

Section 2. Monetary-credit and Budgetary Sphere

2.1. Monetary Policy

In analyzing the processes in the monetary sphere and the Central Banks policies in year 2002, the overall decrease in attention to the developments in that sector of the Russian economy should be regarded as the key factor of analysis. In particular, the issues of monetary and currency regulation (perhaps, with the exception of the debates around new draft Federal Law "On Currency Regulation and Currency Control") remained in the background throughout the year in comparison with changes in the tax field, reforms of the public sector and natural monopolies, Russia's joining the WTO, structural policy and slowdown of growth rates in the real sector of the economy.

Against the background of significant changes in the aforementioned fields, the situation in the monetary sphere (inflationary processes, changes in the exchange rate of the Russian national currency and dynamics of demand for money) seem quite stable and predictable. E.g., the consumer price growth rate was lower in 2002 as against 2001, nearing the values envisaged in the Federal Law "On the Federal Budget for Year 2002" and in "The Main Guidelines of the Monetary Policy for Year 2002". The dynamics of changes in the RUR / US\$ nominal exchange rate remained smooth throughout the year, and the real RUR exchange rate growth remained moderate. The dynamics of RUR/ Euro exchange rate are characterized by greater volatility resulting primarily from fluctuations in the exchange rate of the single European currency against the US Dollar. Despite the change in the management of the Bank of Russia in March 2002, the politics of monetary authorities did not suffer any abrupt modifications and currency control liberalization continued.

At the same time, the set of monetary policy instruments remained in 2002 as limited as in the preceding years, not going beyond interventions in the foreign exchange market and accumulation of funds in the Federal Government's accounts with the CB RF. On the other hand, due to the weak relation between the monetary and real sectors of the Russian economy and lack of clearly defined monetary policy transmission channels, the issue of how urgent it is to expand the Central Bank's ability to implement its policy remains more theoretical than practical¹.

On the whole, one may mark out the following important issues in the area of monetary and exchange rate policy (below we will expand on them in greater detail).

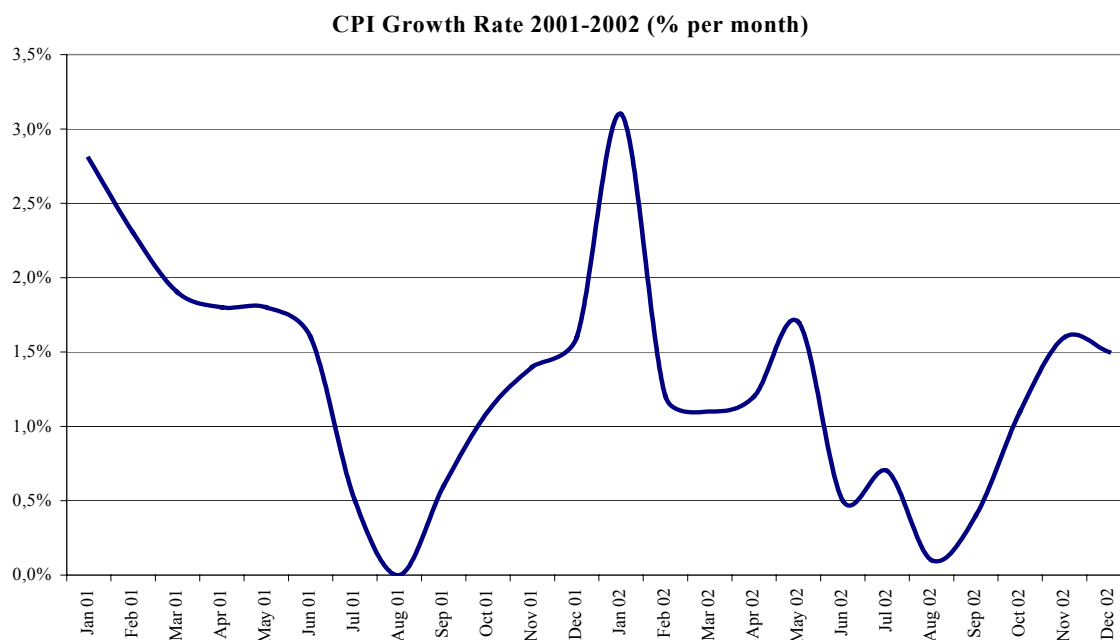
- ☐ the growing role of non-monetary factors (increase in regulated prices of natural monopolies) in determining consumer price growth rates, accompanied by further slowdown of the rate of inflation;
- ☐ smooth dynamics of the nominal RUR exchange rate, remaining low appreciation rates of the Russian national currency and accumulation of gold and currency reserves of the Bank of Russia;
- ☐ change of the management of the CB RF;
- ☐ policies of the monetary authorities in relation to currency control liberalization;

¹ The possibility of existence of various monetary transmission channels in the Russian economy has been analysed in S. Drobyshevski and A. Kozlovskaya "Domestic Factors of the Russian Monetary Policy", *IET Working papers*, No. 45R, Moscow, IET, 2002.

- slowdown of capitalization of the banking system accompanied by relaxation of credit rationing and greater supply of money by the banking system by means of extending loans to the private sector;
- growth of population confidence in deposits with banks.

Inflationary Processes in Year 2002

In 2002 the consumer price index growth was 15.1 percent, or 3.5 percentage points lower than in year 2001. Fig. 1 shows the month-on-month dynamics of CPI growth in 2001 - 2002. As one can see, in 2002 the intra-year inflation volatility increased. The commodity structure of consumer price growth looks as follows: consumer goods, 11.0 percent; non-foods, 10.9 percent; services, 36.2 percent; The highest price growth rates, 20.4 percent, have been observed for petroleum, (- 8.6 percent in 2001); housing and communal services: 48.8 percent against 56.8 percent in 2001; medical services: 30.7 percent against 22.5 percent in the preceding year; public transportation services: 26.0 percent against 25.3 percent in 2001, and telecommunication services: 37.6 percent against 23.3 percent.



Source: State Committee for Statistics of the RF

Fig. 1

In January 2002 inflation rate grew as usual. However, this year the January price fluctuation was greater than in year 2001 (see Fig. 1).

In the first month of 2002 inflation (measured by the CPI) amounted to 3.1 percent (ca. 44 percent p.a.). It should be noted that the January price growth occurred mainly in the two last weeks of the month, after the RF Government decided to increase prices and tariffs on the services of natural monopolies. The commodity structure of the CPI growth confirms the assumption that administrative and seasonal factors affecting the determination of the consumer price growth rate played the leading role while the contribution of monetary factors was insignificant. E.g., the index of prices for medicines grew 5.2 percent (which, to a great extent,



is explained by the repeal of the incentive rate of VAT for this class of goods; the index of service prices grew 7.5 percent. Such a high growth rate of service prices (the highest monthly growth rate of service prices since January 1996) has been caused primarily by a growth of prices for housing and communal services by 8.8 percent, prices for telecommunication services (18.0 percent) and railway transportation (18.9 percent).

However, in the beginning of 2002 the CPI growth rate began to decline sharply. At the end of the first two months CPI growth in 2002 lagged behind the respective figure for 2001 (4.6 percent as compared with 5.2 percent).

In May 2002 the CPI grew 1.7 percent, or 0.5 percentage points more than in the previous month. In the non-food group special attention should be drawn to a growth of prices for petrol that caused significant public response. In May the index of retail petrol prices amounted to 110.7 percent. Low octane brands of A-76 petrol (AI-80 etc.) grew in price by 12.5 percent, AI-92 (AI-93 etc.) grew by 10.5 percent and high octane brands (AI-95 and higher) by 6.3 percent. The growth of fuel prices was uneven from region to region. The greatest growth was observed in the Ulyanovsk oblast: 52.8 percent. Petrol prices continued to grow in June. The weekly growth from 3 till 10 June was 3.7 percent, from 10 till 17 June, 2.0 percent. Let us recall that a similar sharp increase in petrol prices in early summer was observed in 1999, which was related to the growth of petrol prices, in US Dollar terms, up to the level of 0.3 to 0.35 Dollars / liter after the Rouble devaluation. This level obviously reflects the equilibrium petrol price level in the internal market with the account for transportation costs and existing physical limitations on the volume of oil exports. Throughout the two last years petrol price growth rates lagged behind the US Dollar rate (although the difference in rates was significantly lower than in years 1998 - 1999), and, as we suppose, the present jump is of the same origin. Besides, in the spring of 2002 legal limitations on the volume of oil exports were removed, and, against a background of high oil prices on global markets, prices on the internal market also grew.

It is important to note that, besides the above-mentioned petrol prices, non-monetary factors affecting inflationary processes in the summer of 2002 include the decision of the RF Government of 20 June 2002 to increase tariffs on products of natural monopolies. In July 2002 tariffs on gas grew 15 percent.

Tariffs on electroenergy purchased on the Federal Wholesale Market of Electricity and Power grew 2.4 percent and tariffs on railway transportation grew 6.8 percent.

Thus, in the first six months of 2002 inflation in Russia (measured by CPI) was ca. 9 percent (against 12.8 percent in the first six months of 2001).

A seasonal decrease in consumer price growth rates was observed in the period from July to September 2002 (as low as 0.1 percent in August, see Fig. 1); at the same time, prices for housing and communal services continued to grow significantly: the increase was 2.4 percent in July and 4.1 percent in August. In September the CPI was 100.4 percent, with the main growth, 0.3 percent, falling on the last week of the month. Prices for fruits and vegetables continued to decrease: the index for this product group was 90.1 percent in September. The service price index grew 2.8 percent; the greatest growth, 10.9 percent, was observed for prices for education services, which occurred due to the beginning of the new academic year. Prices for housing and communal services grew as before: the increase was 2.6 percent.

In October the CPI started to grow faster. According to the State Committee for Statistics of the RF, in October the consumer price index was 101.1 and in November - 101.6 percent. The seasonal decrease in prices for fruits and vegetables in November was soon replaced

by quick growth: the index for this commodity group amounted to 106.2 at the end of the month. The service price index grew 4.4 percent in the two months of the autumn. In this group, the greatest rise in prices was observed for passenger transport: prices grew 6.6 percent (this occurred primarily owing to urban transport) and telecommunication: prices grew 5.9 percent.

In closing we would like to dwell on the issue of monetary and non-monetary factors contributing to the rates of consumer price growth in post-crisis years. In particular it is important to note that in 2002, for the first time after the 1998 crisis, producer prices grew quicker than consumer prices. According to preliminary estimates, in 2002 the increase in producer price index was 17.1 percent.

To assess the relative contribution of monetary and non-monetary factors to the inflation rate in 1999 - 2002 we have formulated cointegrating relationship between accumulated indices of consumer prices and nominal money supply M2 (the level at the end of August 1998 is taken for one). This formula implies that non-monetary factors would include all inflationary components (with the exception of the increase in money supply proper), namely the increase in regulated prices and tariffs, change in demand for real cash balances and inflationary expectations².

The results of assessing cointegrating relationship (in the assumption about the presence of an intercept and a linear trend) on the basis of monthly data demonstrate that a one percent increase in M2 entails CPI growth of 0.419 percent (the standard error is 0.081 percent), the linear trend slope is -0.057 percent per month, the standard error is 0.008 percent). Consumer price index growth decomposition, adjusted for the calculated contribution of monetary and non-monetary factors in years 1999 - 2002, is shown in *Table 1* below.

Table 1

Contribution of monetary and non-monetary factors to CPI growth in years 1999 - 2002

	CPI growth	Monetary Factors	Other (non-monetary) factors	CPI growth (share)	CPI growth (share)
1999	36.6%	22.7%	62.1%	13.9%	37.9%
2000	20.1%	23.7%	117.9%	-3.6%	-17.9%
2001	18.8%	13.1%	69.8%	5.7%	30.2%
2002	15.1%	8.6%	57.2%	6.5%	42.8%

As is obvious from the results shown in the table, demand for money deterred inflation (i.e., demand for money grew due to increasing economic activity and lowering inflationary expectations) only in 2000, which resulted in CPI lowering by 3.6 percentage points against the value calculated on the basis of actual money supply growth in that year. Besides, in 2000 the greatest gap between the rates of growth of the consolidated consumer price index and

² M2 has been selected based on the results achieved in IET publications by S. Arkhipov and S. Drobyshevski "Simulation of Inflation Dynamics in Years 1992 to 1997"// Economy in Transition. Sketches of Economic Policy in the Postcommunist Russia in 1991 - 1997, Moscow, IET, 1998; and S. Drobyshevski, A. Kozlovskaya "Domestic Factors of the Russian Monetary Policy", *IET Working papers*, No. 45R, Moscow, IET, 2002.

Both series (price index and money supply) are first order integrated series. The Johanssen cointegration test does not reject the hypothesis of one cointegrating relation between the variables under review (with the account for the linear trend). The estimated relation is $P_t = \alpha M2_t + \beta Trend_t$.



prices and tariffs regulated by the government (electroenergy, railway transportation, telecommunication etc.) was observed³.

In 1999, on the contrary, the tight monetary policy was the key factor containing inflation against a background of lowering demand for Rouble money balances and remaining high inflationary expectations after the 1998 Rouble devaluation. According to our calculations, if inflationary expectations and the demand for real Rouble balances had been low, the CPI would have grown 22-25 percent in 1999 (actual growth: 36.6 percent).

Calculations for 2001 - 2002 predicted that the consumer price growth caused by the expansion of money supply proper would be lower than the figures observed in reality. In our opinion, this occurred due to manifold growth of tariffs and prices for the services of natural monopolies in the course of those years. This factor contributed ca. 30 percent (5.7 percentage points) to closing inflation values in 2001 and ca. 43 percent (6.5 percentage points) to the closing value in 2002.

The achieved results demonstrate that at the present time the mere implementation of a consistent monetary policy is not enough to control inflationary processes. The share of price growth falling on non-monetary factors (first of all, increase of regulated prices) becomes comparable with the share occupied by the monetary component. In this connection it becomes ever more important to regulate the policy of the Bank of Russia with the policy of the RF Government in the field of regulation of tariffs on and prices for the services of natural monopolies (electroenergy, railways, gas), reforms of price subsidies for social services (housing and communal services, public transportation, education, medical services), tax policy (first of all, in respect of modification and indexing of indirect taxes, e.g. excise taxes) and customs policy in relation to imports (import duties).

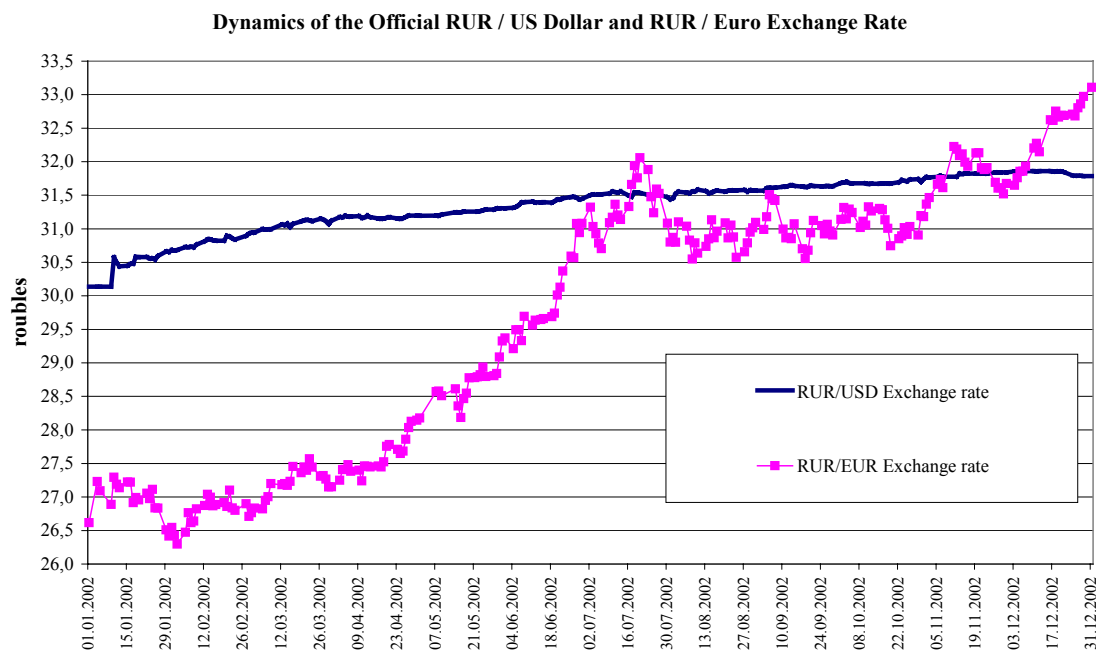
Currency Market and the Dynamics of the Rouble Exchange Rate

In 2002 the official Rouble exchange rate fell 5.46 percent, from 30.14 to 31.7844 Roubles for US Dollar. The official Rouble-Euro exchange rate fell 25.0 percent, from 26.62 to 33.1098 Roubles for Euro. The dynamics of the RUR / US Dollar exchange rate were rather smooth throughout the year while the Rouble - Euro exchange rate suffered significant fluctuations (see Fig. 2) in the wake of Euro rate changes in the global currency markets (see Fig. 3). Players in currency markets were active only for short periods of time.

Rapid growth of the US Dollar exchange rate was observed practically only in January 2002. After auctions on the forex market commenced, already on the first day the Dollar price grew 1.45 percent, or from 30.14 to 30.575 Roubles. Later on attacks on the Rouble exchange rate continued despite contracting excessive reserves of commercial banks. In January the Bank of Russia on many occasions made large-scale currency interventions in order to smoothen the dynamics of the Rouble exchange rate, and, according to indirect estimates, spent ca. 1.3 billion US Dollars from its reserves. However, the resulting decrease in foreign reserves turned out to be by far less significant, ca. 500 million US Dollars; obviously, the CB RF engaged in arbitrage transactions between the morning and the day-time sessions, buying the currency in case of Rouble exchange rate growth. Moreover, growth of the non-monetary component, gold in particular, was observed. The change of the Chairman of the Bank of Russia also affected the dynamics of Dollar quotations only to a small extent; besides, upon V. Gerashchenko's step-down the Rouble retained a certain trend towards nominal strengthen-

³ See: Russian Economy in 2000: Trends and Prospects. (Issue # 22). - Moscow.: IET, 2001

ing. At the same time, in our opinion, the seasonal change of the situation around the balance of trade was the main factor contributing to stabilization of the foreign exchange market in the spring of 2002.



Source: CB RF

Fig. 2

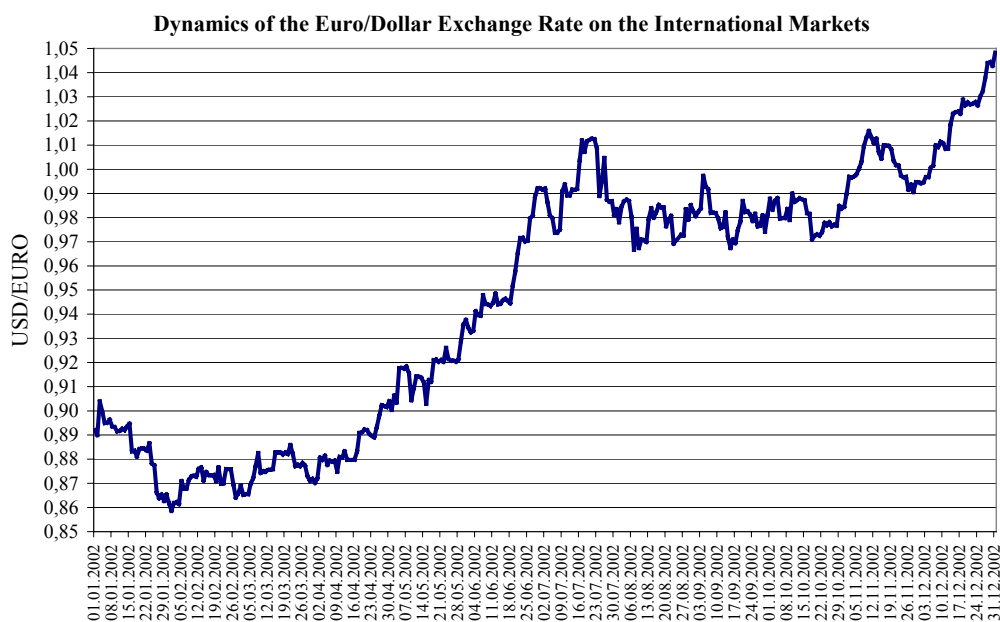
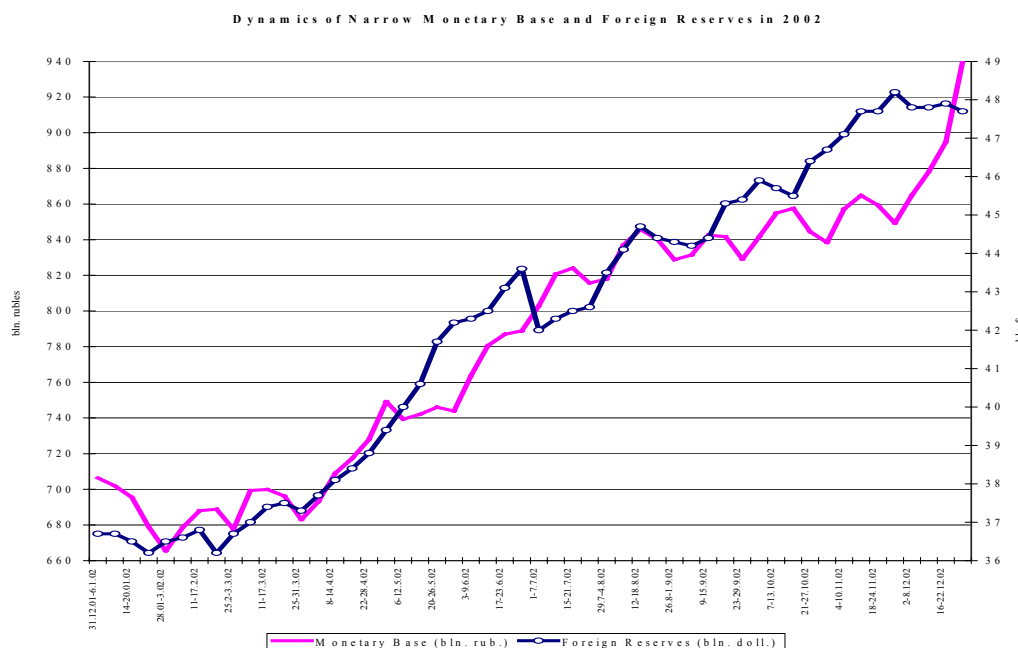


Fig. 3

From March to May, as usual (for the first time this trend became apparent in the spring of 1995), the supply of currency in the market exceeds the demand and the nominal Rouble exchange rate either stabilizes or grows (with the exception for the 1998 case which resulted from the overall financial crisis in Russia). On the whole, in March - May 2002 the reserves of the Bank of Russia increased US\$ 5.5 billion (15.2 percent), including the US\$ 2.5 billion increase in May. At the beginning of June the reserves reached US\$ 41.7 billion. In July 2002 the Bank of Russia changed the methodology of foreign reserves calculation by excluding short-term foreign liabilities from the reserves. In the Bank's view, this allowed "to increase the indicator's information capacity". Upon recalculation the reserves decreased ca. US\$ 1.5 billion, however the overall dynamics of the indicator remained the same (*see Fig. 4*)



Source: CB RF

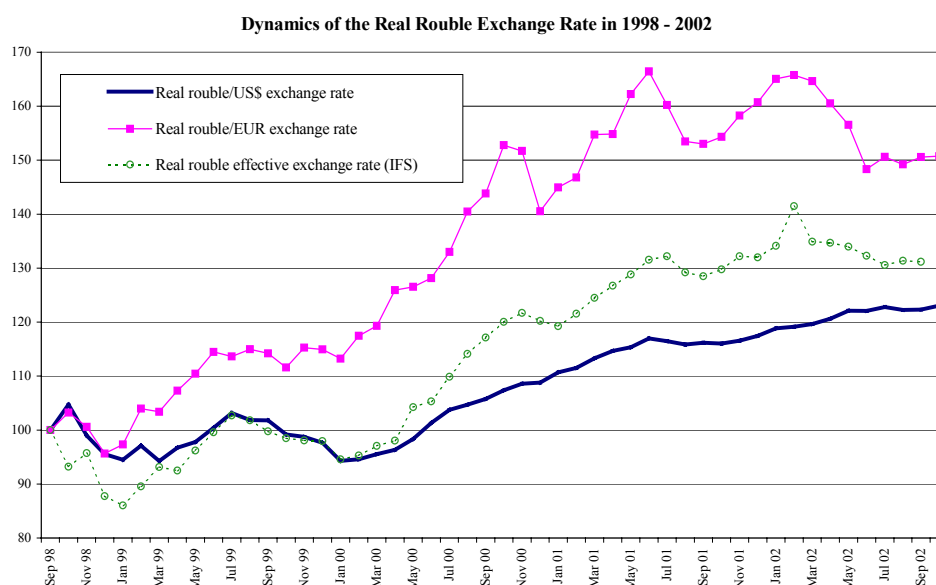
Fig. 4

In September 2002 the Bank of Russia published an Instruction establishing a new procedure for the mandatory sales of a share of exporters' foreign currency proceedings, starting from 1 December 2002. In particular, this document entitles banks to carry out mandatory currency sales over-the-counter. In other words, a considerable share of foreign exchange market turnover is taken out of the Central Bank's control and the Rouble exchange rate is more subject to manipulation by all the parties to a transaction. The issue of the methodology for establishing the official rate of exchange of the Rouble against foreign currencies has not been cleared, though.

Against the background of the forthcoming loss of monopoly, MICEX decided in November to cut the commission on transactions with foreign currency on the SELT dramatically. The fee charged for transactions with US Dollars was decreased 30 times, from 0.06 percent down to 0.002 percent of the transaction amount. In addition, the Exchange cancelled the necessity to deposit cash beforehand in order to participate in an auction. Now, to carry out a transaction on the SELT it is enough to establish a reserve amounting to 1.5 percent of the intended transaction. At the end of 2002 the amount of foreign reserves of the Bank of

Russia reached US\$ 47.79 billion. The share of gold in the reserves does not exceed 7.85 per cent.

In 2002 the trends in dynamics of the real RUR exchange rate were different, subject to the selected foreign currency (see Fig. 5). E.g., during the first ten months the real RUR exchange rate against the US Dollar (calculated on the basis of data on dynamics of the nominal RUR / US\$ rate and the rates of CPI growth in Russia and the USA) increased 4.75 percent. The increase of the real RUR / US\$ exchange rate was 23.0 percent, as compared to September 1998. At the same time the real RUR / Euro exchange rate for the period from January - October 2002 decreased 6.21 percent, returning to the level of late 2000 - early 2001. In relation to the maximum 2002 value (February) the fall of the real RUR / Euro exchange rate reached 9.1 percent.



Source: International Financial Statistics, calculations of IET

Fig. 5

The real effective Rouble exchange rate (calculated with the account of the export structure) actually changed in co-ordination with the real Rouble / Euro exchange rate. According to this indicator, the real depreciation of the Rouble in the course of the first nine months of 2002 reached 0.63 percent (in 2001 the real effective Rouble exchange rate grew 11.1 percent). In the end of July 2002 the real effective exchange rate fell to the level of September 2001. The maximum value of the exchange rate was achieved also in February (+36.2 percent as compared with September 1998).

The Policy of Monetary Authorities

As we have already noted above, the change in the management of the Central Bank of Russia was the key news in respect of the policy of the monetary authorities. It should be mentioned that, following the replacement of CB RF Head, the monetary policy did not undergo any abrupt changes. Already in his first statements the new Chairman of the Central Bank of Russia S. Ignatiev confirmed that the policy of accumulating foreign reserves and keeping low rates of appreciation of the Russian national currency were priority directions. At



the same time the Central Bank did not introduce changes to the claimed rates of increase in money aggregates in 2002 or speed up the process of currency regulation and capital control liberalization. In April 2002 a number of events directly related to the RF monetary policy occurred. On 1 April the Supreme Court of RF satisfied a claim by the Moscow Stock Exchange, which demanded to admit that the CB RF regulation on mandatory sales of currency proceedings by exporters exclusively through the authorized trade floor (in fact, on the SELT at MICEX) conflicted with the law. This ruling by the Court allowed exporters to sell currency within the limits of mandatory sales (50 percent) at any exchange authorized to carry out currency auctions and on the OTC market.

As it has been noted above, following a number of processes, the latest of which was won by the Central Bank (the ruling by the Presidium of the Supreme Court dated 01 August 2002), the Board of Directors of the Bank of Russia passed a decision on 23 August 2002 that the mandatory sales of a part of export proceedings may be carried out through authorized banks on interbank currency exchanges, directly to the Central Bank of the Russian Federation, on the OTC interbank currency market or to the authorized bank providing services to the resident. The monopoly of currency exchanges is thus liquidated.

In our view, economic consequences of such a course of affairs will be negative rather than positive. The only positive consequence would be the liquidation of MICEX's monopoly for this sort of operations and the resulting decrease in costs on currency conversion for all participants of the forex market (first of all due to a decrease in the exchange's commission fee)⁴. At the same time, liquidation of the single foreign exchange market reduces the ability of the Bank of Russia to carry out exchange rate policy and support the exchange rate of the Russian national currency, for one thing. Secondly, it becomes easier for speculation-minded players to attack the Rouble and destabilize the market. Thirdly, it creates conditions for plotting various schemes of fictitious sales of currency proceedings by exporters to affiliated banks on the interbank market and small trade floors. Fourthly, the methodology of determining the official exchange rate of the Rouble against foreign currencies still requires elaboration.

On 9 April the Bank of Russia, for the first time since November 2002, reduced its refinancing rate. The new rate is 23 percent p.a.; this is the lowest figure since November 1997. It should be noted that, just as before, this decision by the CB RF was predominantly symbolic, being aimed at creating expectations of a further reduction of inflation and interest rates in the economy since the mechanism of refinancing is up to the present time virtually non-existent and the current interest rates on loans and treasury bills are far below the level of the refinancing rate. The next reduction of refinancing rate, down to 21 percent p.a., occurred on 7 August 2002.

In our opinion, the other significant event in the field of monetary policy was the RF Pension Fund's entering the internal debt market. In particular, in April 2002 the RF Pension Fund acquired in primary auctions GKO and OFZs for ca. RUR 3 billion, thus creating a considerable portion of demand for the bonds. It is obvious that appearance of such a large institutional investor increases liquidity in the GKO - OFZ market and contributes to a further reduction of bond yields. In addition, investments by the RF Pension Fund of surplus funds in state bonds (on the stipulation that they are purchased from the CB RF on the secondary market) may be regarded as one of the measures aimed at sterilizing Rouble in-

⁴ As we have noted above, MICEX decreased its commission many times already in November 2002.

interventions by the CB RF accumulating foreign reserves (this is similar to the RF Minfin's depositing funds received in bond auctions in accounts of federal agencies with the CB RF).

The Central Bank of Russia introduced a new instrument as part of the policy aimed at increasing the importance of interest rates as a means of monetary regulation. On 26 September 2002 a new type of transactions – currency swaps – were added to the existing system of refinancing of credit institutions. In the course of a currency swap the Bank of Russia will buy US Dollars for Russian Roubles on conditions "today" at the official US\$ / RUR rate of exchange (base rate) with subsequent sale on conditions "tomorrow". In fact, this is lending to commercial banks overnight against a security in the form of foreign currency.

The directions, in which currency legislation would be liberalized, began to clear up in the autumn of 2002. The draft law adopted as a whole on 14 November provides for mandatory repatriation of currency proceedings within 180 days and for the Central Bank's right to impose limitations on capital operations: the so-called account regimen (list of allowed operations) and mandatory reservation of up to 20 percent of the transaction amount for a term of up to one year in case of importing the currency, and of up to 100 percent for two months in case of exporting the currency. The CB RF was also given a right to demand that residents undergo registration before opening currency accounts outside Russia. The upper limit of the mandatory sales of currency proceedings was fixed at the level of 30 percent. It is assumed that all limitations, with the exception of the 100 percent repatriation, will be canceled on 1 January 2007.

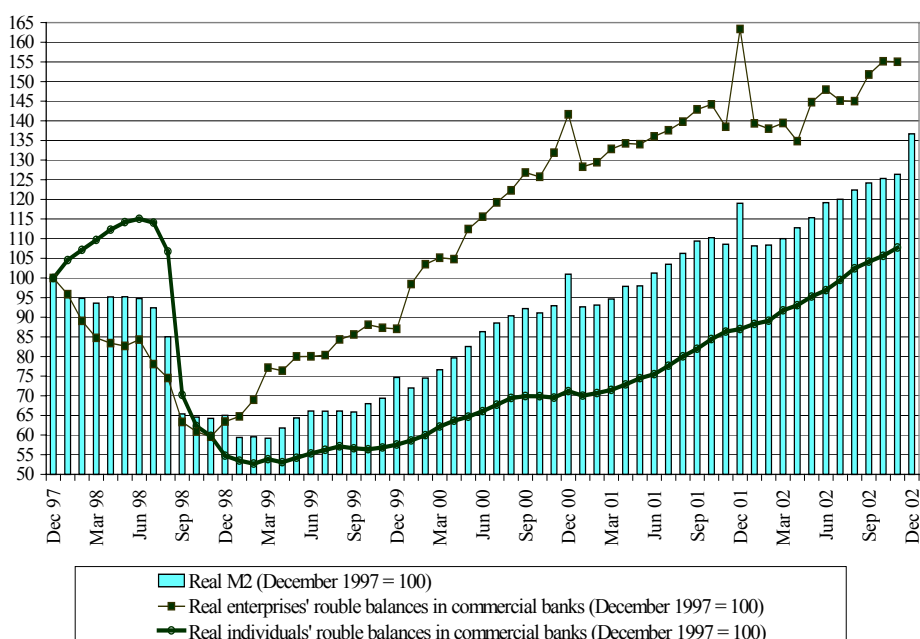
According to the "Main Guidelines of the Uniform State Monetary Policy for 2003" adopted by the Bank of Russia and the RF Government and approved by the RF State Duma, reducing inflation is the main aim of monetary authorities in 2003. The document states that the Central Bank of Russia will devote its main efforts to reducing inflation in 2003 down to a rate of 10 to 12 percent. According to the CB RF's calculations, the base rate of inflation, i.e. the indicator net of seasonal fluctuations and increases in administered prices, should be ca. 8.0 - 8.5 percent. The Bank of Russia will continue the floating rate policy. According to the CB RF's calculations, the increase in money supply (M2 aggregate) should reach from 20 to 26 percent in year 2003.

Dynamics of Money Supply and Demand and Credit Expansion of the Banking System

In 2002 the growth of money supply M2 was 32.26 percent, from 1602.6 up to 2119.6 billion Roubles. At the same time, the narrow money base grew only 32.72 percent in 2002, and the broad money base (reserve money) by 32.73 percent. In 2002 the amount of cash (M0) increased 30.82 percent. Thus, in 2002 the real money supply (M2 aggregate) grew 14.9 percent. The monetization ratio (M2 / GDP) increased also up to 19.36 percent, as opposed to 17.72 percent at the end of 2001. The share of cash (M0) in M2 is ca. 36 percent.

As is obvious from Fig. 6, real money balances in year 2002 grew mainly due to the increase in cash in accounts and term deposits of individuals with banks. During 12 months, from November 2001 to November 2002, real balances in individual Rouble deposits increased 24.8 percent while real balances in corporate accounts grew only 11.9 percent⁵.

⁵ In our view, a comparison with December 2001 would be incorrect due to high volatility of real account balances in the December - January period related to seasonal factors.

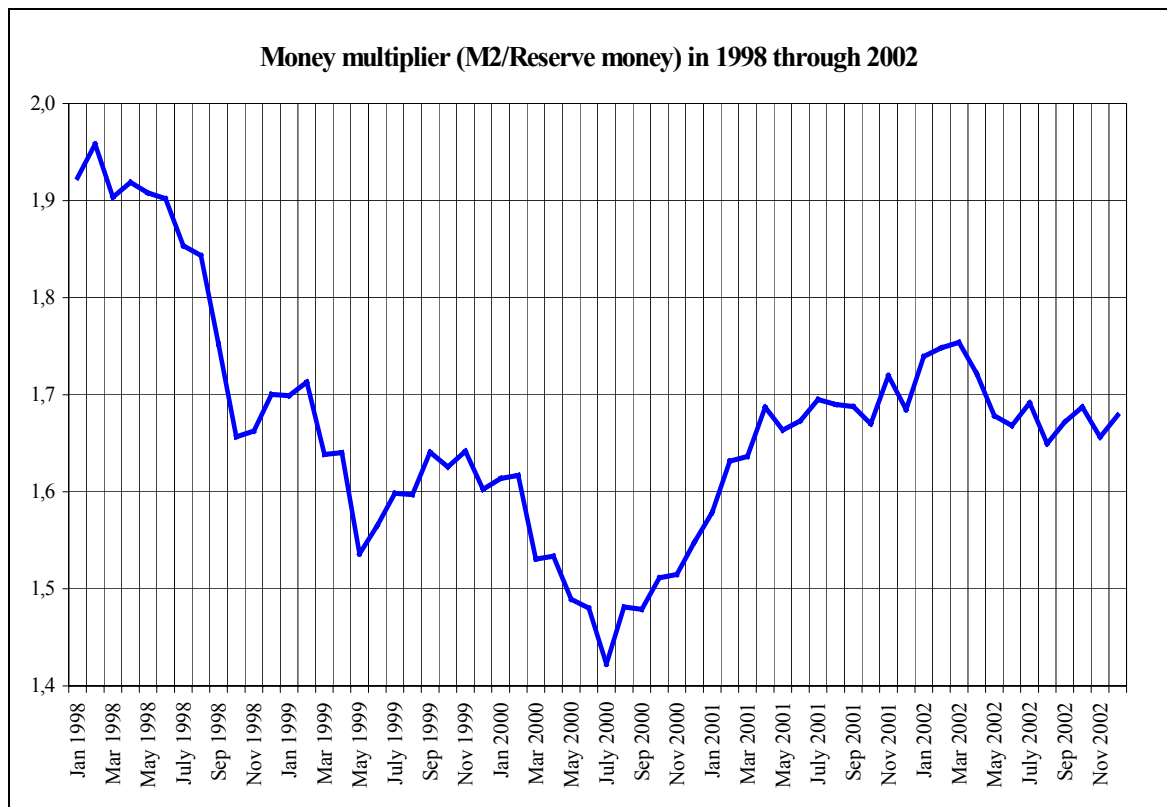


Source: Central Bank of RF, State Committee for Statistics of RF, IET calculations.

Fig. 6. Real Rouble Cash Balances in Years 1998 - 2002.

The structure of reserve money remained stable in 2002. The cash share fluctuated around the 60-65 percent level, while the amount of nonborrowed reserves (balances in commercial banks' correspondent accounts and deposits with the Bank of Russia) did not exceed 23 - 25 percent of the total amount of reserve money. Thus, the structure of the monetary base in 2002 was similar to the one observed in 1997, at the time when the financial market was at its best and commercial banks used available funds to the maximum.

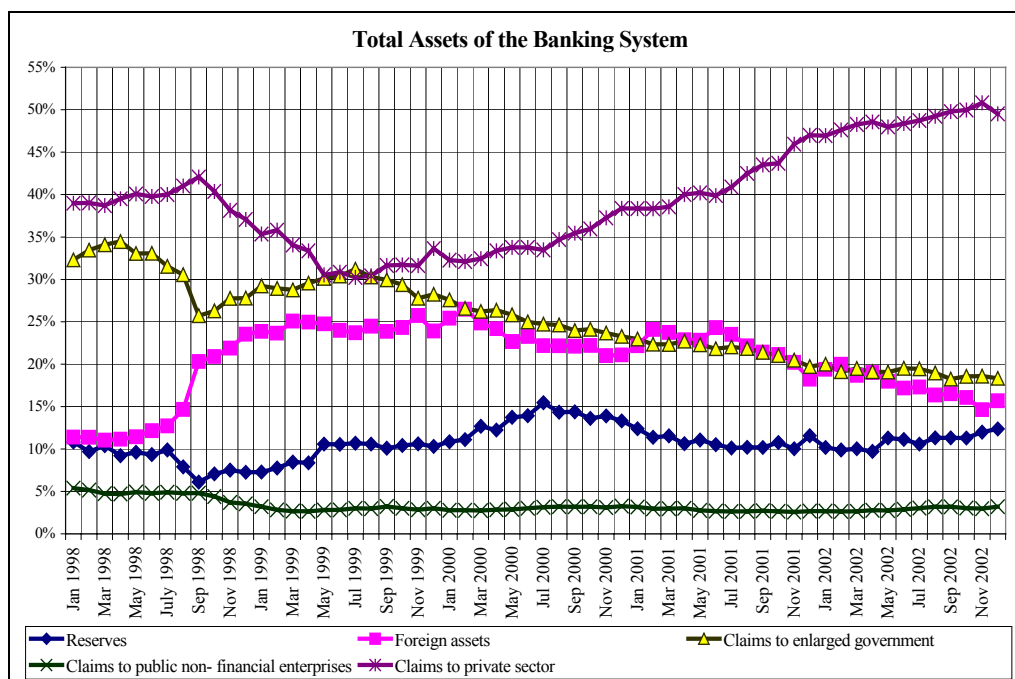
The dynamics of M2 and reserve money demonstrate that, after reaching the post-crisis maximum in March 2002, the money multiplier decreased sharply in the spring and early summer (see Fig. 7). By the end of the 2002 summer multiplier values reduced to 1.65 - 1.67, which corresponds to the level of the middle of 2001 when this indicator remained stable throughout eight months. In our opinion, this is explained by the fact that the maximum level of economy monetization possible under the existing conditions of financial markets and banking system had been reached. In spite of growing amounts of bank lending to the economy, money multiplication chains remain rather short.



Source: Central Bank of RF

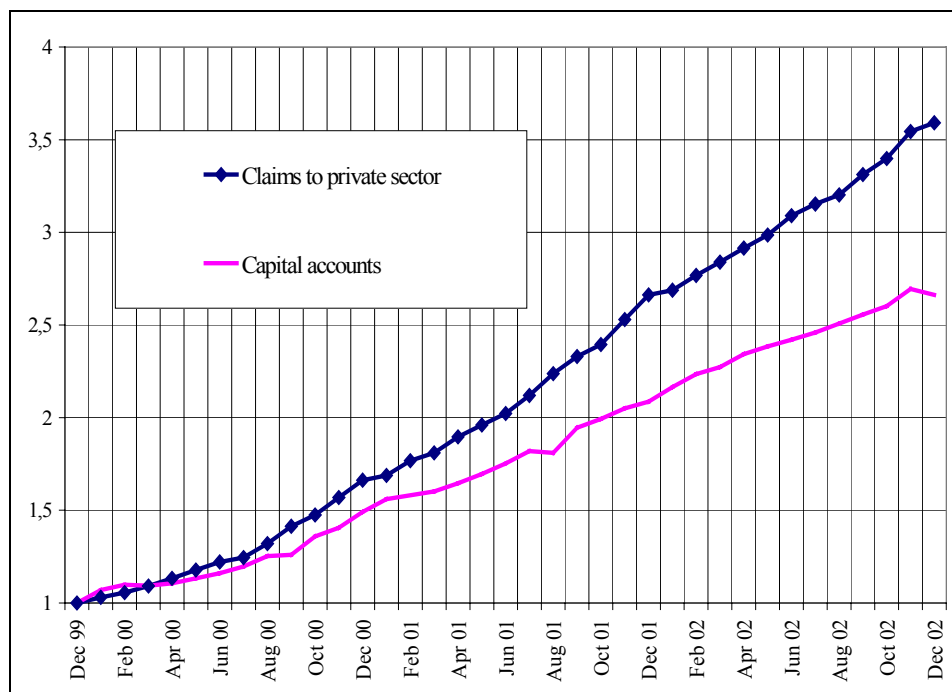
Fig. 7

At the same time it should be noted that, from the point of view of money supply, it may be said that the situation in 2002 has the features of a "lending boom". An analysis of the structure of the asset structure of the banking system (see Fig. 8) shows that liabilities of the private sector enterprises were the only growing component, and in 2002 their share grew from 45 percent to 50 percent of total assets. The nominal growth was ca. 34.9 percent, from RUR 1389 up to 1873 billion. The increase in the share of lending occurred due to a decrease in the liabilities of the extended government (from 20 percent down to 18.5 percent) and foreign assets (from 20 percent down to 15.5 percent). The amount of own reserves remained stable throughout the period, 10 - 12 percent of total assets.



