

Institute for the Economy in Transition

RUSSIAN ECONOMY IN 2004

TRENDS AND OUTLOOKS

(ISSUE 26)

**Moscow
March 2005**

UDC 33(470+571)"2004"
BBC 65.9(2Poc)
R95

Agency CIP RSL

Institute for the Economy in Transition (founded in 1992)

Director: Yegor Gaidar

Editorial Board: *Y. Gaidar* (editor-in-chief)
 S. Sinenikov-Mourylev
 N. Glavatskaya

RUSSIAN ECONOMY IN 2004 TRENDS AND OUTLOOKS (Issue 26) – M.: IET. – 461 p.

ISBN 5-93255-160-7

The present monograph comprises a detailed review of major trends in the Russian economy in 2003. It consists of four major sections highlighting on single aspects of development of Russia's economy: social and political background; monetary and credit and budgetary spheres; the real sector; institutional and macroeconomic challenges. The work is based on a great mass of statistical data that allowed original computations and numerous illustrations in the form of figures and charts.

The publication of the present paper was sponsored with the grant from the United States Agency for International Development (USAID)

UDC 33(470+571)"2004"
BBC 65.9(2Poc)
R95

ISBN 5-93255-160-7

© Institute for the Economy in Transition, 2005

Authors:

- section 1.1 – S. Zhavoronkov, V. Novikov;**
- section 2.1.1-2.1.5, 2.1.7 – S. Drobyshevsky;**
- section 2.1.6 – P. Trunin;**
- section 2.2, 2.5 – S. Ponomarenko;**
- section 2.3 – I. Trunin, A. Katamadze, V. Nazarov;**
- section 2.4.1, 2.4.3 – D. Polevoy;**
- section 2.4.2 – A. Shadrin;**
- section 3.1.1 – O. Izryadnova;**
- section 3.1.2 – O. Izryadnova, Yu. Bobylev;**
- section 3.2 – S. Tsukhlo;**
- section 3.3 – O. Izryadnova, E. Ilyukhina;**
- section 3.4 – N. Karlova, T. Tikhonova, E. Serova, I. Khramova,
O. Shick;**
- section 3.5 – I. Dezhina;**
- section 3.6 – I. Rozhdestvenskaya, S. Shishkin;**
- section 3.7 – N. Volovik, S. Prikhodko;**
- section 3.8 – V. Zatsepin, A. Lebedeva, V. Tsymbal;**
- section 4.1 – A. Radygin, G. Malginov, N. Shmeleva;**
- section 4.2 – I. Mezheraups, A. Radygin;**
- section 4.3 – A. Radygin, Yu. Simachev;**
- section 4.4 – A. Abramov;**
- section 4.5 – E. Marushkina, L. Mihaylov, L. Sycheva, O. Tochilina;**
- section 4.6 – G. Malginov , G. Sternik (Analitical Center
'Miel-Nedvizhimost', The Russian Realtor Guild)**
- section 4.7 – I. Starodubrovskaya;**
- section 4.8 – T. Malinina;**
- annex 1 – I. Mezheraups, A. Radygin**

Table of Contents

Section 1. The Socio-Political Background	9
1.1. The 2004 Economic and Political Outcomes	9
1.1.1. The 2004 Main Economic Outcomes	9
1.1.2. Key Challenges of the Current Stage of Reforms	13
1.1.3. Economic Growth: Discussions and Problems	18
1.1.4. The 2004 Main Domestic Political Outcomes	26
1.1.5. The 2004 Main Foreign Policy Outcomes	29
1.1.6. Short-and Longer- Run Challenges and Risks	31
Section 2. Monetary and budgetary spheres	32
2.1. Monetary Policy	32
2.1.1. Inflation Development	32
2.1.2. Money Supply in the Economy	35
2.1.3. Money Demand	38
2.1.4. RUR Exchange Rate Movement	40
2.1.5. "Banking Crisis" in 2004	42
2.1.6. The state of the balance of payments	44
2.1.7. Key Actions of the RF Central Bank in the Field of Monetary Policy	49
2.2. State Budget	50
2.2.1. General Description of RF Budgetary System in 2004.	50
2.2.2. Analysis of Basic Tax Revenues	51
2.2.3. Budget Expenditures	52
2.2.4. Main Events in the Budget System and Changes in Tax Law	53
2.2.5. Federal Budget for the year of 2005	55
2.3. Interbudgetary relations and subnational finances	60
2.3.1. Relations between budgets of different levels: basic trends of development	61
2.3.2. The problem of soft budgetary constraints on Russian regional authorities	68
2.3.3. Distribution of grants for equalization of budgetary security of RF subjects: new methods	73

2.3.4. Social policy: changes in the division of respective powers among the federal, regional, and local authorities. Monetization of social benefits	77
2.3.5. Switching to the new procedures governing the election of the heads of executive authorities of RF subjects	79
2.3.6. Amendments to the budgetary and tax legislation affecting the state of interbudgetary relations	81
2.3.7. The law on the federal budget for year 2005 and interbudgetary relations.....	109
2.4. Russian Financial markets	114
2.4.1. The Market for Public Debt.....	114
2.4.2. The market for subfederal and municipal debt.....	119
2.4.3. Stock Market.....	131
2.5. Scenario- Based Macroeconomic Forecast for 2005.	146
Section 3. The real sector	151
3.1. Macrostructure of Production	151
3.1.1. The GDP: Trends and Factors behind Change in Ultimate Demand	151
3.1.2. Dynamic and Structure of Production of the GDP	162
3.2. The IET Business Surveys	184
3.2.1. The Dynamics of Demand or Industrial Produce	184
3.2.2. Constraints to the industrial growth in 2004	193
3.2.3. Impediments to rise in output formed by staff problems	197
3.2.4. Capacity-related constraints to rising output.....	203
3.3. Investments in the Real Sector of the Economy	208
3.4. Russian agrifood sector: basic trends in 2004	219
3.4.1. Exhaustion of growth factors and dichotomy forming in the sector.....	219
3.4.2. Basic shifts in domestic support to agriculture	226
3.4.3. Basic trends in agrifood foreign trade.....	231
3.4.4. Food markets	237
3.5. Research and Development Sector.....	247
3.5.1. Administrative Reform in Science.....	247

3.5.2. Attempting to Reorganize Scientific Institutions.....	249
3.5.3. Perspective Forms of Integration of Science and Education	252
3.5.4. Optimizing Budget Financing of Research and Development.....	254
3.5.5. Public Scientific Funds and Private Charity	256
3.5.6. Developing a Program on Foreign Funds and International Organizations	258
3.5.7. HR-Related Problems in Science	260
3.5.8. Expanding Business Participation in Financing Research and Development	262
3.5.9. Private and Public Partnerships	263
3.5.10. Shaping Infrastructure of Innovation Activity	265
3.5.11. Considering Mechanisms of Indirect Regulation in Science and Technology	271
3.6. Sube-sectors of the Socio-Cultural Sphere	273
3.6.1. Health Care	273
3.6.2. Education	284
3.6.3. The Start of Restructuring the Budgetary Institutions Network.....	294
3.7. Foreign Economic Activity.....	298
3.7.1. Main Trends in Russia's Foreign Trade.....	298
3.7.2. Establishing a Single Economic Zone for Russia, Ukraine, Byelorussia and Kazakhstan.....	308
3.7.3. Regulating Foreign Trade	309
3.8. Military Security of Russia under Present Conditions: Economic Problems	317
3.8.1. Military policies and military-economic activities in the Russian Federation	317
3.8.2. Military expenditures of the federal budget	322
3.8.3. Problems of further modernization of Russia's military organization	328
Section 4. Institutional and Macroeconomic Challenges	332
4.1. Policies in the sphere of property relations	332
4.1.1. Privatization and federal property administration: some results of the year of 2004	332

4.1.2. Changes in the normative – legal basis and federal property management	340
4.2. Ownership Rights Protection and Collapse of YUKOS.....	359
4.2.1. Selling YUGANSKNEFTEGAZ	360
4.2.2. Economic Rent, Licensing and Fiscal Policy	364
4.2.3. International Expansion Boundaries	368
4.2.4. Revising Privatization Results	369
Appendix. Selling JSC YUGANSKNEFTEGAZ: legislative aspects	373
4.3. The third law on insolvency: the first results and prospects of improvement.....	380
4.3.1. Legislation on bankruptcy in 1990s through 2000s: specifics of formation	381
4.3.2. Practical implementation of the third law on bankruptcy (2003 and 2004)	391
4.3.3. Perspectives of modification of the institution of bankruptcy.....	401
4.4. Problems of competitiveness of the Russian stock market.....	406
4.4.1. Russian issuers' stock market	407
4.4.2. Problems of development of ruble bond market	416
4.4.3. New niches for the Russian stock market.....	419
4.5. Functioning of the pension system's saving component.....	421
4.6. Realty market in the Moscow Region: some results and forecast	428
4.7. Issues of Practical Implementation of the Local Self-Governance Reform	437
4.7.1. Normative and Legal Regulation of Reforms	437
4.7.2. Determining the Boundaries and Status of Municipal Formations: Practice and Problems.	439
4.7.3. Other Aspects of Municipal Reform Preparation.	444
4.8. Reform of the accounting system in Russia.....	447
4.8.1. The Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook	449
4.8.2. Draft federal law "On Consolidated Financial Statements"	454
4.8.3. Banking sector	456

Section 1. The Socio-Political Background

1.1. The 2004 Economic and Political Outcomes

Where does the specificity of 2004 lie? In the economic area, it displayed the increasingly greater discrepancies: namely, the one between Russia's growing sovereign rating and the worsening investment climate; between record-breaking oil process and the slow-down of GDP growth rates; between the government's multi-vector economy liberalization program and the implemented public sector expansion and private sector "etatization" policy.

In the domestic political area, the main conflict became the one between the growing concentration of power in the hands of the President and the progressing degradation of government institutions.

The most significant developments in the foreign policy area were associated with the former USSR territory: namely, the accession of the Baltic states to EU; Russia's failures to contribute to election campaigns in Ukraine and Abkhazia, as well as the failure to back-up the former leader of Adzharia. Notwithstanding the above and the rise in anti-Western rhetoric (especially in the wake of the Beslan massacre, with respect to the Ukrainian elections, among others), the country kept its course towards cooperation in the foreign relations area (vigorous negotiations on WTO, signing the Kyoto Protocol, and Russia's eagerness to be a reliable partner to the US in the "anti-terrorist" coalition).

1.1.1. The 2004 Main Economic Outcomes

At a brief glance of statistical data, Russia's performance in 2004 was quite successful. The country's output was growing, while inflation was down and the quality of macro-economic policy was proved by several international rating agencies that raised the country's sovereign rating.

The situation in the fuel and energy complex

So far as the foreign trade area is concerned, 2004 has become the most favorable year ever noted in the post-Soviet Russia's history. The oil prices reached their maximum, staying as high as over USD 30/barrel over the year, and sometimes even sky-rocketing up to USD 50/ barrel. It was the government (the budget) and the oil and gas sector¹ that benefited from that at most, while judging the past years' experience, other industries gained nothing, albeit lost nothing either.

In the light of the existing close relation between the budget revenues and the fuel sector's gains (as the price rise for oil at 1 USD/barrel results in a USD 1–1.5 bln. growth in budget revenues), it appears quite logical that while discussions in early 2004 were dominated by the subject of identification of the amount of the permissible increase of the tax burden on the oil producers, by late 2004 the "problem" of using resources of the Stabilization Fund came to the forefront.

The issue of the withdrawal of the "oil rent" has always been fairly politicized and until recently it was put forward only by leftist-hue economists (S. Glazyev, D. Lvov, etc.). But a number of factors emerged by early 2004 allowed to mobilize a new "consensus" that implied transferring a maximum possible proportion of the fuel and energy sector proceeds to the budget. Those factors, particularly, were: the declining administrative and public in-

¹ The gas prices are closely related to those for oil.

fluence of the sector's representatives (the effect of the YUKOS case), a considerable rise in the energy companies' profits, and the government course towards lowering main taxes without a radical reduction in public expenditure.

The RF government made its final decision on withdrawal of a significant part of oil revenues in April 2004 by approving the raising of the mineral tax and the respective export duties rates. By the time the oil lobby's capacity to advocate their interests had already been so low that the decision needed no detailed rationale. At this point, it is worth taking note of a key paragraph of the Explanatory Note to the bill² that justifies the amount of additional withdrawals:

"It is evident that only the part of profit that, from the government's viewpoint, may be recognized as inefficiently used should become subject to withdrawal; given certain reservations, dividends payable in an excessive amount, as well as investment in non-profile assets can be recognized as such. In 2002, by the oil sector as a whole USD 3.0 bln. was spent on dividend distribution, while 2.8 bln. – on purchasing assets. In 2003, the respective amounts were USD 5.6 bln. and 5.5 bln., respectively. That is why, according to our estimates, under the 2005 projected oil price of USD 24/barrel the sum of USD 1.5 bln. (equivalent of 50% of dividends distributed in the sector in 2002) can be withdrawn from the oil sector without a notable damage to it without. Should the oil price be USD 27/barrel, the withdrawal could amount up to USD 2.5 bln., roughly equivalent to 45% of dividends distributed in 2003".

Hence, the MiniFin of RF obviously makes a vague reference to oil prices as a main factor that affects the value of dividends. This is not quite obvious by itself, for one can imagine a great number of other factors that affect this particular indicator. For instance, OAO OMZ ("Obyedinennye mashinostroitelnye zavody") pursued the corporate strategy that provided for refusal to pay dividends during a few years – the decision which in no way was affected by produce prices.

Once the MinFin refers to specific circumstances of 2003, it turns its arguments inaccurate *a priori*, for in 2003 roughly as much as 60% of all dividends in the country were paid by YUKOS and Sibneft (USD 4.1 bln. out of 7 bln.). Plus, being a part of a merger transaction, as a minimum, some dividends *de-facto* were not *de-jure* such. So, the real taxation rate of dividends is far greater value than the declared 45%.

Stabilization Fund

A rapid rise in the budget revenues fueled by the energy sector has resulted in a notable growth of the Stabilization Fund that accounted roughly for Rb. 500 bln., as of late 2004. Given the dirigist group in the government was solidifying its positions, their raising the issue of using the funds to invest in the industrial sector was easy to forecast. But an implementation of such a proposal would mean the rejection of the Fund's stabilizing function and the government sector downsizing policy launched in the 1990s.

A compromise was found: that is, a combination of spending in part the Stabilization Fund resources on "infrastructure projects" and an early debt repayment. But the steadiness of the compromise can be questioned, as the ministries put forward development strategies and concepts that suggest financing, which cannot be secured at the current state of the federal budget. That, however, the RF government so far publicly has not considered unrealistic.

² Explanatory Note to the bill «On introducing amendments to Art. 3 of the RF Law "On customs tariff" and Art. 5 of the Federal Law "on introducing amendments to Section Two of the Tax Code of the Russian Federation and some other statutes of the Russian Federation and on recognition of invalidity of single statutes of the Russian Federation"

Special Economic Zones

The idea of fostering special economic zones (SEZ) in Russia, the concept of creation of which the government approved in February 2004 was a specific reaction of the moderate-liberal wing of the RF Government to the growing dirigism.

The concepts suggests that economic zone should be understood as a part if the territory of the Russian Federation in which the government sets a special regime of entrepreneurial and investment operations, as well as establishes a special customs regime. Accordingly, the concept suggests a special administrative regime there, tax and customs regimes, and a land use regime.

Strengths and weaknesses of CEZ are clear. On the one hand, they can be considered an efficient means of a selective, partial liberalization of an economy in the conditions under which opportunities for the overall liberalization are limited. Foreign experiences show that benefits granted to such zones often happen to outspread (in full or in part) throughout the increasingly growing number of territories of a given country.

But CEZ creation to some extent switches competition from the production and sales spheres to the administrative one, thus creating a specific (and often costly) resource as "operations within CEZ". Plus, once benefits are granted to *single* categories of taxpayers, this decreases the number of participants in the political coalition for *the general* reduction of taxes, customs duties and administrative barriers, and this poses a special problem.

Priority Reform Avenues

In his 2004 address to the Federal Assembly President Putin highlighted 5 critical reforms with which a sustained economic growth should become closely associated. Those are: 1) military reform; 2) educational reform; 3) health care reform; 4) securing the accessibility of the housing market; 5) solving the problem of the Kaliningrad Oblast as Russia's exclave.

There has been no progress in the Russian armed forces manning system, not to mention the military reform. According to leakages to the media, the RF Government considered the following options: general conscription of students for the term of 1 year; encroaching on the civil rights of those who failed to serve their term in the army; conscription prior to enrollment to a university, among others. Were all such proposals accepted, Russia would rapidly, within 4–5 years, lose one of the major competitive advantages – its human capital.

The implementation of another, educational, reform has so been far from completion. There exists a situation intermediary between the old university enrollment examination competition system and the new Uniform State Examination system. It is often up to universities to decide whether or not they should recognize USE results as an enrollment examination.

An insufficient free delivery of qualitative medical services unquestionably poses a threat of similar caliber to the national human capital as that of defects of the educational system. However, the health care area still is in the tug-of-war situation with numerous problems yet unresolved. More specifically those are: who should control compulsory contributions – insurance companies or medical institutions by themselves; to what extent it would be possible to lower the burden on corporate or individual clients in the event they contribute to the system voluntarily; what the minimum assortment of services provided by medical institutions should be.

The package of bills on housing has been designed and submitted to the Parliament, but a number of critical problems have remained unsolved. Those are, in particular: the fail-

ure to ensure the access of the banking capital to financing the shared housing building, under which the bank would remain an owner of the housing until the mortgage is repaid; the volume of shared funding by private individuals is meager, because of swindling against which they remain unprotected. As far as demonopolization of the housing construction area is concerned, the tender-based principle of allocation of construction sites was put off until September 2005, as it had been poorly formulated and allowed numerous loopholes for granting the sites to crony companies. There are no guarantees that the private capital will at least gain access to clearly competitive areas in the housing and communal system (refurbishment, waste disposal), etc. There also exists an unresolved problem of allocation of funds to move non-payers (if a private individual has failed to pay for housing and communal services for over half-year, he is subject to moving to the municipal housing with hostel housing standards, but there is no such housing available).

There was no progress in negotiations on the special status of the Kaliningrad Oblast have lasted for years. The only innovation became the mandatory requirement to Russians to bear their foreign passports, once they travel to the exclave via Lithuania (but this became effective since early 2005 for travelers to most CIS countries, too).

Natural Monopolies Reform

There was no much progress in regard to other structural reforms that President Putin had not stipulated in his 2004 Address as priority ones, albeit they evidently are critical. More specifically, as in 2003, last year's efforts to reform natural monopolists failed to get hold of Gazprom, Russian Railways, Rostelecom. The issue of a timetable and procedures of privatization of electricity generating assets has not been considered as well. So, all the critical anti-red-tape initiatives have been effectively blocked.

Monetization of Benefits

The sole serious institutional step the Government undertook became the adoption by the State Duma of a bill on monetization of benefits (enacted as Federal Law of August, 22, 2004, No 122-FZ "On introducing of amendments to legislative statutes of the Russian Federation and recognizing invalidity of some legislative statutes of the Russian Federation due to the adoption of the Federal Laws "On introducing amendments to the Federal Law "On general principles of organization of legislative (representative) and executive bodies of state power of the Subjects of the Russian Federation" and "On general fundamentals of organization of local self-governance in the Russian Federation").

The law in question bears several main provisions:

- 1) Abolishment of the so-called "unfounded mandates" the effect of which the law on the federal budget suspends annually;
- 2) Liquidation of disproportions in operations of economic agents that have to deliver their services for free or at the part of the price (primarily the housing-communal sector and transport) by means of provision of an entitled individual with compensation in cash for which he could buy the respective services;
- 3) Delegation to the regional level of a number of issues associated with the provision of a considerable part of the respective benefits.

It took the Government just 2 months to pass the bill through the Parliament, with practically no debate on it. It cannot be argued there have been no winners from the monetization of benefits – those were individuals that due to this or that reason had not ever used natural benefits, primarily rural residents. But the law battered heavily the welfare of residents of big cities. The bigger is the city, the more insignificant the amount of the com-

compensation was vis-avis the housing-communal tariffs and transport fares. The government ignored an evident discrepancy between its computations and the value of given services. Plus, the government did not care even to explain the essence of a hard choice it had faced: either equal compensations to everyone, from which the most needy recipients of benefits would benefit the most, or unequal compensations to rural and urban residents, which would mean recognition and fixing of the earlier inequality, or a drastic rise in budget social expenditures. As a result, inevitable claims to reduction in benefits became hypertrophied. Notably, in parallel to Law #122, the Parliament passed another federal statute – “On public civic service”, which reads that bureaucrats and their direct relatives keep their right for free medical and sanatorium-rehabilitation services, increased territorial coefficients, compensations for migration to a new place of job, increased pensions, among other things, as well as the right for a housing subsidy payable once. So, from the qualitative perspective 2004 proved to be a fairly successful year, while the quality of the economic policy lowered notably.

1.1.2. Key Challenges of the Current Stage of Reforms

General Characteristics of Russian Reforms

One should not exaggerate the 2004 successes and failures. Rather, one should pay attention to long-term trends in the public policy area that proceed from the logic of post-communist transformation. It is the success or failure on these particular avenues that ultimately determines transformation outcomes. The current, third, stage of the reform appears to the greatest extent associated with development of political and legal institutions.

At the first stage, that took most of the 1990s, there emerged basic institutions of a market democracy and the macroeconomic and political stability was re-established. Establishment of economic and political order had been basically over to 1999 and resulted in the start of economic growth.

By late 1991 Russia practically completely had fallen short of the institutions whose mission was to secure a stable functioning and even existence of a country. While economic institutions had collapsed, which was evidenced particularly by large-scale goods imbalances (economic slump, shortages of goods, a clear danger of hunger and cold), yet the greater threat was that with the actual and, later, formal breakup of the USSR Russia found itself with no government institutions in place. That is why the country faced an immediate challenge of re-establishment of elementary institutions without which no country can survive: those were public institutions, at least, elementary economic mechanisms, and property relations.

The following tasks had been solved by the late 1990s:

- the establishment and solidification of fundamental political institutions, particularly, the Constitution and regulation of federative relationship;
- accomplishment of the macroeconomic stabilization which resulted, particularly, in a stable currency and balanced budget in place;
- accomplishment of the mass privatization that laid foundation for the transition of the national economy towards market.

The second stage chiefly falls within the 1999-2003 period (the dates are, of course, conditional). In a nutshell, its mission was, basing on the achieved stability, to start shaping political institutions characteristic of the contemporary society and more country-specific, as far as Russia’s path of development is concerned. At that juncture, the focus of attention was put on creation of such fundamental institutions of market economy as the

Civil, Tax, Budget, Labor and Land Codes, and pension law. The government also launched deregulation processes (lifting administrative barriers to the entrepreneurial activity), was improving interbudgetary relations (the relationship between the federal, regional and local budgets), and approached the natural monopolists reform. As well, Russia progressed in terms of joining the WTO and re-galvanized integration processes with its immediate neighbors in the CIS. The rating agencies recognized the country's progress in the socio-economic development area by awarding it with higher credit ratings, while the EU and US granted the country with the market economy status. The implementation of the noted reforms propelled Russia's progress in the economic reform area and secured its economic growth. The CBR's foreign reserves were growing rapidly, while inflation rates were declining.

At this particular stage the country's economic growth appeared chiefly recovery, back-upped by a vigorous introduction to output of production capacities that had been idle in the crisis period, while the other specific feature of recovery growth is its gradual fading, which takes place once available and suitable for usage capacities are exhausted³.

In 2003, the exhaustion of the potential of the second stage of the transformation became notable. While on the one hand, there manifested themselves the signs of the transition to a new model of economic growth – from recovery growth to investment one⁴, on the other hand, the time has come to identify a strategy and tactics of a socio-economic breakthrough and to identify instruments that would ensure a drastic reduction in the gap between Russia and the most developed nations.

Presently, it can be argued that the country finds itself halfway towards **the third stage** of economic reforms and, accordingly economic policy. Today, discussions *should focus on developing a strategy of the socio-economic breakthrough in the conditions of the modern post-industrial society*. This mission is extremely complex, and the mere fact of the transition to this particular stage of reforms by itself does not guarantee the strategic objectives that the nation faces will be successfully solved. The success or failure of the further development depends primarily on the government policy.

The specificity of the third stage of reforms lies in a practically complete exhaustion of the possibility to enhance economic efficiency and consolidate growth efforts exclusively by means of improving the economic sphere and economic law. The country has approached the phase when its further economic development to a significant extent will be pre-determined by the state of its political and legal institutions.

To have a sound labor and land law, acts in the banking area, tax and budget law is not enough to accomplish the ambitious mission of economic spurt. All these rules and statutes should be enforced effectively, and this requires an efficient state machinery, just court of law, decent law enforcement system, and coherent legal system. No law will be effective unless all the government agencies ensure its enforcement and the court of law protects the citizen whose rights have been offended.

The national political and business elites have been increasingly in recognition of the importance of the noted challenges. The year of 2004 saw a heated debate on the administrative and judicial reforms, but the success record in these areas has been modest as yet.

³ On recovery growth see in a greater detail: Russian Economy in 2002. Trends and Outlooks. Issue 24. M., IET, 2003.

⁴ See: Russian Economy in 2002. Trends and Outlooks. Issue 25. M., IET, 2004.

The Administrative Reform Challenges

This particular reform was much discussed in 2004 and found itself in the government's focus of attention.

The decisions proposed in its frame basically meet the contemporary challenges: a specification (most often – contraction) of the executive branch's functions, lowering possibilities for interdepartmental conflicts of interests, creation of an administrative justice system, anti-corruption campaign. It is quite another matter that these measures will not be sufficient to tackle a number of problems, while some of them can be adopted only providing they are substantially specified.

It should first be noted that the administrative reform has not been coupled with a due conceptual "frame" – an identification of the concept for the public-legal building. Hence, the proposed steps appear too abstract, as the government cannot be turned into an equally efficient means to solve any problems.

Besides, it should be recognized that the government has different spheres of operation that, so to say, fall under the purview of the "legal" and "social" state, in terms of the Constitution of RF⁵. Proceeding from these concepts, the legal state has no objectives, except for principles of law and the compulsory exercising of the respective positive obligations by civil servants. By contrast, the social state focuses on certain goals, which suggests that it is free in selecting appropriate means. Employed by such a state, civil servants do not honor their obligations, but enjoy the rights they have been granted with. These differences demonstrate that an introduction of administrative regulations and result-oriented budgeting (ROB) do not form just two reform avenues, but to a significant extent represent competing management technologies, each having its own application area.

Finally, it is worthwhile to note that the society and experts alike still are not in a full appreciation of the conflict between democratic traditions and the ROB ideology that suggests the replacement of political ("arbitrary") decisions with "objective", "academic" ones.

The implementation of the administrative reform was launched in February 2004, when M. Kasyanov's Cabinet was dismissed.

The forecasts of the rise of the United Russia's, the party that enjoyed an absolute majority in the Parliament, influence in the Government were vain. The party has failed to present both ideological and staffing requirements to the country's leadership. Thus, despite the fact that the sole Deputy Chairman of the RF Government became the UR MP from Moscow A. Zhukov, the party has managed to delegate yet just another fellow to a second-echelon position of Head of the Federal Agency for Construction and Housing. A. Kudrin, G. Gref and V. Khristenko who are associated with liberal economic reforms received key ministries of Finance, Economic Development and Trade and Industry and Energy, respectively. The power block of the Government remained practically unchanged.

On 9 March 2004 President Putin signed Decree No 314 "On the system and structure of the federal executive power". Conceptually, it can be reduced to a uniform profile of agencies: while the Ministries identify the policy, the Services gain supervisory functions, and Agencies deliver services on behalf of the state, manage property and conduct registers. It is intended thus to eliminate the conflict of interests, when the same agency com-

⁵ The fundamental principle underlying the legal state is the formal (legal) equality, which implies no pre-set results proceeding from this, including particularly material results of individuals' use of their formal rights. The social state is based upon the refusal (at least, a partial one) of the legal state and adjustment of results of the realization of the principle of formal equality.

On contradictions between the two approaches to the state, see: Mamut L. S. *Sotsialnoye gosudarstvo s tochki zreniya prava*//Gosudarstvo i pravo, 2001. No 7 p. 5-14; Alexeev S.S. *Pravo. Opyt kompleksnogo issledovaniya*. M.: Statut, 1999, p. 520-564

bines “legislative”, enforcement and supervisory functions, i.e. designs procedures, deliver services on their basis and supervises the respective performance. The number of ministries was bound to be reduced, while the prerogative of appointment heads of Services and Agencies now falls within the purview of the Chairman of the Government, rather than the ministry head. However, the number of federal agencies has grown 1.5 times – from 54 (including the Government staff) up to 73. Though the number of ministries is cut down from 23 to 14, instead of yet another 30 agencies there emerge 58 ones – 29 Services and 29 Agencies. Their independence is illusory, for the federal ministers can approve their annual plans and performance indicators, develop statutes on Services and Agencies, set the volume of their financing, and propose to the government candidates to the positions of their heads. It was also announced that the ministers (except for the power agencies) were going to have only two deputies. As expected, the design of the respective documents on ministries and agencies has been delayed and caused numerous conflicts, as well as the declared drastic cuts in the number of government agencies did.

So, it can be argued that in 2004 the administrative reform remained incomplete and needs adjustments in its implementation.

The Judicial Reform Challenges

The judicial reform can hardly boast better outcomes. The overwhelming majority of the economic elite and a considerable part of the political one are in full recognition of the fact that maintaining the current level of corruption in the judicial system forms a major impediment to the entrepreneurial activity. President Putin more than once calls for need to overcome the efficacy of the legal proceeding and judges’ corruption, followed by a very strong statement by the Hon. V. Zorkin, Chairman of the Constitutional Court⁶.

International experts likewise stress the gravity of the problem. While, for instance evaluating the level of Russia’s competitiveness, the World Economic Forum analysts assessed the state of Russia’s judicial and law enforcement systems lower than the country’s average rating (the 88th and 85th positions vs. the 70th one, accordingly) and far lower than the state of macroeconomic environment (the 56th place in the world).

The solidification of the power vertical and the judicial reform underway have entailed some shifts in the judicial power’s performance, albeit not unequivocally positive ones. Rather, there happens replacement of some complex problems in the system with other, not a bit less vicious ones. According to some well-informed observers, with the mitigation of the pressure the crime and private structures used to exercise on the courts of law, there rises a traditional, Soviet-style, influence the government institutions have on their verdicts⁷.

The best illustration of the noted trends can serve the YUKOS case. More specifically, that is a suddenly arose colossal arrears for the period 2000–2003. The mechanics of the process was very simple and involved a selective implementation in the country of the opportunity for judges’ own law creation, which is so characteristic of the system of general

⁶ It is not a surprise that it was the Chairman of the Constitutional Court who raised the issue of corruption in the judicial system. The Constitutional Court is a unique judicial institution that is directly associated with the supreme power and has no countrywide network. Hence, it appears really free for corruption in its vulgar sense (as a judge receiving money for a certain verdict). It is equally naturally that Mr. Zorkin was harshly reprimanded by the Chairman of the Supreme Court of RF the Hon. V. Lebedev who represents the system of the most “disconcentrated” (in terms of territory and the number of problems being solved) legal proceedings..

⁷ Presently, the pressure on the part of the {organized}crime has fallen notably, as the passions on property division began to decline, while the moneybags’ pressure has declined, too, but there exists the notorious “telephone right”, so harshly criticized yet in the Soviet time”. (9See: Zhukova N. Budet li v Rossii spravedlivy sud? (‘Will there be a just court in Russia?’) //Rossiyskaya Federatsia segodnya. 2004. No 14. p.3).

law. That is why in the course of trials on YUKOS case there appeared previously non-existent in the law definitions and notions (“dummy legal entity”, “adequacy of tax benefits”, “actual owner”, “scrupulous taxpayer”, etc.), which formed the grounds for a waiver to apply general law procedures and the computation of fines and penalties at an amount that often proved to be greater than the arrears due. The company’s capitalization consequently experienced over the 15-fold downfall over the year, while the amount of the “tax arrears” proved to be unprecedented both in the domestic and international practice. In 2004, almost all the company management found themselves in the official retrieval, including lawyers that had had no relations with YUKOS.

In December 2004 there took place a notorious action on the sale of YUKOS’ major oil-producing asset –Yuganskneftegas (against the law provisions that require to sell first an indebted enterprise’ s non-profile assets). On the eve of the auction its organizers received quite probable, albeit not seemingly evident, ruling of the US bankruptcy court in Texas that forewarned economic agents and Gasprom in particular to refrain from participation in such a procedure. As a result, the consortium of Western banks refused to disburse a nearly USD 9 bln.-worth loan to buy Yuganskneftegas, and Gasprom’s daughter company did not bid. The winner in the auction became an obscure (even the best informed analysts had no idea of it), albeit known to the President, Baikalfinansgroup that allegedly placed a USD 2 bln. deposit. Immediately in the aftermath of the auction the state-owned Rosneft⁸ bought the winner. It was announced that in early January 2005 Rosneft closed the deal by transferring the remaining a. USD 7 bln. The financial pool for the operation could be either state-owned banks (if so, they obviously breached loan disbursement standards per single company), or billions of US Dollars of budget funds, or, which is most likely, the whole cash turnover around Yuganskneftegas took place just on paper.

An indirect, albeit critical, effect of the YUKOS case became the depreciation of Mr. Putin’s obligations to the nation. It should be noted that the above does not mean any unhappy lexical constructions. Rather, that was an intentional breach of minimum two publicly made commitments under rather serious pretexts: that is, to avoid YUKOS’ bankruptcy and keep governors’ appointment by elections.

YUKOS case has not been a sole example of arbitrary law enforcement in Russia. In 2004, huge tax claims were likewise laid to Vypmelcom, Volgotanker, and other big companies; the sale of Silovye machinery concern to Siemens was blocked; the outcomes of the tender on development of Sakhalin-3 field (won by ExxonMobil and Chevron Texaco) were canceled), etc.

In the light of the above it is worthwhile to note the role played by the Constitutional Court of RF that had long been a firm shield of both the letter and liberal spirit of the 1993 Russian Constitution.

Some recent rulings of the Constitutional Court can be likened to a notorious change in the US Supreme Court’s stance in the President F. Roosevelt era. The most notorious example of the Russian Constitutional Court became its ruling No 169 on the right of VAT rebates only for the companies that have paid to their suppliers with their own, rather than borrowed, cash. When in a half-year the Court had to change its ruling, it once again demonstrated the level of its dependence.

Naturally, the collapse of the arbitration legal proceedings could not help being coupled with an analogous degradation of the criminal proceedings. As a result, the year of

⁸ Interestingly, one of the deputy heads of the Presidential Administration, Mr. I. Sechin, happened to chair the company’s Board.

2004 saw the rise in the number of political prisoners. The group of the two YUKOS' shareholders and head of the company's security was complemented by dozens of individuals under official retrieval and arrested ones. Plus, the group of leftist activists of the national Bolshevik Party that seized the RF Health Care Minister's office without any violence in August 2004 was sentenced to the 5-year imprisonment, yet another 50 their party fellows await the verdict for an analogous action by the Presidential Administration; leaders of regional political organizations, ranging from CPRF to Union of Right Forces were arrested, too; a Chechen woman was sentenced to jail on the basis of mythic fingerprints allegedly left on the explosives that investigators had detonated by themselves, etc.

The "justice" reached its peak with the jury in Krasnoyarsk unanimously sentencing a physicist named V. Danilov to 15 years of imprisonment on a charge of espionage. In this particular case, as earlier in I. Sutyagin's one, the authorities openly applied the technology of cancellation of the jury's earlier verdict of "not guilty" with a subsequent picking of a new, reliable jury out of the non-published, against the law, list.

The law enforcement agencies, accordingly, undergo a similar degradation. Thus, for instance, the general public became aware of a *pogrom* with hundreds of innocent victims the local police made in the town of Blagoveschensk in Bashkiria. While the State Duma declines requests to consider the issue, its organizers still hold their offices.

Thus, it is the state of state power institutions that comes now to the forefront and forms the main bottleneck.

1.1.3. Economic Growth: Discussions and Problems

Like in the prior years, the 2004 economic and political discussion centered on issues of economic growth. President Putin gave an additional impulse, both in the ideological and practical and policy terms, to the debate. The respective statement was made in his 2004 Address to the Federal Assembly, with even some accentuation of the thesis on economic growth by complementing it by the claim to double the average annual per capita GDP by 2010 (i.e. for 10 years since his first election) and to secure a prompt taming of inflation and reach a full convertibility of the national currency⁹.

Russia needs economic growth, but not at any price. First, it should be sustained – indeed, the well studied into "macroeconomic populism" phenomenon, can entail high growth rates, albeit at the expense of creating serious problems to a longer-term economic stability.

It is equally necessary to ensure that high growth rate should bridge the gap between a country and the most developed nations. The combination of these two requirements produces a hard challenge to a government. On the one hand, its economic policy should be better than other nations', thus securing higher growth rates, while the transition to nonstandard decisions increases the risk of negative, rather than positive, outcomes.

The 2004 growth in GDP at 7.1% vs. 7.3% reported in 2003 forms a serious issue for the public and political discussion. The question, "Is it much or not enough?", does not imply a simple answer and requires a few specifying questions.

What are the causes for the slowdown of growth rates vs. 2003? How does this correspond to growth rates of the most developed economies? What is the correlation between Russia's economic growth and that demonstrated by other post-communist (and, particularly, post-Soviet) economies? Who should one assess Russia's growth from the perspective of opportunities that a favorable state of affairs for Russian exports provides?

⁹ The Address of the President of the Russian Federation to the Federal Assembly. Verbatim Record of May 26, 2004. M.: Izvestia. P. 22, 28

In terms of comparative prospects, one should note that Russia has enjoyed substantially greater growth rates than the most developed economies, which allows to recognize that its growth rates have been satisfactory to bridge the gap between them. For reference: according to the data for the 2nd quarter 2004, the growth rates accounted: in the US – 2.5%, in 25 EU countries – 3.6%, France – 3.6%, Germany – 1.9%, UK – 2.5%, while the new members of E, the Central and eastern European economies grew at a rate comparable with, or a bit slower than Russia: Czech Republic – 4.1%, Slovak Republic – 5.4%, Hungary – 4%, Estonia – 5.9%, Latvia – 7.7%, Lithuania – 7.3%). It is evident that their growth was not at all fueled by the generally favorable state of affairs in the foreign trade area. It can be argued the opposite: with all positive factors, their accession to EU could not help creating some challenges to them (with account of the rise in competition, as well as social and other obligations associated with the EU membership).

As concerns the CIS countries, it should be noted that they by and large are ahead of Russia by their GDP growth rates, while the impact of a favorable situation in foreign trade area can serve an explanation only for some of them. Russia's role as the locomotive of growth, of course, plays a certain role, but they find themselves equally affected by world prices for energy sources. However, Russia's role in the Near-Abroad economies' development should not be overestimated, particularly because, as noted above, most of them have demonstrated higher growth rate than Russia's.

Some decline in Russia's growth rate in 2004 does not reject the hypothesis of the completion of recovery growth and transition to investment growth. This is proved by the existence of a fairly high investment activity and the rising labor productivity. Naturally, such fluctuations do not form *per se* a sign of the presence or absence of a growth that is based on new grounds.

Indeed, the economic growth rate results from an interaction between various factors, and it would be a mistake to reduce everything to the economic policy in a narrow sense of the word, i.e. to a set of measures that have a direct impact on a national economy. At this juncture, political factors, soundness and attractiveness of a government course equally matter. Last year, problems arose in this particular area, with the investment climate demonstrating no improvement. Furthermore, there arose a number of factors that compel one to question Russia's further development prospects.

First, economic agents still have been extremely irritated by a low efficiency of the national judicial system, absence of any notable progress, as well as signs of any future progress, therein. Secondly, the administrative agencies have continued to display a low efficiency, while the administrative reform generated numerous complexities that is mirrored by surveys¹⁰. Third, there has been no progress in overcoming the monopolistic trends, which constrained the rise of small- and medium-size businesses and raised their doubts about the government's willingness to progress on the path towards modern market democracy. The situation with the natural monopolies reform and primarily OAO "Gasporm" is particularly complex. Fourth, there grow doubts about political prospects, while expectations of amending the Constitution generate uncertainty in the medium and longer run. At this point, the fundamental problem does not lie so much with concerns of an overly drastic strengthening of the "vertical of power" (for entrepreneurs prefer the order to political liberties), as the absence of certainty and predictability of the government's

¹⁰ According to some assessments, the number of experts that noted the decline in the government's performance reached 62% in autumn 2004, thus practically doubled vs. spring 2004 (See: Konsensus-prognoz a 2004–2005 gody: pros professionalnykh prognozistov. 22 oktyabrya – 2 noyabrya 2004. M.: Centr razvitiya, 2004)

actions and lack of understanding of what the final point of the political evolution and deadlines for reaching it are going to be.

Most likely, it was the deterioration of the noted factors that underlay such 2004 negative outcomes as a deceleration in the growth of investment and the renewal of the private capital flight – the parameter that had been declining over two years prior to 2004.

Finally, the assessment of the role played by the state of affairs in the foreign trade area poses a special problem. In 2004 the analysts continued to share a popular view that implied that economic growth to a significant extent was fueled by high prices for oil and other Russian exports¹¹. In a nutshell, they believe that Russia's GDP growth rates should fall substantially under declining prices for oil, while the most radical experts go as far as to argue that the current growth can be replaced by a slump.

The great role of the mineral (the fuel and energy in particular) sector in Russia's, as earlier in the Soviet, economy cannot be questioned. The recognition of this fact also suggests recognition of a fundamental vulnerability of the country's economic and political system, as the collapse of the USSR to a significant extent was fueled by a drastic downfall of the price level for oil to which the Soviet economy had adjusted over the 1970s. But there cannot be direct analogues.

It is necessary to take into account two conditions: on the one hand, the collapse of the Soviet system was related not only to fluctuations of oil prices, but as well with an irresponsible structural policy the Soviet leadership had pursued over the preceding decades (this will be explained in a greater detail below). On the other hand, given an adequate economic policy, the downfall in oil prices forms a serious unfavorable factor just for the oil sector, while the others can even benefit from that, due to a decline in the oil producers' demand for some production factors that are designated for the consumption by all the sectors.

It should also be emphasized that the concentration of high proceeds within a single sector, or even in a few companies (including oil ones) creates preconditions of a degradation of the quality of an economic policy, gives a rise to the redistribution function of the state, which, in turn, generates prerequisites of an inevitable future crisis associated with the exhaustion of a "pool" for funding populist actions.

Thus, the impact of the downfall in oil prices on Russia's economic development appears far from unambiguous, and at this point one cannot draw any quantitative assessments. However, from the qualitative perspective, it is evident that once their role as the extra-economic source of growth declines, lower oil prices give a rise to additional mechanisms that generate other sector's development. But to make it happen, one needs an economic policy, whose adequacy implies, first, the soundness on the stage of high prices, i.e. prevention from a considerable increase of dependence of the budget on "cheap money", and, second, its adequate reaction to the situation when the foreign economic situation deteriorates.

These challenges are well known from our recent past, while experiences of some other resource abundant countries' likewise witness similar lessons. As noted above, the collapse of the Soviet system was related to the unsound economic, primarily investment policy over the 1970s, when a drastic price rise for oil resulted in an economic and political euphoria. The Soviet leadership was at pains to suspend economic reforms designed between the 1960s–70s, which were aimed at boost the efficiency of the Soviet economy and its adjustment to new challenges (that presently are known as the post-industrial chal-

¹¹ Illarionov A. Putin aide says growth threatened by stes//inancial Times. 004.October 7; OECD. Accounting for Rssia's post-crisis growth.<http://ideas.repec.org/p/oed/aecdec/404.html>.

lenges). The process was coupled with a structural transformation and abandonment of the equilibrium state of the 1960s, whose fundamental feature had been the country's low level of dependence on external markets, and a drastic rise of the latter on the domestic state of affairs. In less than a decade, the Soviet economy found itself dependent on imports, i.e. on foreign exchange reserve needed to ensure import supplies. That particularly concerned the consumer market (food stuffs in particular), and the machine –engineering sector whose produce was designated to ensure the extraction of extra energy resources. The country de-facto implemented the “oil (and gas) for food” program.

Such a policy allowed maintaining the Soviet economic growth at a certain level (albeit not sufficiently high, but as of that moment, higher than in many Western countries that at the time were facing the stagflation challenges) and the postponement of the urgent economic and structural reforms. But ultimately it has led to a complete fiasco.

Another example of the time was Mexico. Thanks to colossal resources the country accumulated because of high oil prices, the government decided that they found a simple way to solve their problems¹². The country was switched to the track of a drastic boosting of its growth rate and securing the nation's economic independence by means of fostering the public sector. With various investment programs in place, Mexican growth rates surged from 3–4% (1975–77) up to 8–9% (1978–1981), while the average annual rise in investment accounted for 16%. The budget was run with deficit, though, as envisaging future revenues, the government was keen to borrow heavily. The situation became to darken with the change in the trend of oil prices in early 1980s. The country's GDP began to fall, Peso was devalued by over 40%, the external debt grew from USD 40 bln. in 1979 up to 97 bln. in 1985 against the background of a drastic acceleration of capital flight and the fall in foreign reserves to USD 1.8 bln¹³.

Finally, it is worthwhile citing Iran – the country whose regime first benefited greatly from the oil boom and collapsed not after the downfall of oil, but on their peak. The critical factor for the destabilization there became an accelerated modernization implemented by the shah's government. The “from- top-to-bottom” modernization was to a significant extent alien to the countries' economic and social life and resulted in a rapid rise of tension in the society followed by the explosion in the form of the Islamic Revolution in the late 1970s.

But the governments of the 1970s could justify their actions, at least, by a practical absence of operating under negative dynamics of oil prices. Nowadays the situation is different – life itself showed that prices for main Russian commodities can fluctuate substantially and their dynamics are unpredictable, which a sound economic policy should take into consideration.

Furthermore, the longer the present price levels for oil are maintained, the more frequent the “this-is-forever” arguments can be heard. Such conclusions, however, are not convincing, and the dynamics of oil prices remains unpredictable and well “foretold in retrospective”, with very convincing arguments of why a given situation took place.

The Government's View on Economic Growth Problems

The RF Government's stand on issues of economic growth is mirrored in its program documents – “Main guidelines for the RF Government's operations for the period until 2008” and the draft of “The medium-term program of socio-economic development

¹² H. Portillo, then the President of Mexico, declared that “...our fundamental mission is to manage the growing welfare” and it was he who began to use the “administrative abundance” term.

¹³ While in the first years of Mr. Portillo in the office, he was a golden boy both domestically and overseas, by the end of his 6-year tenure he was accused of “squandering the nation's oil revenues, bizarre external borrowing and inflating budget expenditures”. After his resignation, President Portillo had to quit Mexico.

(2005–2008)”. Both documents are complex and systemic. While the preceding Medium-term program was approved just in August 2003 and covered the period between 2004 through 2007, the Government ruled to develop a new one. It seems quite natural, as the newly formed Cabinet must have to formulate parameters of its operations by itself. Furthermore, the new “planning period” coincides with Mr. Putin’s second term, i.e. the economic framework is naturally combined with the political one.

The debate focused on the objectives the President articulated in his 2004 Address to the Federal Assembly and, primarily, securing high rates of economic growth. In our preceding reviews, we have already cited four prevailing in the national expert and political community approaches to consolidation of economic growth efforts: an institutional approach (the focus on creation of institutions that promote growth), dirigist (an intensification of the government’s direct participation in economic life); fostering the development of financial-industrial groups; a radical lowering of the budget burden on the economy (the share of budget of the general in GDP)¹⁴. The 2004 discussions highlighted a clear prevalence of the first two approaches, which evidently manifested itself while experts were developing the Medium-term program.

As in earlier analogous documents, the Medium-term program accentuates the shaping of the institutions that secure a sustained functioning of a modern market economy at a high pace. In general terms, the set of proposed measures corresponds to tasks of the third stage of reforms. The priority economic policy avenues for the years to come are:

- creating conditions of increasing human competitiveness, enhancement of efficiency of the health care and educational, and pension and social protection systems, the housing and communal complex, a consistent overcoming the poverty;
- solidification of the state, including implementation of the administrative reform, increasing efficiency of the judicial and law enforcement systems and institutions;
- fostering civil society institutions, which is viewed as a critical factor of consolidation of economic growth efforts;
- strengthening the guarantees of property rights, including intellectual property, as well as promotion of privatization and enhancing of the efficiency of the public property management;
- development of result-oriented budgeting mechanisms, a transition to the development of agencies’ budget reports and new principles of budgeting at the federal level and consequently on the regional level;
- promotion of competition and reduction in the non-market sector, a profound improvement of the anti-monopoly law and the anti-monopoly bodies’ operations, including a liberalization of terms and conditions of economic transactions (mergers) along with a greater liability for monopolistic actions;
- liquidation of “bottlenecks” in the economy’s development, primarily infrastructure and technological ones, including reforming natural monopolists and increasing their operational efficiency;
- boosting the national producers’ competitiveness, developing small- and medium-sized businesses, which also form the investment attraction and economy modernization factor;

¹⁴ Russian economy in 2002. Trends and outlooks. Issue 24. M.: IET, 2003. p. 19-20
Russian economy in 2003. Trends and outlooks. Issue 25. M.: IET, 2004. p. 16-17

- encouragement of the innovational development of the economy, increasing the role of R&D in the country's economic development and their contribution to diversification of the economy;
- fostering economic development of Russian regions, supporting regional socio-economic development strategies, and creation of conditions that would encourage the Subjects of the Federation and municipal entities to mobilize the respective available economic growth resources;
- integration in the world economic ties and promotion of the openness of the national economy, which suggests joining the WTO, development of integration ties in the frame of CIS and other integration agreements (EURASEZ, United Economic Zone, the Union State), intensification of cooperation with EU and receiving the membership in

Proponents of the institutional model of consolidation of economic growth are skeptical towards possibilities for developing sectoral priorities of economic development. It is assumed that in the modern post-industrial world the state may not – and should not – “appoint” priority sectors in the medium- or longer run. Plus, practically all the sectors today have a chance to grow into a locomotive for the growth of a national economy.

In parallel with that, there was designed another approach to the acceleration of economic growth that suggested an intensification of an immediate involvement of the state in economic processes and fostering certain sectors. Underlying the approach is an assumption that economic growth will be fading unless it is not guided by the state and the mission of doubling GDP in ten years will consequently be failed. As concerns main instruments of this particular approach, they are as follows:

Sectoral growth strategies, which should identify major challenges, bottlenecks in the socio-economic development area and suggest ways to resolve them. By their essence, these are ministries and agencies' actions plans, which can also form the basis for assessing performance of the respective agencies and their heads' efficiency.

A serious problem arising in the event this approach is implemented lies with the fact that such strategies are designed practically under non-existent budget constraints. Sectoral representatives identify development avenues and growth points they believe are desirable or necessary and design a program of their development (or elimination of a given bottleneck) and, naturally, set maximum volumes of funding. As a result, by some estimates, the envisaged aggregate volume of resources of the strategies developed in 2004 amounts to USD 1 trln. Though the respective computations suggest the availability of both the public and private capital, they do not substantiate the possibility for their attraction. The RF MinFin appears loosely associated with the work on the strategies design and has not by far regarded them as a serious instrument capable to produce budget requests, while the private businesses' readiness to participate in an implementation of such strategies and the level of their participation are to a greater extent dependable on the political prospects for the country's development, rather than thoroughly designed strategic documents.

Standardized (or targeted) forecasting as the basis of the country's macroeconomic policy. This term first appeared in 2004 in the course of drafting the Main guidelines of the of the RF Government's activity and generated a heated debate. Its proponents viewed it not only as a way of analysis of development tendencies of the national economy, but building the tendencies with account of these or those government's actions, which in this case become exogenous to the forecast and affect envisaged outcomes. In other words, the standardized nature of the forecast reflects its dependence on a given policy underway and, accordingly, proceeding from a set of economico-political options, it can help formulate a set of forecasts one of which will be the targeted one. Critics of this approach

claimed that it essentially did not differ much from the traditional Soviet economic planning system, thus inhibiting the possibility for market forces, which can offer more effective, albeit not planned by the government, to exert their influence.

