund in an amount equal to the co-financing of the pension savings of citizens (in 2011-2013 in the amount of 5-7.5-10 billion rubles, respectively), which will keep the previously accumulated resources of the Fund to ensure the financial stability of the pension system.

Even if the federal budget deficit is reduced, the stability of the financial and budgetary system may be adversely affected by the growth of public debt. In this case its structure will change towards domestic borrowing (in 2010-2013 domestic debt will increase from 5.4 to 14.2% of GDP and the external debt will remain within the limits of 4-5% of GDP), which evidences the sound debt policy of the state.

Although, in the long term, expenditure obligations should decrease, it will still remain at quite a high level (see the figure below). As a result, a stable deficit of the federal budget, of 3-5% of GDP, will remain.

### **Dynamics of income, expenses and deficit of the federal budget,**

*billion rubles, at 1998 constant prices*



*Sources:* Ministry of Finance of Russia, IEP calculations

We should note that there are objective reasons for the growth of expenses. Firstly, it is associated with the ageing population and the necessity to provide social support to certain categories of citizens. Secondly, it is necessary to finance existing obligations in the areas of education and healthcare, in the field of provision of social guarantees for military personnel, the payment of social allowances and compensations and the indexation of salaries of public-sector employees. Thirdly, within the framework of reform of the law enforcement system, financing of the public security militia has been carried out from the federal budget since 2011. In addition, due to objective reasons the Russian government has had to increase spending on the implementation of international obligations and the servicing of the public debt.

However, the existence of a stable deficit in the federal budget, even under a favorable (baseline) scenario, has serious risks for its implementation and the stability of the budgetary system in general. In the case of a less favorable turn of events in the economy and changes in ratios between the basic parameters of social and economic development, either the budget deficit may reach a level which will impede growth of the economy growth or the government will have to cut costs.

## **Medium-term scenarios of social and economic development of the RF**

The key trends in the development of the Russian economy in the medium-term are determined by the effects of the post-crisis recovery, scenarios for the development of the world economy and the budgetary policy of the Russian government.

*The effects of post-crisis recovery* have a different orientation. On the one hand, the economy growth rates in 2010 are relatively high due to the low base of 2009. Furthermore, securing the population's income levels and other anti-recession measures became an additional factor in the maintenance of domestic demand and the personal savings of citizens. On the other hand, the continuance of high risks and uncertainty in the economy and pessimistic expectations of the economic agents impair the effectiveness of the monetary and credit policy of the Central Bank of the RF. In particular, credit activities only respond weakly to the reduction of rates by the Bank of Russia (at the same time, reduction of the refinancing rate discourages saving in commercial banks).

An analysis of the *scenarios of the world economy* appears to show that the main factors and sources of economic growth for our country are:

- price levels for oil and other raw materials for export from Russian;
- physical volume of the demand in the world market for major Russian exports;
- availability of capital for Russian borrowers in global financial markets;
- the pace of global economic growth and demand for non-energy goods in Russian exports.

Hence, the risks and limitations of economic growth in Russia are determined by the possibility of a new crisis, the low speed of recovery of the world economy and weak growth in demand for both energy and non-energy goods as parts of Russian exports, the emergence of promising developing markets and increased competition between BRIC countries in the world capital market. Furthermore, the possibilities for expansion of the domestic market are quite limited and this impedes reliance on this for development (as in China or India).

*The fiscal policy of the RF government* will influence the prospects of economic growth in the following ways:

- fulfillment of the social obligations of the budget;
- implementation of important strategic infrastructure projects;
- the possible negative effects of the budget on macroeconomics (displacement of private borrowing, inflation, etc.);



– the formation of positive expectations by economic agents while providing a long-term stability of the fiscal sector.

At the same time the main risk relating to the fiscal policy is a high probability of budgetary imbalance in the medium-term in the current foreign economic climate. Accumulation of public debt may result in Russian private companies being forced out of the debt markets both within the country and abroad. The low efficiency of budget spending may become an obstacle for their reduction in numbers.