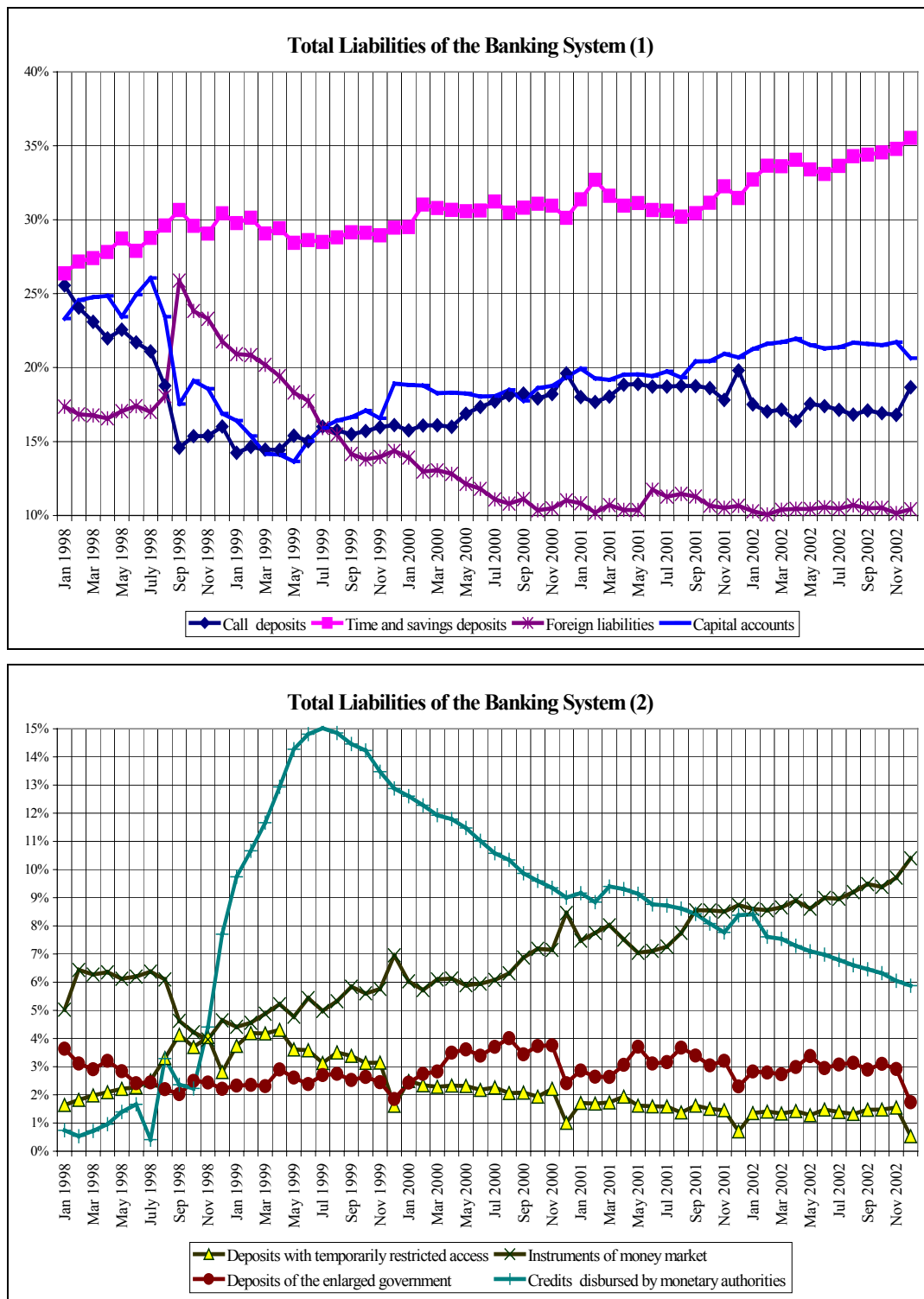
Source: Central Bank of RF

Fig. 8. Structure of the Total Assets of the Banking System



Source: Central Bank of RF

Fig. 9. Dynamics of Liabilities of Non-financial Sector Entities and Capital Accounts of the RF Banking System in 2000 - 2002.



Source: Central Bank of RF

Fig. 10. Structure of Total Liabilities of the Banking System



However, in our opinion, if the current trends remain, the observed positive dynamics of lending to the non-financial sector constitutes a threat to the stability of the banking system in the medium term (up to two years). As one may see in Fig. 9, in the course of the past two and a half years liabilities of the non-financial sector (in nominal terms) grew 1.35 times quicker than capital accounts, i.e. the own reserves of the banking sector. Thus, if the said disproportion remains, the achieved rates of lending may be preserved only by increasing balances in customers' accounts and attracting funds of individuals to the banking sector.

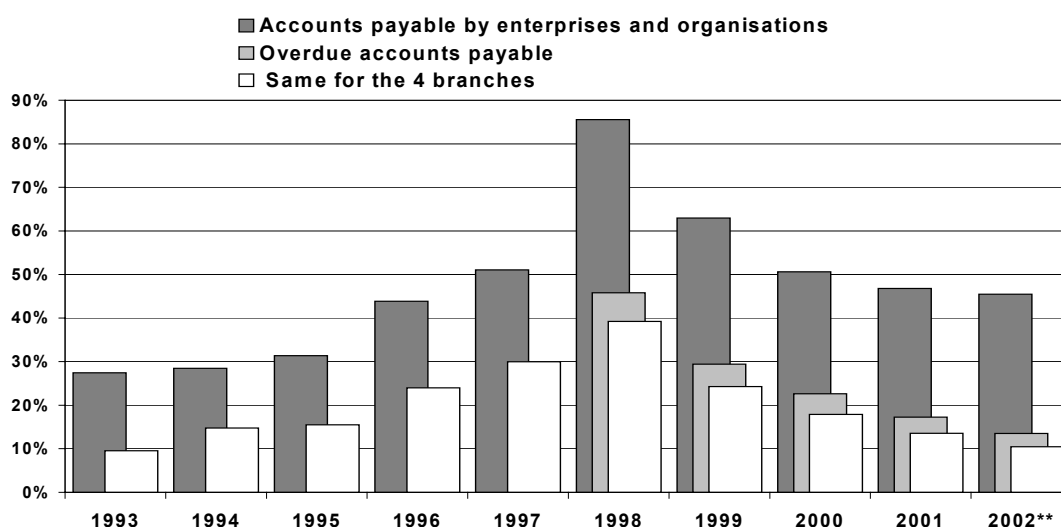
Changes occurring in the liability structure of the banking system during the past two years (see Fig. 10) confirm the proposed thesis of disproportion in the dynamics of bank lending and bank equity. The greatest growth rates were observed in 2002 for the share of term and savings deposits (from 32 percent to 36 percent of total liabilities) and money market instruments (from 8 percent to 10.5 percent). At the same time, the share of foreign liabilities fell down to an unexampled low: 10 percent of the total liabilities.

The situation with non-payments and settlement of accounts

In 2002 (January to October) the trend of non-payments diminishing in the economy persisted. The aggregated volume of accounts payable by enterprises and organisations continued growing in their nominal value, in GNP shares it got stabilized at the level of 45% (see *fig. 11*). Overdue payments of enterprises and organisations in GDP shares continued to decrease and by the end of October 2002 they were about 11%. The share of debts to suppliers was less than 5%. It should be noted that this commodity credit to GNP ratio corresponds to analogous ratios in developed countries. In France the volume of commercial credit (debts to suppliers or debts of buyers) in 1989 accounted for 38% of GDP, overdue debts – 17%, In Finland the ratio was 20% and 9%, in Great Britain – 20% and 12%, In Sweden – 21% and 8% correspondingly⁶.

In nine months of 2002 the overdue accounts payable went down by 6% (93.5 bln roubles) compared to the total accumulated amount, and the accounts receivable by 3.4% (33.7 bln roubles). In the corresponding periods of 2001 there was registered an increase of overdue accounts payable and receivable (by 4.3% and 13.3% correspondingly). The major decrease of overdue accounts payable happened in January 2002, which accounted for 113 bln roubles. The major part of the decrease - 94% (106 bln roubles) – was caused by settlement of long-standing debts – payments overdue for more than 3 months. Taking into consideration that writing down of debts as financial results was not high (see *table 2*) one can say that the non-payments decrease was connected with restructuring and direct settlement of debts. The largest overdue debts were settled with the budget, off-budget funds and suppliers (35, 32 and 71 bln roubles or 11.1%, 4.3% and 22.7 of the accumulated amount correspondingly). Other types of debts increased by 44.6 bln roubles (24.6% to the level of accumulated debts).

⁶ *Schaffer M.E.* Do firms in transition have soft budget constraints? A reconsideration of concepts and evidence // *Journal of Comparative Economics*, 1998, 26(1). P. 80–103.



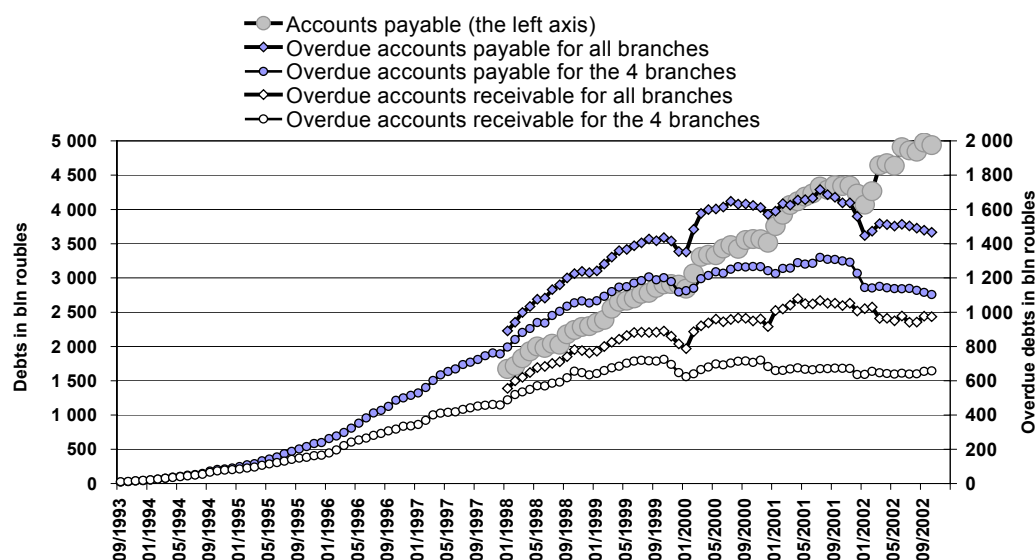
*Until 1997 the 4 branches including

**Assessment (January – October 2002)

Source: The State Statistics Committee of the Russian Federation, calculations by the authors.

Note: The total of overdue account payable by enterprises and organisation include overdue accounts payable and overdue debts to the bank system. The accounts payable in their turn consist of accounts payable to suppliers, debts to budgets of all levels and off-budget funds, arrears of wages and debts to other creditors. Until 1998 the State Statistics Committee of the Russian Federation published the statistics of non-payments only for four branches (industry, agriculture, transport and civil construction). Starting from 1998 the total of debts in the economy is calculated for all branches.

Fig. 11. Accumulation of non-payments in shares of GDP from 1993 until 2002.



Source: The State Statistics Committee, calculations by the authors.

Fig. 12. Accumulation of overdue accounts payable and receivable for all branches of the economy and for the 4 branches (industry, agriculture, civil construction and transport) in current prices

The share of overdue payments in the total amount continued to decrease and by October 2002 accounted for less than 30% (it peaked in 1998 and accounted for 55% then, see *fig. 13*).

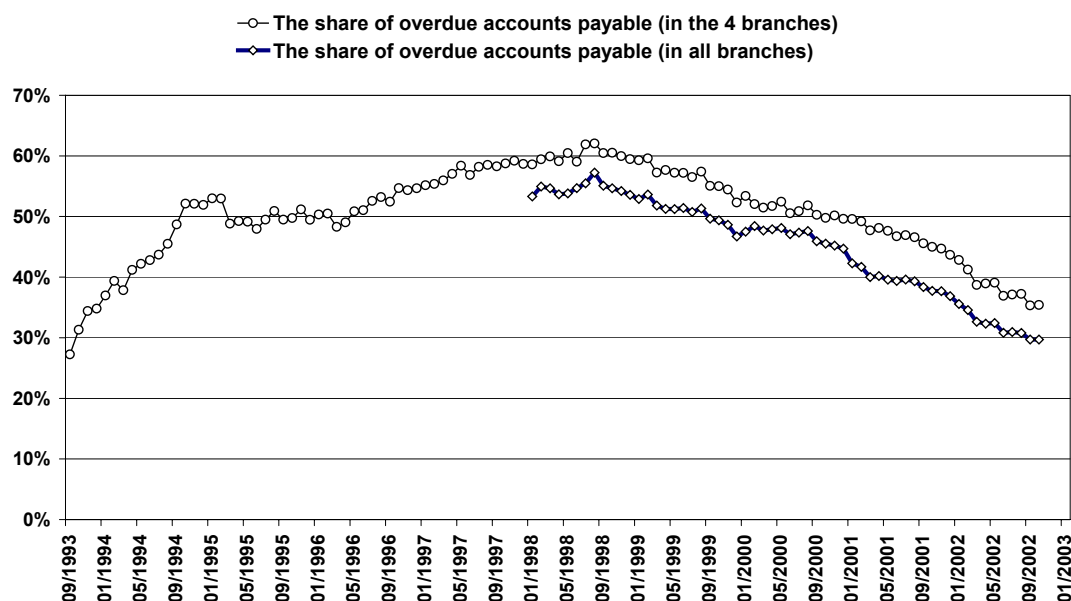
Table 2

Volumes of writing down of debts of subjects of the economy with expired deadline terms as financial results

Period	Accounts payable written off at the expense of profit			Accounts receivable written off as losses		
	Total, mln roubles	In % to overdue accounts payable	In % to annual increment of accounts payable (including the ones written off)	Total, mln roubles	In % to overdue accounts receivable	In % to annual increment of accounts receivable (including the ones written off)
1997	874	0.1%	0.4%	1 921	0.4%	1.5%
1998	2 777	0.2%	0.7%	7 990	1.0%	3.2%
1999	5 597	0.4%	4.3%	12 420	1.5%	19.1%
2000	6 598	0.4%	3.0%	21 955	2.4%	17.8%
2001	10 185	0.7%	-774.5%	25 783	2.6%	22.1%
2002*	6 999	0.5%	-8.1%	15 201	1.6%	-82.2%

*January – October 2002

Source: The State Statistics Committee, calculations by the authors.

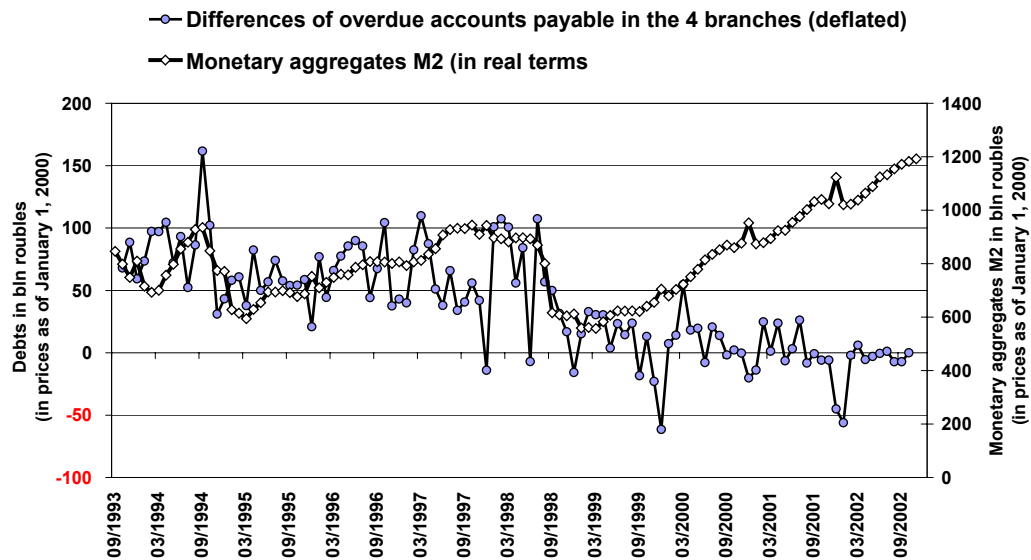


Source: The State Statistics Committee, calculations by the authors.

Fig. 13. Changes in the share of overdue accounts payable in the total of accounts payable

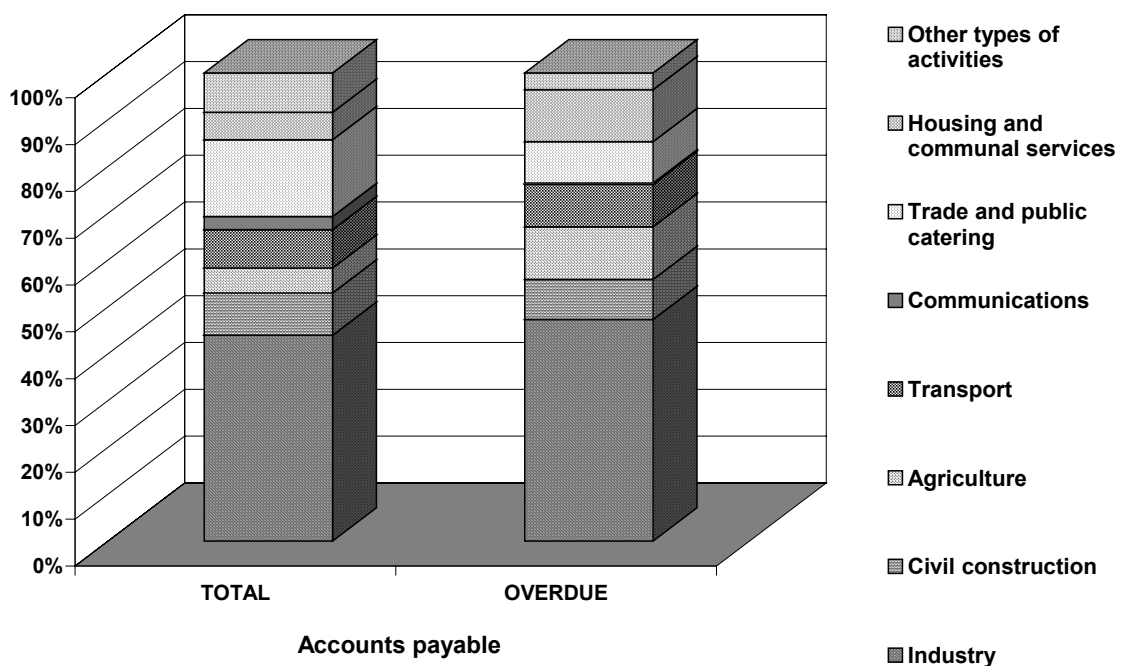
Transition to settlements in money presupposes a higher demand for transactional balances. In all probability this is one of the factors of a stable growth of monetary aggregates in recent years. Starting in 2001 the volume of monetary aggregates has been at its maximum for the period since 1993 (see *fig. 14*). Another reason for this is the increase of banking credits

to the real sector, which promotes replacement of commercial credits and a decrease of non-payments.



Source: The State Statistics Committee, The Central Bank, calculations by the authors.

Fig. 14. Changes in increment of overdue payments and monetary aggregates M2



Source: The State Statistics Committee, calculations by the authors.

Fig. 15. Breakdown of accounts payable by branches of the economy by the results of the first half of 2002

Among branches the biggest share of the total and overdue debts has permanently belonged to the industry. While in the total of accounts payable the share of the industrial sector



accounts for approximately 42%, its share in overdue debts is 47% (as of October 2002). Similarly, the housing and communal services sector and agriculture have a bigger share in overdue accounts payable, than in the total. Overdue debts are 66% of accounts payable in agriculture and 59% in the housing and communal services sector. On the whole in Russia this figure is 30%.

Table 3

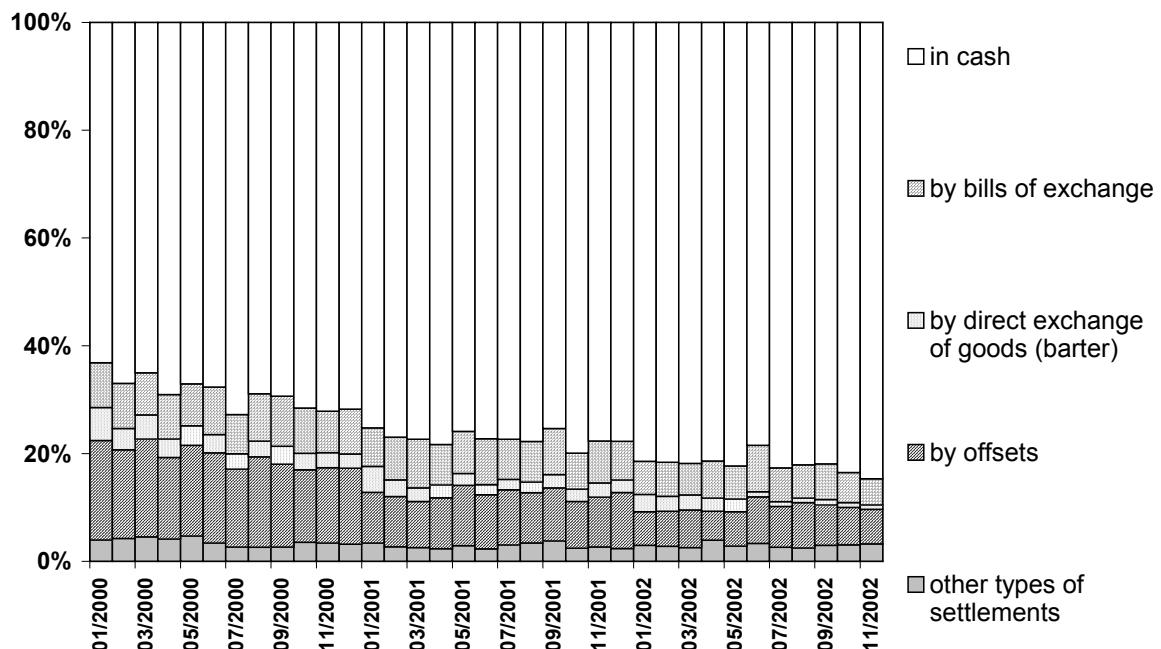
The structure of accounts payable by industrial branches as of the end of October 2002

Branches of industry	Accounts payable		The share of overdue debts in the total, %	The share of accounts payable of the branch in the total debt of the industry, %	The share of overdue accounts payable in the branch in the total overdue debt of the industry, %
	Total, bln roubles	Overdue, bln roubles			
The Industry, total	2040.1	728.9	35.7%	100.0%	100.0%
Including: power industry	234.1	122.9	52.5%	11.5%	16.9%
Fuel industry	500.3	143.1	28.6%	24.5%	19.6%
Including:					
Oil industry	160.4	34.1	21.3%	7.9%	4.7%
Oil refining industry	66.4	5.5	8.3%	3.3%	0.8%
Gas industry (production and processing of natural accompanying gas)	178.2	33.2	18.6%	8.7%	4.6%
Coal industry	93.8	69.1	73.7%	4.6%	9.5%
Ferrous metallurgy	114.7	39.9	34.8%	5.6%	5.5%
Nonferrous metallurgy	141.3	50.6	35.8%	6.9%	6.9%
Chemical and petrochemical industry (without pharmaceutical industry)	109.4	46.9	42.9%	5.4%	6.4%
Machine- building and metal processing	567.1	201	35.4%	27.8%	27.6%
Timber industry, wood-working, pulp and paper industry	58.7	25.6	43.6%	2.9%	3.5%
Construction materials industry	56.9	25.9	45.5%	2.8%	3.6%
Glass, china and faience industry	5.8	2.3	39.7%	0.3%	0.3%
Light industry	34.4	17.3	50.3%	1.7%	2.4%
Food industry	158.7	31.7	20.0%	7.8%	4.3%
Including: fish industry	25	6.2	24.8%	1.2%	0.9%
Microbiology	3.4	2.2	64.7%	0.2%	0.3%
Flour-milling and feed mill industry	13.9	4.2	30.2%	0.7%	0.6%
Medical industry	9.6	2.5	26.0%	0.5%	0.3%
Printing industry	4.3	0.2	4.7%	0.2%	0.0%

Source: The State Statistics Committee, calculations by the authors.

Among branches of the industry the leaders with respect to the share of overdue payments in the total debts are the coal industry (74%), power industry (53%), light industry (50%) and microbiology (65%) (*table 3*). While the amounts of debts of the last two branches are comparatively small, the power industry and fuel industries taken together represent about one third of total debts in the economy. The largest consumer of commercial credits in absolute expression is the engineering and metal-working industries. Their share of debts is about 30% of the total accounts payable in the economy.

An important part in reducing non-payments (starting since 1998) is played by energy monopolies that have cut all types of non-money payments for delivered and purchased goods and services. Among the basic changes in the pattern of settlements for goods and services delivered by the monopolistic enterprises⁷ one shall single out a further ousting of barter transactions by mutual settlement of outstanding accounts. The share of settlements in money in 2002 has increased and was kept at the level of approximately 80% (see *fig. 16*).



Source: The State Statistics Committee, calculations by the authors.

Fig. 16. The pattern of settlements for goods and services delivered by monopolistic enterprises

At the same time some of the recent tendencies are alarming. This is connected first of all with the factors of overdue payments growth⁸. For example in 2002 there was registered a

⁷ Pursuant to the Decree of the Government of the Russian Federation #10 of January 6, 1998 The State Statistics Committee of the Russian Federation shall perform a permanent statistical monitoring of settlement of accounts of the largest taxpayers in Russia: RFO "EES Rossii", OAO "Gazprom", OAO "Aeroflot – Russian International Airlines", organisations in the federal railway transport, as well as industrial monopolistic organisations.

⁸ By the results of econometric research the growth of non-payments is connected in particular with the lack of efficiency of domestic producers, decrease in crediting by banks, etc. For more detail see in "Razvitiye rossiyskogo finansovogo rynka i novye instrumenty privilecheniya investitsiy" by R. Entov, A. Radygin, V. Mau, S. Sinelnikov-Murylev and others, Moscow, IET, 1998, p. 96-149; in "Neplatazhy v Rossiyskoy Federatsii" by O.

stable growth of the share of losing enterprises in the economy (see *Fig. 17*), which compared to the previous year increased by 7-10% in different branches of the economy. As of October 2002 the share of losing enterprises in industry was 45.3% (38.4 in October 2001), 40.5% in civil construction (36% in October 2001), 46.1 in transport (41.4% in July 2001).

Calculations show⁹, that ineffectiveness and financial insolvency of enterprises was one of the decisive reasons of non-payments in the economy, which reveals the presence of a “channel of financing bad companies”. This connection was most typical for the period before 1998. After the crisis the share of ineffective enterprises was constantly decreasing, which also was the case of the statistical significance of this factor. Though no growth of non-payments is being registered, the risk of it is still present.

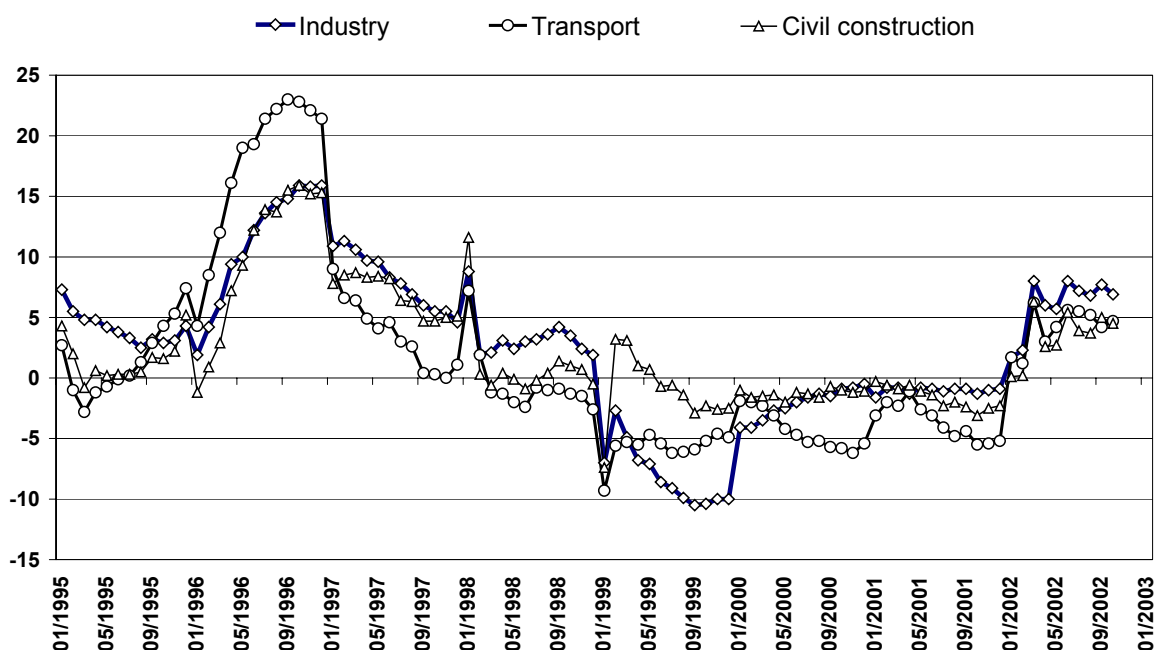
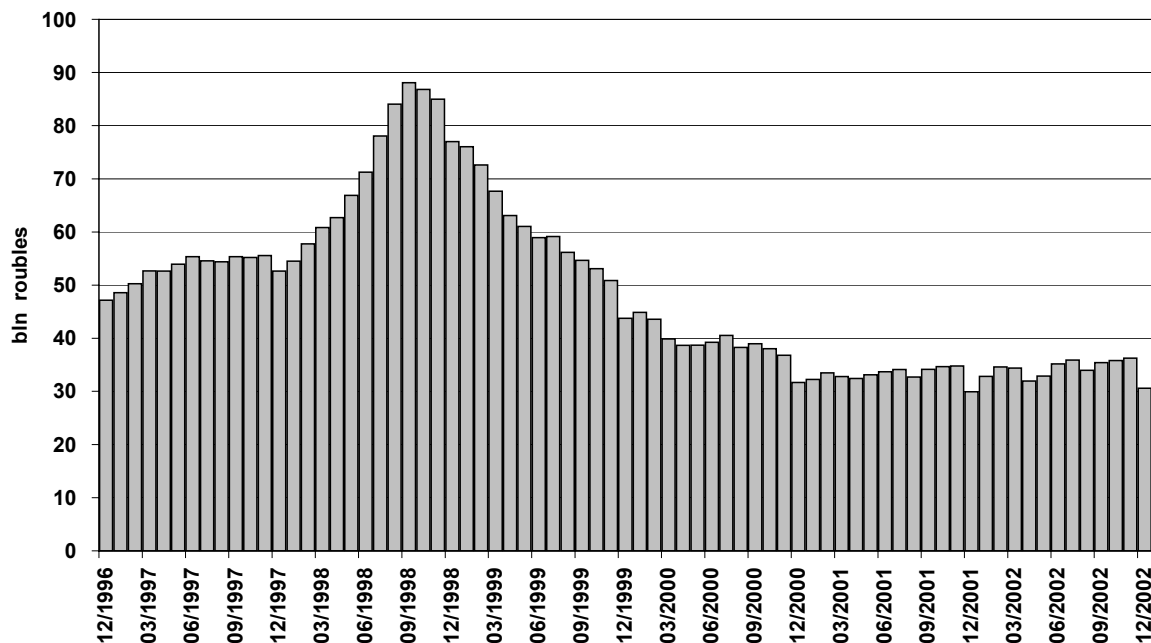


Fig. 17. Changes in the share of losing enterprises in industrial branches (seasonal differences to the corresponding period of the previous year)

Overdue arrears of wages starting from 2000 have been stable at the level of 30-40 bln roubles (in current prices, see *fig. 18*). Their growth since the beginning of 2002 was equal to 2%, which is much lower than the inflation and the real growth of average wages.

Lugovoy, L. Semyonov, IET (with support of USAID), 2000; in “Neplatezhi v rossiyskoy ekonomike i regionakh” by A. Zolotaryova, L. Liderman, O. Lugovoy, R. Entov, IET_CEPRA, 2001.

⁹ Ibid.



Source: The State Statistics Committee, calculations by the authors.

Fig. 18. Changes in overdue payment of wages by enterprises¹⁰

In all probability the reasons for the lack of an upsurge of non-payments in spite of the larger number of losing enterprises and the real exchange rate of the rouble¹¹ lie first of all in normalised government finances, increased financing by the banks, positive changes in the sphere of contract legislation (including the law on bankruptcy) and the reverse effect of the multiplier¹² used in settling accumulated non-payments.

In future the situation in the sphere of payments will depend upon the progress in the real sector of the economy, as well as upon the views of the authorities, which to a high degree depend upon budget revenues.

Though, as we see it, the major reason for the non-payments crisis in an economy in transition lies in non-market measures, which result in covert financing of ineffective companies. The non-payments economy as opposed to the market one can respond to exogenous shocks not only by making smaller debts, but to a much greater degree by an increment of overdue payments. This form of managing the situation is far from being a market one, as far as competition mechanisms, which are essential for the process of ousting ineffective companies by more successful ones, are being switched off. In contrast to a normal market situation,

¹⁰ Given here are overdue payment of wages by enterprises and organisations in industry, civil construction, agriculture, transport, education, health service, culture and arts, science and scientific service, housing and communal services, as well as (starting in August 1998) by organisations in the social security sphere, public authorities in the subjects of Russian Federation and local governments, public order institutions. The given figures are for the end of month.

¹¹ Statistical assessments of relation between the real exchange rate of the rouble and non-payments are given in IET papers (see notes above). According to the basis hypothesis growth of the real exchange rate of the rouble decreases profitability of domestic production, which promotes bigger arrears caused by ineffective production.

¹² For detail about multiplicative effects of non-payments spreading see in: *Lugovoy O.* Arrears in a Transition Economy: the Mechanism of Contagion. RECEP, Russian Economic Trends 2002-Q2. P. 19–30.



losing enterprises in the economy of non-payments can survive as long as there is the possibility not to pay persists (enforcement mechanisms don't function).

If the growth of losing enterprises persists also in the future, which is partially promoted by a higher real exchange rate of the rouble, there will be a rather high probability of a stronger upsurge of overdue payments. Taking the positive experience of recent years into consideration, renewal of non-payments crisis in the same scope become less and less probable with each year, but in case of unfavourable tendencies in the economy on the whole one cannot view such a crisis as improbable. Most alarming at that would be non-performance of budget expenses, which can be caused by a bigger number of losing enterprises and a generation of non-payments by the government itself. The last one can provoke non-payments spreading and crisis renewal in the economy.

2.2. Balance of Payments

Last year, a certain change was registered as concerns the downward trend demonstrated by the current account balance since the year before last. Thus, since the 1st quarter there has been observed a growth in the balance of payment on current account. While in 2001 this balance declined almost twofold (from US \$ 11.5 billion in the 1st quarter to US \$ 5.7 billion in the 4th quarter), in 2002 the current account balance increased from US \$ 6.9 billion in the 1st quarter to US \$ 9 billion in the 3rd quarter; however in the 4th quarter it decreased to US \$ 7.7 billion (according to the preliminary CB RF estimates). As before, the major factor determining the amount of current account balance was the balance of trade, which, in turn, fully depended on the changes in prices of energy resources and other staple Russian exports on world markets. The data presented in *Table 1* demonstrate that the relationship between world oil prices and Russian balance of trade, which was noticeable in 1995 through 2001, also manifested itself over 2002¹³.

It shall be pointed out that in 1st through 3rd quarters of 2002 the increasing volumes of Russian exports accounted for the growth in the balance of trade. The amounts of import also grew, but at a slower rate. However, in the 4th quarter of 2002 the rates of increase in imports outpaced rates of growth in Russian exports. For instance, the amount of Russian balance of trade in the 4th quarter of 2002, according to the preliminary estimates of the CB RF, made US \$ 11.5 billion, at the same time, export of goods increased from US \$ 28.8 billion in the 3rd quarter to US \$ 29.6 billion, while imports grew from US \$ 15.6 billion to US \$ 18.1 billion (i.e. by almost 20 per cent).

Alongside with the declining balance of trade, in 2002 the current account balance was significantly affected by the negative values of the balance of nonfactor services - the surplus of imports over exports increased from US \$ 460 million in the 1st quarter to US \$ 1.6 billion in the 3rd and 4th quarters, what was determined by the growing import of services.

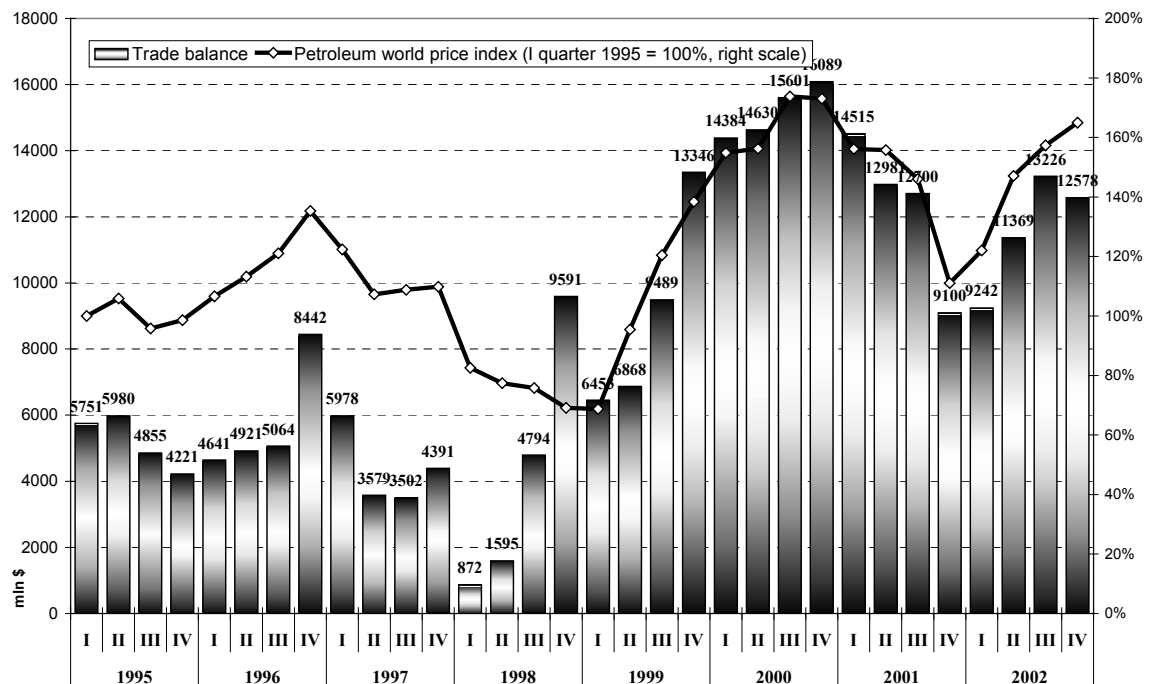
Reviewing the trends of changes in the balance of payments across its components, it may come to notice that in spite of the declining values of the active balance of trade, in 2002

¹³ Evaluations carried out for 1993 through 2002 detected a statistically significant relationship between the RF trade balance (*TB*) and the index of world oil prices (*P*), dummy variable equals 1 in III and IV of 1998 when other factors determined the RF trade balance.

$$TB = -9,2 + 14,3 \cdot P + 5,9 \cdot Dummy$$
$$(-5,1) \quad (10,0) \quad (3,5)$$
$$R^2 = 0,78$$

the surplus of exports over imports primarily accounted for the growth in forex denominated holdings of residents. In other words, all payments to non-residents, as concerns transactions not related to export and import of goods, as well as changes in foreign assets and liabilities of residents, were financed at the expense of the active balance of trade. It primarily concerns the financing of the negative balance of labor and capital services (payment of non-resident's wages and debt servicing), portfolio investment abroad, increase in foreign holdings of Russia's residents, as well as payments aimed to diminish Russian residents' liabilities to non-residents.

An analysis of the aggregate indicators of the Russia's balance of payments in 2002 reveals that as concerns the balance of assets and liabilities Russian forex denominated holdings increased by US \$ 45.3 billion (the balance of trade in January through December of 2002) at the expense of trade transactions between residents and non-residents. Besides, Russian foreign holdings were replenished from such sources as foreign direct investments (US \$ 2.6 billion), portfolio investment in non-financial enterprises (US \$ 2.2 billion), official guaranteed borrowings (US \$ 1.4 billion), as well as loans, deposits, and borrowings on the part of Russian banks and non-financial enterprises (US \$ 8 billion).



Source: CBR, IMF International Financial Statistics, authors' calculations.

Fig. 19. RF trade balance and oil price index in 1995 through III quarter of 2002

The increase in foreign holdings was offset by the changes in balances on the following accounts: net import of nonfactor services (US \$ 8.7 billion), investment income paid on direct and portfolio investment in Russia (US \$ 4.7 billion), repayment of debt securities and repurchase thereof on the secondary market by federal authorities (US \$ 16.7 billion), direct and portfolio investment abroad, other investment in foreign holdings (about US \$ 16.5 billion representing the increase in balances on foreign accounts and deposits, extended trade credits and advances, the increase in non-residents' overdue indebtedness and non-residents'



indebtedness relating to non-repatriated export proceeds and non-repatriated import advances), as well as accumulated reserve assets (US \$ 14.4 billion). Besides, the negative balance on “net errors and omissions” made US \$ 8.7 billion.

Therefore, in 2002 there was observed the same ratio between assets and liabilities as in preceding years: a growth in foreign holdings determined by the large amounts of the trade balance not offset by considerable borrowings was the source of repayment of accumulated over preceding years indebtedness to non-residents, replenishment of Russian foreign holdings, and other forms of capital outflow.

Among the operations primarily financed at the expense of the surplus of the balance of trade there shall be pointed out not only changes in liabilities to non-residents, but also an increase in foreign holdings of Russia’s residents, what has for a number of years remained an important way to utilize residents’ holdings obtained as a result of the active balance of current account. While net liabilities to non-residents by end-year remained at the practically same level, net foreign holdings of Russian residents had increased by US \$ 5.5 billion over the year (at the same time official assets declined by US \$ 14.4 billion, while foreign holdings of banks and non-financial enterprises increased by US 16.8 billion). The major types of Russian foreign holdings, which grew most significantly in 2002, were balances on current accounts and deposits, increase in non-residents’ indebtedness relating to non-repatriated export proceeds and non-repatriated import advances (totaling US \$ 10.6 billion), as well as direct and portfolio investment (US \$ 2.8 billion).

As concerns the increase in the Russian foreign holdings, it is necessary to note the problem of capital flight. It is well known that some foreign holdings of residents in the form of overdue indebtedness and indebtedness relating to non-repatriated export proceeds and non-repatriated import advances, as well as a portion of resources on the “Net errors and omissions” account of the balance of payments may characterize unregistered outflow of capital from the country. It may be assumed that in the case the balances of these accounts have been negative over a long period of time, the dynamics of this indicator may characterize the dynamics of unregistered outflow of capital from Russia. In 2002, basing on the aforesaid indicators, the unregistered outflow of capital remained practically at the same level. While in 2001 the balance of the “Net errors and omissions” account made US \$ -8.5 billion, in 2002 this indicator was at US \$ -8.7 billion. A slightly different pattern may be observed in the course of analysis of the sum of net errors and omissions, overdue indebtedness, and indebtedness relating to non-repatriated export proceeds and non-repatriated import advances: this indicator was at US \$ -19.1 billion in 2002, while in the preceding year this amount made US \$ -9.9 billion. In other words, basing on the latter indicator it may be suggested that unregistered outflow of capital from the country somewhat increased. However, concerning these estimates it shall be stressed that, first, the analyzed indicators may be regarded only as indirect indicators of the dynamics and not of absolute amounts of illegal outflow of capitals, and, second, the increase in both overdue indebtedness, and net errors and omissions might result from the growing value of exports, what in turn might bring about a proportional increase in indebtedness relating to non-repatriated export proceeds and non-repatriated import advances, and account for statistical discrepancies encountered in the process of estimation of the base indicators of the balance of payments.

In the course of the analysis of the Russia’s balance of payments it is necessary to point out that, similarly to the preceding year, the amount of the favorable balance of trade proved so significant that in spite of considerable amounts of payments aimed to diminish

Russian liabilities to non-residents and the growth in Russian foreign holdings the reserve assets also grew: in 12 months of 2002 this indicator increased by US \$ 11.4 billion (the most considerable increase - US \$ 6 billion – was registered in the 2nd quarter). However, the actual increase in reserve assets was below the respective indicator registered in 2000, when gold and forex reserves grew by US \$ 16 billion – the maximal increase observed over the years of monitoring.

As concerns possible future changes in the indicators of the Russian balance of payments, the prospects for 2003 remain rather vague, first, due to the mentioned above dependence of the balance of trade on world oil prices, it may be presumed that changes in foreign holdings of residents resulting from this type of exports depend on the business situation on world markets of raw materials, for instance, on the developments in Iraq.

Second, it is necessary to take into account the foreign creditors' demands to repay the Russian debt. According to the law on the federal budget for year 2002, the expenditures of the Russian Federation for repayment and servicing of the external debt shall make US \$ 17.3 billion. This amount exceeds the actual payments made in 2002, when the federal government assigned about US \$ 15.2 billion for repayment and servicing of the public debt (not including US \$ 1.5 billion for repurchase of Russian debt securities on the secondary market). In this situation it may be presumed that in the case high oil prices persist in 2003, the Russian authorities will be able, similarly to the preceding years, repay and service the debt at the expense of high values of the favorable balance of trade. In conclusion, it shall be pointed out that the trend towards an increase in the rates of real Ruble appreciation, noticeable over the last few months, may negatively affect the Russian balance of payments. In the case the developments on the world oil markets are unfavorable, Russia, in contradistinction to the last year situation, would not be able to anticipate the payments related to the repayment and servicing of the public external debt.



2.3. Public Finances

2.3.1. State Budget

General Description of the Budgetary Situation in 2002

According to the Finance Ministry, the revenues of the federal budget in 2002 made Rub. 2202.1 billion, or 20.1 per cent of GDP, what by 2.5 p.p. exceeds the figures registered in 2001. The revenues primarily grew due to increasing tax revenues, which made 18.6 per cent of GDP in 2002 and grew by 2.3 p.p. as compared with the preceding period. However, it shall be taken into account that in 2002 the single social tax (SST) was included in the composition of federal budget revenues. Therefore, the level of tax revenues of the federal budget minus SST not only failed to grow in 2002 in comparison with the figures registered in 2001, but significantly declined (by 0.7 p.p. of GDP in comparison with the level registered in the last year). Accordingly, budgetary revenues (without SST) also fell and made Rub. 1862.7 billion (17.0 per cent of GDP), what is by 0.6 p.p. of GDP below the level of 2001.

The share of tax revenues in the structure of revenues of the federal budget for 2002 remained at the level registered in the preceding year – 77 per cent (without SST, or 92 per cent with SST), while non-tax revenues (taking into account revenues of budget targeted funds, primarily the Targeted Fund of the RF Ministry of Atomic Energy) made 7.6 per cent of the total revenues, declining somewhat in comparison with the figures observed in the preceding year (8.1 per cent of the total revenues).