The state investment activity forms one of the key parameters of any dirigist policy. It is assumed that the government should invest in some sectors of a national economy which appear either insufficiently attractive to the private sector and may provide a strong impetus to economic growth, or may encourage the private sector to head for the sectors that are considered attractive.

The suggestion to re-galvanize the government's investment activity laid upon yet another grounds: that is, institutional reforms require rather a long period of implementation, while their effect on acceleration of economic growth implies considerable time lags that appear practically unpredictable. By contrast, investment has an immediate effect on growth. But there exists the resident's order to ensure a 7-8% growth annually. Naturally, public investments begin to be viewed as an important instrument of accomplishment of the political mission¹⁵. It is a different thing, however, that it will take time to realize how efficient these investments have been and if they can form a growth factor not only today (when they are being made), but in the future, too. It should not be forgotten, that the USSR, and later Russia's, experiences of employment budget resources for investment purposes have been, by and large, negative.

The year of 2004 saw a widespread of the idea of capitalizing on the use of such an instrument as *the public and private partnership*. Essentially, it is a joint implementation of large projects by the state in cooperation with the private sector. It is assumed that while the government would create infrastructure, private businesses would be developing production around it. This mechanism in principle can prove to be efficient in some cases, but it requires a very high level of mutual trust between the state and businesses, which is not the case in today's Russia, no matter how much both parties hail to this idea. It should also be mentioned that by their concept PPP appears an imperfect alternative to privatization and leasing, as it suggests charging the public assets transferred to private companies with the requirement to use them as per the purposes set by the state.

Price regulation. Last year, after a long pause, ideas of introducing the state price regulation once again began to circulate within the political circles. So far, they were reduced to a restoration of the regulation of domestic prices for oil and ferrous metals, due to a rapid price rise for these commodities, as well as to the respective export restrictions. It was MP=s that very especially vigorous in raising these issues, while in December 2004 the State Duma even produced an official recommendation to the Government to start regulating oil prices¹⁶.

¹⁵ The mission of securing high and sustained economic growth rates sometimes leads to unforeseen consequences. The priority attention begins to be focused not on long-term and efficient projects, but on those that meet two criteria- they should be at the stage of great readiness for implementation and almost immediately secure high economic growth rates. Today, in Russia, these criteria is met most of all by investment in the fuel and energy sector – because of a high level of its development and a great staffing potential. Plus, the sector is in possession of well-designed investment projects and can provide a visible contribution to the rise in GDP – both at the stage of construction and with its exports. As a result, the advocates of reactivation of the state investment policy often find themselves in a dual position: on the one hand, they believe state investments should promote diversification of the national economy, while on the other, they propose to concentrate the government's investment activity on development of the infrastructure of the fuel and energy sector. It is evident that the second task is poorly correspondent to the mission of diversification of the economy and exports.

¹⁶ It would be incorrect to associate such ideas with the Soviet legacy. The eagerness to regulate market problems by means of state price regulation was characteristic of the period of industrialization of the Russian Empire between 19-20th centuries. In the period prior to the World War and especially in 1907–1910) the State Duma repetitiously addressed the issue of price rise for oil and saw its causes lying in the monopolist collusion between oil producers. MP=s, mostly those from the right-wing parties, demanded from the government to take steps that would range from the introduction of the state price regulation to the state monopoly in the oil sector.

Whilst some of such recommendations on intensification of government interference can be explained by challenges the national economics facing these days, in the current Russian practices there exist fundamental obstacles to implementation of the dirigist ideas. First, they lie with extremely limited possibilities for forecasting sectoral and structural priorities characteristic of the present stage of technological development. Second, the lack of maturity of political and legal institutions by itself forms a barrier to deploying state regulation instruments, as the absence of an efficient law enforcement system hampers the design and selection by the state of actually effective projects. Thirdly, the already noted lack of mutual trust between all the participants in the economic life – be those households, firms, or the state itself. In other words, as long as the law enforcement institutions remain inefficient, the government's decisions continue to scare or appall entrepreneurs, while human development remains underfinanced, a direct state interference with the economy (and, primarily, investments) will remain inefficient.

The search of funds to ensure the budget expansion encourages some experts and policy makers to refer to two pools of funds – the Stabilization Fund and foreign reserves. The latter proposal appears clearly bizarre and evidencing the absence of understanding of the nature of reserving, for a use of foreign reserves is equal to the CBR directly crediting the national economy, as the Rb. mass equivalent of the reserves, has already be issued against the purchase of foreign exchange. I.e. some experts *de-facto* suggest using the same forex reserves to once again issue their Rb.-denominated equivalent, which is an unsecured money issuance.

Theoretically, the Stabilization Fund can be spent on current financing, but it consequently would find itself incapable of servicing to its principal mission, which is preclusion from the dependence of the state budget and, accordingly, recipients of budget funds from the state of affairs in the foreign trade area. However, the Stabilization Fund is doomed to be subject to an intense political struggle. With the presence of such a pool of free funds available, a financial agency finds it extremely complex (even impossible) to resist a united pressure of sectoral agencies and other groups of interest, especially when we speak of a country involved in a war and overcharged with huge social obligations. Being keen to protect the fundamental guidelines of their course, in late 2004 the MinFin staff put forward some compromise ideas, such as, in particular: to use the Fund in part to cover the shortage of resources at the Pension Fund in 2005; to raise the cut-off price for completing the Stabilization Fund from USD 20 to 21/barrel, effective as of 2006, to spend the resulting extra budget revenues (a. Rb. 60 bln.) for investment purposes to be set by the RF Ministry of Economic Development and Trade¹⁷. This undoubtedly forms the precedent, and the fundamental becomes the question as to what extent this compromise would mirror the trend towards the loosening of the budget policy. But these modifications were not included in the 2005 budget and the excess of the Stabilization Fund over its threshold level is allowed for spending only to cover the Pension Fund's deficit and an early foreign debt repayment, which is in line with the presidential Budget Address.

Proposals on intensification of the state investment activity appear especially embarrassing, given the unpredictability of oil prices. With the account of this, one should be ready to answer a number of tricky questions. First, what is he going to do if after the

¹⁷ Naturally, the proposals to expand the state investment activity is accompanied by declarations on creation of conditions for a maximum efficient use of the funds. According to the RF Minister of Finance A. Kudrin, " the RF Ministry of Economic development and Trade and the Ministry of Industry and Energy in cooperation with the RF MinFin will be assigned with a task to design procedures for formation of such a fund in the budget frame and consequently develop procedures of project selection and spending funds. It will undoubtedly be an international evaluation, independent assessments, tenders, independent, hired managers, rather than civil servants" (INTERFAX-AIF. 2004. 4 November).

launch of projects back-upped by huge state investments the price for oil falls and the USD inflow fades? Second, what will be the destiny of the sectors that have failed fall under the state patronage, once Rb. further appreciates resulting from an expansion of the state financial activity, which, in turn, leads to a drop in competitiveness of a considerable part of the economy? Third, how would one neutralize effects from a fall in the country's credit rating and what is going to happen with the budget, once a tension arises in this regard? Fourth, what is one going to do with non-interest expenditures in the situation when oil prices have fallen, while the Stabilization Fund has been spent?

While designing the Medium-term program for 2005–2008, proponents of the institutional approach entered in a heated debate with those advocating the dirigist approach. The program ultimately highlights the problem of fostering modern market economy institutions, but coupled with some sectoral references, thus presenting in part a digest of the strategies, while partly – the description of sectoral problems typical of preceding documents of this kind.

In such a situation, it is especially important that the Program provides an unambiguous reference to the necessity of provision of macroeconomic stability and budget constraints under implementation of any economico-political decisions. The document particularly emphasizes the sound macroeconomic policy, with its fundamental parameters, such as predictability, ability to adapt to external changes, and transparency, as a critical condition of fostering a favorable entrepreneurial and investment climate.

All the above has not yet testified to the prevalence of the institutional approach in the country's present economico-political life. The actual economic policy in the short run will be much more important than declared intentions, but that will depend on the price dynamics for oil. Should export prices for major Russian commodities remain high, they will strengthen the position of those who prove the *status quo* will be there in the long run, thus provoking a turn towards softer budget policy and populism.

1.1.4. The 2004 Main Domestic Political Outcomes

Presidential Elections

The presidential elections in Russia took place in March 2004. After CPRF refused to pursue the goal of breakdown of the elections (recommending Mr. N. Kharitonov for the presidential race, appointing observers, propaganda of boycott of the elections in order to decrease the number of votes to less than 50%), there remained no doubts of Mr. Putin's victory. However, it was important both to Mr. Putin and the opposition to understand the level of their popularity.

According to the Central Electoral Commission, 64.3% of voters took part in the elections, i.e. at 10% more than at the parliamentary elections in December 2003. V. Putin gained 71.3% of votes, i.e. at 20% more than in 2000, followed by N. Kharitonov (13.6% of vote), while S. Glazyev and I. Khakamada lagged far behind them with 4.1% and 3.8% of vote, respectively, and yet another 3.4% of votes were against all the candidates. International organizations that monitored the race and elections claimed that the public, primarily electronic, media had put the candidates in different positions, clearly favoring the winner. The OECD observers believed the elections were well organized, but not correspondent to the European standards.

As long as the party and political spectrum is concerned, the communists kept their positions, while deprived of the sponsors' support, Mr. Glazyev suffered a catastrophic defeat. As concerns I. Khakamada, who had counted on attraction of additional "generally

democratic” vote, she failed to at least repeat her own party’s (URF) result at the parliamentary elections. But it does not make any sense to seriously comment on results of the rivals to Mr. Putin, for too meager were the resources they had spent on delivering their messages to the electorate. The presidential elections became the first signal of the degradation of the existing parties and their transformation into political plaster casts.

The State Duma of RF

Once the 2003 parliamentary elections resulted in the rise of the pro-presidential majority in the State Duma, some experts speculated of the opportunity for introducing constitutional amendments that would increase the president’s role or even the one played by United Russia. That did not happen. Instead of that, the emasculation of the constitutional provisions was opted for. That primarily concerned the provision on democracy and implied passing through the Parliament amended statutes on elections, referendum, political parties, procedures of formation of executive power agencies in the Subjects of RF, among others. Thus, referendum (that has not taken place since 1993) appears rather a strong form of influence on the government and an advertising campaign for political parties, while the new statute on referendum contains such a critical innovation as the procedures of collection of signatures: after having their own signatures certified by a notary, 4.5 Thos. individuals, by 100 ones in each region (there should be not less than 45 regions), should collect a 2 mln. signatures within two months, while other individuals have no right for collection of signatures. As a result, the procedures of conduct and organization of referendum became prohibitively bureaucratic and sophisticated.

MPs from United Russia, LDPR and Motherland also passed a bill that demanded from political parties to have 50,000 party members vs. 10,000 as was stated in the earlier law on political parties. Interestingly, the communists refused to support the bill, while apart from the “party of power”, they are the only political party that has a chance to match this particular criterion. Yet more interesting became the fact that Russian political parties do not protest against the United Russia’s initiative, which evidently would grant the right to exist only to “correct” for the power parties, as the criteria of examination of the number of party members are absolutely non-transparent. In all likelihood, other political parties keep silent, because they are merely reluctant to announce the actual number of their members.

In 2004, the Duma ruled to make the transition to the proportional system of parliamentary elections. It was announced that an MP could be recalled upon the ruling by the court of law under such a non-formalized pretext as “the failure to perform his obligations to the citizens”. The Duma also introduced the imperative mandate that ties the MP up to the faction from which he has been elected.

After a series of defeats of the United Russia’s candidates at the 2004 spring regional elections (Arkhangel’sk, Ryazan, Altay) and in the wake of the Beslan massacre, the Duma passed a law package on governors appointment. According to the respective bills, the power to appoint the governor on the no-competition basis falls within the purview of regional legislature. Interestingly, in the event the regional parliament thrice rejects the candidacy, the President of RF may dissolve the parliament and is bound to appoint an acting governor. The President dismisses the governor under various circumstances, particularly, in the event of “the loss of the President’s trust”.

While discussing prospects for the electoral system reform and the one of the regional executive power agencies, it should be noted their insignificant role in the medium and longer run. With no guarantees of free elections (the right for vote re-count, financial sources independent of the government, independent TV, etc) the form of voting, be that a

majority or proportional one, does not matter. As concerns governors, many of them, anyway were *de-facto* appointed by means of withdrawal of their rivals and falsification of elections of votes. One equally cannot speak of most governors as figures that enjoy, at least, a relative independence in the federal politics and are sustainable to pressure, etc.

Main Political Parties in 2004

By contrast to numerous predictions, United Russia has not split into the leftist and right wings in 2004, nor it has developed its own ideology and appeared institutional complete, as far as the legislative process is concerned. In ideological sphere the party rapidly drifts not to the declared “centrism” (notably, its leader, Mr. Gryzlov, no longer call it the right-centrist party), but to an eclectic formation of LDPR-type. As such, United Russia implicitly supports any r. Putin’s initiatives and arrogates all the best happening in the country to itself, while the worst – to its political opponents.

This also lies in line with the strategy of monopolization of the political space by the United Russia, as well as LDPR and Motherland provide an ideological back-up to the policies underway, thus putting UR in a favorable position and, at the same time, frightening the domestic and, especially, overseas public opinion. The UR faction in the Parliament has failed to unfold as a fair parliamentary structure, with its MPs being *de-facto* disfranchised¹⁸, while all the policy proposals fall under powers of its 3–4 heads and a few professional lobbyists. The actual abolishment of the Supreme Council of the party formed by a “long bench” of popular and semi-popular governors became a symbolical sacrifice, for they are not needed now to attract votes. The supreme body of the party is the Bureau of the Supreme Council which de-facto unites the

leadership of the faction, executive party bodies and some representatives of the presidential Administration and sponsors.

In July 2004 two leftists parties, CPRF and Motherland, held their congresses. Whole political commentators predicted the prevalence of the pro-Zyuganov majority at the CPRF party congress, the latter were failed by the archaic party Statute that suggested a cumbersome structure of its executive bodies (elected by the Congress, the party’s Central Committee members outnumbering 100 is to elect the party’s Chairman and his Deputies). Prior to the announced date of the Congress there had been convened two plenums of the central Committee of CPRF, and it cannot be excluded that both managed to have quorum (for Mr. Zyuganov’s enemies concentrated mostly in the party’s central bodies, rather than in its regional organizations, and many CC CPRF members succeeded in attending both forums). One of the plenums dismissed Mr. Zyuganov from the party Chairmanship and elected Mr. V. Tikhonov, the governor of Ivanovo oblast, instead (incidentally, Mr. Zyuganov more than once paid tribute to Mr. Tikhonov as a successful red governor”, notwithstanding an evident impoverishment of his region). In addition this plenum decided to change the Congress venue. The “Zyuganov Plenum” naturally voted for him as the party leader and expelled the opposition leaders from the party.

The two conflicting parties ultimately began to appeal to the RF Ministry of Justice with a request to prove the legitimacy of their respective plenums. As by the date of the Congress most party delegates apparently had become convinced in the power of the pro-Zyuganov’s majority, they deserted to his camp. Finally Mr. Putin received Mr. Zyuganov which was viewed as a sign of support to him from the top.

¹⁸ He is even in a worse position than others. For instance, he cannot introduce a bill or amendment, or even to hire an aide without the faction’s consent.

Because of the internal conflict, the protest actions against the passing in the first reading of the so-called “social package” (monetization of benefits) were substantially weakened. It is not appropriate presently to have CPRF split, for a smaller, albeit independent of the government and radicalized political group would pose a far greater problem to the federal policy makers.

As concerns the Motherland’s congress, whose brand belongs to Mr. D. Rogozin, it was the “congress of winners, with Mr. Rogozin elected as the party Chairman, while Mr. Babakov, the head of TSKA soccer club, – as the Chairman of its Executive Committee.

LDPR, as usual, did not demonstrate any serious activity in the period between elections.

The year of 2004 was not successful for the rightist forces. URF has failed to elect a new leader, while Yabloko, whose self-positioning is a bit more articulated, suffers from a total lack of funding.

The civil congress entitled “Russia for democracy and against dictatorship” was held on December 12, 2004. The forum has failed to emerge into a serious factor of designing the rightist parties’ development strategy. Furthermore, the obvious issue of attraction of the masses to stand for democratic freedoms and against the red-tape oppression triggered a heated debate, for some participants in the forum believed that in Russia the masses can be mobilized only under national-socialist slogans. The leftist-hue participants, on the contrary, saw the genuine source of troubles in the “Eltzin Constitution” and “liberal reforms”.

Obviously, the oppositional to UR parties’ main mission so far will be a historical analysis of the last century’s events – from 1917 through 1993, rather than survival. That is why they do not deserve any interest in, nor they raise any concern about them.

By contrast to the federal parliamentary elections, the parties demonstrated a different performance at regional ones, which were held by party lists in the half of constituencies. The party of power’s performance outcomes showed a striking contrast between 70% of votes collected in Tatarstan and the humble second result in Altay Krai and Sakhalin. Overall, nearly everywhere UE showed poorer performance vis-avis the federal parliamentary elections, while they dropped substantially only at Sakhalin (from 30.1 to 17.7%) and Tula (29.9 to 22.3%) Oblast elections.

The communists have won representation in all the local legislature, while their results do not basically differ from those in December 2003. Quite a number of voters supported Motherland clone blocks and they likewise overcame the 5% barrier practically everywhere.

URF played a real dark horse at the elections, with overcoming the barriers in 5 regions and losing 1 just 2 ones, while Yabloko either failed to participate or suffered a defeat. But a real eye-opener of the political cycle became the Russian Pensioners’ Party that overcame the barrier in all the regions. Finally, representatives of the Agrarian Party were also elected in some regions.

1.1.5. The 2004 Main Foreign Policy Outcomes

Russia’s 2004 foreign policy was bearing two important components: those were, first, economic integration attempts in the CIS framework and, second, negotiations on Russia’s accession to WTO.

Russia’s CIS Policy

The presidents of Russia, Ukraine, Belarus and Kazakhstan agreed on establishment of the United Economic Zone (UEZ) and signed the respective agreement in 2003. But

there was no activity on adoption of documents necessary for the UEZ functioning afterwards. The process began to gain its momentum after Russia had promised in 2004 to pay VAT on its exported energy sources to the other counterparts' budgets. The price of the promise accounts for some Rb. 35.8 bln. annually. After that a task force coordinated the list of 29 priority agreements, which the presidents consequently approved. The documents should be ready for signing by July 1, 2005 and comprise, in particular, agreements on a free moving of goods, services, capital and workforce between the countries. But propelled by political, rather than economic, considerations, the eagerness to accelerate the creation of UEZ will hardly entail greater benefits for Russia than those resulted from other similar projects (the Union state of Russia and Belarus, EurAsEZ).

De-facto, in 2004 UEZ was a PR-club for "non-elected" presidents against the background of parliamentary elections in Kazakhstan and Belarus and presidential ones- In Ukraine. However, the concept for UEZ practically had lost its urgency by late 2004, when back-upped by Mr. Putin, Mr. Yanukovich was defeated at the presidential elections in Ukraine and had to leave the office under the pressure of mass protests against the falsifications. Many analysts believe that the newly elected V. Yuschenko would not be in favor of promotion of the UEZ project, which deprives it of prospects.

Negotiations on Russia's Accession to WTO

The accession to WTO on acceptable conditions as the way to secure Russia's accession to the international arbitration is dictated by the ongoing structural changes in its economy. Given that the USSR export to the West at 90% accounted for oil and gas, the present share of minerals in Russia's export accounts for just 50%. Such a decline in the proportion of minerals in the country's overall export has taken place thanks to the rise in the share of primary processed produce of the metallurgical and chemical sectors. But it is the group of exports that often falls a victim to protectionist policy.

In 2004, it suddenly has become possible to promptly finalize the negotiations between the RF Minister of Economic Development and Trade and the EU Trade Commissar. The final protocol set conditions of accession of EU companies to Russian markets for goods and services. He European Union lifted a greater part of its original claims in respect to the "energy package" (abolition of export duties on energy sources and OAO Gasprom's export monopoly, accession of foreigners to pipeline construction in Russia, increase of domestic gas prices, among others). The protocol contains obligations with regard to a full compensation with the gas price for the gas producers' domestic costs, including the investment component, and the refusal of a further rise of export duties. Other concessions of the Russian party included lowering import tariffs for civic aircraft, assembly parts and cars, cancellation of OAO Rostelecom's monopoly on long-distance communication, the promise to revise the system of levies presently applied to the EU air companies for the trans-Siberian flights, and ratification of the Kyoto protocol by Russia.

The above agreement with EU forms a substantial progress on the path of Russia's accession to WTO. Suffice it to say, the negotiations have been lasting for some 6 years, however, the process is far from completion. Certain countries, such as China and Australia in particular still have some claims to Russia, while the protocol with EU forms just a framework arrangement that needs further specification.

However, the refusal of the "WTO+" claims to Russia and, particularly, those involving an absurd price rise for these or those groups of domestic produces up to an "international" level signifies a considerable success of Russia's foreign trade policy.

The country has also managed to sign the respective individual agreements with Singapore, Taiwan, Chile and South Korea and to preliminarily convince China to cancel its claims for an unlimited supply of workforce.

Meanwhile, still the US and Canada are keen to negotiate such issues as opening banks and insurance companies' branches in Russia, and, in part, prices for energy sources), while Japan questions import tariffs for cars and the Kern group of countries – support to the agrarian sector.

1.1.6. Short-and Longer- Run Challenges and Risks

The fundamental risks to the country's sustained development in the medium run lie with foreign trade factors. The common is the view that a possible downfall in prices for oil and other Russian exports would form the main source of instability in Russia. But the present, extremely favorable, state of affairs on international markets forms a far greater danger, for high oil prices strengthen the populists' positions and appetite for a greater budget expansion at the expense of oil dollars.

The sustainability of Russia's economy demands for a conservative budget policy. It has become increasingly harder to advocate and pursue it when the country enjoys a colossal positive surplus of its trade balance. The pressure on the part of proponents of budget expansion manifests itself in some softening of the budget policy on which the financial agencies compromised in the 2005 budget. These measures include the increase of the projected oil price up to USD 28/barrel and comments on the readiness to spend a part of the Stabilization Fund on investment purposes.

The situation may turn yet more risky, once growth rate decelerate substantially, which cannot be excluded even under a favorable state of affairs in the foreign trade area, for the concerns of the political and legal situation in the country would hamper businesses' investment and entrepreneurial activity. In the event growth rate begin to decline notably against the background of high oil prices, that would give an nearly immediate rise to the emergence of the populist policy and primarily a broad budget expansion. At that juncture, the eagerness to boast with "good figures" may form a dominating motive in the economic decision making process. That would mean the victory of short-run red-tape interests over long-term challenges facing the national economy. Such a scenario is not, of course, inevitable, but it cannot be ignored, for the political and intellectual elites last year have been increasingly displaying a clear inclination to the budget expansion policy.

As long as encouragement of entrepreneurial activity and, consequently, maintenance of acceptable growth rates is concerned, the focus of attention should be put on prospects of development of the judicial and law enforcement systems. Once this particular system shows no signs of progress, this will form a main obstacle to businesses, both foreign and domestic ones. The latter would suffer at most, as they have no choice.

Finally, the predictability of the government's action is a fundamentally important issue. The state should not scare or appall investors and entrepreneurs – either in political area, or in the economic policy one. The first group of these fundamental problems envelops the stability of the constitutional system of which Mr. Putin made repetitious statements in 2004, stable rules of the game and predictability of their modification. The other group implies the return to stable tax and regulative conditions, refusal of the currently emerging tendency to a "manual regulation" of large companies' economic operations, securing the impossibility of employing the court of law and law enforcement agencies in competition.

Section 2. Monetary and budgetary spheres

2.1. Monetary Policy

The RF Government's monetary policy drew more attention in 2004 than in the previous 3 to 4 years. This was basically caused by some developments that took place in the banking system in May and June, namely breaking the upper limit of seasonal movements in the consumer price index that was prevailing over the last few years, and breaking the upper limit of inflation set as a targeted value by the Central Bank and the RF Government.

At the same time, close association of inflation developments and monetary aggregate movements normally breaks up under moderate and low inflation rates, as was clearly demonstrated by comparing their patterns in the previous year. In this case, cost-push inflation (prices of raw materials) and structural changes in prices had more impact on the rate of price increases. Under such circumstances, however, the role the RF Central Bank came down to practically curb real growth of the RUR exchange rate (against the basket of currencies), create initial conditions for introduction of free RUR convertibility and monitor the situation in the banking sector, while the RF Government was entrusted with the task of controlling inflation .

In this context, the following issues are worth analyzing :

- movements and factors of inflation developments ;
- changes in the demand and supply in the money market ;
- movements in nominal and real RUR exchange rate ;
- banking system development.

We will consider these in details below.

2.1.1. Inflation Development

At the beginning of 2004, monthly values of the CPI were less than the corresponding figures in 2003 (*Fig. 1*). The results obtained in the first half of the year allowed one to rely upon the forecast of consumer price growth in 2004 (from 8 to 10%). Since July, however, incremental growth of prices began to exceed the figures of 2003. Such movement was caused by a variety of factors, among which a rapid growth of prices of food products should be emphasized as compared to the previous year. In regard to the prices of non-food products, prices of motor gasoline grew faster than those in 2003. Finally, in regard to paid services, prices of the services rendered to the general public by the passenger transport industry and preschool institutions grew faster than those in 2003 .

Let's consider quarterly movements of the CPI.

Growth rates of consumer prices slowed down notably throughout the quarter 1 of 2004. In spite of the fact that in January prices of paid services for the general public were increasing at the rates comparable to those in January of the previous year, a more moderate movement of prices of food products caused a general decline in the CPI from 2.4% (in January 2003) to 1.8% in January 2004. The figures in February were also positive enough, especially having regard to prices of paid services for the general public whose growth rates dropped by 2.5 percentage points. Growth rates (by 1 percentage point) of prices of paid services kept declining in March 2004, which resulted in that the CPI growth rates decreased down to 0.8%. At the same time, the fact that growth rates in prices of food products and non-food products stopped to decline as was the case over the last few years, was a negative sign in March. Underlying inflation was 2.4% in the quarter 1.

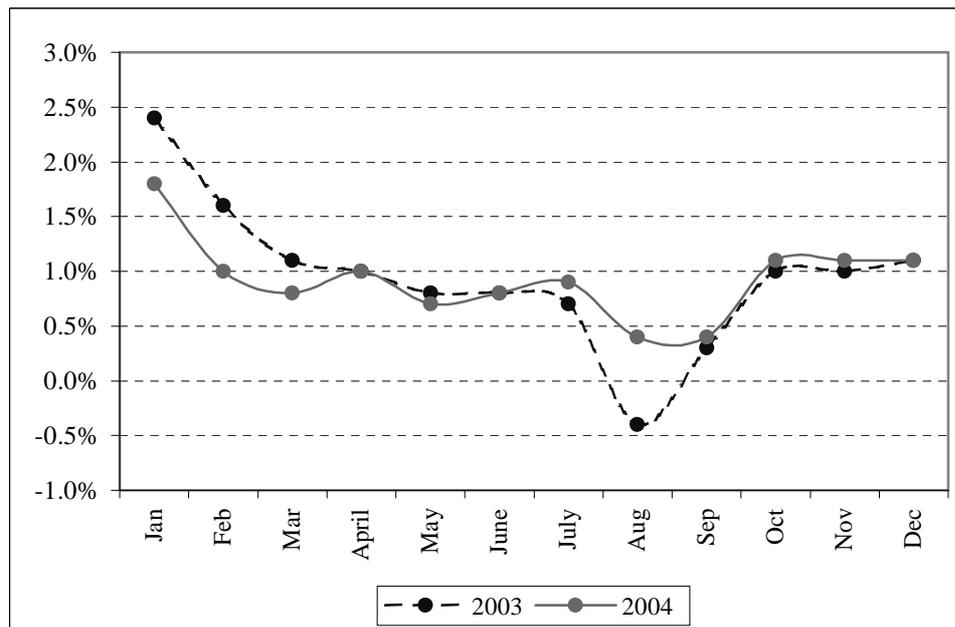


Fig. 1. Producer Price Index Movement in Russian Federation in the Period Between 2003 and 2004

In the quarter 2, the fastest incremental price growth, 11% over the first half of 2004 (by 15.6% in 2003), continued in the category of paid services for the general public. In general, in the first half of the year, all groups of prices of paid services for the general public grew more moderately as compared to the previous year, except for the prices of services rendered by preschool institutions and cultural organizations. Food products came second by incremental growth rates of inflation with price movements coming up to the values of 2003 (8%) for the first time since the beginning of 2004. Total incremental growth in this group accounted for 6% (against 7.3% in the first half of 2003). Basic inflation continued to slow down in the quarter 2 of the year. It accounted for 0.5% in June against 0.6% in May and 0.8% in April. Thus, underlying inflation accounted for 1.9% in the quarter 2. Basic inflation dropped gradually as a result of monetary pressure on prices (see below). It should be noted that inflation rates were equal to the corresponding values of 2003 only in April and June. Taking into account that the CPI grew at a slower rates during the rest of the months of the first half of the year than in the previous year, there were reasons to suggest that consumer prices would grow up within the expected limit of 10%.

However, from the beginning of July consumer prices began to grow at faster rates than in 2003. For example, in the period between July and September 2004 they increased by 1.7% (by 0.6% over the quarter 3 of 2003). The CPI in 2004 was beyond the corresponding value in 2003 in each month of the quarter. By the end of the quarter, prices of food products grew up by 7.2% since the beginning of the year (against 6.1% in 2003). In the period between July and August 2004, seasonal decline in prices of fruits and vegetables went slower as compared to the previous year. As early as in August, when growth rates in prices of food products were positive as opposed to July, price growth since the beginning of the year exceeded the values of the two last years. Prices of non-food products grew by 5.5% by the end of September (by 6.6% in 2003). Prices in all sub-groups of non-food products increased at more moderate rates in 2004 as compared to the previous years. Incremental growth of tariffs on paid services for the general public accounted for

14.3% by the end of the quarter 3 (by 19.7% over the corresponding period of 2003). In this sub-group, incremental growth of services of preschool organizations exceeded the corresponding figures of the previous year (by 6.9 percentage points). The reference index of consumer prices increased by 6.8% since the beginning of the year.

Thus, it is fair to say that according to the figures of the quarter 3, there was no traditional seasonal growth impairment of consumer prices in August thru September, let alone any decrease. In spite of a positive movements of monetary factors (incremental growth of the narrow monetary base accounted for 5.1% over 9 months in 2004 against 26.1% over 9 months in 2003) which encouraged restriction of underlying inflation, a record price rise of industrial products by industrial manufacturers as well as substantial price growth of motor gasoline and a series of vital food products imposed additional inflationary impact on the economy.

Rate of price increases stabilized at 1.1% monthly in the quarter 4 (in 2003, such inflation rate was recorded only in December, while the CPI equaled to 1% in October and November). Prices of food products grew up more rapidly (+4.7%). Prices of food products get up by 12.3% from the beginning of the year (against 10.2% in 2003). It should be noted that prices of red meat and poultry meat grew up dramatically: by 19.6% in 2004, while they didn't exceed 8.9% in 2003. Paid services for the general public came second in terms of growth rates which accounted for 3% in the quarter 4 of 2004 against 17.7% in 2004 (22.3% in 2003). Prices of passenger transportation services (+18% in 2004 against +13.7% in 2003) and services of preschool institutions (+21.6% in 2004 against 15.1% in 2003) grew at faster rates in this group as compared to 2003. Finally, prices of non-food products grew by 1.8% in the period between October and December 2004, while in 2004 they grew up by a total of 7.4% (by 9.2% in 2003). Prices of motor gasoline dropped in December (by -1.7%). However, prices of motor gasoline grew by a total of 31.3% in 2004 (as compared to 16.8% in 2003).

Going to the analysis of factors which governed the growth in consumer prices in 2004, it should be noted that cost-push inflation became the main cause that maintained fast growth rates of the CPI, i.e. price rise of manufacturers' products, prices of final products grew at faster rates in the majority of industries in 2004 as opposed to the previous years (*Fig. 2*). In addition, it is seen from the Figure below that prices of products of food industry and light industry grew at extremely fast rates in 2003, which effected retail prices of the products of these industries in 2004.

In 2004, prices of the products of fuel industry and iron and steel industry (over 60% annually) grew at fastest rates, which is mostly associated with the price rise of corresponding products in the world markets. Hence, one can say that the internal market of oil and ferrous metals in Russia has gradually been integrating into (due to transparency of such industries and a larger share of exported products) the world market, and fluctuations of world prices also have an effect on the internal market. Consequently, high rates of price growth were also recorded in industries consuming the products manufactured by fuel industry and iron and steel industry, i.e. chemical industry, petrochemical industry and machine industry.

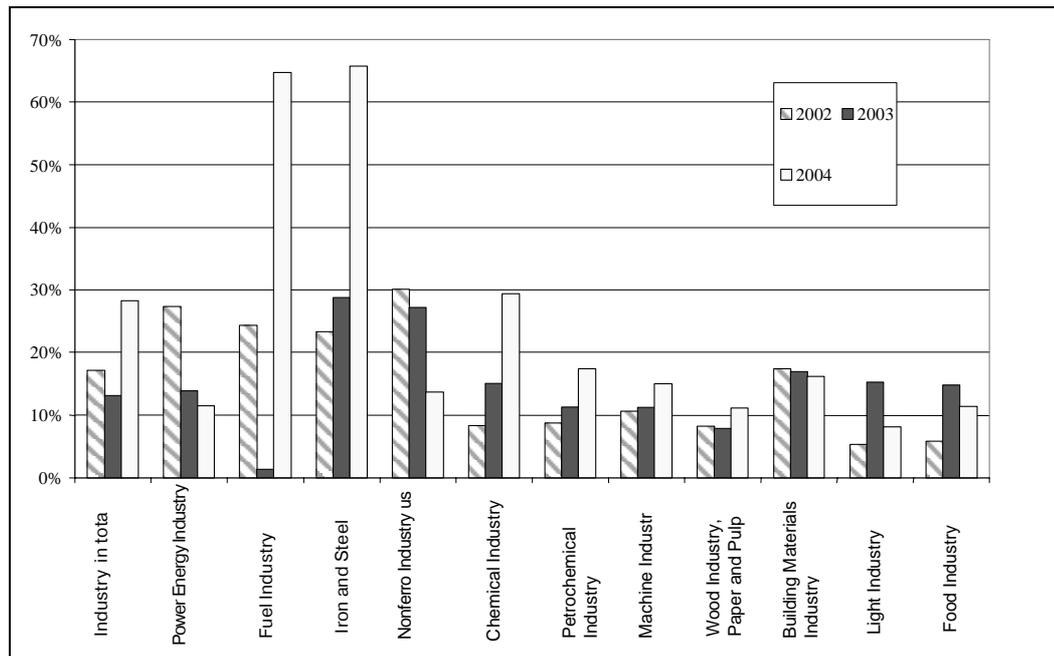


Fig. 2. Incremental Growth of Prices of Manufacturers' Products in Various Industries in the Period Between 2002 and 2004

Hence, according to the figures of 2004, the CPI in Russia accounted for 11.7%, which is slightly beyond the figure (12%) of the previous year. The underlying inflation was 10.5% in 2004 (11.2% in 2003). The industrial manufacturers' price index reached 28.3% (13.1% in 2003). The latter creates preconditions for further growth or retarded decline of inflation in 2005 (for details on the inflation forecast for 2005 please refer to section "Macroeconomic Forecast for 2005" below).

2.1.2. Money Supply in the Economy

In 2004, the gold and foreign exchange reserves of the Russian Federation were built up steadily. This was mainly caused by record-breaking prices of basic Russian export goods, primarily oil. At the same time, incremental growth of the reserves was moderate enough until September when they grew substantially as a result of the USD exchange rate fall in the global financial markets, as well as stabilized situation in the Russian capital market. By the end of the year, the gold and foreign exchange reserves reached \$124.5 billion thus increasing by 61.9% (+\$47,6 billion) during the year.

Such growth of the gold and foreign exchange reserves was apparently accompanied by printing of currency by the RF Central Bank in making transactions in the foreign exchange market. However, annual accumulation of the gold and foreign exchange reserves by the Bank of Russia and consequently monetary base growth was not steady (Fig.3).

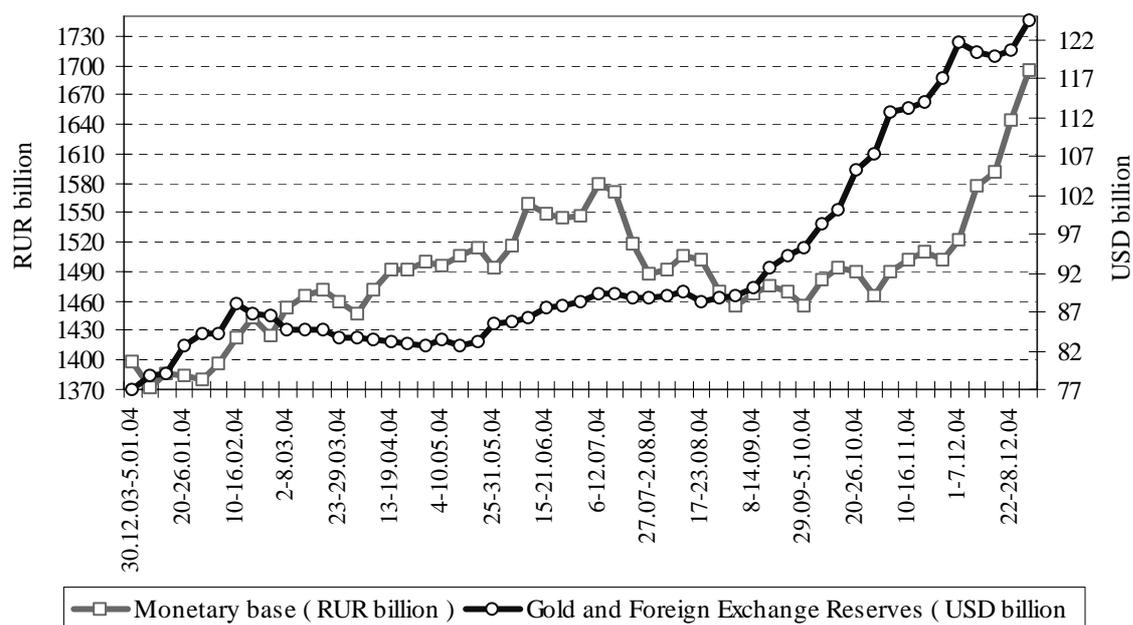


Fig.3. Movements in Monetary Base and Gold and Foreign Exchange Reserves in 2004

By the end of the quarter 1 of 2004, the broad monetary base¹ accounted for RUR1936,6 billion thus increasing by 1.2% since the beginning of the year. It should be noted that the broad monetary base grew at faster rates (4.2%) in the quarter 1 of 2003. At the same time, the volume of cash in hand decreased by 1.9% over the period under review in 2003 against the growth by 0.8% in 2004. Hence, for the first time over the last few years we could see increasing volume of cash in hand in composition of the monetary base in the quarter 1. Growth rates of compulsory reserves in the quarter 1 decreased slightly from 8.9% in 2003 to 7.9% in 2004. The narrow monetary base grew from 1392,1 up to RUR1458,5 billion (+4,8%) over the quarter 1. Incremental growth in the narrow monetary base over the corresponding period in 2003 accounted for 1.1% against 17.4% in the quarter 4 of 2003. Growth rates of the monetary base was caused mainly by slow-downed growth rates of the gold and foreign exchange reserves of the Bank of Russia . According to the results of the quarter, the gold and foreign exchange reserves grew from \$77,8 billion up to \$83,7 billion (+7.6%), which was related mainly to the Bank of Russia's transactions aimed at flattening fluctuations of the USD exchange rate in the Moscow Interbank Currency Exchange (MICEX) and external debt payments .

In the quarter 2, the broad monetary base decreased by 0.9% to account for RUR1,92 trillion as of July 1, 2004. The volume of monetary base increased by 0.3% as compared to the corresponding figure as of January 1, 2004 . It should be noted that the volume of monetary base decreased by 3.5% over the period between April and May, and grew by 2.7% only in June. It will be recalled that the monetary base increased by 19.4% in the quarter 2 of 2003. As of July 1, the volume of cash in hand accounted for RUR1.35 trillion (which exceeds by 9.5% the figures as of April 1, 2004) including cash balances of

¹ The RF broad monetary base includes money on correspondent accounts of credit organizations and bank deposits with the Bank of Russia, besides the outstanding cash issued by the Bank of Russia and compulsory reserve balances in national currency of the funds borrowed by credit organizations and deposited with the Bank of Russia .

credit organizations. The volume of accounts of credit organizations with the Bank of Russia shrank by 3.9% down to RUR223,1 billion over the quarter 2. Compulsory reserves shrank by 12.7% down to RUR251,2 billion in the period between April and June. Banks' deposits with the Bank of Russia decreased down to RUR38,4 billion (-65%) over the quarter 1. As of July 1, the amount of obligations of the Bank of Russia on repurchase of securities decreased by 22.9% as compared to April 1 and accounted for RUR56 billion. Hence the structure of monetary base was effected by the crisis in the banking sector of the Russian Federation that took place in the period between May and June of 2004: sharp reduction in liquidity of the interbank credit market resulted in shrinkage of banks' deposits and accounts with the RF Central Bank, compulsory reserves were reduced as a result of depositors outflow, and the RF Central Bank's attempts to increase liquidity of the interbank credit market led to reduction of its obligations to banks on repurchase of securities.

Substantial growth in volume of cash in hand (+9.5%) in the quarter 2, including deposits outflow from the banking sector and reduction of compulsory reserves, led to increase in the narrow monetary base (cash + compulsory reserves) by 5.9%.

The broad monetary base reduced by 4.8% in the quarter 3 and accounted for RUR1,83 trillion as of October 1, 2004. The monetary base was reduced by 4.5% as compared to the corresponding figure as of January 1, 2004. It should be noted that an insignificant growth of the monetary base was recorded only in September (+0.1%), while it was shrinking in the period between July and August. It will be recalled that the monetary base was reduced by 3.2% over the quarter 3 of the previous year. As of October 1, cash in hand plus balances of credit organizations accounted for RUR1,37 trillion (which exceeds by 1.6% the corresponding figure of July 1 of the current year). In the quarter 3, the volume of credit organizations' accounts with the Bank of Russia remained practically the same and accounted for RUR223,4 billion at the end of the quarter. Compulsory reserves were sharply reduced down to RUR116,1 billion (-53.8%) in the period between July and September. At the same time, banks' deposits with the Bank of Russia increased up to RUR45,4 billion (+18.2%) over the quarter 3. As of October 1, the value of obligations of the Bank of Russia for repurchase of securities increased by 21.4% as compared to July 1 and accounted for a RUR68 billion. Hence the downward movement of the monetary base in the quarter 3 was caused mainly by the shrinkage of the compulsory reserves fund due to substantial reduction in corresponding regulations of the RF Central Bank (since July 8, 2004). At the same time, stabilization in the banking sector led to a growth of banks' deposits with the Bank of Russia and its obligations on repurchase of securities.

Changes in the narrow monetary base (cash + compulsory reserves) in the quarter 3 were also governed by a sharp reduction of the compulsory reserves fund at the background of insignificant growth in cash: as a result, this aggregation was reduced by 4.8% over the period between July and September. In spite of a substantial growth in the gold and foreign exchange reserves in the quarter 3 (+7.8%), the monetary base couldn't show growth due to large withdrawals of liquidity to the budgetary system (incremental growth of deposits of state administration agencies with the RF Central Bank exceeded RUR125 billion in the period between July and August alone).

Over the quarter 4, the broad monetary base increased by 30.6% and accounted for RUR2,39 trillion as of January 1, 2005. The volume of monetary base increased by 24.7% as compared to the corresponding figure as of January 1, 2004. It should be noted that the volume of monetary base increased throughout the entire quarter 4, the fastest growth was recorded in December (+14.5%). It will be recalled that over the quarter 4 of 2003, the monetary base increased by 29% with total growth accounting for 55.3% over 2003. The volume of cash in hand plus balances of credit organizations accounted for RUR1,67 tril-

lion as of January 1 (which exceeded by 21.6% the corresponding figure of October 1, 2004). Volume of accounts of credit organizations with the Bank of Russia increased by 2,2 times, up to RUR486,4 billion over the quarter 4. Compulsory reserves grew by 4.8% up to RUR121,7 billion in the period between October and December. The volume of banks' deposits with the Bank of Russia grew up to RUR91,4 billion (double increase) in the quarter 4. As of January 1, the value of obligations of the Bank of Russia on repurchase of securities reduced by 96% and accounted for a RUR2,5 billion as compared to October 1. Hence, the monetary base of the Russian Federation was notably widened in the quarter 4 at the background of a substantial growth in the gold and foreign exchange reserves.

Expansive growth in both cash in hand (+21.6%) and compulsory reserves (+4.8%) in the quarter 4 led to a 20.3% increase in the narrow monetary base (*Fig. 3*). Such growth was caused by purchase of large volumes foreign currency by the RF Central Bank. The gold and foreign exchange reserves of the Bank of Russia grew by 31% and reached \$124,5 billion in total over the period between October and December.

Hence, according to the results of 2004, the monetary base grew more moderately than in 2003. However, it grew at faster rates in the quarter 4 than in the previous year. It should be noted that the gold and foreign exchange reserves grew slower until September as compared to 2003. On the other hand, reserves of commercial banks shrank substantially after reduction of the compulsory reserve regulations in summer, but such shrinkage ceased to exist in fall. Thus, according to the results of the year, incremental growth in the narrow monetary base accounted for 24.8% (48.7% in 2003) and reserves for 24.4% (54.1% in 2003). The volume of M_0 cash increased by 33.8% against 50.3% in 2003. Consequently, money supply in 2004 was not that heavy as in 2003. The federal budget, specifically the Stabilization Fund, played the key role in sterilizing money issuance of the RF Central Bank. In 2004 incremental growth of deposits of the general government with the RF Central Bank accounted for nearly RUR600 billion, more than a half of the entire issuance of the Bank of Russia was withdrawn from the economy through the budget system of the Russian Federation in 2004. Final incremental growth of reserve money (broad money) was no more than RUR476 billion.

2.1.3. Money Demand

According to the results in 2004, broad money grew at slower rates than the corresponding values in 2003. In particular, M_1 grew by 30.5% over the year against 45.6% in 2003. M_2 grew by 35.8% (50.5% in 2003). A relative fast growth in broad monetary aggregates was recorded only in the quarter 1 (as compared to 2003), however it slowed down in the quarter 2 and 3. Traditionally, monetary aggregates grew up at faster rates in the quarter 4. Such growth, however, was more moderate than in 2003.

Hence, according to the results of 2004, monetization of GDP increased merely from 24.3% of GDP up to 26.0%, but it still remained low. (in 2003, for example, monetization of GDP (calculated by using the IFS data base) was 47% in Bulgaria, 40% in Estonia, 48% in Hungary, 37% in Latvia, 31% in Lithuania, and 64% in Slovakia). As was noted in the previous economic review², such situation maintains high enough growth rates of money supply, which has no adverse effects at least until monetization of GDP reaches 35 to 40%, since money supply growth will be absorbed by the economy due to growing demand for real monetary reserves (provided that currently prevailing inflationary expectations and trends in money demand remain the same).

² Russian Economy in 2003. Trends and Outlooks. Issue 25. M.: IET, 2004.

At the same time, banks continued financing the real economic sector in 2004, as evidenced by the fact that money multiplier grew up to its maximum over the entire period of record (*Fig. 4*). In the period between August and September 2004, the multiplier even reached 2,0 (which is beyond the previous high recorded in February 1998), but it dropped then down to 1,8 due to broadening monetary base at the end of the year, while broad money aggregates are less sensitive to seasonal fluctuations in demand for liquid funds.

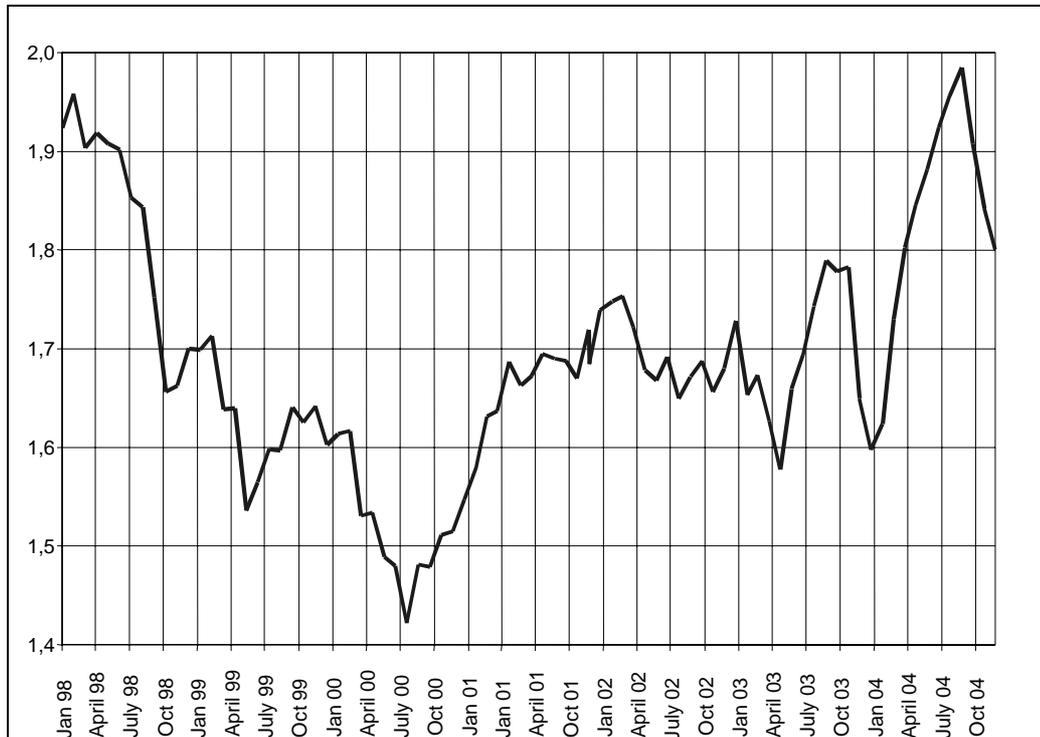


Fig. 4. Money multiplier (M_2 : Reserve Money Ratio)
in the Period Between 1998 and 2004

More money supply from the Russian banks in 2004 was caused mainly by increased requirements to non-financing private enterprises, i.e. credits and investments in private bonds. As indicated in *Fig. 5*, by the end of 2004, a share of requirements to the private sector in total assets of the banking system exceeded 60%, thus growing nearly by 5 percentage points during the year. At the same time, a share of requirements to general government and foreign assets either reduced or remained the same. In total, the volume of assets of the banking system of the Russian Federation reached 39.7% of GDP and the volume of requirements to the non-financing private sector accounted for 24.55% of GDP by the end of the year, while the corresponding figures accounted for 38.57% of GDP and 21.0% of GDP at the beginning of the year.