### *Prospective scenarios of the development of the world economy*

From our point of view, two scenarios for the development of the world economy are possible in the medium-term.

*The Inertial (“as usual”)* scenario suggests that the 2008-2009 crisis in economies of the leading world countries will be fully overcome in 2011 and a new crisis will be avoided. The key preconditions for this are:

- decisive and responsible policy of the leading countries for the reduction of budgetary deficit, coordinated monetary and credit policies;
- coordination of exit-strategies for recovery from the anti-recession measures in different countries;
- reaching agreements within G8 or G20 on the new requirements of the global financial market, better regulation of financial institutions;
- the absence of sensitive local or regional crises in the emerging markets of developing countries.

According to this scenario, the leading world economies will recover from the crisis and continue developing in the medium-term in the face of extremely high debt burdens on state budgets, which means the reduction of spending on social programs, the support of domestic demand and resolving new challenges in the economy. In this case the increase in the debt burden and the growth of pension costs become the key long-term problems for leading world economies. Moreover, sale of real and financial assets nationalized during the crisis is expected.

In this scenario the growth in the world economy in 2010 will not exceed 2.5–3% (primarily, due to the relatively high growth rates in China, India, Brazil and other developing countries and with low but positive growth rates in the USA and the EU) and in 2011-2013 by 3.5-4% per year. In other words, during the period concerned, the world economy will grow more slowly than before the 2008 crisis.

The suggestion of a slow recovery of the leading world economies from the crisis in the absence of a major change in the structure of the global economy requires that the relationship between world currencies will remain practically unchanged. In particular, we suggest that despite some problems in a range of countries in the Eurozone (first of all, in Greece, Spain and Portugal), stability of the euro will remain unchanged and, within the framework of this scenario, the euro/US dollar rate in 2011-2013 is expected to be at the level of 1.35-1.4 dollars. However, if no other focuses of current debt problems in European countries arise other than Greece, Spain and Ireland a new reduction to 1.15-1.2 dollars in the euro/US dollar exchange rate is possible until the middle of 2011. We should note that during the recovery from the crisis, when the assurance of global price competitiveness is more important than investment attractiveness and the possibilities of capital export, the lower the euro exchange rate, the more beneficial this is for all the European economies.

Oil prices on the world market will also remain essentially unchanged: additional demand for oil and oil products due to the economic growth in China and developing countries during this period may be offset by a return to the original levels of extraction by the OPEC group (from the summer of 2008 OPEC took several decision to reduce their production quotas) and other oil producing countries. At the same time, the persisting risk of a new crisis and the growth of public debt in the world, together with strengthening of the regulation of the financial markets will deter the involvement of financial speculators in new large-scale participation in the oil market. We assume that in general, in 2010-2013 the price for 'Urals' oil will be between 70 and 90 dollars per barrel.

Although in 2009-2010 the prices for metals grew by 25-50%, they will remain at a level lower than their pre-crisis value during the period in question. We expect that the nominal prices for ferrous and non-ferrous metals will return to the 2008 level only by the end of 2013.

Stabilization of the situation in the financial sector of leading economies, with a gradual increase in rates, will lead to a revitalization of the activities of global investors in developing countries. However, we believe that due to the slow recovery of the economy and the persistence of a relatively weak situation in the leading mineral markets, the restoration of a large-scale inflow of foreign capital to the RF will be no earlier than 2011.

The expected level of oil and gas prices does not indicate a likely expansion of opportunities for enhancing the introduction and development of new oil and gas deposits in the RF. This means that the production volumes and possibly the export of raw hydrocarbons will be reduced. The situation in Russian metallurgy and metal export will probably improve

as the physical volume of world demand for them will grow in 2011-2013, compared with the level of 2008-2009.