It shall be pointed out that in 2002 there was observed a certain increase in tax revenues of territorial budgets (by 0.6 per cent of GDP). As concerns the total revenues of territorial budgets, they also grew by 0.6 per cent of GDP. On the whole, it may be noted that in 2002 the level of revenues of territorial budgets was at its record high over the last five years.

At the same time, budgetary expenditures increased to 18.7 per cent of GDP in 2002, what is by 4 p.p. above the indicator registered in the preceding year. Even without transfers to the Pension Fund for financing of the base component of the labor pension at the expense of SST, the level of expenditures was by 1 p.p. above the level of 2001. Accordingly, in 2002 the level of budgetary surplus declined to 1.4 per cent of GDP (as compared with 2.9 per cent registered in 2001). In this situation, the financing of the financial reserve of the federal budget was possible at the expense of privatization of state owned blocs of shares in Lukoil and Slavneft (about 0.7 per cent of GDP) and at the expense of unutilized balances on accounts of recipients of budgetary funds (about 0.5 per cent of GDP).

Expenditures of territorial budgets also grew in 2002 – by 1 p.p. of GDP in comparison with the figures registered in 2001 (from 14.3 to 15.3 per cent of GDP). For the first time since 1998 the aggregate budget of RF subjects has been balanced with a deficit, which made of 0.4 per cent of GDP.

In 2002, the consolidated budget was administered with a profit (1 per cent of GDP). The level of budgetary revenues was somewhat below the level registered in the preceding year (29.0 % in 2002 (without SST) as compared with 29.3 per cent in 2001), however, it exceeded the figures observed in 2000 and earlier. At the same time, the expenditures of the consolidated budget were noticeably higher than over last four years, even without SST transferred to the Pension Fund from the federal budget (28 per cent of GDP).

A few major factors, which are discussed below, has been behind a decline in tax revenues. On the whole, such dynamics of revenues of the budgetary system, primarily as concerns the federal budget, may be explained by the following developments. First, world oil prices were volatile over the year and significantly below the level estimated for the budget. Second, changes in taxation of profits of organizations and VAT negatively affected the amount of tax revenues.

Table 4

**Administration of revenues and expenditures
of the federal and territorial budgets (in % of GDP)**

	1998	1999	2000	2001	2002
Federal Budget					
Tax revenues*	9,3	11,6	14,3	16,2	18,6
Including SST	—	—	—	—	3,1
Revenues	11,0	12,8	15,5	17,6	20,1
Expenditures	13,8	13,9	14,1	14,7	18,7
Including transfers to Pension Fund at expense of SST	—	—	—	—	3,1
Deficit	-3,2	-1,1	1,4	2,9	1,4
Territorial Budgets					
Tax revenues*	11,9	11,2	11,8	10,8	11,4
Revenues	14,5	13,6	14,1	14,3	14,9
Expenditures	14,7	13,6	13,7	14,3	15,3
Deficit	-0,3	0,0	0,5	0,0	-0,4
Consolidated Budget**					
Tax revenues*	21,2	22,8	26,0	27,0	29,7
Revenues	24,0	26,8	28,3	29,3	32,1
Expenditures	27,5	28,0	26,4	26,4	31,1
Deficit	-3,5	-1,1	1,9	2,9	1,0

* Before 2001 there were included revenues of Federal Road Fund, Fund of Reproduction of the Mineral and Raw Materials Base, Fund of Management, Study, and Reproduction of Water Biological Resources, Federal Fund of Rehabilitation and Protection of Water Resources, Federal Ecological Fund.

** Excluding interbudgetary transfers.

Source: RF Finance Ministry, authors' calculations.

At the same time, the budgetary situation was positively affected by non-tax revenues. For instance, share dividends, proceeds from state owned property and privatization, and proceeds of external economic activities exceeded targets. However, it shall be taken into account that these revenues make only a small share in the total amount of revenues (below 7 per cent of the total amount of federal budget revenues).

In 2002, the amount of indebtedness to the budgetary system increased in comparison with the figures registered in 2001, what may be explained by the inclusion of the SST related indebtedness relating to the share of SST, which prior to 2002 had been due to the budget of the Pension Fund and since 2002 – to the federal budget. Without taking into account this share of indebtedness, the deflated increase would have made 8 per cent over the first 9 months of 2002 (0.3 per cent of GDP).

It shall be pointed out that the dynamics of arrears in the indebtedness composition were positive. In real terms, tax arrears related to the consolidated budget have diminished more than 1.5 times since 2000. These developments may be explained, on the one hand, by the implementation of measures aimed to restructure the arrears, and, on the other hand, coercive



measures undertaken to exact the indebtedness due to the budgets of all levels, the latter resulting in Rub. 174.8 billion (2.2 per cent of GDP) of repaid indebtedness in 2002.

Table 5

Tax indebtedness to the consolidated and federal budgets

	1999	2000	2001	2002
<i>Indebtedness to consolidated budget (Rub. billion)</i>	378	464	475	522
Including arrears	343	365	245	209
Share of arrears in indebtedness	91%	79%	52%	40%
Annual increase in indebtedness (in real prices) in % of the amount of indebtedness by the beginning of the year		25%	3%	9%
Annual increase in indebtedness in % of GDP		1,2%	0,1%	0,4%

Source: RF Tax Ministry, authors' calculations.

In spite of the fact that in 2002 oil prices were below the estimates used to calculate budget targets, they were above the average price of long standing – US \$ 19 per barrel¹⁴, what affected execution of budgets of all levels. According to our estimates, in tax revenues of the enlarged government budget (including revenues of targeted budgetary funds formed at the expense of taxes), the share of tax revenues presented in *Table 6* may be explained by the oil prices being out of line with the average price of long standing (US \$ 19 per barrel):

Table 6

An Analysis of Major Tax Revenues in 2002

1994	1995	1996	1997	1998	1999	2000	2001	2002
2,9%	1,9%	-1,5%	-0,1%	-6,8%	-1,3%	8,6%	5,1%	4,4%

Table 7

Major tax revenues of the RF budgetary system

	In % of GDP			
	1999	2000	2001	2002
Profit tax	4,6	5,4	5,7	4,2
Personal income tax	2,5	2,4	2,8	3,3
Value Added Tax	8,8	6,2	7,1	6,9
Excises	2,2	2,3	2,7	2,4
Taxes on foreign trade	1,8	3,1	3,6	3,0
Payments to social extra-budgetary funds (single social tax)	7,2	7,3	7,1	7,7*
Including SST due to the federal budget				3,1
Total tax revenues (including revenues of targeted budgetary funds formed at the expense of taxes and mandatory payments)	32,1	35,6	35,2	35,4

* Estimate adjusted for actual SST revenues of the federal budget.

In 2002, the profit tax revenues declined by more than 25 per cent in comparison with the figures registered in 2001 (by 1.5 p.p. in terms of GDP), what may be explained by several factors. First, the approval of the new chapter of the Tax Code concerning the tax on profits of organizations resulted both in significant shifts in the structure and considerable in-

¹⁴ According to IET estimates.

crease in amount of costs deductible from the tax base. Second, the application of so called “transitional” procedure for determination of the tax base (transition to the accrual basis accounting method) allowed the number of enterprises significantly reduce the tax base. Third, in 2002, there was registered a general decline in the balance of financial results of enterprises and organizations.

Profit tax revenues grew by almost 20 per cent in real terms in 2002. The positive dynamics of profit tax revenues related both to the gradual legalization of incomes of individuals (the main goal of the reform), and the general growth of the economy resulting in an increase in aggregate incomes.

VAT revenues somewhat declined in 2002 as compared with the figures registered in 2001 (by 0.2 p.p. in terms of GDP). At the same time, the collection of VAT made 95 per cent of the target. The major factors behind the failure to meet the budgetary target were considerable amount of VAT compensation to exporters (2 per cent of GDP); persisting tax privileges relating to medicines, medicinal products, and books; the amount of GDP was below the target; and there were enacted provisions of the Tax Code permitting to deduct VAT imposed on capital construction and commissioning of objects. Excise revenues have also declined in GDP terms – by 0.3 p.p.

In 2002, the revenues generated by taxes on foreign trade significantly decreased in comparison with the figures observed in 2001 (from 3.6 per cent to 3.0 per cent of GDP). At the same time, in real terms the decline made more than 15 per cent in comparison with the levels registered in the respective period of the preceding year. This development is primarily related to the introduction (since February 1, 2002) of the new procedure governing the calculation of oil duties based on the monitoring of world oil prices in November through December of 2001. Although the targets of the federal budget based on estimated amount of duty at US \$ 21.7 per metric ton, the actual duties were at or below US \$ 10 over the first six months of 2002. As a result, the export tax revenues were by 5 per cent below the target set by the budget. At the same time, due to a growth in imports the revenues generated by import duties increased by about 1.2 per cent of GDP in 2002.

Since January 1, 2002, a certain part of the single social tax has been entered in the federal budget to be further transferred to the budget of the Pension Fund for financing of the base component of the labor pension. Revenues of the federal budget generated by this tax exceeded targets by more than one fourth, what was related to, first, inflow of tax charged in December of 2001, and, second, repayment of respective tax indebtedness due to the federal budget in accordance with the law on the federal budget for year 2002.

Consolidated Budget: Expenditures

The structure of expenditures of the consolidated budget did not change significantly in 2002. While the expenditures for law enforcement have somewhat increased (from 2.0 per cent of GDP in 2001 to 2.2 per cent of GDP in 2002), the expenditures for HPU and subsidizing of agriculture declined (from 2.5 per cent of GDP in 2001 to 2.3 per cent of GDP in 2002 and from 0.8 per cent of GDP in 2001 to 0.5 per cent of GDP in 2002 respectively). There may be also mentioned a slight decrease in expenditures for servicing of the public debt (from 2.7 per cent of GDP in 2001 to 2.2 per cent of GDP in 2002, exceptionally at the expense of the federal budget).



At the same time, the expenditures for education and financial aid to other budgetary levels increased considerably (from 3.1 per cent of GDP in 2001 to 3.8 per cent of GDP in 2002 and from 2.5 per cent of GDP in 2001 to 2.9 per cent of GDP in 2002 respectively).

Table 8

Expenditures of the federal budget, territorial budgets and the consolidated budget in 2001 and 202 (in % of GDP)

	2001			2002		
	Federal budget	Territorial budgets	Consolidated budget	Federal budget	Territorial budgets	Consolidated budget
State administration and local government	0,50	0,80	1,20	0,51	0,85	1,36
Judiciary	0,10	0,00	0,10	0,18	0,02	0,20
International activities	0,30		0,30	0,29		0,29
National defense	2,70		2,70	2,70		2,70
Law enforcement and state security	1,60	0,40	2,00	1,74	0,47	2,20
Basic research and promotion of scientific and technologic advance	0,30	0,00	0,30	0,28	0,02	0,30
Industry, power engineering and construction	0,50	1,20	1,70	0,96	1,35	2,31
Agriculture and fisheries	0,30	0,50	0,80	0,25	0,29	0,55
Transportation, road maintenance, communications and information technology *	0,40	0,60	1,10	0,09	0,40	0,49
Housing and public utilities		2,50	2,50		2,34	2,34
Education	0,60	2,50	3,10	0,75	3,04	3,78
Culture, arts and cinematography	0,10	0,30	0,40	0,09	0,39	0,48
Mass media	0,10	0,10	0,20	0,09	0,08	0,17
Health and physical fitness	0,30	1,80	2,10	0,29	2,09	2,38
Social policy	1,20	1,10	2,40	0,29	1,29	1,58
<i>Transfers to PF at the expense of SST for financing of the base component of pensions</i>				3,10		3,10
Government debt servicing	2,60	0,10	2,70	2,04	0,13	2,17
Financial aid to other levels of government	2,50	0,00	X	2,91	0,01	X
Military reform	0,10	0,00	0,10	0,13	0,00	0,13
Road network				0,35	0,39	0,74
Targeted budgetary funds	0,20	1,40	1,60	0,14	1,42	1,56
TOTAL EXPENDITURE	14,70	14,30	26,30	18,69	15,32	31,09

In 2001, including expenditures for the road network.

Enlarged Government Budget

Table 9 presents the budget of enlarged government. It shall be pointed out that in the process of formation of such aggregate data there inevitably arises the problem of consolidation, i.e. the necessity to avoid double accounting. Since certain data relating to the execution of extra-budgetary funds and budgets of RF subjects can not be interpreted unambiguously

(for instance, it is not clear if the summary statistics relating to territorial and road and ecological funds include information of the funds consolidated in the budgets of RF subjects) and final data on the execution of the budgets of extra-budgetary funds are unavailable, revenues and expenditures of the enlarged government budget may be somewhat distorted. However, it shall be pointed out that these discrepancies can not radically change the general picture.

Table 9

Enlarged government budget in 2000 through 2002 (in % of GDP)

2000				
	Federal budget	Territorial budgets	Extra-budgetary funds	Enlarged government budget
Total revenues	15,5	14,1	10,7	38,3
<i>Tax revenues</i>	14,3	11,8	9,5	35,6
Total expenditures	14,1	13,7	9,1	34,8
<i>Health and physical fitness</i>	0,2	1,8	0,9	2,7
<i>Social policy</i>	0,9	0,8	5,6	6,9
<i>Transport and roads</i>	0,8	1,6***	2,2	3,3
2001				
	Federal budget	Territorial budgets	Extra-budgetary funds	Enlarged government budget
Total revenues	17,6	14,3	9,2	38,0
<i>Tax revenues</i>	16,2	10,9	8,2	35,3
Total expenditures	14,7	14,3	9,1	34,8
<i>Health and physical fitness</i>	0,3	1,8	0,9	2,8
<i>Social policy</i>	1,2	1,2	6,4	8,4
<i>Transport and roads</i>	0,7	1,7***	1,2	2,2
2002				
	Federal budget	Territorial budgets	Extra-budgetary funds	Enlarged government budget*
Total revenues	20,1	14,9	8,4	36,4
<i>Tax revenues</i>	18,6**	11,4	7,3	34,2
Total expenditures	18,7	15,3	9,2	36,1
<i>Health and physical fitness</i>	0,3	2,1	1,0	3,0
<i>Social policy</i>	4,4	1,3	6,7	8,9
<i>Transport and roads</i>	0,6	1,5***	0,8	1,5

* Estimate.

** Including SST.

*** Including expenditures of territorial road funds consolidated in the budgets of RF subjects.

Source: RF Finance Ministry, Goskomstat, authors' calculations.

The following conclusions may be derived basing on the available data:



First, in 2002 tax revenues of the enlarged government budget, as well as total revenues declined in comparison with the figures registered over two preceding years (by about 2 p.p. in terms of GDP as compared with 2000).

Second, the expenditures of the enlarged government budget increased somewhat (by 1.3 p.p. in terms of GDP as compared with the respective figures registered in 2000 and 2001). It shall be noted that in 2002 expenditures for social policy and healthcare grew by almost 2 p.p. and 0.3 p.p. in terms of GDP in comparison with respective indicators of 2001.

On the whole, it shall be pointed out that the tax burden on the economy has been significantly lightened over the last three years. At the same time, the level of expenditures of the budgetary system increased, what resulted in an approximate balance between revenues and expenditures of the enlarged government budget. It is yet another argument that any further reduction of taxes shall be conditioned on the simultaneous curtailment of expenditure obligations.

Appendix 1. Forecasting Tax Revenues in 2002

Over 2002, there were carried out estimates of tax revenues using two types of models: revenue estimation model (REM) and econometric univariate autogressive integrated moving average (ARIMA) models. The method of obtaining predicted values basing on the REM model is to transform the data about revenues for the respective period of the preceding year taking into account the growth in GDP, inflation, changes in tax rates, and the general shifts in the amount of revenues occurred from the beginning of the year until the predicted period in comparison with the preceding year. Therefore, the predictive accuracy of both models significantly depends on the stability of time series dynamics, primarily, their seasonal and trend components. In this respect, ARIMA models turn out to be more sensitive to changes in dynamics, what by no means implies better predictive accuracy, since the input of new data governed by a changed process in the evaluated interval results in deterioration of characteristic of regression and therefore the quality of forecasts. Thus, the changes in the tax legislation enacted since 2002 resulted in a change of dynamics not only with regard to the profit tax, but also with regard to the aggregate tax revenues of both the consolidated and federal budget of the Russian Federation.

The accuracy of the forecasts of tax revenues for year 2002 was tested basing on the comparison between the predicted and actual values from May to November of 2002 inclusively. The use of the progressive total values of tax revenues since the beginning of the year for the comparative analysis makes it difficult to evaluate the quality of forecasts, since by the end-year the rate of the forecast error diminishes significantly. Proceeding from this consideration, the data on the tax revenues and respective forecasts are presented in nominal monthly terms. The key criterion of the accuracy of forecasts is the relative deviation of predicted values from the actual data.

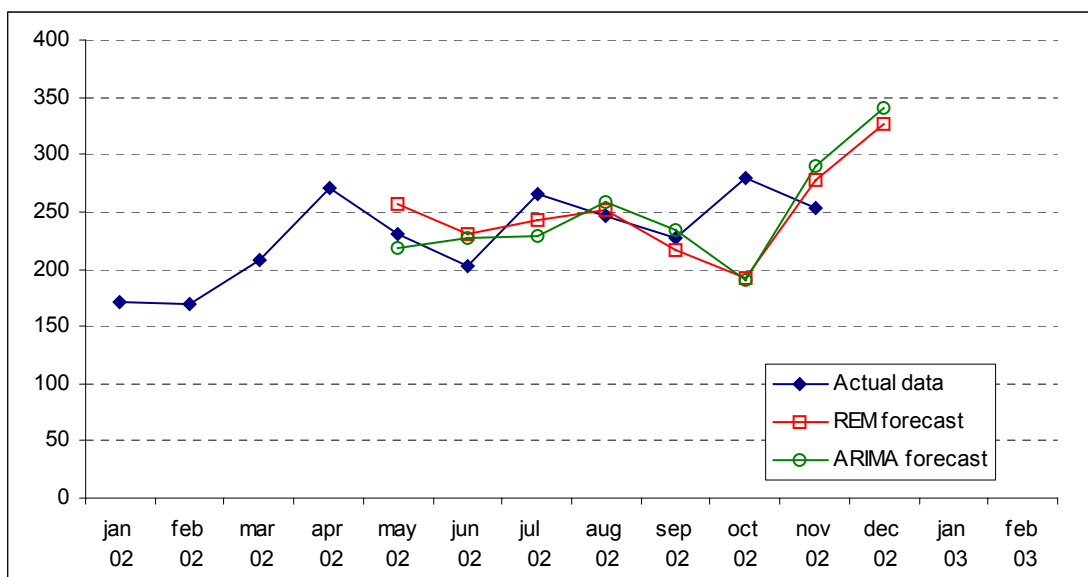


Fig. 20. Actual and predicted amounts of aggregate tax revenues of the RF consolidated budget (Rub. billion)

The mean relative error of the forecast of aggregate tax revenues of the RF consolidated budget for seven months (May – November) made 11.6 per cent for REM model and 12.3 per cent for ARIMA model. The least accurate forecast was obtained in October of 2002, when the relative error for both types of models was above 30 per cent.

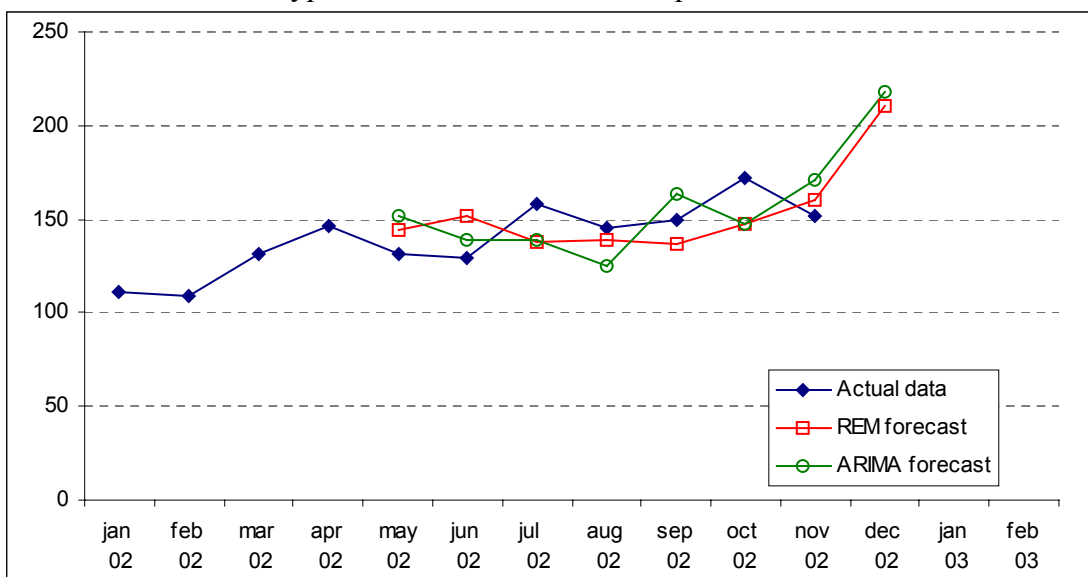


Fig. 21. Actual and predicted amounts of aggregate tax revenues of the RF federal budget (Rub. billion)

The mean relative error of the forecast of aggregate tax revenues of the RF federal budget for the period under observation made 10.3 per cent for REM model, while the relative accuracy of ARIMA model was at 12.2 per cent. On the whole, proceeding from the available

characteristics of forecasts in the interval from May to November of 2002, more accurate forecasts were obtained using REM model.

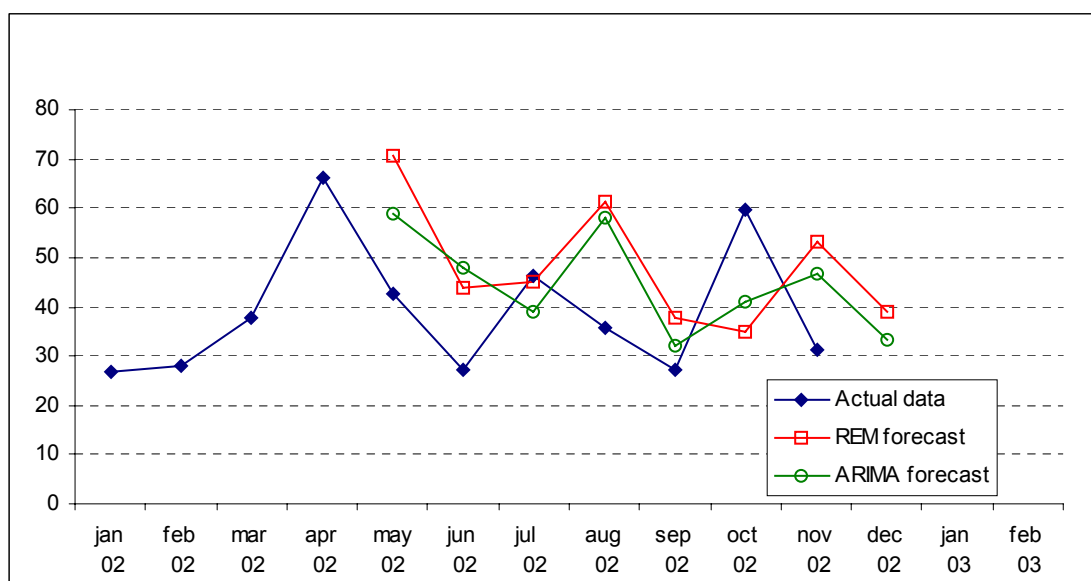


Fig. 22. Actual and predicted amounts of aggregate profit tax revenues of the RF consolidated budget (Rub. billion)

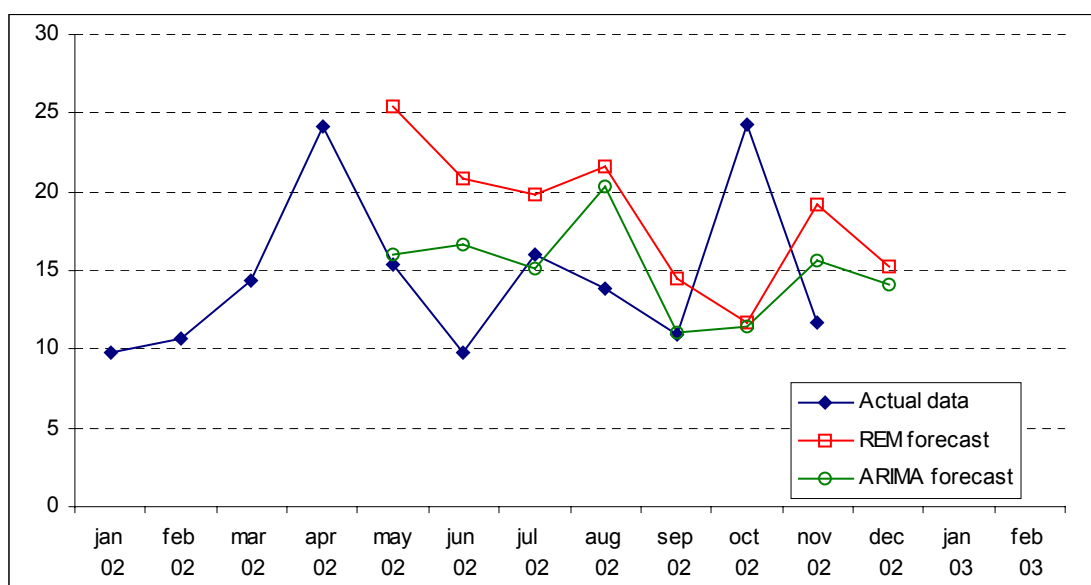


Fig. 23. Actual and predicted amounts of aggregate profit tax revenues of the RF federal budget (Rub. billion)

The mean relative error of the forecast of aggregate profit tax revenues of the RF consolidated budget made 50.5 per cent for REM model and 41.8 per cent for ARIMA model. This significant error of the forecast resulted from the changes in dynamics of the seasonal component in 2002 as compared with the respective indicator observed over preceding years. For instance, the peaks of inflow of profit tax revenues in May, August, and November, characteristic of 2001, shifted in 2002 and occurred in the first month of each quarter with the ex-

ception of January. Similarly important factor behind the error of the forecast is the general decline in the amounts of profit tax revenues registered in 2002, which reversed previous positive dynamics.

The mean relative error of the forecast of aggregate profit tax revenues of the RF federal budget made 58 per cent for REM model and 30.5 per cent for ARIMA model.

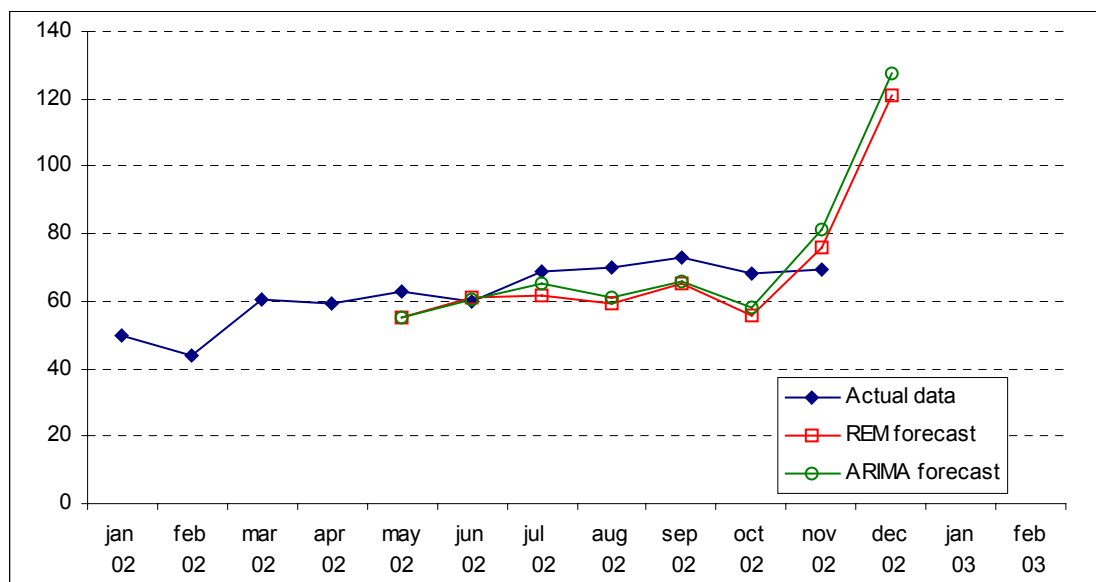


Fig. 24. Actual and predicted VAT revenues (Rub. billion)

The mean relative error of the forecast of VAT revenues made 11.1 per cent for REM model and 10.4 per cent for ARIMA model. The low accuracy of forecasts about inflow of the respective revenues may be explained by the volatility of the series dynamics over the whole estimated interval (since January of 1999) with the exception of regular peaks of inflows occurring each December, what negatively affects the reliability of autoregressive evaluations.

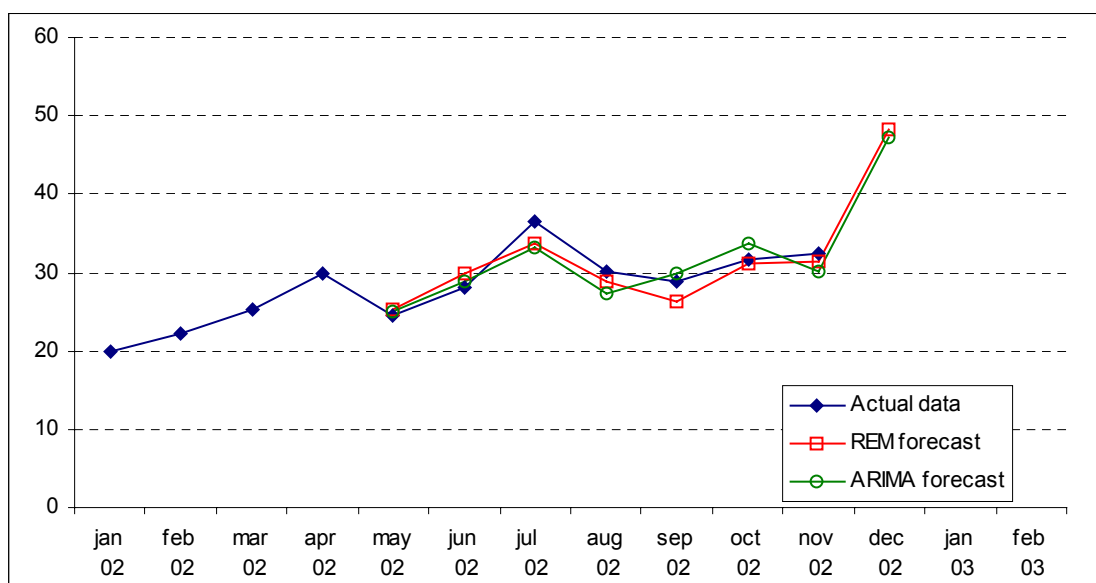


Fig. 25. Actual and predicted income tax revenues (Rub. billion)



The most accurate forecasts of inflows were obtained for the income tax. The mean relative error of the forecast of income tax revenues made 4.9 per cent for REM model and 5.8 per cent for ARIMA model.

On the whole, the low accuracy of the forecasts of tax revenues results from the intensive transformational processes underway in the Russian economy. Besides, changes in the tax legislation result in shifts in dynamics not only of the taxes directly affected by the respective legislative changes, but also impact the dynamics of revenues generated by other types of taxes.

2.3.2. Federal Budget for 2003 and Macroeconomic Forecast of Social and Economic Development of Russia

Federal Budget for 2003

The key parameters of the federal budget for 2003 base on two versions of the forecast of social and economic development of Russia in 2003 and until 2005 - conservative (1) and optimistic (2). The parameters of the conservative (1) and optimistic (2) versions depend on the combination of external and internal factors.

An analysis of internal factors of economic development in the first six months of 2002 and shifts in the external business situation reveals that there is certain potential for more rapid restoration of favorable conditions and trends of growth in the Russian economy. According to the preliminary estimates of the RF Ministry of Trade and Economic Development, in 2002 GDP grew by 4.3 per cent in comparison with the figures registered in the preceding year.

The conservative forecast bases on the assumption of inertial development of the economy and persistence of factors and trends formed in 2001 and in January through June of 2002.

The optimistic forecast relied on more rapid rates of growth in the world economy and increasing influence of expanding external demand on the dynamics of growth in the Russia's economy.

The key differences of forecasts are conditioned by the external environment of development. The decisive factor is the level and dynamics of world oil and natural gas prices: the conservative forecast envisages the average world oil price at US \$ 18.5 per barrel and contract natural gas price at US \$ 78.5 per 1000 cubic meters, while the optimistic forecast sets these indicators at US \$ 21.5 and US \$ 85.4 respectively. At the same time, both scenarios assume that rise in prices will positively affect the dynamics of oil and natural gas exports. Both scenarios also relay on prompt repayment of the principal debt and unfaltering debt servicing.

The ratio between external and internal factors changes over time. While economic growth in 2002 based on the dynamic expansion of external demand for fuel and raw materials resources, in 2001 and early 2002 there was registered an intensive growth in internal demand generated by increasing household incomes and persisting investment activity.

In 2003, the outpacing rates of growth in the internal demand in comparison with the external demand were the dominating trend of changes in the structure of utilized GDP. The conservative forecast envisages, basing on the hypothesis that prices of hydrocarbon raw materials would decline relatively the figures registered in 2002, while dynamics of growth in

the world economy would be even, that falling export revenues become a factor checking rates of growth in the real sector of the Russian economy.

An analysis of major trends of development of the Russian economy over the last three years demonstrates that cardinal changes in the structure of investment in the real sector oriented towards a large scale modernization of fixed assets, increase in productivity of labor and competitiveness of domestic products on the internal and external markets is a key factor behind further economic growth. The substantive component of the estimates underlying the forecast for 2003 through 2005 was the assumption that this factor would be affecting economic development. In 2003, the rates of growth in GDP, taking into account external and internal factors and conditions of economic development, are envisaged to be at 3.5 per cent to 4.4 per cent depending on the version.

Due to the increasing share of funds assigned for the repayment of the public external debt, the structure of gross national savings will change. According to the forecast, in 2003 the share of investment in GDP will make 17.5 to 18.0 per cent as compared with 15.2 per cent registered in 2002. At this scope of savings, the increase in investment in fixed assets in 2003 is estimated to be at 6.3 per cent to 7.5 per cent. The practical implementation of these parameters of investment activities presupposes active shifts in the investment environment and improvement of legal, financial, and economic mechanisms of transformation of savings in investment.

Evaluating attainability of forecasted rates of investment activities, it shall be taken into account that the estimated decline in the share of profits in GDP from 17.6 per cent in 2001 to 12.3 per cent in 2002 will seriously affect the situation. Taking into account the persistence of traditionally high concentration of profits in the export oriented industries of oil and raw materials sectors and the lack of mechanisms of inter-sectoral flow of capitals and accumulation of gross savings for the development of competitive components of the economy it may be hardly expected that radical changes would occur in the nature of the reproduction of fixed capital. The forecast for 2003 envisages that in the case rates of production and proceeds of enterprises decelerate, the current trends will persist. Due to limited own funds in the real sector of the economy and the lack of possibilities of long term borrowing, the situation provoking a shrinking of the domestic investment demand is reproduced in the Russia's economy.

It is forecasted that in the case the present level of household incomes and expenditures is maintained and accompanied by a rise in consumer prices the trends towards growth in savings of the household sector will persist. According to the estimates, in 2003 the growth in real cash incomes will make 5 per cent to 5.8 per cent depending on the forecast version, while the share of poor households will decline from 27 per cent to 25.5 per cent. However, in spite of the forecasted trend towards a growth in real wages and salaries and increase in the share of pay to employees in the structure of GDP, real household incomes remain at 93 to 94 per cent of the figures registered in the pre-crisis 1997.

The forecast relies on hypotheses about improving efficiency of the economy, for instance, it is assumed that power intensity of GDP would decline. At the given level of power intensity of production, the relatively slow development of the fuel and energy complex may become a considerable constraint on economic growth. At the forecasted rate of growth in output of industries manufacturing final products, the power intensity of GDP would decline 2 per cent to 3 per cent a year. It is urgent to pursue active energy conservation policies also because of the forecasted shift in the economic priorities in favor of modernization of production, development of manufacturing industries and sectors oriented towards services and in-



troduction of resource-saving technologies. However, a comparison of dynamics of investment in fixed assets and power availability per worker demonstrates that this factor will not have an impact on labor productivity dynamics in 2003.

Table 10

Revenues as per budget laws and administration of the federal budget in 2002 and 2003

	2002 budget law	2002 budget law, administered	2003 budget law	2002 budget law	2003 budget law, administered	2003 budget law	2003 budget law in % of 2002 budget law	2003 budget law in % of administered 2002 law
	Rub. mil.			% GDP			%	
Tax revenues	1726310,1	1696137,4	1892363,7	15,8	15,5	14,5	92,0	93,6
Taxes on profit (income), capital gain	208452,9	173463,5	179550,5	1,9	1,6	1,4	72,3	86,8
Taxes on goods and services. License and registration fees.	1000976,5	970976,9	1178971,2	9,1	8,9	9,0	98,8	101,9
VAT	773508	752654,6	946218,5	7,1	6,9	7,3	102,6	105,5
Excises	224815	214865,068	227708,8	2,1	2,0	1,7	85,0	88,9
Taxes on aggregate income	5677,6	6200,0	8478,4	0,1	0,1	0,1	125,3	114,7
Fees for use of natural resources	183715,7	214237,432	183129,5	1,7	2,0	1,4	83,6	71,7
Taxes on foreign trade and external economic operations	324108,9	323368,946	335975,5	3,0	3,0	2,6	87,0	87,2
Other taxes, duties, and charges	3378,5	6449,9	5418,6	0,0	0,1	0,0	134,6	70,5
Non-tax revenues	104284,2	150536,052	145721,8	1,0	1,4	1,1	117,2	81,2
Revenue from state and municipal property or activity	50472,5	76887,0	83158,8	0,5	0,7	0,6	138,2	90,7
Proceeds from the sale of land and intangible assets	290	1967,2	0,2	0,0	0,0	0,0	0,1	0,0
Administrative charges	804,1	670,0	1406,5	0,0	0,0	0,0	146,8	176,1
Penalties and indemnity	1691,4	1614,4	1353,6	0,0	0,0	0,0	67,1	70,3
Revenue from foreign economic operations	47911,9	65558,9	55932,7	0,4	0,6	0,4	97,9	71,6
Other non-tax revenue	3114,3	3838,5	3870	0,0	0,0	0,0	104,3	84,6
Fund of the RF Ministry of Atomic Energy	13893,9	15129,8	14066,3	0,1	0,1	0,1	84,9	78,0
Single social tax	281230	339461,0	365640	2,6	3,1	2,8	109,1	90,4
TOTAL REVENUE	2125718,2	2202139,4	2417791,8	19,4	20,1	18,5	95,4	92,1

According to the Finance Ministry estimates, the federal budget lost about Rub. 30 billion as a result of all changes introduced in the revenue section of the law on the federal budget for year 2003 as compared with targets of the budget law for 2002. It is planned to compensate for the budgetary losses by tightening tax administration, for instance, via reduction of the respective accumulated indebtedness and optimization of management of state owned property.

It is planned to generate about Rub. 23 billion at the expense of repaid tax indebtedness. Besides, over Rub. 83 billion (more than 1.5 times above the target set by the budget for 2002 and by 8 per cent higher than expected) should be generated due to the enhancement of efficiency of management of all types of state owned property. The bulk of the increase (two thirds of the expected growth) should be generated at the expense of "other operations relating to state reserves," which was included in the revenues of the federal budget in 2002.

Table 11

Expenditures as per budget laws and administration of the federal budget in 1999, 2000, 2001, 2002 and 2003 (in % of GDP)

	1999		2000		2001		2002		2003	
	Budget law *	Admini- stration	Budget law **	Admini- stration	Budget law *	Admini- stration	Budget law *	Admini- stration	Budget law *	
State administration and local government	0,34	0,31	0,37	0,34	0,53	0,46	0,52	0,51	0,51	
Judiciary	0,12	0,10	0,12	0,11	0,15	0,13	0,17	0,18	0,20	
International activities	0,91	1,24	0,54	0,15	0,29	0,33	0,43	0,29	0,34	
National defense	2,34	2,42	2,87	2,63	2,77	2,73	2,58	2,70	2,64	
Law enforcement and state security	1,28	1,17	1,53	1,44	1,70	1,64	1,52	1,74	1,88	
Basic research and promotion of scientific and technologic advance	0,29	0,24	0,23	0,24	0,29	0,26	0,27	0,28	0,31	
Industry, power engineering and construction	0,36	0,36	0,52	0,48	0,58	0,49	0,49	0,96	0,49	
Agriculture and fisheries	0,23	0,19	0,21	0,18	0,27	0,26	0,20	0,25	0,24	
Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	0,07	0,06	0,06	0,06	0,06	0,05	0,09	0,09	0,08	
Transportation, road maintenance, communications and information technology	0,02	0,02	0,03	0,03	0,39	0,41	0,05	0,07	0,05	
Market infrastructure development	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	
Prevention and/or elimination of the effects of emergencies and natural disasters	0,18	0,16	0,13	0,13	0,08	0,08	0,08			
Education	0,52	0,44	0,52	0,52	0,63	0,60	0,71	0,08	0,16	
Culture, arts and cinematography	0,08	0,06	0,07	0,07	0,08	0,07	0,09	0,75	0,75	
Mass media	0,05	0,04	0,08	0,08	0,08	0,08	0,09	0,09	0,11	
Health and physical fitness	0,26	0,21	0,23	0,23	0,29	0,26	0,28	0,09	0,09	
Social policy	1,05	1,03	0,91	0,93	1,39	1,24	3,71	0,29	0,30	
Public debt servicing	4,17	3,42	2,58	3,53	3,09	2,56	2,65	4,43	1,15	
Replenishment of state stocks and reserves	0,00	0,00	0,00	0,00	0,01	0,00	0,00	2,04	2,13	
Financial aid to budgets of other levels	1,09	1,32	1,33	1,39	2,41	1,21	2,24	0,01	0,16	
Utilization and liquidation of armaments, including under international treaties	0,04	0,08	0,00	0,05	0,08	0,03	0,09	2,91	5,48	
Mobilization preparedness of economy	0,01	0,01	0,01	0,01	0,01	0,00	0,00			
Military reform	0,07	0,07	0,06	0,06	0,06	0,03	0,09			
Research and use of outer space	0,00	0,00	0,00	0,00	0,05	0,03	0,15			
Other expenditures	-0,24	-0,13	0,09	0,09	-0,05	0,07	-0,03			
Road network	0,00	0,00	0,00	0,00	0,00	0,00	0,50			
Targeted budgetary funds	1,10	1,18	1,33	1,34	0,18	0,16	0,13			
TOTAL EXPENDITURE	14,38	13,99	13,89	14,09	15,40	13,21	17,09			

* In per cent of target GDP.

** In per cent of actual GDP.

Table 12

**Budget laws and administration of the federal budget
in 1999, 2000, 2001, and 2002 (in constant prices)**

	1999		2000		2001		2002		2003
	Budget law	Admini- stration	Budget law	Admini- stration	Budget law	Admini- stration	Budget law	Admini- stration	Budget law
State administration and local government	13747	14832	21541	20816	28550	29434	34538	34223	36506
Judiciary	4848	4987	6758	6887	7950	8280	11492	11858	13987
International activities	36594	58080	46688	19171	15561	20820	28433	19622	24363
National defense	93703	116127	117181	158737	150597	173015	171845	179897	189110
Law enforcement and state security	51325	55445	66391	87684	92329	104284	101168	116010	134367
Basic research and promotion of scientific and technologic advance	11635	11197	13250	14588	15498	16613	17916	18922	22069
Industry, power engineering and construction	14583	16921	16698	29139	31329	30964	32527	64260	34803
Agriculture and fisheries	9284	9068	9572	11109	14591	16629	13571	16942	17108
Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2904	2895	3110	3421	3349	3465	5859	6027	5932
Transportation, road maintenance, communications and information technology	902	942	1364	1541	21466	26033	3233	4550	3341
Market infrastructure development	0		0	42	63	63	12	12	55
Prevention and/or elimination of the effects of emergencies and natural disasters	7345	7374	7510	7862	4443	4863	5120	5355	11641
Education	20866	20945	26705	31714	34234	38219	47612	49780	53612
Culture, arts and cinematography	3062	2877	3893	4321	4479	4722	6184	6217	7715
Mass media	2087	2000	4763	5072	4371	5278	6028	6049	6562
Health and physical fitness	10239	10141	13306	14044	15577	16189	18707	19259	21596
Social policy	41871	49096	52410	55187	75605	78740	247588	295429	82711
Public debt servicing	166844	162583	183086	143280	168209	162056	176578	136294	152325
Replenishment of state stocks and reserves	97	93	140	138	304	209	321	412	11503
Financial aid to budgets of other levels	43444	62145	57528	84214	130914	161287	149530	193905	392250
Utilization and liquidation of armaments, including under international treaties	1736	3566	1722	2883	4234	4596	6235	6298	5906
Mobilization preparedness of economy	450	555	416	536	351	660	305	387	274
Military reform	2976	0	2853	0	3220	0	5919	5934	4200
Research and use of outer space	0	0	0	0	2972	0	10083	8763	8673
Other expenditures	-9532	0	0	0	0	0	33227	23604	43424
Road network	0	-2472	3401	10500	-2748	13075	-1692	7377	-4232
Targeted budgetary funds	44038	55275	50404	80929	9746	10187	6203	9185	7721
TOTAL EXPENDITURE	575047	664674	711375	793815	705898	929680	1140805	1246571	1287525

Tax revenues of the federal budget make Rub. 1 trillion 892 billion, or 14.5 per cent of GDP, what is by 1 p.p. below the respective indicators of 2002. Tax revenues declined due to the redistribution of profit tax revenues (since 2003, the federal share of this tax makes 6 %), half of the revenues from excises on oil products (gasoline, diesel fuel, and motor oil), and the full amount of the land tax in favor of territorial budgets. At the same time, since 2003 the federal budget shall receive the full amount of excises on tobacco products.