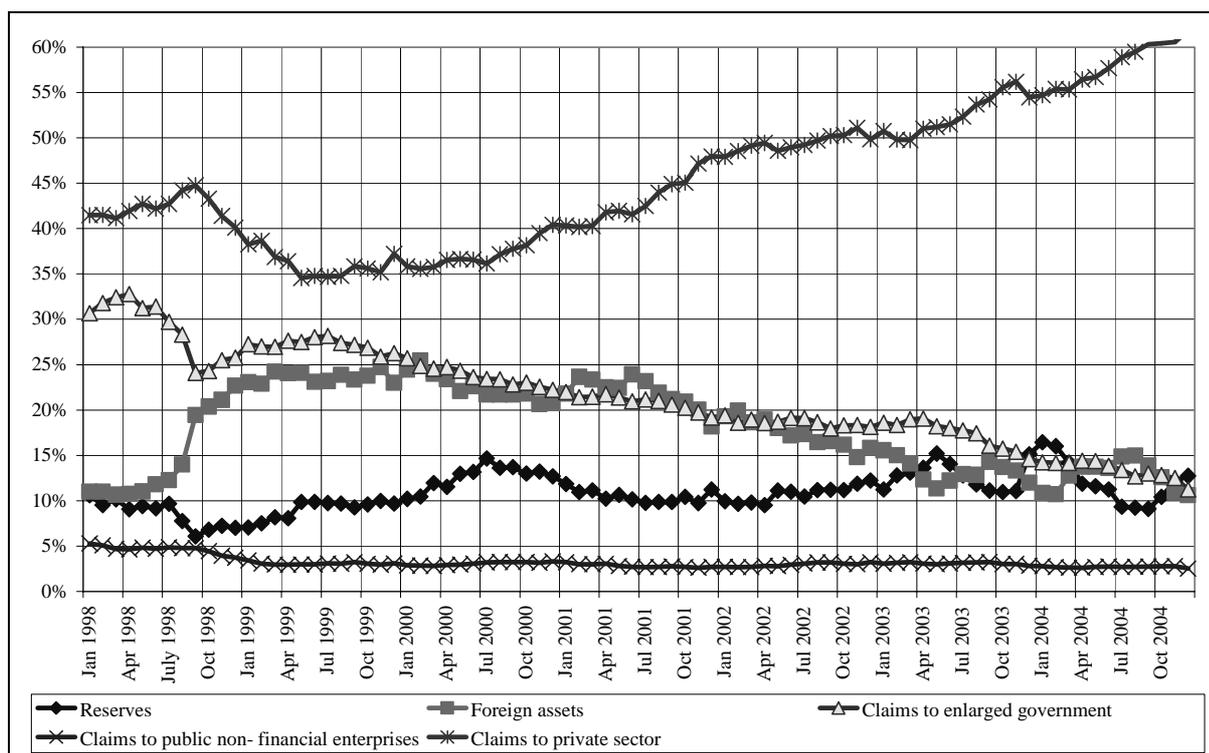


Fig.5. Total Assets of the Banking System of the Russian Federation

2.1.4. RUR Exchange Rate Movement

The official nominal RUR exchange rate to the leading foreign currencies changed gradually enough throughout 2004 (Fig. 6). The RUR/USD exchange rate remained virtually unchanged until the end of the year (from the beginning of the second half of October), when there was an upward trend in the nominal RUR/USD exchange rate. In total, the RUR exchange rate increased from RUR29,45 to 27,75 per \$1 USD, or by 5.79%.

The RUR/EURO exchange rate was less uniform. The RUR grew against the EURO during the first four months until the end of the year, when the EURO exchange rate grew up. The range of fluctuations in the RUR/EURO exchange rate was wider than that of the RUR/USD exchange rate. According to the results of 2004, the official RUR exchange rate declined by 2.68% against EURO, from RUR36,82 up to RUR37,81 per EURO.

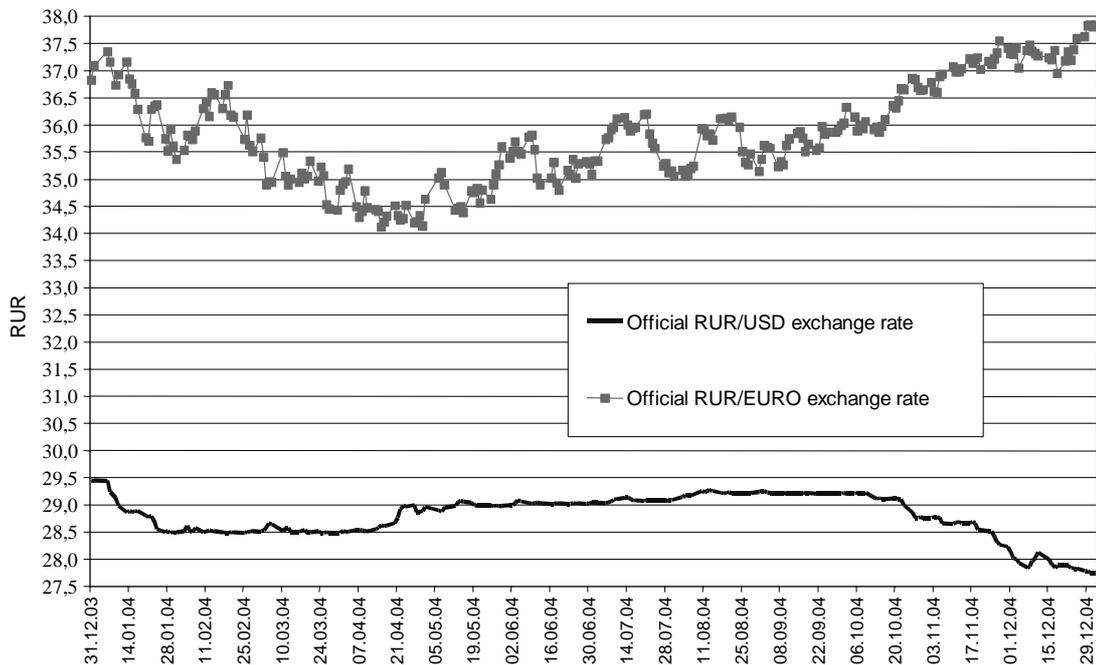


Fig. 6. Official Nominal RUR/USD Exchange Rate and RUR/EURO Exchange Rate in 2004

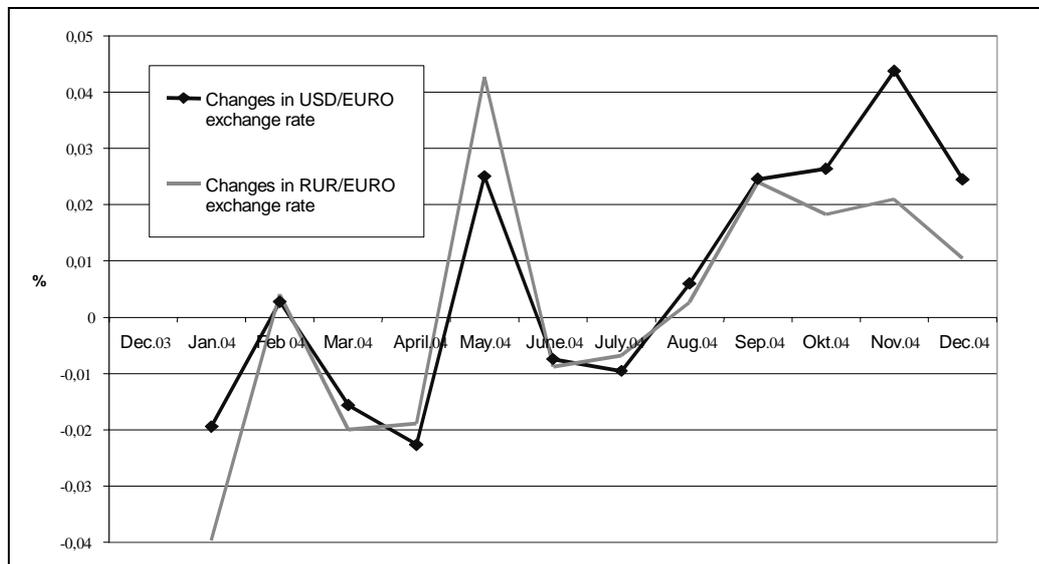


Fig. 7. Monthly Changes in EURO/USD Exchange Rate and EURO/RUR Exchange Rate in 2004

As indicated in *Fig. 7*, the RUR/EURO exchange rate varied in the same manner as the EURO/USD exchange rate. In other words, one can argue that RF Central Bank relied, at least till October 2004, exclusively on the RUR/USD exchange rates, while the real RUR/EURO exchange rate relied on exchange rates of currencies in the world market. Un-

der such circumstances, the real RUR exchange rate could decline against the EURO in the world market, though it grew against the USD.

Close relationship between the exchange rates was broken in the final quarter, which could mean that at the background of growing RUR and EURO exchange rates against the USD the Bank of Russia refused to interfere with the growth of the real RUR/EURO exchange rate under, maybe, the circumstances of accelerated inflation.

According to the results of the year, the real RUR/USD exchange rate as calculated on the basis of nominal exchange rate and CPI rates in Russia and the United States grew by total of 15.5%, while that of RUR/EURO by 6.5% (Fig. 8). It should be noted that while the real RUR/USD exchange rate reached its maximum over the post-crisis period, the RUR is currently weaker against the EURO than, for example, in 2001. The real effective RUR exchange rate as calculated on the basis of the foreign trade pattern of the Russian Federation grew by 5.4% in the period between January and October 2004. Analysis of the real effective RUR exchange rate reveals that the current exchange rate corresponds to that in the quarter 4 of 1996, i.e. it is by nearly 10% lower than the maximum figures recorded in the middle of 1998. Hence, the pre-crisis level of real RUR exchange rate will be reached in the nearest two years provided that the RUR exchange continue to grow at the current rates and the USD exchange rate against the leading world currencies remain within a range of \$1,25 to 1,35 per 1EURO and 105 to 110 yen per 1USD.

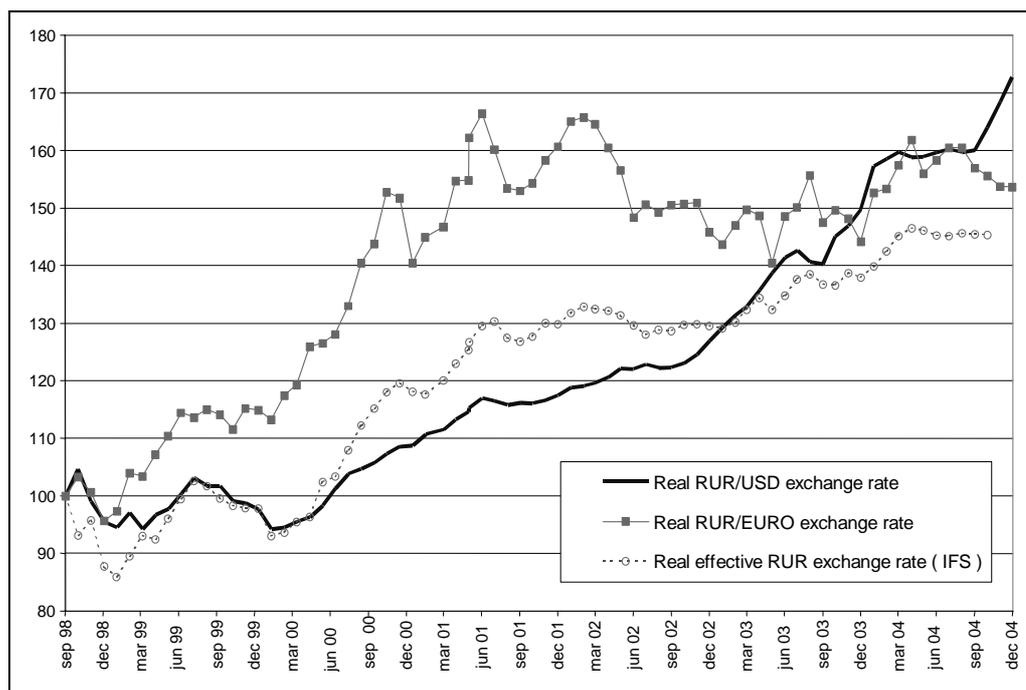


Fig. 8. Real RUR Exchange Rate Movement in the Period Between 1998 and 2004

2.1.5. "Banking Crisis" in 2004

Several developments that took place in the period between May and July became most important events in the RF financial sector in 2004. For instance, in May the RF Central Bank revoked the license from and introduced a temporal management at Sodbiznes-

bank. The bank was ranked 109 by size of assets³ according to the results of the quarter 1 of 2004. Under the circumstances, other market participants discontinued their relationship with Kredittrast Bank (which was ranked 67 by size of assets as of April 1, 2004) in fear of further actions of the RF Central Bank, as it was owned by Sodbiznesbank shareholders. Its license was revoked in June 24, 2004. It is noteworthy that the majority of market participants suspected Sodbiznesbank and Kredittrast in money laundry and restricted business relations with them long before the license revocation. As a result, the actions of the Bank of Russia, though retarded, were considered by the banking community and depositors as a normal “cleaning” which could not lead to panic and banking crisis.

Late in May, however, managers of the Bank of Russia and the RF Financial Monitoring Committee alleged that they had a “black list” of banks suspected in money laundry, which were expected to suffer corresponding measures in the nearest future. In our opinion, it was the actions of the RF Central Bank and the RF Financial Monitoring Committee that caused a problem of non-confidence in the RF interbank market and led to reduction of limits determined by major Russian banks, including state-owned banks, for crediting other banks, primarily medium-size Moscow banks. Correspondingly, the major borrowers in Interbank Loans Market (for example, Guta-Bank, Paveletskiy, Dialog-optim, etc.) began to face problems in servicing their current liabilities to other banks. Such information resulted in mass withdrawals of bank deposits by retail customers, especially from the aforementioned banks and then from those considered as non-confident (for example, those included in the list of “problem” banks published in press and Internet). Among such banks were Guta Bank, Alfa Bank, Impeksbank, Masterbank, Bin-Bank, MDM, etc. The peak of withdrawals fell into the first half of July. However, almost all banks (except for Guta Bank) managed to stay in business and maintain their positions in the private deposit market in the period between June and July 2004. A total of 9 Moscow banks lost their licenses in the period between June and September 2004 (figures in brackets refer to bank’s rating in terms of size of assets as of April 1, 2004), namely Kredittrast (67), Promeksimbank (361), Commercial Savings Bank (351), Moszhilstroibank (1217), RIKOM (975), Dialog-optim (58), Paveletskiy (169), Meritbank (210) and Finanstorgbank (513), as well as Savings and Development Bank (663) incorporated in the Komi Republic.

Hence, we believe that the developments that took place in summer 2004 should not be considered as “banking crisis”; rather it is an indicator of local instability of the Russian system related to its structural and institutional specific features: great number of small and medium -size banks, generally passive treatment by the RF Central Bank of the banks dealing with shadow and semi-legal transactions (which is not a secret for many market participants), low capitalization of the RF banking system, discrepancy in terms of assets and liabilities at many banks, heavy reliance of small and medium-size banks on the Interbank Loans Market, etc. It could be noted on the basis of aggregated data that assets of the banking system and private deposits (both call deposits and fixed deposits) grew in general (including in real terms) in the period between May and July 2004. According to the results of the quarter 3 of 2004, only 9 out of 50 major Russian banks reported reduction in assets (it should be noted that Guta Bank demonstrated a 20% asset growth over the quarter). In addition, we believe that public support of the banking sector was insignificant: in fact, the RF Central Bank made only one move in this direction as part of its general policy: it reduced the regulation of compulsory contributions due to the Compulsory Reserve Fund from 7 to 3.5% since July 8, 2004. However, taking into account the concentra-

³ The figures herein that represent the size of assets of banks rely on the data obtained from Interfax Agency.

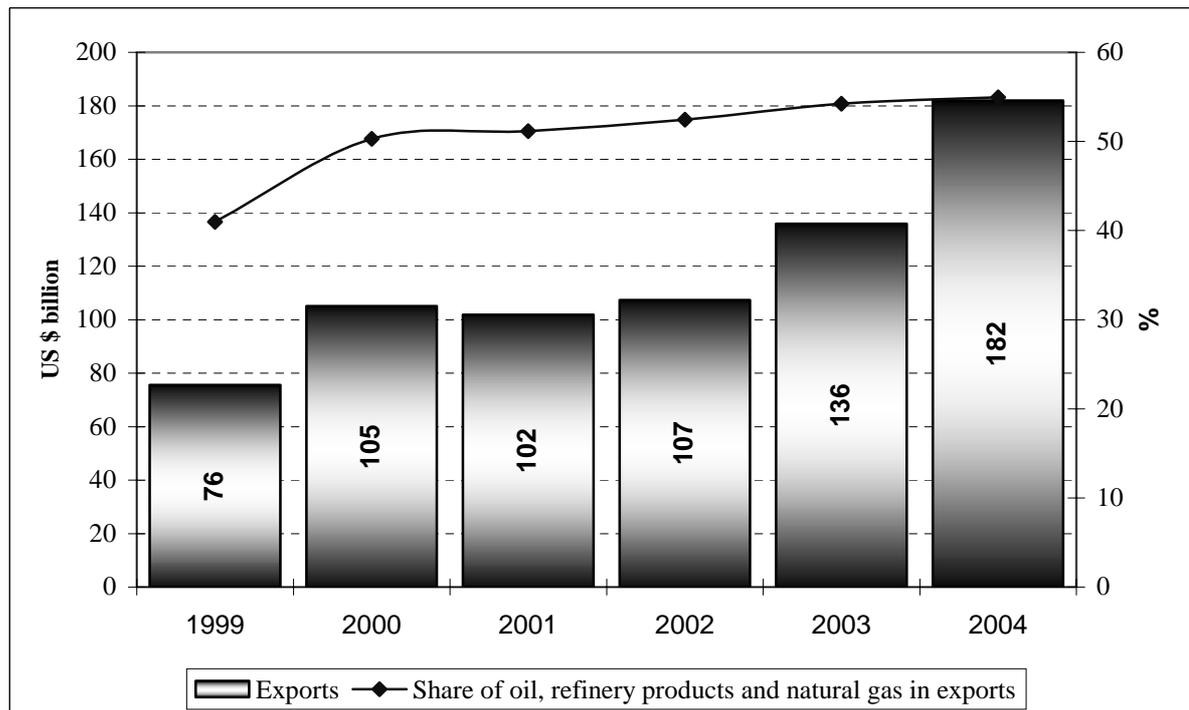
tion ratio of private bank deposits, one can say that most of the deposits were reopened with RF Sberbank and several major banks which could have resolved their problems in hand without such update. We also believe that the decision made by the RF State Duma on providing deposit guarantees at all commercial banks regardless of their participation in the private deposit insurance system could have adverse effects, since it encourages unnecessarily risky behavior of banks, especially those which realize that they have no chance to pass the control of the RF Central Bank to lawfully join the private deposit insurance system.

Guta Bank (ranked 17 in terms of size of assets as of July 1, 2004) was the major bank suffering losses during the "crisis". Nevertheless, it turned no bankrupt, since its acquisition by RF Vneshtorgbank was announced immediately after the bank started to face problems (it should be noted, however, that negotiations on purchasing its share by RF Vneshtorgbank or extending a major loan to Guta Bank started long before the events that took place in the period between May and June 2004). Furthermore, we believe that a stabilization loan extended by the RF Central Bank to RF Vneshtorgbank in the amount of \$700 billion should not be considered a measure aimed at supporting the banking system (such loan increased substantially the total value of liabilities due by the banking sector to the monetary regulation bodies), since, firstly, the bank itself faced no problems during that period, secondly, the amount paid to purchase Guta Bank (RUR 1 billion) was far less than the value of the loan. We also believe that expenses incurred by the owners of private banks (for example, Alfa-Bank) in order to maintain stability and liquidity under a high rate of private deposit withdrawals can not be classified as expenses on "saving" the banking system, since such measures were caused by low actual capitalization of banks and mistakes in managing temporal structure of assets and liabilities.

2.1.6. The state of the balance of payments

In 2004, the stability of the RF balance of payments was maintained at the expense of record high volumes of commodity exports, primarily products of the fuel and energy complex (FEC). At the background of extremely high prices of energy resources, export of goods increased by more than one third. Accordingly, the accumulation of gold and foreign currency reserves of the RF Central Bank continued. However, in 2004 there was interrupted the trend towards a decline in the net capital outflow observed in 2000 through 2003.

According to the preliminary estimates of the RF balance of payments in 2004 published by the Bank of Russia, the surplus on current account made US \$ 58.2 billion, thus increasing by 64.4 per cent in comparison with the figures registered in 2003 (see *Table 1*). Over the year, the active balance of trade grew by 45.7 per cent (from US \$ 59.9 billion to US \$ 87.2 billion), as commodity exports increased by 33.9 per cent (from US \$ 135.9 billion to US \$ 182 billion) and imports grew by 24.6 per cent (from US \$ 76.1 billion to US \$ 94.8 billion). The share of export of oil, oil products, and natural gas made about 55 per cent in the total amount of exports (as compared with 54.2 per cent observed in 2003) (see *Fig. 1*). Therefore, similarly to the situation observed in the preceding years, the major factor determining the amount of current account surplus was the active balance of trade, which, in turn, tremendously depended on the changes in prices of energy resources and other staple Russian exports on world markets. The data presented in *Fig. 2* demonstrate that the relationship between world oil prices and Russian balance of trade, which was noticeable in 2001 through 2003, also manifested itself throughout 2004.



Source: RF Central Bank.

Fig. 9. Dynamics of exports and the share of the Fuel and Energy Complex products in 1999 through 2003

In 2004, the deficit of the balance of services increased by US \$ 14 billion in comparison with the figures registered in 2003 (+ 28.5 per cent). Export of services made US \$ 20.3 billion, thus increasing by US \$ 4.1 billion in comparison with the figures observed in the preceding year (+ 25 per cent). In 2004, import of services grew by 27 per cent and made US \$ 34.3 billion.

In 2004, the balance of compensation of employees continued to diminish and made US \$ -0.8 billion (as compared with US \$ -0.1 billion registered in 2003).

In 2004, as compared with the figures observed in 2003, the deficit of the balance of investment incomes practically did not change and made US \$ 13 billion. At the same time, in absolute terms the amounts of both receivable incomes and payable incomes diminished. Receivable investment incomes diminished from US \$ 10.2 billion to US \$ 4.5 billion, what was determined by a significant decline in the indicator pertaining to nonfinancial enterprises (from US \$ 6.6 billion to US \$ 0.3 billion). A similar decline in payable incomes of nonfinancial enterprises from US \$ 16.8 billion to US \$ 10.8 billion has determined that the total amount of payable incomes decreased from US \$ 23.3 billion to US \$ 17.6 billion.

As compared with the figures registered in 2003, in 2004 the balance of current transfers increased 2.9 times and made US \$ - 1.1 billion.

In 2004, the deficit of the capital and financial account (without changes in foreign exchange reserves) increased 6.6 times in comparison with the figures registered in 2003 (from US \$ 0.8 billion to US \$ 5.4 billion).

The balance of capital transfers was formed by negative figures and amounted to US \$ -1.2 billion.

The increase in the foreign liabilities of the economy made US \$ 27.3 billion, what was by 2.1 per cent below the value of the indicator registered in the preceding year (US \$ 27.9 billion).

Table 1

Major items of the balance of payments in 2002 through 2004 (US \$ billion)

Balance item	2002				2003				2004			
	Q 1	Q 2	Q 3	Q 4	Q 1	Q 2	Q 3	Q 4	Q 1	Q 2	Q 3	Q 4 ⁴
Current account	6,4	7,7	7,2	7,8	11,4	8,1	7,3	8,6	12,6	13,4	14,7	17,4
Capital and financial account ⁵	-4,8	-0,5	-1,8	-4,1	-2,4	1,5	-6,7	6,7	-2,5	-8	-4,8	10
Changes in foreign exchange reserves	-0,5	-6,1	-3,2	-1,6	-7,6	-8,1	2,6	-13,3	-6,8	-5	6,5	-26,9
Net errors and omissions	-1,1	-1	-2,1	-2,2	-1,5	-1,6	-3,2	-1,9	-3,4	-0,4	-3,3	-0,5

Source: RF Central Bank.

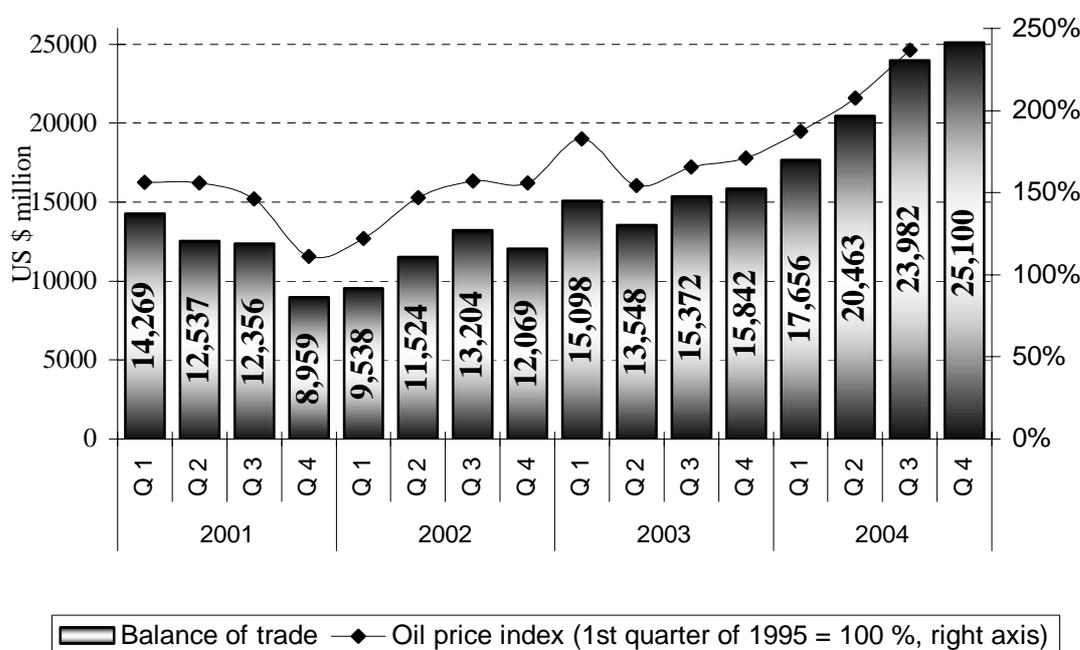


Fig. 10. RF balance of trade and the oil price index in 2001 through 2004

Similarly to the situation observed in the preceding year, the general government was a net payer with respect to nonresident net payers. Its foreign liabilities declined by US \$ 3.5 billion. As concerns the subjects of the Russian Federation, the increase in their foreign liabilities made US \$ 0.1 billion. In 2004, the decrease in the liabilities of the monetary authorities made US \$ 0.2 billion. A decrease in the activity of the banking sector with respect to the attraction of foreign capital resulted in the fact that the increment of liabilities of this sector (US \$ + 7 billion) declined by 37.8 per cent in comparison with the value of this indicator registered in 2003. Investments of nonresidents in the real sector made US \$ 24 billion (as compared with US \$ 22.1 billion registered in 2003).

⁴ Preliminary estimates.

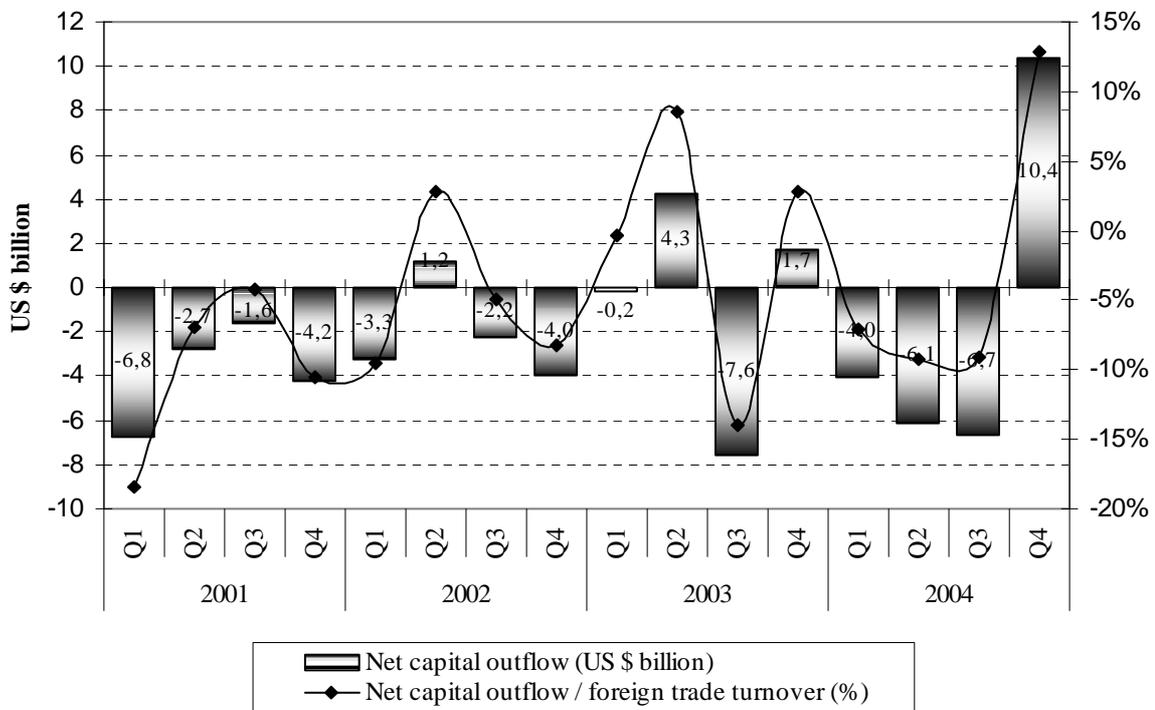
⁵ Without changes in foreign exchange reserves.

In 2004, foreign holdings of residents increased by US \$ 31.5 billion (as compared with the figures registered in 2003, when the respective holdings grew by US \$ 27.2 billion). Operations of the private sector accounted for almost all this increase.

Foreign assets of the general government grew by US \$ 0.2 billion, while foreign assets of the banking sector increased by US \$ 4 billion.

As concerns the sector of nonfinancial enterprises and households, the outflow of capital in this sector practically has not changed and made US \$ 25.9 billion. At the background of an increase in the outflow of capital by items “direct and portfolio investment” (US \$ 6.5 billion) and “trade credits and advances extended” (US \$ 0.6 billion), the amount of cash foreign currency accumulated by this sector and the amount of indebtedness on merchandise supplies according to intergovernmental agreements have significantly decreased (by US \$ 2.9 billion and US \$ 1.3 billion respectively).

At the same time, in 2004 the total net outflow of capital from the nonfinancial sector made US \$ 6.5 billion (in 2003, there was observed an outflow of capital amounting to US \$ 1.7 billion) (see Fig. 11).

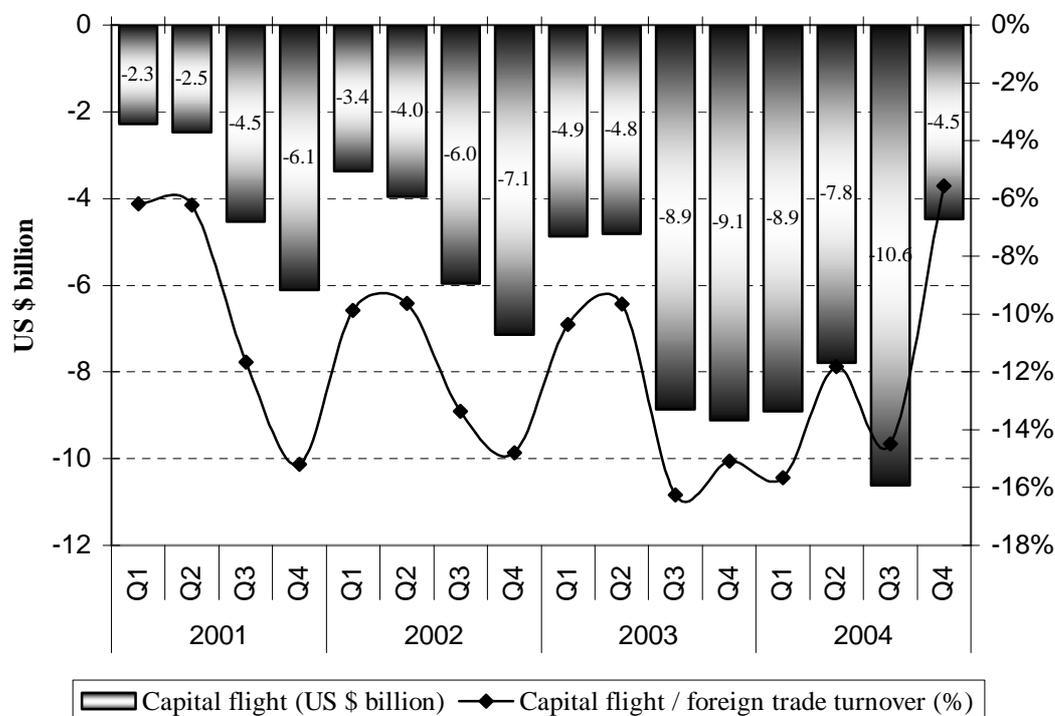


Source: RF Central Bank, IET calculations.

Fig. 11. Dynamics of net capital outflow in 2001 through 2004

It should be noted that over the first three quarters of 2004 there was observed a significant (and accelerating) outflow of capital from the RF private sector. Only in the 4th quarter there was registered an inflow of capital at the level of US 10.4 billion, which can not be explained by any fundamental changes in the investment climate in the country. Most probably, the inflow of such a large amount of capital in the country can be explained by a borrowing abroad made in order to finance the purchase of “Yuganskneftegaz.” In the case such a borrowing was not made, the total outflow of capital registered in 2004 could be even more significant.

As concerns the unofficial outflow of capital (capital flight) (see Fig. 12), in 2004 this indicator increased in real terms by 15 per cent as compared with the figures registered in the preceding year and according to the author's estimates⁶ made about US \$ 31.8 billion.



Source: RF Central Bank, IET calculations.

Fig. 12. Dynamics of capital flight in 2001 through 2004

On the whole, in 2004 there was observed an increase in the share of net capital outflow in the RF foreign trade turnover up to 2.3 per cent this (0.8 per cent in 2003). At the same time, the indicator characterizing the share of capital flight in the RF foreign trade turnover decreased from 13.1 per cent in 2003 to 11.5 per cent in 2004. It should be also noted that in contradistinction to the figures registered in 2003, last year there was observed an increase in the amounts of both net capital outflow, and capital flight.

The outflow of capital from the private sector is still at a rather high level, what may be to a significant extent explained by the situation observed in the corporate sector (the "YUKOS affair"). On the whole, at the background of rather favorable macroeconomic indicators, the worsening of the investment climate and growing risks result in an outflow of capitals from Russia.

Besides, basing on the analysis of the balance of payments, it should be noted that the revenues from the export of energy resources still make more than half of the total export revenues and the share of energy resources in the general structure of exports is growing for several years running. All these facts once again confirm the significant dependence of the Russian economy on the export of raw materials and the respective price situation. At the background of deceleration of the rates of structural reforms, it may be an

⁶ Flight of capital is calculated in accordance with the IMF methodology as a sum of items "trade credits and advances extended," "non-repatriation of exports proceeds, non-supply of goods and services against import contracts," and "net errors and omissions."

evidence of a gradual decrease in the competitiveness of the Russian economy across a number of industries and deterioration of the prospects of its further development in the case the price situation on the world market of energy resources changes.

2.1.7. Key Actions of the RF Central Bank in the Field of Monetary Policy

The fact that the Bank of Russia animated direct and reverse REPO transactions was one of the characteristic features of the RF monetary policy in 2004, since this action serves as a monetary policy tool which is commonly used in global practice, especially for sterilizing excessive money issuance and maintaining liquidity of the banking system.

The RF Central Bank reduced the refinancing rate down to 14% on January 15, 2004. The last time the Bank of Russia changed the refinancing rate (from 18 to 16%) was on June 21, 2003.

In the quarter 2 of the previous year, the Bank of Russia began to apply a new benchmark that was used for determining of an exchange rates policy. The benchmark was represented by a weighted geometric average of exchange rates of basic foreign currencies to the RUR. The basic currencies were represented by the USD and the EURO. The EURO weight was set at 10 to 20% for a start. This measure, however, led to no real changes in the RUR exchange rate to these currencies, as indicated above.

In June 11 the Bank of Russia announced a reduction (from 9 to 7% since June 15) in mandatory contributions due by banks to the Compulsory Reserve Fund out of RUR funds they borrowed from legal entities and foreign currency funds they borrowed from legal entities and physical bodies. At the same time, the Bank of Russia reduced the refinancing rate from 14 to 13% per annum, as well as extended a list of securities that could be used as collateral in entering into direct REPO transactions with banks. Such measures were caused basically by low liquidity in the Russian financial market. It should be noted that changes in the refinancing rate have no such a substantial impact on the economy of the Russian Federation as it does in most of the developed countries. Nevertheless, by extending the list of securities that could be used as collateral in borrowing funds from the RF Central Bank, the Bank of Russia managed to improve liquidity management in the RF banking system. Later on, as problems raised in the banking sector, the reservation regulations were reduced once again (on July 8, 2004) to 3.5% on liabilities to residents of the Russian Federation and to 0% on liabilities to non-resident banks. However, the latest rise (up to 2%) was announced on August 1.

Since August 16, 2004 the Bank of Russia started to issue modified bank notes of 1997 (as modified in 2004) denominated in RUR 10, 50, 100, 500 and 1000. The issuance was intended to increase protection of these bank notes as well as make it easy for the general public to verify their authenticity. The modified bank notes retained basic composition of the 1997 ones. The bank notes of 1997 remain as legal tender as the modified ones.

In August 2004, the Bank of Russia extended the list of securities that can be used as collateral by banks in borrowing from the Bank of Russia. The list included bonds issued by constituent entities of the Russian Federation, as well as bonds of mortgage agencies and credit organizations secured by public warranty. By extending the list, the RF Central Bank managed to improve liquidity of the RF banking system. However, the use of newly listed securities was restricted. For example, they were not supposed to be used for REPO transactions.

In November 2004, the Board of Directors of the RF Central Bank approved a document: Basic Guidelines of Unified Public Monetary Policy for 2005. Inflation forecast for 2005 remained unchanged in the document in spite of the fact the forecast for 2004 failed,

which obviously led to growth of inflationary expectations of economic agents. Hence, price advance rates are very unlikely to slow down to 6.5–8.5% in 2005 .

It is specified in the document that the real effective RUR exchange rate is the basic focus of the monetary policy. However, the calculation methodology for this indicator is quite questionable, which in practice gives no way of identifying direct relationship between the real effective RUR exchange rate and competitiveness of Russian manufacturers. In addition, inflation remains high enough in the Russian Federation, and we believe that it is the inflation that the Bank of Russia should focus on.

At the end of the year, the management of the Bank of Russia stated that the structure of gold and foreign exchange reserves could be changed. Prior to that the structure of gold and foreign exchange reserves was as follows: 70% of USD, nearly 25% of EURO and nearly 5% of other hard currencies. Perhaps, such intention of the RF Central Bank was most likely to be caused by a continuous fall of the USD exchange rate against other basic currencies.

2.2. State Budget

2.2.1. General Description of RF Budgetary System in 2004

Table 2

Execution of Revenues and Expenditures of Consolidated, Federal and Local Budgets (% of GDP)

	1998	1999	2000	2001	2002*	2003	2004
Federal Budget							
Tax Revenues	8.8	10.7	13.2	16.2	18.6	18.0	18.8
Including single social tax	–	–	–	–	3.1	2.7	2.6
Revenues	11.3	12.9	15.4	17.6	20.1	19.4	20.4
Expenditures	14.5	14.0	13.1	14.7	18.7	17.7	16.1
Deficit (-) / Surplus (+)	-3.2	-1.1	2.4	2.9	1.4	1.7	4.4
Local Budgets							
Tax Revenues	11.5	10.4	10.2	9.6	10.0	10.0	10.6
Revenues	14.8	13.6	14.4	14.3	14.9	14.5	14.3
Expenditures	15.2	13.6	14.0	14.3	15.3	14.9	14.1
Deficit (-) / Surplus (+)	-0.3	0.0	0.5	0.0	-0.4	-0.4	0.2
Consolidated Budget							
Tax Revenues	20.3	21.1	23.4	25.8	28.6	28.0	29.4
Revenues	24.5	25.2	28.5	29.3	32.1	31.1	32.3
Expenditures	28.1	26.3	25.6	26.4	31.1	29.7	27.8
Deficit (-) / Surplus (+)	-3.6	-1.1	2.8	2.9	1.0	1.4	4.5

* Since 2002, including revenues from single social tax and consequently expenditures to finance public extra-budgetary funds.

Data source: the RF Ministry of Finance; IET's estimates.

It is noteworthy that general description of the RF budgetary system in 2004 shows much higher revenues and less expenditures as compared to 2003 (refer to Table 2). At the end of 2004, the revenues of the federal and consolidated budgets reached their maximum over the last six years. The federal budget revenues in 2004 increased by 1 percentage point of GDP, 20.4% of GDP, as compared to the previous year. In 2004, the consolidated budget revenues were nearly 1.2 percentage points of GDP thus reaching 32.3%

GDP. It should be noted that expenditures in 2004 continued its downward trend which started as early as 2002. Federal budget expenditures in 2004 decreased by more than 1.5 percentage points of GDP to account for 16.1%, as compared to the previous year. Local budget expenditures decreased by nearly 0.8 percentage points of GDP, while the consolidated budget accounted for 1.9 percentage points of GDP. Thus, by the end of 2004, Russia achieved the biggest budget surplus ever in the history of the post-Soviet era, namely 4.5% of GDP for the consolidated budget and 4.4% of GDP for the federal budget.

High oil prices is one of the key factors making the budgetary revenues grow, and consequently the volume of mineral tax revenues and export duties to the consolidated budget in 2004 exceeded that of the previous year by 0.5 percentage points of GDP and 1.7 percentage points of GDP correspondingly. This resulted in that on October 27, 2004, the RF State Duma approved amendments to the 2004 federal budget on increasing budgetary revenues by RUR531 billion up to RUR3273,8 billion and consequently increasing budgetary expenditures by RUR108,6 billion up to RUR2768,1 billion.

2.2.2. Analysis of Basic Tax Revenues

A series of amendments to the tax law came into force in 2004. The most essential ones are: VAT reduction from 20 to 18% with the reduced rate remaining at 10%; from January 1, 2004, increase in the basic mineral tax rate in relation to oil production from RUR340 up to RUR347 per 1 ton of raw material, as well as ad valorem tax rate on production of gas condensate from 16.5 up to 17.5%; changes in the export tax rate in relation to crude oil from the middle of 2004; abolishing sales tax on January 1, 2004.

Table 3

Basic Tax Revenues to RF Budgetary System (% of GDP)

	1999	2000	2001	2002	2003	2004
Profit tax	4.6	5.4	5.7	4.2	4.0	5.2
Income tax	2.5	2.4	2.8	3.3	3.4	3.4
VAT	8.8	6.2	7.1	6.9	6.6	6.4
Excises	2.2	2.3	2.7	2.4	2.6	1.5
Mineral Tax*	1.2	1.6	1.6	2.5	2.5	3.0
Foreign trade taxes	1.8	3.1	3.6	3.0	3.4	5.1
single social tax, to the RF consolidated budget				3.1	2.7	2.7

Data source : the RF Ministry of Finance .

* Prior to 2001, the Mineral Tax was calculated as a total amount of oil excise, mineral excises and duties and contributions to rehabilitation of mineral resources .

As is evident from *Table 3*, the downward trend in profit tax revenues which started in 2001, ceased to exist in 2004. At the end of 2004, the budgetary profit tax revenues accounted for nearly 5,2% of GDP thus exceeding by 1.2 percentage points of GDP that of 2003. The tax revenues growth is based mostly on the increased profit tax base. According to the Russian Statistics Agency's data, the growth in consolidated financial figures (total corporate income less losses) over the period between January thru October 2004 accounted for 50% against the same period of the preceding year , while in 2003 the growth of this parameter accounted for -12% (negative). The growth in tax revenues can be explained to some extent by termination of various profit tax allowances which entered into force prior to the tax reform in 2002.

At the end of 2004, a share of income tax revenues in GDP, as well as a share of the single social tax in GDP remained the same as compared to the previous year, 3.4 and

2.7% of GDP correspondingly. Moreover, according to the Russian Statistics' Agency, real income of the population in 2004 accounted for 7.8%, and 10.8% in real wages increase, which is exceeding the 2004 GDP growth rate by 1 percentage point and 4 percentage points correspondingly. Thus, the effective rate of single social tax in real terms appears to be lower in 2004 against 2003, while that of the income tax remained almost unchanged. The reduction of the effective rate of single social tax in 2004 can be explained by the fact that in the previous periods the Russian federal budget revenues on single social tax also included the arrears on single social tax which used to be credited to the Pension Fund.

VAT revenues to the budgetary system of the Russian Federation remain the biggest ones thus accounting for more than RUR1 trillion or 19.7% of the consolidated budget revenues and 31.2% of the federal budget revenues by the end of 2004. In spite of the decrease in the basic VAT rate from 20 to 18% from January 1, 2004, a share of VAT revenues in GDP decreased by barely 0.2 percentage points of GDP, while the forecasted decrease was expected to be by nearly 0.6 percentage points of GDP. The increase in VAT revenues was to some extent based on the decrease in VAT refund volumes. For instance, according to the Federal Tax Service, the volume of refunded VAT accounted for 1.8% of GDP over the first 8 months in 2004, while that of the similar previous period accounted for 2.3% of GDP.

In 2004, excise revenues reduced by 1.1 percentage points of GDP and accounted for nearly 1.5% of GDP as compared to the previous year. Such a substantial reduction is caused by abolition of the natural gas excise from January 1, 2004. The revenues from this excise in 2003 accounted for more than 45% of the budget aggregate revenues on excises.

The mineral tax revenues its maximum (since its initial introduction), 3% of GDP, in 2004. As noted above, the tax growth was primarily caused by high oil prices and the increase in the mineral tax base rate from RUR340 to RUR347 per 1 ton of raw materials. In addition, the growth in mineral tax revenues was encouraged by the increase in oil production in 2004 which exceeded by 8.6% that of the previous year, according to the Russian Statistics Agency's data.

The volume of the foreign trade tax revenues in 2004 was in excess of by 1.7 percentage points of GDP as compared to the previous year and accounted for 5.1% of GDP. This was mainly caused by high oil prices in 2004 and changes in export tax from the second half of 2004, both for foreign trade tax and mineral tax.

2.2.3. Budget Expenditures

No essential changes were made in the structure of the consolidated budget expenditures in 2004 (refer to *Table 4*) as compared to 2003. Slightly reduced were the consolidated budget expenditures on state debt service (from 1.8% of GDP in 2003 to 1.4% of GDP in 2004), expenditures on municipal housing and public utilities (from 1.9% of GDP in 2003 to 1.7% of GDP in 2004), and on "Industry, construction and power energy" item (from 2.5% of GDP in 2003 to 2.3% of GDP in 2004).

No expenditures were increased other than that on "International activity" item (by 0.1 percentage points of GDP) for the federal and consolidated budgets, and social policy item by (also by 0.1 percentage points of GDP) local budgets. Thus, the aggregate expenditures at the end of 2004 were smaller than that in the previous year for the budgets at all levels: by 1.6 percentage points of GDP for the federal budget, by 0.8 percentage points of GDP for the local budgets, and by 1.9 percentage points of GDP for the consolidated budget.

Table 4

**Expenditures of Federal Budget, Local Budgets and Consolidated Budgets
in 2002 thru 2005 (% of GDP)**

	2002			2003			2004		
	Fed- eral Budg et	Local Budg ets	Con- soli- dated Budg ets	Fed- eral Budg et	Local Budg ets	Con- soli- dated Budg ets	Fed- eral Budg et	Local Budg ets	Con- soli- dated Budg ets
Public administration and local self-administration	0.5	0.8	1.4	0.5	0.9	1.4	0.5	0.8	1.3
Judicial power	0.2	0	0.2	0.2	0	0.2	0.2	0.0	0.2
International activity	0.3	0	0.3	0.2	0	0.2	0.3	0.0	0.3
National defense	2.7	–	2.7	2.7	0	2.7	2.6	0.0	2.6
Law enforcement and national security	1.7	0.5	2.2	1.9	0.4	2.3	1.9	0.4	2.3
Fundamental scientific research and scientific progress promotion	0.3	0	0.3	0.3	0	0.3	0.3	0.0	0.3
Industry, power energy and construction	1	1.3	2.3	0.5	2	2.5	0.5	1.9	2.3
Agriculture and fishery	0.3	0.3	0.5	0.2	0.3	0.5	0.2	0.3	0.5
Transport, road network, communication and informatics	0.1	0.4	0.5	0	0.3	0.3	0.0	0.2	0.3
Housing and public utilities	0	2.3	2.3	0	1.9	1.9	0.0	1.7	1.7
Education	0.7	3	3.8	0.8	2.8	3.6	0.7	2.8	3.5
Culture, arts and cinematography	0.1	0.4	0.5	0.1	0.3	0.5	0.1	0.3	0.4
Mass media.	0.1	0.1	0.2	0.1	0.1	0.2	0.1	0.1	0.1
Health care and sport.	0.3	2.1	2.4	0.3	1.9	2.2	0.3	1.9	2.2
Social policy	4.4**	1.3	5.7**	1	1.4	2.4	0.9	1.5	2.4
State debt service	2	0.1	2.2	1.7	0.1	1.8	1.2	0.2	1.4
Financial aid to budgets at other levels	2.7	0	–	6.0***	0	3.2***	5.4	0.0	3.0
Military reform	0.1	0	0.1	0.1	0	0.1	0.0	0.0	0.0
Road network	0.4	0.4	0.7	0.3	0.5	0.8	0.3	0.2	0.5
Targeted budget funds	0.1	1.4	1.6	0.1	1.1	1.2	0.1	1.0	1.1
Total expenditures	18.7	15.3	31.1	17.7	14.9	29.7	16.1	14.1	27.8

* In 2001, including road network expenditures.

** Including transfers to the RF Pension Fund for financing basic part of pension at the expense of a single social tax's share centralized in the federal budget.

*** Since 2003, this item reflects transfers to public extra budgetary funds.

2.2.4. Main Events in the Budget System and Changes in Tax Law

In 2004, various amendments were made as part of the tax reform to the RF tax law and budget law, in particular, single social tax (the basic rate of single social tax was reduced from 35.6 to 26% for annual wages of employees within RUR280 thousand; the single social tax rate is established at 10% for annual wages of employees ranging between RUR280 thousand and RUR600 thousand, and 2% for wages in excess of RUR600 thousand). Changes in single social tax are to become effective from 2005, which is expected to result in budget losses of nearly RUR280 billion in 2005, according to the estimates of RF Ministry of Finance.

The legislation was also amended in relation to oil export tax and mineral tax. These amendments were generally expected to result to increase load on the petroleum industry

and partially compensate the RF Pension Fund's deficit, according to the RF Government's plans. According to a new export tax schedule, a tax would be 0% if oil price was up to \$15 per barrel; up to 35% of the difference between actual oil price and \$15 if oil price was \$15 to \$20 per barrel; not more than \$12,78 plus 45% of the difference between actual oil price and \$20 if oil price was \$20 to \$25 per barrel; not more than \$29,2 and 65% of the difference between actual oil price and \$20 if oil price was more than \$25 per barrel. At the same time, the basic mineral tax rate was increased from RUR347 to RUR400 per ton in the Mineral Tax calculation formula. The tax-free oil price threshold was also increased from \$8 up to \$9. In addition, the RUR exchange rate was revised from RUR31.5 to RUR29 per \$1. According to the Government's estimates, the understated RUR exchange rate in the Mineral Tax calculation formula resulted in extra amount of nearly \$1 billion remained in the petroleum industry. The corresponding amendments to the Mineral Tax are to come into force since 2005.

Furthermore, for the purpose of compensating federal budget's losses incurred from the reduced single social tax rate, amendments were made to the Budget Code in relation to reallocation of 1.5% percentage points of the profit tax rate for the benefit of the federal budget. As a result, the rate at which profit income revenues are credited to the federal budget is increasing up to 6.5%. Amendments to the budget law were also related to a growth in the standards of mineral tax contributions and regular payments payable to the federal budget from 2005, transition of water tax to the federal level and consequently crediting the entire single agricultural tax to the revenues of the constituent entities of the Russian Federation.

In collecting value added tax, the RF Government plans from 2005 to shift from the "country of origin" principle to the "country of destination" on oil and gas in its relations with the CIS countries (Ukraine, Byelorussia, Kazakhstan and Moldova). As a result, the RF budget is expected to lose RUR39,9 billion. The RF Government believes that the budget losses can be compensated by increasing the mineral tax rate for production of oil and gas.