*Scenario of slow recovery from the crisis (new crisis).* Within the framework of this scenario we consider a pessimistic turn of events in the world and in the Russian economy. The following preconditions are typical for this scenario.

1. Mistakes made in the implementation of crisis exit strategies by the economic authorities of the developed countries: premature sharp increase in basic interest rates, inability to resist further increase in the budget deficit, etc. The realization of hidden risks in the US or European economies: further growth of unemployment, a crisis in the commercial property sector, a new round of write-offs of “toxic” assets by financial institutions, etc.

2. A reduction in the efficiency of fiscal incentives in the Chinese economy. In the case of a stagnating external demand, this would lead to a sharp slow-down of the development of the Chinese economy, with possible negative social and political consequences, and a drop in aggregate demand for raw materials in the world market.

3. The occurrence of local or regional crises in developing markets which are important for the world’s financial sector, for example, increasing financial problems in the UAE or other countries of the Persian Gulf, crises of a “traditional” nature (i.e. similar to those in the 1990s) in Latin American, South-East Asian or other developing countries.

In this scenario we suggest that the main decline caused by a new crisis would occur in 2011-2012 and the pace of world economic growth may be reduced to 0-2% (depending on the cause of the crisis) and in 2013 the world economy would grow no more than 2.5-3%.

For Russia this scenario would mean a new sharp decrease in prices for raw materials (e.g. oil by 30-50 dollars per barrel), a reduction in the physical volume of exports of raw materials and an inability to explore new deposits, with extremely limited access to the global capital market. It is possible that there would be a further reduction in the global market prices for metals to the level of 2008-2009.

From the point of view of the relationship between the major world currencies this scenario introduces the greatest uncertainty because one possible outcome would be a crisis in one of the countries issuing reserve currencies. Thus, in the case of worsening problems in the Eurozone, devaluation of the euro would occur (probably, to the level of 0.7-0.8 euro per dollar) or in the case of an inflationary solution to resolve debt problems in the USA –there could be dollar devaluation (to 2-2.5 dollars per euro).

### *Main scenarios for the development of the Russian economy*

In the medium-term, the two most likely scenarios for the development of the Russian economy are:

The *baseline scenario* which assumes a relatively high growth rate for the Russian economy in 2010-2013: 3.5-4% per year. The conditions needed for this scenario would be the implementation of the inertial scenario for the world economy together with conducting a responsible fiscal policy:

- this guarantees the balancing of the federal budget by 2013, with oil prices of 70-80 dollars per barrel, and at these higher prices, a return to the policy of the formation of oil and gas funds;

- increasing the efficiency of budgetary spending which will guarantee the implementation of the most important strategic infrastructure projects.

In this scenario the Russian economy, in the longer term, may follow the growth path provided by Concept-2020 which would ensure diversification of the economy and an increase in well-being.

Note that the implementation of a quick recovery scenario for the world's economy allows the achievement of higher GDP growth rates in the medium term (5-6.5% per year by 2013). However, in the longer term this scenario is less stable because it reproduces the fundamental problems of the economy in the lead-up to 2008 (overheating of certain markets, the dominance of the raw materials sector, etc.)

*The worst-case (pessimistic) scenario* assumes a new crisis in the world economy. Under these conditions in terms of fiscal policy there is really only one choice: the Russian government would be forced to cut spending and balance the budget, even with oil prices lower than those in the baseline scenario. Accordingly, the rate of economic growth in Russia in 2011-2012 would drop again, even becoming negative, depending on the depth and extent of the world crisis, so, in 2013, a new phase of the crisis would begin.

The following calculations show the indicators of the social and economic development of the Russian Federation under the two scenarios, based on a structural econometric model of the Russian economy (see tables 7 and 8). This model represents a system of regression equations and identities describing the dynamics of the main indicators of the social and economic development of Russia.