The aforesaid changes resulted in a decline in profit tax revenues to 1.4 per cent of GDP (1.9 per cent in accordance with the law on the budget for 2002, 1.6 per cent of GDP in accordance with the results of 2002), while excise generated revenues decreased to 1.7 per cent of GDP (2.1 per cent and 2.0 per cent respectively). Besides, it is assumed that in 2003 revenues from taxes on foreign trade may decline to 2.6 per cent of GDP (from 3 per cent registered in 2001 and 2002) in relation to the expected decrease in world oil prices and planned reduction of export customs duties.

At the same time, it is expected that VAT revenues will increase somewhat (up to 7.3 per cent of GDP from 7.1 per cent of GDP targeted in the budget for 2002 and 6.9 per cent of GDP according to the results of 2002).

In the course of elaboration of the budget, the Government proceeded from tax collection being at the level of the current year (95 per cent). Besides, VAT repayment budgetary target was increased by one fourth as compared with the respective indicator registered in 2002 and made Rub. 240 billion.

The federal budget expenditures for year 2003 are planned at the level of 17.97 per cent of GDP, estimated GDP making Rub. 13050 billion. Certain changes were introduced in the structure of expenditure classification as concerns the sub-item "Social assistance" (resources due to extra-budgetary funds were transferred to the section "Financial aid to other budgetary levels") and the section "Law enforcement" (expenditures for fire protection were moved to the section "Prevention and elimination of the effects of emergencies," some expenditures for national defense, which were transferred to other sections, and other changes.

The most considerable increase in expenditures as compared with the law on the budget for 2002 was registered in expenditures for social policy (by 1/4 of GDP point in terms of comparable classification and by almost 40 per cent in comparable prices), law enforcement (by almost 0.4 GDP point, or 30 per cent in comparable prices). The expenditures for judiciary were also raised (by 0.06 p.p. in terms of GDP and more than 20 per cent in comparable prices). Expenditures for national defense increased by 0.15 p.p. in terms of GDP and by 14 per cent in real terms. As concerns the structure of social expenditures, there were raised expenditures for culture and arts (by 0.02 p.p. in terms of GDP, or by 25 per cent in comparable prices), education (by 0.03 p.p. or 13 per cent respectively), and health (0.02 p.p. or 15 per cent respectively).

Table 13

Certain expenditure items in the draft federal budget for year 2003 and the law on the federal budget for 2002 in comparable classification

	2002 budget law in % of GDP, comparable classification	2003 budget law in % of GDP	2002 budget law in % of 2003 budget law in comparable prices and classification
International activities	0,45	0,34	81,6
National defense	2,50	2,64	114,0
Law enforcement and state security	1,53	1,88	132,4
Basic research and promotion of scientific and technologic advance	0,30	0,31	110,1
Industry, power engineering and construction	0,57	0,49	91,1
Prevention and/or elimination of the effects of emergencies and natural disasters	0,14	0,16	126,0
Social policy	0,90	1,15	138,5
Financial aid to budgets of other levels	5,46	5,48	108,3

The major factors behind the growth in expenditures were the rise in cash allowances for military personnel, increase in wages of employees of the budgetary sphere, and higher scholarships raised in the beginning of 2003 / 2004 academic year. Increasing expenditures for road network is related to the growth in subsidies to territorial budgets in order to compensate for the loss of revenues generated by the tax on motor road users. In 2003, expendi-



tures for the judiciary system include additional financing of newly created jobs across the whole structure of the judiciary system.

A decline in expenditures of the federal budget was most pronounced in the section "International activities" (by 0.11 p.p. in terms of GDP and by 18 per cent in comparable prices). Besides, the 2003 budget envisages a decline in financing of expenditures for support of industry, power engineering, and construction by almost 0.1 p.p. of GDP, or by 10 per cent in real terms in comparison with the current budget in comparable classification, as well as a number of other items, including the military reform, research and use of outer space, mobilization preparedness of economy, and utilization and liquidation of armaments. The aggregate reduction of these expenditures made 0.07 p.p. in terms of GDP or 15 per cent in real terms.

Interest expenditures as set forth in the budget for 2003 were reduced by one fifth of percentage point in GDP terms, or by 14 per cent in comparable prices in comparison with the respective targets of the budget for 2002.

On the whole, it seems that the revenue section of the 2003 budget was worked out proceeding from the optimistic scenario. First, the results of the execution of the 2002 budget do not allow to draw definite conclusions as concerns the Tax Ministry ability to meet the tax revenue targets in 2003 taking into account the fact that it collected less taxes than set forth in the law by Rub. 30 billion in 2002. Second, revenues at Rub. 23 billion in repaid indebtedness look questionable taking into account lack of positive trends in the preceding year (tax arrears increased by about 2 per cent in real terms, while deferred payments decline by less than 1 per cent).

Expenditures set forth in the budget for year 2003 do not require any serious changes in the structure of the expenditures of the federal budget, with exception of change in the amount of financing of certain items because of the reclassification of certain types of expenditures. On the whole, it may be concluded that two major problems the Government tried to address in the budget for 2003 were raise in wages and salaries of employees of budgetary organizations and repayment of external debt due in 2003.

Scenario Based Macroeconomic Forecast for 2003

Three scenarios of the development of the economic situation in Russia in 2003 determined by different dynamics of world oil prices over the year seem most probable. The estimates proceed from the assumption that world oil prices will remain the decisive factor for the development of Russia's economy in the short term in spite of the fact that at some moments the role of other variables (for instance, domestic demand) may gather in importance.

Two scenarios envisage a growth in oil (Brent) prices up to US \$ 40 over the first six months of 2003 due to the escalation of tensions relating to Iraq and North Korea, higher risks to extract and export oil from the Persian Gulf countries, and falling oil production in Venezuela. Both scenarios presume the US attack against Iraq or replacement of the country's leadership in the second quarter of 2003. Further these scenarios diverge.

The first scenario envisages a fast and successful military campaign or a coup resulting in the replacement of the country's leadership and resumption of Iraqi oil export in large volumes already in 2003. In this situation it is expected that oil prices will rapidly decline in the 3rd and 4th quarter of 2003 to US \$ 20 to 25 per barrel.

The second scenario is based on a prolonged war or instability in Iraq (over six months), what would prevent the resumption of Iraqi oil export and result in higher volatility on world raw materials markets. It is assumed that in this case oil prices will also go down by the end

of the year due to higher quotas of OPEC member countries, growing exports from other countries, and development of new deposits rendered profitable by high oil prices. However, the decline will be more smooth and Brent oil prices will be at or above US \$ 30 per barrel by the end of the year.

The third scenario envisages that the US either will not start the military campaign against Iraq, or delay it until 2004. However, persisting instability in the Persian Gulf region and the threat of military action will result in higher oil prices (at about US \$ 32 per barrel) over the year.

For the dynamics of oil prices in 2003 according to all scenarios described above and two scenarios elaborated by the Ministry for Trade and Economic Development in the course of planning the budget for year 2003 see Fig. 26¹⁵.

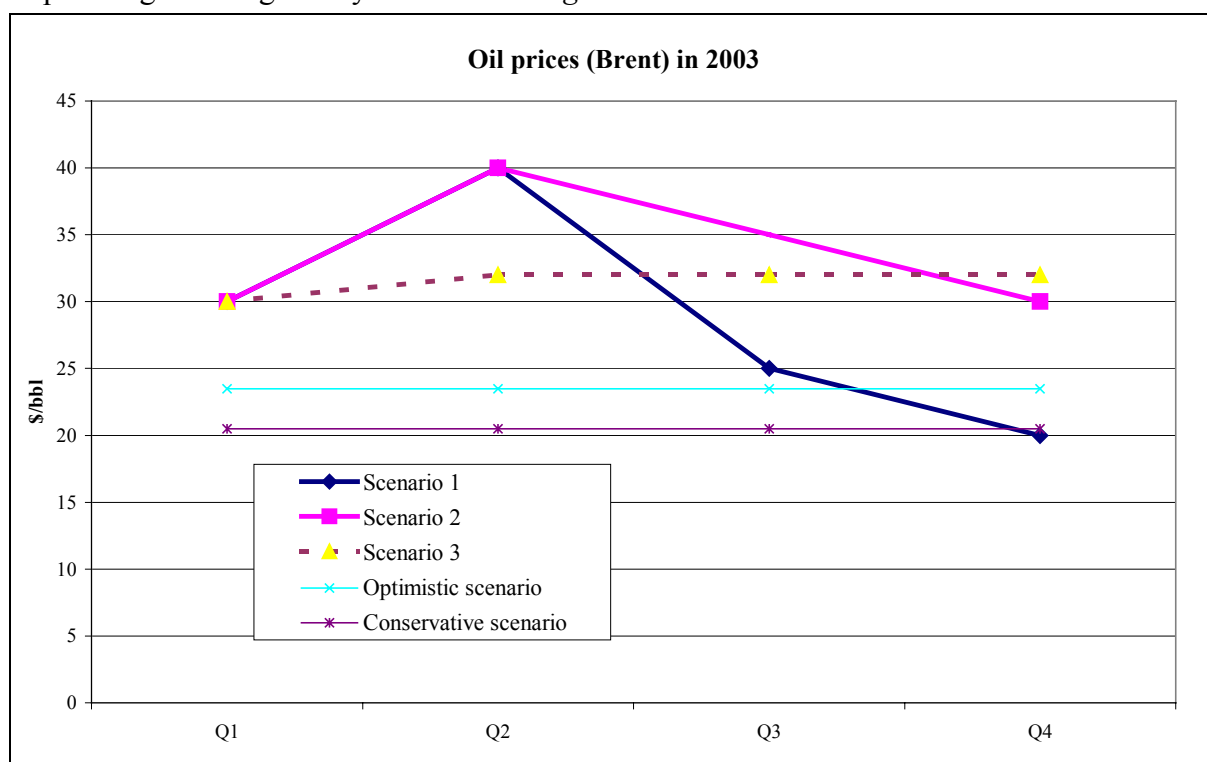


Fig. 26

The scenario based forecasts based on the model of medium term prognostication elaborated by the Russian European Center for Economic Policy at the request of the RF Ministry for Economic Development and Trade. The model consists of 8 equations and 3 identities.

Modeled variable	Explanatory factors
Real GDP	Real GDP with a lag, real investment in fixed assets with a lag, real household incomes with a lag, oil prices
Exports	Oil prices

¹⁵ Scenarios of the RF Ministry of Trade and Economic Development (MTED) are based on the Urals oil prices, therefore for comparability purposes these prices were increased by US \$ 2 per barrel, what corresponds to the average difference in Urals and Brent prices over the last years.



Inflation (CPI)	Inflation with a lag, increase in money supply M_2 with a lag, real GDP with a lag
Tax revenues	Nominal GDP, exports
Imports	Real GDP, real Ruble rate
Gold and currency reserves	Exports, imports, nominal Ruble rate
Change in the Ruble nominal rate	Gold and currency reserves

It is assumed that changes of exogenous variables (the rate of increase in real investment and the rate of increase in real household incomes) will also depend on the level of oil prices due to the fact that a considerable share of domestic demand for investment goods is formed in the export sector, while growth in household incomes is secondary to the growth of incomes in the economy at large. Therefore, it is assumed that in 2003 there will take place the following changes of exogenous variables:

	Oil prices	Real investment in fixed assets	Real household incomes
Scenario 1	20-40	7-8%	7%
Scenario 2	30-40	7-9%	8%
Scenario 3	32	7-8%	8%
Conservative scenario	20,5	6,3%	5,0%
Optimistic scenario	23,5	7,5%	6,0%

The model has been built basing on the quarterly data for the period from the 1st quarter of 1995 to the 4th quarter of 2002. The data were obtained from official publications of Goskomstat, Bank of Russia, and International Monetary Fund (International Financial Statistics). Alongside with variables shown above, there was used a number of dummies, for instance, for seasonal effects (quarter, years), the crisis of 1998, etc.

The predicted values of variables were obtained in two stages. At the first stage, in order to better evaluate the predictive power of the model, equations were tested basing on the period from the 1st quarter of 1995 to the 4th quarter of 2001 and prognosis was made for 2002. The best specification of the model was chosen on the basis of the minimal discrepancy between predicted values of this model and actual values of variables.

Table 14

	Scenario 1	Scenario 2	Scenario 3	Governmental scenario
Growth in real GDP, %	4,6%	5,0%	4,9%	4,0%
CPI, %	11,7%	12,2%	11,9%	11,0%
Nominal GDP, Rub. billion	13440	13550	13480	13300
Tax revenues of the RF federal budget, Rub. billion¹⁶	2322	2383	2353	2239
Tax revenues of the RF federal budget, % of GDP	17,28%	17,59%	17,46%	16,83%
Export from RF, US \$ billion	109,9	122,0	116,6	93,5
Import from RF, US \$ billion	64,9	65,6	65,2	63,7
Gold and currency reserves of the RF CB, US \$ billion	53,1	58,7	57,2	46,0
Nominal Ruble rate, Rub. / US \$	33,72	33,13	33,38	34,57
Real effective Ruble rate (December of 1994 = 100)	106,3	108,7	106,5	103,1

At the second stage the best specification was evaluated basing on the whole available data array, including 2002. Prognosis for 2003 based on coefficients obtained for the last model. For the results see the Table. Calculations for the governmental scenario were carried out basing on mean values of the conservative and optimistic scenarios of the RF MTED.

¹⁶ Including SST revenues.

Therefore, the estimates indicate that according to the most probable scenarios the situation in the Russian economy in 2003 will be better than shown in the forecasts of the RF Ministry for Trade and Economic Development used for work on the draft federal budget. The rates of growth in real GDP are expected to somewhat exceed target indicators (up to 5 per cent), while inflation estimates demonstrate that the rise in prices most probably will be within the range of base values selected by the Finance Ministry and RF Central Bank. Predicted tax revenues of the federal budget exceed the amounts set forth in the law on the federal budget for 2003, what allows the Government to execute the budget taking into account the record high amount of payments related to repayment and servicing of the RF external debt. Moreover, it is expected that by end-year the financial reserve, which may become the basis for formation of the future stabilization fund, will be preserved, or even increased the more so that the RF Finance Ministry has in fact balanced the target expenditures of the budget for 2003 against revenues derived in the case oil prices would be close to the average long term level (US \$ 18 to 20 per barrel).

2.3.3. Interbudgetary Relations and Sub-National Finance

The main specifics of the preceding year were attempts to take radical decisions in the sphere of economic policies directly relating to problems of interbudgetary relations, regional and municipal finance. First, possible policy shifts may be attributed to the effect of the preliminary results of the reform concerning the tax on profits of enterprises, especially such its aspect as changes in the sharing arrangements of this tax among the federal budget, budgets of RF subjects, and municipal budgets. Second, there started an active discussion about the possible ways to compensate federal and regional budgets for the revenues generated by the abolished since January 1, 2003, taxes on users of motor roads and vehicle owners. Third, the Presidential Commission working out recommendations as concerns delimitation of jurisdictions and powers among the federal authorities, subjects of the Russian Federation, and local governments completed its work, which resulted, among other documents, in the draft new version of the federal law "On general principles of organization of local government in the Russian Federation" and the draft law "On general principles of organization of legislative (representative) and executive authorities of RF subjects." It is expected that enactment of these documents will have a serious impact on the development of interbudgetary relations, regional and municipal finance.

Budgets of Different Levels: Trends in Relationships

In order to analyze main trends observed in 2002 as concerns the relations among budgets of different levels, it would be feasible to review the structure of the consolidated budget of the Russian Federation and its dynamics over the few past years. For data characterizing the share of tax revenues, revenues and expenditures of budgets of RF subjects in the consolidated budget of the Russian Federation see *Table 15*.

Table 15

**The share of certain budgetary indicators in the consolidated budget
of the Russian Federation in 1992 through 2002 (in %)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tax revenues	44,20	53,10	53,40	47,60	49,50	53,10	54,00	48,90	43,50	37,40	39,34
Revenues*	44,08	53,08	52,91	47,59	49,52	53,07	50,64	46,42	43,57	36,81	37,39
Expenditures	34,00	40,30	37,70	43,40	45,40	48,10	48,40	46,90	54,40	56,60	49,27

* Financial aid from the federal budget is excluded.

Source: RF Finance Ministry, authors' calculations.

The data presented in *Table 15* demonstrate that the trend towards a decline in the share of tax revenues of the consolidated budget received by the budgets of RF subjects observed over the last four years has somewhat changed. For instance, according to the results of budget administration in 2002, consolidated budgets of RF subjects received over 39 per cent of the total tax revenues of the budgetary system. At the same time, the share of aggregate revenues of RF subjects in the "Total revenues" item was at the level slightly above the level registered in the preceding year making a little over 37 per cent. At the same time the share of expenditures of the budgetary system financed from consolidated budgets of RF subjects declined: according to the results of 2002 it made about 50 per cent.

It shall be pointed out that the growth in the share of tax revenues of regional budgets in the revenues of the consolidated budget of the Russian Federation took place even at the background of technical increase in tax revenues of the federal budget at the expense of single social tax transferred to the budget of the Pension Fund for financing of the base component of the labor pension. As compared with budget administration in 2001, tax revenues of regional consolidated budgets have increased from 9.64 per cent to 10 per cent of GDP in 2002, while tax revenues of the federal budget declined from 16.16 per cent in 2001 to 15.5 per cent of GDP in 2002. Tax revenues of the budgets of RF subjects grew in spite of a decline in revenues generated by the tax on profits of organizations by 0.66 per cent of GDP as compared with the figures registered in the preceding year, which was nevertheless compensated by an increase in revenues generated by the tax on incomes of individuals, property taxes (primarily the tax on property of enterprises), charges for use of natural resources, and other taxes and charges. At the same time, a factor behind the increase in revenues from the property tax on organizations was the revaluation of fixed assets taking place in the beginning of the year. In spite of the decline in non-tax and other revenues, the total amount of revenues of the consolidated budgets of RF subjects has exceeded the level registered in the preceding year by 0.5 p.p. of GDP.

In 2002, there was also observed a growth in revenues of the consolidated budgets of RF subjects from 14.35 per cent to 14.91 per cent of GDP, while expenditures increased more considerably – from 14.32 per cent to 15.31 per cent of GDP. Accordingly, a deficit of the consolidated budget of RF subjects has been registered for the first time over the few past years. The deficit made –0.4 per cent of GDP (as compared with the surplus at 0.04 per cent of GDP registered in 2001). The deficit was primarily financed at the expense of issuance of government and municipal bonds and federal budget loans, other credits, and revenues generated by privatization of state and municipally owned property.

The following conclusions may be derived basing on the analysis of quantitative characteristics of financial aid to the budgets of RF subjects from the federal budget (see *Table 16*).

First, the total amount of financial support (including the balance of funds borrowed from and repaid to the federal budget) of regions at the expense of the federal budget has somewhat increased in comparison with the figures registered in the preceding year and made over 3 per cent of GDP in 2002. Second, subsidies for equalization of minimal budgetary security still made the bulk of the financial aid (transfers from the Fund of Financial Support of Regions) – over 50 per cent of the total amount of financial aid, while subventions and subsidies from the Compensatory Fund (CF) made about 15 per cent of the total amount of financial aid.

Table 16

Federal financial aid to budgets of other levels in 1992 through 2003 (in % of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001		2002		2003*	
										Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
Subsidies and subventions	0,00	0,02	0,09	0,06	0,09	0,13	0,10	0,06	0,15	49060,0	0,54	31059,2	0,34	31905	0,24
<i>Including:</i>															
Subsidies and subventions to CATEs and the town of Baikonur									0,11	10590,0	0,12	11544,4	0,13	14538	
Subsidies to CATEs														7955	
Subsidies to the town of Baikonur														564	
Capital investment subventions to CATEs														4195	
Resettlement subventions to CATEs														824	
Subventions to CATEs for financing of CATE development programs														1000	
Other subsidies and subventions									0,04	38470,0	0,42	19514,8	0,21	17368	
Subsidy to the town of Sochi														1046	
Subsidies to budgets of RF subjects to compensate for losses relating to excises on tobacco and alcohol products														6000	

Table 16 (cont'd)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
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										Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
Subsidies compensating losses relating to maintenance of HPU objects transferred under jurisdiction of local governments														5000	
Other subsidies to budgets of RF subjects														4069	
Other subventions to budgets of RF subjects and local governments														1253	
Subventions	0,79	0,69	0,42	0,12	0,12	0,09	0,02	0,20							
Transfers from FFSR	0,00	0,00	0,36	1,17	1,04	1,22	1,12	0,99	0,96	103210,0	1,14	147490,9	1,62	173168	1,33
<i>Including:</i>	0,00							0,00							
Transfers	0,00	0,00	0,36	0,86	0,68	0,86	1,00	0,99	0,96	103210,0	1,14	147490,9	1,35	173168	
Of which: state support of seasonal deliveries to the North									0,06	7000,0	0,08	8963,0	0,08	8809	
Transfers at the expense of VAT	0,00	0,00	0,00	0,31	0,36	0,36	0,12								
Subsidies and subventions from the Compensatory Fund										33380,0	0,37	40757,6	0,45	47011	0,36
<i>Including:</i>															
Subsides for implementation of the law on social security of disabled persons										11480,0	0,13	11943,7	0,13	6630	
Subventions for implementation of the law on state family allowances										21900,0	0,24	23904,5	0,26	22213	

Table 16 (cont'd)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
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										Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
Subventions for compensation of privileges related to payment for HPU services in accordance with the federal legislation														13820	
Other subventions and subsidies from Compensatory Fund														4349	
Resources of the Fund of Co-Financing of Social Expenditures												18732,1		5000	0,04
Resources of the Fund of Regional Development								0,03	0,11	4530,0	0,05	17491,7	0,19	25072	0,19
State support of road networks							0,18	0,11	24880,0	0,27	29736,0	0,33	39000	0,30	
Resources of the Fund of Reformation of regional finances										0,0	0,00	1200,0	0,01	1300	0,01
Funds transferred as mutual payments	0,61	1,95	2,54	0,42	0,81	0,43	0,36	0,14	0,28	4510,0	0,05		0,00		
Loans minus repayment to other budgetary levels:	0,09	0,03	0,02	0,04	0,23	0,64	-0,03	-0,10	-0,08	1625,2	0,02		0,00		
Arrears of transfers from budgets of RF subjects to target budgetary funds	0,00	0,00	0,00	0,02	0,05										
Other types of financial aid								0,00		11500,0	0,13	8675,0	0,10	14240	

Table 16 (cont'd)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
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											Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
<i>Including:</i>																
Funds transferred to budgets of other levels for implementation of state programs									0,00	10400,0	0,11		0,00			
Measures of regional development															14240	
Total: funds transferred to budgets of other levels	1,49	2,70	3,4	1,8	2,3	2,5	1,60	1,36	1,54	232695,2	2,56	275210,4	3,03	336697	2,58	
Expenditures of the federal budget	21,76	21,18	23,0	16,6	15,8	15,3	14,5	14,62	8,95	1325688,2	14,58	1947386	21,42	2345641	18	

* As stipulated by the law on the federal budget for year 2003.

The factors behind the growing amount of funds transferred to subjects of the Russian Federation from the federal budget were increases in amounts of following budgetary items: subsidies for equalization of minimal budgetary security increased to 1.6 per cent of GDP, funds transferred in the course of mutual payments (including the funds assigned for compensation of additional expenditures of regional budgets because of decision taken by higher level authorities) and an increase in the balance of granted and repaid loans from the federal budget. At the same time, the growth in the amount of transfers from the Fund of Financial Support of Regions in comparison with the figures registered in the preceding year was planned, while the amount of funds transferred in the process of mutual payments increased due to such factors as assignment of resources from the governmental reserve fund for liquidation of extraordinary situations and compensation of additional expenditures borne by regional authorities in relation to decisions taken by higher level authorities (this item includes transfers to the budgets of RF subjects aimed to rise wages and salaries financed from the budget and financing of other decisions of federal authorities generating growth in expenditures of sub-national budgets).

An analysis of distribution of financial aid from the federal budget across regions reveals that dependence of consolidated budgets of RF subjects on federal financial support somewhat increased in comparison with the preceding year: while in 2001 about 15 per cent of regional and municipal budgetary expenditures were financed from the federal budgets, in 2002 this indicator exceeded 17 per cent. This trend may be explained by the growth in the total amount of assigned federal funds discussed above (an increase in the amount of FFSR, assignment of additional types of federal aid, and the expansion of the list of federal expenditure mandates financed at the expense of subsidies and subventions from the Compensatory Fund). As before, the list of RF subjects most heavily financed at the expense of federal financial aid include such regions as the Chechen Republic, Republic of Tyva, Ust'-Orda Buryat Autonomous Okrug, Komi-Permyak Autonomous Okrug, the Republic of Dagestan, the Ingush Republic, the Republic of Altai, Yevreyskaya Autonomous Oblast, the Karach-Cherkessian Republic, Aginsky-Buryatsky autonomous okrug, the Karachayevo-Cherkessky Republic, the Kabardian-Balkarian Republic, the Koryak autonomous okrug, the Kabardino-

Balkarian republic, Aginsky Buryat Autonomous Okrug, Koryakian Autonomous Okrug, the Republic of North Osetia.

On the whole, the analysis of trends in the development of interbudgetary relations in 2002 did not reveal any significant changes in comparison with 2001 with exception of fluctuations of some indicators, such as an increase in the total amount of federal interbudgetary transfers to the budgets of RF subjects and insignificant changes in the structure of tax revenues of regional budgets.

The Law on the Federal Budget for Year 2003

The law on the federal budget for year 2003 contains a number of substantial novations concerning the relations between the federal budget and the budgets of RF subjects, as well as formation of regional budgets. The most significant provisions of this legislative act as concerns interbudgetary relations and sub-national finances will be discussed below.

Distribution of Tax Revenues among Levels of Budgetary System

The law on the federal budget stipulates some changes in proportions of the distribution of certain federal taxes among budgets of different levels necessary to compensate the losses borne by budgets due to the abolishment of taxes on motor road users and on vehicle owners since January 1, 2003.

The following most significant novations relating to changes in the structure of distribution of tax revenues among the levels of the budgetary system shall be pointed out:

First, the rate of excises on fuel and lubricants (gasoline, diesel fuel, and motor oil) due to the federal budget was lowered to 40 per cent. In the preceding years all revenues generated by this tax were due to the federal budget.

Second, the law on the federal budget stipulates that in 2003 the total amount of revenues from excises on tobacco products shall be transferred to the federal budget, while previously the revenues generated by this tax were equally apportioned between the federal budget and the consolidated budgets of RF subjects where respective taxpayers were situated.

Third, it was proposed to grant the 15 per cent share of revenues generated by land tax, which had been previously due to the federal budget, to regional and municipal budgets to be equally apportioned between these budgetary levels.

Fourth, the law on the federal budget for 2003 has corrected the faults characteristic of laws on the budget for 2001 and 2002, which just stipulated that revenues from excises on vodka and other alcohol products should be equally distributed between the federal budget and the consolidated budgets of RF subjects. As a result, in the course of administration of the revenues of the federal budget federal treasury offices distributed revenues from excises on vodka and other alcohol products in equal shares between the federal budget and the consolidated budgets of RF subjects at each stage of sales (both at the stage producers transferred goods to excise warehouses, and at the stage the goods were transferred from excise warehouses to the retail trade network. The law on the federal budget for 2003 stipulates that the total amount of excises on vodka and other alcohol products collected at the stage of transfer of goods to excise warehouses shall be due to the federal budget and the total amount of excises collected at the stage of transfer to the retail trade network shall be due to regional budgets. As a result, the revenues from excises on alcohol products are more evenly distrib-



uted across the country's territory and better correspond to the volumes of consumption of alcohol products across regions.

It is necessary to point out that on the whole the enacted novations concerning the distribution of tax revenues among the levels of authorities will result in an improvement of effectiveness of the system of interbudgetary relations. For instance, the transition to the new methods of apportionment of excises on alcohol products, centralization of excises on tobacco products and decentralization of a part of the land tax will result in more fair distribution of revenues among the levels of authorities, since these developments are aimed to centralize taxes imposed on the base unevenly distributed across the national territory, while tax revenues imposed on the immobile and evenly distributed base shall be centralized.

At the same time, it shall be pointed out that it is planned to decentralize and assign to the consolidated budgets of RF subjects a considerable portion of excise revenues from oil products (60 per cent). In the case it is taken into account that since January 1, 2003, the new procedure governing collection of excises on oil products, which transfers the obligation to pay excises to wholesale and retail trade, this centralization may be viewed as an attempt to redistribute excise revenues in favor of the budgets of RF subjects where oil is consumed. This approach (not taking into account a possible decline in revenues due to deteriorated collection of excises) will allow to distribute revenues from indirect taxes on use of motor roads among regional budgets in accordance with evaluations of traffic intensity expressed via volumes of wholesale and retail sales of oil products. However, it would seem more feasible to organize collection of excises on oil products similarly to excises on alcohol products, i.e. a portion of the excise exacted from producers is transferred to the federal budget, thus eliminating ineffectiveness related to uneven distribution of respective plants across the national territory.

Financial Aid to Budgets of Other Levels

The law on the federal budget for 2003 also contains a number of novations concerning distribution of financial resources provided by the federal budget among subjects of the Russian Federation.

The methods of distribution of resources from the Fund of Financial Support of Regions applied in the course of drafting of the law on the federal budget for 2003 have not changed considerably in comparison with the preceding year. Subsidies for equalization of budgetary security are still distributed among RF subjects basing on the comparison of estimated budgetary security, i.e. indicators of the per capita tax potential adjusted for the interregional index of the volume and cost of provision of base budgetary services. At the same time, 80 per cent of FFSR funds are distributed among all RF subjects where estimated per capita budgetary security is below the national average (the funds are distributed in proportion to the value of the aforesaid deviation), while the balance (20 per cent) is apportioned aiming to equalize per capita budgetary security indicators (the number of regions receiving subsidies from the 20 per cent portion of the Fund and the target level of equalization is determined proceeding from the absolute amount of resources the Fund assigns for these purposes).

At the same time, some changes were introduced in the methods of distribution of subsidies aimed at the equalization of budgetary security and calculation of regional tax potentials and expenditure requirements. For instance, since 2003 the methods applied to distribute

transfers have envisaged allocation of so called compensatory payments to certain regions¹⁷. These payments are primarily aimed, as formulated in the methods of apportionment of FFSR resources, to “maintain rates of growth in subsidies for equalization of budgetary security at a level at or above that of 2002 as adjusted for inflation” (12 per cent). In other words, the amount of subsidies to each RF subject shall be set at a level at or below the target stipulated by the law for 2002 as adjusted for estimated inflation rates. The amount of payment is calculated as the difference between the estimated amount of transfer for 2003 and the amount of transfer received in 2002 as adjusted for the estimated changes in the price index (only for regions receiving FFSR financing in 2002). The total amount of these compensations made Rub. 14.7 billion, or 8.5 per cent of FFSR. On the one hand, introduction of such compensatory payments is conditioned by the necessity to obtain approval of changes in the methods of FFSR funds apportionment and initial data, on which the distribution should be based, from RF subjects whose share of transfers declines in relation to the changes. On the other hand, the use of the mechanism of compensatory payments can not be a permanent component of the methods of distribution of equalizing transfers, since the present methodology seems to be non-optimal proceeding from a number of considerations, while its improvement shall result in a decrease in the number of recipients of equalizing subsidies. In this situation maintenance of amounts of financial aid at the previous level would result both in the lack of incentives to enhance the effectiveness of the system of apportionment of transfers on the whole, and the lack of effort to enhance the effectiveness of fiscal policies in regions being major recipients of federal financial aid (excluding subventions for financing of federal expenditure mandates) exceptionally in the form of compensatory payments. Therefore, admitting on the whole the necessity to compensate for sharp fluctuations in financial aid to regions resulting from changes in apportionment methods, it seems that such a mechanism should be more flexible and its role should be reduced to a partial compensation of losses within a predetermined amount. At the same time, the use of such compensations should be justified by considerable changes in the methods and not be reduced to a mechanical repayment of the difference in received financial aid.

It shall be also pointed out that no changes were directly introduced in the methods of calculation of subsidies aimed to equalize budgetary security in 2003. Accordingly, the fluctuations in the amounts of financial support most probably resulted from changes in the initial data. For instance, in the course of calculation of the tax potential index for 2002 there were used initial data on the gross regional product for 1998 and 1999, while calculations for 2003 relied on average values registered in 1999 and 2000. Taking into account the fact that the maximal rates of economic growth were observed in 2000, new initial data even used in accordance with the old methods considerably affected the results.

According to the apportionment of resources of the Fund of Financial Support of Regions as stipulated in the law on the federal budget for 2003, the number of RF subjects not receiving FFSR financing remained at the level registered in the preceding year (18 regions).

The methods of distribution of subventions and subsidies from the Compensatory Fund also has not changed considerably in comparison with the preceding period. The only novation was the abolishment of financing of expenditures borne by the consolidated budgets of RF subjects in relation to privileges granted to the military, militia, employees of the Interior

¹⁷ It shall be pointed out that in spite of the similar term, such payments do not relate to subventions and subsidies from the Compensatory Fund.



Ministry and Tax Police, and customs officials as concerns the payments for housing and public utilities services and communication services at the expense of subsidies from this fund. Instead of this item, the methods of distribution of the CF resources for 2003 envisage assignment of subsidies aimed to compensate for privileges relating to the payments for housing and public utilities services in accordance with the federal law "On amendment of the law of the Russian Federation 'On principles of the federal housing policies' and other legislative acts of the Russian Federation as concerns the improvement of the system of payments for housing and public utilities services." At the same time, proceeding from the initial data underlying the calculation of subsidies' amounts, it may be concluding that these subsidies are assigned exceptionally to compensate for privileges granted to disabled persons in relation to the payments for housing and public utilities services.

The law on the federal budget envisages Rub. 6 billion worth of subsidies for compensation of losses relating to excises on tobacco products, vodka, and other alcohol products in the composition of federal aid to lower budget levels. It shall be pointed out that for the first time amounts of such compensations have been calculated for all regions in accordance to the single methodology. Regions where the share of excises on tobacco products in the tax revenues of consolidated budgets for 2001 made over 1 per cent were eligible to participate in the distribution of compensations for the losses related to excises on tobacco products. The compensations relating to tobacco excises were apportioned proceeding from the total amount of available funds (Rub. 6 billion) in proportion to the tobacco excise generated revenues of regional budgets in 2001 taking into account respective levels of estimated budgetary security (after the distribution of FFSR resources) minus the estimated amount compensation for losses at the expense of FFSR financing (estimated). In addition to the compensation for losses relating to excises on tobacco products, the law on the federal budget envisages compensation for losses relating to excises on vodka and other alcohol products. These compensatory subsidies were distributed among the subjects of the Russian Federation where the share of excises on alcohol products in the tax revenues of consolidated budgets for 8 months of 2002 made over 10 per cent, while the share of respective excise revenues in the total amount of such excises generated in the Russian Federation exceeded the share of population in the total population of the Russian federation more than twofold. In accordance with these limitations, the right for the compensation was granted only to two RF subjects – the Kabardian-Balkarian Republic and the Republic of North Osetia. The total amount of such compensations made Rub. 251.7 million.

The law on the federal budget for 2003 envisages that since January 1, 2003, the RF Government shall ensure the transfer of ownership of budgetary loans for support of the seasonal deliveries to the North granted in 1994 and 1995 and earlier transferred under management of RF subjects. It shall be pointed out that until recently the federal authorities, which could not enforce the payment of debt on the part of regions have transferred the debt under management of regions. It seems that the transfer of the aforesaid subsidies in ownership of regions will result in formalization of the current situation where RF subjects can not repay the debt due to the lack of funds, and the write off of regional debts to the federal budget.

The provisions of the law on the federal budget for year 2003 also envisage assignment of Rub. 5 billion for repayment of federal indebtedness to RF subjects in the form of subsidies compensating for the losses relating to maintenance of housing, public utilities, and objects of the social and culture sphere transferred under jurisdiction of local governments. In previous years these expenditures were classified in the item "Funds transferred in the course of

mutual payments”; the total amount of the respective financing was not approved by the law on the federal budget and the Finance Ministry determined the concrete amount of subsidies to individual regions in the course of budget administration. Therefore, the law for year 2003 considerably curbs subjectivism in the distribution of funds pertaining to this item. At the same time, taking into attention the specifics of subsidized expenditures of regional budgets, it would be feasible to envisage in the law on the federal budget certain deadlines for transfer of housing owned by state agencies in municipal ownership thus facilitating the completion of the program of transfer of housing owned by state agencies in municipal ownership financed from the federal budget.

Analyzing the novations contained in the law on the federal budget for year 2003, it shall be pointed out that this document attempts to regulate tax privileges granted to the town of Baikonur (in preceding years such privileges were used for massive tax evasion as concerns excises and VAT). Similarly to the preceding year, provisions of the law envisage that all taxes and charges exacted in the territory of the town of Baikonur shall be due to the town budget, however, they at the same time limit the right of town authorities to grant tax privileges setting several eligibility criteria, including the necessity to have premises or property complexes for production and sale of goods (works, services) in the Baikonur territory. At the same time, the law prohibits to grant privileges relating to VAT, excises, profit tax on organizations, single social tax, and other federal taxes and charges. The law also prohibits to register in the town legal entities – taxpayers not operating in the Baikonur territory. While admitting that these stipulations considerably limit the potential for unfair tax competition, it is necessary to point out that it would be more feasible to either to make respective amendments to the Tax and Budget Codes, or adopt a special legislative act regulating the tax and budgetary status of extraterritorial administrative entities which, in contradistinction to the law on the federal budget, would be valid for more than one budget year.

The law on the federal budget for year 2003 instructs the RF Government to prolong the term of repayment of budgetary loans amounting to Rub. 20 billion granted before January 1, 2003, until September 30, 2003. The prolongation of budgetary loans is a form of financial aid governed by rather non-formalized procedure and therefore very subjective. On the one hand, it is necessary to allow regional budgets defer their obligations relating to federal budgetary loans in the situation where wages and salaries of employees of the budgetary sphere are rising in the framework of the single tariff schedule, while revenues decline due to incomplete compensation for the abolition of the tax on motor road users. On the other hand, it would be feasible to impose a number of conditions on such deferments, for instance setting forth requirements to undertake measures aimed to rehabilitate regional finances.

It is necessary to point out that the law on the federal budget for 2003 widely employs such type of penalties for infringements on the budgetary legislation and misuse of funds as transfer to the federal budget of the share of federal tax revenues due to the budgets of RF subjects and closed administrative territorial entities (CATEs). For instance, Article 77 of the law stipulates that in the case of failure to comply with the terms of repayment and misuse of funds to be repaid to the federal budget (i.e. budgetary loans and credits), respective amounts will be exacted by the federal treasury at the expense of revenues generated by federal taxes and charges due to respective budgets. This type of exaction is a most effective economic lever of influence on budgetary policies of RF subjects not being recipients of unconditional financial aid, or receiving insignificant amounts of subsidies from the federal budget.



In the framework of financial resources assigned from the federal budget to the budgets of RF subjects for financing of road networks, there has been formed a reserve amounting to Rub. 35 million, which the RF Government uses to increase the amounts of subventions and subsidies to the budgets of RF subjects for financing works relating to commonly used motor roads destroyed in the result of natural calamities. RF subjects are eligible to receive funds from this reserve only in the case they have formed own reserves for same purposes and in the case these funds prove insufficient to finance respective works. The creation of this reserve is also conditioned by the necessity to provide federal financial aid to regions in the case they may have difficulties financing road networks due to the abolishment of the tax on users of motor roads and the tax on vehicle owners.

Similarly to the preceding law on the federal budget, the resources of the Fund of Regional Development (total amount is Rub. 25.0 billion) are primarily used to finance two federal targeted programs: the federal targeted program "Social and economic development of the Republic of Tatarstan until 2006" amounting to Rub. 11.3 billion and the federal targeted program "Social and economic development of the Republic of Bashkortostan until 2006" amounting to Rub. 7.4 billion. Similarly to 2002, these considerable amounts of financing of development programs in two regions are primarily conditioned by the arrangements between the authorities of the two Republics and the federal center concerning the compensation for abolishment of the special fiscal regime applied to these RF subjects prior to 2001. However, it is necessary to point out that in the situation where funds are lacking to compensate for the decline in revenues resulting from the abolishment of the tax on users of motor roads and the peak of repayment of the external debt, it seems very inefficient and unfeasible to assign these considerable financial resources to two RF subjects ranked among national leaders in terms of budgetary security.

This structure of federal budgetary expenditures as set forth in the sub-item "Fund of Regional Development" seems to be one of the most serious flaws of the law on the federal budget for year 2003 as concerns interbudgetary relations. On the one hand, previous arrangement should be complied with in order to maintain stability of relations between the Russian Federation and its subjects. However, on the other hand, such arrangements were not officially registered in respective regulatory or legislative acts. In this situation adherence to the arrangements with two subjects of the Russian Federation only increases the asymmetric character of fiscal federalism. It would seem feasible to considerably reduce, if not abolish, these federal targeted programs and use the funds made available for other purposes.

The law on the federal budget for year 2003 contains a provision according to which territorial offices of the Tax Ministry ensuring that regional and local budgets receive additional revenues may act on paid basis depending on their performance by concluding agreements with the executive authorities of RF subjects and municipal entities. The additional revenues should be accounted for as proceeds from entrepreneurial activities and fully utilized for maintenance of territorial tax offices, development of material and technical base of territorial tax offices, and security of premises. On the one hand, this provision might be feasible in the case the regional authorities and local governments bore full costs of administering of regional and local taxes respectively. In this case, introducing regional and local taxes regional and local administrations could conclude agreements with territorial tax offices according to which the latter were reimbursed for the costs of administering these taxes. On the other hand, according to the legislation currently in force, administering of all taxes and charges in the Russian Federation is vested with federal tax agencies and carried out at the expense of the federal budget. In this situation no criteria exist to evaluate the performance of tax agencies as concerns mobilization of additional reve-

nues and, respectively, determine the amount of remuneration of tax authorities, what, in turn, may result in abuse of taxpayers on the part of tax agencies.

Similarly to preceding years, the law on the federal budget for 2003 approved the list of heavily subsidized regions whose budgets, according to Article 49, should be administered by the federal treasury offices. The list contains 29 regions, in comparison with the list for 2002, the Republic of Sakha, Primorski krai, and Taimyr Autonomous Okrug were excluded, while the Republic of Mari El was included.

The Law on Federal Budget: Quantitative Characteristics

As concerns financial aid to regions, for respective major characteristics of the federal budget for 2003 see *Table 17*.

Table 17

The law on the federal budget for year 2003: Financial aid to budgets of other levels

	Rub. mil.	% of GDP
Subsidies and subventions	31905	0,24
<i>Including:</i>		
Subsidies and subventions to CATEs and the town of Baikonur	14538	0,11
Subsidies to CATEs	7955	0,06
Subsidies to the town of Baikonur	564	0,00
Capital investment subventions to CATEs	4195	0,03
Resettlement subventions to CATEs	824	0,01
Subventions to CATEs for financing of CATE development programs	1000	0,01
Other subsidies and subventions	17368	0,13
Subsidy to the town of Sochi	1046	0,01
Subsidies to budgets of RF subjects to compensate for losses relating to excises on tobacco and alcohol products	6000	0,05
Subsidies compensating losses relating to maintenance of HPU objects transferred under jurisdiction of local governments	5000	0,04
Other subsidies to budgets of RF subjects	4069	0,03
Other subventions to budgets of RF subjects and local governments	1253	0,01
Transfers from FFSR	173168	1,33
<i>Including:</i>		
Transfers	173168	1,33
Of which: state support of seasonal deliveries to the North	8809	0,07
Subsidies and subventions from the Compensatory Fund	47011	0,36
<i>Including:</i>		
Subsides for implementation of the law on social security of disabled persons	6630	0,05
Subventions for implementation of the law on state family allowances	22213	0,17
Subventions for compensation of privileges related to payment for HPU services in accordance with the federal legislation	13820	0,11
Other subventions and subsidies from Compensatory Fund	4349	0,03
Resources of the Fund of Co-Financing of Social Expenditures	5000	0,04
Resources of the Fund of Regional Development	25072	0,19
State support of road networks	39000	0,30
Resources of the Fund of Reformation of regional finances	1300	0,01
Other types of financial aid	14240	0,11
<i>Including:</i>		
Measures of regional development	14240	0,11
Total: funds transferred to budgets of other levels	336697	2,58

Source: the law on the federal budget for year 2003.

The data presented in the Table demonstrate that the total amount of financial aid to be granted to regions in 2003 is planned at 2.58 per cent of GDP, what is somewhat below the amount targeted in the law on the federal budget for year 2002 (3 per cent). Transfers from the Fund of Financial Support of Regions made the bulk of the expenditures for financial aid to budgets of other levels (60 per cent). The aggregate share of resources distributed in accordance with formalized methods (transfers from the Fund of Financial Support of Regions and



subventions and subsidies from the Compensatory Fund) made about 75 per cent of the total amount of financial aid. As compared with the targets set forth in the law on the federal budget for 2002 across all types of financial aid to regions, the more pronounced decline was detected in relation to such items (in per cent of GDP) as subsidies from the Fund of Reform of Regional Finances (78 per cent of the figure registered in 2002), subventions and subsidies from the Compensatory Fund (80 per cent), transfers from FFSR (82 per cent). The financing of road networks remained at the level targeted in the law on the budget for 2002.

Basing on the results of the analysis of characteristics of the law on the federal budget for year 2003 concerning interbudgetary relations, the following conclusions may be derived:

1. Changes in proportions of apportionment of revenues generated by federal taxes planned for 2003 should, on the whole, result in more even distribution of tax revenues among budgets of different levels, what would allow regions to partially compensate for losses borne in relation to the abolishment of the tax on users of motor roads (by transferring certain excises in the budgets of regions where excisable products are consumed), and generate additional revenues of the federal budget due to centralization of excises on tobacco products, the base of which is unevenly distributed across the national territory.