During 2004, the issues related to reforming the value added tax were under active discussion. In particular, as early as in 2004, amendments to the VAT law were adopted, including establishing a procedure of VAT collection under the "country of destination" principle" in relation to transactions with Byelorussia. In 2005, the RF Ministry of Finance plans to consider the issue of reducing the basic VAT rate from 18 to 15%–16% and simultaneous abolishing the preferential 10% rate since 2006. Other options are also under consideration, down to establishing a single rate of 13%. From 2006, transition from the cash basis to the accrual basis for VAT payment is scheduled, with some exceptions which are likely to be granted for small businesses. The RF Government also made its proposals on considering options of accelerated VAT refunding. In addition, consideration was made of an option of authorizing banks to collect data on value added tax payment. According to the official statements of representatives of the RF Ministry of Finance, in 2004, the RF Government totally refused the idea of introducing VAT accounts. As a reminder, the basic VAT rate was reduced from 20 to 18% from January 1, 2004.

In 2004, the RF Ministry of Finance commenced to consider the issue of amending the Tax Code in relation to transfer pricing. Basic amendments should be referred to specifying a list of interdependent persons and its enlarging by including companies with different structure of ownership. Also, for purpose of substantiating a transaction price, the taxpayer must provide a series of documents, as requested by tax authorities, according to a well defined list including marketing research data.

On August 22, 2004, the RF State Duma adopted a law that replaces welfare benefits with cash payments, including well-fare benefits related to healthcare, public utilities service, transport fees, etc. The majority of the welfare benefits specified in the law are to be financed with the federal budget funds with total expenditures being estimated nearly RUR171,2 billion. In this case, the constituent entities of the Russian Federation are to finance welfare benefits of the social groups as follows: retired persons with long-term service record (labor veterans), citizens who were unlawfully retaliated for alleged political disloyalty, and persons who were employed in the period between June 22, 1941 and May 9, 1945. The RF Ministry of Finance expressed its readiness to allocate RUR 5–10 billion in 2005 to assist the regions in transition under the new welfare law. Such funds will be allocated from the Reserve Fund which totals RUR30 billion.

As of January 1, 2005, the Stabilization Fund totals nearly RUR522,3 billion. According to the draft federal budget, contributions to the Stabilization Fund in 2005 are estimated to be RUR387,7 billion, with estimated utilization capacity being RUR242,6 billion, including RUR74,7 billion scheduled to cover budget deficit of the RF Pension Fund, and RUR167,9 billion to repay the Russian foreign debt.

All in all, in the nearest 2 years, the RF Ministry of Finance plans to finalize the tax reform. As a result, the main outcome could be a released tax load and simplified taxation system of the Russian Federation. For example, in 1998, the number of taxes amounted to 52, while it is expected to be reduced down to 15 by 2006. According to the estimates of the RF Ministry of Finance, transfer pricing remains one of the key issues of the upcoming reform.

2.2.5. Federal Budget for the year of 2005

Tax revenues of the federal budget for 2005 have been determined in the total of RUR2 trillion 232 billion 700 million (11.93% of GDP or 10.05% of GDP without consideration of single social tax), which is less almost by 3.5 percentage points of GDP than that under the budget law for 2004. The reduction is due mostly to the changes in classification of incomes, which in 2005 enables the revenues from tax duties to be attributed to non-tax revenues which used to be reflected in the item representing foreign trade tax and foreign economic operations (Foreign economic activity revenues). In addition, from 2005, aggregate income tax revenues are to be transferred to the local budgets.

According to the tax classification of 2004, tax revenues of the federal budget in 2005 (without consideration of single social tax) should amount to nearly RUR2 trillion 834 billion, or 15.1% of GDP, which is virtually by 1.6 percentage points of GDP more than that specified in the budget law for 2004, but by 1.1 percentage points less than actual tax revenues in 2004 (nearly 16.2% of GDP). Total federal budget revenues under the 2004 law is virtually comparable with the revenues under the 2005 federal budget, 17.90 and 17.77% of GDP correspondingly. At the end of 2004, federal budget revenues appear to exceed these figures by 2.5 to 2.6 percentage points (20.6% of GDP).

The key reason for the reduction in federal budget revenues in 2005 against the actual revenues in 2004 is reduction in 2005 of the effective single social tax by nearly RUR280 billion or 1.5 percentage points of GDP, as well as reduction in the income from public and municipal property and from activity of public and municipal organizations by 0.8 percentage points of GDP.

Table 5

**Revenues in Budget Laws and Execution of Federal Budget
in 2003–2005 (RUR million)**

	2003 Budget Law	Executed for 2003	2004 Budget Law	Executed for 2004	2005 Budget Law*
Tax Revenues**	1892363,7	2029566,5	2071384,5	2712122,7	2834120,8
Profit (income) tax , capital gains tax	179550,5	537303,4	164765,6	205991,49	259003,3
Taxes on products and services; Licensing and incorporation duties	1178971,2	1135752,3	1088389,6	1188151	1205557,0
VAT	946218,5	882063,5	988368,2	1069691,5	1120751,3
excise	231368,3	252531,3	98516,8	117205	84805,7
Aggregate income tax ***	8478,4	10074,9	150,8	167,22	–
Single agricultural tax ****	–	257,8	150,8	167,22	–
Tax on securities transac- tion	840,0	1663,3	824,0	121,26	–
Payments of utilization of natural resources	183129,5	249507,7	279381,1	434252,61	483035,6
Taxes on foreign trade and foreign economic opera- tions	335975,5	452789,2	532538,2	859736,84	867969,0
Other taxes, fees and du- ties	5418,6	7069,4	5335,2	23702,36	285055,9
Non-tax revenues	145721,8	176718,3	219194,4	221995,52	225420,3
Incomes from public and municipal property and from activity of public and municipal organizations	83158,8	112680,8	165612,1	169394,48	73004,0
Administrative fees and charges	1406,5	1383,1	1381,2	2395,308	1714,0
Penalties, compensation of damage	1353,6	1975,1	1157,8	1683,37	1483,9
Incomes from foreign eco- nomic activity	55932,7	52924,3	45205,2	38470,391	51124,8
Other tax revenues	3870,0	7755,0	5827,2	10051,934	98093,6
Fund of the Ministry of Nuclear Power Energy of the Russian Federa- tion	14066,3	14349,0	14061,5	14074,644	0,0
Single social tax	365640,0	364593,8	438210,0	442218,25	266500,0
Total revenues	2417791,8	2586191,2	2742850,4	3426334,2	3326041,1

* In the table above, unlike the established classification of incomes specified in the draft federal budget law for 2005, the amount of tax duties (Taxes on foreign trade and foreign economic operations) is attributed to tax revenues.

** Without consideration of single social tax .

*** From 2004, for the purpose of compensation for non-receipt of revenues by the budgets of constituent entities of the Russian Federation as a result of abolished sales tax, the federal part of tax revenues under special tax treatments of small businesses, aggregate income tax, is transferred to the budgets of the constituent entities of the Russian Federation .

**** Provides for coming into force, since January 1, 2004, of a revised chapter of the Tax Code regulating a special tax treatment as a single agricultural tax .

Table 6

Revenues in Budget Laws and Execution of Federal Budget in 2003–2005

	2003 Budget Law	Exe- cuted for 2003	2004 Budget Law	Exe- cuted for 2004	2005 Budget Law *	2005 Budget Law against 2004 Budget Law
	% of GDP					%
Tax Revenues**	14.2	15.3	13.5	16.2	15.1	112.0
Profit (income) tax , capital gains tax	1.4	4.0	1.1	1.2	1.4	128.6
Taxes on products and services; Licensing and incorporation duties	8.9	8.6	7.1	7.1	6.4	90.6
VAT	7.1	6.6	6.5	6.4	6.0	92.8
excise	1.7	1.9	0.6	0.7	0.5	70.4
Aggregate income tax ***	0.1	0.1	0.0	0.0	–	–
Single agricultural tax ****	-	0.0	0.0	0.0	–	–
Tax on securities transaction	0.0	0.0	0.0	0.0	–	–
Payments of utilization of natural resources	1.4	1.9	1.8	2.6	2.6	141.5
Taxes on foreign trade and foreign economic operations	2.5	3.4	3.5	5.1	4.6	133.4
Other taxes, fees and duties	0.0	0.1	0.0	0.1	1.5	-
Non-tax revenues	1.1	1.3	1.4	1.3	1.2	84.2
Incomes from public and municipal property and from activity of public and municipal organizations	0.6	0.9	1.1	1.0	0.4	36.1
Administrative fees and charges	0.0	0.0	0.0	0.0	0.0	101.5
Penalties, compensation of damage	0.0	0.0	0.0	0.0	0.0	104.9
Incomes from foreign economic activity	0.4	0.4	0.3	0.2	0.3	92.5
Other tax revenues	0.0	0.1	0.0	0.1	0.5	–
Fund of the Ministry of Nuclear Power Energy of the Russian Federation	0.1	0.1	0.1	0.1	0.0	0.0
Single social tax	2.8	2.7	2.9	2.6	1.4	49.8
Total revenues	18.2	19.5	17.9	20.4	17.8	99.2

* In the table above, unlike the established classification of incomes specified in the draft federal budget law for 2005, the amount of tax duties (Taxes on foreign trade and foreign economic operations) is attributed to tax revenues.

** Without consideration of single social tax .

*** From 2004, for the purpose of compensation for non-receipt of revenues by the budgets of constituent entities of the Russian Federation as a result of abolished sales tax, the federal part of tax revenues under special tax treatments of small businesses, aggregate income tax, is transferred to the budgets of the constituent entities of the Russian Federation .

**** Provides for coming into force, since January 1, 2004, of a revised chapter of the Tax Code regulating a special tax treatment as a single agricultural tax .

Besides the reduction of the single social tax revenues, the same is true with the value added tax revenues in 2005. In this case, the reduction is caused by introduction on January 1, 2005 of a value added tax collection procedure on the “country of destination”

basis for hydrocarbons exported to the CIS countries, as well as value added tax exemption on the goods exported to the Republic of Byelorussia.

In spite of the fact that in drafting the federal budget law for 2005, the forecasted Urals oil price is decreased down to \$28 per barrel as compared to actual annual average price levels in 2004, the volume of payments for utilization of natural resources against GDP in 2005 will remain unchanged as compared to actual level of tax revenues in 2004. This is due to an increase in the tax rate on oil production.

Eventually, due to changes in the tax law, tax revenues of the federal budget were reduced by RUR251,8 billion in 2005 and by 1.35% of GDP. At the same time, changes in standards for defining taxes by budgetary level enabled the federal budget revenues to grow by RUR102,1 billion or by 0.55% of GDP.

Table 7

**Expenditures in Budget Laws and Execution of Federal Budget
in 1999–2004 (% of GDP)**

	1999		2000		2001		2002		2003		2004		2005
	Bud get Law *	Exe cu- tion	Draft budg et Law *										
Public administration and local self-administration	0.34	0.31	0.48	0.34	0.53	0.46	0.52	0.52	0.51	0.50	0.50	0.48	0.48
Judicial power	0.12	0.10	0.15	0.11	0.15	0.13	0.17	0.18	0.20	0.19	0.22	0.20	0.20
International activity	0.91	1.22	1.05	0.15	0.29	0.33	0.43	0.31	0.38	0.24	0.29	0.32	-0.02
National defense	2.34	2.40	2.63	2.62	2.77	2.73	2.58	2.72	2.65	2.68	2.69	2.56	2.37
Law enforcement and national security	1.28	1.15	1.49	1.44	1.70	1.65	1.52	1.75	1.87	1.87	2.03	1.88	1.90
Fundamental scientific research and scientific progress promotion	0.29	0.23	0.30	0.24	0.29	0.26	0.27	0.29	0.31	0.31	0.30	0.28	0.83
Industry, power energy and construction	0.36	0.35	0.38	0.48	0.58	0.49	0.49	0.97	0.48	0.52	0.44	0.49	0.63
Agriculture and fishery	0.23	0.18	0.22	0.18	0.27	0.26	0.20	0.26	0.23	0.24	0.19	0.21	0.13
Environmental and natural resources protection, hydro-meteorology, mapping and geodesy	0.07	0.06	0.07	0.06	0.06	0.05	0.09	0.09	0.08	0.09	0.08	0.08	0.10
Transportation, communication and informatics	0.02	0.02	0.03	0.03	0.39	0.41	0.05	0.07	0.04	0.05	0.04	0.04	0.22
Market infrastructure development	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-
Prevention and liquidation of consequences of emergency situations and natural disasters	0.18	0.16	0.17	0.13	0.08	0.08	0.08	0.08	0.16	0.18	0.17	0.16	0.18
Education	0.52	0.43	0.60	0.52	0.63	0.60	0.71	0.75	0.75	0.75	0.77	0.72	0.81
Culture, arts and cinematography	0.08	0.06	0.09	0.07	0.08	0.07	0.09	0.09	0.11	0.11	0.11	0.10	0.14
Mass media	0.05	0.04	0.11	0.08	0.08	0.08	0.09	0.09	0.09	0.09	0.07	0.07	0.06

	1999		2000		2001		2002		2003		2004		2005
	Bud get Law *	Exe cu- tion	Draft budg et Law *										
Health care and sport	0.26	0.21	0.30	0.23	0.29	0.26	0.28	0.29	0.30	0.30	0.31	0.29	0.44
Social policy	1.05	1.02	1.18	0.93	1.39	1.24	3.71	4.46	1.15	1.04	1.05	0.92	0.95
State debt service	4.17	3.38	4.11	3.53	3.09	2.56	2.65	2.11	2.13	1.66	1.88	1.22	–
Building up government provisions and reserves	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.01	0.16	0.16	0.13	0.12	0.00
Financial aid to budgets at other levels	1.09	1.30	1.29	1.39	2.41	2.54	2.24	2.93	5.45	5.99	5.31	5.39	5.02
Disposing and liquidation of military weapons, including implementation of international agreements	0.04	0.07	0.04	0.05	0.08	0.07	0.09	0.10	0.08	0.08	0.07	0.07	–
Mobilizing preparation of the economy	0.01	0.01	0.01	0.01	0.01	0.01	0.00	0.01	0.00	0.00	0.01	0.01	0.02
Researches and use of space	0.07	0.07	0.06	0.06	0.06	0.08	0.09	0.09	0.06	0.07	0.08	0.07	–
Military reform	0.00	0.00	0.00	0.00	0.05	0.06	0.15	0.13	0.11	0.12	0.05	0.04	–
Other expenditures	-0.24	-0.13	0.09	0.09	-0.05	0.07	-0.03	0.11	-0.05	0.74	1.00	-0.01	1.82
Road network	0.00	0.00	0.00	0.00	0.00	0.00	0.50	0.36	0.61	0.34	0.52	0.29	–
Targeted budget funds	1.10	1.17	1.13	1.34	0.18	0.16	0.13	0.14	0.11	0.11	0.09	0.08	3.57
Total expenditures	14.38	13.83	15.98	14.09	15.40	14.67	17.09	18.91	17.97	17.75	17.36	16.07	16.28

* In comparable classification of expenditures.

Expenditures of the federal budget for 2005 are planned to reach RUR3 trillion 47,9 or 16.3% of GDP with GDP forecast amounting to RUR18 720 billion. Out of this amount, RUR 341,2 billion (11.19% of total expenditures) will constitute the funds allocated to the RF Pension Fund to pay basic labor pensions, RUR254,1 billion will constitute interest costs and RUR2 trillion 793,8 billion, non-interest costs (8.33 and 91.66% correspondingly).

Interest costs the budget 2005 will be reduced by 0.5 percentage points Of GDP (virtually by 20% in comparable prices) as compared to the budget law of 2004.

Noteworthy are changes in functional classification in the draft federal budget for 2005:

- reducing the number of sections and subsections of functional classification of expenditures of the budgets of the Russian Federation ;
- reflecting expenditures on management and applied scientific research in the corresponding spheres of activity included into sections and subsections of functional classification ;
- reflecting expenditures on capital investments included into economic classification of expenditures of budgets with possibility of their distribution between all items of the functional classification ;
- strengthening the items of economic classification with their reference to a new chart of accounts .

It can be noted that under the new functional classification, in 2005 expenditures on general state issues are reduced by virtually 0.4 percentage points of GDP as compared to

the budget of 2004. In addition, expenditures on housing and public utilities, environmental protection and education will be reduced in real terms. In this case, expenditures on education will be reduced by 0.2 percentage points of GDP. In other cases, liabilities in 2005 will grow in real terms as compared to 2004. The biggest share of expenditures will be utilized for financing national defense, national security and intergovernmental transfers, correspondingly 16, 13.1 and 30.8% of the aggregate federal budget expenditures in 2005. "Applied scientific research in the field of national defense", more than RUR81 billion or 0.04% of GDP, is one of the most essential subsections of expenditures on national defense. Expenditures reflected in "National security and law enforcement" section will grow by 0.07 percentage points of GDP or by 1,17 times in comparable prices. Expenditures on "Intergovernmental transfers" will grow in real terms by 1,06 times, while they will be decreased by 0.3 percentage points of GDP.

Table 8

**Comparison of Expenditures Items in the Federal Budget Law for 2004
with those of the Federal Budget Law for 2005 in comparable classification**

	2004 (Law)			2005 (Law)			Actual growth rates, %
	RUR billion	% GDP	% of expenditures total	RUR billion	% GDP	% of expenditures total	
Total expenditures	2 659,4	17.36	100	3 047,9	16.28	100	106,1
General state issues	458,7	2.99	17,3	460,4	2.46	15,1	92,9
National defense	413,7	2.7	15,6	531,1	2.84	17,4	118,9
National defense and law enforcement	316,3	2.06	11,9	398,9	2.13	13,1	116,8
National economy	213,5	1.39	8	242,1	1.29	7,9	105,0
Housing and public utilities	16,6	0.11	0,6	8,6	0.05	0,3	48,2
Environmental protection	5,0	0.03	0,2	4,6	0.02	0,2	85,7
Education	156,4	1.02	5,9	155,3	0.83	5,1	92,0
Culture, cinematography, mass media	32,8	0.21	1,2	39,2	0.21	1,3	110,6
Healthcare and sport	75,5	0.49	2,8	85,7	0.46	2,8	105,1
Social policy	154,1	1.01	5,8	167,4	0.89	5,5	100,6
Intergovernmental transfers	816,7	5.33	30,7	954,5	5.10	31,3	108,2
Including to budgets at other levels	317,2	2.07	11,9	274,6	1.47	9,0	80,2

Data source: Federal Budget Law for 2005 ; IET's estimates.

2.3. Interbudgetary relations and subnational finances

In 2004, there were observed no radical changes in the system of interbudgetary relations. The structure of tax revenues and tax powers of different levels of authorities remained on the whole similar to that registered in the preceding year with the exception of several insignificant changes. At the federal level, there continued to function the channels of financial support of regional budgets set up within the last few years – interbudgetary

transfers in the form of grants for equalization of budgetary security, subventions, and subsidies from the Compensatory Fund, interbudgetary transfers from the Fund of Regional Development, the Fund of Reform of Regional Finances, other types of interbudgetary transfers allocated on the basis of previously approved principles⁷. At the background of a growth in the revenues of the federal budget in real terms, the financial standing of subnational budgets (taking into account the received federal financial aid) may be characterized as rather stable.

At the same time, the expert community was focusing attention on the tax and budgetary aspects of relations among the authorities of different levels during all the period under observation. First, in 2004 there were enacted the decisions concerning the abolishment of the sales tax and redistribution of tax revenues between the federal and regional budgets for the purposes of compensation for the budgetary revenues lost because of the abolished tax; there began to function the revised tax on the property of organizations. Second, during the year there were discussed the changes in the tax and budgetary legislation, which the Parliament reviewed in the framework of the federative reform, the legal framework of which started to form yet in 2003⁸. Third, there was widely discussed the adoption of legislation aimed at the liquidation of unfunded mandates (so called "monetization of social benefits" what was closely related to the development of interbudgetary relations. Fourth, the decision concerning the actual abolishment of the appointment of the heads of executive authorities of RF subjects by election will also have an impact on the state of interbudgetary relations and subnational finances in a medium term outlook. The law on the federal budget for year 2005 was elaborated and adopted taking into account not only the changes in the system of interbudgetary relations, but also on the basis of certain principles of the starting reform of the budgetary process.

2.3.1. Relations between budgets of different levels: basic trends of development

In order to analyze main trends observed in 2004 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 the 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 9*.

Table 9

The share of certain budgetary indicators in the consolidated budget of the Russian Federation in 1992 through 2004 (in %)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Tax revenues	44,2	53,1	53,4	47,6	49,5	53,1	56,6	49,2	43,5	37,4	35,1	39,6	36,1
Revenues *	44,1	53,1	52,9	47,6	49,5	53,1	54,0	48,9	45,4	40,1	37,4	37,6	34,1
Expenditures	34,0	40,3	37,7	43,4	45,4	48,1	54,1	51,9	54,4	54,2	49,3	50,0	50,8

*Without financial aid from the federal budget (with the exception of the balance of unredeemed loans from the federal budget) as well as the revenues of targeted budget funds.

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

⁷ See annual IET surveys for years 1999 and 2001.

⁸ See: Russian Economy in 2003. Trends and Outlooks. Issue 25. M.: IET, 2004.

The data presented in *Table 9* demonstrate that starting since 2001 (taking into account the fact that a portion of revenues from the single social tax is due to the federal budget) the share of tax revenues of subjects of the Russian Federation in the consolidated budget of Russia fluctuated from 35 per cent to 38 per cent and was above this level in 2003. According to the results of budget administration in 2004, consolidated budgets of RF subjects received over 36 per cent of the total tax revenues of the budgetary system as compared with 39.6 per cent registered a year ago. At the same time, the share of aggregate revenues of RF subjects (without financial aid from the federal budget) in the "Revenues" item of the consolidated budget of Russia declined from 37.6 per cent in 2003 to 34.1 per cent in 2004.

It should be pointed out that over the last few years the share of revenues of regional budgets in the consolidated budget of the Russian Federation was below the value of the respective indicator characterizing tax revenues. This fact may be primarily explained by higher amounts of non-tax revenues of the federal budget and unavailability of the data characterizing such an important source of non-tax revenues of the budgets of RF subjects as interbudgetary transfers.

At the same time, the share of expenditures of RF subjects in the consolidated budget of the Russian Federation increased from 50.0 per cent to 50.8 per cent.

In this connection, it should be pointed out that by the end of 2004 there was observed an increase in the share of revenues of the consolidated budget of the Russian Federation from 31.1 per cent of GDP registered in 2003 to 32.3 per cent (by 1.2 p. p.). At the same time, the tax revenues of the consolidated budget of Russia (not taking into account extra-budgetary funds) grew more considerably – by 1.4 p. p. of GDP. It should be also noted that the federal budget accounted for a significant portion of this growth (0.8 p. p. of GDP), while the tax revenues of consolidated budgets of RF subjects increased not so significantly – up to 10.6 per cent of GDP from 10 per cent of GDP registered in 2003. Exactly this circumstance had determined the decline in the share of the tax revenues of consolidated budgets of RF subjects in the total tax revenues of the RF consolidated budget. In 2004, simultaneously with an insignificant increase in the tax revenues, there was observed a certain decline in the amount of aggregate total revenues of regional budgets – from 14.5 per cent registered in 2003 to 14.3 per cent of GDP caused by the decrease in the amount federal financial aid.

The data presented above permits to arrive to the conclusion about a certain centralization of financial resources in the federal budget to the detriment of the budgets of RF subjects: on the whole the national level of tax burden has increased, however, the federal budget accounted for the bulk of this growth. At the same time, the federal financial aid to regions calculated as the share of GDP decreased, while the share of expenditures of regional budgets in the RF consolidated budget grew. These facts indicate that the vertical imbalance of the distribution of sources of revenues and assignment of expenditure obligations across the federal and regional levels of authorities has increased. At the same time, in the course of analysis of the structure of distribution of revenues across the levels of the budgetary system in 2004 it should be taken into account that at that time the budgets of all levels received additional tax revenues resulting from the inspection of the NK YUKOS and its affiliated companies, what could distort the analyzed indicators⁹.

⁹ According to expert estimates, in 2004 the Russian budgetary system received about Rub. 140 billion as the repayment of indebtedness associated with tax payments, arrears, penalties, and fines related to the tax on profits of organizations transferred by the NK YUKOS.

In the course of analysis of the tax revenues received by consolidated regional budgets in 2004, it should be noted that similarly to the situation observed in the preceding years two taxes (the income tax on individuals and the tax on profits of organizations) accounted for more than a half of the total tax revenues (32 per cent and 37 per cent of the tax revenues of regional budgets respectively). It should be noted that in 2004 the revenues generated by these two taxes increased in terms of their shares in GDP. While the revenues generated by the income tax on individuals remained at the previous level (about 3.4 per cent of GDP), the revenues generated by the profit tax have sharply increased (from 2.7 per cent of GDP to 3.9 per cent of GDP). At the same time, the growth in excise generated revenues also grew (up to 0.8 per cent of GDP), while the revenues associated with payments for utilization of natural resources declined (down to 0.9 per cent of GDP). The taxes on small businesses increased by 0.1 per cent of GDP after an insignificant decline registered in 2003.

In the course of analysis of the respective indicators of administration of consolidated budgets of the Russian Federation and comparison of these data with the results of execution of the federal budget, it should be stressed that starting since 2003 there has been taken the measures aimed at the increase of the rate of centralization of tax revenues in the federal budget. It should be reminded that in 2003 there were enacted such decisions as the full abolition of the tax on users of motor roads, as well as the switching to the transfer of the total amount of revenues generated by excises on tobacco products to the federal budget. In 2004, this trend became even more pronounced as there was abolished a whole range of fees the revenues from which were transferred to the budgets of RF subjects and the federal share in the revenues generated by the mineral extraction tax was raised.

However, the results of all these decisions were compensated in full by such measures in the sphere of interbudgetary redistribution of tax revenues as the transfer of the total federal share of tax revenues generated under the special taxation regimes applicable to small businesses to the budgets of RF subjects, the transfer of the federal share of excises on vodka and liquor products (the procedures governing the payment of these taxes were simultaneously reformed), and the transfer of 1 p. p. of the federal rate of the tax on the profits of organizations.

As a result, in 2004 the tax revenues of the RF subjects increased by 0.6 p. p. of GDP as compared with the figures registered in the preceding year. These developments were primarily determined by the growth in the revenues generated by the profit tax by 1.2 p. p. of GDP. The increase in the revenues generated by the profit tax was caused by both the growth in the regional share in the profits tax, and the increase in the tax base. It may be surmised that the growth of the profit tax base has been favorably affected by the reduction of the base VAT rate from 20 per cent to 18 per cent occurred in 2004. According to some hypotheses, the growth in the profit tax revenues observed in 2004 was related to the improved discipline of taxpayers caused by the active actions taken by the federal authorities with respect to the NK YUKOS.

At the same time, an analysis of the per capita indicator of the tax revenues of consolidated budgets of RF subjects demonstrates that in 2004 the interregional unevenness of this indicator increased; thus, the value of the respective Gini coefficient grew over the year and made 0.57 (as compared with 0.52 registered in 2003). A decline in the real tax revenues was observed only in four subjects of the Federation: the Republic of Adygeya, the Astrakhan oblast, the Saratov oblast, and the Republic of Altai. At the same time, in absolute terms the maximal increase in the tax revenues was registered in the city of Moscow, the Republic of Tatarstan, the Tyumen oblast, the Khanty Mansi AO, and the Republic

of Mordoviya, i.e. either in the regions characterized by high budgetary security (the first four regions), or the high shares of the profit tax in the structure of tax revenues (the Republic of Mordoviya). An analysis of changes in the per capita tax revenues demonstrates that the maximal positive increment of per capita tax revenues in real terms was observed in such regions as the Evenk AO, the Republic of Mordoviya, the Chukotka AO, the Tyumen oblast, and the Khanty Mansi AO. The success of the Tyumen oblast and the Khanty Mansi AO may be easily explained by high oil prices and the measures aimed at the exaction of additional tax payments from certain oil companies and respective growth in tax payments made by oil companies to regional budgets. At the same time, the significant growth in the per capita tax revenues in real terms in the Evenk AO, the Republic of Mordoviya, and the Chukotka AO may be explained by a high share of the profit tax in the total tax revenues of these regions. Thus, in 2004 the share of the profit tax in the total tax revenues of the Evenk AO made 95 per cent, the Chukotka AO – 85 per cent, and the Republic of Mordoviya – 78 per cent, while the average national level of this indicator was observed to make 37 per cent. As concerns the Republic of Mordoviya, there the growth in this indicator should be primarily associated with additional tax payments made by taxpayers engaged in resale of oil, who were registered in this subject of the Russian Federation, since the region granted significant tax privileges.

Therefore, the results of the analysis permit to state that tax revenues grew across all regions with the exception of four. At the same time, in 2004 the unevenness of the distribution of tax revenues only increased, what may be explained by a growing importance for their revenues of such taxes characterized by the unevenly distributed base as the profit tax. The validity of this argument is confirmed by the fact that among the regions benefiting from the redistribution of tax resources are both highly subsidized regions like the Evenk and Chukotka autonomous okrugs, and non-subsidized RF subjects, for instance, the Tyumen oblast, the Khanty Mansi AO, etc. The only specific feature common for these regions is significant payments associated with the profit tax in absolute and relative terms. Other decisions in the sphere of tax policy implemented in 2004 did not produce so significant effect across all regions. Thus, the abolishment of the sales tax, which was rather high in Moscow, did not result in a decline in the tax revenues of this region. At the same time, the changes in the scheme of distribution of excises on fuels and lubricants were not completely compensated by other redistribution measures only in the Saratov oblast.

Contrary to the situation observed in 2003 and 2002, in 2004 the aggregate surplus of consolidated budgets of RF subjects was registered at 0.2 per cent of GDP. This surplus resulted in an increase in the balance of the budget by 0.6 p. p., what made 1.2 per cent of GDP by the end of the reporting period. Among the sources of financing used by regions in 2004 there were the issue of state and municipal securities, attraction of credits on behalf of RF subjects and municipal entities, and privatization of state and municipally owned property. It should be noted that both in 2003 and 2004 at the national level there were observed negative balances of such a source of financing of the budget deficit as federal budgetary loans (i.e. in 2004, across the country RF subjects repaid their liabilities associated with these loans in amounts exceeding new respective borrowings). These developments may be seen as the turning point with respect to the negative trend observed up to 2003.

An analysis of qualitative characteristics of the financial aid to subjects of the Federation from the federal budget (see *Table 10*) reveals that in spite of a considerable growth in the tax revenues of the federal budget the amount federal financial resources transferred to subnational budgets on free basis increased only insignificantly in nominal terms and made about Rub. 401 billion, or 2.39 per cent of GDP (as compared with 2.85

per cent of GDP observed in 2003) in 2004. At the same time, in real terms the financial aid to regional budgets declined by 3 per cent in comparison with the figures registered in 2003.

In 2003, the expenditures of the federal budget associated with financial aid provided to RF subjects and municipal entities did not change as compared with the figures registered over a number of preceding years. In spite of the implementation of reforms, the specific features of this type of federal budgetary expenditures still are significant amounts of funds distributed in the course of interbudgetary regulation without any methodological, financial, and economic justification. In the total amount of transferred resources, the share of financial aid allocated on the formalized basis makes about 60 per cent. Similarly to the situation observed in the preceding years, on the formalized basis there was formed and allocated only a limited amount of financial aid (Federal Fund of Financial Support, Compensatory Fund, Fund of Co-financing of Social Expenditures, and Fund of Reform of Regional Finances). At the same time, no procedure governing the formation and allocation of even a portion of the said funds was approved in the framework of official regulatory and legal acts. The only exception was the Fund of Reform of Regional Finances, since the respective methods of formation and distribution of this fund were approved by a resolution of the RF Government, what was a condition set forth by the World Bank, which sponsored the financing of this type of financial aid. At the same time, in 2004 there became perceptible a positive trend as concerns the approval of the methodologies of formation and distribution of the funds of financial support of regions by the resolutions of the RF Government. However, the decisions with respect to formalization of financial aid to regions taken in 2004 will enter into force only in 2005.

All other types of financial support have been formed and allocated outside of any clear methodological procedures (with the exception of the grants for support of the measures aimed at the ensuring of the balanced nature of the budgets of RF subjects).

In 2004, similarly to 2003, the specific feature was the revision of the law on budget and an increase in the initially allocated amounts of financial aid to regions by Rub. 73 billion. It should be noted that over the last 4 years such changes have become rather customary, what challenges the efficiency of the reform, which had been implemented in the sphere of distribution of financial aid to regions.

The problem of annual revisions of the budget laws and increases in the initially planned amounts allocated to regional budgets is not only that the additionally allocated amounts are not subject to the formalized procedures underlying the elaboration of the law on federal budget for next financial year. The annual rises of the amounts of financial aid in comparison with the originally envisaged transfers, as well as the lack of clear and well known rules of distribution of such additional amounts result in a significant softening of budgetary constraints on subnational authorities, what is discussed in more details below. In other words, in the case the regional authorities in advance assume that in the course of allocation of additional financial aid the federal authorities will orient towards such indicators of needs as the wage and salaries arrears, the amount of creditor indebtedness in the sector of housing and public utilities, etc, and not the objective characteristics of regional tax potential and expenditure needs of regions used for the distribution of transfers from the Fund of Financial Support of Regions, it will fail to facilitate implementation of measures aimed at enhancement of efficiency of budgetary expenditures and conduct of reform of the public sector.

As examples of the existing procedures and principles of distribution of additional financial aid there may be cited the following decisions:

- 1) In 2004, the Compensatory Fund was increased from Rub. 49.9 billion to Rub. 56.2 billion, i.e. by 13 per cent;
- 2) The Fund of Co-financing of Social Expenditures was increased from Rub. 3.3 billion to Rub. 6.3 billion, i.e. by 91 per cent;
- 3) The grants for equalization of regional budgets were increased from Rub. 20.2 billion to Rub. 21.8 billion, i.e. by 8 per cent.

The considerations discussed above indicate that over the last years the process of the reform of interbudgetary relations started in 1997 and 1998 has been apparently slowing down, and in some cases (for instance from the viewpoint of the ratio between the federal resources distributed across regions on the basis of formalized and discretionary principles) in 2002 through 2004 there was observed a certain regress. This situation may be explained by several factors.

First, at present the objective overburdening of the budget sphere with federal expenditure obligations not backed by the respective financing persists. In the situation, where the total amount of expenditure obligations exceeds the financial resources available to the authorities, the government naturally strives to have available some financial reserves, which could be immediately transferred to regions depending on the arising needs.

Second, the powers to distribute financial aid among regional budgets outside transparent procedures fixed by regulations are the most important lever of influence on the decisions and policies of subnational authorities. In the situation, where the degree of interregional unevenness of budgetary security is high (what is a specific feature of Russia), it is needed to support a rather high degree of centralization of tax revenues in the federal budget, and, respectively, a larger amount of the budgetary resources redistributed among regions. Therefore, due to the use of financial mechanisms the degree of influence on regional authorities, which to a certain degree are formally independent as concerns the decisions they take within their competence, may be rather significant. From the point of view of the authors, this situation is one of the key reasons, why the methods of distribution of the major types of financial aid used over the last years have not been fixed in the budgetary legislation as yet.

In any case, as it is demonstrated by the recent practices the reform of the principles underlying the distribution of the federal financial aid is still on the agenda, since the existing system is insufficiently transparent, what does not permit to draw any conclusions about its efficiency and provides grounds to surmise that it may be used in order to create negative incentives as concerns budgetary policies pursued by regional and local authorities. However, in 2004 there was taken a number of decisions permitting to assert that interbudgetary relations become more transparent and there are observed certain changes in their substantive characteristics. These changes will be discussed below.

Table 10

Financial aid provided from the federal budget to the consolidated budgets of RF subjects in 1992 through 2004 (in % of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*
Grants and subventions	0.00	0.02	0.09	0.06	0.09	0.13	0.10	0.06	0.15	0.54	0.28	0.29	0.27	0.24
<i>Including:</i>														
Grants and subventions to CATEs and the town of Baikonur									0.11	0.12	0.11	0.11	0.09	0.08
Grants and subventions to CATEs											0.11	0.06	0.06	0.05

Section 2.
Monetary and budgetary spheres

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*
Grants to the town of Baikonur											0.00	0.00	0.00	0.00
Capital investment subventions to CATEs												0.03	0.02	0.03
Resettlement subventions to CATEs												0.01	0.01	0.01
Subventions to CATEs for financing of CATE development programs												0.01	0.00	0.00
Other subsidies and subventions									0.04	0.42	0.17	0.18	0.18	0.16
Grant to the town of Sochi												0.01	0.01	0.01
Grants compensating losses relating to maintenance of HPU objects transferred to jurisdiction of local governments												0.08	0.08	0.03
Other grants to budgets of RF subjects (for support of the equilibrium of budgets and compensation of losses)												0.07	0.09	0.13
Other subsidies and subventions to budgets of RF subjects and municipal entities												0.01	0.01	0.01
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	1.14	1.36	1.30	1.05	1.01
<i>Including:</i>														
Transfers	0.00	0.00	0.36	0.86	0.68	0.86	1.00	0.99	0.96	1.14	1.36	1.30	1.05	1.01
Of which: state support of seasonal deliveries to the North									0.06	0.08	0.08	0.07		
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											0.37	0.38	0.36	0.34
<i>Including:</i>														
Subsidies for implementation of the law on social security of disabled persons											0.13	0.12	0.06	0.09
Subventions for implementation of the law on state family allowances											0.24	0.21	0.16	0.12
Subventions for compensation of privileges related to payment for HPU services in accordance with the federal legislation											0.02	0.10	0.09	
Other subventions and subsidies from Compensatory Fund											0.02	0.04	0.04	
Resources of the Fund of Co-Financing of Social Expenditures											0.15	0.11	0.04	0.12
Resources of the Fund of Regional Development									0.03	0.05	0.10	0.10	0.15	0.01**
State support of road networks								0.18	0.11	0.27	0.27	0.31	0.22	0.16
Resources of the Fund of Reform of regional finances										0.00	0.01	0.01	0.01	0.00
Funds transferred as mutual payments	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.28	0.05	0.20	0.14	0.12	
Loans minus repayment to other levels of authorities	0.09	0.03	0.02	0.04	0.23	0.64	-0.03	-0.10	-0.08	0.02	0.09	-0.01	-0.02	

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*
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	0.13	0.18	0.23	0.19	0.30
<i>Including:</i>														
Funds transferred to the budgets of other levels for implementation of state programs									0.00	0.11	0.00			
Measures in the sphere of regional development, targeted federal and other programs											0.18	0.23	0.13	0.30***
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	2.56	3.03	2.84	2.39	2.02

* In accordance with federal law on the federal budget for year 2005 No. 173-FZ of December 23, 2004.

** Since 2005, only the financial resources associated with the program "Reduction of differences in the social and economic development of regions of the Russian Federation" should be included in the Fund of Regional Development

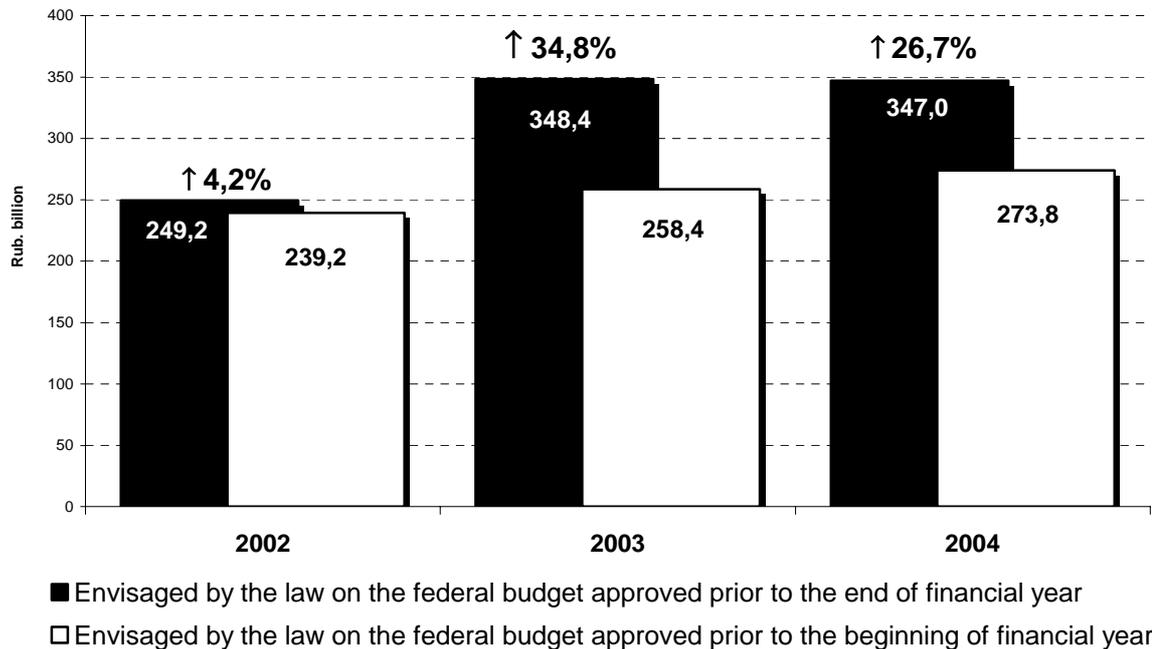
*** Including the grants to Tatarstan and Bashkortostan aimed for implementation of measures envisaged by federal targeted programs of social and economic development until year 2006.

2.3.2. The problem of soft budgetary constraints on Russian regional authorities

As it has been noted in the survey "Russian Economy in 2003. Trends and Outlooks," the amount of financial resources distributed in the form of financial among the budgets of RF subjects in the recent years has significantly exceeded the amount of financing initially envisaged by the laws on the federal budget for respective financial years and brought to the notice of regional authorities. Thus, according to the authors' point of view, in 2003 the allocation of additional financial aid to regions across different channels was carried out in line with the striving to ensure the favorable for the federal center outcomes of the Parliamentary elections held in December of 2003.

In 2004, these practices were continued. Throughout the year, there were approved legislative acts concerning the amendments to the law on the federal budget aimed at the allocation of additional revenues of the federal budget for the purposes including increases in expenditures across financial aid budget items. In the *Fig. 13*, there are presented the data characterizing the differences between the amounts of financial aid to regions as envisaged in the law on the federal budget approved by the Parliament and signed by the President immediately prior to the beginning of the respective financial year, and the amount of financial aid registered in the law on the federal budget as in force at the end of the respective financial year, i.e. adjusted for the amendments made to the law during the year.

As it is demonstrated by the data presented in *Fig. 13*, in 2003 and 2004 the increase in the amount of financial resources distributed in addition to the amount envisaged in the initial version of the law on the federal budget was significant. While the law on the federal budget for year 2002 at the end of that year envisaged the amount of resources for distribution among the budgets of RF subjects only by 4.2 per cent exceeding the targets made public prior to the beginning of the financial year, at the end of 2003 this indicator made 34.8 per cent, and at the end of 2004 – 26.7 per cent of the amount initially envisaged by the law on the federal budget.



Source: The laws on the federal budget for years 2002, 2003, and 2004, different versions.

Fig. 13. The excess of financial aid envisaged by the law on the federal budget approved prior to the end of financial year over the amount of financial aid envisaged by the law on the federal budget approved prior to the beginning of financial year

There may be several factors behind this phenomenon. First, there may be responsible the financial planning of insufficient quality; for instance, in the beginning of the year such indicators as the revenues of the federal budgets and needs of regions as concerns financial resources were underestimated. Second, it is highly probable that the federal authorities deliberately kept significant amounts of financial resources for the purposes of distribution of these resources during the financial year among the regions, which due to economic and (or) political reasons are in need of additional financing. Third, such a situation might be determined by the circumstance that the planning of the revenue and expenditure indicators of the federal budget proceeded from a conservative forecast of external business situation, while favorable developments on the world markets of raw materials resulted in higher amounts of additional revenues, part of which could be distributed among the regions in the form of financial aid.

Notwithstanding the possible reasons (most probably, all three are valid to a certain degree), the present situation has a very negative impact on the incentives of regional authorities as concerns the pursuit of efficient budgetary policies. In the world literature, the situation, where the federal authorities do not adhere to the principles announced in advance and provide additional financial aid to the regions experiencing financial difficulties is defined as the situation of *soft budgetary constraints*¹⁰. As it is demonstrated by the international experience, soft budgetary constraints on subnational authorities result in a whole number of negative economic effects, including both the excess over the efficient

¹⁰See, for instance, *Fiscal Decentralization and the Challenge of Hard Budget Constraints*. Rodden, Jonathan, Gunnar Eskeland and Jennie Litvack (eds). – Cambridge: MIT Press, 2003.

level of budgetary expenditures, and effects of a more general nature (creation of barriers to the growth in private investment and increase in the number of inefficient investment projects involving higher risks).

In practice it means that in the situation, where regional authorities can justifiably expect additional financial aid as compared with the amounts made public initially, there may be observed several types of negative effects. First, regional authorities may assume higher risks both in the course of implementation of budgetary programs and as concerns borrowings. Second, the probability to receive additional financing permits regional authorities to assume additional obligations in the form of creditor indebtedness and to refrain from taking of measures aimed at the improvement of the efficiency of budgetary expenditures in the region. Third, basing on the experience of past years, regional authorities may surmise an approximate list of indicators on the basis of which the federal authorities will distribute additional financial aid among regions, regional authorities can influence the respective indicators (for instance, the level of creditor indebtedness in the region, the level of wages and salaries arrears in the public sector, the level of indebtedness of public institutions as concerns payments to public utilities, etc). As a result, the seemingly favorable for the residents of the regions receiving financial aid decision about the provision of additional financial aid may have consequences producing negative effects not only on the residents of concrete regions, but the country at large (the state of its public finances). At the same time, the probability of such negative effects increases in the cases, where additional financial aid is distributed on the regular basis.

A factor facilitating the softening of budgetary constraints on Russian regional authorities is not only the increase in the total amount of financial aid envisaged in the law on the federal budget. The amount of financial resources made public already prior to the beginning of the financial year remains rather high, however the powers concerning the decisions on the concrete methods of the distribution of these resources are vested with the Government, which takes respective decisions during the financial year. As a result, regional authorities have no information about the methods of distribution of certain financial resources, what creates incentives for origination of soft budgetary constraints, as well as for the wish of regional authorities to receive additional financial aid.

Thus, in 2004 about 25 per cent of the financial resources in the form of the grants aimed at the balancing of regional budgets were not distributed among regions on the basis of the law on the federal budget: the grants provided to the budgets of RF subjects for support of the measures aimed at the balancing of budgets of RF subjects in amount of Rub. 15 billion 194 million 335 thousand were redistributed in accordance with supplement No. 36 to the law on the federal budget, while the procedures governing the distribution and amounts of grants provided to the budgets of RF subjects with the purpose to ensure the balance of the budgets of RF subjects, which amounted to Rub. 4.965 billion, were set forth by the Government of the Russian Federation.

The creation of the reserves without having in place clear procedures of distribution in the beginning of the financial year may also have a negative impact on the fiscal behavior of regional authorities (expressed in attempts to receive yet undistributed financial reserves of the center in stead of optimization of own financial resources), and on control over the distribution and utilization of the said funds.

The same practices persist in 2005. In *Fig. 14*, there are presented the dynamics of grants for stabilization of regional budgets proceeding from the methodology of distribution of these funds and distribution of these funds at the Government's discretion.

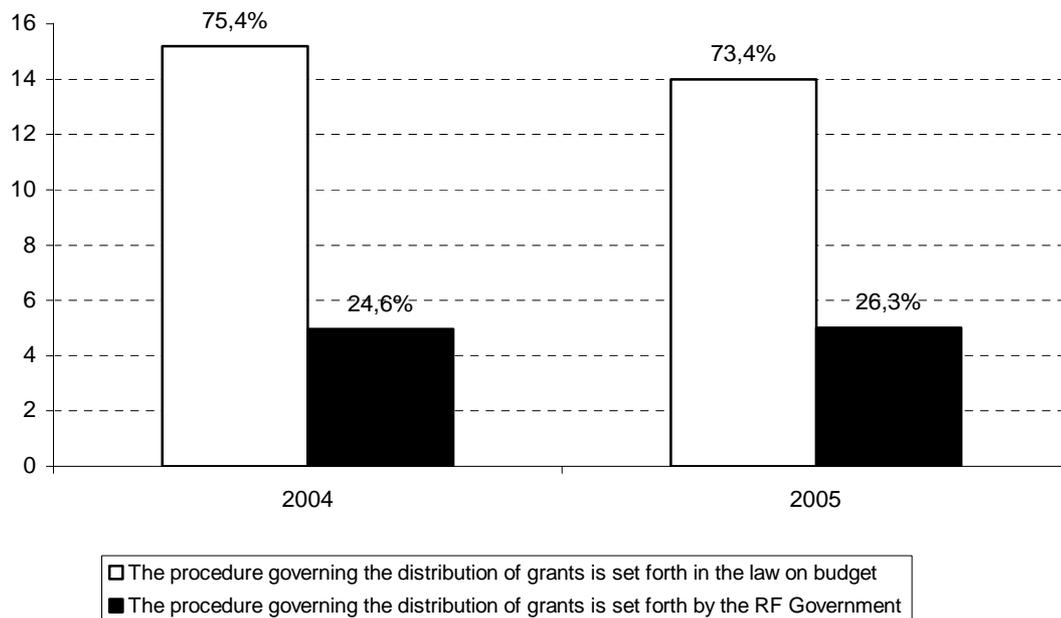


Fig. 14. The dynamics of amounts and shares of grants for stabilization of regional budgets proceeding from the methodology of distribution of these funds and distribution of these funds at the Government's discretion (Rub. billion)

As it is demonstrated by the data presented in *Fig. 14*, the share and amount of grants for the support of the balances of regional budgets provided under procedures set forth by the Government were significant both in 2004, and 2005. The share of these financial resources makes about one fourth of the total amount of grants provided for the support of the balances of regional budgets.

The procedures and rules of distribution of grants provided for the support of the measures aimed at the balancing of the budgets of RF subjects in 2004 were elaborated and set forth by the governmental resolution approved in the second half of the financial year. The key feature of the said rules is that they usually base on the reporting indicators of regional budgets, although the use of such indicators was deemed inefficient yet in 1998 in the course of revision of the Methods of distribution of grants provided from FFSR¹¹.

In accordance with the resolution of the RF Government, the right to obtain grants aimed at the balancing of budgets should have the regions, where the ratio between primary expenditures of the consolidated budget (expenditures for wages and salaries, charges on the payroll, payments associated with mandatory medical insurance as concerns non-working residents, compensation of the difference between the set level of household payments for public utilities and the economically justified tariffs, capital repairs of the housing fund, payments to the population as concerns subsidies for housing and public utilities expenditures) for the first 5 months of 2004 and the consolidated revenues for 5 months of 2004 (minus the financial reserves of the Compensatory Fund, the Federal Fund of Financial Support of RF subjects transferred in advance, and certain types of grants) made less than 60 per cent.

¹¹ See the Concept of reform of interbudgetary relations in the Russian Federation in 1999 through 2001 approved by Resolution of the RF Government No. 862 of July 30, 1998.

The amount of the grant provided to individual regions should depend on the amount of the expenditures of the consolidated budget of this region in 2003, the ratio between its primary expenditures and revenues in the first 5 months of 2004, and the level of its budgetary security after the distribution of the FFSR financial reserves in 2004.

Grants are provided in two stages. At the first stage (in September of 2004) the regions received 30 per cent of the total amount of grants for support of the balance of regional budgets. At the second stage (in October of 2004), according to the aforementioned resolution the regions should receive 70 per cent of the amount of grants, which should be distributed among the regions on the basis of the indicators discussed above with the use of an adjustment coefficient.

This adjustment indicator of the fulfillment of measures aimed at the balancing of the budgets of RF subjects should take into account the activities of sub-federal authorities aimed at the improvement of the financial standing of regions.

The adjustment indicator was calculated on the basis of:

- 1) reduction of the creditor indebtedness of the regional budget as concerns wages and salaries, charges on payroll, provision of state allowances to citizens with children, and payments for public utilities;
- 2) attrition rate of arrears associated with the regional and local tax on profits (the share due to the consolidated budget of the RF subject);
- 3) attrition rate of unregulated indebtedness of the RF subject to the federal budget.