Table 7

**Baseline scenario**

	2008	2009	2010	2011	2012	2013
Oil prices (Brent, dollars per	93.9	60.7	74.2	75	78	79

barrel)						
Real GDP growth rate (%)	5.2	-7.9	3.6	3.1	3.8	4.2
Federal budget income (% of GDP)	22.4	18.8	18.5	17.9	18.1	18.3
Federal budget expenditure (% of GDP)	18.3	24.7	23.1	20.0	18.8	18.5
Surplus / deficit (-) of the federal budget (% GDP)	4.1	-5.9	-4.6	-2.1	-0.7	-0.2
Exports (billion dollars)	472	303.3	380	388	403	414
Imports (billion dollars)	293	192.7	230	266	303	334
Capital transactions account balance (billion dollars)	-138.8	-45.2	13.9	15.0	25.0	30.0
Gold and foreign exchange reserves (billion dollars)	427	439	493	587	665	728
Nominal ruble/US dollar exchange rate (RUR/USD)	24.80	31.68	30.45	29.40	28.8	28.1
EUR/USD exchange rate	1.47	1.39	1.3	1.35	1.35	1.4
Change in real effective ruble exchange rate (%)	5.1	-5.6	11.6	5.1	5.0	2.9
CPI growth (%)	13.3	8.8	8.0	7.5	7.0	6.4
M2 growth rate (%)	1.7	16.3	19.6	22.0	19.2	16.7
Monetization (%)	32.6	40.2	43.9	48.8	52.9	56.2
Government debt (% of GDP)		7.9	11.9	12.9	12.4	11.5

Table 8

**Worst-case scenario**

	2008	2009	2010	2011	2012	2013
Oil prices (Brent, dollars per barrel)	93.9	60.7	74.2	50	50	60
Real GDP growth rate (%)	5.2	-7.9	3.6	-0.3	0.9	2.3
Federal budget income (% of GDP)	22.4	18.8	18.5	16.0	16.4	17.1
Federal budget expenses (% of GDP)	18.3	24.7	23.1	20.6	19.8	18.5
Surplus / deficit (-) of the federal budget (% GDP)	4.1	-5.9	-4.6	-4.6	-3.4	-1.4
Exports (billion dollars)	472	303.3	380	318	319	355
Imports (billion dollars)	293	192.7	230	236	270	291
Capital transactions account balance (billion dollars)	-138.8	-45.2	13.9	-15.0	0	10.0
Gold and foreign exchange reserves (billion dollars)	427	439	493	517	520	546
Nominal ruble/US dollar exchange rate (RUR/USD)	24.80	31.68	30.45	35.50	32.2	28.2
EUR/USD exchange rate	1.47	1.39	1.3	1	1.15	1.5
Change in real effective ruble exchange rate (%)	5.1	-5.6	11.6	1.2	6.8	2.8
CPI growth (%)	13.3	8.8	8.0	7.9	7.6	7.3
M2 growth rate (%)	1.7	16.3	19.6	14.4	8.4	7.2
Monetization (%)	32.6	40.2	43.9	47.2	47.6	46.9

Government debt (% of GDP)		7.9	11.9	15.7	18.0	18.0
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Thus, in the baseline scenario the level of the federal budget deficit in 2011-2013 may become lower than that provided for by the 2011 Federal Budget Law and the planning period of 2012-2013. In particular, in 2013 it would almost be possible to achieve a balanced budget with oil prices at 79 dollars per barrel. In our model, this is achieved through a higher level of nominal income to the federal budget with the total expenditure fixed in nominal terms. High nominal figures would be obtained through a higher inflation rate and the GDP deflator, together with a less conservative forecast of the real federal revenues (as a share of GDP).

In the worst-case scenario, the federal budget deficit in 2011-2012 will rate higher than that according to the Federal Budget Law, due to the low dynamics of real output and lower profitability in the economy. In 2013, the situation with the budget deficit would get somewhat better at higher rates of inflation and low exchange rates for the RUR, however, as mentioned above, in this case the nominal federal expenses should not change. During a new downturn in the economy, and with an increased demand for government anti-crisis measures, such a condition seems difficult to fulfill.