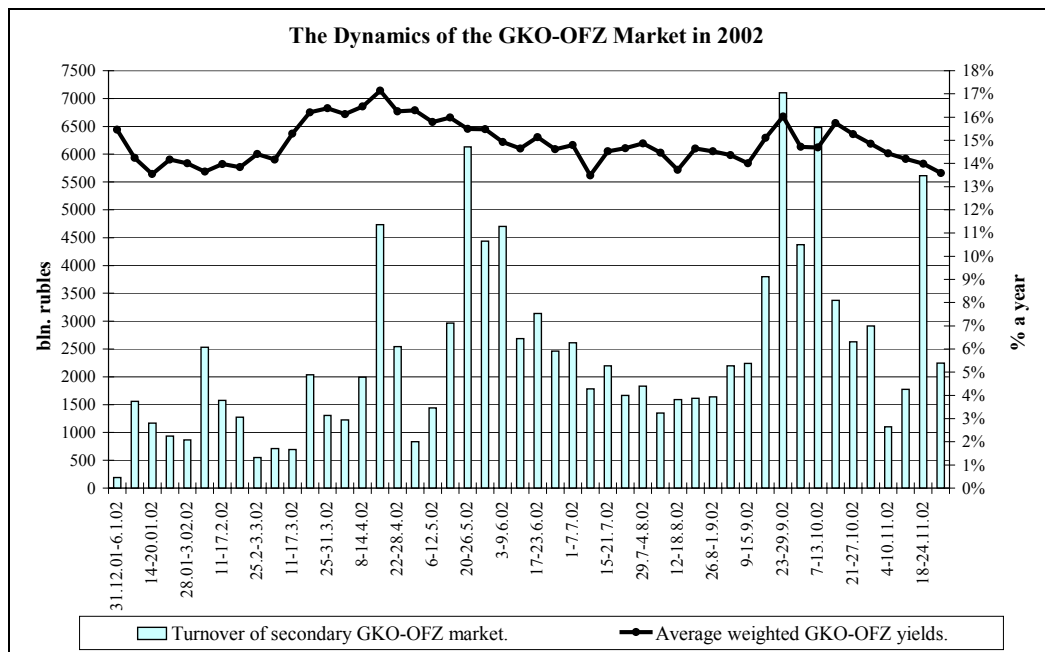
2. The system of federal financial aid to regions on the whole answers the principles set forth in the Program of reforming fiscal federalism until 2005 (the amounts of financial aid and methods of its apportionment will be presented at the second or third reading); however, certain types of financial aid to regions present in the budget rises questions. For instance, it does not seem feasible to assign about Rub. 20 billion (an amount equal to the planned amount of financial reserve for the next year) for implementation of federal targeted programs of development of Republics of Tatarstan and Bashkortostan in the situation where federal budget is stretched to meet external debt obligations and compensate for losses resulting from the lighter tax burden.

2.4. Russia's financial markets

2.4.1. The public debt market

Internally held public debt. As of the beginning of 2003 the internally held public debt in form of securities accounted for 654.5 bln roubles, that is about 6% of the GDP. Of this the basic sum of the debt (up to 90%) was held in federal bonds (OFZ) with a permanent or fixed yield, and amortization federal bonds, that is securities with a circulation period exceeding one year at the time of issue. The share of short-term government securities (GKO) did not exceed 3%.

The past year can be characterised first of all by an unprecedented decrease in dividend yields with low sales during the most part of the year (*see fig. 27*). The nominal average yield of the GKO-OFZ when redeemed decreased to 13.5-14% per annum, while the secondary market turnover in certain weeks went down under 1 bln roubles. Thus at the beginning of the year monthly sales became minimal since the spring of 1999, when the market was only starting to function after the 1998 crisis.



Source: Information agency "Finmarket", calculations by the IET.

Fig. 27

The average yield level at the internally held public debt market in the Russian Federation grew in March and May of 2002. The average yield of the GKO-OFZ when redeemed reached 16.5-17.5% per annum, which was the highest peak since July – August of 2001. At the same time it should be noted that taking the downtrend in the inflation rates into consideration the real value of debts at the domestic market in that period became positive and accounted for 3-3.5% per year.

By the middle of 2002 a sales growth was registered. A greater interest to the GKO-OFZ can be explained as we see it first of all by currently lower inflation rates, which made investments into bonds at their present yields more attractive. Secondly, the Ministry of finance of the Russian Federation increased its additional distribution of bonds (in certain days these additionally floated securities accounted for as much as 50% of the total secondary market turnover). In the third place there appeared a new big player at the market in April – the Pension Fund of the Russian Federation.

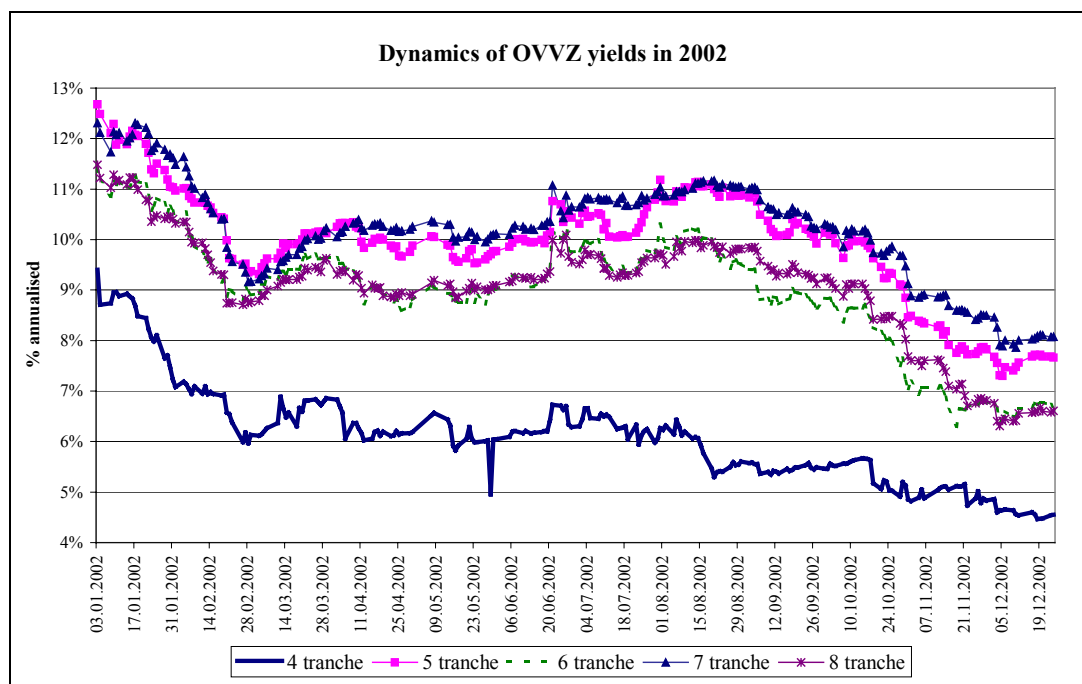
But already in June – July the securities' yield dropped again to its historical minimum – 13.5-14.5% per annum. An essential point should be noted here, though, the one that adds to the negative assessment of the market situation – in the past months the Pension Fund has become one of the principal market participants that ensure a high demand for bonds, while private investors have practically lost their interest to this type of investments. According to its chairman M. Zurabov the Pension Fund's monthly investments plans exceeded 3.5 bln roubles.

In 2002 on the whole the Ministry of finance held 29 auctions to float securities. The supply accounted for 180 bln roubles, including 29 bln roubles worth of securities to be paid off in 6 months, 19 bln roubles in one year, 26 bln roubles in two years, 23 bln roubles in 3 years and 95 bln roubles from 3 to 10 years. Total demand on the part of investors reached 134.9 bln roubles, there were floated bonds for a total sum of 86.2 bln roubles, that is less

than 48% of the total securities supply. The average yield at the auctions was 15.28%. The Ministry of finance of the Russian Federation sold securities for 80.9 roubles.

External debt. The total external public debt of the Russian Federation (according to the internationally accepted calculation methods and data provided by the Central Bank of Russia) in nine months of 2002 decreased by 7 bln US dollars from 113.5 to 106.5 bln dollars. The securities part of the debts in the first three quarters got reduced from 28.8 to 28.0 bln dollars, first of all due to the pay off of a part of European bonds floated within the framework of the second restructuring of debts of the former USSR to the London Club of creditors. During the whole of the year there were circulated at the market 6 tranches of the OVVZ and 10 tranches of the European bonds.

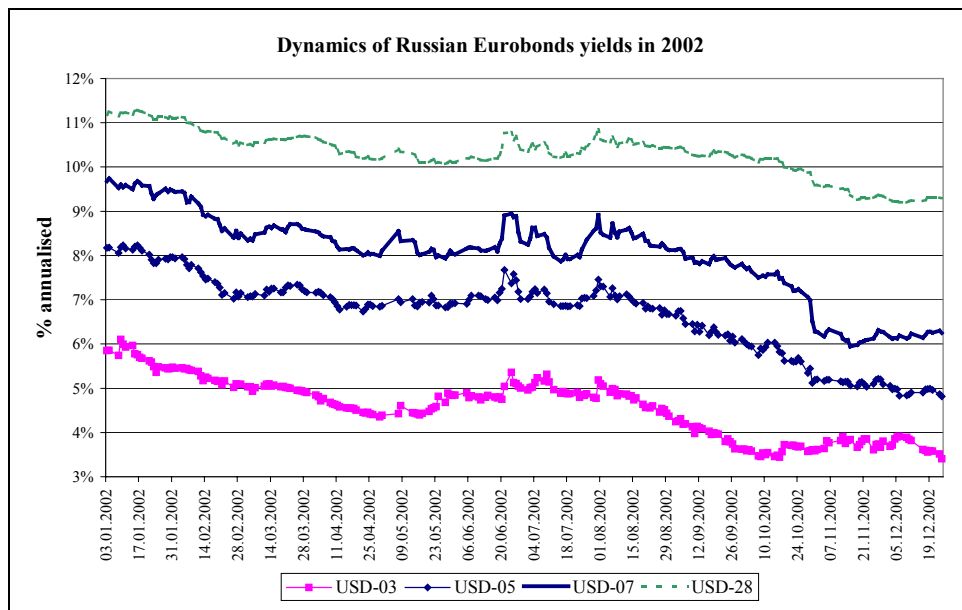
In 2002 a quick growth of quotations of all Russian securities continued (see *Fig. 28 and 29*). In particular, the yield of the OVVZ when redeemed decreased from 9-12.5% to 4.5-8.0 per annum, of the European bonds to 3.5-9.5% par annum. Thus the income derived from holding Russian securities (not counting bond coupons payments) reached 38.2% for the European bonds (the issue with pay-off in 2030) and 43.2% for the OVVZ (the 7th tranche, pay-off in 2011, they are referred to as debts of the Russian Federation).



Source: Information agency "Finmarket".

Fig. 28

Such a growth of prices on Russian securities as we see it is predominantly explained by a greater demand for them on the part of international investment funds. The stabilized economic situation in Russia, good showings in economic growth, a low probability of default on external debts made it possible for the investors to review their limits for Russian securities and to increase them. In one year the national ratings of the Russian Federation climbed several steps and by the end of the end reached the BB+ level (in national currency) and BB (in foreign currencies, Standard & Poor's) and Ba2 (Moody's), that is got really close to the investment ratings category.



Source: Information agency "Finmarket".

Fig. 29

It should be noted that in January – February 2002 the Ministry of finance of the Russian Federation was paying off the OVVZ of the 4th series at the secondary market, which (together with payments by the Bank of Russia to the International Monetary Fund performed before due time) allowed unburdening the federal budget for 2003. At present the default bonus for the 4th tranche of the OVVZ (obligations of the former USSR, which are traditionally viewed by the investors as the most risky ones; to be paid off in 2003) is assessed by the investors as 1 per cent point per annum, the yield of the European bonds to be paid off in the near future taken into consideration).

In addition to technical factors (a correction after the period of quick growth of quotations) the profitability of Russian securities in March was influenced by a number of other important factors. First of all, all the positive information about Russia's economic growth outlooks in 2002 had already been taken into account in the bonds' prices, as well as Russia's higher national credit ratings by international agencies. At the same time the real sector showings in the last months of 2001 and in the beginning of 2002 were clearly negative. Secondly, in March the Ministry of finance was probably not pursuing the policy of repurchasing its securities, which decreased the total demand for Russian securities. Hence, one can assume, that the yield reduction by 1-1.5 per cent points in January – February of 2002 was due to debts' pay-off operations, and in March bonds' ratings returned to the level corresponding to the risk assessments by the investors. Thirdly, in March there appeared expectations about a soon increase of rates by the US Federal Reserve System, which influenced rates of all assets in US dollars to grow.

In April 2002 the foreign debts market of the Russian Federation witnessed contradictory tendencies. When yields of the European obligations continued to decrease during the whole of the month and reached the lowest level in their history, the OVVZ ratings moved in the opposite direction. Yields of the 4th and the 6th issues of OVVZ, which dropped at the very beginning of the month got stabilized. At the same time prices on the 5th and the 7th issues remained at the same level as in March or even got slightly diminished. These changes in rat-



ings of Russian securities as we see it can predominantly be explained by lack of significant news from Russia and a relatively quiet situation at the developing markets on the whole (the persistent crisis in the Argentine has now practically no influence on other markets).

In June – July 2002 the Russian external debts market witnessed a new fall in securities ratings caused first of all by the developments in Brazil. The menace of a foreign debt default in this Latin American country, which is one of the largest loan securities issuers led to an overall revaluation of investment risks for bonds of developing markets. In this way the yield growth influenced also Russian bonds in spite of clearly expressed positive trends (gold and foreign currency reserves growth and the fact that the European Union acknowledged Russia as a country of market economy). In particular in the second part of July the yield of all of the OVVZ and the European bonds (independently of their pay-off terms) grew by approximately 1 per cent point.

In August 2002 the yield growth tendency at Russia's external debts market stopped and gave place to a downtrend for the most types of securities. These changes in Russian securities' ratings were basically caused by the fact that Standard & Poors increased the national rating of Russia from B+ to BB- (on July 26, 2002) and fluctuations at international markets were dampened among other things due to the agreement between Brazil and the IMF on a package of financial aid of 30 bln dollars. Besides, the negative expectations' potential connected with elections in Brazil in all probability got exhausted in October – November prior to the new president's appointments.

As the most important event at the Russian securities market in November one can regard the restructuring of commercial debts of the former USSR by the Ministry of finance for a total sum of 1.1 bln dollars into European bonds to be paid off in 2010 and 2030.

2.4.2. The Market for Municipal and Subfederal Borrowings

The State of the Market

The market for subfederal and municipal loans consists of two large sectors: bank lending and debt securities (bonds). Furthermore, there are loans of non-market character granted by higher-level government agencies. The market for subfederal and municipal loans was founded in 1992, reached its peak in 1997 and contracted significantly following the 1998 crisis when dozens of territorial government agencies defaulted on their obligations. (*See Table 1*).

As at 1 November, 2002, the estimated volume of the internal market for municipal and subfederal securities was RUR 32.1 billion, or 15 percent of the total volume of the internal market for government securities and one third of the corporate bond market.

Investments of commercial banks into city and regional securities amounted on that date to RUR 17.0 billion, or 53 percent of the market volume, and the volume of lending to subfederal and municipal government agencies was RUR 29.5 billion. Thus, the total funding granted by commercial banks to territorial government agencies was RUR 46.5 billion, or less than 1.2 percent in the structure of the banks' assets.

By November 2002 the exchange turnover in subfederal and municipal securities reached RUR 6.2 billion during the month; the St.-Petersburg Currency Exchange and MICEX were the main trade floors, and RTS is gradually entering this market. The yield spread between government securities and subfederal and municipal securities moved in the 1 - 4 percent range. The yield on most of securities was 13 to 18 percent, which, considering the inflation rate, meant an extremely low real interest rate.

Among constituent entities of the Federation borrowing in the internal market, Moscow and St. Petersburg became the largest borrowers (including the bond market). The main amount of accumulated debt nominated in foreign currency also fell to their share. Moscow's eurobonds, with the credit rating equal to the sovereign rating, sold with a spread of 1.0 to 1.2 percent to the yield of RF eurobonds, or within the range of 10 to 11 percent p.a. in Euros. Thus, even the regions formally entitled to borrow in foreign currency (in accordance with the Budget Code, this right has been granted to the regions repaying the accumulated currency debt) found this less attractive compared with internal loans. At the same time, external loans had the advantage of a comparatively longer term and the possibility to count on comparative lowering of the debt burden from currency-nominated liabilities in case the real exchange rate of the Rouble would grow.

The regions were quite successfully repaying or refinancing the accumulated debt against a background of economic growth and increasing budget revenues, and no new defaults occurred in the market. At the same time, a number of entities of the Russian Federation failed to meet their obligations on the so-called 'agricultural' bonds of 1997 - 1998, with maturity up to three years, that had been issued in the course of restructuring regional debts to the federal budget. However, some investors do not think that the default on the 'agricultural' obligations increases the risk on new loans significantly.

Growing investments by pension funds that are expected to take place in the course of the pension reform, create the necessary conditions for a considerable growth of demand for regional and municipal securities, both due to potential investments by the funds themselves and due to the possibility that they would 'squeeze' investor money out of other sectors of the financial market. The trend towards an increase of the international credit rating of the RF, which encourages the growth of regional credit ratings, has the same effect. In this connection, the ability of regional government agencies to use the attracted funds efficiently gains primary importance.

Dynamics of Market Growth

The resulting consolidated regional budget for 2002 had a deficit of RUR 44.1 billion, i.e. 2.7 percent of the expense side, or 0.40 percent of the GDP. The budgets of the entities of the RF had a deficit of almost RUR 37 billion (3.0 percent of the expense side), budgets of municipal entities - a deficit of RUR 20.5 billion (2.8 percent of the expense side).¹⁸

A deficit of the regional consolidated budget was previously observed in Russia in 1999. In 2000 the budget was implemented with a surplus amounting to 0.49 percent of the GDP, and in 2001 the surplus was 0.02 percent of the GDP. There were two reasons that contributed to the increase in budget deficit in 2002 in approximately equal proportions: growth of lending by higher-level budgets and growth in net borrowing on issues of securities and on lending by commercial banks (*Table 18*).

¹⁸ The amount of deficit of the consolidated regional budget is not equal to the sum total of the deficits of regional and municipal budgets since it does not include the amount of loans extended by regions to municipal entities that are carried as the deficits of municipal budgets but are not included in the deficit of the consolidated regional budget.

Table 18
Net Borrowings by Regional and Local Budgets (percent of GDP)

Year	1995	1996	1997	Jan. - Aug. 1998	Jan. - Decem. 1998	1999	2000	2001	2002
Borrowings from subfederal and local government agencies, including:	0.38	0.87	1.43	0.71	0.33	0.15	-0.29	-0.04	0.47
Repayable loans from budgets of other levels	0.07	0.23	0.66	0.05	-0.09	-0.11	-0.03	0.04	0.12
Subfederal (municipal) bonds	N.a.	0.16	0.22	0.08	-0.01	-0.05	-0.27	-0.07	0.16
Other borrowings	0.31	0.48	0.55	0.58	0.43	0.31	0.01	-0.02	0.19
Lowering of balances in budget accounts	...	0.03	-0.18	0.09	0.02	-0.19	-0.30	-0.05	-0.04
Funding deficit out of borrowings and lowering balances in budget accounts	0.38	0.9	1.25	0.8	0.35	-0.04	-0.59	-0.09	0.38

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

The relation of municipal budgets' deficit to their expense side increased only 0.18 percent compared to 2001. The deficit of the consolidated regional budget is explained exclusively by the budgetary policy of RF entities: the surplus of 0.98 percent of the budgets' expense side was replaced by a deficit of 3.02 percent of the expense side. (See Table 19).

Table 19

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
Year 2002	-2.67	-3.02	-2.81
Year 2001	0.12	0.98	-2.63
Year 2000	3.41	3.95	-1.41

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

In 2002, in 26 RF entities the consolidated regional budget was implemented with a surplus amounting to a total of RUR 10.98 billion, or 2.29 percent of the corresponding budgets' expenses. The median level of the budget surplus was 1.6 percent of the revenues of the corresponding budget. The greatest ratio of surplus to budget revenues was observed in the Lipetsk Oblast (11.9 percent), Jewish Autonomous Okrug (9.5 percent), Chechen Republic (6.6 percent), Yamal-Nentsi Autonomous Okrug (4.8 percent) and the Leningrad Oblast (4.5 percent).

Eight RF entities provided over 81.5 percent of the total surplus: the Yamal-Nentsi Autonomous Okrug (21.2 percent of the total surplus, or RUR 2.3 billion), Krasnodar Krai (11.8 percent, or RUR 1.3 billion), Lipetsk Oblast (11.6 percent, or RUR 1.27 billion), St.-Petersburg (9.7 percent, or RUR 1.1 billion), Leningrad Oblast (7.5 percent, or RUR 0.8 billion), Chukotka Autonomous Okrug (7.5 percent or RUR 0.8 billion), Chelyabinsk Oblast (6.3 percent or RUR 0.7 billion) and Tyumen Oblast (6.1 percent, or RUR 0.7 billion).

The consolidated regional budget of 63 RF entities was implemented with a deficit in 2002. The budget deficit in these regions totalled RUR 55.1 billion, or 3.78 percent of the revenue side of their budgets.

The median value of the budget deficit was 2.1 percent of the budget's revenue side. The highest level of deficit was observed in the Evenki Republic: 30.6 percent of the revenue side (covered out of bank loans); Sakhalin Oblast: 11.5 percent; Nentsi Autonomous Okrug: 8.4 percent; Voronezh Oblast: 7.5 percent; Moscow: 7.4 percent, and Komi Republic: 6.1 percent (*See Table 20*).

Table 20

Implementation of Consolidated Budgets of RF Entities (percent)

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
Central Federal Superregion								
Belgorod Oblast	12 216 882	-325 092	-2.66	10.42	4.80	6.15	3.62	-180.6
Bryansk Oblast	10 323 730	-180 550	-1.75	3.39	2.06	1.44	0.90	-117.7
Vladimir Oblast	13 504 225	48 793	0.36	4.07	1.26	2.92	3.66	349.0
Voronezh Oblast	16 159 220	-1 300 065	-8.05	23.89	8.48	16.14	2.01	-105.4
Ivanovo Oblast	10 373 746	-49 791	-0.48	1.28	-0.41	1.71	0.92	86.1
Kaluga Oblast	10 050 638	-108 831	-1.08	3.84	1.21	2.86	1.47	-111.4
Kostroma Oblast	6 845 743	-58 894	-0.86	8.49	0.61	8.53	1.44	-70.6
Kursk Oblast	7 713 682	-168 091	-2.18	5.77	2.45	3.69	1.20	-112.4
Lipetsk Oblast	11 944 195	1 270 731	10.64	6.66	-0.70	8.01	11.99	-6.5
Moscow Oblast	71 285 558	-3 355 974	-4.71	30.55	9.14	22.56	5.58	-194.2
Oryol Oblast	7 032 636	-231 530	-3.29	5.68	4.77	0.91	2.54	-144.9
Ryasan Oblast	11 210 363	-152 181	-1.36	2.93	1.23	1.83	2.43	-90.6
Smolensk Oblast	8 156 596	-147 301	-1.81	5.65	1.08	4.80	0.88	-59.6
Tambov Oblast	9 970 166	-200 157	-2.01	3.22	1.93	1.34	0.42	-96.3
Tver Oblast	12 650 858	-462 536	-3.66	12.42	7.41	5.56	4.48	-202.5
Tula Oblast	15 458 952	-545 912	-3.53	7.17	1.90	5.79	0.83	-53.8
Yaroslavl Oblast	16 298 052	-29 451	-0.18	6.11	-1.32	8.08	1.00	733.0
Moscow	281 781 422	-22 392 245	-7.95	11.82	6.23	7.20	5.64	-78.4
Total	532 976 664	-28 389 077	-5.33	12.88	5.33	8.68	4.60	-100.0
Northwest Federal Superregion								
Republic of Karelia	9 781 915	-503 278	-5.14	11.64	6.55	5.68	1.83	-127.3
Republic of Komi	18 157 028	-1 186 749	-6.54	24.05	8.50	16.73	0.82	-130.0
Arkhangelsk Oblast	14 455 261	-109 292	-0.76	4.99	1.14	4.40	1.16	-150.5
Vologda Oblast	14 936 510	6 258	0.04	6.29	-0.24	7.02	3.40	-567.3
Kaliningrad Oblast	9 434 136	-136 702	-1.45	4.87	1.35	3.68	2.00	-93.2
Leningrad Oblast	18 985 134	818 993	4.31	3.11	-2.60	7.00	5.85	-60.3
Murmansk Oblast	13 003 840	-469 491	-3.61	14.16	7.16	7.24	3.52	-198.2
Novgorod Oblast	5 830 199	-190 401	-3.27	5.04	2.18	3.07	1.42	-66.8
Pskov Oblast	8 202 664	197 986	2.41	4.07	-2.96	8.19	1.51	-122.7
St.-Petersburg	67 026 698	1 061 370	1.58	18.70	-1.06	22.15	5.27	-66.9
Nentsi Autonomous Okrug	2 643 545	-243 420	-9.21	1.62	0.63	1.02	4.50	-6.8
Total	182 456 930	-754 726	-0.41	12.75	1.13	12.95	3.63	-273.9



Table 20 (cont'd)

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
Southern Federal Superregion								
Republic of Adygea	5 390 950	72 178	1.34	8.66	2.21	6.46	4.60	164.8
Republic of Daghestan	22 882 591	-173 656	-0.76	0.44	0.01	0.44	2.32	-0.8
Republic of Ingushetia	6 260 157	-31 672	-0.51	4.31	0.30	4.06	1.46	-60.0
Kabardin-Balkar Re- public	7 711 489	-453 888	-5.89	13.07	4.84	9.14	0.86	-82.2
Republic of Kalmykia	3 462 065	-51 561	-1.49	5.92	2.17	4.39	1.38	-146.0
Karachaevo-Cherkessk Republic	4 917 007	173 353	3.53	4.55	1.28	3.29	6.07	36.3
Republic of North Ossetia - Alania	7 353 791	-40 900	-0.56	8.04	1.65	6.73	4.66	-297.2
Chechen Republic	7 555 418	466 713	6.18	2.12	0.00	2.12	11.06	0.0
Krasnodar Krai	50 349 054	1 300 936	2.58	5.41	1.38	4.14	5.10	53.5
Stavropol Krai	19 657 429	-417 396	-2.12	8.95	3.47	5.50	4.34	-163.6
Astrakhan Oblast	7 896 187	-339 758	-4.30	7.51	3.21	4.47	1.26	-74.7
Volgograd Oblast	18 244 890	-351 330	-1.93	12.87	2.48	12.03	1.22	-129.0
Rostov Oblast	34 776 622	105 823	0.30	3.03	0.39	2.98	2.31	127.1
Total	196 457 650	258 842	0.13	5.86	1.52	4.64	3.57	1155.9
Volga Federal Superregion								
Republic of Bashkiria	44 909 825	-514 003	-1.14	3.98	1.50	3.07	5.36	-131.1
Republic of Mari-El	6 195 871	-191 132	-3.08	8.28	2.72	5.71	0.52	-88.0
Republic of Mordovia	9 642 981	-542 595	-5.63	13.89	5.67	8.56	0.73	-100.8
Republic of Tatarstan	62 499 716	-187 083	-0.30	3.72	-0.61	4.44	1.95	204.7
Udmurt Republic	17 106 448	-772 546	-4.52	4.75	2.74	2.10	3.54	-60.8
Chuvash Republic	12 322 960	-205 428	-1.67	3.85	2.72	1.37	2.01	-163.2
Kirov Oblast	12 853 073	-323 636	-2.52	5.84	2.36	3.68	0.66	-93.9
Nizhny Novgorod Oblast	28 250 894	-395 997	-1.40	15.65	2.58	14.14	4.45	-184.2
Orenburg Oblast	17 971 704	-290 017	-1.61	4.47	1.67	3.16	1.25	-103.4
Penza Oblast	9 848 732	55 669	0.57	1.68	-1.44	3.86	1.84	-254.3
Perm Oblast	30 244 110	-774 439	-2.56	5.17	3.19	2.14	4.11	-124.4
Samara Oblast	32 464 002	208 718	0.64	5.33	0.78	4.88	5.56	121.0
Saratov Oblast	18 711 929	118 511	0.63	6.34	-1.92	9.36	0.44	-302.6
Ulyanovsk Oblast	9 319 622	-537 260	-5.76	8.77	6.01	2.95	2.30	-104.3
Komi-Permyak Autonomous Okrug	2 452 381	28 772	1.17	1.81	-1.35	3.39	0.54	-115.0
Total	314 794 248	-4 322 466	-1.37	5.95	1.39	4.96	3.08	-101.5
Ural Federal Superregion								
Kurgan Oblast	9 480 396	-42 501	-0.45	3.59	0.61	3.17	0.83	-136.6
Sverdlovsk Oblast	38 609 833	-379 542	-0.98	2.38	-0.47	3.57	1.78	48.0
Tyumen Oblast	29 851 331	665 485	2.23	0.52	-1.69	2.74	5.75	-75.7
Chelyabinsk Oblast	30 615 923	693 010	2.26	1.22	-0.35	1.58	3.76	-15.6
Khanty-Mansi Autonomous Okrug	116 500 471	-5 229 815	-4.49	4.44	1.41	3.18	2.87	-31.5
Yamal-Nentsi Autonomous Okrug	51 246 923	2 326 058	4.54	12.51	-3.84	17.05	2.92	-84.5
Total	276 304 877	-1 967 305	-0.71	4.84	-0.38	5.58	3.07	53.6

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Table 20 (cont'd)

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
Siberian Federal Superregion								
Republic of Altai	5 078 798	72 145	1.42	1.21	-1.30	2.75	0.90	-91.2
Republic of Buryatia	16 159 292	-813 537	-5.03	29.43	9.16	21.45	0.44	-181.9
Tyva Republic	6 630 974	-90 742	-1.37	2.56	1.49	1.07	0.43	-109.0
Republic of Khakassya	5 373 442	-101 136	-1.88	8.95	2.14	7.05	1.16	-113.9
Altai Krai	24 399 905	-83 150	-0.34	3.15	-0.97	4.12	0.57	283.9
Krasnoyarsk Krai	45 649 093	-2 756 977	-6.04	19.63	8.01	12.29	2.29	-132.6
Irkutsk Oblast	26 845 721	-740 695	-2.76	7.16	3.11	4.24	2.90	-112.8
Kemerovo Oblast	34 067 810	-155 646	-0.46	5.99	0.32	5.72	2.75	-70.6
Novosibirsk Oblast	26 481 996	-1 050 088	-3.97	140.89	10.68	133.20	2.24	-269.2
Omsk Oblast	15 934 118	-164 477	-1.03	35.97	2.64	34.84	0.66	-255.9
Tomsk Oblast	13 737 001	218 908	1.59	23.36	0.19	24.89	2.28	12.1
Chita Oblast	15 395 419	41 863	0.27	0.31	0.18	0.13	1.71	65.6
Aginsk Buryat Autonomous Okrug	1 403 452	24 506	1.75	3.00	3.00	0.00	5.33	171.7
Taimyr (Dolgan - Nentsi) Autonomous Okrug	4 018 959	-90 507	-2.25	0.00	0.00	0.00	10.60	0.0
Ust-Orda Buryat Autonomous Okrug	2 341 159	9 244	0.39	1.07	0.41	0.66	1.23	103.9
Evenki Autonomous Okrug	2 322 467	-1 025 234	-44.14	142.03	85.77	86.31	5.40	-194.3
Total	245 839 606	-6 705 523	-2.73	28.00	4.61	24.42	2.05	-169.1
Far Eastern Federal Superregion								
Republic of Sakha (Yakutia)	35 634 038	-1 332 367	-3.74	10.10	3.07	7.24	2.45	-82.0
Primorsky Krai	26 357 485	82 564	0.31	7.27	0.78	6.67	1.41	248.3
Khabarovsk Krai	23 444 193	-924 339	-3.94	7.41	1.76	5.79	1.83	-44.5
Amur Oblast	13 107 451	-177 051	-1.35	4.35	1.49	3.14	1.28	-110.4
Kamchatka Oblast	10 119 323	-281 694	-2.78	13.08	3.35	10.13	1.25	-120.4
Magadan Oblast	8 802 916	-49 323	-0.56	4.95	2.74	2.23	2.68	-489.3
Sakhalin Oblast	11 519 640	-221 605	-1.92	11.21	0.04	11.30	1.34	-2.2
Jewish Autonomous Oblast	3 447 347	91 710	2.66	0.75	-0.71	1.74	5.07	-26.7
Koryak Autonomous Okrug	1 895 213	-246 883	-13.03	16.20	12.09	4.71	0.87	-92.8
Chukotka Autonomous Okrug	9 496 626	822 782	8.66	2.63	2.47	0.16	12.21	28.6
Total	143 824 232	-2 236 206	-1.55	7.96	2.04	6.11	2.58	-131.0
Total Federal Super- regions	1 892 654 207	-44 116 461	-2.33	11.40	2.70	9.45	3.44	-115.7

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

Over 61 percent of the total deficit fell to the share of four entities of the Russian Federation: Moscow with 40,6 percent of the total deficit, or RUR 22.4 billion, the Khanty-Mansi Autonomous Okrug with 9.5 percent or RUR 5.2 billion, Moscow Oblast with 6.1 percent, or RUR 3.4 billion, and Krasnoyarsk Krai with 5.0 percent, or RUR 2.8 billion. Consequently, it is the policy of debt management in Moscow that continues to have the greatest influence over the resulting picture of the balance of the regions' consolidated budget in Russia on the



whole. One year before, in 2001, Moscow implemented the budget with a surplus of RUR 8.9 billion, which accounted for more than 44 percent of the total surplus of the Russian regions' budget.

Changes in the Structure of the Accumulated Debt

In 2002 the accumulated debt of the regions' consolidated budget grew RUR 51.1 billion, or 0.47 percent of the GDP. Practically all of the growth amount resulted from an increase of the internal debt (i.e., the debt nominated in Roubles). The external debt of regional consolidated budgets decreased RUR 4.2 billion and the internal debt grew RUR 55.3 billion.

Alongside with a growth of the debt on securities in the amount of RUR 17.7 billion, the debt on loans from the federal budget and on internal bank lending grew RUR 12.8 billion; the debt on other borrowings, including bank lending, grew RUR 20.1 billion.

The considerable increase in the debt of regional government agencies, supported by a growth in the offer of free credit funds, results from the surplus of the federal budget and lower credit risks. On the one hand, favourable market conditions allow to expand the volume of potentially effective investments into modernisation of public infrastructure facilities; on the other hand, it creates the obvious risks of preserving an inefficient structure of budget expenses coupled with providing funds for investment projects known to bring low returns and realised only in the selfish interests of representatives of regional government agencies.

Interest Expenses

The total interest expenses of regional budgets reached RUR 178.9 billion, or 9.45 percent of the revenue side of the regional consolidated budget. Debt service costs were RUR 14.15 billion, or 0.75 percent of the revenue side of the consolidated budgets. In the Evenki Autonomous Okrug the costs of debt servicing reached a menacing value of 30.05 percent of the total revenues of the consolidated budget (including grants). In all other regions debt service costs did not exceed 3 percent of budgetary revenues.

Structure of Borrowings

In 2002 the total borrowings of the consolidated regional budget were RUR 215.8 billion, including RUR 4.7 billion in external borrowings (received by: St.Petersburg, RUR 4.674 billion, and Kaliningrad, RUR 2.4 million). The total internal borrowings by regions and municipalities were RUR 211.1 billion. The largest borrowers were the Novosibirsk Oblast with RUR 37.3 billion, Moscow with RUR 33.3 billion, the Moscow Oblast with RUR 21.8 billion, St.-Petersburg with RUR 12.5 billion and Krasnoyarsk Krai with RUR 9.0 billion.

The largest net borrowings to budget revenues ratio was observed in the regions with a pronounced budget deficit, namely: the Evenki Autonomous Okrug (in which the amount of net borrowings exceeded the amount of the revenue side of the budget, including transfers from the federal budget) with 85.8 percent, Koryak Autonomous Okrug with 12.1 percent, Novosibirsk Oblast with 10.7 percent and the Republic of Buryatia with 9.1 percent.

The largest net borrowers were: Moscow with RUR 17.5 billion, the Moscow Oblast with RUR 6.5 billion, Krasnodar Krai with RUR 3.7 billion, Novosibirsk Oblast with RUR 2.8 billion, Evenki Autonomous Okrug with RUR 2.0 billion, Khanty-Mansi Autonomous

Okrug with RUR 1.6 billion, Republic of Komi with RUR 1.5 billion, Voronezh Oblast with RUR 1.4 billion and Republic of Sakha (Yakutia) with RUR 1.0 billion.

The following borrowers take first place in reducing the accumulated debt: the Yamal-Nentsi Autonomous Okrug: RUR 2.0 billion; St. Petersburg: RUR 0.7 billion; Tyumen Oblast: RUR 0.5 billion; Leningrad Oblast: RUR 0.5 billion; Tatarstan: RUR 0.4 billion; and, to smaller extents: the Yaroslavl, Ivanovo, Vologda, Pskov, Penza, Saratov, Sverdlovsk and Chelyabinsk Oblasts, the Altai Krai, Republic of Altai, Jewish Autonomous Oblast and Komi-Permyak Autonomous Okrug.

Security issues accounted for 13.8 percent, loans from the federal budget for 11.9 percent and other borrowings (primarily, bank loans) for 74.2 percent in the total internal borrowings of the consolidated budget.

Table 21

Structure of Internal Borrowings by Subnational Budgets in 2002 (percent).

	Year 2002			Year 2001		
	Regional Consolidated Budget	Regional Budgets	Municipal Budgets	Regional Consolidated Budget	Regional Budgets	Municipal Budgets
Total (RUR million)	194 001.7	148 424.1	89 726.2	100 803.9	77 432.0	54 113.2
Security Issues	15.0	19.0	1.1	15.0	18.4	1.7
Loans from the Budget	13.0	17.4	48.5	15.6	20.5	56.5
Other Borrowings	72.0	64.6	51.4	69.4	61.1	41.8

Table 22

S & P International Credit Rating

Russia's Ratings on the International Scale			
Name of Issuer	Date of Assignment (Latest Revision)	In Foreign Currency / Forecast	In Local Currency / Forecast
Sovereign Rating			
Russian Federation	05.12.2002	BB/Stable	BB+/Stable
Ratings of Regions and Municipalities			
Bashkiria	13.11.2001	B/Positive	--/--
Vologda Oblast	04.02.2003	B/Stable	--/--
Irkutsk Oblast	04.10.2002	B-/Positive	--/--
Moscow	06.12.2002	BB/Stable	--/--
Moscow Oblast	24.01.2003	B/Stable	--/--
Nizhny Novgorod Oblast	06.09.1999	Rating withdrawn	
Rostov Oblast	31.07.2000	Rating withdrawn	
Samara Oblast	21.10.2002	B+/Stable	--/--
St. Petersburg	06.12.2002	BB/Stable	BB/Stable
Sverdlovsk Oblast	14.11.2002	B-/Positive	B-/Positive
Surgut	20.12.2002	B/Stable	B/Stable
Tatarstan	09.10.2001	CCC+/Positive	--/--
Khanty-Mansi Autonomous Okrug	20.12.2002	BB-/Stable	--/--
Yamal-Nentsi Autonomous Okrug	22.10.2002	B-/Positive	--/--

Source: Standard & Poor's.

In the course of 2002 the total balances in budget accounts of the regional and local budgets nominally increased only by RUR 5.1 billion (a growth of 8.5 percent), which, in real terms, means a decrease of almost 7 percent. This is explained both by increasing salary expenses in the public sector and by improving financial resource management upon transfer to the treasury system of budget implementation.



Owing to the economic growth, steady debt servicing by the federal government and stable condition of the budget, Standard and Poor's have upgraded the Russian Federation's international rating to BB, which has led to subsequent growth of the credit rating of federation entities that have been servicing their debts on time. (See Table 22).

The upgrading of credit ratings improves the prospects for attracting borrowed assets by subnational government agencies. At the same time, efficient application of the borrowed assets remains a crucial issue.

Internal Bonded Loans

In 2002 bonded loans of 20 RF constituent entities and five municipal entities were registered (compared to 11 regional and three municipal loans in 2001). The issuers were: Moscow, St.-Petersburg, Republic of Karelia, Republic of Bashkiria, Chuvash Republic, Republic of Sakha (Yakutia), Komi Republic, Republic of Mordovia, the Volgograd, Irkutsk, Kostroma, Kursk, Tomsk, Tver, Murmansk, Moscow, Belgorod, Sakhalin Oblasts, the Khabarovsk Krai, Khanty-Mansi Autonomous Okrug, the cities of Ufa, Volgograd, Ekaterinburg, Nizhny Novgorod and Yuzhno-Sakhalinsk (See Table 23).

The largest issuers were as follows: Moscow, RUR 11.85 billion, or 40.7 percent of the total issues of subfederal and municipal securities; St.-Petersburg, RUR 7.86 billion, or 27.0 percent; the Khanty-Mansi Autonomous Okrug, RUR 1.33 billion, or 4.6 percent, and the Republic of Bashkiria, RUR 1.27 billion, or 4.4 percent.

Table 23

Placement of Subfederal and Municipal Securities in 2002

Constituent Entity of the Federation	Amount of Issue (RUR Million)	Amount of Issue to Total Internal Borrowings (percent)	Share in Total Amount of Issue (percent)
Belgorod Oblast	300.0	50.0	1.0
Voronezh Oblast	2.0	0.1	0.0
Kostroma Oblast	3.4	0.6	0.0
Kursk Oblast	95.5	22.2	0.3
Moscow Oblast	2 705.1	12.6	9.3
Tver Oblast	532.6	33.9	1.8
Moscow	11 847.8	35.6	40.7
Republic of Karelia	178.7	16.6	0.6
Komi Republic	836.6	19.3	2.9
Arkhangelsk Oblast	15.0	6.7	0.1
Murmansk Oblast	250.0	13.6	0.9
St.-Petersburg	7 858.8	62.7	27.0
Stavropol Krai	4.8	0.3	0.0
Volgograd Oblast	317.1	14.0	1.1
Republic of Bashkiria	1 270.3	100.0	4.4
Republic of Mari-El	7.9	1.5	0.0
Chuvash Republic	254.0	54.7	0.9
Nizhny Novgorod Oblast	200.0	4.6	0.7
Sverdlovsk Oblast	92.5	10.7	0.3
Khanty-Mansi Autonomous Okrug	1 331.5	25.7	4.6
Yamal-Nentsi Autonomous Okrug	206.8	6.3	0.7
Irkutsk Oblast	257.2	13.7	0.9
Tomsk Oblast	30.2	1.0	0.1
Republic of Sakha (Yakutia)	450.9	13.0	1.5
Sakhalin Oblast	100.0	7.8	0.3
Total	29 141.8	13.8	100.0

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

Borrowings in the form of securities grow more slowly than the total borrowings by cities and regions. While the volume of municipal and subfederal security issues almost doubled, growing from RUR 29.1 billion in 2002 compared with RUR 15.1 billion in 2001, the percentage of securities in the total internal borrowings by cities and regions reduced from 15.0 percent to 13.8 percent, which is far below the market capacity. E.g., the ratio of the current amount of subfederal securities in circulation to the GDP is less than 30 percent of the 1997 level (*See Table 24*).

Table 24

Volume of Subfederal and Municipal Security Issues (percent of GDP)

Year	1996	1997	1998	1999	2000	2001	2002
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10
Net Financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16 ¹⁹

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

It should be noted that there is a negative balance between the number of issuers increasing their debt issued in the form of securities and the number of regions reducing such a debt. Only in 16 constituent entities of the Federation have issuers been able to attract via the market for subfederal and municipal securities the funds exceeding the nominal value of the bonds to be redeemed. These issuers are as follows: Moscow (the amount of borrowings less expenses on repayment of debt on securities was RUR 8.6 billion); the Moscow Oblast, RUR 2.7 billion; St.-Petersburg, RUR 2.5 billion; Khanty-Mansi Autonomous Okrug, RUR 1.3 billion; Republic of Komi, RUR 0.8 billion; the Tver Oblast, RUR 0.5 billion; Republic of Sakha (Yakutia), RUR 0.4 billion; the Murmansk Oblast, RUR 0.3 billion, Belgorod Oblast, RUR 0.3 billion, and others (*See Table 23*).

At the same time, a reduction of the debt granted in the form of securities was observed in 28 regions, including: the Omsk Oblast, RUR 0.2 billion; Volgograd Oblast, RUR 0.1 billion; Novosibirsk Oblast, RUR 0.1 billion. While, owing to the overall growth of borrowings by cities and regions, the prospects for expanding the market for subfederal and municipal bonds are good, the market expansion is contained by a relatively high level of transaction costs related to primary offerings. Therefore, the regions give preference to bank loans, and two thirds of the market fall to the share of Moscow and St.-Petersburg.

Against this background the share of securities placed by municipalities in the total issues by territorial government agencies is continuing to diminish. E.g., in 2001 the percentage of municipal bonds was almost one quarter of the 2000 amount, 5.9 percent compared to 22.6 percent, respectively, of the total issue of subfederal and municipal securities. In 2002 it again reduced to almost a half of the previous amount, falling to 3.3 percent.

¹⁹ The amount of net funding does not equal the difference between the issue and redemption due to approximation error.