Thus, there was made an attempt to compensate negative effects of irregular provision of financial aid and to create incentives for regional authorities to use the grants for implementation of measures aimed at the rehabilitation of regional finances.

At the same time, the rationality of the existence of grants for the balancing of regional budgets proceeding from the reporting indicators and to a certain extent envisaging the targeted nature of the funds received by the region seems to be arguable.

A similar effect could have been achieved, on the one hand, by an increase in the amount of FFSR, and on the other hand, by granting various conditional subventions for rehabilitation of regional finances. Both measures could have been envisaged in the law on the budget for year 2004. All individual and extra requirements with respect to additional financing on the part of regions not related to emergency situations can be met at the expense of borrowings in the market sector. These measures could result in more reliable data used by regions in the course of elaboration of their budgets and partially mitigate the urgency of the problem of soft budgetary constraints (in the cases of active use of borrowings, the problem of soft budgetary constraints may emerge as subnational authorities are granted financial aid for the repayment of borrowings they are unable to pay at the expense of own funds).

It appears that it would be more feasible not only to distribute the total amount of planned financial aid to regions via the mechanisms set in place in advance, but also inform regional authorities about the amounts of financial aid targeted for each region even prior to the beginning of the planned period. At the same time, it is necessary either to refrain from granting financial resources in excess of the targets, or envisage the closed list of cases, where additional financial aid may be granted, and the respective procedures in the framework of the federal legislation.

Yet another "mechanism of flexibility" of the federal budget became the option permitting to redistribute grants and subventions to closed administrative and territorial entities (CATE). In accordance with the RF Government resolution No. 409 of August 12, 2004, the RF Finance Ministry was granted the right to redistribute grants from CATEs, where revenues exceeded 15 per cent, in favor of the CATEs, where the revenues were below the

planned level. A similar reduction should be applied to subventions for capital repairs and resettlement, as well as misused subventions.

2.3.3. Distribution of grants for equalization of budgetary security of RF subjects: new methods

In accordance with the requirements set forth by the new budgetary legislation, which has entered into force since January 1, 2005, in 2004 there was elaborated and approved by the RF Government resolution No. 670 of November 22, 2004, the new Methodology of distribution of financial resource of the Federal Fund of Financial Support of Regions (FFSR), which took into account the flaws of the preceding methodologies. For the first time since the FFSR has started to operate, the methods of distribution of grants for equalization of budgetary security of RF subjects was fixed in the form of a regulatory and legislative act (prior to 2005, the methodology existed only in the form of information materials presented by the Government in the package of documents supplemented to the draft federal law on the federal budget for the next financial year). There may be singled out the following innovations, which make the new principles of distribution of FFSR resources different from the preceding methodologies.

1. Starting from 2005, FFSR financial resources should be distributed in the form of grants only for the purposes of equalization of the rated budgetary security of RF subjects (in 2004, the grants for the equalization of rated budgetary security of regions made about 94 per cent of FFSR). The subsidies for the state support of procurement and delivery of oil, oil products, fuels, and food products to the regions of Far North and the territories granted equal status, as well as subventions for compensation of tariffs on electrical power granted to the territories of the Far East and Arkhangelsk oblast were excluded from the composition of grants for the equalization of budgetary security.

In fact, this measure completes the next stage of the reform of equalizing transfers in Russia by setting forth the non-conditional nature of distribution of all financial resources of FFSR. Yet since the switching to the unified formula of distribution of FFSR resources in 1999, certain components designated for the financing of individual types of expenditures persisted in the composition of the fund. The major factor behind the continuing existence of such components was the compromise, in the framework of which the switching to new principles of distribution of transfers provided from FFSR was accompanied by persistence of its targeted component. Gradually, this targeted component began to be singled out of the total amount of financial reserves on the basis of a unified formula and lost any connection with its declared purposes (financing of the seasonal deliveries to the North and compensation of high tariffs on electrical power). The logical completion of this stage was the abolishment of the targeted component.

2. The approved Methodology of distribution of the financial resources of the Fund of Financial Support of Regions for year 2005 reduced the level of per capita rated budgetary security setting the cap on the right of regions to receive FFSR resources. The preceding methodologies made a region eligible for financial aid provided from FFSR in the case the per capita rated budgetary security in this region decreased below the value of the respective average national level. In 2005, the border separating the regions receiving and not receiving transfers from FFSR was set somewhat below the average national level: in the case the level of rated budgetary security of a region is above 60 per cent of the average national level, the region has no right to receive grants from FFSR. This provision permits to achieve a higher degree of concentration of financial aid in recipient regions. As a result,

in 2005 the number of regions not receiving grants from FFSR increased by 2 (the Sverdlov and Arkhangelsk oblasts)¹².

3. According to the new Methodology of distribution of resources of the Fund of Financial Support of Regions, the fund has ceased to single out the share of its resources previously (till 2005) aimed at the raising of the minimum budgetary security of most poor regions (subjects of the Federation with the minimal levels of per capita rated budgetary security) up to a single level (until 2005, the share of the fund allocated for these purposes made 20 per cent of its total amount). Since 2005, all financial resources of the Fund should be allocated for a prorated reduction of the gap between the per capita rated budgetary security of regions and the level of per capita budgetary security set forth as the criterion of equalization (i.e. the level of budgetary security set forth as the target of equalization).

In accordance with the new principles of distribution of FFSR financial resources, the equalization of budgetary security is carried out in two stages. At the first stage, the grants provided from FFSR are distributed among the RF subjects, where prior to the distribution of FFSR financial resources the level of rated budgetary security is at or below the criterion of equalization of budgetary security, i.e. 60 per cent of the average national per capita level of rated budgetary security.

At the same stage of equalization regions receive 85 per cent of the resources necessary to raise the level of their rated budgetary security to 60 per cent of the average national level of rated budgetary security. The gap between the actual value of the indicator and the level of 60 per cent of budgetary security is not covered in full, only up to 85 per cent. This measure is envisaged so that the regions with higher levels of budgetary security prior to the equalization could maintain their advantage after receiving grants from FFSR. The use of the 0.85 coefficient in the course of raising the actual level of rated budgetary security of regions up to 60 per cent of the average national level in fact renders the effect from such an equalization identical to the prorated equalization. According to the estimates presented by the RF Finance Ministry, this amount should be significantly below the amount of FFSR: for instance, in 2005 it should make Rub. 83.7 billion (or 44 per cent of the total amount of FFSR).

At the second stage, there is distributed the FFSR balance. The remaining funds are distributed in proportion to the divergence of the level of the rated budgetary security of the region adjusted for the amounts of transfers received at the first stage of equalization; however, the criterion of equalization (the level, towards which the amount of transfer is oriented) is the average level of budgetary security. Therefore, the balance of FFSR financial resources is distributed in proportion with the divergence of the rated per capita budgetary security of RF subjects registered after the first stage of equalization from the average national level of budgetary security.

In the framework of budget estimates for year 2005, 44 per cent of the total amount of FFSR was distributed at the first stage and 56 per cent – at the second stage of equalization.

Thus, in the period prior to 2005, the process of interbudgetary equalization was carried out as a process outlined in *Fig. 15*, where there are shown the level of per capita average rated budgetary security prior to the allocation of the transfer, after the first stage – proportional equalization (distribution of the first portion of FFSR equal to 80 per cent of

¹² In 2004, 18 regions did not receive transfers from FFSR: the Lipetsk and Yaroslavl oblasts, the city of Moscow, the Republic of Komi, the Vologda and Leningrad oblasts, the city of St. Petersburg, the Nenets autonomous okrug, the Republic of Bashkortostan, the Republic of Tatarstan, the Udmurt Republic, the Orenburg oblast, the Perm, Samara, and Tyumen oblasts, the Khanty Mansi and Yamal Nenets autonomous okrugs, the Krasnoyarsk krai.

the amount of the Fund), and after the second stage after the raising of the level of budgetary security of the most poor regions to a common level (distribution of the second portion of FFSR equal to 20 per cent of the amount of the Fund).

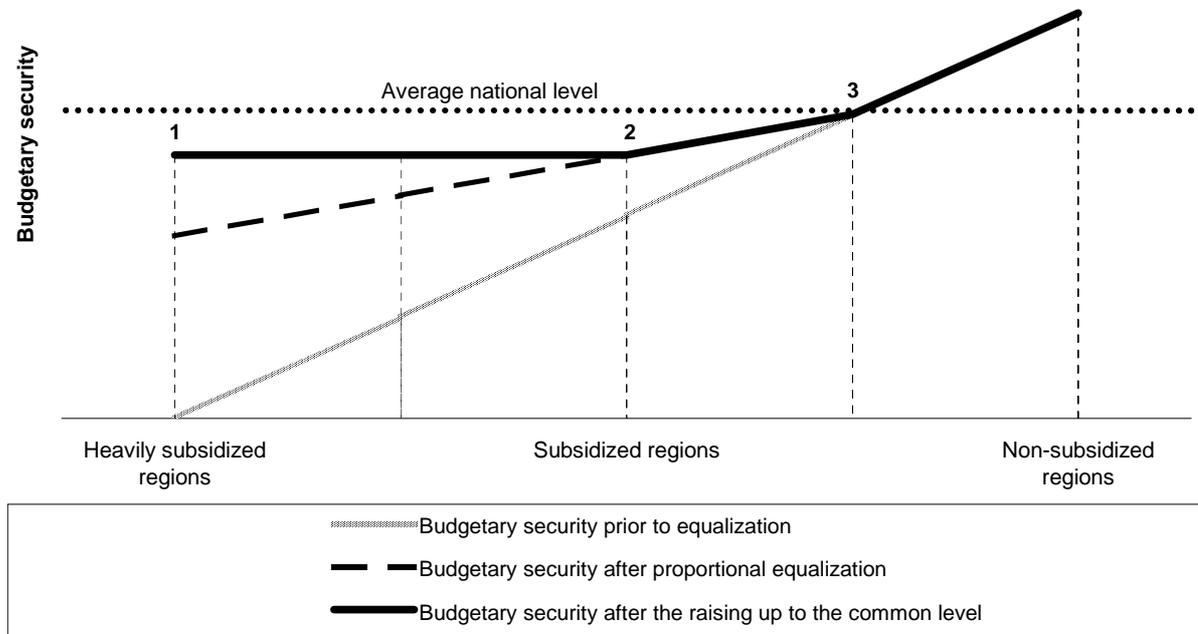


Fig. 15. Distribution of FFSR financial resources in accordance with the methods used prior to 2005

As *Fig. 15* demonstrates, certain regions being in the interval of per capita rated budgetary security between points 1 and 2 are at the equal level of budgetary security after equalization in spite of the fact that prior to equalization these levels have significantly differed. In 2004, there were 33 such regions¹³. Therefore, it may be surmised that in accordance with the formula of distribution of transfers used prior to 2005, there were created specific negative incentives for a rather large number of regions, since at the given low level of tax potential the amount of financial aid granted to such regions was too large. However, the methods applied since 2005 are free of this flaw.

In *Fig. 16*, there is schematically presented the process of equalization of the per capita budgetary security carried out in accordance with two criteria applied in the Methodology of FFSR distribution for year 2005.

¹³ The Bryansk, Ivanovo, Tambov, Pskov oblasts, the Republic of Adygeya, the Republic of Dagestan, the Ingush Republic, the Kabarda Balkar Republic, the Republic of Kalmykiya, the Karach Cherkessk Republic, the Republic of North Osetiya – Alaniya, the Chechen Republic, the Republic of Mari El, the Republic of Mordoviya, the Chuvash Republic, the Penza oblast, the Komi Permyak autonomous okrug, the Kurgan oblast, the Republic of Altai, the Republic of Buryatiya, the Republic of Tyva, the Altai krai, the Chita oblast, the Aginsk Buryat, Taimyr (Dolgan Nenets), Ust Orda Buryat, Evenk autonomous okrugs, the Kamchatka and Magadan oblasts, the Evreiskaya autonomous oblast, the Koryak and Chukotka autonomous okrugs.

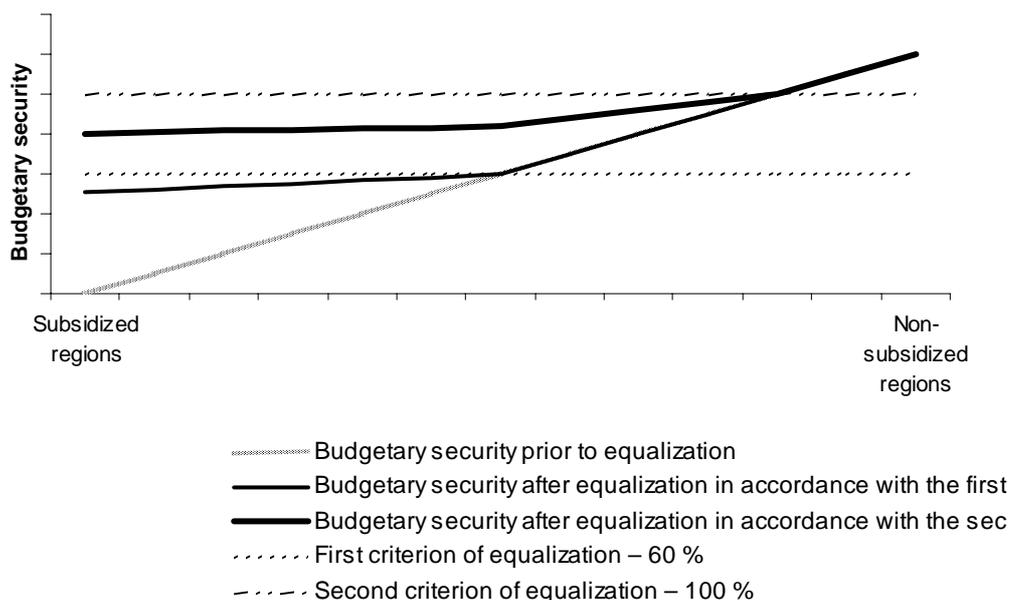


Fig. 16. The principle of interbudgetary equalization used in the framework of the methods of FFSR distribution for year 2005

The data presented in Fig. 16 demonstrates that according to the new methods of distribution of grants for equalization of the level of budgetary security regions retain more incentives to make fiscal efforts. This result is achieved due to the fact that subjects of the Russian Federation with higher levels of rated budgetary security observed prior to the distribution of transfers also maintain their advantages after the distribution of FFSR financial resources.

4. In the course of elaboration of the Methodology of distribution of the financial resources of the Fund of Financial Support of Regions for year 2005, there was reduced the number of industries used for the calculation of the Tax Potential Index (TPI) of regions. In particular, there were excluded such industries, the major share of taxes due to regional budgets from which is formed at the expense of indirect taxes (excises). The formula used for calculation of the tax potential index was also simplified (there were removed additional adjustment coefficients as concerns the sectoral structure of chemistry and petrochemistry, the sectoral structure of lumber, woodworking, and pulp and paper industry, the sectoral structure of light industry).

5. Alongside with the reduction of the number of parameters used in the framework of evaluation of the tax potential index, there was also reduced the number of parameters on the basis of which there is carried out the calculation of the Budgetary Expenditure Index (BEI). Thus, since 2005 the methods of evaluation of the budgetary expenditure index are based exclusively on the factors determining the amount of expenditures of subnational budgets on the whole: these factors include the level of wages and salaries in the region, the level of prices of housing and public utilities services, and the level of consumer prices in the RF subject.

It should be noted that the discussion with respect to the simplification of the Methods of distribution of FFSR financial resources as concerns the evaluation of the tax potential index and the budgetary expenditure index has been led for a rather long time – since the moment of the introduction of the new Methods of distribution of FFSR financial re-

sources. Initially, the complexity of the formula of evaluation of the budgetary expenditure index has been determined by the large amounts of unfunded mandates, which the federal legislation devolved on the regional and local budgets. As a result, the methods of calculation of BEI took into account the interregional differentiation of budgetary expenditures across each type of regional budgetary expenditures regulated by the federal legislation. After the enactment of the new Budget Code and federal law No. 122-FZ, the amount of unfunded federal mandates was significantly reduced, what permitted to substantially simplify the methods of evaluation of the budgetary expenditure index.

Somewhat different factors facilitated complication of the methods of evaluation of the tax potential index. In the course of introduction of the new Methods of distribution of FFSR financial resources the evaluation of the tax potential index has been carried out in accordance with a relatively simple method – by the way of neutralization the average national share of tax withdrawals across major sectors forming added value of the subjects of the Russian Federation. At the same time, the distortions observed in the distribution of financial aid caused by the switching to the new methodology were compensated for by the introduction of a number of limitations on the marginal size of deviations of the amounts of grants calculated in accordance with the new methods from the actual amount of grants received over the preceding year. Later, after these limitations were removed on the initiative of certain regions, the methods were extended by the way of introduction of adjustment coefficients, which took into account the specifics of the tax burden on individual industries. It should be noted that in many cases the introduction of such coefficients either had no significant impact on the amounts of financial aid distributed in accordance with the methodology, or the respective impact was limited to several regions. The cessation of the use of such coefficients permitted to simplify the methods again by returning to its original composition.

6. Starting from year 2005, it is planned to carry out the distribution of FFSR financial resources proceeding from the new census data prepared by Rosstat, this will have a significant impact on the distribution of FFSR financial resources among regions.

It should be noted that the very fact of approval of the Methods of distribution of financial resources of the Fund of Financial Support of Regions by the Resolution of the Government and the changes made in these methods in comparison with the principles applied throughout the preceding years may be evaluated in a positive way. No doubt, in the case the Russian Federation continued to maintain the system permitting to link preferences shown by regional voters and the decisions taken by the regional authorities in the tax and budgetary sphere, the respective changes would result in the creation of favorable fiscal incentives for subnational authorities. The effects of the application of the new methods in the present situation will be revealed by the results of 2005 and 2006.

2.3.4. Social policy: changes in the division of respective powers among the federal, regional, and local authorities. Monetization of social benefits

The approval of the legislation aimed at the liquidation of unfunded mandates (the so called monetization of social benefits) in 2004 was closely related to the development of interbudgetary relations and had a wide public response. Earlier, there had been made amendments to 155 laws currently in force, which contained provisions about social benefits. Besides, there was abolished law No. 41, which declared social benefits never financed in practice.

Since January 1, 2005, cash payments should have substituted the right of free use of urban and suburban transport services, free medicines, and free medical treatment at

health resorts. Initially, the RF Finance Ministry has proposed to substitute more than 10 social benefits with cash payments.

All recipients of social benefits were classified in the federal and regional groups. The category of regional recipients of social benefits was primarily composed of labor veterans, workers of the home front, and victims of political repressions. As concerns these categories of citizens, the issue of provision of social benefits and substitution thereof with cash payments should be settled at the regional level. However, the Fund of Co-financing of Social Expenditures in the framework of the federal budget for year 2005 had available significant financial resources aimed at support of regions with respect to their obligations to recipients of social benefits. Thus, it is planned to allocate Rub. 12.7 billion, or 55 per cent of the total amount of the Fund of Co-financing of Social Expenditures, for the social support of these categories of citizens. At the same time, the amount of the fund was sharply raised in comparison with the level observed in 2004 – from Rub. 6 billion to Rub. 23 billion.

In theory, subjects of the Russian Federation had enough time to evaluate the changes and determine if they maintain social benefits and in what forms.

However, in spite of the measures taken for these purposes, there may be predicted certain difficulties related to the monetization of social benefits exactly at the regional level.

First, the very fact of classification of the recipients of social benefits in the federal and regional groups contradicts the theoretical principles of efficient distribution of expenditures powers between the levels of state authorities in the sphere of social policy, since the level of social support of the population would be inevitably higher in more well-to-do regions, what could result in the putting in place of different barriers preventing the movement of citizens between regions. There arises a situation, where the people having equal rights and merits with respect to the Federation (for instance, workers of the home front) will most probably receive different compensations depending on their places of residence.

Second, the classification of the recipients of social benefits in the regional and federal groups diminishes the possibilities of the federal center as concerns the control over the situation at the expense of financial resources of the federal budget. Thus, the most important financial tool used for maintenance of social tranquility – indexation of pensions and social benefits – can not completely remove social tensions, since in certain regions citizens may need no such indexation, and in other regions this indexation would be insufficient to pay for abolished or underfinanced social benefits.

Third, due to the fact that there are sufficient grounds for the emergence of the problem of soft budgetary constraints discussed above (i.e. regional authorities have good reasons to believe that the federal authorities will distribute additional financial resources throughout the year), regional authorities would have incentives to understate the level of financing of the abolished social benefits in order to receive the respective resources from the federal budget.

Fourth, the process of approval of the respective legislative acts at the level of RF subjects as concerns the problems being in the jurisdiction of regions was the prerogative of the regional authorities and should not be subject to control at the federal level; therefore many regions had no time, could not, or did not want to approve respective laws by the beginning of the new financial year. Meanwhile, the population links the flaws of the new system of social protection with the legislation approved by the federal authorities.

2.3.5. *Switching to the new procedures governing the election of the heads of executive authorities of RF subjects*

On December 15, 2004, there were published the amendments to the federal law "On the general principles of organization of legislative (representative) and executive authorities of RF subjects." The amended law contained the decision about the actual abolishment of the electivity of the heads of executive authorities of RF subjects. According to the new scheme, the direct election of the heads of regional executive authorities is abolished and substituted by the appointment of the candidate by the legislative authorities of RF subjects. The candidate for the office of the head of the regional executive authorities should be nominated by the RF President. The new procedures governing the election of the heads of RF subjects will no doubt have an impact on the state of interbudgetary relations and subnational finances.

On the one hand, the motives of the federal authorities facilitating the transition to the new procedures envisaging the appointment of the heads of executive authorities of RF subjects are clear. Alongside with the purely political reasons, including the toughening of administrative control over the economic policies pursued by regional authorities, enhancement of controllability of the country, transfer of a number of functions performed at present by territorial agencies of the federal authorities under control of appointed officials. It may be surmised that these decisions resulted from the experiment of appointment of plenipotentiary representatives of the President in federal okrugs, although the positive results of this experiment turned out to be more modest than initially expected. The results of the activities of the Presidential representatives have demonstrated that the only important outcome of their work was the harmonization of regional legislations with the federal legislation. However, it should be noted that this result could be well achieved by the use of available institutions of federal authorities (primarily, procurators' offices). In the regions of the Northern Caucasus, the office of Presidential representative could be well justified by objective circumstances; however, first, it does not provide the grounds for the establishment of such offices for other regions (federal okrugs), and, second, as the practice revealed, the efficiency of the measures taken by the plenipotentiary representative of the President primarily depends on the personality of the official taking this post.

On the other hand, the authors believe that the negative long term consequences of these decisions are as clear as the national benefits of the abolishment of elections of governors are illusory. Thus, alongside with the purely political reasons the major factors behind the switching to the actual appointment of the heads of regional executive authorities were the creation of possibilities for optimization of the structure of regional executive authorities, liquidation of overlapping functions as concerns the territorial agencies of the federal executive authorities, the executive authorities of RF subjects, and Presidential representatives. It should be noted that the solution of all problems discussed above could be achieved by the improvement of the federal legislation as concerns the division of powers and enhancement of efficiency of the structures of federal executive authorities *per se*.

Besides, there may be listed the following flaws of the decision about the appointment of the heads of regional executive authorities in a long term outlook.

First, one of the main reasons of the efficiency of the federative state structure is decentralization of responsibility for the decisions taken by the authorities including the decisions in the sphere of tax and budgetary policies. A decentralized system of power implies the accountability of the elected authorities to their voters; it should be noted that the higher is the level of decentralization, the shorter is the distance dividing the authorities and the voters. In the situation of an efficient division of powers, decentralized systems re-

sult in more efficient functioning of the public sector than centralized structures¹⁴. At the same time, in the situation, where governors are appointed and legislative assemblies may be dissolved, regional authorities will reorient towards the federal authorities as concerns the decision making process, what will result in the removal of many advantages of centralized systems. It may be argued that the responsibility of regional authorities to their voters was not a determining factor in the process of decision making at the regional level; however, in this case the efforts of federal legislators and the resources of the federal authorities at large should be directed to putting in place the mechanisms aimed at the ensuring such responsibility. Thus, one of the possible mechanisms of responsibility of governors could become the procedure of recall of the top local executive officials initiated either by the federal authorities (as represented by the RF President), or the population (by referendum), or the local Legislative Assembly (vote of no confidence) on the condition that such a decision is clearly defined in the legislative terms and there is a closed list of the grounds, on which the head of a region can be dismissed from the office. For instance, the Institute of the Economy in Transition has many times proposed to introduce such an efficient mechanism of control of conscientiousness of the financial policies pursued by regional authorities as the institution of the external financial management, which has been partially stipulated in the new budgetary legislation (see below).

Second, the creation of a new system of interbudgetary relations, division of powers between the levels of state authority, approval of other decisions in the sphere of the reform of the budgetary system have been based on the prerequisite that regional authorities should be independent within the limits of their jurisdictions. Changes in the system of incentives and responsibilities of regional authorities will result not only in the fact that the tools and institutions introduced over the last few years in the practices of interbudgetary relations at a great cost may turn out partially inefficient, but to the search for new mechanisms of interbudgetary regulation based on coercion and hierarchical control. The latter can only enhance the trends towards centralization and manifestations of negative effects of the new system.

Third, centralization of responsibility may result in a slowdown of already slow pace of the reform of the economy and the budgetary sphere. It may be surmised that being limited by responsibility to the President, the appointed governors will less actively assume the risks related to the implementation of too often unpopular reforms. At the same time, the voters will believe that the President, who appointed the governor, should bear responsibility for the decisions taken at the regional level; therefore the President will also shun the active support of risky decisions taken by the appointed official. The first outcomes of the monetization of social benefits at the regional level have demonstrated that already at present voters are inclined to blame not regional, but federal authorities for the failures and negative effects of the reform.

As a result, there may be drawn the conclusion that the last political initiatives advanced by the federal center in the sphere of regional policies may have an ambiguous impact on the state of the economy and budgetary sphere at the regional and local levels of authorities in the medium and long term outlook. The new system of state authorities may prove to be less efficient than the one, which has existed over the last few years. In any case, it may be surmised that political and economic costs of improvement of this system could be significantly below the possible costs related to the functioning of the new system.

¹⁴ See, for instance, Buchanan J. M., "Federalism and Fiscal Equity" // *American Economic Review*. – Vol. 40 (4), September, 1950, pp. 583-599. Oates W. E., *Fiscal Federalism*. – New-York: Harcourt Brace Jovanovich, 1972.

2.3.6. Amendments to the budgetary and tax legislation affecting the state of interbudgetary relations

The changes occurring in the sphere of the federal legislation in 2004 and aimed at the regulation of interbudgetary relations and subnational finances turned out to be so significant that it is necessary to dwell on the analysis of these legislative acts, which have set new basic principles of interbudgetary relations in Russia for a medium term outlook.

Below, there is presented a review of federal law No. 120-FZ of August 20, 2004, "On amendments to the Budget Code of the Russian Federation as concerns the regulation of interbudgetary relations." The new version of the RF Budget Code, which implements the principles and stipulations formulated in such federal laws earlier adopted in the framework of the reform of federative relations and local government as federal law No. 95-FZ of July 4, 2003, "On amendments to the federal law "On the general principles of organization of legislative (representative) and executive authorities of RF subjects" and No. 131-FZ of October 6, 2003, "On the general principles of organization of local government in the Russian Federation" contains the detailed regulation of the financial aspect of relations among all levels of the budgetary system of the Russian Federation¹⁵. Therefore, upon the adoption of law No. 120-FZ the legislative formation of the new system of interbudgetary relations in Russia has been completed.

Law No. 120-FZ envisages that the following amendments should be made in the RF Budget Code along the following key avenues:

- more precise definition of the budgetary structure and general principles of organization of the budgetary system of the Russian Federation;
- assignment of sources of revenues to different levels of the budgetary system of the Russian Federation;
- setting up of the procedures governing the assignment of expenditure obligations to different levels of the budgetary system of the Russian Federation;
- regulation of provision of interbudgetary transfers;
- setting up of the procedures governing the exercise of fiscal powers vested with state authorities of RF subjects and local governments in the case of introduction of a provisional financial administration;
- more precise definition of procedures governing the cash servicing of the execution of the budgets within the Russian budgetary system.

Below, there is presented a detailed description of changes introduced by law No. 95-FZ of July 29, 2004, "On the amendments to Sections 1 and 2 of the Budget Code of the Russian Federation and invalidation of certain legislative acts (provisions of legislative acts) of the Russian Federation on taxes and fees." The key amendments to the RF Tax Code are directly related to the amendments made to the RF Budget Code as concerns the assignment of tax revenues to the budgets of different levels and in fact reproduce the

¹⁵ Due to the approval of law No. 95-FZ, federal law No. 184-FZ of October 6, 1999, "On the general principles of organization of legislative (representative) and executive authorities of RF subjects" was in fact presented in its new version, while federal law No. 119-FZ of June 24, 1999, "On the principles and procedures of the division of jurisdiction and powers among the authorities of the Russian Federation and the authorities of RF subjects" was abolished.

Since January 1, 2006, (i.e. from the moment of enactment of the key provisions of federal law No. 131-FZ) federal law No. 154-FZ of August 28, 1995, "On the general principles of organization of local government in the Russian Federation" and federal law No. 126-FZ of September 25, 1997, "On the financial principles of local government in the Russian Federation" become invalid. Therefore, during the transitional period from October of 2003 through January of 2006 two legislative acts will be simultaneously in force in the sphere of local government: old federal law No. 154-FZ of 1995 and new federal law No. 131-FZ. Both these laws regulate the same sphere of subjects. In spite of the fact that at present only a small part of provisions of law No. 131-FZ are in force, the public authorities of all levels will have to turn to the provisions of law No. 131-FZ in order to bring the legislation of the Russian Federation (federal and regional), as well as regulatory acts of local governments in conformity with this law.

structure of assignment of tax revenues to different budgets in the framework of tax legislation. At the same time, law No. 95-FZ introduces a number of other amendments to the RF Tax Code reviewed in detail in the respective part of this section.

Federal law No. 120-FZ "On amendments to the Budget Code of the Russian Federation as concerns the regulation of interbudgetary relations"

More precise definition of the budgetary structure and general principles of organization of the budgetary system of the Russian Federation

The new version of article 10 of the RF Budget Code defining the structure of the RF budgetary system envisages the division of local budgets in the following components:

- budgets of municipal districts;
- budgets of town okrugs;
- budgets of intra-city municipal entities of the federal cities of Moscow and St. Petersburg;
- budgets of urban and rural settlements¹⁶.

At the same time, the law more precisely defines such terms as "consolidated budget," "local budget," "budget of the RF subject," and "federal budget" (articles 14 – 16 of the RF Budget Code). The preceding version of the RF Budget Code the budgets were defined as the forms of organization and expenditure of financial resources earmarked for ensuring of objectives and functions assigned to the jurisdiction of different levels of authority. However, the existing division of jurisdictions among the budgets of different levels did not permit to clearly and unambiguously determine the avenues of expenditure of budgetary funds. The new approach to the organization of the RF budgetary system unambiguously linked the definitions of budgets with the concept of expenditure obligations¹⁷. The new versions of articles 14 – 16 of the RF Budget Code define budgets as the forms of organization and expenditure of financial resources earmarked for the fulfillment of expenditure obligations of the respective budgetary level (Russian Federation, RF subjects, and municipal entities) within one financial year.

The consolidated budget of the Russian Federation comprises the federal budget and the budgets of other levels of the budgetary system of the Russian Federation without taking into account interbudgetary transfers among these budgets with the exception of budgets of the state extra-budgetary funds and territorial state extra-budgetary funds (article 16 of the RF Budget Code)¹⁸.

Among the innovations related to the definition of the concept of "budget" there should be noted the provision of article 14 of the RF Budget Code, which specifically prohibits local governments to use any forms of organization and expenditure of financial resources for the fulfillment of their expenditure obligations other than local budgets. However, the respective provisions concerning the federal budget and the budgets of RF subjects are less strict. In accordance with articles 15 and 16 of the RF Budget Code, the

¹⁶ This regulation became necessary, since law No. 131-FZ set forth the new territorial organization of local government consisting of municipal districts (town okrugs) (the "upper" level of local government) and urban and rural settlements (the "bottom" level of local government).

¹⁷ For details on the new division of expenditure powers between the levels of authorities and the term "expenditure obligation" see below.

¹⁸ Similarly, the consolidated budget of the RF subject is formed by the budget of the RF subject and the budgets of municipal entities in its composition (without taking into account the interbudgetary transfers between these budgets) (article 15 of the RF Budget Code). The consolidated budget of the municipal district is formed by the district budget and the budgets of urban and rural settlements (without taking into account the interbudgetary transfers between these budgets) (article 14 of the RF Budget Code).

state authorities of RF subjects should have the right to use other forms of organization and expenditure of their financial resources for the fulfillment of their expenditure obligations being in compliance with the RF Budget Code, while the federal authorities should have the right to use other forms of organization and expenditure of their financial resources in accordance with other federal laws. In other words, the RF Budget Code contains a direct prohibition to create any extra-budgetary funds at the local level; however, it permits the existence of other than budgets forms of expenditure of public financial resources at the level of RF subjects (somewhat limited), and at the level of the Russian Federation.

Assignment of tax revenues to different levels of the budgetary system of the Russian Federation

The following group of changes and amendments introduced to the RF Budget Code by law No. 120-FZ concerns the fixation of assignment of the sources of revenues to the different levels of the RF budgetary system (article 6 of the RF Budget Code).

The Code more precisely defines the term “own revenues of budgets,” which, in accordance with the new version of article 47 of the RF Budget Code, include tax and non-tax revenues, as well as the revenues obtained as free and irrevocable transfers with the exception of subventions granted from the Federal Compensatory Fund and regional compensatory funds¹⁹. Therefore, at present “own revenues of budgets” include all types of revenues with the exception of subventions transferred to the lower level budgets for the execution of “delegated” powers, i.e. the powers execution (administration) of which is devolved from the superior level of authority to the lower level together with the transfer of the respective financial resources (subventions).

Until recently (prior to the amendments made to article 6 of the RF Budget Code by law No. 120-FZ), the key concept of distribution of revenues among the levels of the Russian budgetary system was “regulatory revenues,” i.e. federal and regional taxes and other payments subject to the standard rates of assignment to regional and local budgets set forth each year for not less than 3 years²⁰. In spite of the fact that tax revenues of regional and local budgets were also financed from such sources of revenues as own taxes (regional and local), the overwhelming majority of tax revenues of the budgets of RF subjects and municipal entities were defined as regulatory revenues, i.e. the terms of assignment of such taxes and the regulation of setting of different elements of taxation were controlled by either federal authorities or authorities of RF subjects. Therefore, subnational budgets lacked significant sources of revenues formed at the expense of own taxes and non-tax payments. On the one hand, this was a very negative circumstance, since in this situation the fiscal autonomy of regional and local authorities was very limited, what had negative impact on the incentives for pursuit of efficient budgetary policies. On the other hand, this situation was determined by objective factors and it may be surmised that in that situation a significant enhancement of fiscal autonomy of regional and local authorities was impossible.

A principal innovation contained in article 6 of the RF Budget Code is the assignment of tax revenues to budgets of all levels on a long term basis and the rejection of the splitting of revenues generated by regional and local taxes among the budgets of different level via federal laws. All major taxes (VAT, income tax on individuals, profit tax on organizations, and excises) are retained as federal taxes, however, in contradistinction to the previous

¹⁹ Financial aid in the form of grants and subsidies was not included in the composition of own revenues of budgets in the previous version of item 3 of article 47 of the RF Budget Code.

²⁰ Article 48 of the RF Budget Code, the version not amended by law No. 120-FZ.

status of regulatory tax revenues, in accordance with the new procedure the rates of assignment of such federal taxes are not subject to annual changes and are fixed directly in the RF Budget Code (see article 50, p. 2, article 56, p. 2, article 61, p. 2, article 61.1 p. 2 and article 61.2 p. 2) (see *Table 11*). At the same time, RF subjects received the powers concerning the setting of the rates of assignment of own (regional) taxes and other tax revenues due to regional budgets (including revenues generated by federal taxes), the budgets of municipal districts and settlements²¹. The only requirement set forth by the federal legislation in this case is that a law of the RF subject set uniform (for all municipal entities of the same type) rates of assignment for an indefinite period of time (the setting of these norms by laws of RF subjects for a limited period of time is prohibited by item 1 of article 58 of the RF Budget Code). Similar requirements are set with respect to the procedures governing the transfer of tax revenues of municipal districts to the budgets of settlements (article 63 of the RF Budget Code).

These requirements do not concern only the income tax on individuals, since the additional rates of assignment of this tax (in contradistinction to the minimal rates of assignment of this tax set forth by the RF Budget Code²²) can be differentiated and set forth by laws of RF subjects for a limited period of time (item 2 of article 58 of the RF Budget Code). Regional authorities are also granted the right to take decisions with respect of the additional rates of assignment of the revenues generated by the income tax on individuals choosing between uniform rates (set for indefinite period of time) and additional rates (set for the respective financial year) of assignment of this tax.

In the case the RF subject takes decision to transfer tax revenues generated by this tax (the income tax on individuals) to local budgets in accordance with uniform rates, this transfer should be carried out in accordance with general rules of transfer of tax revenues due to regional budgets (i.e. on the long term basis). In the case there is taken the decision to transfer tax revenues generated by this tax to local budgets in accordance with additional rates (i.e. regulated in the course of the annual budgetary process and set forth in the course of approval of the law on the budget), the RF subject should comply with the requirement about calculation of these revenues in the framework of distribution of grants from the regional fund of financial support of settlements and respective portion of grants from the regional fund of financial support of municipal districts (town okrugs) (p. 2, article 58 of the RF Budget Code). In this case, additional rates of assignment of the income tax on individuals are defined as substitution for the grants provided from the regional fund of financial support of settlements and the regional fund of financial support of municipal districts (town okrugs) (articles 137 and 138 of the RF Budget Code). At the same time, notwithstanding the choice of the procedures governing the transfer of this type of revenues the RF subject should transfer to local budgets at least 10 per cent of the tax revenues of its consolidated budget generated by the said tax in addition to the minimal rates of assignment of the revenues from this tax (item 3, article 58 of the RF Budget Code).

The powers of state authorities of RF subjects with respect to the setting of additional rates of assignment of the income tax on individuals with the budgets of settlements may be delegated by the law of the RF subject to the representative authorities of municipal districts (p. 2, item 2 of article 58 of the RF Budget Code). In this case (if the additional rates of assignment of the income tax on individuals substitute grants provided from the regional

²¹ In accordance with item 1, article 58 of the RF Budget Code, the shares of federal and regional taxes and fees due to regional budgets, which should be transferred to the budgets of town okrugs, are determined as the sum of the rates set forth for settlements and municipal districts of the respective RF subject.

²² See p. 4, item 2, article 56, p. 2, item 2, article 61, p. 2, item 2, article 61.1, p. 2, item 2, article 61.2 of the RF Budget Code (version in accordance with law No. 120-FZ).

fund of financial support of settlements), according to item 6 of article 137 of the RF Budget Code the said rates should be approved by the budget of the municipal district.

As concerns the regulation of non-tax revenues, the new version of item 1 of article 51 of the RF Budget Code sets forth the extended list of non-tax revenues of the federal budget (with the exception of the revenues derived from utilization of property in state ownership, revenues from paid services provided by budgetary institutions, and a part of profits of unitary enterprises established by the Russian Federation), which includes:

- license fees for production and turnover of ethyl alcohol, alcohol and alcohol containing products at the 100 per cent rate;
- other license fees at the 100 per cent rate;
- customs duties and customs charges at the 100 per cent rate;
- fees for utilization of the forestry fund as concerns the minimal rates of payment for not felled lumber at the 100 per cent rate;
- payments for the re-registration of forest lands as non-forest lands and re-registration of forest lands as lands of other categories at the 100 per cent rate;
- payments for the use of water biological resources in accordance with intergovernmental agreements at the 100 per cent rate;
- fees for negative impact on the environment at the 20 per cent rate;
- consular fees at the 100 per cent rate;
- patent fees at the 100 per cent rate;
- payments for information about registered rights for real estate and transactions involving such real estate at the 100 per cent rate.

In accordance with the new version of article 57 of the RF Budget Code, non-tax revenues of RF subjects (with the exception of those already envisaged in articles 41–43, 46, and 57 of the RF Budget Code) should be also formed at the expense of:

- fees for negative impact on the environment at the 40 per cent rate;
- fees for utilization of the forestry fund as concerns the excess of the minimum rates of payment for not felled lumber at the 100 per cent rate²³.

In accordance with the new version of article 62 of the RF Budget Code, the fees related to negative impacts on the environment are due to the budgets of municipal districts and town okrugs at the rate of 40 per cent. Until the completion of singling out of state owned lands, the revenues generated from sales and leasing of state owned land plots suitable for residential housing construction and located within the limits of settlements and town okrugs are due to the budgets of such settlements and town okrugs at the rate of 100 per cent. Until the completion of singling out of state owned lands, the revenues generated from sales and leasing of state owned land plots suitable for residential housing construction and located on inter-settlement lands are due to the budgets of municipal districts at the rate of 100 per cent.

As concerns the regulation of budgetary revenues, federal law No. 120-FZ entered into force on January 1, 2005, with the exception of certain provisions. In particular, the changes in the rates of assignment of federal tax revenues to local budgets shall come into force on January 1, 2006 (in 2005 the rates of assignment of the tax to local budgets will be set forth by the laws on budgets of RF subjects).

It appears that the new assignment of the sources of revenues to the budgets of different levels envisaged in federal laws No. 95-FZ and No. 131-FZ, which was more precisely set in Federal law No. 120-FZ, to a significantly greater degree ensures fiscal inde-

²³ 80 per cent of the payments for negative influence on the environment should be transferred to the budgets of federal level cities – Moscow and St. Petersburg.

pendence of subnational authorities. In contradistinction to the previously existing practices of annual fixation of the rates of assignment of the revenues from regulatory taxes assigned to regional (local) budgets, fixation of the rates of assignment on the long term basis and the cessation of the practices of setting of the rates of assignment of revenues of local budgets generated by regional taxes by federal laws permit subnational budgets to be sufficiently independent of the decisions taken by superior authorities and increase the predictability of the conditions, under which they function regional and local authorities. At the same time, these laws contain a number of flaws.

Thus, both the Budget and Tax Codes fail to settle the issue concerning self taxation of the citizens, although in accordance with law No. 131-FZ these funds are a source of revenues of local budgets (item 1, article 55).

In accordance with article 56 of law No. 131-FZ, the revenues generated by self taxation of citizens are defined as nonrecurring payments made by citizens for the settlement of concrete problems of local importance. The issues of the jurisdiction over and utilization of such payments should be settled at local referendums or meetings of citizens. The amount of payments is set in absolute terms for each resident of the municipal entity. First, this definition of self taxation permits to review it as payments of the tax nature (because of their mandatory character), and, second, the revenues generated by such payments should be of targeted nature (since these funds should be used for the settlement of local problems). However, this source of revenues of local budgets is not properly fixed both in the Tax and Budget Codes.

In accordance with the Budget Code, these funds could be defined only as free and irrevocable transfers of individuals within the composition of own revenues of local budgets; however, the Budget Code fails to regulate the necessity of targeted use of these funds. In principle, the legislation envisages such a form of matching revenues and expenditures as targeted budgetary funds. However, the new version of the RF Budget Code also fails to unambiguously stipulate if such funds can be created in the framework of regional and local budgets²⁴.

In accordance with the new version of article 12 of the RF Tax Code, all federal, regional, and local taxes and charges are set only by the RF Tax Code (item 6). Taking into account the fact that the revenues generated by self taxation of citizens have all indications of tax payments, there arises the question about the lawfulness of introduction of such payments by decisions taken at local referendums or meetings of citizens as it is stipulated in law No. 131-FZ. At the same time, in the case the revenues generated by self taxation of citizens are of voluntary (non-mandatory) nature for all residents of the administrative territorial entity, there arises the question about the efficiency of such source of financing of expenditure obligations of subnational budgets²⁵. Therefore, there may be drawn the following conclusion: either the procedure governing the collection of payments in the framework of self taxation of citizens should be regulated in the legislation in more detail, or this provision of law No. 131-FZ will not work.

²⁴ Article 17 of the RF Budget Code stipulates that targeted budget funds are created in accordance with the RF legislation at the expense of targeted revenues or targeted deductions from concrete types of proceeds and other revenues and should be utilized in accordance with a separate estimate. At the same time, the RF Budget Code contains article 54, which covers revenues of the federal targeted budget funds, while there are no similar articles concerning the revenues of targeted funds of RF subjects and municipal entities.

²⁵ The literature dedicated to the economy of public sector often addresses the well known so called "free rider problem," which prevents the financing of provision of public goods (it should be noted that it is the major function of regional and local authorities) at the expense of voluntary payments.

Table 11

**Distribution of tax revenues among the levels of the RF budgetary system
in accordance with law No. 120-FZ**

Tax	Share (in %) due to				
	Federal budget	Budgets of RF subjects	Budgets of mu- nicipal districts	Budgets of set- tlements	Budgets of town okrugs
I. Federal taxes and fees					
Tax on profits of organizations - at the rates set for the federal budget	100				
Tax on profits of organizations - at the rates set for the budgets of RF subjects		100			
Tax on profits of organizations (as concerns the profits of foreign organizations not operating in the Russian Federation via their permanent representations and as concerns the profits received in the form of dividends and interest on state and municipal securities)	100				
Income tax on individuals		70	20	10	30
Added value tax	100				
Excises on ethyl alcohol produced from food raw materials and alcohol containing products	50	50			
Excises on ethyl alcohol produced from any type of raw materials with the exception of food raw materials	100				
Excises on alcohol products		100			
Excises on beer		100			
Excises on tobacco products	100				
Excises on motor gasoline, diesel fuel, motor oils for diesel and carburetor (injector) motors	40	60			
Excises on cars and motorcycles	100				
Excises on excisable goods (products) imported to the RF territory	100				
Mineral extraction tax as concerns hydrocarbon mineral resources (flammable natural gas)	100				
Mineral extraction tax as concerns hydrocarbon mineral resources (with the exception of flammable natural gas)	95	5			
Mineral extraction tax (with the exception of hydrocarbon mineral resources and widespread mineral resources)	40	60			
Mineral extraction tax as concerns widespread mineral resources		100			
Mineral extraction tax as concerns the extraction of mineral resources on the continental shelf of the Russian Federation, within the exclusive economic zone of the Russian Federation, outside of the territory of the Russian Federation	100				
Water tax	100				
Gift and inheritance tax		100			
Fees for the use of water biological resources (excluding internal water objects)	70	30			
Fees for the use of water biological resources (as concerns internal water objects)	100				
Fees for the use of fauna resources		100			
Single social tax	100				
Government duties with the exception of those due to the budgets of RF subjects and local budgets	100				
Government duties due to the budgets of RF subjects in accordance with article 56 of the RF Budget Code (version of law No. 120-FZ)		100			
Government duties due to the budgets of municipal districts and town okrugs in accordance with articles 61.1 and 61.2 of the RF Budget Code (version of law No. 120-FZ)			100		100
II. Regional taxes*					
Tax on gambling		100			
Transport tax		100			
Tax on property of organizations		100			

Tax	Share (in %) due to				
	Federal budget	Budgets of RF subjects	Budgets of municipal districts	Budgets of settlements	Budgets of town okrugs
III. Local taxes					
Tax on property of individuals				100	100
Tax on property of individuals collected in inter-settlement territories			100		
Land tax				100	100
Land tax collected in inter-settlement territories			100		
IV. Taxes envisaged in the framework of special tax treatments					
Single tax collected in relation to the application of the simplified taxation system **		90			
Single tax on imputed income for certain types of activities ***			90	0	90
Single agricultural tax ****		30	30	30	60
Tax on profit of organizations collected in the framework of production sharing agreements concluded prior to the enactment of federal law No. 225-FZ of December 30, 1995, "On production sharing agreements" not envisaging special rates of this tax due to the federal budget and budgets of RF subjects	20	80			
Regular mineral extraction payments (royalties) collected in the framework of production sharing agreements concerning hydrocarbon raw materials (flammable natural gas)	100				
Regular mineral extraction payments (royalties) collected in the framework of production sharing agreements concerning hydrocarbon raw materials (with the exception of flammable natural gas)	95	5			
Regular mineral extraction payments (royalties) as concerns the extraction of mineral resources on the continental shelf of the Russian Federation, within the exclusive economic zone of the Russian Federation, outside of the territory of the Russian	100				

* In accordance with item 4 of article 56 of the RF Budget Code (as amended by law No. 120-FZ), tax revenues generated by regional taxes set forth by the authorities of a krai (oblast), which includes an autonomous okrug are due to the budget of the krai (oblast). Tax revenues generated by regional taxes set forth by the authorities of an autonomous okrug are due to the budget of autonomous okrug. In the case there are no other arrangements set forth in an agreement between the state authorities of a krai (oblast), which includes an autonomous okrug, and the state authorities of the respective autonomous okrug, tax revenues generated by federal taxes and fees due to the budgets of RF subjects should be transferred to the budget of krai (oblast).

** In accordance with item 1.1 of article 146 of the RF Budget Code (as amended by law No. 120-FZ), the tax revenues generated by the single tax collected in relation to the application of the simplified taxation system (distributed across the levels of the RF budgetary system by the agencies of the Federal Treasury) should be transferred to the budgets of state extra-budgetary funds as follows: to the budget of the Federal Mandatory Medical Insurance Fund at the rate of 0.5 per cent; to the budgets of territorial Mandatory Medical Insurance Funds at the rate of 4.5 per cent; and the budget of the RF Social Insurance Fund at the rate of 5 per cent.

*** In accordance with article 146 of the RF Budget Code, the tax revenues generated by the single tax on imputed income for certain types of activities (distributed across the levels of the RF budgetary system by the agencies of the Federal Treasury) should be transferred to the budgets of state extra-budgetary funds as follows: to the budget of the Federal Mandatory Medical Insurance Fund at the rate of 0.5 per cent; to the budgets of territorial Mandatory Medical Insurance Funds at the rate of 4.5 per cent; and the budget of the RF Social Insurance Fund at the rate of 5 per cent.

**** In accordance with article 146 of the RF Budget Code, the tax revenues generated by the single agricultural tax (distributed across the levels of the RF budgetary system by the agencies of the Federal Treasury) should be transferred to the budgets of state extra-budgetary funds as follows: to the budget of the Federal Mandatory Medical Insurance Fund at the rate of 0.2 per cent; to the budgets of territorial Mandatory Medical Insurance Funds at the rate of 3.4 per cent; and the budget of the RF Social Insurance Fund at the rate of 6.4r cent.

Source: RF Budget Code.

Setting of the procedures governing the assignment of expenditure obligations to the different levels of the budgetary system of the Russian Federation

The principle of independence of budgets set forth yet in the preceding version of the RF Budget Code presupposed that the authorities of RF subjects and municipal entities have the right to independently determine the substantive aspects of their expenditures. This principle has limited the possibilities of the federal authorities to directly influence the structure of expenditures of regional and municipal budgets.

At the same time, contrary to this principle there has been in force a significant number of sectoral federal laws envisaging that the expenditures incurred in the course of implementation of these legislative acts should be covered from the own funds of subnational budgets (there were introduced so called unfunded federal expenditure mandates). These laws often regulated not only the objectives and general terms of expenditures made by regions and municipal entities, but the concrete amounts of such expenditures, while envisaging no clear obligations to compensate such expenditures on the part of the Federation.

The problem of unfunded federal mandates was primarily determined by the lack of clear division of expenditure powers among the budgets of different levels. Any federal mandate is a result of such a division of powers among the authorities of different levels, which assigns legislative and executive powers concerning the same jurisdiction to the authorities of different levels. Accordingly, the problem of unfunded federal mandates could not be settled without a revision of the existing division of powers between the state authorities and local governments.

Elaboration of legislative proposals aimed at a more precise definition of the mechanism of distribution of expenditure powers among the tiers of the budgetary system of the Russian Federation and financial security of expenditure powers of budgets of different levels has been carried out since the end of 2002 and was completed by the adoption of federal laws No. 95-FZ and No. 131-FZ. Item 1 of article 26.3 of law No. 95-FZ set forth the closed list of expenditure powers vested with the state authorities of RF subjects as concerns the objects under the shared jurisdiction of the Russian Federation and RF subjects. (*Annex 1*). Law No. 131-FZ has set forth the exhaustive lists of issues of local importance for different types of municipal entities, including settlements (article 14), municipal districts (article 15), town okrugs (article 16). The exclusive expenditure powers of RF subjects include all powers not specifically assigned to the exclusive jurisdiction of the Russian Federation, shared jurisdiction, and issues of local importance.