Our calculations show that in order to reduce the risk of the budget imbalance having a negative influence on the economy a further increase of budgetary spending can not be allowed. Realizing the need to fulfill its social obligations and to meet the challenges of economic development, we urge improvement in the efficiency of expenditure within the existing volumes.

## **Basic steps to improve fiscal policy in the medium and long term**

### *Challenges and policy options in the field of budgetary income*

In the next decade, the Russian tax system will face two enormous challenges. Firstly, decisions made in the field of pension reform do not provide a balanced pension system but unnecessarily increase the load on the payroll and imply a need for constant replenishment of the federal budget. Consequently, certain changes are needed to the tax system to ensure it is adapted to the ageing of the population.

Secondly, in the event of a rapid growth of non-oil and gas industries and the strengthening of the real exchange rate for the RUR, the share of the mining sector in GDP will decline. In this case, the tax burden on the mining sector will be much larger than on other sectors. As a result, in the medium-term, Russia would face a reduction of rental revenue, which would lead to the need to optimize the tax burden on the economy.

*Pension reform.* The approaches to reforming the pension system in Russia laid down in Federal Law No.212-FZ dated 24 July 2009 ‘On Insurance Premiums to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Compulsory Medical Insurance Fund and Territorial Funds of Compulsory Medical Insurance’ are, in our opinion, irrational. They do not provide for any long-term balance of the pension system while they do greatly increase the tax burden and complicate tax administration<sup>2</sup>.

In order to increase the replacement rate at the end of 2009 the Russian government has implemented large-scale changes in the pension system. As a result, the total expenditure on pensions compared with 2009 increased by 1.3 trillion rubles, or 2.4% of GDP, which led to an increase in the pension system deficit to 5.2% of GDP in 2010. In order to compensate for the increased costs in 2011, the mandatory pension insurance tariff increased from 20% to 26%. The aggregate rate for compulsory pension, health and social insurance increased from 26% to 34%. As a result, the tax burden on the payroll will increase by 1.6% of GDP.

The proposed insurance premium rate is much higher than in most OECD countries. The increase in the tax burden on the working population runs counter to world trends where, in order to increase economic competitiveness, the tax burden on labor and capital is reducing and consumption is increasing. In our view, it is appropriate to stay within the limits of the moderate indexing scale of insurance premiums so that there is no increase in the tax burden on the labor market in 2011-2012.

In the medium-term, it is necessary to attract financial resources into the pension system, other than the premiums for mandatory pension insurance. In addition to reserve funds we should talk about the privatization of state property, including its transfer to the Pension Fund of the Russian Federation and to state pension funds in the current account fees on the pension savings element.

In order to maintain a long-term balance of the pension system it is necessary to increase the retirement age. Taking into account all the political complexity of the issue, we should note that increasing the retirement age (in combination with other measures) would solve the problem of balancing the pension system in the long term as well as the increase of

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<sup>2</sup> *Nazarov V., Sinelnikov-Murylev S. On the Strategy of Improvement of the Russian Pension System // Ekonomicheskaya Politika (Economic Policy). 2009, No.3. Pages 150-177.*

the replacement rate. To minimize the political costs<sup>3</sup> the required increase should be gradual and only affect those people who are relatively young at the moment.

There are concerns that pensioners will not be needed in the labor market. However, this point of view was formed in a situation when the size of the working age population in our country had increased and employers often preferred younger workers. At the moment, for demographic reasons, Russia has already entered into a long-term reduction in the labor force: it is expected that the number of the employed population will be reduced by 4 million people in the next ten years. Under these conditions the demand for labor resources in the country will most probably increase.

Increasing the retirement age will lead to a marked reduction in the cost of pensions as the effect of a reduction in the duration of retirement will block the effect of rising pension capital. As a result, it will be possible to achieve not only an increase in the replacement rate but also a reduction of the pension system deficit.