Table 25

**Net Borrowings on the Market for Internal Subfederal
and Municipal Securities, RUR thousand**

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
Year 2002			
Net Borrowings	17 696 530	17 153 760	542 770
Attracted Funds	29 141 777	28 169 158	972 619
Repayment of the Principle Amount	11 445 247	11 015 398	429 849
Year 2001			
Net Borrowings	6 601 447	6 667 592	-66 145
Attracted Funds	15 123 785	14 226 931	896 854
Repayment of the Principle Amount	8 522 338	7 559 339	962 999
Year 2000			
Net Borrowings	- 1 877 328	-2 286 175	408 847
Attracted Funds	13 042 220	10 090 208	2 952 012
Repayment of the Principle Amount	14 919 548	12 376 383	2 543 165

Source: RF Ministry of Finance

In the course of the past four years only 25 constituent entities of the Russian Federation and 10 cities have used security market instruments to borrow funds. Moscow, St.-Petersburg, the Republic of Chuvashia, Volgograd Oblast and city of Volgograd have been issuing bonds every year following the crisis, and the Tomsk Oblast, Republic of Komi and city of Ekaterinburg in the course of the past three years (*See Table 26*).

Table 26

Issues of Subfederal and Municipal Securities in 1999 - 2002

Russian Federation Issuers: Con- stituent Entities of the	Date of Registration			
	1999	2000	2001	2002
Moscow	*	*	*	*
St.-Petersburg	*	*	*	*
Republic of Chuvashia	*	*	*	*
Volgograd Oblast.	*	*	*	*
Tomsk Oblast.		*	*	*
Republic of Komi		*	*	*
Republic of Bashkiria			*	*
Leningrad Oblast.			*	*
Irkutsk Oblast.			*	*
Moscow Oblast.				*
Belgorod Oblast.				*
Tver Oblast.				*
Khanty-Mansi Autonomous Okrug				*
Khabarovsk Krai				*
Murmansk Oblast.				*

Table 26 (cont'd)

Russian Federation Issuers: Con- stituent Entities of the	Date of Registration			
	1999	2000	2001	2002
Kostroma Oblast.				*
Republic of Sakha (Yakutia)				*
Republic of Mordovia				*
Kursk Oblast				*
Sakhalin Oblast				*
Stavropol Krai			*	
Primorye Krai		*		
Kabardin-Balkar Republic		*		
Republic of Mari-El		*		
Novosibirsk Oblast.	*			
Municipal Entities				
Volgograd	*	*	*	*
Ekaterinburg		*	*	*
Ufa				*
Nizhny Novgorod				*
Yuzhno-Sakhalinsk				
Novocheboksarsk	*		*	
Kostroma	*	*		
Cheboksary	*			
Arkhangelsk	*			
Dzerzhinsky	*			

Source: RF Ministry of Finance

In December, 2002, Standard & Poor's upgraded the ratings of Moscow and St.-Petersburg to BB, practically simultaneously with the rating of the Russian Federation; thus, these ratings have exceeded the pre-crisis level of BB- (1997) and, as before, correspond with the sovereign rating (*See Table 22 above*).

It should be noted that, in the period from February to December, 2002, both the sovereign rating and the rating of Moscow and St.-Petersburg jumped two levels at one stroke (starting from B+), and now there remain only two steps to the investment-level rating of BBB-, which makes it possible to attract funds from the largest foreign institutional investors.

Despite the relatively high rating of some federation entities, the problems of restructuring past-due debts on a number of previously issued subfederal securities still remain to be solved. E.g., according to Rosbank's depository, as at 1 November, 2002, 19 constituent entities of the Federation did not even begin their payments under the 3rd tranche of the 'agricultural' bonds²⁰ due as long ago as 2000 - 2001 (*See Table 27*). Other regions have redeemed their agricultural bonds only partially.

It is noteworthy that the available funds in accounts of those regions that have past-due debts on the 'agricultural' bonds are sufficient to redeem the bonds. E.g., as at the end of 2002 the amount of all three tranches of the unredeemed agricultural securities issued by the Arkhangelsk Oblast was RUR 52.27 million, and the balances in the Oblast's budget accounts were RUR 168.0 million. The situation is similar in the Kostroma Oblast: the amount of three tranches of agricultural bonds that have not been redeemed at least partially is RUR 22.08 million, and the amount of budgetary balances is RUR 98.7 million.

²⁰ Agricultural bonds were issued in accordance with Resolution of the RF Government No. 224 of 26 February, 1997, "On Economic Conditions of the Functioning of the Agroindustrial Complex in 1997".



Thus, even if one considers the necessity for these regions to pay the interest income due in the amount of 10 percent p.a., the refusal by many regions to redeem their bonds at least partially testifies to the weakness of enforcement in respect of borrowings by subfederal level government agencies.

Table 27

**Constituent Entities of the Russian Federation that Have Not Started
to Redeem the Nominal Value of the Third Tranche of their 'Agricultural'
Bonds (as at 01 November, 2002)**

Komi-Permyak Autonomous Okrug, Taimyr Autonomous Okrug, Republic of Tyva, Republic North Ossetia - Alania, Ulyanovsk Oblast, Primorye Krai, Kurgan Oblast, Pskov Oblast, Republic of Adygeya, Kabardin-Balkar Republic, Republic of Altai, Novosibirsk Oblast, Evenki Autonomous Okrug, Belgorod Oblast, Arkhangelsk Oblast, Kursk Oblast, Kostroma Oblast
--

Source: Rosbank Depositary

**The Issues of Improving Legislative Regulation of the Market
for Subfederal and Municipal Loans**

Development of the market for subfederal and municipal securities is related to two issues; their solution will determine further directions and dynamics of the market's development.

Issue No. One relates to the remaining relatively high level of credit risk on the liabilities of cities and regions.

On the one hand, this is determined by objective reasons. These include unstable municipal entities' revenues from regulated taxes; the authorities of constituent entities of the Russian Federation have a right to redistribute these taxes between municipalities as often as they like and to a very large extent.

At the same time, the amount of expense liabilities of the federal constituent entities and municipal entities remains undefined. E.g., federal government agencies still apply the practice of establishing the so-called 'non-funded mandates'. As a result, a territorial government agency's wish to repay its debts on time may contradict the demand by federal authorities – just as binding – to increase social expenses (e.g., in respect of increasing salary to public sector workers).²¹

On the other hand, there is a risk that the borrower would act in irresponsible, 'opportunistic' manner. The history of the market for 'agricultural' bonds has demonstrated that, due to lack of the mechanism of compulsory collection (restructuring) of past-due debts of federal and municipal entities an investor may spend an indefinite time on unsuccessfully trying to realise its right to collect the debt through the court, even if the respective court ruling has been positive and the region has got the necessary funds.

However, even subject to full realisation of the reform of interbudgetary relationship aimed at balancing and strengthening the regional government agencies' power over the ex-

²¹ The reform of salaries in the public sector related to abolition of the single tariff scale implies granting greater rights to regions in respect of establishing the salary amount.

penses and revenues²², and to formation of a working normative base for collecting past-due debts, the extremely important issue of *efficient* application of the attracted funds remains a priority both for creditors and taxpayers.

Due to low transparency and efficiency of the system of budget expenses, including budgetary investments, the risk of inefficient application of budget funds is too great. In this connection one understands the requirements of the Budget Code that has introduced strict constraints on borrowings by regions and municipalities, relating them to the amount of their revenues, and has almost banned any external borrowings.

At the same time, against a background of low real interest rates in the internal market, the need for investments in the territorial social and economic infrastructure (road building, modernisation of the housing and communal services infrastructure, etc.) makes it necessary to analyse the possibility of changing the market regulation priorities.

Budgetary planning, budget implementation and control remain the main means of fighting inefficient application of borrowed funds; this is true first of all for capital expenditure and government purchases, and, besides, for the modernisation the system of funding housing and communal services that is one of the largest (12.9 percent of the regions' consolidated budget) and least efficient items of expenditure in territorial budgets.

It is obviously impractical to support debt increases by the territorial budgets that 'have a hole' on the expense side. It would be expedient to considerably reduce limitations on territorial borrowings only upon increasing the efficiency of budgetary policy related to expenses and implementing structural reforms at the regional and municipal levels.

Against this background one could propose a plan implying that the regions and municipalities, which have adopted and realised a programme of budgetary finance restructuring, would be granted a right to borrow in excess (to a certain extent) of the current limitations and to issue external loans²³.

2.4.3. The Stock Market

In 2002, despite persisting negative trends, the Russian stock market again demonstrated steady growth. Insignificant economic growth rates in the USA, Japan and the European Union, financial and political crises in a number of developing countries (e.g., Argentina and Venezuela) could not make investors any more optimistic, either. Among the factors that have supported the Russian stock market one should note high prices in the oil market, the continuing growth of the Russian economy, on-time external debt payments, recognition of Russia as a market economy and its exclusion from the FATF blacklist. Further steps aimed at reforming the Russian legislation in accordance with the requirements of the market economy have without doubt attracted investors to the Russian market. However, one cannot help noting a number of negative factors. Lack of considerable structural changes in the economy (such as reforms of natural monopolies and the housing and communal services, public service, banking and stock markets), frequent cases of opacity of corporate and financial management systems, significant influence of the so-called 'political factors' in solving economic disputes has impeded the normal functioning of the market of corporate securities.

²² The Programme of Budget Federalism Development in the RF for the Period up to 2005. Approved by Resolution of the RF Government No. 584 of 15 August, 2001.

²³ The formalised criteria used in selecting the regions applying for funds from the Fund for the Reform of Regional Finances may be used as a basis for developing the methodology for determining the region complying with the conditions for abating limitations on the size of borrowings.

In 2002 the Russian stock market demonstrated excellent results compared with other markets. Consequently, the Morgan Stanley index calculated for the Russian market (MSCLRU) grew 16.2 percent during the year, while the similar index for emerging markets (MSCLEMGLF) dropped 7.97 percent and the world index dropped 16.94 percent. In Quarter One of the current year the RTS index retained its second position in the list of the fastest growing stock indices of the world published by Merrill Lynch, with only Merval (Argentina) in front of it. During the year the Russian stock indicator became more than one third heavier (38.07 percent); compare with the indices of other emerging markets: Bovespa (-24.22 percent); IPSA (-25.11 percent); IPC (-10.03 percent); KOSPI (-0.12 percent); Strait Times (-12.45 percent); and the indices of developed countries: DJIA (-13.14 percent); NASDAQ (-26.09 percent); NIKKEI (-16.79 percent); DAX (-35.64 percent).

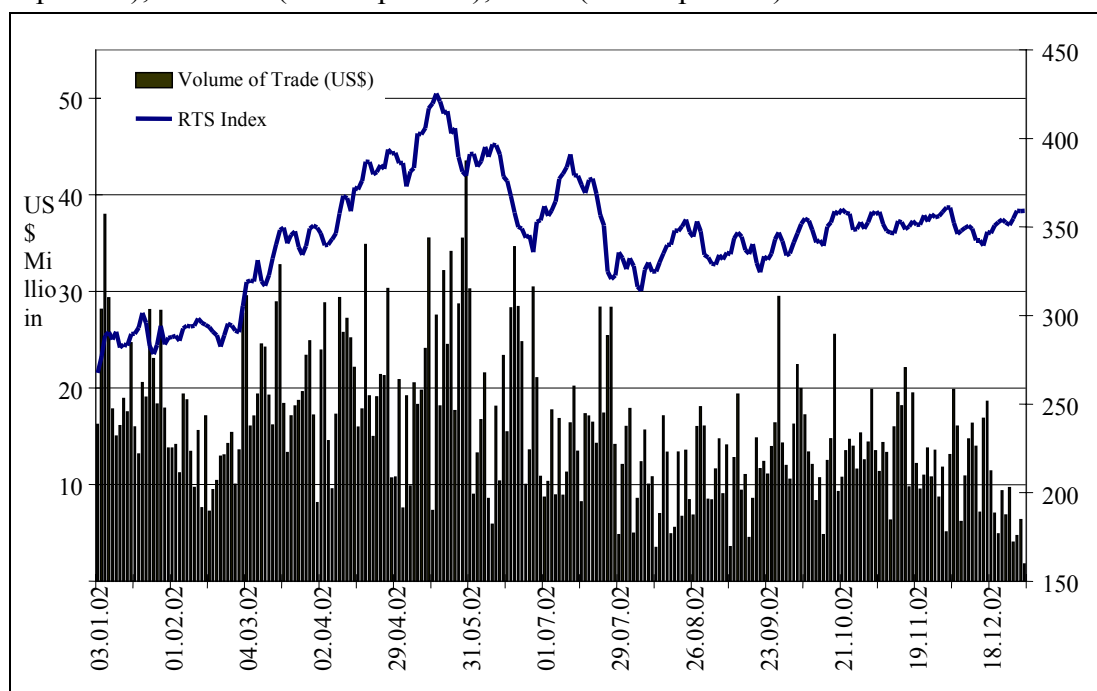


Fig. 30. Dynamics of the Russian Stock Market

During the year the RTS index grew 101.1 points (38.88 percent), and the trade volume was cca. US\$ 3.8 billion. It should be noted that, compared to last year, it has remained practically unchanged. In describing the RTS index dynamics several periods could be pointed out. In January the stock index grew 10.57 percent and the trade volume grew 51.48 percent. In February the stock indicator remained practically unchanged (1.12 percent) and the trade volume fell 41.12 percent. Then a growth followed until mid-May. On 20 May the market reached a new historic high: 425.43²⁴ points with the trade volume of cca. US\$ 450 million during that month. It should be noted that on 30 May, 2002, the turnover was US\$ 43.5 million, the highest value of the day in that year. In mid-May a recession began that lasted until 26 June, when the index dropped 89.54 points down to the value of 335.89 points. Then a new "increase-decrease" cycle followed: by 10 July the RTS index grew up to 391.17, and by 6 August the index fell to the levels observed in March: 313.99 points. In August market participants were traditionally inert: the trade volume was the least, US\$ 239 million, and on 12

²⁴ The maximum value since 6 November, 1997.

August the turnover hit the year's lowest value of US\$ 3.49 million. A slow growing trend was observed in the market until late November, and by 29 November the index grew up to 361.15 points. A greater index growth was prevented by the fact that the consideration of the key legislation on reforms in the Russian power industry was postponed until next year and by alarming rumours pertaining to Gazprom's capability to service its enormous debt. By the end of the year the index somewhat decreased; on 31 December it was 359.07 points.

During the year almost all of Russian 'blue chips' (with the exception of the companies in the power sector) demonstrated positive dynamics. Last year's growth leaders demonstrated excellent results this year as well. Income leaders were the shares of Sibneft (176.10 percent), Sberbank (159.71 percent) and Yukos (74.04 percent). The shares that changed to a lesser degree in value were: Tatneft (46.55 percent); Lukoil (36.80 percent); Rostelekom (35.69 percent) and MMC Norilsk Nickel (21.97 percent). As we have already mentioned, quotations of power sector companies diminished in value during the year: Mosenergo, -17.07 percent, and RAO UES of Russia, -20.87 percent. In the 'second tier' the maximum growth was demonstrated by privileged shares of Rosneft-Stavropolneftegas (1587.50 percent), ordinary shares of Rosneft-Stavropolneftegas (863.86 percent) and privileged shares of Tverenergo (548.15 percent); however, the trade activity was very low: only three deals have been struck with each of the aforementioned securities during 2002. One should also note privileged shares of Krasnoyarskenergo (185.91 percent), Slavneft-Megionneftegaz (144.1 percent) and ordinary shares of Orenburgneft (104.94 percent), the Chelyabinsk Tube Works (103.90 percent) and Slavneft-Megionneftegaz (103.22 percent). AvtoVAZ, last year's growth leader, grew only 46.99 percent in 2002.

The percentage of RAO UES's ordinary shares in the total turnover of RTS slightly decreased to 26.3 percent as compared to 32.86 percent in 2001; Lukoil's share grew up to 19.31 percent (16.65 percent); that of Surgutneftegas reached 10.65 percent (9.02 percent). Yukos that so rapidly entered the top five last year, retained its positions this year, growing up to 10.41 percent (13.2 percent); and OAO Tatneft grew 5.51 percent (5.06 percent). Thus, in 2002 the securities of the five issuers accounted for 72.18 percent of RTS's total turnover (in 2001: 76.91 percent).

In 2002 the volume of trade in Gazprom shares carried out via RTS terminals at the St.-Petersburg Stock Exchange amounted to approximately US\$ 1.01 billion (cca. 1.22 billion shares); a total of 111.9 thousand deals with the gas concern's shares have been concluded. The value of the gas concern's securities grew 46.8 percent.

The largest number of deals, cca. 11.4 thousand, have been noted for the securities of RAO UES circulating in the RTS; Lukoil followed these with 6.2 thousand.

According to RTS, at the end of December the five Russian companies leading by capitalisation changed compared to 2001. Oil Company OAO Yukos took the top position (US\$ 21,038 million); OAO Gazprom (US\$ 18,039 million) and OAO Lukoil (US\$ 13,099 million) followed. Surgutneftegas, last year's capitalisation leader, came only the fourth (US\$ 11,409 million), and OAO Sibneft brings up the rear (US\$ 10,478 million). It should also be noted that the share of oil companies in the total RTS capitalisation is cca. 60 percent. The fact that all largest Russian companies belong to the oil and gas sector testifies to the remaining structural distortions in the Russian economy and its orientation toward exporting raw materials. Let us compare: OAO Sberbank, the capitalisation leader among the companies not belonging to the oil and gas sector or power sector, has US\$ 3.629 billion; OAO Rostelekom has the



lowest aggregate value (US\$ 870 million) among the blue chips, and the total capitalisation share of blue chips in the total RTS capitalisation is cca. 78 percent.

To explain the above-mentioned dynamics of Russian security quotations, let us examine in greater detail the following groups of factors:

- ☐ internal political situation;
- ☐ relationship with international financial organisations;
- ☐ situation in international financial markets;
- ☐ FORTS market of term contacts;
- ☐ corporate news; and
- ☐ dynamics of oil prices in the world's markets.

We will examine the first five factor groups in this section. The last (but not least) factor, the dynamics of oil prices in the world's markets, has been surveyed comprehensively in the section "The Macrostructure for Preparation of this Survey"²⁵.

Internal Political Situation

It is important to note that the strengthening of political stability in Russia, the Government's steady economic policy and adoption of a number of key legislative acts by the legislative authorities have played a positive role in the successful growth of the Russian economy on the whole and the stock markets in particular. These factors have resulted in greater appeal of the Russian economy both for domestic and foreign investors. On 13 September the State Duma of the Russian Federation adopted in the third hearing amendments to the Federal Law "On the Stock Market". The new edition of the Law is aimed at making the Russian stock market more transparent. We would like to note that a notion of price manipulation has been introduced in the Law, which enables to protect the market from such schemes. Furthermore, the Law now contains tougher requirements to the contents of the prospectus and the issuer's quarterly report.

Relationship with International Financial Organisations

The Government has been servicing the external debt according to the payment schedule and in full. A total of US\$ 12.5 billion have been paid to creditor nations, banks, companies and international organisations and as interest on Eurobonds (including: US\$ 6.2 billion as the principal and US\$ 6.3 billion as interest). In 2003 the payments on external debt will amount to US\$ 17.3 billion.

On 15 November, 2002, Mikhail Kasyanov, the Chairman of the RF Government, signed a Decree "On Introducing Changes in the Financial Terms and Conditions of Exchanging the Debt of the Former USSR Approved in Decree of the RF Government No. 931 of 29 December, 2001 "On Regulating the Commercial Debt of the Former USSR to Foreign Commercial Creditors".

Last year Russia was excluded from the blacklist of the countries that are not active enough in preventing money laundering. Russia was included in that list in June, 2000, since it had no laws on preventing the legalisation of criminal incomes. Since that time the Russian Federation entered the international convention, passed a law on prevention of criminal income legalisation, established an authorised body, the Committee for Financial Monitoring,

²⁵ Макроструктура производства настоящего обзора

created a system for fighting the laundering of dirty money and was admitted into Egmont Group – the association of international financial intelligence services.

The upgrading of the Russian Federation's sovereign ratings reflects the positive changes in the Russian economy and the rating agencies' growing confidence in Russia's ability to ensure the servicing and repayment of the government's external debt in 2003 even in the event of a sharp drop in prices for energy carriers.

On 2 May, 2002, FITCH IBCA upgraded the long-term rating of the Russian Federation on borrowings in foreign and domestic currencies to BB-; the forecast for long-term ratings has been upgraded from stable to positive. The short-term rating has been confirmed on the B level.

In December international rating agencies upgraded sovereign ratings of the Russian Federation. On 5 December Standard & Poor's announced that it upgraded Russia's long-term ratings from BB- to BB+ on the liabilities in the national currency, and from BB- to BB on the liabilities in foreign currency on the international scale. Thus, the appraisals of the Russian economy have drawn near the investment rating that starts from BBB on the S&P scale. Russia's rating on the national scale has been confirmed on the ruAA+ level. The agency's analysts note that the reasonable tax policy and improving debt management system make it impossible to return to a large budget deficit even in case of cuts in oil prices. The new management of the Central Bank of Russia has promoted banking reform. Still, S&P does not intend to upgrade the ratings of RF any further due to forthcoming parliamentary elections in late summer and the related slowing down of structural economic reforms.

On 17 December, Moody's Investors Service also upgraded Russian foreign currency liabilities from Ba3 to Ba2. The revision was based on the assessment of Russia's financial and macroeconomic indicators and on the data about on-going structural reforms, in particular, the reforms of natural monopolies.

Situation in International Currency Markets

In contrast to the Russian market, the situation in the largest international markets was not as favourable. Following 11 September, a series of corporate scandals related to forged financial reporting by leading US companies swept over the USA, which affected investor confidence negatively.

By early July Dow Jones and NASDAQ fell below 8000 and 1300, respectively. At the end of June, pressed by negative news from international markets, quotations of Russian shares that had been demonstrating enviable stability throughout the period also experienced a sharp drop. Some European indices fell to 1997 levels. In order to stabilise the situation, the two Chambers of the US Congress approved a new law aimed at fighting corporate fraud. Investors have found this news, and positive financial reports of a number of large corporations, such as 3M, McDonald's, DuPont, very positive. On 24 July, the closing values of the leading indices grew sharply: the Dow increased 6.4 percent; NASDAQ grew 5 percent, and S&P's grew 5.7 percent.

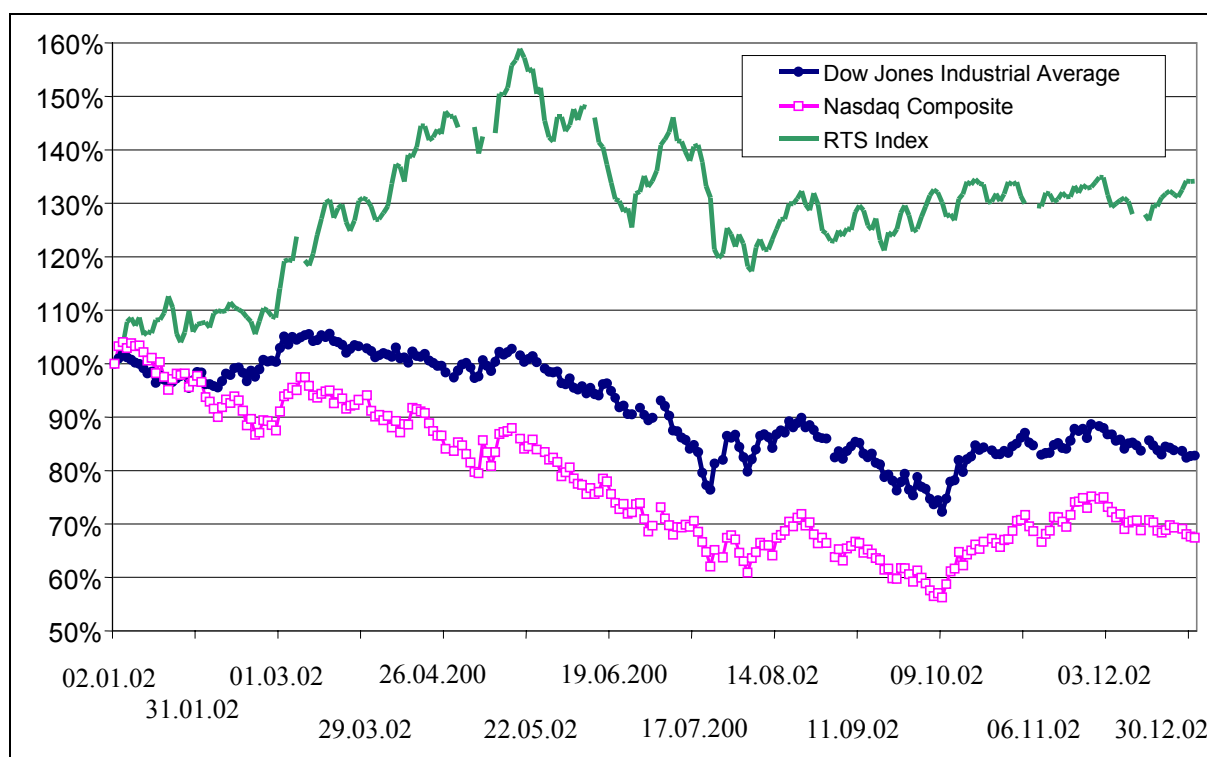


Fig. 31

However, the player's optimism did not last long, and a recession on the largest international trade floors continued until the first half of October. DJ's resulting values in Quarter 3 were the weakest since 1987 (-17 percent), and NASDAQ lost cca. 20 percent. In the course of the trade session on 9 October the Dow fell to the level of 1997 (7286.27), and NASDAQ, to the level of 1996 (1114.11). Such dynamics resulted from negative corporate news and the uncertainty in respect of military actions against Iraq. However, by the end of the month the US stock indices partially regained the lost positions. By 23 October DJ and NASDAQ had grown to 8494,27 (+16.6 percent growth from the minimum level) and 1320.23 (+18.5 percent), respectively. On the whole, DJ grew 11.89 percent and NASDAQ 12.64 percent during the month. The increase in asset quotation was above all brought about by positive financial reports by the largest corporations. E.g., the performance of Yahoo!, the insurance company Aetna, IBM, Microsoft and Citicorp exceeded experts' forecast and General Electric, the world's capitalisation leader, completed the quarter according to the experts' expectations. Performance of the largest companies was better than the respective forecast, which allows to assume that the period of recession in corporate revenues is nearing its end.

Despite the alarming situation in the US economy, the US Federal Reserve has kept its interest rate at 1.75% in the course of almost the entire year; only on 6 November the US did the Fed Open Market Committee announce a reduction of the discount rate by 50 percentage points at one stroke (forecast: 25 points). On the one hand, the US Fed's management admitted that its previous steps aimed at bringing the economy out of the recession were not efficient enough, but, on the other hand, it demonstrated its determination to bring the economy out of the crisis by any available means. The US stock market reacted by increasing stock indices because a reduction of the discount rate will lead to growing consumption and invest-

ment volumes. Moreover, good reports of HP and General Electric also influenced the growth of the US indices. As at 22 November DJIA grew more than 20 percent compared to the historic minimum of 09 October, and NASDAQ, more than 31 percent. However, by the end of the year DJIA and NASDAQ had again dropped, reaching by 31 December 8341.63 and 1335.51 points, respectively.

In December 2002, the European Central Bank, for the first time since November 2001, lowered the discount rate 0.5 percent to the level of 2.75 percent. The US Fed left the key rate at 1.25 percent – the lowest level in the past 41 years. In its statement the FOMC noted that the risk of inflation increase and the risk of a further weakening of the economy are equally possible. The Bank of England has also decided to leave the discount rate unchanged at the level of 4 percent.

In Asia the situation in stock markets could not fill one with optimism, either. The growth in problem loans in Japan poses a real threat of bankruptcy for many large credit institutions. The value of NIKKEI-225 fell to its 19-year minimum.

The Market for Term Contracts

On 19 September, 2002, a year passed since the beginning of trade in the FORTS market for term contracts. During the period, turnover in this segment of the stock market exceeded RUR 70 billion; market participants concluded cca. 420 thousand deals and the monthly growth rate of trade volume was cca. 30 percent.

On the whole, in 2002 participants of the term contract market concluded 546 thousand deals for RUR 94.9 billion (22 million contracts). The average daily volume of trade increased 3.45 times compared to 2001 up to RUR 378 million, or 3.1 times in terms of concluded contracts, which amounts to 87.5 thousand contracts per day. Activity of the participants almost tripled, growing to 2168 deals per day, compared to 746 deals in 2001. At the end of the period, on 31 December, the total open positions on standard contracts reached RUR 1.191 billion, or 292 thousand contracts, growing 2.3 times in Rouble terms and 3.5 times in contract terms (as at 29 December, 2001: RUR 514 million and 83 thousand contracts).

By the end of 2002 the FORTS market had reached new levels. On 26 November the trade volume was RUR 795.47 million (188.5 thousand contracts, 3785 deals), which is the highest figure in the market's history.

On 16 September, 2002, September futures contracts totalling cca. RUR 194 million were executed. The highest execution volume in the floor's history, RUR 74.98 million, was registered on the futures contract on the price of OAO Lukoil shares.

On 15 December, 2002, December futures contracts totalling RUR 209 million were executed. The greatest amount of contracts presented for execution, 20,896 contracts totalling RUR 88 million, fell on the futures contract on the price of shares RAO UES of Russia (EESI: 12.02).

Corporate News

In 2002 the largest international rating agencies assigned new ratings and upgraded old ratings of Russian companies, thus noting positive changes in their performance. E.g., S&P's upgraded the corporate governance rating of the telecommunications operator OAO North-west Telecom from 5.0 to 5.6. However, the practice of corporate governance is characterised



by negative features related to the increased influence exerted by a single majority shareholder and its dominating role in the decision-making process, and also due to underdeveloped independent control mechanisms.

S&P's also assigned a corporate governance rating of 6.0 to another telecom operator, OAO Uralsviazinform.

OAO Mobile Telesystems has the highest rating among Russian companies: 7.4. In its reports the rating agency notes that, compared to the majority of Russian companies, MTS has high corporate governance standards that conforms with the practice accepted in the leading international companies. Such corporate governance policy is a result of observation of the requirements posed by SEC to the companies whose shares are listed at NYSE.

Standard & Poor's upgraded Tatneft's rating from stable to positive and confirmed the company's long-term rating at the B- level. The company's rating reflects its considerable exports, reasonable financial policy, significant assets and the insufficient diversification of operations, shortage of processing facilities, delays in the development of the main fields, high levels of short-term debts and influence of the Tartar Republic's government. S&P's has also noted the success of Russia's sixth largest oil company OAO Sibneft, assigning it a B+ long-term credit rating, forecast: developing. Standard & Poor's also assigned Sibneft a credit rating on the national scale at the level of ruAA.

Standard & Poor's has also upgraded Lukoil's long-term credit ratings from BB- to B+. The upgrading is explained by the company's leadership in the amounts of reserves, production and exports in Russia. The limiting factors include a high level of mid-stream costs and a considerable debt.

S & P's have upgraded the ratings for six Russian banks, which reflects the improving economic situation in Russia.

In November RAO UES published its financial results for the current year. According to the Russian accounting standards, the energy holding net income for 9 months grew to RUR 39.98 billion, and the IAS net income grew to RUR 17.8 billion. According to the statement by V. Sinyugin, Chairman of the Board of Directors, made during his meeting with investors in Boston, the corporation also intended to increase dividend payments approximately two times.

During eight months of 2002 Surgutneftegas produced 32.15 million tons of oil, which is 11.7 percent over last year's level. Gas production reached 8.7 billion cubic meters. The drill meterage grew to almost two million meters, or 13 percent more than in the corresponding period of 2001 (including the growth in exploration drilling by 9 percent, or 191 thousand meters). 613 new wells were commissioned. OAO Surgutneftegas was licensed to explore and develop the Severo-Labatyugansk area. According to the current legislation, the company received the license upon exploration work on risk conditions, without any bidding.

Sberbank presented its RAS financial report for Quarter 3 of 2002. The net income grew 95 percent up to RUR 28.7 billion compared to last year. Besides, according to the bank's officials, the income for 2002 can reach RUR 30 billion, which exceeds the previous forecast of RUR 27.2 billion, and the dividends can double.

US GAAP earnings of Sibneft from January till June 2002 grew 19 percent, reaching US\$ 1.984 billion (US\$ 1.663 billion in the corresponding period of 2001). The EBITDA were US\$ 786.1 million (US\$ 870.5 million in the corresponding period of 2001). Net income fell from US\$ 615.8 million in the first six months of 2001 to US\$ 457.5 million.

In 2002 Russian companies pursued the policy aimed at acquisition of new assets, including foreign assets, and establishing long-term partnership relations.

MMC Norilsk Nickel acquired 100 percent of the largest Russian gold producing company Polyus. In 2002 the company plans to produce 25 tons of gold, which will bring it earnings of cca. US\$ 250 million and a profit of cca. US\$ 75 million. The MMC paid US\$ 226 million in cash for 100 percent of Polyus's shares. In addition to purchasing domestic assets, Norilsk Nickel is actively operating abroad: MMC is buying a controlling block of Stillwater Mining Company, the only US producer of platinum group metals, for US\$ 341 million; US\$ 100 million will be paid in cash and the remaining US\$ 241 million in 876,000 ounces of palladium.

The trading company Norimet, Ltd., a full subsidiary of the MMC, has entered into a long-term contract with General Motors on delivering platinum group metals. Since the beginning of 2002 Norilsk Nickel has not been delivering platinoids to the international market, and the conclusion of a contracts with a leading US company gives hope for the improvement of the metal holding's overall performance.

Russian companies continue to enter international markets and take active measures aimed at improving their image with foreign investors.

After the Securities and Exchange Commission toughened its requirements to financial reports of the companies whose shares are traded in the USA, on 4 September Rostelekom announced it would revise its financial accounts for 2001 due to the situation with its former auditor Arthur Andersen. As a result of a second audit carried out by Ernst & Young a number of financial performance indicators were reduced. However, the company must have only gained from this action since it has demonstrated the business community a responsible approach to the issuer's financial information.

The UK Listing Authority included the company's securities in the official list; thus Lukoil obtained a full secondary listing at the London Stock Exchange. All ordinary shares and Level 1 ADRs of the company have been listed. The shares will trade in the form of ADRs. On 6 August the ADRs started to trade at US\$ 55 per ADR. As the first Russian company to receive a full secondary listing, Lukoil will be subject to more onerous requirements than those, which currently apply to it as an issuer of securities. The new requirements imply more detailed disclosure of information on the operations of the Lukoil group and regular reporting to the holders of its securities.

In early February Wimm-Bill-Dann Foods OJSC, Russia's leading producer of dairy and juices, completed an IPO of American Depositary Shares. The company floated 10,62 million ADSs at a price of US\$ 19.50 per share totalling US\$ 207.1 million. The demand exceeded the offer five times. Thus, US investors valued the company's market capitalisation at US\$ 828.4 million. This is the first large listing by a Russian company operating in the market of the basic consumer products. ADSs of only four Russian companies traded at NYSE until recently, three of them in the telecom sector – Vimpelcom, Rostelekom and MTS – and Tatneft. Undoubtedly, the successful placement of WBD's American Depositary Shares has positively influenced the dynamics of the Russian market and allows to hope for inflow of investments into other national issuers' shares.

Lukoil's President Vagit Alekperov, President of OAO Sibneft Yevgeni Shvidler, Executive Director of OAO TNK German Khan and Chairman of the Board of Directors Mikhail Khodorkhovski have signed a "Memorandum on Mutual Understanding on the Issue of Constructing an Oil Pipe-line System for the Transportation of Oil through an Offshore Oil-



Loading Terminal in the Murmansk Area". The construction of the Murmansk oil pipeline is the first Russian joint project in the field of hydrocarbon raw material transportation carried out by the largest national oil companies. The parties have agreed to develop a co-ordinated version of a Declaration of Intent on the Project as soon as possible. After that they will decide on further projections, select the best route for the pipeline, co-ordinate the main requirements to pipeline facilities and prepare a detailed schedule of project realisation.

In December one of the key events was the auction, in which the RF Government sold its block of shares of the Oil and Gas Company Slavneft. Before the beginning of the auction representatives of the RF Accounting Chamber estimated the selling price of the 74.95 per cent block of Slavneft shares at US\$ 3 to 3.2 billion. However, on 18 December, in the course of the auction the oil company was sold to TNK and Sibneft for a far smaller amount of US\$ 1.86 billion. According to A. Kudrin, Minister of Finance of the RF, privatisation of the Government's block of Lukoil and Slavneft shares allowed to create a necessary financial reserve.

However, this acquisition worsened the financial state of both companies, resulting in downgrading of their ratings by the largest agencies. E.g., Standard & Poor's revised Sibneft's rating from developing to negative and excluded TNK from the CreditWatch list where it had been put in December 2002 with positive forecast. Sibneft's rating on the national scale was downgraded from ruAA to ruA+.

Appendix 2. A Review of Changes in the Legislation Regulating Taxation Issues in the Russian Federation

Changes in the Legislation Approved in the End of 2001 and Enacted in 2002

Federal Laws

Federal law No. 179-FZ of December 28, 2001, amended Articles 149 and 164 of the RF Tax Code concerning the introduction of VAT at the rate of 10 per cent in relation to medicines (including medicinal substances, among them those produced in pharmacies), products intended for medicinal purposes, as well as periodicals (except periodicals of advertising or erotic nature).

Federal law No. 187-FZ of December 29, 2001, amended Section 2 of the RF Tax Code and other legislative acts concerning taxes and charges. The RF Tax Code was supplemented with subsection VII.1 "Special tax regimes. The system of taxation of agricultural producers (the single agricultural tax)."

The single agricultural tax (SAT) shall be enacted by a law of a subject of the Russian Federation introducing this tax. Organizations, farms, and individual entrepreneurs shall become subjects of SAT not depending on the number of employed.

The object of taxation shall be the area of agricultural lands owned, tenured, and (or) used. The SAT tax base shall be the area of agricultural lands comparable in terms of the cadastral value defined in accordance with the methods set forth and approved by the Government of the Russian Federation.

Transition to SAT shall be carried out on condition that a share of proceeds from sales of agricultural produce from the farm lands made not less than 70 % of the total proceeds in the preceding calendar year and shall mean that this tax replaces all taxes and charges payable

in accordance with Articles 13, 14, and 15 of the Code, with the exception of the following taxes and charges:

- 1) value added tax;
- 2) excises;
- 3) charges for abuse of the environment;
- 4) tax on purchase of foreign currency and payment documents denominated in foreign currency;
- 5) state duty;
- 6) custom duty;
- 7) tax on property owned by individuals (as concerns residential buildings, facilities, and structures owned by individual entrepreneurs);
- 8) tax on property transferred as succession or gift;
- 9) license charges;
- 10) insurance fees related to mandatory pension insurance (shall be paid in accordance with the legislation of the Russian Federation on pension security).

The definition of agricultural producers shall exclude agricultural organizations of industrial type (poultry plants, greenhouse integrated works, state fur farms, animal industry agri-businesses, etc.), as determined in accordance with the list approved by the legislative (representative) authorities of RF subjects in order prescribed by the Government of the Russian Federation.

The tax period of this tax shall be one quarter. The tax rate shall be determined in Rubles and kopecks in relation to one hectare of farm lands. It is also stipulated that the substitution of several taxes with one is not the introduction of a new tax, but a special regime.

Federal law No. 190 FZ of December 29, 2001, amended the RF law "On Customs Tariff" and the second section of the RF Tax Code.

The law stipulates the procedures governing the determination of export duties on crude oil. For instance, according to the law, the Government of the Russian Federation shall monitor the prices of Urals crude oil on world markets of oil raw materials (Mediterranean and Rotterdam) aiming at the determination of the average price over the period of monitoring (2 months).

The rates of the export duties shall be introduced by the RF Government for 2 calendar months and shall be below the amount of the maximal duty rate calculated as follows:

In the case the average price of Urals crude oil was below US \$ 109.5 per metric ton (inclusive) over the period of the monitoring the rate shall be 0 per cent;

In the case the price was US \$ 109.5 to 182.5 per metric ton – 35 % of the difference;

In the case the price was above US \$ 182.5 per metric ton the duty shall be below US 25.53 and 40 % of the excess over US \$ 182.5.

Federal law No. 195 FZ of December 30, 2001, enacted the RF Code of Administrative Offences (CAO RF).

The Code regulates issues relating to administrative fines imposed for defaults on taxes (charges). According to Article 3, an administrative fine is a pecuniary penalty and its amount may be set forth in multiples of unpaid taxes and charges. The amount of an administrative fine calculated proceeding from the amount of unpaid taxes and charges shall not exceed the triple value of the respective object, or the amount of unpaid taxes and charges.

Article 15 stipulates the amounts of fines imposed on public officials for infringements upon financial legislation (tax, banking legislation, laws concerning accounting and reporting,



as well as legislation relating to the stock market). The law sets forth concrete amounts of fines for infringements upon the tax legislation, including the failure to register for tax purposes, untimely tax registration, failure to timely submit information about opening or closing of an account with a bank or another credit organization, etc. to tax authorities or an agency of a state extra-budgetary fund. The same article sets forth administrative fines imposed on bank officials for failures to execute their duties relating to keep taxpayers' accounts, etc. Article 16 stipulates fines for administrative violations of customs regulations. Articles 23 and 28 set forth the procedures governing the consideration of administrative offences by tax authorities, federal agencies of tax police, and customs authorities.

Federal law No. 198-FZ of December 31, 2001, amended the RF Tax Code and certain other legislative acts concerning taxes and charges. The law more precisely formulates a number of key provisions of the RF Tax Code Article 24 "Single Social Tax" in particular those concerning the definition of the taxpayer, the object of taxation (integrated with Articles "Profit Tax" and "Income Tax on Individuals," the procedure governing determination of the taxable base), and the tax base.

As concerns individual entrepreneurs subject to the simplified system of taxation, the tax base is defined as the product of gross proceeds and coefficient 0.1.

There were more precisely defined the rules concerning the implementation of the descending tax scale. In the case at the moment the advance payment is made the average amount of tax base accumulated since the beginning of the year per individual divided by the number of preceding months in the current tax period makes less than Rub. 2500, the tax shall be paid at its maximal rate independently of the actual amount of the tax base per individual. Such taxpayers shall not have the right to use the descending tax scale until the end of the tax period.

The calculation of the amount of the average tax base per employee for taxpayers employing more than 30 persons shall not take into account payments to 10 of the employees per cent with largest incomes, while for taxpayers employing less than 30 persons (inclusive) – payments to 30 per cent of employees with largest incomes.

The calculation of the average tax base per employee shall be based on the average number of employees.

In order to calculate the amount of tax (advance tax payment) the applicable rates of the tax due to the federal budget shall be reduced by the tariff rate of the mandatory pension insurance charges due to the Pension Fund of the Russian Federation.

The RF Ministry of Defense, the RF Ministry of Interior, and a number of other agencies shall be exempt from this tax.

Governmental Resolutions

Resolution of the RF Government No. 915 of December 29, 2001, sets forth rates of the advance payments made in relation to the purchase of regional special stamps relating to goods liable to excise duties:

- ☐ alcohol beverages containing up to 25 per cent of ethyl alcohol in terms of volume inclusively – Rub. 0.3 per one stamp;
- ☐ alcohol beverages containing over 25 per cent of ethyl alcohol in terms of volume – Rub. 0.8 per one stamp.

Resolution of the RF Government No. 920 of December 29, 2001, sets forth the list of goods produced and (or) sold by non-governmental organizations of disabled persons, enterprises solely owned by non-governmental organizations of disabled persons, and organizations employing disabled persons (where disabled persons make not less than 50 per cent of the total number of employees and the share of remuneration due to disabled persons in the total labor costs makes not less than 25 per cent), production and sale related costs of which shall not include funds expended for social security of disabled persons and (or) functioning of non-governmental organizations of disabled persons for purposes of calculation of the profit tax base, including:

- ☐ car tires;
- ☐ hunting guns;
- ☐ yachts, boats (except special purpose ones);
- ☐ production of ferrous and non-ferrous metallurgy (except secondary scrap ferrous and non-ferrous metals and hardware)
- ☐ jewels and precious metals;
- ☐ fur articles (except children clothes);
- ☐ high quality articles made of crystal and porcelain;
- ☐ sturgeon and salmon caviar;
- ☐ ready-made delicacy fish and sea products;
- ☐ securities.

Resolution of the RF Government No. 926 of December 29, 2001, sets forth the minimal and maximal rates of regular payments for the use of mineral resources.

The exact amount of the regular payments for the use of mineral resources as broken down by all areas situated on the continental shelf of the Russian Federation, within the exclusive economic zone of the Russian Federation, or outside the Russian Federation in the territories under the jurisdiction of the Russian Federation, as well as those leased from foreign states or used on the base of an international treaty, shall be determined by the RF Ministry of Natural Resources within the aforesaid minimal and maximal rates. The rates are in terms of Rubles per square meter. The resolution determines maximal rates of regular payments for the use of mineral resources: a) for purposes of surveying and evaluation of mineral resources; b) for purposes of prospecting of mineral resources.

Acts of Ministries and Agencies Developing the RF Tax Code

Letter of the State Customs Committee No. 01-06/50748 of December 24, 2001, explains that according to Article 151 of the RF Tax Code the taxation of import is carried out in accordance with the chosen tax regime. In the case the regime of temporary importation is applied, a partial tax exemption is granted, while in the case the goods are imported under the customs regime of release for free turnover, the tax shall be paid in full. According to Articles 78 and 79 of the Tax Code, the excessively exacted or paid amounts of taxes and charges may be used as offsets against the tax payments. These articles can not be applied to periodical customs payments stipulated by Article 72 of the RF Tax Code. The aforesaid payments shall be made in the framework of the customs regime of temporary importation for the time the goods are under this customs regime and are not defined as excessively paid or exacted. Therefore, the offset of periodic customs payments made for the time the goods are under the customs regime of temporary importation in the case this regime is substituted by the customs



regime of release for free turnover is stipulated neither in the Tax Code, nor in the Customs Code.