At the same time, the issues of the substance of powers vested with the authorities of the Russian Federation, RF subjects, and municipal entities, as well as the issues of responsibility for financing of different obligations were addressed by another legislative act – federal law No. 122-FZ of August 22, 2004, “On amendments to legislative acts of the Russian Federation and invalidation of certain legislative acts of the Russian Federation in relation to the adoption of federal laws ‘On amendments to the federal law ‘On the general principles of organization of legislative (representative) and executive authorities of RF subjects’ and ‘On the general principles of organization of local government in the Russian Federation.’” Therefore, the new version of the RF Budget Code only set forth the financial mechanisms ensuring the exercise of powers by the authorities of different levels and regulated financial relations between the levels of state authorities and local governments as concerns the formation of revenue sources and the issues of financial security of financing of expenditure obligations.

In its turn, federal law No. 120-FZ introduced the new concept of “expenditure obligations” and set forth the new version of article 11 of the RF Budget Code, which addressed the assignment of expenditure obligations to the different levels of the budgetary

system. The expenditure obligations are defined as the obligations of the Russian Federation, RF subject, or municipal entity to transfer certain funds of a respective budget (state extra-budgetary fund, territorial state extra-budgetary fund) to individuals or legal entities, state authorities, local governments, foreign states, international organizations and other subjects of international law in accordance with laws, other regulatory and legal acts, treaties, or agreements (article 6 of the RF Budget Code). The major difference between the new version of article 11 of the RF Budget Code and the preceding version is the absence of the list of expenditures “co-financed” from different budgets²⁶.

In accordance with the new assignment of expenditure powers, articles 14–16 of the RF Budget Code more precisely define the rules of reflection of expenditure obligations in budgets. In accordance with the new procedure, in each budget there should be separately earmarked the funds allocated for the expenditure obligations fulfilled at the expense of own financial resources and the expenditure obligations fulfilled at the expense of subventions from the upper budgetary level.

The general principle of the assignment of jurisdictions set forth by the aforementioned laws is that with respect to the objects under exclusive jurisdiction²⁷ of each level of public authorities all elements of expenditure powers (i.e. the normative and legal regulation, financial security²⁸, and execution of expenditures) are assigned to the respective level of public authorities. At the same time, it is envisaged that each level of authorities should have the right to delegate its powers concerning the execution of certain expenditures on the condition of transfer of necessary financial resources in the form of subventions. The feasibility of such a decision may be determined by higher efficiency of the subnational authorities as concerns the exercise of certain powers.

From the long list of the objects under the shared jurisdiction of the Federation and its subjects set forth by the Constitution, there were singled out the powers of RF subjects as concerns the objects under the shared jurisdiction (item 2, article 26.3 of law No. 131-FZ). All other expenditure powers related to the objects under the shared jurisdiction are deemed to be under the exclusive jurisdiction of the Russian Federation. The resulting groups of powers of the Federation and its subjects are backed by financial resources in accordance with the same procedure as the exclusive powers of the respective level of the budgetary system. In other words, the Russian Federation backs the exercise of its own powers concerning the objects under shared jurisdiction by its financial resources, while regional authorities back the exercise of their powers with respect to the objects under shared jurisdiction.

The differences between the exclusive powers of different levels of the budgetary system and powers relating to the objects under shared jurisdiction lay in the procedures of the normative and legal regulation. In accordance with the new legislation in this sphere there is no division with respect to concrete objects under shared jurisdiction: the federal authorities retain the right to adopt federal laws as concerns each object under shared jurisdiction, while regional authorities are granted the right to adopt their laws on the basis

²⁶ The most recently adopted document was federal law No. 122-FZ of August 22, 2004, “On amendments to legislative acts of the Russian Federation and invalidation of certain legislative acts of the Russian Federation in relation to the adoption of federal laws ‘On amendments to the federal law ‘On the general principles of organization of legislative (representative) and executive authorities of RF subjects’ and ‘On the general principles of organization of local government in the Russian Federation.’” Beside reformulation and setting of a new division of expenditure powers between the levels of authority, this federal law is primarily aimed at the maximal reduction of non-financed expenditure mandates and harmonization of the legal acts setting forth expenditure powers of the budgets of different levels with federal laws No. 95-FZ, No. 131-FZ, and No. 120-FZ.

²⁷ The laws do not contain the term “exclusive jurisdiction”; however, it is used in this section conventionally for greater clarity.

²⁸ “Financial security” is understood as the allocation of own budget revenues (with the exception of the revenues received in the form of targeted transfers from the budget of other level) for financing of expenditures.

and in development of federal laws on the objects under shared jurisdiction. At the same time, the federal laws regulating the issues assigned by item 2 of article 26.3 of law No. 95-FZ to the powers of RF subjects as concerns the objects under shared jurisdiction can not set forth the amounts of expenditures of regional budgets for the exercise of these powers. Besides, the provisions of item 5, article 26.3, stipulate that until the adoption of respective federal laws RF subjects should have the right to issue their laws setting forth their powers (not envisaged by item 2 of article 26.3) as concerns the objects under shared jurisdiction on condition that such laws are in compliance with the federal laws and on condition of financial backing of such powers at the expense of own funds. In other words, until there are no respective federal laws, RF subjects should have the right to independently carry out the normative and legal regulation, provide financial backing, and execute expenditures as concerns these issues.

As concerns the objects under shared jurisdiction, the powers related to the execution of expenditures also may be delegated from one level of the budgetary system to another, and also on condition of financial backing of these powers at expense of subventions. However, there is an exception from this rule: subventions for the exercise of delegated powers may be not granted in the case the powers set forth by federal laws do not envisage the necessity to create new bodies of state authority of the RF subject, state institutions of the RF subject, and state unitary enterprises of the RF subject, as well as additional budgetary investment, payments from the budget of the RF subject to citizens and legal entities, increase in the number of state civil employees on permanent staff of the RF subject, and the number of employees of state institutions of the RF subject.

This provision retains the possibility of existence of unfunded federal mandates in the form of different standards, which do not envisage direct expenditure of funds of lower level budgets. For instance, primary and secondary educations are the object under the shared jurisdiction of the Russian Federation and its subjects. At the same time, the setting of mandatory minimal standards of secondary education (in the form of a mandatory educational program) does not meet the requirements envisaging the obligatory allocation of subventions for the exercise of the delegated powers, however, it results in the formation of expenditure obligations of regional and local budgets. This example, on the one hand, illustrates that the new legislation has not completely freed the Russian budgetary system from unfunded mandates. On the other hand, this example demonstrates that the retention of certain priorities of the national policy (for instance, as concerns the provision of secondary education of certain quality to the population) does not permit to completely reject unfunded mandates without making some amendments to the Constitution currently in force.

As concerns the issues of local importance (defined in articles 14–16 of law No. 131-FZ), the general rule remains the same: normative and legal regulation, financial backing, and execution of expenditures are vested with the local government. At the same time, in accordance with item 3 of article 18 of law No. 131-FZ federal laws and laws of RF subjects “should not contain provisions determining the amounts of expenditures of local budgets” (items 2 – 3, article 18). This provision implies that in the case the Russian Federation and its subjects have the right to carry out normative regulation of the issues of local importance, what, from the point of view of the authors, somewhat contradicts to the concept of the reform. In accordance to item 1, article 18 of law No. 131-FZ, the list of issues of local importance can not be altered in any other way as by amendments made to this law. In other words, RF subjects have no right to expand the lists of issues of local importance. Financial obligations arising in relation to the settlement of the problems of local importance are met at the expense of local budgets (with the exception of subventions granted from other levels of the budgetary system). In the cases and under the procedure set forth

by federal laws and laws of RF subjects, the said obligations may be additionally financed at the expense of financial resources of the federal budget, state extra-budgetary funds, and budgets of RF subjects.

The expenditure powers delegated to local governments are also exercised at the expense of subventions. As concerns three powers of RF subjects relating to the objects under the shared jurisdiction of the Russian Federation and its subjects (organization of educational process in general education schools, provision of targeted housing subsidies to poor citizens, and granting of allowances for public transport fares), there was introduced the regime of “mandatory delegation” of the powers of RF subjects to local governments (subparagraphs 13, 24, 25 of item 2 of article 26.3 envisage that the state authorities of RF subjects should mandatory delegate the execution of expenditures associated with the said powers to local governments and provide the respective financial resources necessary for carrying out these activities).

In order the public authorities could exercise their powers in the framework of the set assignment of expenditure powers, each level of authority is assigned property.

In accordance with article 26.11 of law No. 95-FZ, RF subjects should have the right to own the following types of properties:

- property necessary to the state authorities of RF subjects in order to exercise their powers concerning the objects under their exclusive and shared jurisdictions (i.e. powers indicated in article 26.2 and items 2, 7, and 8 of article 26.3);
- property necessary to the state authorities of RF subjects to exercise certain powers concerning the objects under the jurisdiction of the Russian Federation (i.e. powers indicated in article 26.5);
- property necessary for ensuring of activities of the state authorities of RF subjects, state civil employees of RF subjects, employees of state unitary enterprises of RF subjects and employees of state institutions of RF subjects in accordance with the laws of RF subjects.

In accordance with item 1 of article 50 of law No. 131-FZ, municipal entities may own properties designated for:

- settlement of the problems of local importance;
- exercise of certain state powers delegated to local governments in the cases determined by federal laws and laws of RF subjects;
- ensuring of activities of local governments, officials of local governments, municipal employees, employees of municipal enterprises and institutions in accordance with normative legal acts approved by representative bodies of municipal entities.

In order to implement the said provisions, the RF Government determines the procedures and terms of free transfer of property from the federal or municipal ownership to the ownership of RF subjects, as well as from ownership of RF subjects to federal or municipal ownership in accordance with the set division of powers.

Prior to January 1, 2005, laws of RF subjects should determine the lists of the types of property necessary for the exercise of the powers envisaged in articles 26.2 and 26.3 of law No. 95-FZ, as well as the property necessary to ensure the activities of the state authorities of RF subjects, state civil employees of RF subjects, employees of state unitary enterprises of RF subjects and employees of state institutions of RF subjects (as concerns RF subjects, the relations envisaged by laws No. 95-FZ and No. 120-FZ were enacted on January 1, 2005).

Accordingly, prior to January 1, 2006, the state authorities of RF subjects should set forth the lists of properties designated for the settlement of the problems of local impor-

tance, which are in ownership of RF subjects and ensure the free transfer of such properties in municipal ownership (item 1, article 85 of law No. 131-FZ).

Local governments should set forth the lists of properties, which are in municipal ownership, but are designated for the exercise of the powers of the federal authorities and the authorities of RF subjects in accordance with the set division of powers and ensure the free transfer of such properties in federal ownership and ownership of RF subjects (item 8, article 85 of law No. 131-FZ) (as concerns municipal entities, the relations envisaged by laws No. 95-FZ and No. 120-FZ will be enacted on January 1, 2006).

On the whole, as it has been mentioned above, the new assignment of expenditure powers to the budgets of different levels to a significantly greater degree ensures independence of budgets of different levels. At the same time, the adopted laws have certain flaws and in a number of cases there are observed rather substantial contradictions between these laws.

First, according to the new version of the articles of section 11 of the RF Budget Code the expenditure obligations of regional and local budgets may originate only in respective regional and local normative acts and agreements, what creates an illusion of the complete liquidation of unfunded mandates. However, it is only an illusion, since the complete liquidation of unfunded mandates is impossible in the framework of the Constitution currently in force. The process of division of expenditure powers among the levels of the budgetary system *per se*, which is exclusively vested with the Russian Federation, is the process of imposition of certain expenditure obligations on the subnational budgets. Besides, according to item 2 of article 26.3 of the law "On the general principles of organization of legislative (representative) and executive authorities of RF subjects" the Russian Federation has the right to regulate the procedures of execution of expenditures of regional budgets with respect to certain objects under shared jurisdiction. At the same time, item 8 of article 26.3, as it has been noted above, permits to adopt at the federal level legislative acts setting expenditure obligations of RF subjects without granting subventions from the federal budget in the case such expenditure obligations are not too "burdensome." Therefore, laws No. 95-FZ and No. 131-FZ to a certain degree permitted the setting of expenditure obligations of regional and local budgets by federal laws.

One of the most principal flaws of the preceding legislation was the substitution of division of functions for division of objects of ownership. The RF Budget Code did not assign such most important functional avenues of state expenditures as education, health care, and culture to the powers of a certain level of the budgetary system, however, it recognized the maintenance of institutions and organizations being in jurisdiction of respectively the Federation, its subjects, or municipal entities to be in exclusive powers of the budgets of each level. At the same time, the RF Budget Code failed to indicate what institutions and organizations from the viewpoint of the functions they perform should be in the jurisdiction of each level of the public authorities. Following this logic, local governments, for instance, should participate in financing of education and health care only in the cases they had the respective institutions in their jurisdiction. So in the case a higher education establishment was under jurisdiction of a local government, it should be financed from the local budget.

The new legislation also failed to completely remove this flaw. In the sense of article 26.11 of law No. 95-FZ and article 50 of law No. 131-FZ, property should be in the ownership of a level of authorities proceeding from the set assignment of expenditure powers. However, this principle is sometimes not adhered to, and this is related to the fact that the issues of local importance listed in law 131-FZ often overlap with the powers of RF subjects as set forth in law 95-FZ. For instance, in accordance with subparagraph 18 of item 1 of article 26.3 of law No. 95-FZ, "organization and support of institutions of culture and arts (with the exception of federal state cultural and art institutions, the list of which should be

approved by the RF Government)” should be under jurisdiction of the state authorities of RF subjects. Law No. 131-FZ envisages that town okrugs and settlements also may own property designated for provision of services provided by cultural institutions to the residents of settlements (town okrugs) (pp. 2 and 4 of article 50). Therefore, it is admissible to finance the services rendered in the sphere of culture simultaneously from regional and local budgets. Each level of authority ensures that institutions of culture in its ownership could provide their services; however, there is no legislatively determined criterion of assignment of institutions involved in the same core activities to the ownership of different levels of authorities. In this situation, the granting to regions the right to transfer property “designated for the settlement of the problems of local importance” in municipal ownership may result in vesting with municipal entities the responsibility to finance practically any institution of culture.

For the purposes of control and analysis of expenditure obligations, federal law No. 120-FZ introduced the term “registers of expenditure obligations” in the RF Budget Code. According to article 87 of the RF Budget Code, the register of expenditure obligations is defined as the list of normative and legal acts, as well as agreements and contracts (individual articles, items, subparagraphs, paragraphs of normative legal acts, contracts, and agreements) concluded by the state authorities (local governments) envisaging the generation of expenditure obligations subject to the execution at the expense of respective budgets. As it seems, the issue of accounting for expenditure obligations has not been settled yet due to the following reasons.

First, in accordance with p. p. 4 and 5 of article 87 of the RF Budget Code the registers of expenditure obligations of RF subjects and municipal entities should be maintained in accordance with the procedures set forth by the executive authority of the RF subject and local administration. Therefore, the determination of the procedure of drawing up of the list of expenditure obligations, which should be financed from regional and local budgets, is vested with the same bodies, which are responsible for formation of the respective budget. This may permit the executive state authorities of RF subjects and local administration to avoid the inclusion in the register of the obligations, the financing of which they deem undesirable.

Second, the RF Budget Code not only fails to set forth the procedures for taking into account the register of expenditure obligations in the process of formation and approval of budgets, but also does not indicate the necessity of the use of the register for these purposes. therefore, the amendments to the RF Budget Code do not prevent regions and municipal entities to ignore the existing obligations in the process of formation and approval of the budget.

Among other innovations introduced in the RF Budget Code by federal law No. 120-FZ with respect to regulation of expenditures, there should be noted the exclusion of the notion of minimal social standards. Earlier (prior to the adoption of law No. 120-FZ) the notion of “norms of financial expenditures per unit of services rendered by state institutions” was closely related to the concept of “minimal social standards.” It was envisaged that minimal social standards should be enacted by a respective federal law, while the financial norms elaborated on the basis of these standards by an executive authority would be minimally acceptable for all levels of the budgetary system. However, taking into account the fact that the amendments to the RF Budget Code introduced by law No. 120-FZ removed the notion of minimal social standards from the Code, the law on state minimal social standards and article 177 of the RF Budget Code setting the norms of financial costs associ-

ated with provision of state and municipal services will never enter into force²⁹. In this situation, federal legislators should exclude this article from the Code; however the article stipulating the norms of financial costs was preserved in its old version.

Interbudgetary transfers granted from the federal budget

According to the new version of article 16 of the RF Budget Code enunciated and introduced by law No. 120-FZ, all free transfers among the budgets and extra-budgetary funds were consolidated in the category of “interbudgetary transfers.” At the same time, federal financial resources are transferred to regional and local budgets in the forms set forth by the RF Budgetary Code:

- Financial aid to the budgets of RF subjects, including the grants from the Federal Fund of Financial Support of RF Subjects and other grants and subsidies;
- Subventions to the budgets of RF subjects from the Federal Compensatory Fund and other subventions;
- Financial aid to the budgets of certain municipal entities granted in the cases and in accordance with the procedures set forth by federal laws;
- Other free and irrevocable transfers;
- Budgetary credits to the budgets of RF subjects.

Therefore, there was indicated the distinction between the financial aid, i.e. the support of relatively poor regions, and compensations for the expenditures associated with the exercise of delegated powers provided by the federal authorities, and assistance to investment in the region.

Article 130 of the RF Budget Code reflects the major conditions of granting of interbudgetary transfers. In the course of comparison of key conditions of granting of financial resources of the federal budget to RF subjects in the new and old versions of the RF Budget Code there may be singled out the following changes.

1. According to the new version of the RF Budget Code, interbudgetary transfers from the federal budget (with the exception of subventions provided from the Federal Compensatory Fund) are granted on condition the state authorities of RF subjects and local governments comply with the budget legislation of the Russian federation and the legislation of the Russian Federation on taxes and fees.

2. Budgetary credits from the federal budget are extended to the budgets of RF subjects on condition that the respective state authorities of RF subjects have no overdue indebtedness to the federal budget. The use of budgetary credits received by the budgets of RF subjects from the federal budget for granting budgetary credits to legal entities is prohibited. This innovation was intended for toughening of budgetary discipline, although the prohibition to use federal budgetary credits for extending budgetary credits to legal entities may be interpreted in two ways. In the first interpretation, regions can not use for crediting of legal entities exactly the budgetary credits extended by the federal center; however, it would be difficult to control. At the same time, the legislators could imply that the regions receiving budgetary credits are prohibited to extend credits to legal entities. In this case this provision should be clarified.

3. Grants from the Federal Fund of Financial Support of RF subjects and budgetary credits from the federal budget are provided to the budgets of RF subjects, where over two of the last three reporting years the share of such grants in the total amount of own revenues exceeded 50 per cent. The grants and credits are provided for three financial years starting from the next financial year and on condition of complying with the agreement concluded with the RF Finance Ministry with respect to the measures aimed at the en-

²⁹ In accordance with federal law No. 159-FZ of July 9, 1999, “On the enactment of the Budget Code,” article 177 of the RF Budget Code should have been enacted on the date of entering in force of the federal law on state minimal social standards.

hancement of efficiency of utilization of budget financial resources and growth of tax and non-tax revenues of the budget of the RF subject.

The preceding version of the RF Budget Code set forth quite different requirements with respect to the regions – recipients of FFSR grants. On the one hand, these requirements were much more precise: RF subjects had no right to create better conditions for state employees financed from the budget of the RF subject (wages and salaries, traveling allowances and other expenditures) in comparison with state employees of federal institutions (taking into account regional wage coefficients), extend budgetary credits to legal entities exceeding 3 per cent of the total expenditures of the budget of the RF subject, give state guarantees on behalf of the RF subject exceeding 5 per cent of the total expenditures of the budget of the RF subject. On the other hand, these requirements were set for all recipients of financial aid from FFSR (at present this condition is applicable only to heavily subsidized regions).

These developments may indicate certain shifts in the policy pursued by the federal center with respect to subsidized regions: the federal center grants to lightly subsidized regions relatively higher financial independence, while with respect to heavily subsidized regions there is carried out the transition to a very high level of control over the management of subnational finances.

4. In the case the state authorities of RF subjects and local governments infringe upon the conditions of granting of interbudgetary transfers from the federal budget set by the budgetary legislation, the RF Finance Ministry should have the right to suspend the granting of interbudgetary transfers (with the exception of subventions from the Federal Compensatory Fund) to the respective RF subjects (municipal entities). This provision in fact introduces the option of imposition of sanctions with respect to the regions failing to comply with the conditions of granting of interbudgetary transfers, what should enhance the responsibility of regional authorities as concerns their regional policies. The old version of the RF Budget Code did not envisage such tough sanctions for failures to comply with the conditions of granting of financial aid.

The new version of article 131 of the RF Budget Code sets forth the procedures governing the formation and expenditure of the financial resources of the Federal Fund of Financial Support of RF Subjects. The most important novellas of this article are the following provisions.

1. The key principles of allocation of the Fund's financial resources were fixed in the framework of the legislation, there was envisaged that the RF Government should approve the Methods of allocation of the financial resources of the Fund.

2. There was established the procedure of evaluation of the amount of the Federal Fund of Financial Support of RF Subjects, which should be approved for the next financial year. According to the new version of the RF Budget Code, this amount is evaluated by multiplying the amount of the Fund subject to approval for the current financial year by the estimated rate of inflation in the next financial year (Consumer Price Index). Earlier, the amount of FFSR was formed at 14 per cent of the expenditures of the federal budget although this rate has not been indicated in the legislation. The legislative fixation of the amount of FFSR should render financial policy pursued by the federal center more predictable for regions. At the same time, in the case the objective circumstances require significant changes in the amounts of resources provided in the form of transfers from FFSR, it will require to make amendments to the RF Budget Code.

3. There was established the procedure governing the estimation of transfers by the RF Finance Ministry. According to the requirements of the new version of the RF Budget Code, the RF Finance Ministry should forward to the executive authorities of RF subjects the initial data for the conduct of calculation with respect to the allocation of the financial resources of the Federal Fund of Financial Support of RF Subjects for the next financial

year prior to August 1 of the current financial year. Prior to October 1 of the current financial year, the Ministry should carry out a comparative check of the said initial data with representatives of executive authorities of RF subjects.

The changes in the RF Budget Code noted above render the allocation of FFSR financial resources more predictable for regional authorities: the methods of allocation can be changed only by a resolution of the Government and in the framework of the legislation currently in force; the amount of FFSR is easily to estimate in advance; the terms of calculations for the further allocation of FFSR grants are clearly determined.

4. It was legislatively prohibited to use actual or prognosticated indicators of revenues and expenditures of regional budgets for the estimation of the level of budgetary security.

5. It was set forth that the level of rated budgetary security of RF subjects as adjusted for grants provided from the Federal Fund of Financial Support of RF Subjects should not exceed the level of the rated budgetary security as adjusted for grants provided from the Federal Fund of Financial Support of RF Subjects of any other RF subject, which prior to the allocation of grants from the Federal Fund of Financial Support of RF Subjects demonstrated a higher level of the rated budgetary security.

These two changes in fact have legislatively determine the key principles of the Methods of allocation of FFSR grants, which has been discussed above in the respective section of the study.

6. The new version of the RF Budget Code has regulated the issues of granting of financial aid to the autonomous okrugs being in the composition of other RF subjects. In accordance with this version of the RF Budget Code, the grants provided from FFSR to krajs and oblasts, which include autonomous okrugs, should be estimated for consolidated budgets of such krajs and oblasts, including the budgets of autonomous okrugs, and should be entered in the budgets of such krajs and oblasts if there are no other arrangements set forth by a contract and (or) an agreement between the authorities of the krai or oblast and the authorities of the autonomous okrug.

This change in the legislation is an important step in the regional policy pursued by the federal center with the purpose of gradual elimination of such a type of region as autonomous okrugs being in the composition of other RF subjects and their integration in the respective oblasts and krajs.

The new version of article 132 of the RF Budget Code envisages the objectives of creation and certain aspects of functioning of two sources of financial aid to regions: the regional development fund aimed at the granting to the budgets of RF subjects of subsidies for participation financing of investment programs, and the Fund of co-financing of social expenditures, which is formed for financing of priority socially important expenditures of consolidated budgets of RF subjects. These funds have functioning without legislative fixation even prior to the adoption of law No. 120-FZ.

The new version of article 133 of the RF Budget Code sets forth regulation of the granting of transfers from the Compensatory Fund. Since 2005, the Compensatory Fund should accumulate financial resources for financing of all explicit federal expenditure mandates existing in the legislation. The Federal Compensatory Fund is formed within the federal budget and is aimed at the granting of subventions for the execution of expenditure obligations of RF subjects and (or) municipal entities, whose financial security is ensured at the expense of subventions granted from the federal budget in accordance with the law "On the general principles of organization of legislative (representative) and executive authorities of RF subjects" and (or) "On the general principles of organization of local government in the Russian Federation."

Subventions from the Federal Compensatory Fund are distributed among the subjects of the Russian Federation in accordance with the methods approved by the RF Gov-

ernment and in compliance with the requirements set forth by the RF Budget Code, federal laws, and normative legal acts of the RF President and the RF Government.

Subventions from the Federal Compensatory Fund are distributed among all subjects of the Russian Federation in accordance with the standard method applicable to the respective type of subventions pro rata of the size of the population (separate groups of population), consumer of respective budgetary services, eligible recipients of transfers to individuals, and other indicators taking into account objective conditions affecting the costs of provided budgetary services (amount of payments) in RF subjects.

In the course of allocation of subventions provided by the Federal Compensatory Fund, it is prohibited to use the indicators characterizing own revenues of the budgets of RF subjects (local budgets).

In accordance with the new version of the RF Budget Code, which does not envisage such type of financial aid as budgetary loans, there is set forth a stringent requirement about the repayment of budgetary credits to the budgets of RF subjects within the budget year. In the case the extended budgetary credits are not repaid in time, the balance of non-repaid credits including interests, penalties and fines is repaid at the expense of grants from the Federal Fund of Financial Support of RF subjects and at the expense of the shares in the revenues generated by federal taxes and fees, taxes set forth in the framework of special tax treatments (with the exception of local taxes) due to the budgets of RF subjects.

Interbudgetary transfers granted from the budgets of RF subjects to local budgets

According to the new version of the RF Budget Code, significant changes were made in the sphere of interbudgetary relations between regions and municipal entities. In fact, the legal norms of interbudgetary relations between the center and regions were projected to the sub-federal level. Thus, the new version of article 136 of the RF Budget Code entering into force on January 1, 2006, sets forth the key conditions of granting interbudgetary transfers from the budgets of RF subjects and practically duplicates the provisions of article 130 with respect to relations between regional and local authorities. As concerns interbudgetary relations at the sub-federal level, Article 135 of the RF Budget Code sets forth the forms of financial support mainly similar to those envisaged by article 129 of the RF Budget Code with respect to transfers provided from the federal budget:

- Financial aid to local budgets, including the grants from regional funds of financial support of settlements, grants from regional funds of financial support of municipal districts (town okrugs), other grants and subsidies;
- Subventions to local budgets from the regional compensatory funds and other subventions including those to the budgets of autonomous okrugs being in the composition of krais and oblasts; for exercise of the powers of the state authorities of RF subjects delegated on the basis of agreements concluded in compliance with the federal legislation between the state authorities of autonomous okrugs and the state authorities of respective krais or oblasts;
- The funds transferred to the federal budget in relation to the repayment and (or) servicing of the public debt of RF subjects to the federal state authorities and (or) fulfillment of other obligations of the RF subject to the federal budget;
- Other free and irrevocable transfers;
- Budgetary credits to local budgets.

In accordance with the new version of the RF Budget Code regional funds of financial support of settlements are formed within the budgets of RF subjects for the purposes of equalization proceeding from the number of residents, financial resources of local governments of settlements as concerns the exercise of their powers aimed at the settlement

of problems of local importance. The procedure of formation and allocation of financial resources of the fund are determined by the legislation of the respective RF subject. Besides, in the course of formation and (of) approval of the budget of the respective RF subject, grants from the regional fund of financial support of settlements due to the budget of the settlement may be in full or partially substituted by additional rates of assignment of the revenues generated by the income tax on individuals. During the financial year, it is prohibited to change the additional rates of assignment of the income tax on individuals due to the settlement, and the financial resources received by the settlement from the additional rate of assignment of the income tax on individuals in excess of the estimated amount of grants (estimated portion of the grant) from the regional fund of financial support of settlements should not be transferred to the budget of the respective RF subject and (or) be taken into account in the course of the next allocation of financial aid to local budgets. These provisions, on the one hand, permit regions to carry out financial equalization independently, and on the other hand protect municipal entities from the changes in the “rules of the game” during the financial year.

Regional funds of financial support of municipal districts (town okrugs) are formed within the budgets of RF subjects for the purposes of equalization of budgetary security of municipal districts (town okrugs). The procedure of formation and allocation of financial resources of the fund are also regulated by the respective RF subject. Grants from the regional fund of financial support of municipal districts (town okrugs) of RF subjects are provided to the municipal districts (town okrugs), where the level of rated budgetary security is at or below the level set as the criterion of equalization of the rated budgetary security of municipal districts (town okrugs).

In accordance with the provisions of the new version of the RF Budget Code, the level of rated budgetary security of municipal districts (town okrugs) is determined by the rate of the tax revenues per one resident, which could have been received by the budget of the municipal district (town okrug) proceeding from the level of development and structure of the economy and (or) the tax base (tax potential), as well as the similar indicator characterizing the average level across municipal districts and town okrugs of the respective RF subject taking into account the differences in the structure of the population, social, economic, climate, geographical, and other objective factors and conditions affecting the costs of provision of budgetary services (amount of payments) per one resident.

However, part of the grants from the regional fund of financial support of municipal districts (town okrugs) may be provided to municipal districts (town okrugs) proceeding from the number of residents of the municipal district (town okrug) and calculated per one resident and in accordance with the uniform methodology.

These provisions are rather a reference point than an action plan for the region as concerns its financial policy. The majority of mandatory stipulations concern the provision to the local governments of certain guarantees that financial policy of the region will be stable over the year. Other norms in fact grant the regional authorities the opportunity to form their own financial policy and are therefore to a significant extent of dispositive character.

According to article 139 of the RF Budget Code, within the budgets of RF subjects there may be formed funds of municipal development of RF subjects in order to provide local budgets with subsidies for participation financing of investment programs (projects) aimed at the development of public infrastructure of municipal importance, while for the purposes of provision of local budgets with subsidies for participation financing of priority socially important expenditures of local budgets there may be formed regional funds of co-financing of social expenditures.

In the cases and under procedures set forth by laws of RF subjects and other normative legal acts of the state authorities of RF subjects, local budgets may receive other

grants and subsidies from the budgets of RF subjects at or below 10 per cent of the total amount of financial aid granted to local budgets from the budgets of RF subjects. This limitation should somewhat unify interbudgetary relations at the subnational level, since no less than 90 per cent of financial aid to local budgets from the budget of the RF subject should be provided in the forms envisaged by the RF Budget Code. However, because of the considerable degree of freedom as concerns the formation and allocation of financial aid at the subnational level, this restriction is insignificant.

Article 140 of the RF Budget Code regulates regional compensatory funds. Regional compensatory funds are formed within the budgets of RF subjects in order to provide financial backing to local governments exercising certain state powers at the expense of:

- subventions from the Federal Compensatory Fund aimed to assist local governments to exercise certain powers vested with the federal authorities;
- own revenues and sources of financing of the budget deficits of RF subjects in the amount necessary to local governments to exercise certain powers of the state authorities of RF subjects.

As concerns the formation and allocation of the compensatory fund, the only significant restriction on regional authorities is the necessity to elaborate the uniform methods of provision of subventions to all municipal entities.

The procedure governing the granting of budgetary credits from the budgets of RF subjects to local governments is similar to the procedure under which budgetary credits are granted to the budgets of RF subjects from the federal budget as discussed above.

The new version of article 142 of the RF Budget Code envisages the following forms of interbudgetary transfers provided from local budgets:

- financial aid granted to the budgets of settlements from the budgets of municipal districts;
- subventions transferred to regional funds of financial support of settlements and regional funds of financial support of municipal districts (town okrugs);
- subventions transferred from the budgets of settlements to the budgets of municipal districts in order to settle the local problems of inter-municipal nature;
- financial resources transferred to the federal budget or budgets of RF subjects in relation to the repayment and (or) servicing of municipal debts of municipal entities to the federal state authorities or the state authorities of RF subjects, and (or) other obligations of local governments to the state authorities;
- other free and irrevocable transfers.

The procedures governing the formation and allocation of the said types of interbudgetary transfers is rather similar to the organization of interbudgetary transfers at the regional level. No such regulation was envisaged in the preceding version of the RF Budget Code. For the first time in the Russian legislation there was envisaged the procedure of granting subventions from local budgets to the budgets of RF subjects. Laws of RF subjects may stipulate the transfers of subventions to the budgets of RF subjects from the budgets of settlements or municipal districts (town okrugs), where the estimated tax revenues of local budgets (without taking into account tax revenues associated with additional rates of assignment) exceeded the levels set forth by the laws of the respective RF subjects.

The said level should not be set below the double average level observed across settlements or municipal districts (town okrugs) of the respective RF subject calculated per one resident. Subventions from the budgets of settlements transferred to the budgets of RF subjects as stipulated by this article are due to the regional fund of financial support of settlements. In fact, this provision introduces negative interbudgetary transfers at the regional level. The RF Budget Code sets only two requirements with respect to negative interbudgetary transfers:

- 1) the amount of the said subvention for individual municipal entity in per one resident terms should not exceed 50 per cent of the difference between the rated tax revenues of the local budget (without taking into account the revenues from additional rates of assignment) in per resident terms and the double average level of rated tax revenues in per resident terms in the last reporting year;
- 2) rated tax revenues of the municipal entity in per resident terms after the exclusion of the subvention due to the budget of the RF subject should not be below the rated tax revenues in per resident terms of another municipal entity, where prior to the exclusion of the said subvention had demonstrated a lower level of rated tax revenues in per resident terms.

Therefore, the adoption of law No. 120-FZ resulted in the following changes in the system of regulation of interbudgetary financial flows via the federal legislation.

1. All interbudgetary transfers at the federal, regional, and local levels were classified in three groups: financial aid, transfers from compensatory funds, and transfers from funds of regional development. There was indicated the distinction between the financial aid, i.e. the support of relatively poor regions / municipal entities, and the compensations provided by the federal / regional authorities for the expenditures associated with the exercise of delegated powers, and assistance to investment in territories. As a result, the budgetary classification differentiates between the financial resources provision of which may result in various restrictions on the part of federal / regional authorities, and other types of transfers to the budgets of lower levels, which are not related to their financial needs and are determined only by the necessity to comply with the federal / regional legislation or priorities of upper levels of authorities and various forms of joint activities.

2. The procedures governing the formation and allocation of all funds involved in distribution of interbudgetary transfers from the federal budget were fixed in the RF Budget Code.

3. The RF Budget Code was supplemented with the provisions regulating interbudgetary transfers at the regional and municipal levels. Among the specific features of these innovations there should be noted that these norms are to a significant extent of dispositive character. The majority of imperative norms in this sphere are related to the necessity of creation of equal and predictable conditions, in which municipal entities could pursue their own fiscal policies.

4. One of the most important innovations in the practice of interbudgetary relations at the regional level has become the introduction of so called negative transfers for municipal entities, i.e. the transfers from municipal budgets to the budgets of RF subjects.

**Setting up the procedures governing the temporary exercise
of fiscal powers vested with state authorities of RF subjects
(local governments) in the case of introduction
of a provisional financial administration**

Until the middle of 2003, special legislative regulation of the status of insolvent regions and municipal entities has been practically nonexistent. At the same time, article 112 of the RF Budget Code envisaged the possibility to undertake certain measures with respect to regions (municipal entities) in the case they exceeded the caps on the amounts of deficit, debt, and (or) expenditures associated with the servicing of the debt, or defaulted on their debt obligations; however, in practice this article did not work. Besides, the measures stipulated by this article, which could be undertaken by the superior financial authority with respect to insolvent regions (municipal entities), like to inspect the execution of the budget or place it under the control of a superior financial authority seem to be inefficient, since insolvency practically always results from the decisions taken by the representative body and can not be overcome in the process of execution of the budget.

A qualitatively new phase of development of the legislation in this area has started with the adoption of federal laws No. 95-FZ and 131-FZ and was completed with the introduction of law No. 120-FZ, which supplemented the RF Budget Code with article 19.1. This article regulates the status and functions of provisional financial administration introduced in the case of insolvency of an RF subject or a municipal entity.

The major tenor of article 19.1 of the RF Budget Code is as follows. In the case the overdue indebtedness associated with the fulfillment of debt and (or) budgetary obligations originating through the fault of the state authorities of an RF subject (local government) exceeds 30 per cent of own revenues of the respective budget in the last reporting year, in such an RF subject (municipal entity) for up to a year there should be introduced a provisional financial administration (p. p. 1, 3, article 168.2 of the RF Budget Code). The provisional financial administration should not be introduced within one year since the date the representative body of the state authority of the RF subject (representative body of local government) was vested with power (item 5, article 168.2 of the RF Budget Code). In RF subjects, the provisional financial administration should be introduced on request of the RF Government by decision of the Supreme Arbitration Court, as concerns municipal entities, on request of the top executive or the head of the supreme executive authority of the RF subject and (or) representative body of the municipal entity, the head of the municipal entity by decision of an arbitration court of the subject of the Russian Federation (item 3, article 168.2 of the RF Budget Code).

According to article 168.3 of the RF Budget Code, the provisional financial administration introduced in the subject of the Russian Federation (municipal entity) should exercise the following powers:

- organize inspection (audit) of the budget of the RF subject (local budget) in accordance with procedures set up by the Government of the Russian Federation (the executive state authority of the RF subject);
- organize audit of the overdue indebtedness related to the debt and (or) budgetary obligations of the RF subject (municipal entity) in accordance with the procedure set forth by the federal law;
- develop a draft plan as concerns rehabilitation of solvency of the RF subject (municipal entity);
- elaborate and submit to the state authorities of the RF subject (local government) draft normative legal acts of the RF subject (local government) envisaged by the plan of rehabilitation of solvency of the RF subject (municipal entity) as approved by the Supreme Arbitration Court of the Russian Federation (arbitration court);
- in the case a draft law of the RF subject (draft decision of the representative body of municipal entity) elaborated by the provisional financial administration as concerns the amendments to the law of the RF subject (draft decision of the representative body of municipal entity) on the budget of the RF subject (local budget) for the current year, or a draft law of the RF subject (draft decision of the representative body of municipal entity) on the budget of the RF subject (local budget) for the next financial year is not adopted within one month since such draft law has been presented by the provisional financial administration to the legislative state body of the RF subject (representative body of the municipal entity), or adopted with amendments not approved by the head of the provisional financial administration, the provisional financial administration should submit to the RF Government (supreme executive body of the RF subject) the respective draft budgets for submission to the State Duma (legislative body of the RF subject) for approval of these draft budgets by a federal law (the law of the RF subject);

- in the case the draft normative legal acts of the executive authorities of the RF subject (local administration) elaborated by the provisional financial administration are not adopted within 15 days since such draft documents have been presented by the provisional financial administration, or adopted in a version not approved by the head of the provisional financial administration, the provisional financial administration should approve the aforesaid drafts;
- control the implementation of the plan of rehabilitation of solvency of the RF subject (municipal entity) approved by the Supreme Arbitration Court of the Russian Federation (arbitration court) and the respective normative legal acts;
- control execution of the budget of the RF subject (local budget).

In accordance with the temporary provisions envisaged by law No. 120-FZ, the stipulations of article 19.1 of the RF Budget Code as concerns RF subjects will enter into force since January 1, 2007, and as concerns municipal entities – since January 1, 2008.

Among the positive features of the innovations relating to the regime of provisional financial administration introduced by law No. 120-FZ, there should be noted the reflected in the law definition of the insolvency of the region (municipal entity). The merit of this definition is, first, that the provisional financial administration may be introduced not only in the case the marginal amounts of the debt or expenditures associated with the servicing of the debt are exceeded, but also in the case of the factual default on debt obligations. This option permits to refrain from taking coercive measures with respect to the region (municipal entity), which has not yet exhausted the capacity to overcome its financial crisis situation by its own efforts, for instance, via restructuring of the debt, attraction of additional borrowings for refinancing of the debt, and (or) reduction of expenditures.

The second merit of this definition is that it concerns only the indebtedness, which was originated through the fault of the region or the municipal entity. In other words, the indebtedness originated through the fault of superior authorities is excluded from the composition of the liabilities, which should be taken into account in the course of detection of the indications of insolvency. Thus, the upper levels of the budgetary system can not shuffle off the responsibility for their ill considered decisions on to the lower tiers.

Yet another merit of the definition of insolvency introduced by the law is that alongside with the indebtedness related to the obligations included in the composition of the regional (municipal) debt there should be also taken into account the indebtedness relating to the budgetary obligations. It is an important condition permitting to avoid discrimination of certain creditors of a region (municipal entity) against the others. In the case insolvency is detected proceeding only from the amount of liabilities included in the composition of the public (municipal) debt in the narrow sense of the term (i.e. liabilities resulting from credit agreements, guarantees, and bond issues) creates incentives to repay such liabilities at the expense of accumulation of creditor indebtedness relating to other types of obligations to be met at the expense of the debtor's budget. Such obligations include both the liabilities of the public law nature (i.e. those resulting from laws and other normative legal acts envisaging budgetary expenditures), and liabilities of the civil law character, which are not included in the composition of the public (municipal) debt as defined by the law. The latter include, for instance, liabilities resulting from contracts for purchase of goods, works, or services for state and municipal needs, liabilities relating to remuneration of labor of employees of budgetary organizations, etc. At the same time, in order to ensure the efficient functioning of the provision permitting to take into account the indebtedness relating to budgetary obligations in the process of taking the decision about the introduction of the provisional financial administration, it is necessary to settle the issue of what types of indebtedness and of what types of the subjects of the public sector are included in

the indebtedness of this budget. Without the regulatory settlement of this issue, there are possible abuses on the both sides.

As it appears, the major flaw of the provisional financial administration procedure envisaged in laws No. 95-FZ and 131-FZ, as well as in the respective article of the RF Budget Code, is the excessive extent of interference of superior authorities in the budgetary process of the debtor. For instance, article 19.1 of the RF Budget Code stipulates that in the case a region or a municipal entity fails to adopt the law on the budget in the version presented by the provisional financial administration, the budget law should be adopted by a federal law in the case of the RF subject, and by a law of the RF subject for a municipal entity. This stipulation appears to be rather arguable taking into account the fact that the Constitution does not envisage the option of adopting federal laws on the issues not being in the jurisdiction of the Russian Federation or in the shared jurisdiction of the Russian Federation and its subjects; or regional laws on the issues of local importance (while article 132 of the Constitution directly stipulates that approval and execution of local budgets are issues of local importance).

Besides, this provision of the law minimizes the role of the court as a moderator in the framework of insolvency proceedings concerning regions (municipal entities). In the situation, where superior authorities are vested with the right to approve the final version of the law on the debtor's budget, the importance of the plan of rehabilitation of the debtor's solvency approved by the court is leveled. It should be noted that in the case the regional budget is approved by the federal law, it is impossible to contest its contents even in the case it contradicts to the plan of rehabilitation of solvency approved by the court, since federal laws may be contested only on the grounds that they are at variance with the Constitution. Therefore, the commented provisions create risks that superior authorities may abuse the powers vested with them in the framework of insolvency proceedings.

**More precise definition of procedures governing
the cash servicing of the execution of the budgets
of the Russian budgetary system**

The new version of article 215-1 of law No. 120-FZ stipulates that cash servicing of the budgets of all tiers of the budgetary system of the Russian Federation should be vested with the Federal Treasury and be implemented via accounts with the Bank of Russia. If agreed with the executive authorities of the RF subject, the powers of the Federal Treasury as concerns cash servicing of the execution of the budget of the RF subject (budgets of territorial state extra-budgetary funds of the RF subject) and budgets of municipal entities may be transferred to the executive authorities of the RF subject on condition that the said powers are financially ensured at expense of own revenues of the RF subject and that the RF subject owns (uses, manages) the property necessary for the exercise of such powers.

Therefore, it may be asserted that as a result of the changes introduced in the Code, the powers of the Federal Treasury concerning the process of execution of subnational budgets were formally broadened (earlier, the cash execution of budgets was implemented only in the RF subjects being recipients of grants for equalization of budgetary security from the federal budget). At the same time, there is observed a formal limitation of the powers vested with the Federal Treasury. While earlier item 1 of article 134 of the RF Budget Code (as not amended by law No. 120-FZ) has envisaged that the Federal Treasury directly executed the budgets of subsidized RF subjects³⁰, the new version of the RF

³⁰ In accordance with the previous version of item 1 of article 134 of the RF Budget Code, the financial aid allocated from the federal budget for the purposes of equalization of minimal budget security was provided to RF subjects on condition that such RF subjects should sign agreements on the execution of the respective regional budget via the Federal Treasury. There is no such provision in the new version of the RF Budget Code (see article 130 of the new version of the RF Budget Code).

Budget Code envisages only cash servicing of the execution of budgets. At the same time, article 6 of the RF Budget Code notes that cash servicing of the execution of budgets is defined as the carrying out and accounting of the operations related to cash revenues and cash expenditures of the budget. Although the Code contains the definition of cash servicing, it remains unclear what it implies.

The new version of article 227 of the RF Budget Code stipulates that cash payments of budgetary expenditures should be carried out as the debiting of funds from the single budget account in the amount of the confirmed cash liability in favor of the respective individuals and legal entities. Therefore, cash payments presupposes that a number of functions should be carried out in advance, including the function of confirmation of the cash liability, i.e. the verification that the payment documents presented by the budget recipients correspond to the approved estimates of revenues and liabilities and the limits of budget liabilities. At the same time, the law does not directly determine the agency responsible for the confirmation of cash liabilities as concerns the expenditures of regional and local budgets. In the case the confirmation of cash liabilities is transferred to the jurisdiction of the Federal Treasury, the subjects of the Russian Federation and municipal entities will lose the real control over the execution of their budgets, since exactly the Federal Treasury will decide what expenditures answer the law on the budget, budget estimates, and the limits of budgetary liabilities.

In the case it is planned that the confirmation of cash liabilities should remain with the financial agencies of RF subjects and municipal entities, the Federal Treasury will have to effect payments approved by the regional (local) financial agency. In this case, the Federal Treasury will fully duplicate the functions performed by the Bank of Russia, which does not have administrative powers with respect to budgetary funds and effecting payments exclusively on clients' instructions. In this case, the cash servicing of the execution of regional and local budgets by the Federal Treasury is reduced to execution of payment operations through two banks instead of one.

The only effect of this measure will be the prolongation of the time of payments by minimum one working day (on the condition that the staff performs its functions with maximum efficiency, the system of flow of documents is ideal, and technical capacities are adequate), since there is introduced yet another stage of processing of payments. Longer time taken to effect payments will further negatively affect the final recipient of the payment and the payment discipline in the country. As a result, due to the additional processing of payment documents by the Federal Treasury at the end of the financial year there may be observed accumulation of large balances of budgetary funds.

**Federal law No. 95-FZ "On the amendments to Sections 1 and 2
of the Budget Code of the Russian Federation and invalidation
of certain legislative acts (provisions of legislative acts)
of the Russian Federation on taxes and fees"**

The major group of amendments introduced by federal law No. 95-FZ of July 29, 2004, "On the amendments to Sections 1 and 2 of the Budget Code of the Russian Federation and invalidation of certain legislative acts (provisions of legislative acts) of the Russian Federation on taxes and fees" concerns the new structure of assignment of own tax revenues to each level of authorities. As it has been noted above, these amendments related to the changes introduced by law No. 120-FZ to the RF Budget Code and in fact reproduce the structure of assignment of tax revenues to different budgets in the framework of tax legislation.

The new version of article 12 of the RF Tax Code stipulates that federal taxes should be defined as all taxes and fees stipulated in the RF Tax Code and mandatory payable

anywhere in the territory of the Russian Federation. Regional taxes should be defined as the taxes stipulated in the RF Tax Code and respectively by the laws of RF subjects concerning taxes and are mandatory payable in the territories of respective RF subjects. Accordingly, local taxes are defined as the taxes stipulated in the RF Tax Code and normative legal acts of representative bodies of municipal entities and mandatory payable in the territories of respective municipal entities. Special tax regimes may envisage special procedures of determination of taxation elements, as well as waivers of the obligation to pay certain taxes and fees stipulated in the RF Tax Code.

As compared with article 12 of the previous version of the RF Tax Code, the new version of the article more clearly defines the powers vested with the regional and local authorities with respect to the introduction of taxes and fees. First, the article establishes that federal, regional, and local taxes and fees should be abolished or introduced only by the RF Tax Code (items 5 and 6 of article 12). Second, regional and local authorities were deprived of the right to determine the forms of reporting with respect to regional and respectively local taxes. All elements of taxation with the exception of tax rates (within the limits set forth by the Code), the procedures and terms of payment of taxes, as well as the grounds and procedures of application of tax privileges (as concerns respectively regional and local taxes) (item 3, article 56) should be directly determined in the RF Tax Code.

The RF law No. 2118-1 of December 27, 1991, "On the principles of the tax system of the Russian Federation" was invalidated on January 1, 2005 (i.e. on the date of enactment of the bulk of amendments made to the RF Tax Code by law No. 95-FZ), while the exhaustive list of taxes was fixed in the new version of articles 12–15 of the RF Tax Code. In comparison with the list of taxes and fees stipulated by articles 19–21 of law No. 2118-1, the new version of articles 12–15 of the RF Tax Code abolished a number of taxes and fees. The Code introduced 15 taxes and fees at all three tiers of authorities. In particular, in accordance with the new version of article 13 of the RF Tax Code, the federal taxes and fees include:

- value added tax;
- excises;
- income tax on individuals;
- single social tax;
- profit tax on organizations;
- mineral extraction tax;
- gift or inheritance tax;
- water tax;
- fees for the use of fauna resources and for the use of water biological resources;
- stamp tax.

According to article 14 of the RF Tax Code, regional taxes and fees include:

- tax on property of organizations;
- tax on gambling;
- transport tax.

Local taxes (article 15 of the RF Tax Code) include:

- land tax;
- property tax on individuals.

Therefore, there were abolished two taxes – on operations with securities (a federal tax) and on advertisement (a local tax), as well as the fee for the use of terms "Russia" or "Russian Federation" and the charge for licenses permitting to produce alcohol products. At the same time, representative bodies of municipal districts or town okrugs (as well as

legislative bodies of the federal cities of Moscow and St. Petersburg) have the right to include such a type of activities as outdoor advertising in the composition of the types of activities subject to the tax on imputed income.

The new version of article 18 of the RF Tax Code introduces such special tax regimes as:

- system of taxation of agricultural producers (single agricultural tax);
- simplified taxation system;
- system of taxation in the form of the single tax on imputed income for certain types of activities;
- system of taxation applied in the course of implementation of production sharing agreements.

The following group of amendments introduced to the RF Tax Code by law No. 95-FZ is of the legal and technical nature and was made in connection to the administrative reform underway in the Russian Federation. Decree of the RF President No. 314 of March 9, 2004, transformed the RF Tax Ministry in the Federal Tax Service. The functions of the RF Tax Ministry concerning the approval of normative legal acts in the respective sphere, interpretation of the legislation of the Russian Federation on taxes and fees were transferred to the RF Finance Ministry. At the same time, the newly created within the RF Finance Ministry Federal Tax Service is the federal executive body empowered to control and supervise the sphere of taxes and fees.