*Export duties.* The restructuring of the Russian economy in the long term is closely linked with the abolition of export duties which currently can mean subsidizing the domestic consumers of raw materials and energy through the rent from the use of natural resources owned by the state. Under the current system mining companies pay MET and export duty and, for products sold in the domestic market, suffer losses equal to the difference between the domestic and world prices.

The elimination of export duties offset by increased MET and excise taxes on petroleum products will lead to an increase in the domestic prices for raw materials and energy to the level of world prices. As a result, domestic enterprises will be forced to increase the resource efficiency of production to the level of those countries which import raw materials and energy. Without the implementation of such a measure we can hardly ensure environmental protection and the efficient use of natural resources.

For the Russian oil industry, characterized by a low level of technological development, the negative effect of the abolition export duties means that, in the case of an increase of domestic oil prices to the world level, no acceptable cost-effectiveness would be provided. This will inevitably lead to a shift from the export of oil products to the export of crude oil, so the task of increasing domestic oil refining and the export of petroleum products

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<sup>3</sup> Such a reform will affect the interests of the majority of Russia's population: according to official statistics, about 60% of men and 90% of women live to the age of 60. The life-expectancy of a man who has reached the age of 60 is 73 years, and for a woman who has reached the age of 60 it is 78 years.



will not be resolved. To maintain positive margins for oil refining for some time, the domestic price of oil needs to be lower than the world price.

Therefore, it is appropriate to reform the export duties on oil and oil products stage by stage. At the first stage, crude oil export duty should be reduced to a level that ensures an acceptable cost-effectiveness for oil refining, and the export duties on oil products should be abolished. At the second stage, after modernization of the Russian oil industry, the export duties on crude oil should be abolished.

It would be appropriate to offset the reduction and elimination of export duties on oil and oil products partially by raising the MET rate and by increasing the excise tax on oil products. The MET rate for oil production should be increased by an amount which offsets the reduction in export duties on crude oil, while the rate of excise duty on oil products should be changed by an amount which offsets the abolition of export duties on oil products.

At the same time the MET rate should be reduced for specific regions and categories of deposits which have higher development expenses. In the future, it is appropriate to impose a tax on the additional revenue obtained from the new oil fields.

*Value added tax.* The following measures can be offered here:

- to regulate and simplify the procedure for VAT refunds where zero rates apply, and in other cases. In particular, in order to confirm exports, only one criterion should be required: goods crossing the Russian customs border;

- to introduce a single rate of VAT at a level which ensures permanence of budgetary income (16-17%). The transition to a single rate will help to simplify administration but will reduce the progressivity of tax distribution among different income groups in the population. Compensation for losses by such groups should be provided by the budget expenditure;

- to reduce the number of VAT exemptions, bringing them in line with a standard list<sup>4</sup>. Given the social importance of certain exemptions, their removal should be accompanied by budget subsidies and other instruments of social policy.

*Direct taxes.* Any change in the tax structure involves a gradual decline in the share of direct taxes in favor of consumption taxes. For this purpose it is expedient:

- to create an effective system of control over transfer pricing and to introduce the concept of consolidated accounts for taxes on profits;

- to increase the exemption limit for personal income to a level comparable to the minimum wage;

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<sup>4</sup> The availability of standard exemptions from payment of VAT is, in particular, due to the fact that under certain conditions (for example, financial) it is, for administrative purposes, either impossible to determine tax obligations or the administrative costs exceed the expected benefits.

- to shift from a simplified tax system to taxes on real cash flows with imputed tax applying only to micro-enterprises (with 1-5 employees) providing services to the public.