Letter of the State Customs Committee No. 01-06/51165 of December 26, 2001, explains the procedure governing the exaction of VAT on certain categories of goods imported in the customs territory of the Russian Federation. Since January 1, 2002, the tax privileges related to import of the following goods in the customs territory of the Russian Federation shall be abolished:

- medicines, products intended for medicinal purposes, medical equipment, as well as raw materials and completing parts for production thereof;
- raw materials and equipment purchased by handicraft enterprises for production of handicraft articles (sub-item 12 of item 13 of the Instruction);
- technological equipment (completing and spare parts) thereof are not manufactured in the Russian Federation;
- products of mass media and books relating to education, science, and culture.

At the same time, federal law No. 179 FZ of December 28, 2001, introduces VAT at the rate of 10 per cent in relation to medicines, including medicinal substances, as well as products intended for medicinal purposes and periodicals (except periodicals of advertising or erotic nature) imported in the customs territory of the Russian Federation since January 1, 2002.

Changes in the Legislation Approved in 2002

Federal Laws

Federal law No. 83 FZ of July 9, 2002, "On financial rehabilitation of agricultural producers" sets forth a procedure (outside the RF Tax Code) of restructuring of tax arrears of organizations in a separate economic sector.

The decision on restructuring shall be taken by the territorial commission with participation of creditors of the debtor. The commission shall calculate the indicators characterizing the financial standing of the debtor in accordance with the prescribed calculation methods. The territorial commission shall determine the respective option depending on the indicators of the debtor's financial standing and in accordance with the base terms of restructuring of debts.

The restructuring of debts envisages the full write-off of the amount of penalties and fines, granting of deferments (for periods up to 5 years) relating to the principal debt and interest charges, as well as write-off of the principal and interest charges. The amount of payment for deferred debts related to payments to the federal budget and budgets of the state extra-budgetary funds makes 0.5 per cent per annum.

Article 8 of federal law No. 147 FZ of July 31, 1998, "On enactment of section one of the Tax Code of the Russian Federation," according to which the provisions of the first section of the Code should not be applied to the relations regulated by the federal law "On financial rehabilitation of agricultural producers" was respectively amended in relation to the enactment of this law.

According to federal law No. 104 FZ of July 24, 2002, there were amended Section 2 of the RF Tax Code and other legislative acts concerning taxes and charges, while certain legislative acts concerning taxes and charges were abolished. For instance, the RF Tax Code was

supplemented with Articles 26.2 (simplified system of taxation) and 26.3 (single tax on imputed income)²⁶.

Federal law No. 106 FZ of July 24, 2002, amended Article 7 of the RF law “On property tax on enterprises.” The amendments stipulate that property tax on enterprises included in the United natural gas supply system shall be transferred to the budgets of RF subjects proportionally to the value of the property located in the territory of the respective subjects of the Russian Federation and evenly distributed between the budget of the RF subject and local budgets of territories where the property is located. As concerns Moscow and St. Petersburg, the tax shall be transferred to the budgets of RF subjects in full.

Federal law No. 110 FZ of July 24, 2002, amended Section 2 of the RF Tax Code and other RF legislative acts. For instance, the amendments regulate the payment of VAT and excises relating to sales of ores, scrape, and refining of precious metals, and operations relating to precious metals and gems.

According to the aforesaid amendments, the persons engaged in operations related to oil products shall be subject to registration and be granted respective certificates, including those allowing production, wholesale trade, wholesale and retail trade, retail trade. The amendments set forth that the procedure governing the issuance of certificates shall be determined by the RF Tax Ministry. According to the new procedure of payment of excises on oil products, both the reception and entry in the balance sheet shall be subject to taxation. The amounts of charged excises may be offset against the sellers’ liabilities related to the tax in the case both sellers and buyers are licensed persons. Liabilities originating from purchase of oil products from retail traders shall not be subject to offsets.

In accordance with the new system of taxation there was introduced the mechanism of operations of customs offices carrying out the system of measures of customs control over production and (or) sale (transfer) of oil products.

There was regulated the problem concerning tax exempts relating to taxpayers selling excisable goods outside the territory of the Russian Federation. The tax exempt shall be granted only in the case excisable goods are sold outside the RF territory under the customs regime of exportation. As concerns transfers of give and take raw materials, tax exemptions shall be granted upon the presentation of a bank guarantee to the tax authorities. In the case no bank guarantee is submitted, the taxpayer shall pay the excise in accordance with the procedure of sale of excisable goods on the territory of the Russian Federation.

There were introduced new rates of excises on alcohol and alcohol beverages, tobacco products, vehicles, gasoline, etc.

As concerns profit tax, there were made amendments relating to the mechanism of determination of replacement value of depreciated assets for taxation purposes as concerns re-evaluation (depreciation, appreciation) of fixed assets. Besides, there are set forth proportions of the distribution of the profit tax rate (24 per cent) among budgets of different levels (the tax revenues collected at the rate of 6 per cent are due to the federal budget, at the rate of 16 per cent – to budgets of the RF subjects, at the rate of 24 % - to local budgets).

RF subjects have the right to adopt laws reducing the tax rate (not below the 12 per cent rate) for different categories of taxpayers as concerns taxes due to the budgets of RF subjects.

²⁶ For more detailed review of the simplified system of taxation and single tax on imputed incomes see the section concerning taxation of small business.



The mechanism of tax accounting carried out by budgetary organizations was introduced in the RF Tax Code. It is set forth that accounting related to operations of calculation of proceeds from commercial activities and expenditures related to carrying out these activities shall be conducted by budgetary organizations separately from the funds of targeted financing. The tax base of budgetary organizations is determined as the difference between the received amount of proceeds from the sold of goods, completed works, rendered services, the amount of proceeds not related to sales (without VAT, sales tax and excises on excisable goods) and the amount of actual expenditures related to commercial activities.

The excess of proceeds over expenditures related to commercial activities before taxes can not be utilized to cover expenditures related to the targeted financing earmarked in the balance of proceeds and expenditures of the budgetary organization.

For taxation purposes, expenditures for public utilities, communication services, transport expenditures related to the servicing of the administrative and managing staff are set forth in proportion corresponding to the share of funds received from entrepreneurial activities in the total amount of proceeds (including targeted financing). At the same time, for taxation purposes, the total amount of proceeds do not include proceeds not related to sales (proceeds received as bank interests on funds at current and deposit accounts, lease revenues, differences in rates of exchange, etc.).

In relation to the abolishment of the tax on motor road users, there were made amendments to RF law No. 1759-1 of October 18, 1991, "On road funds of the Russian Federation.." According to the amendments, the following sources were set forth to finance territorial road funds at the expense of targeted budget funds: transport tax; excises on oil products (50 per cent of proceeds); land tax (100 per cent of proceeds) due to the budgets of the subjects of the Russian Federation; proceeds from repayment of debts related to the tax on motor road users generated before January 1, 2003; fines and penalties for untimely payment of the aforesaid tax; final settlement of payments related to the tax on motor road users for year 2002; subventions to the budgets of RF subjects granted at the expense of the federal budget funds earmarked for financing of road construction, etc.

In relation to the aforesaid amendments, Article 28 setting forth the procedure governing the payment of the transport tax was included in the RF Tax Code.

The article recognizes motor vehicles, motorcycles, motor scooters, buses and other pneumatic tired and caterpillar tracked motor vehicles and mechanisms, airplanes, helicopters, motor ships, yachts, sail boats, boats, snow going vehicles, etc. as the object of taxation. The tax base is determined as the motor horsepower of the vehicle. At the same time, the tax base relating to not self propelled (towed) vessels shall be defined as their gross tonnage in metric tones; as concerns other water vessels and air planes – as one vessel or aircraft. Tax rates shall be set forth respectively depending on the motor horsepower, tonnage, or per one vessel or aircraft.

Federal law No. 127 FZ of October 26, 2002, "On Insolvency (Bankruptcy) changed the order of repayment of debtor indebtedness.

In contradistinction to the previous version of the law, the new law stipulates that indebtedness relating to mandatory payments shall be included in the general (third) group. At the same time, the law stipulates that in the case the debtor fails to make mandatory payments in full in the period between the arbitration court issues the decision to consider the claim to declare the debtor's bankruptcy and the initiation of bankruptcy proceedings, the claims not

cleared off before the arbitration court declares the debtor bankrupt and starts bankruptcy proceedings shall be repaid first.

Governmental Resolutions

Tax Administration

Resolution of the RF Government No. 319 of May 17, 2002, stipulates that in order to execute Article 2 of the federal law "On state registration of legal entities" the RF Tax Ministry shall be the authorized federal executive agency carrying out the state registration of legal entities since July 1, 2002.

Resolution of the RF Government No. 818 of November 11, 2002, approves amendments to governmental resolutions concerning restructuring of creditor indebtedness of legal entities related to taxes, charges, insurance contributions to state social extra-budgetary funds, and penalty and fine arrears.

Resolutions of the RF Government No. 1002 of September 3, 1999, No. 458 of June 8, 2001, "On the priority and terms of restructuring of outstanding indebtedness (principal debt and interests, penalties and fines) of agricultural producers and organizations relating to federal taxes and charges, as well as insurance contributions to budgets of state extra-budgetary funds," No. 699 of October 1, 2001, "On the priority and terms of restructuring of indebtedness relating to insurance contributions to state social extra-budgetary funds, taxes, and charges of organizations as on January 1, 2001, shall be supplemented with a provision that the right to restructure the indebtedness of a restructured organization granted in accordance with this Resolution, shall be retained by the legal successor (successors) of the organization.

Resolution of the RF Government No. 765 of November 6, 2001, "On the restructuring of indebtedness relating to taxes and charges due to the federal budget and indebtedness relating to penalties and fines of federal state unitary enterprises within the penal system" and No. 890 of December 25, 2001, "On the restructuring of indebtedness of federal railway transport organizations relating to taxes and charges, and indebtedness relating to penalties and charges due to the federal budget" were amended.

Profit Tax

Resolution of the RF Government No. 1 of January 1, 2002, approves the Classification of fixed assets included in amortization groups for the purposes of enforcement of Article 258 of the RF Tax Code. The classification may also be used for accounting purposes.

Resolution of the RF Government No. 68 of January 30, 2002, approves the rules governing the contribution of funds to reserves earmarked to maintain the safety of nuclear power plants at all stages of their operation and development by exploiting organizations. The contributions to reserves shall be accounted for as costs of exploiting organizations for the purposes of determination of the profit tax base. The reserves are earmarked to finance expenditures ensuring:

- ☐ nuclear, radiation, technical, and fire safety of nuclear power plants;
- ☐ physical protection, accounting, and control of nuclear materials;
- ☐ development of nuclear power plants;



- ☐ removal from service of nuclear power plants and conduct of research and development and works aimed at the substantiation and increase of safety of objects removed from service.

The resolution also sets forth the rates of contributions the exploiting organizations shall make to the reserves:

- ☐ up to 10 per cent of proceeds of the exploiting organization from the sale of goods (works, services) relating to the use of nuclear power shall be contributed to the reserve earmarked for nuclear, radiation, technical, and fire safety of nuclear power plants;
- ☐ up to 1 per cent of proceeds shall be contributed to the reserve earmarked for physical protection, accounting, and control of nuclear materials;
- ☐ the contributions to the reserve earmarked for the development of nuclear power plants shall be made on the basis of the list of capital construction objects in accordance with the investment program annually approved by the RF Ministry of Atomic Energy in coordination with the Ministry of Economic Development and Trade of the Russian Federation and the Federal Energy Commission of the Russian Federation;
- ☐ the contributions to the reserve earmarked for removal from service of nuclear power plants and conduct of research and development and works aimed at the substantiation and increase of safety of objects removed from service shall be at 1.3 per cent of the proceeds.

Resolution of the RF Government No. 92 of February 8, 2002, sets forth the rates of expenditures, which organizations may assign as compensation for the use of personal cars for business purposes. The expenditures within the approved rates shall be included in other expenditures related to production and sale of goods (works, services) for determination of the organization's profit tax base.

Resolution of the RF Government No. 93 of February 8, 2002, sets forth the rates of expenditures, which organizations may assign for payment of daily and field allowances. The expenditures within the approved rates shall be included in other expenditures related to production and sale of goods (works, services) for determination of the organization's profit tax base. The following rates were set forth:

a) for each day of a business trip within the territory of the Russian Federation the daily allowance shall make Rub. 100;

b) for each day of a business trip outside the territory of the Russian Federation the daily allowance shall make an amount according to the annex (US \$ 67 per day as concerns business trips to the USA);

c) daily field allowances paid to employees of exploration and topographic and geodetic organizations, employees of forest management organizations, prospecting crews, etc (Rub. 50 to 200 depending on the area and objects).

Resolution of the RF Government No. 748 of October 4, 2002, abolishes resolution of the RF Government No. 216 of April 4, 2002, "On the procedure governing determination of the marginal limit of fluctuation of market price of works (services) relating to development of natural resources."

The aforesaid resolution was abolished due to the more exact definition introduced by federal law of the RF No. 57 FZ of May 29, 2002 in the text of item 6 of Article 261 of the RF Tax Code. According to the new version of the item, for the taxation purposes expendi-

tures related to purchase of works (services), geological and other data from third parties, including state agencies, as well as expenditures for independent works related to the development of natural resources shall be defined as the actual amount of such expenditures. The clarified version abolished the constraints on the taxpayers' right to exempt all substantiated and confirmed by documents expenditures.

Resolution of the RF Government No. 814 of November 12, 2002, sets forth the procedure governing the approval of rates of natural loss related to storage and transportation of goods and materials. For the purposes of enforcement of Article 254 of the RF Tax Code, the Government of the Russian Federation has determined the list of ministries having the right to approve the rates of natural loss and stipulated that the rates of natural loss applicable for determination of permitted amount of irretrievable loss due to the shortage and (or) damage of goods and materials shall be reviewed from time to time, but at least once in 5 years.

Value Added Tax

Resolution of the RF Government No. 19 of January 17, 2002, in accordance with Article 149 of Section 2 of the RF Tax Code approves the list of most important and vitally necessary medical equipment to be exempted from VAT in the case such equipment is sold in the territory of the Russian Federation.

Resolution of the RF Government No. 283 of April 29, 2002, for purposes of enforcement of the VAT exemption set forth in sub-item 3 of item 1 of Article 150 of the RF Tax Code, approved the list of materials for manufacturing of medical immunobiological compounds for diagnostics, preventive and (or) medical treatment of infectious illnesses, import of which in the customs territory of the Russian Federation shall be subject to VAT exempt.

In accordance to the changes introduced in Article 149 of the RF Tax Code, resolution of the RF Government No. 661 of September 6, 2002, amended Resolution of the RF Government no. 251 of March 31, 2001 as concerns more precise definition of religious items included in the list of items exempt from VAT in the case such items are sold or transferred for own needs.

Taxation of the Mineral and Raw Materials Sector

Resolution of the RF Government No. 180 of March 23, 2002, approves the new version of the Regulations governing the formation and utilization of the liquidation funds in the course of implementation of production sharing agreements.

In accordance with Article 261 of the RF Tax Code, Resolution of the RF Government No 216 of April 4, 2002, approves the Rules governing the determination of the marginal market prices of works and services relating to the development of natural resources.

The Rules set forth the procedure governing the determination of the limits of the market price band related to works (services) aimed at the development of natural resources relating to the geological surveying of mineral resources, prospecting of mineral resources, preparatory works, and appoint federal authorities responsible for the determination of the determination of the limits of the market price band related to specific works and services.

Resolution of the RF Government No. 282 of April 29, 2002, in accordance with article 346.2 of the RF Tax Code sets forth the criteria making agricultural organizations eligible for



the status of agricultural organization of industrial type. The agricultural organizations of industrial type do not enjoy tax preferences granted to enterprises engaged in agriculture. Agricultural organizations of industrial type include agricultural organizations (poultry farms, greenhouse integrated works, state fur farms, animal industry agri-businesses, etc.):

- those not using farm lands for agricultural production;
- those where the share of forage raised at farm lands owned and (or) used and utilized for own agricultural production makes less than 20 per cent of the total volume of utilized forage.

Excises

Resolution of the RF Government No. 723 of October 1, 2002, approves the general requirements relating to the Regulations and terms applicable to the issue of permits to establish excise warehouses and the Procedure governing the issuance of regional stamps.

The procedure governing the issuance of permits to establish excise warehouses and terms of the issuance of the permits shall be determined by the subjects of the Russian Federation as approved by the RF Tax Ministry. Permits shall be issued by territorial tax agencies of the RF Tax Ministry. The key condition, on which permits are issued, is that the organization has the license to produce, store, and sell alcohol products or the license to purchase, store, and sell alcohol products (in the case it indicates the location of the excise warehouse). Executive authorities of a RF subject shall have the right to introduce additional terms, on which the permit may be granted. Information on the issued permits shall be reflected in registers of permits to be kept by territorial agencies of the RF Tax Ministry. The consolidated register shall be kept by the RF Tax Ministry. The procedure governing the manufacture and purchase of excise stamps, as well as their price shall be determined by RF subjects where is carried retail trade with alcohol products.

The rules determine technical characteristics of stamps (size, color, the procedure of product stamping, protection measures – line code). The contents of the code and the procedure governing the coding shall be determined by the RF Tax Ministry, which shall take into account the proposals about additional information submitted by RF subjects. The issuance of stamps to organizations establishing excise warehouses shall be vested with territorial tax agencies after such organizations transfer advance payments relating to excises on alcohol products.

The price of stamps shall included the costs related to their manufacturing, storing, delivery, VAT, etc. The price of stamps shall be below 1 % of the tax rate related to alcohol products where the volume share of ethyl alcohol exceeds 25 per cent, as stipulated by Article 193 of the RF Tax Code. The price of stamps shall be entered in expenditures deductible for profit tax purposes.

Taxation of Small Businesses

Decision of the RF Government No. 1590-r of November 13, 2002, stipulates that according to Article 346.27 of the RF Tax Code information relating to the cadaster value of land used for the calculation of the amount of the single tax on imputed income as concerns certain types of activities shall be presented to taxpayers via respective official sources of information not later than on November 30 of the current calendar year.

Resolution of the RF Government No. 828 of November 15, 2002, amended resolutions of the RF Government No. 92 of February 8, 2002, and No. 93 of February 8, 2002, and stipulated that the provisions of these resolutions shall be also applied to the simplified taxation system since January 1, 2003.

Resolution No. 92 of February 8, 2002, extended to motorcycles the regulations concerning the determination of expenditures borne by organizations to compensate for the use of personal cars for business trips eligible for exemption for purposes of determination of the profit tax base.

Resolution of the RF Government No. 93 of February 8, 2002, amended the procedure of inclusion of the expenditures for payment of daily and field allowances (according to respective standards) in expenditures eligible for determination of the profit tax base. The amended procedure stipulates that either daily or field allowances may be included in such expenditures, but not both these types of allowances.

Acts of Ministries and Agencies Developing the RF Tax Code

Tax Administration

Letter of the RF Tax Ministry No. ShS-6-14/252 of March 5, 2002, explains the Ministry's position as concerns the issue of defining information about taxpayers' arrears as confidential tax information.

According to sub-item 3 of item 1, Article 102 of the RF Tax Code (hereafter referred to as the Code), confidential tax information shall be defined as any data on taxpayers obtained by a tax authority excluding information relating to offenses against the tax laws and measures of responsibility for such offences.

Failure to pay or promptly pay taxes, according to the RF Tax Ministry, is a tax offence (as defined in Article 106 of the Code), or an infringement on the procedure of tax payment set forth by the tax legislation. Therefore, information about any infringements on the procedure of tax payment on the part of taxpayers shall not be defined as confidential tax information.

Order of the RF Tax Ministry No. BG-3-32/169 of April 2, 2002, approves the Procedures governing the submission of tax declarations in electronic form via telecommunication channels. The submission of tax declaration in electronic form shall be carried out at taxpayers discretion in the case the respective tax agency has technical capacity to receive and proceed such declarations in accordance with standards, formats, and procedures approved by the RF Tax Ministry.

Letter of the RF Tax Ministry No. FS-6-10/555 of April 26, 2002, in accordance with Article 88 of the federal law "On the Federal Budget for 2002," provided information about and instructions concerning the implementation of Resolution of the RF Government No. 251 of April 18, 2002, "On writing off debts generated in relation to non-prompt payments to main contractors and contractors of works related to the state defense procurement in 1994 through 1999 as concerns penalties as charged on January 1, and outstanding tax payments due to the federal budget and extra-budgetary funds."

According to the Regulations approved by the aforesaid Resolution, arrears of penalties charged for outstanding tax payments due to the federal budget, i.e. the arrears of penalties relating to federal taxes and charges, which should be transferred to the federal budget in full,



are eligible for the write-off. As concerns federal taxes to be shared among the levels of the budgetary system, only penalties relating to the federal share shall be written off.

Joint letter of the RF Central Bank (No. 85-T of July 2, 2002) and the RF Tax Ministry (No. 24-2-02/252 of July 1, 2002) explains the issues relating to cash payments among legal entities. For instance, it was clarified that the approved limit of such payments as concerns one contract between legal entities (notwithstanding the number of payment documents relating to payments under this contract).

Letter of the RF Tax Ministry No. MM-6-09/922 of July 2, 2002, explains that according Article 83 of the RF Tax Code, organizations shall be registered with tax agencies responsible for the territories where they have their separate units and territories where their unmovable property and transport vehicles subject to taxation are located. At the same time, according item 2 of Article 23, taxpayers defined as organizations have to within 10 days report in writing to the tax agencies responsible for territories where such organizations are registered and where they have their separate units and territories where their unmovable property and transport vehicles subject to taxation are located in the case they open (close) bank accounts.

In the case organizations infringe on this procedure, they shall be subject to sanctions stipulated by Article 118 of the Code.

The RF Tax Ministry issued the address "On state registration of legal entities" explaining that since July 1, 2002, all territorial tax agencies of the Russian Federation start to register legal entities in the case they are established, reorganized, liquidated, amend their founding documents, and amend information on such legal entities not related to their founding documents.

Applicants for the state registration may present respective documents in person or by mail attaching the list of contents.

In the case a legal entity fails to submit information to the respective registering agency until January 1, 2003, it shall be liquidated by a court ruling based on the application of the registering agency.

Order of the RF Tax Ministry No. BG-3-29/404 of July 31, 2002, approves the methodological recommendations concerning the procedure of arrest of taxpayers' property as security against tax obligations, which were also approved by the General Prosecutor office. Property may be arrested only as approved by a prosecutor and is a temporary limitation of the ownership rights of a taxpayer or a tax agent for purposes of ensuring compliance with tax obligations.

Arrest of property as a means to ensure tax collection shall be carried out if two conditions coincide:

- ☐ failure to promptly pay a tax;
- ☐ justified grounds to believe that a taxpayer is going to take measure to flee and conceal the property.

The methodological recommendations determine the grounds conclusive of a taxpayer or a tax agent to flee and conceal the property, which include: movable property on the balance sheet (including securities) sufficient to repay over 25 per cent of the tax arrears if sold; debtor indebtedness in the case no measures have been taken to recover the respective debts in accordance with the procedures stipulated by law in time exceeding one quarter; the total amount debts relating to taxes and other mandatory payments (including fines and penalties), which include deferred payments, exceed 50 per cent of the property value as per balance

sheet; systematic failure to appear in the tax agency; hasty sell-out of property or transfer of property to dummies, participation of intermediary firms in payments for products; accumulation of funds of a taxpayer (payer of charges) or a tax agent on accounts of other legal persons; failure to comply with decisions taken by a tax authority basing on the results of a tax inspection; facts demonstrating the concealment of proceeds from realization of goods (works, services) derived in the preceding tax periods; information on facts demonstrating failure to pay excises in preceding tax periods or unjustified recovery of excises from the budget obtained by tax authorities; location of the debtor's property at addresses different from the debtor's legal address; establishment of a new legal entity by the director of the taxpayer organization and transfer of the taxpayer's property as the authorized capital of the new entity, etc.

The decision about the arrest shall be taken by the head or deputy head of a tax authority, who shall issue a special resolution to this effect. The resolution shall be submitted to the prosecutor office supervising the respective tax agency for approval of the arrest not later than one day after the date the resolution was issued. The arrest shall be carried out by the tax agency not later than three working days after the receipt of the prosecutor's approval. Only property necessary and sufficient to fulfil the respective tax obligations shall be arrested. Property valued as per the balance sheet equally to the amount of tax debt shown in the resolution is subject to the arrest.

Joint letter of the RF Central Bank and the RF Tax Ministry No. 151-T; FS-18-10/2 of November 12, 2002, explains that taxpayers defined as organizations shall pay taxes and charges independently in the form of transfer from their bank accounts opened with crediting organizations, subsidiaries of crediting organizations, and offices of the Bank of Russia. Taxpayers-organizations shall have no right to deposit with banks cash for direct transfer to accounts monitoring revenues of respective budgets in the case the legislation of the Russian Federation does not stipulate otherwise.

Income Tax

Letter of the RF Tax Ministry No. SA-6-04/60 of January 22, 2002, explains that Articles 227 and 229 of Section 23 of the RF Tax Code "Income Tax on Individuals", and sub-item 4 of item 1 of Article 23 of the RF Tax Code stipulate that individual entrepreneurs shall submit income tax declarations to the respective tax agencies where they are registered (reside) notwithstanding they possess an object of taxation.

Letter of the RF Tax Ministry No. SA-6-04/124 of February 4, 2002, explains the procedure governing the granting of social tax exemptions as stipulated by Article 219 of Section 23 of the RF Tax Code (hereafter referred to as the Code). Besides, it explains that social tax exemptions may be granted to taxpayers receiving incomes taxable at a 13 per cent rate in preceding tax periods.

Letter of the RF Tax Ministry No. SA-6-04/341 of March 22, 2002, explains the procedure governing the granting to individuals of the property tax exemption as stipulated by sub-item 2 of item 1 of Article 220 of the Code.

The taxpayers who started to use the tax relief stipulated by law of the Russian Federation No. 1998-1 of December 7, 1991, "On Income Tax on Individuals" but had not utilized this relief to the full extent before January 1, 2001, shall have the right to use tax exempt relating to the same object (apartment of a residential house) according to the procedure stipu-



lated by the RF Tax Code. All previously borne expenditures shall be taken into account in the process of determination of the tax base.

Tax exemptions shall be granted to taxpayers basing on the declaration for the preceding tax period, applications in written form, and documents confirming the right of ownership as concerns purchased (built) houses or apartments, as well as property executed payment documents confirming payments made by taxpayers.

Value Added Tax

Letter of the RF Tax Ministry No. VG-6-23/72 of January 23, 2002, amends the list of states whose diplomatic missions and respective staffs are subject to VAT at zero rate.

In order to implement the provisions of Resolution of the RF Government No. 19 of January 17, 2002, which approved the list of most important and vitally necessary medical equipment to be exempted from VAT in the case such equipment is sold in the territory of the Russian Federation, the RF Ministry of Healthcare issued letter No. 2510/2698-02-23 of March 25, 2002, explaining the methods to be applied in order to determine the eligibility of certain types of medical equipment for the inclusion in the list of most important and vitally necessary medical equipment.

Letter of the RF Finance Ministry No. 16-00-14/112 of March 27, 2002, explains the procedure governing the determination of the VAT base in the case goods are sold below cost in the case organizations export goods in the framework of intergovernmental agreements. In the course of sales of goods (works, services) involving subsidies from budgets of different levels not increasing returns of organizations, but are assigned to compensate for actual losses related to the use of state fixed prices by taxpayers, the value added tax base shall be determined as the cost of sold goods (works, services) calculated basing on the actual sale prices.

Profit Tax

Letter of the RF Tax Ministry No. VG-6-02/1 of January 3, 2002, explains the procedure governing the calculation and making of advance profit tax payments due to the budget as concerns advance payments related to the profit tax in the first quarter of 2002 and transition to cash basis accounting method in 2002.

Taxpayers making monthly advance profit tax payments shall calculate the amount of monthly advance payments due in the first quarter of 2002 proceeding from one third of the amount of the tax due to the budget in the third quarter of 2001.

The amount of tax due to the budget in the third quarter of 2001 shall be determined basing on the Calculations (tax declarations) of the tax from profit results for nine months and first six months of 2001 (Supplement No. 9 to Instruction of the RF Tax Ministry No. 62 of June 15, 2000, "On the procedure governing the calculation and payment to the budget of the tax on profits of enterprises and organizations").

Calculation of the tax proceeding from the profit results in the first quarter, first six months, nine months, and 2002, shall be carried out in accordance with the Tax declaration as approved by Order of the RF Tax Ministry No. BG-3-02/542 of December 7, 2001 (registered with the RF Ministry of Justice, registration No. 3084 of December 17, 2001).

Not all organizations shall employ this procedure. The procedure shall not be applicable to organizations, which completed the transition to the calculation of monthly advance payments proceeding from their profit results, organizations financed from the budget, foreign

organizations operating in the Russian Federation via their permanent agencies, not for profit organizations, organizations whose proceeds from sales were on the average below Rub. 3 million in each quarter over the preceding four quarters, etc.

As concerns the possibility to apply the cash basis method, according to item 1 of Article 273 of the RF Tax Code, organizations shall have the right to apply this method in the case the amount of proceeds from sales of goods (works, services) of such organizations (without taking into account VAT and sales tax) were on the average below Rub. 1 million in each quarter over the preceding four quarters.

Letter of the RF Tax Ministry No. VB-6-21/87 of January 25, 2002, explains the procedure governing the payment to the budget of advance payments related to the tax on the mining of minerals in the first quarter of 2002. The tax on the mining of minerals (hereinafter referred to as the tax) and respective advance payments shall be paid by an organization (individual entrepreneur) in the subject of the Russian Federation, where mining operations are conducted. In the first quarter of 2002, advance tax payments shall be calculated as one third of the amount of payments for the use of mineral wealth and fees assigned for reproduction of the mineral and raw materials resources charged in the fourth quarter of 2001 and indicated in the Calculations of payments for the right to use mineral wealth and the Calculations of fees assigned for reproduction of the mineral and raw materials resources submitted to the tax agency responsible for the territory where mineral resources were used.

As concerns oil and gas condensate from oil and gas condensate deposits, advance tax payments shall be calculated as one third of the amount of such payments, as well as the amount excise charged in the fourth quarter of 2001 (as a share proportional to the volume of oil and gas condensate from oil and gas condensate deposits in the territory under the jurisdiction of the respective tax authority in the fourth quarter of 2001).

Personal accounts relating to the tax on the mining of natural wealth shall be kept by the tax authority having jurisdiction over the seat (place of residence) of the taxpayer-organization (individual entrepreneur). Tax authorities having jurisdiction over territories where taxpayers are registered as payers of the tax on the mining of mineral wealth shall provide information on the advance payments made by the taxpayer for purposes of its registration on personal accounts of taxpayers.

Directive of the Bank of Russia No. 1103-U of January 28, 2002, abolishes directive of the Bank of Russia No. 810-U of June 29, 2000, "On taking into account the amount of reserves for probable losses relating to loans for tax purposes" formed by crediting organizations in accordance with the requirements set forth by instruction of the Bank of Russia No. 62a of June 30, 1997, "On the procedure governing the formation and utilization of reserves for probable losses relating to loans" and sets forth the definition of loan-related and similar debts for the purposes of enforcement of Article 292 of the RF Tax Code (as concerns credits, including inter-bank credits; bills of exchange discounted by crediting organizations; balances of bank guarantees; operations carried out under agreements of financing against assignment of cash claims (factoring); funds transferred to correspondent accounts of crediting organizations).

Letter of the RF Tax Ministry No. VG-6-02/160 of February 8, 2002, explains the procedure governing the making of advance profit tax payments. The calculations are illustrated with numerical examples. The RF Tax Ministry points out that since the calculation of advance payments is carried out proceeding from the quarterly advance payment for the quarter preceding the quarter in which the payment is made, no grounds for charging of penalties for



non-prompt monthly advance payments exist as concerns the enactment of Article 25 of the RF Tax Code.

Letter of the RF Tax Ministry No. VG-6-02/203 of February 22, 2002, clarifies the issue of submission of tax reports and terms of payment of the profit tax for year 2001.

The profit tax for year 2001 shall be determined basing on the calculation (tax declaration) of the tax on profit results according to the form set forth in Supplement No. 9 to Instruction of the RF Tax Ministry No. 62 of June 15, 2000 and attached references and calculations.

The calculation shall be submitted and the charged amount of the tax shall be made according to the procedure and in time stipulated by Article 8 of law of the Russian Federation No. 2116-1 of December 27, 1991, and item 5 of Instruction No. 62.

Order of the RF Tax Ministry No. BG-3-02/98 of February 26, 2002, approves the Methodological recommendations concerning the enforcement of Article 25 of Section 2 of the RF Tax Code "Profit tax on organizations."

Letter of the RF Tax Ministry No. VG-6-02/392a explains the procedure of making monthly advance profit tax payments due on April 15, 2002. According to Article 286 of the RF Tax Code, taxpayers shall make monthly advance payments over the reporting period (quarter). The monthly advance payments shall be made in equal installments (one third of the quarter advance payments charged in the quarter preceding the quarter, in which the monthly advance payments is made).

Since no declarations confirming the amount of the quarterly advance payments for the first quarter of 2002 will be submitted to tax authorities, taxpayers shall make advance payments (due on April 15) proceeding from the operative data of taxpayers on their revenues and expenditures in the first quarter of 2002.

Letters of the RF Tax Ministry No. VG-6-02/401 and the RF Finance Ministry No. 01-MM-17 of April 2, 2002, explain the procedure governing the determination of the profit tax base and calculation methods pertaining to the tax in relation to amendments to Article 10 of federal law No. 110 FZ of August 6, 2001 (Article 10 concerns profits generated in relation to the transition to the accrual basis accounting method since January 1, 2002, the amount of tax charged in relation to this tax base shall be payable since the second reporting period of 2002).

In 2002, taxpayers shall pay the tax on these profits not later than 30 days after the end of the first half-year. The payments shall be made in equal installments in time set forth for the payment of respective quarter advance payments, i.e. not later than in 30 days after the closing date of the respective reporting period and not later than on March 31, 2003.

The taxpayers who completed the transition to monthly advance payments shall pay the tax on these profits in equal installments in time set forth for the payment of monthly advance payments relating to profit results starting the term of advance payments for the first six months of 2002, i.e. not later than on the 30th of each month following the preceding month. For these taxpayers, January 30, 2003, shall be the last valid date of the payment.

Single Social Tax

Letter of the RF Tax Ministry No. SA-6-05/415 of April 4, 2002, explains certain issues relating to the payment of the single social tax.

For instance, it has been explained that payments and remuneration (notwithstanding of the form) shall not be objects of taxation in the case taxpayers-organizations do not include such payments in expenditures diminishing the organizations' profit tax base in the current (tax) period.

Therefore, payments and remuneration in the form of full or partial redemption of goods (works, services, property or other rights) for individuals (employees or members of employees' families) including payments for public utilities, food, recreation, education, and voluntary forms of insurance shall be excluded from the tax base for purposes of calculation of the single social tax in the case the taxpayers-organizations do not include such payments in expenditures diminishing the organizations' profit tax base in the current (tax) period.

Letter of the RF Tax Ministry No. ShS-6-14/1201 of August 7, 2002, explains that it is necessary to act according to judicial practice deciding if payers of the social tax shall be hold liable for respective tax offenses.

According to the Tax Ministry, taxpayers may be hold liable for such tax offenses as non-submission of estimates of advance single social tax payments as defined in Article 119, in the case taxpayers fail to comply with the terms of submission of estimates (since the calculation of employers' advance payments is based on real financial results of taxpayers' operations). At the same time, in the case there is formed judicial practice indicating unjustified enforcement of Article 119 of the RF Tax Code, taxpayers may be hold liable according to Article 126 of the RF Tax Code for failure to submit documents and (or) other information as stipulated by the RF Tax Code. The article sets forth a penalty at Rub. 50 per each not submitted document.

It is justified to hold taxpayers liable for failure to pay or non-prompt payment of the single social tax in accordance with the results of reporting periods as stipulated by Article 122 of the RF Tax Code.

Excises

Telephone message of the RF Tax Ministry No. BK-6-07/18 of January 10, 2002, explains that until a new Resolution of the RF Government on the procedure and terms of issuance of permits to establish excise warehouses and the procedure of granting of regional special stamps by the subjects of the Russian Federation, it shall be acted in accordance to the requirements set forth in Resolutions of the RF Government No. 1026 of December 30, 2000 and No. 1023 of December 30, 2000.

Letter of the RF Tax Ministry No. BK-6-07/244 of February 27, 2002, explains the procedure governing the operation of excise warehouses. According to Article 197 of the RF Tax Code, storage of alcohol products before shipment (delivery) to other buyers in locations other than excise warehouses and vehicles transporting such products in conformity with the transportation regime shall be prohibited.

Delivery (transfer) of alcohol products from excise warehouses of organizations to their structural units not granted the excise warehouse status shall not be carried out since it is not stipulated by the RF Tax Code.

Order of the RF Tax Ministry No. BG-3-03/478 of September 4, 2002, (registered with the RF Ministry of Justice, registration No. 3805 of September 17, 2002) is issued to enforce federal law No. 110 FZ of July 24, 2002, "On amendments to the second part of the Tax Code of the Russian Federation and certain other legislative acts of the Russian Federation," ap-



proves the Regulations governing issue of certificates for registration of persons engaged in operations related to oil products worked out in accordance with provisions of Article 22 of the RF Tax Code.

The regulations set forth the procedure governing the issuance of certificates for registration of persons engaged in operations related to oil products and shall be extended to organizations and individual entrepreneurs carrying out operations related to production, wholesale, wholesale and retail, and retail sale of oil products.

Certificates shall be documents justifying excise exemptions in order set forth by Article 22 of the RF Tax Code.

Separate certificates termed for 1 year shall be issued for each type of activities, including the following operations:

- ☐ Production of oil products;
- ☐ Wholesale trade with oil products;
- ☐ Wholesale and retail trade with oil products;
- ☐ Retail trade with oil products.

Decisions on granting, refusal to grant, suspension, renewal, annulment of certificates for registration of persons engaged in operations related to oil products shall be vested with the heads (deputy heads) of the Tax Ministry territorial offices in the RF subjects and the Interregional Inspection of the RF Tax Ministry for largest taxpayers No. 1.

The same order approves the list and forms of documents required to issue certificates.

Tax on the mining of minerals

Order of the RF Tax Ministry No. BG-3-21/220 of April 22, 2002, (registered with the RF Ministry of Justice, registration No. 3398 of April 23, 2001, tax agencies informed by letter of the RF Tax Ministry No. NA-6-21/528 of April 23, 2002) approves the forms of calculation of regular payments for the use of mineral wealth and the Procedures governing the completion thereof. Regular payments shall be made in accordance with Section V of the law of the Russian Federation No. 2395-1 of February 21, 1992, "On Mineral Wealth" and Resolution of the RF Government No. 926 of December 29, 2001.

Regular payments for the use of mineral wealth shall be exacted only for the types of use included in Resolution of the RF Government No. 926 of December 29, 2001, which approved the minimal and maximal rates of regular payments for the use of mineral wealth.

Letter of the RF Tax Ministry No. NA-6-21/524 of April 23, 2002, explains the procedure governing the payment of the tax on the mining of minerals with coefficient Kts. This coefficient is applicable in relation to the rate of the tax on mining of minerals as concerns oil and gas condensate from gas condensate deposits and allows to take into account the dynamics of world oil prices. The coefficient shall be applied in accordance with Article 5 of federal law No. 126 FZ of August 8, 2001, and is defined as the ratio between the average US \$ exchange rate and the average level of prices of Urals oil over the respective period.

According to federal law No. 126 FZ of August 8, 2001, in order to calculate coefficient Kts, there shall be used the average US \$ / Rub. exchange rate as set by the Central Bank of the Russian Federation (to be determined as the sum of values of the US \$ / Rub. exchange rate set by the Central Bank of the Russian Federation at each day auctions were held divided by the total number of auction days in the respective tax period) and the average level of Urals oil prices over the tax period (to be determined as the sum of arithmetic mean purchase

and sale prices registered on world oil markets (Mediterranean and Rotterdam) at all days of auctions and divided by the number of auction days in the respective tax period).

Order of the RF Tax Ministry No. VG-3-21/475 of September 3, 2002, amends the Methodological recommendations on the enforcement of Article 26 "Tax on the mining of minerals" of the RF Tax Code.

Letter of the RF Tax Ministry informs and instructs tax agencies about Order of the Tax Ministry No. BG-3-21/448 of August 19, 2002, "On approval of the form of calculation of regular payments for the use of mineral wealth and the procedure governing its completion" (registered with the RF Ministry of Justice, registration No. 3739 of August 26, 2002) as follows.

In the case the deposit of mineral wealth is located in the territory under jurisdiction of several tax agencies, the user of the mineral wealth shall submit the calculation to one tax agency as determined by the Tax Ministry office in the respective subject of the Russian Federation.

Regular payments for the use of mineral wealth shall be made for the whole period of the validity of the license for the certain type of use of mineral wealth notwithstanding the actual amount of works relating to the respective type of use of mineral wealth. The regular payments shall be ceased basing on the reference issued by the territorial fund of geological information confirming the acceptance of the final report on completion of surveying and prospecting of mineral resources indicated in the license.

The fact of discovery of a mineral resources deposit shall be set since the date of the issuance of the certificate confirming the discovery of the mineral resources deposit by the RF Ministry of Natural Resources or one of its territorial offices.

Taxation of Small Businesses

Letter of the RF Tax Ministry No. SA-6-05/150 of February 6, 2002, explains that the use of single tax on imputed income derived from certain types of activities shall be defined as a special tax regime presupposing the replacement of the totality of taxes and charges with the single tax.

Letter of the RF Tax Ministry No. SA-6-22/1497 explains the procedure governing the payments made by taxpayers as concerns the single tax on imputed income in relation to the enactment of federal law No. 104 FZ of July 24, 2002, abolishing the obligation to pay the single social tax for organizations, which completed the transition to the payment of the single tax on imputed income.

Taxpayers are allowed to diminish the amount of the single tax on imputed income calculated for the respective tax (reporting) period in 2002 by the amount of insurance payments relating to mandatory pension insurance made in 2002. However, the amount of the single tax shall not be diminished by more than 35 per cent. The excessively paid amounts of the single tax on imputed income detected in the course of recalculation shall be offset or repaid in accordance with the procedure stipulated by Article 78 of the RF Tax Code.

Decisions concerning the offset or repayment of excessively paid amounts of the single tax on imputed income shall be vested with tax authorities.



Transport Tax

Letter of the RF Tax Ministry No. NA-6-21/1704 of November 6, 2002, explains the procedure governing the enactment of Article 28 of the RF Tax Code "Transport Tax." Article 28 "Transport Tax" shall be enacted on January 1, 2003.

The transport tax shall be introduced and carried into force by the RF Tax Code and laws on transport tax approved by the legislative (representative) bodies of RF subjects.

In order to enact transport tax on January 1, 2003, RF subjects shall approve and officially publish respective laws before December 1, 2002. The respective laws of RF subjects on the transport tax shall define the following elements of taxation: tax rate, procedure, order, and terms of payment. The laws of RF subjects may either set forth, or not set forth tax privileges.

The respective laws of RF subjects shall determine the procedure and terms relating to the payment of the tax. The laws may stipulate either single payment of the whole amount of the tax after the completion of the tax period, or advance payment(s) during the tax period to be recalculated after the end of the tax period. It is a mandatory requirement that respective laws of RF subjects shall determine terms of advance payments and terms of payment of tax balances (according to recalculation taking into account advance payments) after the completion of the tax period.

Court Determinations and Rulings

Letter of the RF Tax Ministry No. ShS-6-14/166 informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 1322/01 of December 18, 2001. According to the Ruling, provisions of item 2, Article 45 of the RF Tax Code stipulating that tax obligations shall be deemed completed on the date the taxpayer submits to the bank the order to pay the respective tax in the case this taxpayer's cash balance is sufficient, shall be extended only to *bona fide* taxpayers.

Letter of the RF Tax Ministry No. ShS-6-14/163 of February 8, 2002, informs territorial tax agencies about determination of the RF Constitutional Court No. 257-O. It is pointed out that due to insufficient delimitation of formal components of tax offenses items 1 and 2 of Article 135 shall not be enforced simultaneously.

Besides, provisions of Part 2 of Article 136 of the Tax Code concerning the exaction of penalties defined in Articles 133 and 135 in accordance with Article 60 of the Tax Code are similar to provisions the Constitutional Court ruled to unconstitutional by its Ruling No. 20-P of December 17, 1996. Due to this fact, courts, other authorities, and officials shall not use Part 2 of Article 136 of the RF Tax Code.

Letter of the RF Tax Ministry No. ShS-6-14/436 of April 8, 2002, informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 2635/01 of January 1, 2002, concerning the claim of the taxpayer whose tax payment was written off the account as indicated in the account record but not transferred to the budget due to the insufficient balance on the bank's correspondent account.

The rulings of the lower court and appellate instance of the Novosibirsk oblast Arbitration Court holding the head of the RF Tax Ministry Inspection liable of inaction (failure to diminish the tax indebtedness on the taxpayer's account) were reversed.

Letter of the RF Tax Ministry No. ShS-6-14/470 of April 15, 2002, informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the

Russian Federation No. 9111/01 of January 30, 2002, according to which tax agencies shall have the right to submit claims for adjudication in bankruptcy of absent debtor notwithstanding the amount of debt.

The RF Supreme Court by its determination No. KAS 02-361 of July 25, 2002, concluded that the RF Government had exceeded its legal authority by approving its Resolution No. 8 of January 14, 2002, as concerns the changes in patent fees relating to inventions, useful models, industrial designs, registration of trademarks and service marks as approved by Resolution of the Council of Ministers – the Government of the Russian Federation No. 793 of August 12, 1993.

The Supreme Court proceeded from the fact that after the enactment of the RF Tax Code the amount of patent fees for actions relevant in law may be determined only by a federal law and not by a resolution of the RF Government, since these fees should be defined as tax payments.