The following group of amendments introduced to the RF Tax Code by law No. 95-FZ concerns a more precise definition of the procedures governing the granting of deferrals and installment plans with respect to the payment of taxes and investment tax credits. First, in accordance with the changes introduced in article 66 of the RF Tax Code, the stipulation envisaging that financial agencies of RF subjects should take decisions with respect to the extension of investment tax credits as concerns the tax on the profits (proceeds) of organizations due to the budget of the RF subject were excluded from the RF Tax Code.

According to article 63 of the RF Tax Code, there are the following agencies vested with the powers to take decisions concerning changes in the terms of payment of taxes and fees: the Federal Tax Service as concerns federal taxes and fees; territorial tax inspections acting on approval of regional (local) financial agencies – as concerns regional and local taxes and fees. At the same time, in accordance with item 6 of article 64 of the RF Tax Code (as not amended by law No. 95-FZ) “decisions concerning the granting of deferrals and installment plans with respect to the payment of taxes should be taken by an *authorized agency* within one month since the receipt of the application of the interested person.” Thus, this stipulation did not take into account the necessity to coordinate the decision with the regional (local) financial agencies (in the case it concerns the deferrals or installment plans for taxes due to different budgets). Law 95-FZ has corrected this flaw.

It is important to note the amendment made to article 60 of the RF Tax Code. This article sets forth the obligations of banks with respect to the execution of orders for transfer of taxes and fees and decisions concerning collection of taxes and fees. In accordance with this article, banks should execute the orders given by clients of tax agents as concerns the transfer of tax payments to the respective budgets (extra-budgetary funds), as well as decisions taken by tax agencies with respect to collection of taxes at the expense of the funds of the taxpayer or the tax agent in the order of priority set forth by the civil law. Banks should execute orders for transfers of tax payments or execution of decisions about collection of taxes within one business day following the day of receipt of such order or decision if the RF Tax Code does not stipulate otherwise.

The amendment stipulates that the branches of the banks without own corresponding accounts should have additional time (5 business days) for transfer of payment documents received from citizens. The date of submission of the payment order to the bank by the taxpayer has been retained as the actual date of payment of the tax. At the same time, it should be taken into account that the taxes paid by taxpayers on the last day before the deadline will be received by the respective budget not earlier than in one week.

The last group of amendments introduced to the first section of the RF Tax Code is as follows: the term "taxes" was inserted in the articles previously referring to customs duties and payments. Therefore, it has been set forth that the customs should turn to the RF Tax Code as concerns all tax related issues.

The substantive changes in the second section of the RF Tax Code introduced by law No. 95-FZ primarily concern the tax on imputed income. There should be noted three key changes concerning this tax.

First, since January 1, 2006, the single tax on imputed income will be regulated not by regional authorities, but by the municipal level of government (also in the cities of Moscow and St. Petersburg). In accordance with item 3 of the new version of article 346.26 of the RF tax Code, the normative legal acts issued by representative bodies of municipal districts (town okrugs) and the laws adopted by the federal cities of Moscow and St. Petersburg should determine the following:

- the procedure of introduction of the single tax on imputed income in the territory of respective municipal district, town okrug, federal cities of Moscow and St. Petersburg;
- the types of entrepreneurial activities subject to the single tax as listed by the RF Tax Code;
- values of K2 coefficient (the adjustment coefficient of base profitability, which takes into account the specifics of businesses, including the assortment of goods (works, services), seasonal factor, duration of operation, amount of proceeds, specifics of the location of the business, dimensions of the information field of light and electronic displays, dimensions of the information field of printed outdoor advertisements, and other specifics).

Second, since January 1, 2005, the table of base profitability presented by article 346.29 of the RF Tax Code has been changed – practically all indicators were increased twofold.

Third, as it has been noted above, since January 1, 2005, outdoor advertising should be included in the composition of the types of activities subject to the tax on imputed income (item 2 of article 346.26 of the RF Tax Code). The respective physical indicators are set forth in article 346.29: dimensions of the information field of outdoor printed advertisements and dimensions of the information field of light and electronic outdoor displays. Both indicators are rated in square meters. The respective base profitability is set at Rub. 3000 and Rub. 4000 respectively.

The last group of amendments introduced to the second section of the RF Tax Code by law No. 95-FZ concerns the changes in the rates of the tax on the profit of organizations due to the budgets of RF subjects. In accordance with the new version of article 284 of the RF Tax Code, the amount of the tax calculated at the 6.5 per cent rate is due to the federal budget (previously the respective rate was set at 5 per cent), while the amount of the tax calculated at the 17.5 per cent rate is due to the budgets of RF subjects (previously the respective rate was set at 17 per cent). Prior to the changes introduced by law No. 95-FZ, 2 per cent of the tax on profit has been transferred to local budgets. The changes discussed

above resulted from the necessity to redistribute tax revenues among the budgets in connection to the shifts in expenditure obligations of budgets of different levels.

2.3.7. The law on the federal budget for year 2005 and interbudgetary relations

The law on the federal budget for year 2005 contains a number of innovations concerning the relations among the budgets of different levels.

First of all, it should be noted that the decisions taken in the sphere of division of powers between the tiers of state authority, as well as decisions relating to the ongoing tax reform have resulted in the necessity to redistribute tax revenues among the budgets of different levels. The most significant shift in this sphere was the next stage of redistribution of the revenues generated by the profit tax on organizations in favor of the federal budget: while in 2004 the federal budget received the revenues from the tax on the profits of enterprises and organizations calculated at the rate of 5 per cent, in 2005 the federal budget will receive the revenues from the profit tax calculated at the 6.5 per cent rate. In 2005, the revenues of regional budgets will be also affected by such decisions as the indexation of specific rates of excises, changes in the revenues generated by the tax on profits and the income tax on individuals resulting from the reduction of the effective rate of the single social tax.

As a result, the proportions of distribution of tax revenues between the federal budget and consolidated budgets of RF subjects will remain practically the same as compared with the data for years 2003 and 2004; it is planned that in 2005 the share of tax revenues of subnational budgets in the framework of the comparable budgetary classification (i.e. including in the composition of tax revenues the proceeds from external economic activities) will made about 40 per cent. However, taking into account the scale of planned transformations in different spheres; at this stage it seems problematic to arrive to conclusions about the inter-territorial distribution of tax revenues as concerns regions.

As concerns the distribution of tax revenues among the budgets of different levels, it should be also noted that since 2005 there will be enacted the new rule of entering of revenues generated by federal taxes to the budgets of autonomous okrugs in the composition of oblasts and kraia introduced by the new version of the law "On the general principles of organization of legislative (representative) and executive authorities of RF subjects" (article 26.17) and the new version of the RF Budget Code. In accordance with this rule, the revenues generated by federal taxes and fees should be due to the budget of the oblast (krai) in the case the agreement about the division of powers between the okrug and oblast (krai) does not stipulate otherwise.

However, article 27 of the law on the federal budget for year 2005 contains an exception from this rule as concerns the tax on the profits of enterprises and organizations and the mineral extraction tax as concerns hydrocarbon mineral resources (with the exception of natural gas): the respective revenues should be distributed between the budgets of Khanty Mansi and Yamal Nenets autonomous okrugs in the Tyumen oblast. The same article stipulates that these two autonomous okrugs should retain the rights to receive interbudgetary transfers similar to the rights of other RF subjects, which are not autonomous okrugs being in the composition of an oblast (krai). In other words, the draft law on the federal budget for year 2005 makes for two autonomous okrugs in the territory of the Tyumen oblast an exception from the general rule set for the RF subjects of the same status. It should be reminded that in 2004 the authorities of these okrugs agreed to transfer to the federal budget a considerable portion of additional tax revenues generated by the repayment of the tax arrears on the part of NK YUKOS; therefore, it may be surmised

that such a concession in the sphere of interbudgetary relations was made with respect to these two regions in exchange for transfer of additional revenues to the federal budget.

These practices do not seem productive, since any other forms of asymmetry and exceptions from the general arrangements set in the sphere of interbudgetary relations in a federative state undermine the efficiency of the incentives of behavior of regional authorities, soften budgetary constraints on regional and local authorities, and create incentives making the regional authorities to take decisions aimed at the satisfaction of preferences of the federal center, and not regional voters as it should be in a federative state.

In the course of an analysis of such an aspect of the law on the federal budget for year 2005 as interbudgetary relations, it is necessary to dwell on the problem of allocation of interbudgetary transfers as concerns the transfers from the federal budget to the budgets of territories. In 2005, it is planned to introduce certain changes, which seem to be radical in comparison with the trends observed in the laws on the federal budget for years 2001 through 2004.

In connection to the reform of the budgetary classification all gratis transfers between budgets and extra-budgetary funds are grouped in the section of the functional classification of budgetary expenditures "Interbudgetary transfers." At the same time, federal financial resources are transferred to regional and local budgets across several subsections: "Financial aid to budgets of other levels," "Compensatory Fund," and "Fund of Regional Development." Therefore, there was indicated the distinction between the financial aid, i.e. the support of relatively poor regions, and compensations for the expenditures associated with the exercise of delegated powers provided by the federal authorities, and assistance to investment in the region. As a result, the budgetary classification differentiates between the financial resources provision of which may result in various restrictions on the part of federal authorities (for instance, organization of the execution of regional budgets via the Federal Treasury) and other types of transfers to the budgets of lower levels, which are not related to their financial needs and are determined only by the necessity to comply with the federal legislation or priorities of upper levels of authorities and various forms of joint activities.

The total amount of financial resources planned to be transferred to the regional and local budgets in 2005 makes about Rub. 379 billion and in real terms (taking into account that the estimated growth in the consumer price index will make 8 per cent in 2005) is at about the same level as that targeted in the law on the federal budget for year 2004. However, taking into account the prognosticated growth in the gross domestic product interbudgetary transfers to territorial budgets will somewhat decline – from 2.2 per cent of GDP envisaged by the federal budget in 2004 to 1.9 per cent of GDP in 2005). As it will be demonstrated below, the structure of the planned transfers from the federal budget to regional budgets has also changed.

The major channel through which regional authorities receive financial aid is subventions for equalization of the budgetary security provided by the Fund of Financial Support of Regions; while in real terms the respective amount remained at the same level, it declined in terms of GDP: from 1.15 per cent of GDP registered in 2004 to almost 1 per cent in 2005.

In comparison with the figures registered in 2004, according to the law on the federal budget in 2005 in real terms the amounts of transfers from FFSR will decline in 33 RF subjects, increase in 36 RF subjects, and 2 regions will not receive FFSR transfers.

The regions, which are the "winners" because of the changes introduced in the Methods of distribution of FFSR financial resources include: Belgorod, Bryansk, Voronezh,

Ivanovo, Kursk, Tambov, Tula, Arkhangelsk, and Murmansk oblasts, Republic of Adygeya, Republic of Dagestan, Ingush Republic, Kabarda Balkar Republic, Karach Cherkess Republic, Stavropol krai, Volgograd and Rostov oblasts, Republic of Mari El, Chuvash Republic, Kirov, Nizhni Novgorod, and Penza oblasts, Komi Permyak autonomous okrug, Kurgan oblast, Republic of Altai, Altai krai, Irkutsk and Omsk oblasts, Taimyr (Dolgan Nenets) autonomous okrug, Republic of Sakha (Yakutiya), Primorski krai, Kamchatka and Magadan oblasts.

The regions, which are the “losers” because of the changes introduced in the Methods of distribution of FFSR financial resources include: Vladimir, Kaluga, Kostroma, Moscow, Orel, Ryazan, Smolensk, and Tver oblasts, Republic of Kareliya, Kaliningrad, Novgorod, and Pskov oblasts, Republic of Kalmykiya, Republic North Osetiya – Alaniya, Chechen Republic, Krasnodar krai, Republic of Mordoviya, Saratov, Ulyanovsk, and Chelyabinsk oblasts, Republic of Buryatiya, Republic of Tyva, Republic of Khakasiya, Kemerovo, Novosibirsk, Tomsk, and Chita oblasts, Aginsk Buryat, Ust Orda Buryat, and Evenk autonomous okrugs, Khabarovsk krai, Amur and Sakhalin oblasts, Evreiskaya autonomous oblast, Koryak and Chukotka autonomous okrugs.

The transfers of FFSR financial resources to Astrakhan and Sverdlovsk oblast were ceased.

The relationship between the changes in the amount of FFSR grants and the level of budgetary security of the region is presented in *Table 12*.

The data presented in *Table 12* demonstrate that there is no clear relationship between the level of budgetary security and the changes observed in the amounts of grants provided by FFSR in accordance with the new methodology of distribution. This result is caused by a large number of differently directed changes in the Methods of distribution of FFSR financial resources. Thus, all 14 regions³¹ receiving less FFSR financial resources in real terms in 2005, in 2004 were in the group of regions receiving grants from the second part of FFSR aimed to raise the respective levels of budgetary security to the guaranteed minimum level. Due to the changes in the methodology these regions received less financial resources.

Table 12

The relationship between the changes in the amount of FFSR grants in 2005 in comparison with the data for 2004 in real terms and the level of budgetary security of the region

Level of budgetary security	Number of regions receiving FFSR grants in real terms in 2005	
	Less than in 2004	More than in 2004
Below 50 %	14	18
50–70 %	11	9
Over 70 %	13	6

It should be noted that the law on the federal budget for year 2005 envisages a decline in the amount of the Compensatory Fund from Rub. 50 billion in 2004 to Rub. 33 billion in 2005 (from 0.33 per cent to 0.18 per cent of GDP). This development may be explained primarily by the reform of the system of social support. The transfer of powers

³¹ The Pskov oblast, the Republic of Kalmykiya, the Republic of North Osetiya – Alaniya, the Chechen Republic, the Republic of Mordoviya, the Republic of Buryatiya, the Republic of Tyva, the Aginsk Buryat, Ust Orda Buryat, Evenk autonomous okrugs, the Amur oblast, the Evreiskaya autonomous oblast, the Koryak and Chukotka autonomous okrugs.

concerning the introduction of the majority of social benefits (including the payment of child benefits, what represents the bulk of expenditures of the Compensatory Fund) to the regional level resulted in the following changes in the targets of subventions and subsidies provided from the Compensatory Fund in 2005:

- subventions and subsidies to certain categories eligible for federal social benefits in 2005 as concerns HPU payments (the HPU related social benefits should be abolished later), which are envisaged in federal laws on support of disabled persons, veterans, persons who participated in the liquidation of the consequences of the Chernobyl disaster, victims of other radiation accidents;
- subventions for financing of powers concerning the state registration of births, daths, and marriages;
- subventions for implementation of the stipulations of the federal legislation as concerns payments to donors of blood.

Therefore, starting since 2005, the Compensatory Fund will consolidate the financial resources for financing of all federal expenditure mandates defined as such in the legislation. It is one of the positive features of the law on the budget.

Unfortunately, the measures aimed at the reform of the system of interbudgetary transfers to regional and local authorities in 2005 practically did not concern the Fund of Regional Development (FRD). The only significant decision with respect to FRD was related to the inclusion in the composition of the Fund of transfers to RF subjects aimed at support of motor road network. From the authors' point of view, this decision can hardly be defined as justified and efficient.

The necessity of the reform of the mechanism of state support of road networks in regions and municipal entitles can not be denied. Both the methods of distribution of respective financial resources and the forms of provision thereof need to be reformed; however the inclusion of these resources in the composition of FRD does not answer the requirements of such a reform.

First, no transparent uniform methods of distribution of the funds aimed at support of the motor road network have been elaborated by 2005, and this problem has not been solved by the transfer of the respective financial resources to FRD.

Second, this transfer does not answer the objectives of the Fund set by the present concept of the further reform of interbudgetary relations – co-financing of investment projects of regional and local authorities in the sphere of social infrastructure carried out on tender basis. At present this objective can not be achieved, since FRD is a combination of federal targeted programs of regional development, where the financial resources of federal program “Equalization of differences in the social and economic development of RF subjects...” (the major source of co-financing of investment projects in the sphere of social infrastructure) makes only an insignificant part.

Third, the investment-oriented nature of the Fund of Regional Development does not correspond to the fact that financial resources for the state support of motor road networks in RF subjects are expended not only for capital construction and capital repairs of motor roads for general use, but also for maintenance and current repairs of motor roads. All these circumstances result in a significant distortion of objectives of FRD transfers and may have a significant negative impact on other components of this Fund.

Besides, it should be noted that in 2005 there will significantly decrease the expenditures (the amount of which in preceding years was rather large) associated with the federal targeted programs for development of the Republics of Tatarstan and Bashkortostan, which were adopted as a compensatory measure after the cessation of special tax and

budgetary conditions of agreements about the division of powers between these regions and the federal center. Thus, while in the preceding years the expenditures associated with these programs made more than Rub. 20 billion, in 2005 the respective financing will make about Rub. 11 billion.

The law on the federal budget for year 2005 also contains certain decisions aimed at the alteration of the procedures governing the granting of discretionary (i.e. not regulated and formalized) types of interbudgetary transfers. Thus, in accordance with the new version of the RF Budget Code, which does not envisage such types of financial aid as budgetary loans, the law on the budget for year 2005 contains a tough requirement that budgetary credits to the budgets of RF subjects were extended within the budgetary year. Credits to the budgets of RF subjects from the federal budget may be provided for the purposes of liquidation of temporary cash gaps and financing of expenditures relating to the liquidation of consequences of natural calamities. At the same time, a clearly positive result of the switching to the use of budget credits is that credits from the federal budget are provided on paid basis: in 2005 the payment of the use of newly extended credits will make one fourth of the refinancing rate of the Central Bank; however, the credits extended in relation to the liquidation of consequences of natural calamities should be free.

The law on the federal budget grants the RF Finance Ministry to prolong budgetary loans extended prior to the enactment of the law, i.e. prior to October 1, 2005. However, after this date free budgetary loans should be reregistered as paid budgetary credits. The law also envisages tough measures in the cases of non-repayment of the funds of the federal budget like write-downs from accounts, withholding of revenues generated by federal taxes, recovery of transfers.

On the face of it, the provisions of the law on the federal budget for year 2005 facilitate an enhancement of efficiency of interbudgetary relations and regional finances. No doubt that the introduction of payment for the use of the financial resources of the federal budget will facilitate a gradual cessation of the use of budgetary loans as an additional type of financial aid provided on approval of the RF Finance Ministry in the case of financial difficulties.

However, the consequences of the decision to cease the use of budgetary loans will to a great extent depend on the practices of granting of budgetary credits in 2005. Taking into account the low interest rates of the credits, it may be surmised that in the case these credits are granted at a significant scale, are frequently restructured, and may be legislatively prolonged, while no measures are taken to exact overdue indebtedness, this measure may result in a further softening of budgetary constraints on regional authorities and gradual waning of positive effects expected from the introduction of these stipulations of the law on the budget.

2.4. Russian Financial markets

2.4.1. The Market for Public Debt

Since 2001 the government has demonstrated different trends in its policy on the market for external and domestic debt. More specifically, despite the existence of a stable surplus of the federal budget, the volume of the domestic debts has been growing over last 2–3 years, while the volume of borrowings overseas was declining gradually (*Table 13*).

Table 13

**The Dynamics of Russia's External and Domestic Debt in 1993–2004
(as of End of the Year)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Domestic debt (as Rb. bln.)	0.22	10.62	76.76	248.98	450.97	493.74	529.83	531.81	511.06	654.7	663.67	756.82
Foreign debt (as USD bln.)	112.7	119.9	120.4	125	130.8	150	157.5	143.4	130.1	123.5	119.7	112.9 ³²

Against the background of an extremely favorable state of affairs on mineral markets in 2004, the government raised the issue of the possibility of an early debt repayment to the Paris Club. Should the parties concerned arrive to an agreement on the issue, the volume of Russia's foreign debt may decrease substantially. The state of affairs in the area of the nation's domestic and external debt in 2004 found itself under the impact of various factors that will be addressed below.

Domestic Debt

By 2004 results, the volume of Russia's public domestic debts in T-bills grew roughly by 14.0% from Rb. 663.7 to 756.8 bln. (while it fell in shares of GDP equivalent from 5.0 to 4.5% of GDP). The federal bonds account for 99.99% of the public debt (*Table 14*).

Table 14

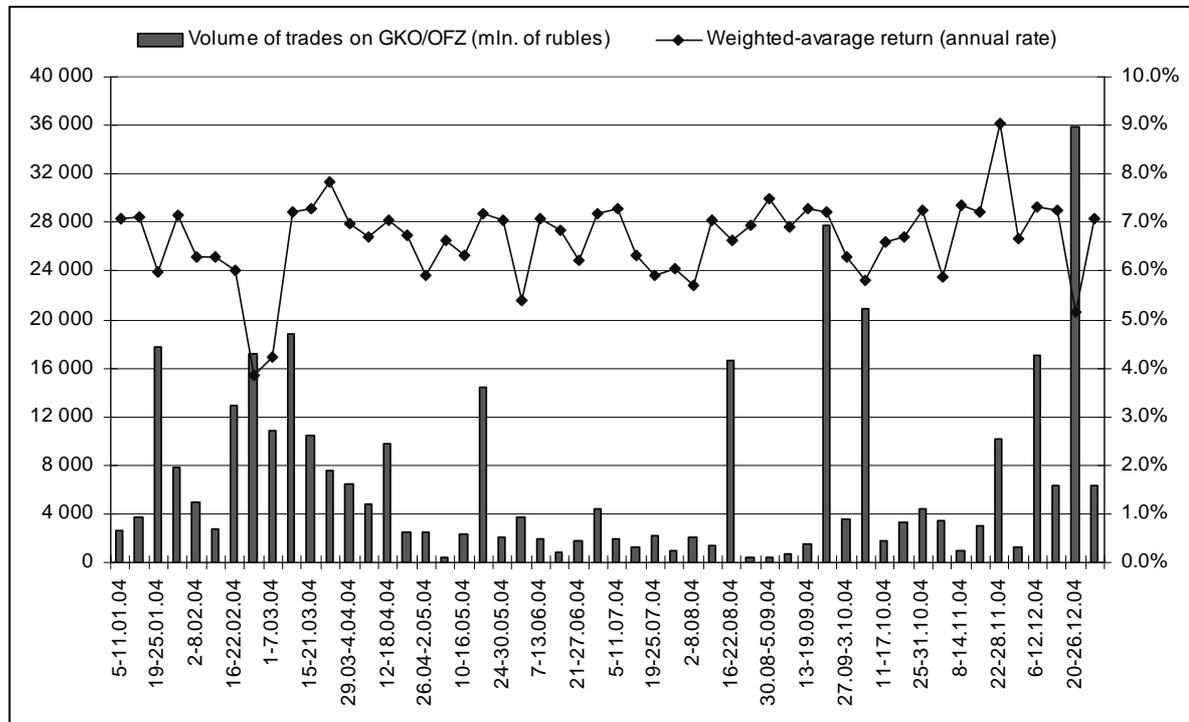
The Structure of Russia's Public Domestic Debt (as Rb. Bln.)

Types of securities	As of 1 January 2004	As of 1 January 2005
GKO	2.72	0.02
OFZ-PK	24.1	0.001
OFZ -PD	50.48	43.31
OFZ -FK	199.31	171.22
OFZ -AD	375.42	542.24
OGNZ	11.5	0
1992 ORVZ.	0.04	0.03
OGSZ	0.1	0.0002
Total	663.67	756.82

In 2004, the dynamics of quotations of the Rb—denominated T-bills was not gradual. By the 2004 results the average weighted yields of the traded issues fell by just 0.43%—from 7.1 down to 7.08% annualized (*Fig. 17*). However the market has been quite volatile through the year, with the average weighted yields fluctuating between 4 to 9% annualized, while investors' activity grew notably vs. the respective 2003 indicators. Thus the ag-

³² As of October 1, 2004.

gregate turnover if trades in the market for GKO-OFZ in 2004 roughly accounted for Rb. 350.8 bln. vs. 243.8 bln. in 2003 (44%). The peak weekly volume of trades in 2004 was a Rb. 35.87 bln. (20.43 bln. in 2003), while the minimum volume was Rb. 350 mln. (in 2003-750 mln.).



Source: Finmarket investment agency, the IET computations

Fig. 17. The Dynamics of the GKO-OFZ Market in 2004

The dynamics of the market for Rb.-denominated government bonds have undergone a series of changes over 2004. Thus, between January through February the yields tended to decline, with the market being affected by two main factors: that is, an excessive liquidity in the banking sector and a notable appreciation of Rb. against USD. The market was also affected by the RF Minfin's declaration regarding the 2004 domestic borrowing program that provided for a more than 5-fold rise in the offer of the papers vs. the 2003 indicators. In February, the market for public debt demonstrated the rise in the primary offer with a premium vs. the secondary one. That contributed to a successful completion of the actions, notwithstanding a moderate demand. Given a favorable situation with liquidity, the demand at the auctions was at an acceptable level, which, however, has led to some fall in investors' activity on the secondary market and contributed to just a moderate price rise of Rb-denominated bonds. Notably, it was February 2004 when the average weighted yields of GKO-OFZ sank to the 2004 minimum value of 3.85 % annualized.

The average weighted yields rate grew by early March, while the markets absorbed up to a half of the volume of papers offered by the MinFin. The price rise resumed after V. Putin's re-election, with non-residents apt to buy Rb.-denominated assets, which increased limits on Rb.-denominated instruments. The average weighted yields slid by mid-April to the level of 5.9% annualized, followed by the start of adjustment in the market that was in place until late May. The change of the trend was triggered by a drastic deterioration of the situation with liquidity in the banking sector, coupled with Rb. appreciating against USD.

Between June through July the quotations of T-bills were experiencing sporadic fluctuations, with no clear trend in place. The situation was affected by the commotion around Sodobusinessbank and Kredittrust; plus, the market proved to be sensitive to a certain negative impact of the takeover of Gута-bank by Vshehtorgbank. And if it was not enough, YUKOS' darkening prospects generated investors' flow from the corporate securities market to the one for T-bills, which can potentially be viewed as a factor that supported the latter.

August 2004 saw a relatively stable market, whereat, on the one hand, an insignificant change in quotations could be explained by seasonality, while on the other hand, their low volatility could evidence a great stability of already emerged price levels. In September, the yields rates of the trade bonds were lowering against an extremely high level of liquidity in the banking system (with the respective indicators being the highest ones over the past half year). October-November 2004 saw the investors' overflow from the secondary to primary market, and the demand was chiefly steered by a favorable situation with the banking liquidity and the USD depreciation. Given this particular background, the November volume of trades on the secondary market sank to the 2004 minimum level, while that on the primary market proved to be record – breaking. The demand for placed papers to a significant extent was inspired by Fitch, which had increased Russia's credit rating from "BB+" up to the investment level "BBB-", with the forecasted stability of the rating.

In December, the rise in quotations of T-bills was fueled mostly by the improving situation in terms of the banking liquidity and the ongoing depreciation of USD against Rb. The leap of yields at the very end of the year could be explained by growing inflationary expectations, which could not yet been compensated by a Rb. appreciation.

In 2004, the MinFin successfully held 27 auctions on placement of GKO-OFZ. The volume of face-value offer accounted for some Rb. 172.3 bln., while the actual volume of placed papers made up roughly as much as 87.9 bln. As of December 31, 2004, the volume of the GKO-OFZ market was Rb. 557.56 bln. at face-value and 544.82 bln. – in market prices. The duration of the GKO-OFZ market portfolio made up 1756.63 days.

Given the dynamics of the 2004 market for Rb.-denominated bonds, it can be assumed that in 2005 the quotations will find themselves affected by two main factors: that is, the USD/Rb. exchange rate and a high liquidity in the banking sector. Plus, as on January 31, 2005, S&P's increased Russia's rating up to the investment level may also support a favorable state of affairs on the market for Rb.-denominated T-bills. However, given the remaining trends to growth in the volume of borrowings on the domestic market, a considerable downfall in yields rates is unlikely. Yet another factor that can constrain the rise in quotations is inflation. As it has become clear in late 2004 that by results of the year the price rise rates would overshoot the 2004 original budget indicators, while the price rise over the first two months 2005 accounted for slightly under the half of the 2005 inflation targets, the emergence of inflationary expectations can also exert a negative influence on prices of Rb.-denominated bonds in 2005.

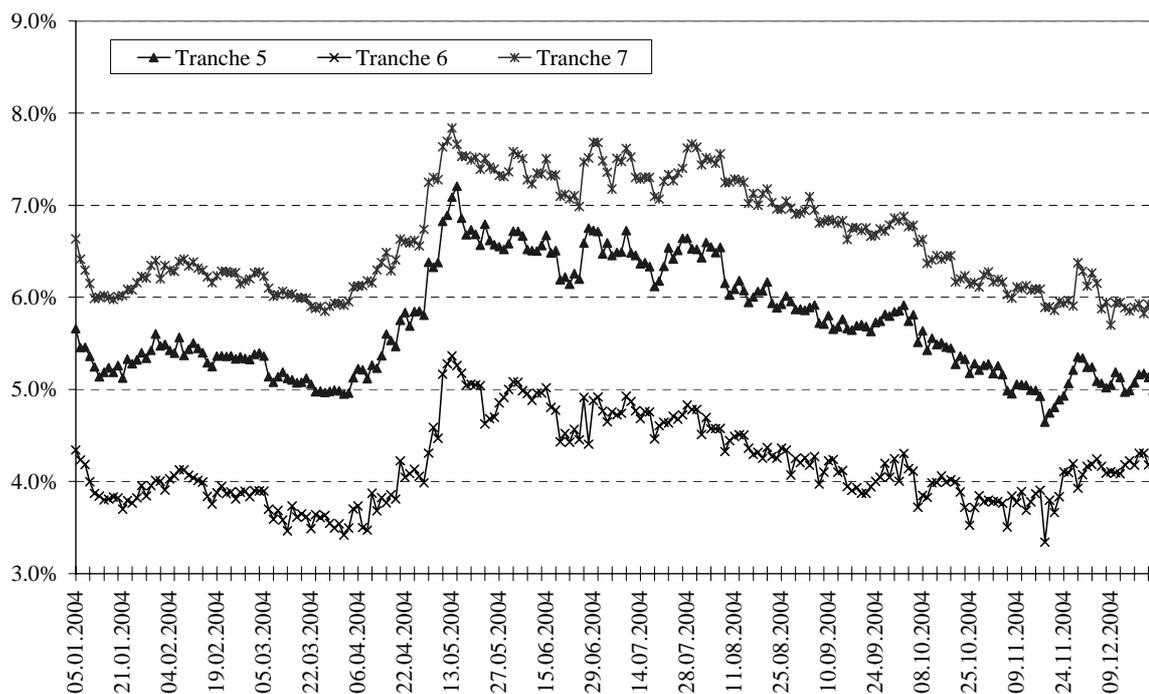
External Debt

As of October 1, 2004, the volume of Russia's external debt shrank from USD 105.7 bln. to 99.8 bln. (according to CBR), which means a 5.58% reduction in the absolute amount of foreign debt accumulated by the RF Government. In 2004 Russia paid on a sole Eurobond issuance, which took place in March. By contrast, over the period in question the private sector (banks and companies) boosted their debt to non-residents from USD

80.0 bln. up to 92.3 bln. (+15.4%). So, by results of the first 9 months 2004 Russia's aggregate foreign debt grew from USD 185.7 bln. up to 192.1 bln.

As concerns the market of forex-denominated bonds, quotations of a number of trade papers were surging over the period in question, while some other were declining. More specifically, in late December 2004 the yields rates of the papers of the 5th OVZ tranche accounted for 4.99% annualized (5.66% as of the beginning of the year), while those of the 6th OVZ tranche – 4.2% annualized (4.34%). By contrast, the yields rates of RUS-30 dropped from 7.35% to 6.64%, while yields to maturity of RUS-07 was a. 6.35% annualized (4.42 as of early 2004), and RUS-18 were traded at prices equivalent to 7.02% annualized (6.59% as of early 2004).

The dynamics of the 2004 Eurobond market found themselves under such critical positive factors as an extremely favorable price situation in the world markets for oil and metals and a fairly stable macroeconomic situation in the country. The noted increase of Russia's investment rating by Fitch has also formed a positive factor, so long as the price dynamics for Eurobonds are concerned. Speaking of critical negative factors, one should primarily note the unfolding conflict between the authorities and YUKOS. In addition, the increase of interest rates in the US (in response to the peril of a rise of inflationary processes in the US economy) has fueled the rise in the yields rates of the US T-bills, which was also mirrored by the dynamics of the Russian segment of the world market for Eurobonds.

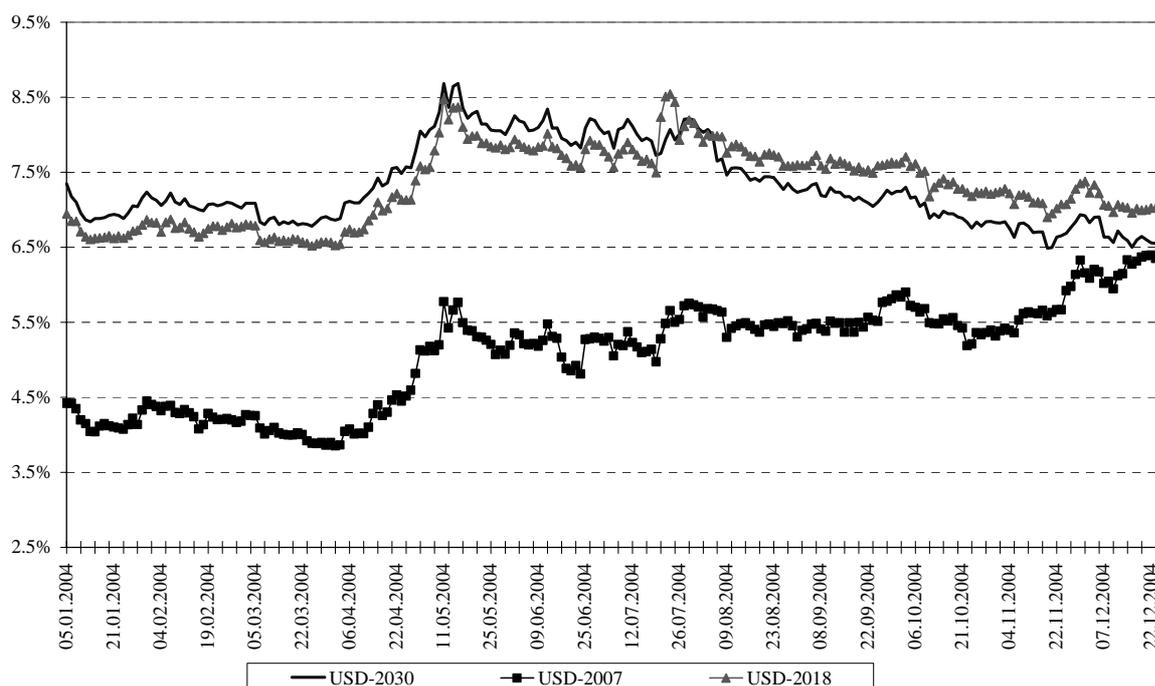


Source: Investment Agency "Finmarket"

Fig. 18. Yields to Maturity of OVZ in 2004

The dynamics of quotations of Eurobonds allows to single out several periods (Fig. 19). In the 1st quarter 2004, the quotations of the whole range of Eurobonds in circulation was rising gradually, which can be explained by a series of factors, such as the dynamics of the basic assets (the US T-bills). The latter was determined by statements of the FRS' representatives. They argued that it was not the time yet to raise interest rates in the economy

and the interest rate should remain unchanged, at least, within the next months. The noted increase of Russia's credit rating in forex equivalent by S&P's from "BB" up to BB+" can also be regarded as a positive factor, but it failed to secure a long-lasting effect on quotations. Rather, it caused just a short-term price rise. A favorable macroeconomic situation in the country and the rise in world prices for oil encouraged foreign investors in the market for the Russian Eurobonds. Finally, the political environment also influenced the markets: for instance, while Mr. Putin's re-election for the second term had lowered uncertainty about the RF Government's course for the next 4 years, the Cabinet reshuffle caused just a transient and reserved reaction of the markets.



Source: Investment Agency "Finmarket"

Fig. 19. The 2004 Yields to Maturity of the Russian Eurobonds with the Maturity Dates in 2030, 2018, and 2007

April 2004 saw the change of the upward dynamics of the quotations and the start of a downfall in quotations which lasted through late May. A substantial deterioration of the situation on the market for Eurobonds was fueled by the negative dynamics of the basic assets. In addition, April saw a greater capital outflow from Russia, which could be the foreign investors' reaction to the deterioration of the investment climate in the country against the background of the YUKOS case. The situation with liquidity was also deteriorating-sometimes to the extent there were no transactions on some kinds of bonds. The vectors of prices of the Russian Eurobonds were being opposite until August: while the state of affairs on the markets for minerals had a favorable impact both on the dynamics of the quotations and Russia's budget, there were several factors that were exercising at once a negative pressure on the prices. The prices primarily reacted to a greater volatility of basic assets. Thus, over a single month the yields rates of the US government bonds would reach a two-year peak and consequently fell nonetheless. The prices of the Russian forex-denominated bonds were also affected by the issuance by Germany of credit notes tied to

Russia's debt repayment to Germany. While the notes formally are the German government papers, investors viewed that as an increase of the offer of Russian papers. Finally, the court marshals' decision to sell the core YUKOS's oil-producing asset, Yuganskneftegas, obviously did not contribute to a rise in the quotations.

However, the trend to a rise in quotations of the Russian Eurobonds was prevailing over the next three months. More specifically, in August, the rise in quotations was triggered by the information of Russia's intention to start consultations with the Paris Club on a repayment or exchange of its USD 4.7 bln.-worth debt to the club, and investors appreciated Russia's eagerness to reduce the volume of its foreign debt. The price rise for basic assets also contributed to the one for Russia's forex-denominated bonds. In September, the quotations of the latter somewhat grew against a fall in the yields rates of the US bonds. Once the information appeared that the Moody's investors Service had decided to revise Russia's sovereign rating up to "positive" due to the improvement of the macroeconomic situation in the country, it also generated the consequent price rise in October.

However, the price rise on the market for the Russian Eurobonds discontinued in November. That in part can be explained by soaring yields rates of the US bonds due to A. Greenspan's statement of a possibility for foreign investors to loose their interest in the US papers. It was only thanks to Fitch's raising of Russia's sovereign rating up to the investment level in mid-November that Russia's Eurobonds ceased to fall. In December, they bounced back and forth, because of a simultaneous influence of opposite factors. On the one hand, the dynamics of prices of the US T-bills were favorable for the price rise for Russian bonds. Another favorable news became Moody's raising Gasprom's rating up the investment level. On the other hand, back-tax claims to Megaphon and Vympelkom triggered a downfall in prices, while the results of the auction on Yuganskneftegas did not appear particularly encouraging either.

Overall, the 2004 dynamics of the market for the Russian Eurobonds were fairly moderate and mirrored the presence of political risks investors might face in the country. However, against the background of the raising of the US basic interest rate the yields rates of the basic assets, the US bonds, remained practically unchanged, which also affected the dynamics of the Russian segment of the respective market. Given the current general economic trends in the US economy, one can expect a further increase of the rates. This should undoubtedly have an effect on the yields rates of the US T-bills and, accordingly, other segments of the world market for Eurobonds, including Russia's. The factor capable of neutralization of this particular effect could be just a lowering of political risks in Russia, as well as S&P's raising its credit rating up to the investment level. Furthermore, the RF Government's eagerness to ensure an early debt repayment to the Paris Club and the IMF should help the Russian Eurobonds in 2004, providing the negotiations are a success.

2.4.2. The market for subfederal and municipal debt

Dynamics of market development

Following the results of 2004, the regional consolidated budget was executed with surplus amounted to Rb 31.9 bn, i.e. 1,1% of its expenditure side or 0,19% of GDP. The budgets of the Federation's subjects were executed with a surplus of almost Rb 28.7 bn (1,6% of the expenditure side), the budgets of the municipal formations – with surplus Rb 2.2 bn (0,2% of the expenditure side).

In the preceding two years the regional consolidated budget was executed with deficit. In such a way, in 2003, deficit of the Federation's subjects' budget amounted 2,3% of its expenditure side (3,0% in 2002). Earlier, the municipalities' budgets were also executed with deficit 3,2% – in 2003, and 2,8% – in 2002 (*Table 15*).

Table 15

The territorial budgets' surplus (deficit) to budget expenditures (%) ratio

	Regional consolidated budget	Regional budgets	Municipal budgets
2004	1.1	1.6	0.2
2003	-2.6	-2.3	-3.2
2002	-2.7	-3.0	-2.8

Source: IET calculations based on the data of the Ministry of Finance of the RF.

As of January 1, 2005, the consolidated budget in 43 Russian federation's subjects was executed with surplus. An aggregate volume of the budget surplus reached in those regions Rb 82.7 bn or 6,08% of the value of revenue side of their budgets. The median value of the budget surplus made 1,79% of the expenditure side of the budget.

The highest surplus to consolidated budget revenues level ratio had been achieved in the Evenk Autonomous District (AD) – 47,7%, Tyumen Region – 27,6%, Nenets AD – 17,4%, Lipetsk Region– 13,8%, Khanty-Mansijsk AD – 13,6%, Chukotka AD – 12,8%, and in Vologda Region– 12,2%. Almost half – 48,8% – of aggregate surplus of the regional budget was provided by the two Federation's subjects: Khanty-Mansijsk AD – 29,5% or Rb 24.4 bn, and Tyumen Region – 18,8% or Rb 15.6 bn. According to estimates, the major cause of such considerable surplus of the Federation's subjects, following the results of 2004, became Yukos' unplanned tax revenues, paid by the company in accordance with the legal actions won by the government on the revealed tax arrears of the previous years.

In 2004, in 46 subjects of the RF the consolidated budget, an aggregate volume of which totaled Rb 50.8 bn or 3,45% of the revenue side of their budgets, had been executed with deficit.

The median level of the budget deficit made 2,3% of the relevant budget revenues. The highest deficit to budget revenues ratio observed in Khabarovsk Territory (12,6%) and Novosibirsk Region (10,1%).

About 68% of the aggregate deficit fell on 6 Federation's subjects – Moscow (27,2% or Rb 13.76 bn), the Moscow Region (10,7% or Rb 5.42 bn), Khabarovsk Territory (8,5% or Rb 4.28 bn), the Republic of Tatarstan (7,6% or Rb 3.85 bn), Republic of Sakha (Yakutia) (7,2% or Rb 3.65 bn), Novosibirsk Region (6,9% or Rb 3.5 bn) (*Table 16*).

Table 16

**Execution of consolidated budgets
of the Russian Federation's subjects in 2004 (%)**

	Budget revenues, million rubles	Budget surplus (deficit), million rubles	Surplus (deficit) to revenues ratio	Attracted borrowings to revenues ratio	Net borrowing to revenues ratio	Interest expenditures to revenues ratio	Balances of budgetary accounts to revenues ratio	Net borrowings to surplus (deficit) ratio
Central federal district								
Belgorod Region	20 295.38	1 541.28	7.59	2.38	-1.41	0.76	8.93	-18.59
Bryansk Region	14 236.23	-468.09	-3.29	8.71	3.65	0.69	1.07	-110.94
Vladimir Region	18 234.29	51.07	0.28	0.78	0.02	0.06	4.22	6.56
Voronezh Region	23 850.79	-155.72	-0.65	14.49	0.95	1.33	1.74	-146.08
Ivanovo Region	14 473.23	33.76	0.23	2.56	0.59	0.18	2.79	253.49
Kaluga Region	14 905.97	-510.24	-3.42	4.08	3.20	0.08	2.88	-93.47
Kostroma Region	9 613.40	-369.48	-3.84	13.12	3.14	1.23	1.67	-81.82
Kursk Region	14 068.87	88.51	0.63	3.74	-0.96	0.40	0.61	-153.14
Lipetsk Region	24 908.78	3 438.32	13.80	0.02	-0.02	0.00	20.04	-0.11
Moscow Region	115 863.94	-5 417.58	-4.68	28.59	8.00	2.67	7.49	-171.10
Oryol Region	9 980.82	-28.75	-0.29	0.80	-0.27	0.00	3.28	95.13
Ryazan Region	13 994.32	-107.56	-0.77	2.29	-0.07	0.28	3.09	9.25
Smolensk Region	12 421.39	8 460.00	0.07	3.55	-0.10	0.38	1.29	-148.17
Tambov Region	13 853.19	-276.95	-2.00	2.31	1.54	0.04	0.65	-76.87
Tver Region	18 431.36	78.46	0.43	3.08	0.53	1.28	3.20	125.08
Tula Region	21 482.54	-177.33	-0.83	14.15	0.47	1.31	1.16	-56.94
Yaroslav Region	21 675.18	-1 958.65	-9.04	24.34	6.95	1.71	1.25	-76.92
Moscow	394 450.57	-13 760.93	-3.49	12.38	5.06	1.89	11.15	-145.16
Total	776 740.23	-17 991.41	-2.32	12.89	4.16	1.59	8.24	-179.54
North-Western federal district								
Republic of Karelia	13 843.52	-593.54	-4.29	12.48	1.34	1.05	0.98	-31.34
Komi Republic	30 071.04	-23.42	-0.08	4.77	0.00	1.08	3.80	6.38
Arkhangelsk Region	24 659.77	120.02	0.49	5.13	0.74	0.44	2.38	152.77
Vologda Region	29 515.33	3 604.28	12.21	1.63	-0.52	0.27	15.47	-4.25
Kaliningrad Region	13 957.72	-268.10	-1.93	7.22	1.89	0.34	2.43	-97.95
Leningrad Region	27 310.98	-1 020.72	-3.74	9.94	3.44	0.87	4.99	-92.08
Murmansk Region	20 012.30	447.62	2.24	5.70	-1.05	0.55	3.64	-46.88
Novgorod Region	8 796.88	11.23	0.13	3.47	0.12	0.14	1.95	95.19
Pskov Region	9 463.55	-288.42	-3.05	8.51	3.91	0.46	2.37	-128.31
St. Petersburg	95 778.28	1 251.06	1.31	14.31	-1.88	1.83	4.30	-143.58
Nenets AD	5 319.72	927.63	17.44	1.69	0.56	0.39	20.21	3.23
Total	278 729.0	4 166.76	1.49	8.85	-0.06	1.03	5.18	-4.25
South federal district								
Republic of Adygeya	5 074.44	-110.92	-2.19	4.67	2.10	0.02	1.97	-96.25
Republic of Dagestan	27 289.71	-453.06	-1.66	0.18	-0.09	0.00	0.89	5.56
Republic of Ingooshetia	5 271.25	162.13	3.08	0.28	-0.99	0.00	3.67	-32.07
Kabardino-Balkarian Republic	8 120.07	-48.57	-0.60	21.70	0.08	1.13	0.44	-14.01
Republic of Kalmykia	6 450.29	461.89	7.16	0.47	-2.10	0.19	6.21	-29.29
Karachai-Circassian Republic	6 033.28	-234.66	-3.89	29.60	4.11	0.50	1.20	-105.69
Republic of North Ossetia - Alania	10 566.15	192.31	1.82	0.65	-0.99	0.18	3.64	-54.67
Chechen Republic	25 038.03	428.50	1.71	0.00	-0.26	0.00	2.39	-15.08
Krasnodar Territory	65 149.14	-767.01	-1.18	2.67	0.52	0.19	3.62	-44.38
Stavropol Territory	24 979.69	-120.94	-0.48	2.01	0.82	0.02	4.72	-169.67

RUSSIAN ECONOMY in 2004
trends and outlooks

	Budget revenues, million rubles	Budget surplus (deficit), million rubles	Surplus (deficit) to revenues ratio	Attracted borrowings to revenues ratio	Net borrowing to revenues ratio	Interest expenditures to revenues ratio	Balances of budgetary accounts to revenues ratio	Net borrowings to surplus (deficit) ratio
Astrakhan Region	10 872.39	-431.60	-3.97	9.37	2.56	0.36	1.65	-64.56
Volgograd Region	25 750.46	-1 285.50	-4.99	10.48	3.20	1.20	1.13	-64.03
Rostov Region	49 521.88	709.63	1.43	0.39	-0.51	0.14	4.91	-35.32
Total	270 116.7	-1 497.78	-0.55	3.74	0.51	0.26	3.13	-91.87
Privolzhsky federal district								
Republic of Bashkortostan	58 915.10	369.10	0.63	3.83	1.65	0.35	14.95	263.94
Republic of Marij El	9 335.29	-241.20	-2.58	5.08	1.74	0.40	0.79	-67.26
Republic of Mordovia	23 269.49	1 387.29	5.96	0.71	-3.56	1.04	4.14	-59.72
Republic of Tatarstan	95 824.50	-3 845.82	-4.01	5.03	1.91	0.21	1.07	-47.62
Udmurtian Republic	21 920.93	-537.89	-2.45	5.96	1.95	0.22	5.87	-79.51
Chuvashi Republic	16 680.15	-529.79	-3.18	5.29	2.63	0.61	2.60	-82.70
Kirov Region	19 721.37	-861.96	-4.37	2.57	-1.85	0.16	1.82	42.31
Nizhni Novgorod Region	40 511.90	122.32	0.30	19.29	-0.35	1.80	2.61	-117.15
Orenburg Region	26 785.52	546.25	2.04	1.02	-0.72	0.15	2.86	-35.47
Penza Region	15 902.18	41.15	0.26	3.86	0.28	0.24	2.60	106.59
Perm Region	48 278.43	3 193.72	6.62	1.85	-0.22	0.09	11.01	-3.35
Samara Region	47 110.39	827.07	1.76	7.55	-1.80	0.87	6.86	-102.80
Saratov Region	27 822.35	-591.48	-2.13	7.33	1.80	0.83	0.70	-84.68
Ulyanovsk Region	13 325.82	195.87	1.47	3.12	-1.06	0.38	3.29	-71.79
Komi-Permyak AD	3 557 151.00	38 125.00	1.07	0.97	-0.29	0.14	2.21	-27.32
Total	468 961.4	112.75	0.02	5.56	0.37	0.52	5.21	1 542.95
Ural federal district								
Kurgan Region	13 767.14	-49.93	-0.36	1.66	-0.42	0.32	1.12	115.44
Sverdlovsk Region	60 207.10	912.66	1.52	1.38	-0.72	0.07	2.33	-47.81
Tyumen Region	56 332.16	15 569.77	27.64	0.20	-1.49	0.27	31.09	-5.39
Chelyabinsk Region	55 751.02	5 469.07	9.81	0.04	-0.23	0.01	18.80	-2.31
Khanty-Mansijsk AD	179 227.73	24 407.37	13.62	1.20	0.27	0.29	16.67	1.96
Yamalo- Nenets AD	67 774.40	2 410.28	3.56	2.25	-0.55	0.77	7.46	-15.44
Total	433 060.4	48 719.22	11.25	1.13	-0.31	0.30	14.89	-2.78
Siberian federal district								
Republic of Altai	7 042.15	-22.13	-0.31	4.67	1.09	0.28	5.66	-348.00
Republic of Buryatia	21 367.03	93.27	0.44	14.47	0.57	1.34	1.44	131.33
Republic of Tuva	8 224.78	-26.30	-0.32	1.64	0.38	0.00	0.29	-117.88
Republic of Khakassia	7 694.83	209.87	2.73	1.26	-1.01	0.11	2.90	-37.01
Altai Territory	34 786.68	-513.30	-1.48	5.61	2.06	0.08	1.36	-139.94
Krasnoyarsk Territory	74 452.82	1 064.64	1.43	11.69	1.58	1.10	6.09	110.23
Irkutsk Region	39 130.90	-847.02	-2.16	9.02	1.96	0.51	2.67	-90.73
Kemerovo Region	61 923.98	3 072.48	4.96	0.98	-0.19	0.25	7.66	-3.90
Novosibirsk Region	34 626.65	-3 502.94	-10.12	126.71	15.16	5.38	1.09	-149.87
Omsk Region	35 531.54	2 951.65	8.31	18.90	-0.96	1.09	8.77	-11.53
Tomsk Region	20 980.18	-643.07	-3.07	22.14	2.69	1.56	1.45	-87.71
Chita Region	20 246.43	-290.43	-1.43	1.86	1.21	0.08	1.43	-84.55
Aginsk Buryat AD	4 122.93	471.81	11.44	0.53	0.21	0.00	16.44	1.87
Taimyr (Dolgano-Nenetsk) AD	5 380.82	0.48	0.01	0.00	-0.28	0.00	5.47	-3 099.17
Ust-Ordynski Buryat AD	3 004.32	-38.65	-1.29	0.03	0.03	0.00	2.29	-2.36
Evenk AD	6 630.60	3 164.13	47.72	3.17	-49.54	3.24	1.47	-103.82
Total	385 146.6	5 144.50	1.34	19.29	1.33	1.12	4.41	99.57
Far East federal district								
Republic of Sakha (Yakutia)	59 660.85	-3 646.72	-6.11	11.45	3.19	1.05	1.50	-52.14
Primorie Territory	36 529.10	95.69	0.26	4.02	-0.66	0.25	1.06	-253.59
Khabarovsk Territory	33 908.86	-4 284.14	-12.63	17.41	7.18	1.42	0.84	-56.79

	Budget revenues, million rubles	Budget surplus (deficit), million rubles	Surplus (deficit) to revenues ratio	Attracted borrowings to revenues ratio	Net borrowing to revenues ratio	Interest expenditures to revenues ratio	Balances of budgetary accounts to revenues ratio	Net borrowings to surplus (deficit) ratio
Amur Region	20 756.26	-226.64	-1.09	6.59	1.79	0.50	1.61	-163.65
Kamchatka Region	12 852.93	-501.69	-3.90	9.35	1.79	0.60	0.91	-45.73
Magadan Region	10 180.05	-176.81	-1.74	3.25	1.60	0.05	2.30	-92.08
Sakhalin Region	18 374.88	-405.66	-2.21	7.43	2.07	0.55	1.72	-93.70
Jewish Autonomous Region	4 382.00	70.63	1.61	2.23	0.28	0.08	5.29	17.34
Koryak AD	2 991.12	-144.45	-4.83	11.58	5.16	0.51	1.63	-106.85
Chukotka AD	19 257.91	2 470.97	12.83	0.00	-3.17	0.38	12.34	-24.68
Total	218 894.8	-6 748.83	-3.08	8.64	2.19	0.72	2.39	-71.00
Total federal districts	2 831 649.46	31 905.21	1.13	9.15	1.55	0.90	6.99	137.29

Source: IET's calculations based on the data of the Ministry of Finance of the RF.