### *Policies in the field of budget expenditure*

Given their unpredictability a conservative approach is required in determining the level of spending of oil revenues - one which will ensure budgetary sustainability. The current application of oil and gas transfer (the amount of which is linked to the GDP) does not properly limit expenses at a level which is secure in terms of the budget balance. In order to improve the efficiency of the existing procedure for using opportunistic revenue to fund budget obligations, it is expedient to supplement it with an additional rule. This should limit budgetary revenues in the allocation of MET and the export duties on crude oil as a deterrent to the growth of federal spending at the planning stage. In other words, the amount of oil and gas transfer should be limited to a particular threshold oil price which remains the same throughout the entire period of budget planning (i.e. over three years).

All oil revenues in excess of the threshold level should be directed to oil and gas funds in accordance with the existing procedure. (The threshold value can be set, based on the average estimate of oil prices for the coming three-year period, forecast in the conservative scenario of social and economic development of the Russian Federation.) Financing the budget deficit using money from the Reserve Fund should occur only in the case of budget shortfalls due to oil prices falling below a certain level in the macroeconomic forecast on which the main parameters of the federal budget are calculated.

This approach will ensure budgetary stability because the level of government spending will be fixed at the stage of budget planning. In particular, the application of this approach for the base oil price of 30-35 dollars per barrel would, in 2009, contribute to the withdrawal of about 700 billion rubles of revenue from the federal budget into the oil and gas funds.

A similar rule was used in 2004-2007 while distributing oil revenues between the budget and the Stabilization Fund, proving its effectiveness as a constraint on the growth of budget expenditure. Additional federal revenues were credited to the Stabilization Fund in the form of two components: the share of export duty on crude oil and the MET share (for oil production). The proportion of the actual revenues to be credited to the Fund was directly related to the excess of the current rate of the corresponding tax over the settlement rate, determined on the basis of the reference oil price (cut-off price).

Thus, the amount of contributions to the Stabilization Fund depended on the excess of the current oil price over the base crude oil price<sup>5</sup>. Settlement and transfer of additional revenues to these accounts, opened in the Central Bank the Russian Ministry of Finance performed monthly, not later than 30 days prior to each reporting month<sup>6</sup>. The Stabilization Fund could be used either to finance the federal budget deficit if the price of oil was lower than the base price, or for other purposes, if the accumulated amount of the Fund exceeded a pre-set limit (set at 500 billion rubles<sup>7</sup>). The amount of Fund money used was determined by the Federal Budget Law for the relevant financial year.

It is expedient to use a cut-off price (similar to the one on which the Stabilization Fund was based when it was formed in 2004-2007) to calculate the tax revenues from the production and export of both oil and gas.

Subject to the limitations of government spending the effectiveness of their use should be increased. Improvement in the quality of budget management is possible only through an integrated approach which allows for covering the widest possible range of regulatory instruments and coordinating their application over time. Therefore, in the coming years it will be necessary to focus on the issues of restructuring the budget network, improving the transparency of government procurement and optimizing individual budgetary procedures. With the formation of appropriate institutional conditions in the country, the further development of such management tools as ROB, performance-oriented activities and public-private partnerships, may become an important factor in the rationalization of budget expenditure and improvements in the efficiency of the budgeting process as a whole.

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<sup>5</sup> From 1 January 2004 the base price was set at the level of 20 dollars per barrel for 'Urals' oil (Federal Law dated 23.12.2003 No. 184-FZ) and from 1 January 2006 it was increased to 27 dollars per barrel (Federal Law dated 12.10.2005 No. 127-FZ).

<sup>6</sup> These calculations used an average US dollar/ruble exchange rate for the reporting month and an average oil price for the month, which was determined as the arithmetic mean of the purchase and sale prices for all trading days in the reporting month.

<sup>7</sup> Note that the volume of the Stabilization Fund exceeded the set minimum level at the end of 2004 (amounting to 522.3 billion rubles). As a result, in 2005-2007 a total of 1,611.5 billion rubles from the Fund was used for "other purposes" (1,281.5 billion rubles to repay external debt, 300 billion rubles to finance development institutes in 2007, and 30 billion rubles to cover the Pension Fund deficit in 2005).