The court ruled that the RF Government had no right to increase the amount of patent fees set by the legislation, since federal taxes are within the exceptional jurisdiction of the legislature and not the RF Government. The law defines that payments of patent fees are made in relation to actions relevant in law and are clearly defined as fiscal payments on the part of the applicants, and are included in such tax obligations as fees and duties (what is confirmed by the title of the payment).

The Ruling of the Moscow Arbitration Court of December 13, 2001, on case No. A40-41151/01-12-241 renders unlawful the decision of the Chief Directorate for Federal Customs Revenues of the RF State Customs Committee (CDFCR SCC) as concerns the prohibition to offset amounts of recurrent customs payments made over the time goods are under the customs regime of temporary import.

Letter of the RF Tax Ministry No. ShS-6-14/1353 informs and instructs tax agencies about Resolutions of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 11654/01 of June 4, 2002, and of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 58/02 of July 9, 2002, concerning the repayment of VAT related to export operations.

1) The RF SAC dismissed the claim of an organization to repay it the amount of VAT charged to (written off) costs of purchased goods paid in excess over the amount of VAT charged in the course of the consequent export sale of these goods to customers outside the CIS member countries. The difference generated in relation to such operations should normally be offset against next payments of taxes or repaid within 10 days since the date of receipt of the calculation for the respective tax period.

The dismissal of the claim based on the fact that the organization was located at a place different from that as per founding documents according to which it was registered with a tax agency. This is the justified ground to hold the registration of a legal entity null and void.

Since taxpayers must submit tax calculations to the respective tax agencies, and the address indicated in the application for the repayment of VAT was in fact neither the location of the taxpayer's operations, neither the location of the taxpayer's bodies, the claim was dismissed.

The RF SAC also pointed out that lower courts had not paid attention to the fact that the claimant and the company, which transferred goods to the claimant, were established on the same date and that the claimant did not carry out any operations other than organization of transactions relating to the goods being the subject of litigation.



2) The RF SAC reversed the ruling to dismiss a claim for repayment of VAT paid for goods shipped to a foreign buyer by the commissioner from the federal budget basing on the fact that respective documents had not been signed by the chief accountant.

The RF SAC pointed out that according to item 6, Article 169, of the RF Tax Code the invoice should be signed by the head of organization and its chief accountant, or other officials authorized to sign such documents, and sealed with the organization's seal. According to the federal law "On Accounting," heads of organizations may keep accounting personally depending on the amount of respective work. Therefore, the absence of the chief accountant's signature should not be justification to refuse the repayment of VAT.

The RF SAC Presidium (Ruling No. 10335/01 of July 4, 2002) dismissed the claim filed by a tax inspection to exact a fine from a bank failing to inform about the opening of a taxpayer's transit foreign currency account for entering forex denominated proceeds.

According to the law of the Russian Federation "On foreign currency regulation and foreign currency control" and Presidential Decree No. 629 of June 14, 1992, "On certain amendments to the procedure of mandatory sale of part of forex denominated proceeds and exaction of export duties," there was approved Instruction of the Bank of Russia No. 7 of June 29, 1992.

According to the instruction, legal persons opening current forex accounts shall simultaneously open transit forex accounts in order to enter the full amount of forex denominated proceeds, including those not mandatory salable.

Therefore, the transit forex account shall be opened in parallel to the current forex account, therefore, notwithstanding the organization's will, notice of the opening of the current forex account is at the same time, the notice about the opening of the transit forex account.

The RF SAC explained that there are no grounds to hold the bank liable for offenses as defined in Article 132 of the RF Tax Code.

The RSFSR law of December 19, 1991, "On protection of natural environment" (Article 6) authorizes the RF Government to determine maximal payments for abuse of environment, pollution, and other harmful actions (the law was invalidated as the federal law "On environmental protection" was enacted on January 10, 2002). In order to enforce this stipulation, the RF Government adopted Resolution No. 632 of August 28, 1992, "On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions" (hereinafter referred to as the Resolution).

The open joint stock company "Kolskaya Mining and Smelting Company" filed with the RF Supreme Court a claim to render the Resolution (as amended on June 14, 2001) unlawful referring to the fact that it did not comply with the current legislation since it unlawfully set forth a tax payment.

The Supreme Court ruled that in terms of law the payment for abuse of environment should be defined as a tax in accordance with Article 8 of the RF Tax Code (it was mandatory, not individually repayable, transferred by payers to finance the state).

The representatives of the RF Government admitted that the payment for abuse of environment is a federal tax in a written response to the claim (application) and in the course of proceedings. The court also took into account the fact that according to Supplement 2 to the law "On the Budget Classification of the Russian Federation," where payments for abuse of environment were included in the section of tax budgetary revenues (code 1050600, what corresponds to the sub-group of payments for the use of natural resources of the group of tax

revenues), and Supplement 2 to the RF law “On the Federal Budget for 2002,” where payments for abuse of environment were included in the list of federal taxes and charges.

However, all substantive elements of the aforesaid tax payments were determined not by a federal law, but by a resolution of the RF Government and regulatory acts of the federal executive authorities.

The Supreme Court satisfied the claim of the open joint stock company “Kolskaya Mining and Smelting Company” substantiating the ruling by the following facts: proceeding from Article 17 of the RF Tax Code, a tax due to the federal budget should be deemed as lawfully set forth only in the case the respective payers and elements of taxation are directly defined in a federal law, and ruled the Procedure and Resolution unlawful as not complying with Article 6 of the RF Tax Code and infringing upon the rights of the claimant making the claimant pay a tax not stipulated by a federal law.

The representatives of the RF Government argued that the Resolution complied with the current tax legislation, since according to Article 7 of the law of 1998 “On Enactment of Section One of the RF Tax Code” normative and legal acts of the RF Government concerning the issues which according to Section One of the RF Tax Code might be regulated only by federal laws should remain in force until respective federal laws were approved.

However, the Supreme Court did not agree with this argument and ruled as follows:

“According to the legal standing of the Constitutional Court of the Russian Federation as expressed in Ruling No. 16-P of November 11, 1997, in relation to the “Case of verification of compliance of Article 11.1 of the Russian Federation law of April 1, 1993, ‘On the State Border of the Russian Federation’ with the RF Constitution,” authorization of the RF Government to determine substantive elements of tax obligations do not comply with the legislatively set delimitation of power between the legislative and executive authorities...

Taking into account the fact that the challenged Resolution and Procedure contain legal provisions similar to those ruled non-constitutional by Ruling of the RF Constitutional Court No. 16-P of November 11, 1997, the court has no right to rule these provisions lawful even in spite of Article 7 of the federal law of July 31, 1998, “On Enactment of Section One of the RF Tax Code.”

The Court also pointed out that at present the challenged Resolution of the RF Government runs counter to the federal law of January 10, 2002, “On environmental protection” since according to item 1 of Article 16 negative influence on environment shall be paid for, while concrete forms of such payments shall be set forth by federal laws. The Supreme Court considered this provision as an additional confirmation of the conclusion that payments for abuse of environment may be set only by a federal law and not by an act of the RF Government.

According to Determination of the Supreme Court No. KAS 02-232 of June 4, 2002, this ruling remained in force, while the appeal of the Russian Government was repudiated.

Later the RF Government requested the RF Constitutional Court to verify if the Resolution complied with the Constitution claiming that payments for abuse of environment were not tax payments and could not be defined as tax obligations in terms of constitutional law, therefore being outside the system of payments set forth by laws as stipulated by Articles 57 and 75 (section 3) of the RF Constitution. According to the claimant, the Resolution had been approved in compliance with the constitutional powers of the RF Government and did not in-



fringe upon stipulations of federal laws, therefore it should be enforced in contravention to the ruling of the Supreme Court.

The Constitutional Court having examined the relevant normative and legal complex issued its Determination No. 284-O of December 10, 2002, as concerns the request of the RF Government to verify the compliance with the RF Constitution of the RF Government Resolution “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” and Article 7 of the law “On Enactment of Section One of the Tax Code of the Russian Federation,” pointing out that:

“... payments for negative influence on environment as a necessary condition under which legal persons and individual entrepreneurs may be granted the right to carry out economic and other activities negatively affecting the environment shall be defined as mandatory public law payments (in the framework of financial legal relations) for the measures undertaken by the state in order protect and restore environment as concerns the consequences of economic and other activities negatively affecting the environment within limits set forth by the state. These payments are of individually payable and compensatory nature and therefore, in legal terms, are not a tax but a fiscal charge. The general principles of exaction of such charges, a number of substantial features thereof, i.e. payers, object of taxation – types of harmful (negative) influence on the environment, as well as the tax base in general form – standards of pollution, waste disposal, etc., and the list of standards of maximal acceptable negative impact on the environment and respective substantial characteristics shall be directly set forth by a federal law. As concerns the procedure governing the determination of maximal amount of payments, the federal legislature has granted this right to the RF Government.

This authorization of the RF Government shall not be viewed as arbitrary an unsubstantiated, since, according to the RF Constitution, the Government of the Russian Federation shall execute its authority by ensuring (including the issuance of normative legal acts) the pursuit of single financial and ecological policies in the Russian Federation; the rights and freedoms of citizens (including their right for favorable environment, what requires to ensure environmental protection and ecological security) and execute other powers vested with it by federal laws regulating the spheres within the jurisdiction of the Russian Federation and its subjects (items “b,” “c,” “f,” and “g” of Section 1, Article 114 in relation with Article 42, items “c” and “f” of Article 71, items “b” and “e” of Section 1, Article 72, Section 1 of Article 110, Article 115, and item “a” of Section 2, Article 125, of the RF Constitution) (paragraphs 6 and 7 of item 5 of the justificatory section).

However, we find the argument that the RF Government shall have the right to set forth the procedure governing determination of maximal amounts of payments for abuse of environment, pollution, and other types of harmful influence because according to the RF Constitution the RF Government “undertakes measures ensuring rights and freedoms of citizens (therefore, including the right for favorable environment, what requires to ensure environmental protection and ecological security) is too vague and arguable.”

Finally, the Constitutional Court ruled as follows:

- “Resolution of the RF Government No. 632 of August 28, 1992, “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” (No. 463 as amended on June 14, 2001), since it was adopted by the RF Government to enforce the authority vested with it by the federal law and stipulated exaction of payments of

non-tax nature, shall remain in force and be enforced by courts, other agencies, and officials as an act being in compliance with the RF Constitution as concerns the delimitation of jurisdiction between the Federal Assembly and the Government of the Russian Federation” (item 1 of the judicial disposition);

- “The constitutional and legal purport of this Determination concerning the Resolution of the RF Government “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” shall be compulsory, what excludes any other interpretation of this Resolution by enforcement agencies including general jurisdiction courts (item 2 of the judicial disposition).

Appendix 3. Reforming the Taxation of Small Businesses

The new articles of the Tax Code setting forth special taxation regimes of small businesses and introducing imputed income for certain types of activities were approved in July of 2002 and should be enacted in 2003. The first outcomes of the reform will become clear only in a year. However, at present it is possible to advance some hypotheses about the prospects of further development of small businesses and the possible effect of the reform on tax revenues, including other taxes and taxes on other enterprises, not only small businesses and enterprises²⁷ operating under simplified regimes.

In order to analyze the special taxation regime, it is necessary to establish what the introduction of the special regime is aimed at.

Different countries aim to achieve different goals working out the procedures of taxation of small businesses, what to the greater extent determines the differences in applied regimes. The goals depend on the environment small businesses have to operate in, their contribution to GDP production, sectoral structure of the economy, size of tax evasion in the society and specific forms of this evasion across countries. Besides, the specifics of regimes of taxation of small businesses may be generated due to differences in both tax and non-tax legislation, and the institutional structure of a concrete society. In the countries where small businesses make greater contribution to GDP production due to the specifics of the structure of production the fiscal component aimed to minimize tax evasion of small businesses *per se* may prevail, since in this case the contribution of small businesses in budget revenues may be considerable. In other cases the circumstances may determine that different rates of taxation of revenues from different sources make taxpayers seek to derive revenues in the forms taxed at lower rates. It is often more feasible at the level of small businesses, therefore special regimes may aim at establishing rules tightly regulating classification of incomes as derived from specific sources. Certain countries seek to lower the tax burden on small businesses, since there are specific types of economic costs, which primarily affect small enterprises. In this case small businesses either are taxed at lower rates, or granted certain privileges. In a number of cases there are introduced simplified regimes allowing to more or less precisely evaluate obligations pertaining to different types of taxes and (or) exempt small businesses of certain taxes in order to decrease alternative costs of taxation, which are higher for small enterprises due among other factors to the lack of internal need to use a developed accounting system. In Russia, small businesses do not constitute a developed sector of the economy gen-

²⁷ Hereinafter understood as a legal entity or individual legally carrying out entrepreneurial activities rather than the property complex as defined in the RF Civil Code.



erating a considerable share of revenues. The insignificant share of small businesses (in comparison with many other countries) and their insufficient contribution to the size of employment, as well as unsatisfactory dynamics of output and investment lead to the conclusion that small enterprises in the Russian economy are in an unfavorable situation. For instance, although the share of employment in small businesses increased from 12 per cent to 12.9 per cent in 1997 through 2001 (remaining rather low), the share of respective output declined from 8 per cent to 5.6 per cent, while investment in fixed assets fell from 5.4 per cent to 2.7 per cent²⁸. The real situation may be even worse: in certain cases medium sized and large enterprises are prompted to use the special regime of taxation of small businesses in order to minimize their tax obligations conducting certain transactions via small businesses, sometimes established specifically to perform this function. For instance, the procedure of taxation of individuals using the simplified system of taxation, which was in force in Moscow until 2003, was rather favorable. This regime was especially favorable in the case the taxpayers' expenditures relating to purchase of goods, works, and services from third parties were low or absent. Therefore, large and medium sized enterprises often used this regime to make payments under civil law contracts instead of employing and remunerating (or additionally remunerating) their own workforce. In other cases it might be feasible to overstate costs of services rendered to enterprises using simplified or imputed regimes. For instance, it is difficult to verify the costs of transportation services rendered by an enterprise paying the tax on imputed income, at the same time, the consumer overstating the cost of such services may be granted larger exemptions from the profit tax base, what does not affect the tax obligations of the producer. Therefore, it may be assumed that the aggregate indicators of real small businesses are even lower than statistics demonstrate as concerns officially registered small businesses. Apparently, the situation of small businesses is determined not only by their tax environment. However, the effect of taxation on the distribution of resources among the branches and sectors of the economy may be significant.

In this connection, the priorities of the tax reform as concerns small businesses in Russia should include, first, new incentives for development of small businesses, and, second, measures aimed to decrease tax evasion on the part of relatively large enterprises related to operations via small businesses. The second goal is important not only in fiscal terms, but also as a means to create normal competitive environment for small businesses. Tax evasion by concluding transactions between enterprises subject to different rules determining their tax bases allows to minimize tax obligations as compared with any other, even preferred, regime. However, the real small enterprises in the sense that they bear high alternative costs of taxation can not use this form of minimization of tax payments and therefore risk to operate in even worse competitive environment than in the case no special regimes were applied in the economy. At the same time, in order to facilitate rapid development of small businesses, form a competitive economic environment, and facilitate employment and self employment, it seems feasible to somewhat reduce budget revenues generated by small businesses on condition that the decrease in the tax burden shall be extended only to real small enterprises. Besides, it would be feasible to permit small enterprises keep tax accounting according to a simplified system.

The key problems encountered in the course of elaboration of special tax regimes for small businesses were more thoroughly analyzed in the IET survey for 2001. In the same pub-

²⁸ Source: Goskomstat, collection "Maloye predprinimatelstvo v Rossii (Small Businesses in Russia)", 2002.

lication, there were offered respective feasible options. This section focuses on the analysis of the new articles of the Tax Code approved in 2002 and certain draft laws submitted to the State Duma.

As it was noted above, proceeding from the declared priorities of the reform the main criterion of evaluation of recommendations aimed to simplify taxation is the real reduction of the tax burden and minimization of tax related costs of small enterprises at the same time preventing tax evasion on the part of enterprises other than small businesses. Unfortunately, the majority of materials concerning the reform of present system did not answer this requirement²⁹. The systems proposed for discussion provided considerable opportunities to evade taxes (to a considerable extent these opportunities remain available in accordance with approved articles 26.2 and 26.3 of the Tax Code): for instance it is the opportunity to mask a business as a small enterprise or formally divide an enterprise into several small businesses, or create small businesses as profit generating units within a controlled group of enterprises. The considerable opportunities to evade taxes contained in drafts proposed for discussion resulted from the very wide sphere subject to the new regime, while no tight constraints were put on the scope of enterprises' operations. The list of admissible operations included retail trade, household and transport services, construction and repairs, other services, agriculture, industry, the sphere of science and technology, etc. While household services and retail trade are natural spheres of small entrepreneurship, where the risk in terms of tax evasion is reduced to the division of enterprises in smaller businesses and the use of different regimes by enterprises engaged in similar types of activities and belonging to the same owner, in the case services are provided to other enterprises the risk of tax evasion increases considerably. At the same time, these systems fail to create serious incentives for development of small businesses in Russia.

It seems not feasible to include in priorities relating to the systems of taxation of small businesses the reduction of tax evasion in the sectors where it is difficult to control parameters forming the tax base. The current system of taxation of imputed incomes and respective proposed legislation attempt to settle this problem by introducing this regime as mandatory for certain types of activities. This decisions seems to be wrong and will result in a sharp limitation on the scope of implementation of simplified taxation systems and losses borne by bona fide taxpayers. As concerns the types of activities where tax evasion is prevalent and difficult to detect in the course of ordinary tax inspections, it is possible to apply minimal imputed tax significantly lower than in the framework of a voluntary chosen system.

Articles 26.2 "Simplified taxation system" and 26.3 "Taxation system in the form of single tax on imputed incomes as concerns certain types of activities"³⁰ of the RF Tax Code approved by federal law No. 104 FZ of July 24, 2002, are not free of the shortcomings charac-

²⁹ It concerns, for instance, the package of draft laws elaborated by the RF Tax Ministry and Ministry for Trade and Economic Development, which includes following draft articles of the RF Tax Code: Charge for the right of trade; Simplified system of taxation of individual entrepreneurs operating on the base of patents; Single tax on imputed income as concerns certain types of activities; Simplified system of taxation of organizations and individual entrepreneurs; as well as a draft federal law "On amendment of the Tax Code of the Russian Federation" (as concerns the simplified taxation system applicable to small businesses) introduced by I. D. Grachev and O. G. Dmitrieva, State Duma deputies (June 27, 2001).

³⁰ For a brief summary of these articles, see this survey, section "A Review of Changes in the Legislation Regulating Taxation Issues in the Russian Federation." The provisions not presented in this section or being of special interest from the viewpoint of this section are described below.



teristic of taxation regimes applicable to small businesses in force before 2003. Many provisions of the taxation regime introduced by these articles infringe upon the neutrality of taxation, while failing to create favorable conditions for the majority of small businesses. At the same time, they provide considerable advantages to those able to create several enterprises using different regimes and distributing different types of incomes and expenditures among enterprises under different regimes in order to minimize tax obligations.

At the same time, some of the provisions of this taxation regime, although criticized, are acceptable compromise allowing to reduce tax evasion via small businesses, while not hindering those in real need of the simplified system.

Thus, the provision substituting VAT with the single tax on the results of economic activities is justified in the case there is no mechanism of detection and punishment of abuses taking advantage of different terms of determination of incomes and expenditures following the cash basis accounting method applied under the simplified regime and the accrual basis accounting method. For instance, the fact that those taking advantage of the simplified regime can not be payers of VAT, what renders unprofitable to create artificial intermediaries (or organizations making insignificant changes in products for sale to enterprises using these products as factors of production) in order to delay tax payments by utilizing the delays in payments of entities using the accrual method to entities using the cash method.

The constraints on the direct share of other organizations in those using the simplified system (25 per cent) are important factors partly mitigating the problem of tax evasion on the part of groups of affiliates, however, their effect is limited (Article 246.12, item 3, sub-item 14). For instance, two enterprises operating under different tax regimes may belong to the same owner. It is also possible that the same person indirectly participates in different organizations (the share of such a person may be rather considerable). Besides, there remain the possibility to substitute dividends from a large enterprise with income from a small enterprise (a legal entity or an individual). At the same time, in the case enterprises where the shares of the same owner are even larger are not engaged in similar activities and do not conclude mutual transactions, the possibilities to minimize taxation via small businesses are limited. It shall not be excluded that there may be introduced limitations solving a number of problems relating to tax evasion and abuse of specific tax regimes. For these purposes, the eligibility of an enterprise for the simplified regime shall be determined basing not only on the income of and the number of employees at the enterprise applying for the special regime, but also on the aggregate income of and the number of employees at all enterprises affiliated with the applicant enterprise, concluding mutual transactions with this enterprise, or were engaged in similar types of activities. It is more difficult to administer this regulation than limitations set forth by the Code, however, such advantages as, first, the possibility to simplify a number of other terms of the regime, and, second, to use in the future the automated information system of the RF Tax Ministry thus considerably reducing the costs of administration, outweigh the difficulties.

It is very important to introduce limitations concerning the amount of gross income. Article 26.2 sets the respective amount at Rub. 15 million a year. This parameter gave rise to the most heated debate. Different options were argued, including the abolition of the limitation. The Government originally proposed to set the limit at Rub. 10 million. However, it seems that limitation can not be reviewed separately from other limitations and the ability of tax authorities to administer such limitations. The limit of gross income at Rub. 15 million might be considered as acceptable for enterprises under the simplified regime taking into account the

Russian realities in the case there were introduced some other regulations preventing the creation of several affiliated enterprises all or some of which using the simplified regime in order to minimize tax obligations. In the case no such limitations are introduced, the limit should be set at the amount rendering the use of the simplified regime less suitable to evade taxation, since constraints on the amount of income making enterprises eligible for alternative regimes at the same time limit the amount of transactions such enterprises may conclude and, therefore, minimize the possible gains resulting from the decrease in tax obligations achieved via such transactions. Creation of affiliates in order to evade taxes has its costs, therefore, in the case these costs are comparable with the potential gain resulting from the decrease in taxes, it becomes less advantageous to use this form of evasion. It seems feasible to initially set the limit at Rub. 4 million a year (the amount making taxpayer eligible for exemption from VAT). Later, the limit may be increased as possible shortcomings of the regime are detected and corrected.

The limitations on the number of employees make enterprises employing up to 100 workers eligible for the simplified regime (Article 246.12, item 3, sub-item 15). It is difficult to imagine that such enterprises do not employ professional accountants. Therefore, it may be assumed that such enterprises will take advantage of the simplified regime not to simplify accounting, but rather to minimize taxes. In the case it is taken into account that there are no sufficient barriers to pay wages and salaries at large enterprises via small enterprises, this limit seems to be set too high.

The value of assets set at Rub. 100 million (Article 246.12, item 3, sub-item 16) could become a serious constraint. However, this provision concerns only depreciable assets, i.e. fixed and intangible assets. In the case an eligibility criterion for simplified regimes is the limitation on property, it would be more feasible to limit the amount of inventory holdings, since the aforesaid limitation on the depreciable assets only rarely may be significant for real small businesses, while possible misuse of assets for the purposes of tax evasion may be prevented by other means. Besides, in order to determine if an enterprise is eligible according to this requirement it would be necessary to evaluate the residual cost of depreciable assets at the end of each reporting period, i.e. to keep accounting of depreciable assets, what significantly increases the tax related costs borne by small businesses. Moreover, the amendment introduced by federal law No. 191 FZ of December 31, 2002, sets forth the requirement to evaluate residual costs "in accordance with the laws of the Russian Federation on accounting," i.e. introduces additional accounting of fixed assets. However, the accounting of fixed assets is a most difficult component of accounting and it shall be noted that double-entry accounting is easier than keeping income and expenditure ledger.

An important factor is the limitation on the taxpayers' right to choose between the simplified and general regime (Article 346.13, item 7). At the same time, in order to curb possible abuse it would be feasible to increase the period after which it is permitted to turn to the simplified regime again up to three year. However, the original version of the article permitted to turn again to the simplified regime only after two years of using the general regime, while federal law No. 191 FZ of December 31, 2002, amended this provision permitting to return to the simplified regime after one year.



A considerable limitation is that the “taxpayer shall have no right to change the object of taxation over the whole period when the simplified system of taxation is used”³¹ (Article 346.14, item 2). However, the possibility of simultaneous coexistence of several simplified regimes *per se* creates opportunities to evade taxation, especially taking into account the fact that taxation at lower rates makes it more effective to use simplified regimes for these purposes. It may be expected that in 2003 and 2004 payment of wages and salaries via such small enterprises will acquire massive character. It seems that this regime will be hardly abolished before 2005, when it is to be abolished in accordance with the Tax Code; however, it is important to prevent its prolongation.

It seems dangerous that there are no limitations on the use of simplified regimes for participants of external economic activities. Although the complete prohibition seems to be an excessive measure, at the same time the complete absence of constraints does not seem feasible. First, it may result in evasion practices relating in considerable losses of the budget (what may be facilitated by vague definitions of the Tax Code as concerns VAT imposed on imports; however, it shall be noted that federal law No. 191 FZ of December 31, 2002, amends this provision stipulating that VAT exemptions shall not concern VAT payable on goods imported to the customs territory of the Russian Federation in accordance with the Tax Code (see Article 346.11, item 3). Second, as a rule participants of external economic activities have forex accounts, what requires regular professional accounting, i.e. such enterprises would less benefit from simplified accounting, moreover, professional accountants would be more comfortable with double-entry accounting.

The incomes as defined for the purposes of the simplified system include proceeds from sales and proceeds other than those from sales as defined in Articles 249 and 250 of the RF Tax Code. The consistent use of cash flow tax of type R³² requires taxation of only real cash flows, i.e. proceeds relating to goods, works, and services shall be included in the tax base, while borrowings and interest shall be excluded. Payments for purchased factors of production shall be also excluded from the tax base, while payments relating to interest and principal debt shall be taken into account. In order to correctly define such a base it would be feasible either make a separate list of incomes and expenditures for small businesses, or refer to respective articles of Chapter 25. In the latter case, it would be necessary to take into account the specifics of the structure of the RF Tax Code, which includes a part of proceeds from sale of foreign currency, proceeds from leased property, payments for the right to use the results of intellectual activities, property acquired free of charge, and some other types of incomes in a

³¹ It concerns rather the possibility to choose between objects of taxation in the framework of the simplified regime as set forth in the Code, i.e. income and income reduced by the amount of expenditures taxable, respectively, at 15 per cent and 6 per cent, rather than the possibility to choose the simplified or general regime. The right to choose income as the object of taxation shall be valid until January 1, 2005.

³² Economists have worked out several types of cash flow taxes, all of which are investment-neutral in the sense that such taxes do not distort marginal investment decisions. Each tax has its merits and shortcomings. From our point of view, the tax on Real (R-based) cash-flows is best suited for taxation of small businesses. Other cash-flow taxes include the tax of RF type (real plus financial) imposed on all real and financial flows, i.e. the base of which includes all cash inflows (proceeds, borrowings, and interest) minus all expenditures (payments related to purchase of goods, works, services, repayment of borrowings and interest) and the S type tax imposed on net cash flows to shareholders, i.e. dividends plus purchase of shares minus cost of newly issued shares. The two latter taxes are practically similar (in the first case the tax base includes the tax itself, while in the second case the tax is excluded since in legal terms the tax shall be paid by an enterprise from the amounts paid to shareholders) (See: Tax Policy Handbook, IMF, 1995. P. 169).

separate article “proceeds other than those from sales” (Article 250). The same article concerns received interest. Therefore, it would be feasible to specifically refer to this rule in order to exclude received interest from the tax base. A symmetrical procedure should be introduced in relation to payable interest, i.e. such interest payments shall not be excluded from the tax base.

However, the State Duma took the decision to include received interest in incomes and deduct paid interest from the expenditure component of the tax base. This decision ensures neutrality, however, only on condition that incoming cash flows are included in the tax base alongside with interest, while all cash outflows are excluded, i.e. in the case the RF tax from the cash-flow group is imposed. In this case the principal debt should be included in the tax base, and be deducted from the tax base after repayment. Therefore, the tax as defined in Article 26.2 of the Tax Code is not a cash-flow tax. However, definitions are irrelevant. The point is that the main advantage of cash-flow taxes, investment neutrality, is not ensured under the new Russian simplified regime. Besides, this regime ensures the advantage of the enterprises receiving credits over those having to rely on own resources, while small businesses are most interested in deduction of costs relating to financing of investment at the expense of own funds, since real small businesses seldom have an opportunity to use borrowed funds. Apparently, all reflections on the neutrality of cash flow taxes make sense only in the case there are no limitations on transfer of losses (this issue is analyzed below).

At the same time, it is necessary to note that in reality not all taxpayers are eligible for the immediate deduction of expenditures for fixed assets in accordance with Article 26.2. As concerns fixed assets purchased by an enterprise prior to the introduction of the simplified regime, in fact there is applied depreciation, although according to other rules than those determined by the general regime. As concerns fixed assets operable under 3 years, the deduction shall be made in one year, while assets operable from 3 to 15 years, depreciation shall make 50 per cent, 30 per cent, and 20 per cent in the first, second, and third years under the simplified regime respectively (Article 346.16, item 3). Assets operable for longer periods shall be written off “within 10 years of operation under the simplified system of taxation, in equal shares of the value of fixed assets.” It turns out that no immediate deduction is carried out, depreciation is charged, and, in the case the term of an asset operation makes 16 years, and it has been operated for 15 years prior to the introduction of the simplified regime, its residual cost would be written off over the next 10 years. Although in this case the amounts are probably rather small, accounting becomes more complex nevertheless. This procedure in fact renders the “simplified” system rather complicated for those earlier operating under another regime. The purpose of this is rather vague, since the deliberate acceptance of the general regime at the moment of investment followed by the transition to the simplified regime does not benefit the enterprise as concerns taxes. In the case depreciation is carried out, double-entry accounting is easier and more free of errors than proceeding directly from the income and expenditure ledger. Apparently, enterprises employing professional accountants would prefer the double-entry accounting while reporting in accordance with the “simplified forms.” In these circumstances the abolishment of the requirement to submit balance sheets to tax agencies seems to be unfeasible.

As concerns the enterprises where owners who are not accountants keep books independently, this system is too complicated and does not decrease costs relating to the tax payments, i.e. this regime does not allow to achieve its announced goals.



Moreover, enterprises are required to recalculate depreciation for the time of operation under the simplified regime in accordance with the general procedure in the case the asset is sold. In fact, the budget benefit from the respective penalties. At the same time, the tax base resulting from the sale do not change. Income resulting from the recalculation shall be deducted from the tax base since the residual cost of fixed assets diminishes by the same amount. It seems that this measure was introduced to prevent the potential possibility to write assets off via small enterprises and their consecutive sale to individuals or other persons having no right to deduct expenditures for purchase of fixed assets from the tax base. In the case it is true, it would be more feasible to set forth a special respective clause.

Article 346.18 describes the procedure of collection of the minimal tax (1 per cent of proceeds) applicable to those who chose proceeds minus expenditures as the object of taxation. Generally speaking, this stipulation is justified, however, it may become too tight in combination with the limitations on transfer of losses. Moreover, although the consequent transfer of the paid minimal tax is a feasible measure, it becomes considerably less advantageous because it is subject to all tight limitations on all other losses.

The procedure governing the transfer of losses contains all limitations in force for enterprises operating under the general regime, where they also are unjustified. "A loss shall not diminish the tax base by more than 30 per cent. At the same time, the balance of the loss may be transferred to next tax periods, but not more than 10 tax periods" (Article 346.18, item 7). The role played by the transfer of losses in creating incentives for investment and the destabilizing effect of limitations were repeatedly discussed in works by different authors. It shall be noted that limitations have the most serious destabilizing impact on small businesses. Alongside with the general limitation, those using the simplified system are subject to an additional limitation – losses accumulated over the term under the general regime are not set off in the course of transition to the simplified regime and vice versa. The first limitation does not make sense at all, since it is better to set off the losses accumulated under the general regime in the framework of the same regime, since the 24 % rate is higher than the 15 % rate applied under the simplified regime. There is no danger that budget revenues decline due to transition to the simplified regime (except the losses directly relating to the use of the simplified regime). As concerns the losses accumulated under the simplified system, the issue is more complex. Nonetheless, the complete prohibition to transfer losses in the course of transition from one regime to another is a too tight measure destroying enterprises' development incentives. The potential of tax planning – transition to the simplified system for the moment of investment aimed at the rapid depreciation - may be effectively prevented by capitalizing losses accumulated under the simplified regime in the process of transition to the general regime and write them off over a number of years. In this case it would be feasible to limit acceptance of losses in the case of mergers in order to prevent trade with losses.

The prohibition to transfer losses is not the only too tight limitation relating to the transition from one regime to another. Article 346.25, item 3, stipulates that the value of fixed assets purchased in the period of operation under the simplified system shall be recalculated in accordance with the regulations applicable to the general regime. This measure is too tight and will result in losses both for enterprises and society. The potential of tax planning may be effectively prevented by the simple method mentioned above, i.e. capitalize losses accumulated under the simplified regime in the process of transition to the general regime and write them off over a number of years. At the same time, the approved procedure of recalculation will artificially check development of enterprises and increase accounting costs in cases it be-

comes profitable to expand the capacity of enterprises even exceeding threshold indicators, and increase costs borne by tax agencies in the process of verification of the tax base. At the same time, this measure fails to eliminate major possibilities to evade taxes. Enterprises subject to such limitations may expand by creating new organizations eligible for the general regime, or lease fixed assets from small enterprises owning these assets. These developments will result in even more considerable losses of the budget than in the case enterprises could expand and transit to the general regime without any limitations.

It shall be once more stressed that introduction of the 5 per cent tax on alternative objects of taxation, i.e. an income-related tax will result in massive tax evasion relating to wages and salaries. The most simple scheme of such evasion is to register employees as individual entrepreneurs and conclude respective civil law contracts in stead of paying wages and salaries. The paid amounts, similarly to wages and the single social tax, shall be deducted from the profit tax base, however, in this case in stead of paying the single social tax at the rate of 35.6 per cent (in the case the wage is over Rub. 100 thousand and the enterprise answers a number of requirements) the enterprise has to pay relatively small (in 2002 – Rub. 150 a month) payments to the Pension Fund. Besides, these payments are deductible from the single social tax (up to 50 per cent, however, it is difficult to exceed this limit taking into account the negligible payments to the Pension Fund).

The chief disadvantage for the society which may result from the adoption of this procedure is that real small businesses will be taxed either at 6 per cent of gross incomes or 15 per cent of net incomes. At the same time those able to create several enterprises specifically to misuse the tax base may achieve a decrease in effective rate to 6 per cent of net incomes (in the case that according to documents relate to the enterprise choosing incomes minus expenditures or profits as the object of taxation, while the excess of profits over expenditures is received by the enterprise whose object of taxation is income). Therefore, small enterprises may have to compete with medium-sized enterprises more bitterly than in the case the general regime were extended to all taxpayers. So, these measures fail to ensure the main goal of the reform – creation of favorable environment for small businesses.

Yet another important issue shall be stressed. Rates of simplified taxes on small businesses are low, potential of tax evasion is not eliminated, threshold parameters of eligibility to use simplified regimes are high. Besides, these measures will negatively affect not only revenues from the profit tax, but also income tax and the single social tax. A decline in budget revenues is inevitable both at the federal and regional levels. However, the respective decision was taken by the State Duma, not regional or local authorities. In this situation it would be feasible that the federal budget assumes the greater responsibility for the decision. For instance, the lowered rate could be reviewed as the refusal of the federal budget to receive its share of the tax. Besides, it would be right if the major part of (or all) tax revenues is transferred to local budgets.

Article 26.3 “Taxation system in the form of single tax on imputed incomes as concerns certain types of activities” of the Tax Code introduces the new procedure of collection of the tax on imputed income.

As compared with the previous procedure, the changes may be viewed as positive. There were excluded the types of activities primarily used to sell products to other enterprises. Household services are the major subject of the tax on imputed income. The new procedure may help to prevent tax evasion in the form of rise in expenditures due to purchases of services from enterprises subject to the imputed tax. Besides, there were excluded



the types of activities subject to stricter control not relating to taxation (for instance, gathering and sale of non-ferrous metal scrap). The procedure governing the determination of the imputed tax base was described more thoroughly. At the same time, certain intrinsic shortcomings of imputed taxation remained. The compulsory character of the tax as concerns certain types of activities will result in the impossibility to compare the results of taxation of these types of activities under the imputed and general regimes, thus misleading about the correcting coefficient K_2 ³³. Moreover, the use of such a tax will affect the horizontal equity of the tax system, since the averaging basing on natural indicators results in different taxation of enterprises showing equal results of economic activities. Regional authorities still may arbitrarily determine the tax base, since the coefficient K_2 may be considerably varied from 0.1 to 1, and regional authorities are responsible of its parameters. At the same time, it may turn out that for certain enterprises there may be determined practically individual tax bases (too high or too low) depending on the preferences of regional authorities and their ties with enterprises. This coefficient may be also used to hinder new enterprises to access markets in the case the authorities have interest in or control over businesses subject to the tax on imputed income operating in the region.

In this relation it seems feasible to apply the tax on imputed income only to especially small enterprises on voluntary basis. The considerable efforts the Government made to determine indicators significant for evaluation of profitability may prove useful for the tax authorities. Basing on the imputed methods it is possible to evaluate the potential amount of tax payments of enterprises and in case of considerable differences between the reported results and the evaluation made by tax authorities set inspection priorities. It would allow to minimize tax evasion, increase budget revenues, and render taxation more fair.

Finally, it seems important to once more refer to the statistics reflecting the role small businesses play in the Russian economy. Goskomstat does not publish the data on added value in the sector of small business. However, the volume of output, number of employed and small businesses may increase not only due to the development of real small enterprises, but also due to increasing tax evasion via small businesses. Even the indicator of added value does not adequately reflect the real situation. It would be feasible to survey only small enterprises not affiliated with large businesses or a large number of other small enterprises in order to monitor the consequences of the new tax procedure.

Appendix 4. Analysis of Certain Results of the Personal Income Taxation Reform

Within the framework of the analysis of certain results of the incomes taxation reform in Russia there was made a study of keys problems related to the income tax functioning in Russia and results of the reform made in 2000³⁴.

The reform of the income tax or taxes on incomes of natural persons as it is called in the new version of the corresponding part of the Tax Code, was made in 2000 at the first stage of the tax reform and consisted first of all in establishing a flat single rate at a level close to the

³³ K_2 is the correcting coefficient of base profitability taking into account the totality of other specifics related to business activities, including the range of goods (works, services), seasonal factors, time of work, amount of incomes, and other specifics (see Article 346.27 of the Tax Code).

³⁴ S. Sinelnikov-Murylyov, S. Batkibekov, P. Kadochnikov, D. Nekipelov "Otzenka Resultatov Reformy Podokhodnogo Naloga" (see <http://www.iet.ru>).

lowest marginal tax rate of previously effective scale, reduction of tax preferences and simplification of the tax payment and collection procedure. Income tax changes were called forth by the need to enhance its role both in total tax revenues and in tax redistribution processes.

Such a radical income tax reform is being made for the first time in Russia; because of this in contrast to other countries that have already undergone that kind of reforms Russia has practically no experience in studying the changes' influence on the level of taxable incomes, tax proceeds to the budget and the tax's role in the process of redistribution of citizens' incomes.

Among the most important conclusions that follow from the analysis of the situation prior to the reform one can name the following: the income tax played *a little role in the tax system* due to low average incomes of the population, first of all because of small wages, intricate tax legislation and weak administration of this tax, and as a consequence of this - mass tax evasion, the tax possessed *a low redistribution capability*, which followed from an abundant use of different mechanisms to evade it predominantly by taxpayers with high incomes. In such a situation the possibilities to increase tax revenues by using a higher marginal tax rate were limited, as in conditions of poor administration this could lead to a more intensive tax evasion. In those conditions a lower marginal tax rate and a harmonization of the aggregated profit tax rate for enterprises and taxes on wages for employees, alongside with a stronger tax administration according to the fathers of the reform would have promoted a lower concealment of incomes from taxation.

With the aim to form theoretical hypotheses about the reform's influence on the level of income tax revenues there were used models of tax evasion of Allingham-Sandmo type. Bearing in mind the conclusions made on the basis of such models, we formulated three basic hypotheses. The first one is that a lower marginal tax rate shall entail an increase of the taxable basis. The second one is that a lower evasion, first of all among taxpayers with highest incomes, shall lead to a higher taxation of those, and as a consequence to a higher progressiveness of the income tax. And the third one is that in spite of a lower marginal tax rate there will be higher tax revenues.

We studied the model of relation between changes in tax revenues and in the tax income basis in 2000-2001 and changes of the average marginal tax rate on the basis of data on per capita income tax revenues in different regions in Russia, and models aimed at making an assessment of the degree of progressiveness of the income tax in 2000-2001.

When building a model for income tax revenues as an assessment of the effective incomes of the population including "shadow" incomes, we used the factor of consumer expenses, as far as their changes turned out to be less correlated with changes in the average marginal tax rate than changes in incomes. In the model for the tax basis we also used this factor as an indication for an independent real tax basis increment not connected with changes in the marginal rate. Progressiveness of the income tax was assessed by using three tax revenues models – linear, quadratic and logarithmic. The results of the regression analysis that we acquired allowed us to formulate several basic conclusions.

The first conclusion is that following the hypothesis based on an analysis of theoretical models of tax evasion we managed to reveal a negative association between showings of the taxable basis and marginal tax rate as a result of the incomes taxation reform in Russia in 2000-2001. The second conclusion, as was assumed, taking into account the ineffective income tax rate prior to the reform we revealed a negative association between tax revenues and the marginal income tax rate. The third conclusion was that the results of assessments showed



that the income tax is progressive with respect to wages and non-progressive with respect to taxable incomes. Besides, judging by the results of panel assessments for the two years we can talk about a higher progressiveness of the income tax with respect to wages in 2001 as compared to the year of 2000. Similar conclusions can also be made from Kakwani and Musgrave progressiveness indices analysis, which reveals an income tax progressiveness growth. As a corollary we can speak about a higher progressiveness in income taxation of wages when it is not possible with the help of applied methods to reveal a progressiveness of taxable incomes on the whole.

Using the the tax revenues model built up in the course of the research one can define the roles of the actual growth of incomes of the population and of the marginal income tax rate growth with respect to tax revenues. Revenues from the income tax in 2001 as compared to the year of 2000 were higher by 76.4 bln roubles (a 43.9% growth). Model calculations show³⁵ that due to changes in the tax rate (taking into consideration the opposite effects of the rates that were both lower and higher for different categories of taxpayers, and a decrease in tax evasion) revenues from this tax grew by approximately 42 bln roubles, and revenues due to the overall economic growth in the country and a number of other factors grew by 34 bln roubles. The research allowed to formulate a number of practical recommendations to improve the income taxation.

The presence of a positive dependence between changes in the taxable basis and the marginal tax rate gives us ground to hope about a continuation of the tendency to legalise incomes that started in 2001. The basic conditions for it, as we see it, can be first of all keeping the flat income tax rate for a long-term period and, secondly, a higher effectiveness of tax administration including legislative methods to eliminate possibilities to evade paying taxes and to impose heavier penalties for the evasion. The first condition is the key one, as it is quite evident that in the first year of the flat tax rate the evasion decreased to a considerable degree, but did not change itself from a mass phenomenon to a seldom or an exceptional one. In many respects it is connected with of the taxpayers' certain distrust to innovations, they still think that after they legalise their incomes the tax rate will be sizeably heightened.

There is an important factor that can add to the effectiveness of the second of the above conditions; it is the fact that when the marginal rate of wage taxation is lowered considerably it shall become much less profitable to use different schemes of tax evasion than sticking to the law, the risks of sanctions for the evasion taken into consideration. A certain potential for reduction of tax evasion lies in the sphere of a stronger administration. In this connection instead of a more strict control of big expenditures on the part of natural persons, which is a rather difficult thing to be effectively administered, it is expedient to establish the required legal instruments to provide the tax authorities with a possibility to make their assessments of taxation basis using so-called "external indications" of wealth.

³⁵ The presence of a constant (which showed to be not significant) does not allow us to factorise incomes changes with no remainders by two factors: the average marginal income tax rate change and changes in expenditures. For the purpose of analysis of the factors' influence the equation about correlation between changes in tax revenues and changes in consumers' expenditures and changes of the average marginal income tax rate was assessed with no constant. It should be noted that such a calculation is bound to be conditional to a certain degree, as far as changes in expenditures are correlated to changes of the average marginal rate (correlation coefficient is 0.24) and coefficients that were acquired in the model can fail to reflect the true correlation between tax revenues changes and changes in expenditures and average marginal tax rate.

The fact that there is no legible answer to the question as to how effective the income tax is with respect to redistribution of the population's incomes testifies to the effect that it is needed to work out and establish a system of measures to enhance the progressiveness of the tax system on the whole and the income tax in particular. With respect to the taxation of incomes one might possibly suggest abolishing the regressive property deduction from taxes and deductions for charity, working out a system of progressive taxation of interest yields, improving methods of fringe benefits taxation. At the same time it should be taken into consideration that curtailment of income tax concessions can have a rather strong political opposition.

In future other payments from budgets of different levels to different categories of the population can also be included into the taxable basis. One should take into consideration, though, that this may call for additional budget allocations to compensate for the payments that will be reduced as a result of taxation. Besides, in part of those payments that originate in higher authorities (considering that income tax is paid to territorial budgets) elimination of tax concessions may require taking corresponding decisions in the sphere of relations between budgets.

One of the possible ways to enhance the progressiveness of the income tax may be a higher exemption limit. But this measure needs a more thorough analysis from the point of view of possible budget losses and shall in all probability be implemented step by step. Besides, there emerges the problem to organise administration of the big exemption limit. When there are several income sources there will have to be made the choice of which of the sources that kind of exemption can be applied to.