Changing the structure of accumulated debt

In 2004, the volume of accumulated debt of the regional consolidated budget increased by Rb 43 684.6 million or by 0,26% GDP. Increase of the debt was due to growth of the domestic debt (i.e. the debt denominated in rubles). The foreign debt of the regional consolidated budgets decreased by Rb 3421.1 million, domestic debt – increased by Rb 47 105.6 million (Table 17).

Table 17

Net borrowings of regional and local budgets (% to GDP)

	1995	1996	1997	Jan.– Aug. 1998	Jan.– Dec. 1998	1999	2000	2001	2002	2003	2004
Borrowings of sub-federal and local government including:											
Repayable loans from the budgets of other level	0.38	0.87	1.43	0.71	0.33	0.15	-0.29	-0.04	0.47	0.37	0.26
Subfederal (municipal) bonds	n.d.	0.16	0.22	0.08	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29
other borrowings	0.31	0.48	0.55	0.58	0.43	0.31	0.01	-0.02	0.19	0.6	
Lessening of budgetary accounts' balances		0.03	-0.18	0.09	0.02	-0.19	-0.30	-0.05	-0.04	-0.18	-0.62
Financing deficit using borrowings and cutting the balances of budgetary accounts	0.38	0.9	1.25	0.8	0.35	-0.04	-0.59	-0.09	0.38	0.19	-0.36

Source: IET's calculations based on the data of the Ministry of Finance of the RF.

The structure of borrowings

The total volume of borrowings of the regional consolidated budget of 2004 amounted to Rb 259 019.9 million, of them the external borrowings – Rb 14 699.0 million. The external loans' recipients were: Moscow – Rb 13 434.0 million, Bashkortostan – Rb 1 262.5 million, and St. Petersburg – Rb 2.5 million.

The total volume of domestic borrowings of the regions and municipalities made up Rb 244 320.9 million. The following borrowers became the largest on the domestic market: Moscow – Rb 35.4 bn, Moscow Region – Rb 33.1 bn, Novosibirsk Region – Rb 18.0 bn, St. Petersburg – Rb 13.7 bn. As compared to 2003, an increase of borrowings in nominal terms reached Rb 26.8 bn or 11,2%, which practically is in accord with the level of inflation.

The regions with clearly defined budget deficit demonstrated the most net borrowings to budget revenues ratio: Novosibirsk Region – 15,2%, Moscow Region – 8,0, Khabarovsk Territory – 7,2, Yaroslavl Region – 7,0, Koryak AD – 5,2, Moscow – 5,1%.

The largest net borrowers became: Moscow – Rb 20.0 bn, Moscow Region – Rb 9.3 bn, Novosibirsk Region – 5.2 bn, Khabarovsk Territory – Rb 2.4 bn, Republic of Sakha (Yakutia) – Rb 1.9 bn, Republic of Tatarstan – Rb 1.8 bn, Yaroslavl Region – Rb 1.5 bn, Krasnoyarsk Territory – Rb 1.2 bn.

To the highest degree the accumulated debt was cut by: Evenk AD – Rb 3.3 bn, St. Petersburg – Rb 1.8 bn, Samara Region – Rb 850 million, Tyumen Region – Rb 839 million, Republic of Mordovia – Rb 829 million.

In the total volume of domestic borrowings of the regional consolidated budget securities issuing accounted for 32,5%, loans from the federal budget – 3,0%, other borrowings (primarily for banking credits) – 64,5%. Special attention deserves continuation of active securitization of the subfederal debt. As compared to previous year, the share of borrowings in regions' securities increased, in 2004, by 7,2 points – from 33,8 to 41,0%, and in borrowings of the municipal administrations – 1,6 times (from 2,5 to 4%). Therefore, for the last 2 years, the level of securitization of the market of domestic municipal borrowings increased 4 times, while the market of regional borrowings – more than 2 times (*Table 18*).

Table 18

The structure of domestic borrowings of the subnational budgets in 2004 (%)

	2004			2003			2002		
	Regional consolidated budget	Regional budget	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Total, million rubles	244 320 927.0	183 003.8	110 466.4	229 789.0	174 852.6	108 436.3	211 135.2	154 077.4	101 206.3
Securities issuance	32.5	41.0	4.0	26.9	33.8	2.5	13.8	18.3	1.0
Budgetary loans	3.0	4.0	46.4	7.9	10.6	48.9	11.9	16.7	43.1
Other borrowings	64.5	55.1	49.6	65.3	55.6	48.6	74.2	65.0	56.0

Source: IET's calculations based on the data of the Ministry of Finance of the RF.

During 2004, the aggregate surplus balances on the accounts of regional and local budgets increased by Rb 103.6 bn – to Rb 198.1 bn, i.e. an increase in real terms was 87,7%. In conditions of continuing economic growth, largely explained, as before, by the external business environment, a wish to increase the budgetary reserves of the territorial government agencies appears to be justified.

Domestic bonded loans

In 2004 the bonded loans had been registered of 24 federation's subjects and 10 municipal formations (as compared to 23 regional and 7 municipal loans in 2003). The total volume of placed bonds made up in 2004 Rb 79,4 bln., in comparison with Rb 67.1 bln in 2003, i.e. increased for a year from 0,46 до 0,47% GDP (*Table 19*).

The low level of interest rates on the market of government papers contributed to placement of bonds: the spread to OFZ bonds of Moscow and St. Petersburg was 0,5–1,5%, other issuers, for example Murmansk and Irkutsk regions, Republic of Karelia, Komi Republic, Chuvash Republic, Republic of Bashkortostan – 2–4% of OFZ level. For a year, the spread of subfederal papers to OFZ decreased 1,5–2 times. Yield to maturity on most of the subfederal papers did not exceed the level of inflation. For the first 10 months of 2004 the volume of the market of subfederal papers had grown even 1,5 times, having increased up to Rb 121.4 bln. The volume of monthly exchange turnover of the subfederal and municipal bonds increased almost 2 times – from Rb 29.7 bln in October 2003 to Rb 59.2 bln in October 2004.

Table 19

Volume of issuance of subfederal and municipal papers (% to GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Issuance	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47
Repayment	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19
Net financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29

Source: IET' calculations based on the data of the Ministry of Finance of the RF.

In 2004, issue prospectuses had been registered in the Ministry of Finance of the RF by: Moscow, St. Petersburg, Chuvash Republic, Volgograd and Tomsk regions, Komi Republic, Leningrad, Irkutsk and Moscow regions, Khabarovsk Territory, Republic of Sakha (Yakutia), the Republic of Marij El, Novosibirsk Region, Yamalo-Nenetsk AD, Yaroslavl Region, Krasnoyarsk Territory, Republic of Bashkortostan, Republic of Karelia, Krasnodar Territory, Lipetsk, Nizhni Novgorod, Voronezh, Kaluga and Bryansk regions, Ekaterinburg, Ufa, Yuzhno-Sakhalinsk, Krasnoyarsk, Novosibirsk, Tomsk, Novocheboksarsk, Barnaul, Perm, Noginsk District of Moscow Region.

The largest issuers of debt securities became: Moscow, which accounted for Rb 32.4 bln. or 40,7% of the volume of total issuance of territories, St. Petersburg – Rb 13.7 bln. or 17,2% of the total issuance, Moscow Region – Rb 9.9 bn or 12,4%, Novosibirsk region – Rb 3.8 bln. or 4,7%. Therefore, the four largest issuers accounted for 75,2% of the total volume of issuance of placed regional and municipal bonds .

Also, large volumes of issuance had been placed by: Krasnoyarsk Territory – Rb 2.2 bln., Republic of Sakha (Yakutia) – Rb 2.2 bn, Yaroslavl region – Rb 2.0 bln., Irkutsk Region– Rb 1.8 bln., Tomsk region – Rb 1.5 bln., Nizhni Novgorod Region– Rb 1.0 bln., Leningrad Region – Rb 1.0 bln., Krasnodar Territory – Rb 1.0 bln., Komi Republic – Rb 0.9 bln., Republic of Bashkortostan – Rb 0.9 bln. (*Table 20*).

Table 20

Placement of subfederal papers in 2004

Federation's subject	Volume of issuance, million rubles.	Issuer's share in the total volume of issuance, %	Volume of issuance to domestic borrowings ratio, %
Central federal district			
Bryansk Region	200.0	0,25	16,13
Voronezh Region	600.09	0,76	17,37
Kaluga Region	300.0	0,38	49,27
Kostroma Region	150.0	0,19	11,89
Moscow Region	9 884.59	12,44	29,84
Yaroslav Region	1 999.12	2,52	37,89
Moscow	32 365,1	40,74	66,25
North-Western federal district			
Republic of Karelia	449. 28	0,57	26,00
Komi Republic	937. 5	1,18	65,33
Leningrad Region	1 000.0	1,26	36,82
St. Petersburg	13 702.75	17,25	99,98
South federal district			
Krasnodar Territory	1 000.0	1,26	57,53
Volgograd Region	769.05	0,97	28,51
Privolzhsky federal district			
Republic of Bashkortostan	927. 14	1,17	41,12
Republic of Marij El	200.0	0,25	42,20
Chuvashi Republic	514.82	0,65	58,33
Nizhni Novgorod Region	1 000.0	1,26	12,80
Perm Region	200.0	0,25	22,42
Komi-Permyak autonomous district	0.68	0,00	1,96
Ural federal district			
Sverdlovsk Region	105.0	0,13	12,64
Khanty-Mansijsk autonomous district	539.1	0,68	24,98
Yamalo- Nenets autonomous district	0.78	0,00	0,05
Siberian federal district			
Altai Territory	197.96	0,25	10,14
Krasnoyarsk Territory	2 230.0	2,81	25,61
Irkutsk Region	1 830.54	2,30	51,86
Novosibirsk Region	3 773. 0	4,75	8,60
Tomsk Region	1 464.42	1,84	31,52
Far East federal district			
Republic of Sakha (Yakutia)	2 195.76	2,76	32,15
Khabarovsk Territory	700.0	0,88	11,86
Sakhalin Region	200.0	0,25	14,65
Total	79 436.7	100,00	30,67

Source: IET' calculations based on the data of the Ministry of Finance of the RF.

By now, the high level of securitization had been demonstrated by the largest issuers – these are Moscow (66%), St. Petersburg (100%), Komi Republic (65%), Chuvash Republic (58%), Krasnodar Territory (57%), Irkutsk Region (52%). At the same time, because of considerable transaction costs, concerned with organization of bonds' issuing, issuance of small loans proved to be too cost based, and the municipalities continued to borrow

from commercial banks. Still, for the largest cities, issuance of papers became more and more attractive, which led, in 2004, to increasing the volume of placed municipal bonds more than 1,5 times in real terms (*Table 21*).

Table 21

**Volumes of net borrowings on the market of domestic subfederal
and municipal papers (million rubles)**

	Regional consoli- dated budget	Regional budgets	Municipal budgets
2004			
Net borrowings	47 880. 30	44 470. 13	3 410. 17
Attraction of funds	79 436. 71	74 995. 96	4 440. 74
Repayment of the principle debt body	31 556. 41	30 525. 84	1 030. 57
2003			
Net borrowings	41 908. 20	40 043. 51	1 864. 69
Attraction of funds	61 712. 63	59 012. 90	2 699. 73
Repayment of the principle debt body	19 804. 44	18 969. 39	835. 05
2002			
Net borrowings	17 696. 53	17 153. 76	542. 77
Funds' attraction	29 141. 78	28 169. 16	972. 62
Repayment of the principle debt body	11 445. 25	11 015. 40	429. 85
2001			
Net borrowings	6 601. 45	6 667. 59	-66. 15
Funds' attraction	15 123. 78	14 226. 93	896. 85
Repayment of the principle debt body	8 522. 34	7 559. 34	962. 99
2000			
Net borrowings	- 1 877. 33	-2 286. 17	408. 85
Funds' attraction	13 042. 22	10 090. 21	2 952. 01
Repayment of the principle debt body	14 919. 55	12 376. 38	2 543. 16

Source: the Ministry of Finance of the RF.

Stabilization of the financial market caused an increase in number of regions and cities, that entered the capital market on a regular basis. Since 1999, annual bond issuance had been made by Moscow, St. Petersburg, Chuvash Republic, Volgograd Region; since 2000, – Tomsk Region and Komi Republic, Ekaterinburg; since 2001, – by Leningrad and Irkutsk regions (*Table 22*).

Table 22

Issuance of subfederal and municipal papers in 1999–2004

Issuer Federation's Subjects	Issuer 1999	Issuer 2000	Issuer 2001	Issuer 2002	Issuer 2003	Issuer 2004
Moscow	*	*	*	*	*	*
St. Petersburg	*	*	*	*	*	*
Chuvash Republic	*	*	*	*	*	*
Volgograd Region	*	*	*	*	*	*
Tomsk Region		*	*	*	*	*
Komi Republic		*	*	*	*	*
Leningrad Region			*	*	*	*
Irkutsk Region			*	*	*	*
Moscow Region				*	*	*
Khabarovsk Territory				*	*	*
Republic of Sakha (Yakutia)				*	*	*
Republic of Marj El		*			*	*
Novosibirsk Region	*				*	*
Yamalo- Nenets AD					*	*
Yaroslav Region					*	*
Krasnoyarsk Territory					*	*

Issuer Federation's Subjects	Issuer 1999	Issuer 2000	Issuer 2001	Issuer 2002	Issuer 2003	Issuer 2004
Republic of Bashkortostan			*	*		*
Republic of Karelia						*
Krasnodar Territory						*
Lipetsk Region						*
Nizhni Novgorod Region						*
Voronezh Region						*
Kaluga Region						*
Bryansk Region						*
Belgorod Region				*	*	
Tver Region				*	*	
Khanty-Mansijsk AD				*	*	
Murmansk Region				*	*	
Kostroma Region				*	*	
Samara Region					*	
Tambov Region					*	
Republic of Mordovia				*		
Sakhalin Region				*		
Kursk Region				*		
Stavropol Territory			*			
Primorie Territory		*				
Kabardino-Balkarian Republic		*				
Municipalities						
Ekaterinburg		*	*	*	*	*
Ufa				*	*	*
Yuzhno-Sakhalinsk					*	*
Krasnoyarsk					*	*
Novosibirsk					*	*
Tomsk					*	*
Novocheboksarsk	*		*			*
Barnaul						*
Perm						*
Noginsk District of Moscow Region						*
Volgograd	*	*	*	*	*	
Nizhni Novgorod				*		
Kostroma	*	*				
Cheboksary	*					
Arkhangelsk	*					
Dzerzhinsky	*					

Source: the Ministry of Finance of the RF.

Creditability of territorial governments

Credit rating

In recent years the high economic growth rates in Russia led to raising of the sovereign credit rating and rating of territorial government agencies.

In so doing, the process of raising the credit rating of the territorial governments to the investment level observed. In November 2004, the first of the Russian regions – the city of Moscow – was awarded by the credit rating agency Fitch a credit rating of the investment level "BBB–" on borrowings in foreign currency. Then, the agency Moody's granted a credit rating of the investment level "Baa3" to Moscow and St. Petersburg. At the beginning of February 2005, the agency Standard&Poor's also raised the credit rating of Moscow to the investment level "BBB–" (*Table 23*).

Table 23

International credit rating of Standard&Poor's

Issuer name	The rating award date (latest update)	In foreign cur- rency/Forecast	In national cur- rency/Forecast
Sovereign credit ratings			
Russian Federation	31.01.2005	“BBB-“/Stable	“BBB”/Stable
Ratings of local and regional administrations			
Balashikha district	10.12.2004	“B-“/Stable	-/-
Bashkortostan	12.03.2004	“BB-“/Stable	-/-
Vologda Region	16.02.2004	“B”/Stable	-/-
Kaluga Region	16.02.2004	“B+”/Stable	-/-
Krasnodar Territory	14.09.2004	“B+”/Stable	“B+”/Stable
Irkutsk Region	22.11.2004	“B”/Stable	-/-
Klin district	28.09.2004	“B-“/Stable	-/-
Leningrad Region	25.10.2004	“B+”/Stable	-/-
Moscow	01.02.2005	“BBB-“/Stable	-/-
Moscow Region	29.09.2004	“BB-“/Stable	-/-
Samara Region	12.03.2004	“BB-“/Stable	-/-
St. Petersburg	01.10.2004	“BB+”/Stable	“BB+”/Stable
Sverdlovsk Region	29.12.2004	“B+”/Stable	“B+”/Stable
Stavropol Territory	23.06.2004	“B”/Stable	“B”/Stable
Surgut	09.12.2004	“B”/Positive	“B”/Positive
Khanty-Mansijsk autonomous district	13.08.2004	“BB-“/Stable	-/-
Tatarstan	08.09.2004	“B-“/Stable	-/-
Ufa	14.04.2004	“B”/Stable	-/-
Yamalo- Nenets autonomous district	21.10.2004	“B+”/Stable	-/-

Source: Standard&Poor's.

Problems of outstanding debt restructuring

Despite raising the credit ratings of a number of the Federation's subjects, up until now the issues of outstanding debt restructuring have not been solved. According to the data of the Ministry of Finance of Russia, the volume of outstanding debt increased since November 2003 to October 2004 by more than Rb 8.7 bln., in nominal terms – from Rb 20.3 to Rb 29.0 bln., which constituted 1,02% of the revenue side of regional consolidated budget or 0,17% of GDP.

The outstanding bonded debt is most considerable in the following regions: Chukotka AD - Rb 6.1 bn or 31,9% of the revenue side of the budget, Oryol Region – Rb 2.8 bln. or 28,1% of the revenue side of the budget, Orenburg Region – Rb 2.5 bln. or 9,3% of the revenue side of the budget, in Republic of Tuva – Rb 0.7 bln. or 8,1% of the revenue side of the budget (*Table 24*).

Table 24

Non-restructured outstanding bonded debt of the Federation's subjects

	The volume of outstanding debt (thousand rubles)*	Outstanding debt to budget revenues ratio, %**
Central Federal district		
Belgorod Region	106 063.5	0,5
Vladimir Region	58 711.8	0,3
Kostroma Region	326 928.0	3,4
Kursk Region	109 830.0	0,8
Moscow	500 000.0	0,1
Moscow Region	113 693.6	0,1
Oryol Region	2 805 785.6	28,1
Ryazan Region	1 233.1	0,0
Smolensk Region	209 370.3	1,7
Tver Region	412 252.2	2,2
Yaroslav Region	643 068.3	3,0
North-Western federal district		
Republic of Karelia	12 680.0	0,1
Arkhangelsk Region	62 776.0	0,3
Kaliningrad Region	13 027.2	0,1
Leningrad Region	709.0	0,0
Novgorod Region	23 821.5	0,3
Pskov Region	389 164.7	4,1
South federal district		
Volgograd Region	33 736.7	0,1
Kabardino-Balkarian Republic	160 250.0	2,0
Krasnodar Territory	455 898.2	0,7
Republic of Adygeya	43 244.0	0,9
Republic of Kalmykia	48 920.0	0,8
Republic of North Ossetia-Alania	599 750.2	5,7
Stavropol Territory	984 105.7	3,9
Privolzhsky federal district		
Kirov Region	80 293.0	0,4
Nizhni Novgorod Region	617 203.3	1,5
Orenburg Region	2 502 191.3	9,3
Penza Region	509 120.7	3,2
Perm Region	659.6	0,0
Republic of Bashkortostan	106 791.5	0,2
Republic of Mordovia	468 091.0	2,0
Republic of Tatarstan	194 525.0	0,2
Samara Region	285 576.8	0,6
Udmurtian Republic	539 529.6	2,5
Ulyanovsk Region	118 727.9	0,9
Ural federal district		
Kurgan Region	103 343.0	0,8
Sverdlovsk Region	1 855.5	0,0
Tyumen Region	816 354.0	1,4
Chelyabinsk Region	23 902.7	0,0
Siberian federal district		

	The volume of outstanding debt (thousand rubles)*	Outstanding debt to budget revenues ratio, %**
Altai Territory	249 415.7	0,7
Irkutsk Region	20 137.0	0,1
Krasnoyarsk Territory	935 563.4	1,3
Novosibirsk Region	325 298.9	0,9
Omsk Region	941 195.1	2,6
Republic of Tuva	662 284.3	8,1
Republic of Khakassia	2 444.7	0,0
Taimyr (Dolgano-Nenetsk) autonomous district	26 229.0	0,5
Tomsk Region	500 414.0	2,4
Ust-Ordyn Buryat Autonomous District	65 702.0	2,2
Far East federal district		
Kamchatka Region	937 795.9	7,3
Magadan Region	20 450.0	0,2
Primorie Territory	424 594.0	1,2
Republic of Sakha (Yakutia)	2 121 595.9	3,6
Khabarovsk Territory	6 250.5	0,0
Chukotka Autonomous District	6 147 020.7	31,9
Total	28 964 081.8	1,02

*According to the data of October 1, 2004.

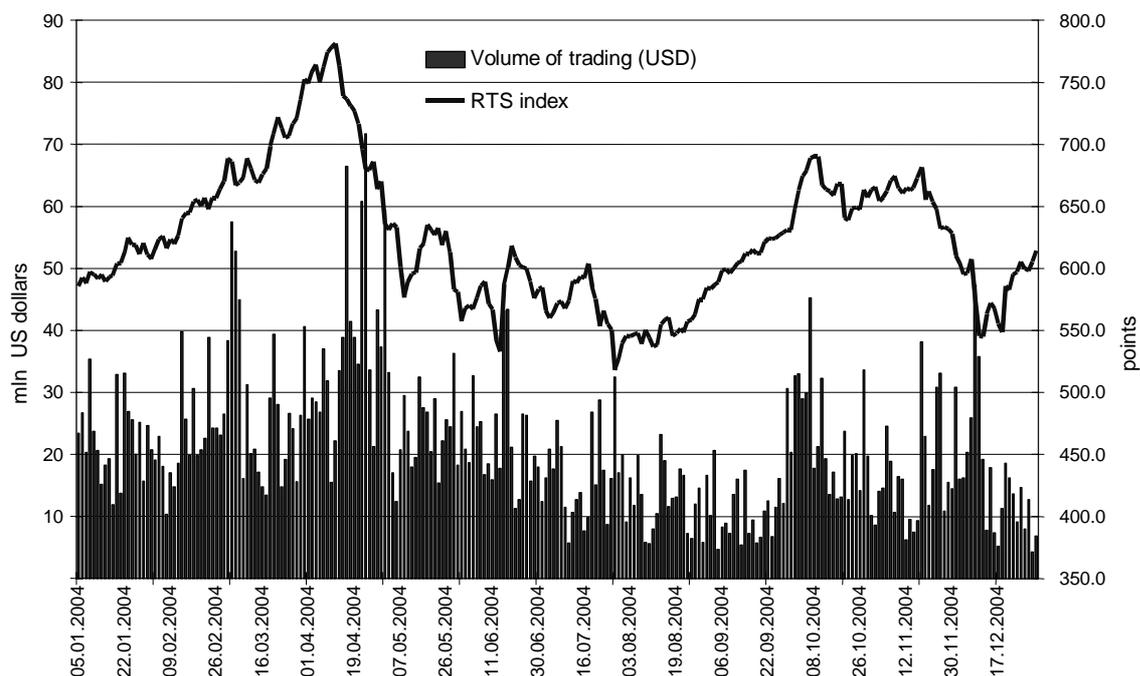
**The outstanding debt, as of October 1, 2004, to the 2004 regional (non-consolidated) budget revenues ratio.

Source: IET' calculations based on the data of the Ministry of Finance of the RF.

2.4.3. Stock Market

In 2004, Russian stock market demonstrated more moderate growth rates than in the prior years (*Fig. 20*), with stock indices sometimes falling down quite drastically. The reason for such downfalls were growing political risks associated with the attack against YUKOS. Backtax claims for 2001–2003, arrests of the company's bank accounts and assets, accusation and detainment of a number of its senior managers and ultimately the sale of its main oil-producing assets, Yuganskneftegas, – all that triggered sales along the whole range of Russian blue chips and resulted in the fall of the stock indices. The “crisis of confidence” burst out in the banking sector in June through July 2004 also battered the dynamics of the national financial markets and particularly the stock market.

Given the above, however, a favorable macroeconomic situation against the background of extremely high world prices for oil and oil products saved the stock market from a drastic fall and sometimes contributed to a notable rise in quotations. In addition, the dynamics of the market were encouraged by the September 2004 auction on the sale of a part of the government stake in LUKOIL, as well as the granting to Russia of investment rating by Fitch.



Source: the RTS Exchange

Fig. 20. The Dynamics of the RTS Stock Index and Volume of Trading in 2004

In 2004, the Russian RTS stock index grew by 46.7 points, from 567.4 up to 614.11 points, or by 8.23%. These results appears fairly moderate vs. those of 2003, when the RTS index grew by 206.46 points (+57.22%) in absolute terms. As to investors' activity, it proved to be lower in 2004 vs. 2003. More specifically, the 2004 turnover on the classical stock market in RTS roughly accounted for USD 5.7 bln., which is a 7% down vs. 2003 (6.1 bln.). Plus, 2004 saw 48.84 Thos. deals stricken vis-avis 56.269 Thos. reported in 2003, which also evidences a lower activity than in 2003. The average daily turnover of trading sessions on the stock included in the computation of the RTS index in the trading system in 2004 made up USD 21.15 mln., thus a 11.9% down vs. 2003 (USD 24.0 mln.).

The dynamics of the market were different over the year. Between January through April the market was dominated by the upward trend and the RTS index climbed up by 195.47 points – from 586.08 up to 781.55 (+33.35%). Hence, the new historic maximum registered on April 12, 2004. The rise in the RTS index was accompanied by a notable growth in the volume of trades. Given that between January to February the monthly volume of trades with the stock used to compute the RTS index roughly accounted for USD 430 mln., in March and April it grew up to USD 617 and 830 mln., respectively. At this juncture it should be noted that it was in April 2004 when the record-breaking volume of daily trades was registered: namely, on 22 April, the respective amount was USD 71.67 mln. The main reason for the positive dynamics of the stock market was an extremely high level of liquidity in the banking sector, which was growing steadily over the 1st quarter. That helped investors accumulate free capital and, at least, in part fueled their demand for stock. The market was further encouraged by presidential elections outcome, when having perceived Mr. Putin's victory as an evidence of a future political and economic stability, non-residents began to show a greater interest in the national stock market.

The fanfares subsided in mid-April, however. The fall in the market started after the arrest of YUKOS' assets and the consequent S&P's decision to decrease the company's rating. The information that the government was considering the possibility of acquisition of the generating companies' stock not only in exchange for RAO UES Russia's stock, but also for cash contributed to the sharp turn of the upward trend as well. As a result, by 28 July the RTS index slid to its 2004 minimum value (518.15 points), minus 33.7% (263.4 points) vs. its peak value of 12 April. Between May through July the trading volume was declining affected by the "summer idleness" factor: given that between May to June the volume of trades on the stock used to compute the RTS index remained roughly at the 2004 average level (USD 419 and 482 mln., respectively), in July it slid to some 368 mln.

Notably, the volatility of the stock market was growing between May through July. While in May it was explained by the deterioration of the cash liquidity in the banking sector that had been supporting the market over the first four months of the year. June was full of news associated with YUKOS, and any input often resulted in considerable fluctuations of quotations of both YUKOS's and even the most liquid papers. For instance, in June, Mr. Putin made a statement that the government was not keen to see such a company as YUKOS go bankrupt. The statement triggered an avalanche-like rise in demand for all blue chips and caused a local upward adjustment of the market as a whole. However, the nervousness present in the banking sector in July prevented the positive dynamics and shortly afterwards caused the restoration of the overall negative trend on the market. In July, the domestic market displayed an extremely negative reaction to the statement issued by representatives of the RF Ministry of Justice on a possibility to sell Yuganskneftegas to cover the company's tax arrears.

The next stage of the dynamics of the 2004 national stock market was formed by the rise in quotations between early August through mid-October, with the RTS index growing by 172.37 points, or at 33,27% vs. its value of 28 July. The growth was taking place under rather a low investor activity. More specifically, in August and September the volume of trades on the papers that are included in the listing to compute the RTS index accounted for USD 277 and 262, respectively, which is roughly 1.6–1.7 times down vis-a-vis the 2004 average monthly value (some USD 442 mln.). However, in October, after the holiday season was over, the investor activity was back to the normal level and the trading volume in RTS on the stock used for computation of its index accounted for USD 470 mln.

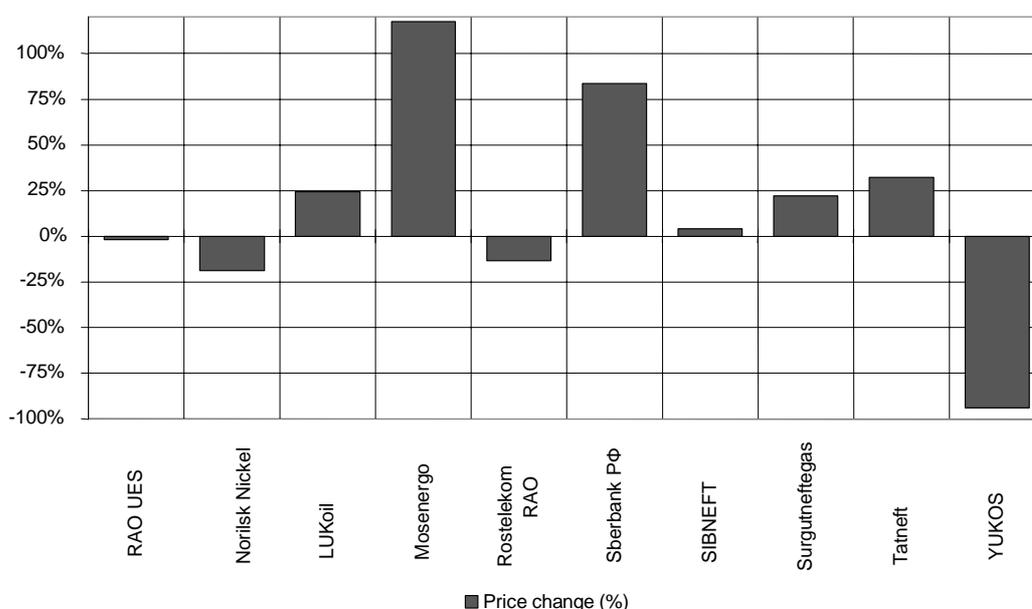
In that period, the stock prices found themselves under the impact of a whole range of favorable and unfavorable factors. While a substantial price rise for oil was notably backing up the quotations of the national oil companies' stock in August and the subsequent months, September in turn proved to be full of favorable corporate news: the process of making key decisions in the electricity reform area was re-galvanized, which generated a notable price rise of the energy companies' papers, primarily those of RAO UES Russia and OAO Moseenergo; the auction on the sale of a government package in LUKOIL became a success, with victorious ConocoPhillips announcing its readiness to increase its share in the company up to 20%. Against such a background, the YUKOS case began to exert a far lesser influence on the market- not because investors grew "immune" to negative news, but the company's stock lost a great deal of weight in the stock market index to stir it up. The only short-term negative effect on the stock market in September was caused by the information of some MPs' appeal to the General Attorney's office about the necessity to investigate into "gray" schemes non-residents use to purchase the company's papers.

The announcement issued by the RF Ministry of Justice on a USD 10.4 bln.-worth appraisal of Yuganskneftegas, which proved to fall far below the market expectations,

formed a signal to the break of the upward trend and the start of the stage of consolidation. The market dynamics were moderate until mid-November, while the RTS index was fluctuating between 640 to 670 points and investors' activity was at a level slightly below the average one. Thus, the monthly volume of trades on the stock that form the listing to compute the RTS index amounted roughly to USD 350 mln.

During the last one and a half months of 2004 the stock market saw a downfall in prices for traded papers, followed by a slight adjustment. More specifically, between 18 November through 10 December 2004, the RTS index fell by 136.35 points – from 681.87 down to 545.52 points, or roughly by 20%. After some restoration of earlier lost positions, the pretext for a regular fall was formed by the statement of the RF Ministry of Justice on setting 19 December as the date of the auction on the sale of Yuganskneftegas. Plus, the tax authorities produced new claims to the company worth USD 9 bln. in backtaxes. Since that moment YUKOS' aggregate tax debts made up USD 14 bln. Furthermore, the fall of the market accelerated following the government's decision to postpone the date of the discussion of the electricity reform and take the issue of privatization of generating companies away from the agenda, which de-facto evidenced the government was not ready to sell generating capacities. Interestingly, the fall was taking place against a sufficient investor activity: the volume of trades over the period in question (18 November– 10 December 2004) accounted for some USD 406 mln., which was slightly lower than the average monthly index.

During the last three weeks in December (11–31 December) the RTS index grew by 68.59 points – up to 614.11 points. Some fall of the index was noted immediately in the wake of the auction on Yuganskneftegas formally won by the obscure Baikalfinansgroup. The uncertainty vanished by the end of that week, nonetheless, when it became known that Rosneft in turn had taken over the dark horse. In the aftermath of the scheme the investor activity fell notably, and the 2004 trading sessions finished against the background of a slight adjustment which enabled the RTS index to end the year in a positive area.



Source: the RTS Exchange

Fig.21. The Dynamics of Quotations of Blue Chips by Results of 2004

By contrast to 2003, when all the blue chips enjoyed a notable rise in quotations, overall 2004 became a year of a relatively stable quotations (*Fig. 21*). It was investment in OAO Mosenergo stock that proved to be most profitable in 2004, with the rate of return of 117.52 (114.79 in 2003), followed by OAO Sberbank of Russia – 83.46% (37.43%), while the stock of OAO Tatneft, OAO LUKOIL and OAO Surgutnetegas lagging far behind them – 32.31% (44.2), 24.39% (49.07%) and 21.95% (81.4%), respectively. At the bottom of the positive area was OAO Sibneft whose stock quotations grew by meager 4.11% (vs. 28.33 in 2003). RAO UES Russia demonstrated the least rate of fall in quotations in 2004 – 1.72% (+112.36% in 2003), followed by OAO Rostelecom and OAO Norilsk Nickel –13.27% (+66.67%) and –18.67% (+ 220.38%). As far as the downfall in stock quotations is concerned, the unquestionable leader became the disgraced YUKOS whose stock lost 93.82% (+14.89% in 2003), which turned once the most attractive Russian blue chip into a clear loser.

As concerns companies of the “second echelon”, the maximum increment in their 2004 stock quotations was demonstrated by OAO Verkhnesaldinsly Metallurgicheskoye Obyedineniye (336.99%), Zhiguly Power Plant (250.0%) and Zeyskaya Power Plant (225.93%), while the market was treating these papers with caution anyway. There were less than 50 transactions involving energy companies (except for the leader), while 580 deals were stricken with the OAO Verkhnesaldinsly Metallurgicheskoye Obyedineniye papers. It should be noted, however, out of the top 10 companies by rise in stock quotations 5 ones represent the electricity sector.

RAO UES Russia’ stock once again kept their leading position in terms of the volume of turnover at RTS. By the 2004 results, their share accounted roughly for 25.86% vs. 30.23% in 2003. LUKOIL’s share grew from 17.87% in 2003 up to 21.2% in 2004, followed by Norilsk Nickel (10.55% vs. 4.74% in 2003) and Surgutneftegas (6.14% vs. 10.23% in 2003). So, the overall proportion of transactions at RTS involving the noted five issuers’ stock accounted for 72.44% vs. 77.35% in 2003.

As of December 31, 2004, the top five companies by the volume of capitalization comprised: Surgutnetegas worth USD 26.65 bln. (vs. 20.76 bln. in 2003), LUKOIL –26.01 bln. (19.77 bln.), Sibneft– 14.22 bln. (13.5 bln.), Norilsk Nickel –11.87 bln. (13.94 bln.), RAO UES Russia – 11.7 bln. (11.45 bln.). So, the 2004 list of leading companies somewhat changed vs. 2003. Thus, Surgutneftegas held the 2nd position in the 2003 list after YUKOS. It important to note that three out of five leaders in terms of capitalization represent the oil and gas sector³³, while in 2003 there were four of them. Such a stable position of mineral companies by capitalization was determined by a favorable situation on mineral markets in 2004. Plus, after holding the 6th position in 2003, RAO UES Russia entered the noted top five list, which can be explained by a successful promotion of the electricity sector reform, which encouraged investor demand for the company’s stock. As concerns companies of the non-mineral sector, it is Sberbank of Russia that likewise in 2003 once again had the greatest capitalization in 2004: as of end of the year it reached USD 9.33 bln. (vs. 4.99 bln. in 2003).

The Market for Forward Contracts

The market for forward contracts, *alias* FORTS aged 3.5 years in December 2004. The turnover on the market has been growing substantially from year to year and 2004 did not make an exception. According to the annual results, in 2004 the aggregate turnover of trading with futures and options accounted for a. Rb. 336.37 bln. vs. 214 bln. reported in 2003. In other words over 2004 alone FORTS grew practically 1.5 times. The participants in

³³ The capitalization of RAO Gasprom is not considered in the present review, as there are no official data on the company.

the market concluded a. 1.5 mln. deals, which made up a. 41.5 mln. contracts (vs. 901,000 deals and 34 mln. contracts in 2003). Thus, the above figures evidence a notable rise in investor activity in this particular sector of the stock market. The aggregate volume of open positions by standard contracts as of the end of the period in question (31 December) reached Rb. 8 bln., 992,000 contracts (2.335 bln. 339,000 contracts) and grew 3.5 times in Rb.– and 2.9 times in contract equivalent.

As in 2003, futures in 2004 likewise predominated over the segment of forward contracts. Their proportion in the overall volume of trades accounted for 91.95% (94.4% in 2003), or Rb. 309.3 bln. (201.9 bln. in 2003), while the share of options made up just Rb. 27.06 bln. (12.1 bln. In 2003), which evidences some rise in the latter share, albeit an insignificant one. In 2004, it still was the forward contracts on quotations of RAO UES Russia stock that formed the most attractive instrument to investors. Despite that, their proportion in the overall volume of trades fell from 66% in 2003 to 54% in 2004 and made up Rb. 182 bln. The forward contracts on Gasporm stock rose from the 3rd line in 2003 to the 2nd one in 2004, with their respective share accounting for 19.64% (Rb. 66 bln.) vs. 7% in 2003. The share of transactions with LUKOIL futures in 2004 made up 12.8% (Rb. 43 bln.) vs. 12.9% in 2003. The year 2004 saw two new contracts on the market: namely, an option for a forward contract on the RAO Rostelecom stock quotations and a forward contract on OAO Norilsk Nickel stock quotations. Hence, at present participants in FORTS enjoy the possibility to conduct operations by 8 forward and 4 option contracts.

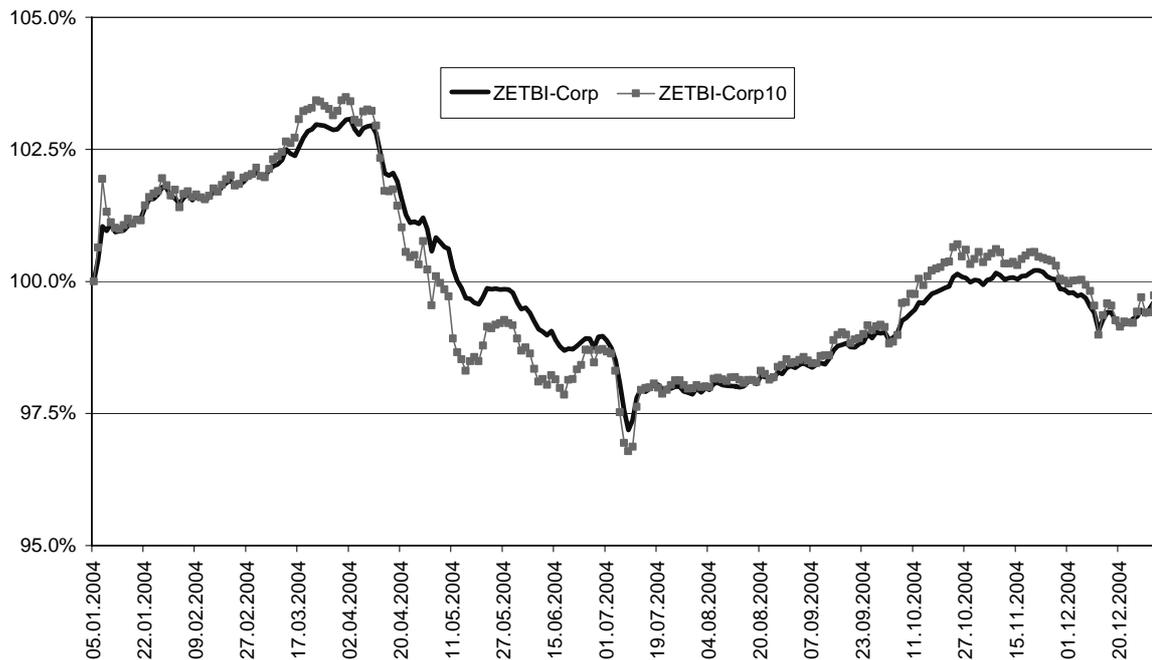
The Market for Corporate Bonds

The dynamics of the market for corporate bonds in general followed the situation in the stock market, except for by contrast to the latter, its state of affairs had somewhat deteriorated by the end of the year. This is evidenced, in particular, by the dynamics of corporate bonds indices that Bank Zenit computes basing on market quotations of bonds traded at MICEX³⁴. Thus, by the 2004 results, ZETBI-Corp slid by 0.42 points (-0.38%) from 111.11 down to 110.69 points, while ZETBI-Corp10 computed on the basis of quotations of the most liquid corporate bonds fell by 0.31 p. (-0.27.%- from 115.8 to 115.49 p.

As noted above, the market for corporate bonds passed through several periods of up- and downward trends alternating with each other, which, however, in general coincide with the respective periods noted on the stock market. However, the volatility of the market for corporate bonds was notably smaller than that of the stock market (*Fig. 22*).

In the 1st quarter 2004, the market for corporate bonds saw a notable rise in quotations against the background of the growing investor activity. The volume of trade with corporate bonds at MICEX in January, February and March was Rb. 39.7 bln., 55.32 bln. and 60.5 bln., respectively. Such a favorable situation was determined primarily by an excessive liquidity in the national banking sector and some appreciation of Rb. against USD. The dynamics of yields rates of the US T-bills also contributed to the price rise of corporate bonds. Interestingly, while in January and March the respective demand was concentrated mostly on the secondary market which had a direct effect on quotations, in February prices of bonds were rising against the background formed by a considerable primary offer. Additional growth factors in March became an extremely favorable state of affairs on mineral markets and Mr. Putin's re-election.

³⁴ Bank Zenit has computed its ZETBI-Corp and ZETBI-Corp 10 indices since January 3, 2002.



Source: Bank Zenit

Fig. 22. The Dynamics of Price Indices of Corporate Bonds in 2004
(January 5, 2004 = 100%)

The 2nd quarter became the period of the turn of the upward trend on the market in question. Quotations were falling at a rather high pace, while the periods of a positive adjustment were short and investor activity fluctuated considerably. Given that in April the turnover of the trades of the MICEX section of corporate bonds made up a Rb. 68.8 bln., in May and June it was 35.5 bln. and 48.8 bln., respectively. The price downfall was determined in part by deterioration of the external environment, particularly, the rise in the US T-bills. There also were some domestic causes, such as some depreciation of Rb. and a number of fairly large placements conducted in April and May. But it was an extremely unfavorable situation with liquidity in the banking sector that had a critical effect on the dynamics of quotations. On the one hand, the tide of crisis manifestations on the interbank credit market compelled numerous banks of the 2nd–3rd echelon to sell bonds to complete their liquidity, which put a pressure on prices. On the other hand, having an excessive liquidity due to the reduction in limits on the interbank credit market, large banks were buying the first-echelon banks' bonds, thus supporting prices. Notwithstanding this, by late June-early July the sellers had intensified their pressure on the market for corporate bonds across yet a greater assortment of issues. That was fueled by rumors of Guta-Bank's problems and the private clients' raid on Alfa-Bank. Consequently, in mid-summer the bonds quotations demonstrated repetitious ups and downs against the background of a downward trend. The unfavorable situation on the market restricted possibilities for issuers to borrow capital under acceptable terms, which is why many of them decided to postpone placements of their bonds.

July saw a record-breaking downturn in quotations. Thus, the corporate bonds index Zenit computes basing on the MICEX quotations made up 107.9 p. on 8 July, while the in-

dex of the 10 most liquid bonds sank to 112.08 p. Thus, given a general improvement of the situation in the banking system, the market basically stabilized in early July, with the turnover of trades on corporate bonds accounting for Rb. 49.12 bln. The situation on the world market also remained stable, with the yields rates of the US T-bills somewhat lowering. However, in Russia, the quotations found themselves under a relatively greater impact on the part of domestic factors. More specifically, because of the private depositors' agitation, the banks had to maintain a sufficient volume of liquidity, which compelled them to sell assets and particularly the Russian corporations' bonds. More fuel to the fire was added by S&P's statement regarding vague prospects for raising Russia's credit rating because of political risks associated with the YUKOS case, problems in the banking sphere and deceleration of the electricity sector reform. The key event of the month became the information of a possible sale of Yuganskneftegas. That generated vigorous sales in all the segments of the Russian financial market, including the one for corporate bonds, which resulted in a notable downfall in quotations.

Between August through October the market for corporate bonds was undergoing the stage of a gradual restoration of quotations. In August, the activity on the market was low, due to the holiday season. External factors were remaining favorable to the bonds market, including Russia's, while a stable situation with the banking liquidity against the summer lull helped quotations stabilized at earlier attained levels. However, in the second half of the month, the market reacted to the statement of the government of the city of Moscow on its willingness to place two new issues by sales of these papers. That could be determined by the investors' eagerness to create a favorable environment prior to the trades. But, as the placements outcome had failed expectations of most investors, that resulted in fixing profits on the market. In early September, the market was still after the 'Moscow' auctions, but in mid-September investors were keen to buy the first-echelon papers. That was steered by the data on inflation that evidenced that CBR would have to cope with the "Mission Impossible" of simultaneously holding inflation within 10% and have Rb. appreciate by not more than 7%. Some investors might sense a slight rise in the USD/Rb. exchange rate as a signal that the Bank of Russia had made its choice in favor of inflation and decided not to appreciate USD. That is why stags began to close their positions on the forex market and switch to long papers. But the Central Bank kept on maintaining the USD exchange rate at the level of 29 Rb., which chilled investors' optimism and resulted in a price adjustment in the market. October 2004 saw the investor activity on the market for corporate and regional bonds being on a record-breaking level, which helped the quotations of the most liquid issues to finish the month in the positive area. The turnover of the market for corporate bonds made up a Rb. 72 bln. The positive dynamics of the market were also inspired by Moody's decision to raise Vneshtorgbank's and Sberbank's ratings at 1 point above the country's.

Rather a long of growth was followed by the adjustment phase in November. Given no clarity in regard to the CBR's policy priorities on the forex market, the inflation and exchange rate factors exerted far weaker influence on the dynamics of quotations, thus being replaced by the external state of affairs and particularly the negative dynamics of the basic assets. After the November drop, in December investors were trying to restore their activity, albeit quotations were falling across the most liquid issues. Once a substantial volume of primary offer had attracted a considerable part of liquidity, that helped bears operating on the secondary market. Then the information on backtax claims to Vympelkom triggered the avalanche of sales, especially in the telecom sector. Notwithstanding that, the situation on the primary market was a bit better, which was evidenced by a successful

placement of the Russian Railroads' bonds against the background of a high level of liquidity in the banking sector.

The issuers' activity on the primary market differed substantially from month to month. Thus, the peak volume of placements of corporate and regional bonds on the primary market was registered in April and accounted for a. Rb. 27.93 bln., while the minimum volume was noted in May and it accounted for Rb. 4.81 bln. The aggregate volume of primary placements of corporate bonds over the whole 2004 roughly made up Rb. 194.87 bln. vs. 84 bln. reported in 2003.

The Factors of the Dynamics of the Russian Stock Market

The 2004 dynamics of the national stock market were determined a whole range of factors that can be conditionally classified into the following groups:

- Domestic political situation;
- Relations with international financial organizations;
- Situation on the international financial markets;
- World prices for minerals (oil, particularly).

Each group was exercising an ambiguous influence on the dynamics of different segments of the domestic financial market. That is why we are going to analyze their influence individually and in a greater detail, while the last group will be considered below, in the respective section of the present review.

Domestic political situation. The year 2004 has become the period of the growing pressure on the national business community, which logically was accompanied with growing political risks in the domestic financial market. While investors viewed Mr. Putin's re-election as a warrant of the continuation of the political course, it became clear that the government was keen to increase its intervention in the private sector.

The most obvious evidence became the systematic attack on YUKOS. Thus, in April 2004, the court of law ruled to arrest the company's assets. In the aftermath of that S7P's decreased the company's long-term rating. In May, the Moscow City Arbitration Court ruled to exact from YUKOS over Rb. 99 bln. in backtaxes, penalties and fines for 2000. In July, the Ministry of Taxes and Levies produced new backtax claims for 2001. Plus, at the end of that month the market received information of a possible sale of YUKOS's pearl, Yuganskneftegas, to repay the company's tax debts. In September, the RF Ministry of Justice informed of a USD 10.4 bln.-worth appraisal of Yuganskneftegas, which proved to fall far below the market expectations and the appraisal by Drezdner Kleinwort. Furthermore, there shortly appeared information of a probability of a sale of a 77% stake of Yuganskneftegas with a 60% discount. The pressure on the company intensified by the end of the year – in November, USD 9 bln. – worth backtax claims were produced which increased the aggregate amount of backtax claims up to USD 14 bln., i.e greater than the company's overall capitalization as of the date. In December, the investors' attention focused on results of the auction on Yuganskneftegas. As noted above, the formal buyer of the company became previously unknown Baikalfinansgroup, and the uncertainty around the auction vanished after it became known that the winner in turn had been acquired by Rosneft. An additional rise in political risks was caused by information of backtax claims to Vypelcom in December. By contrast with YUKOS, Vypelcom was established after the period of the "dubious" privatization deals and has been one of the most transparent companies in the country.

Overall, 2004 saw the rise in political risks and the authorities' pressure on the private sector. Despite an extremely favorable state of affairs on the world mineral markets, it is

because of the political risks that the Russian stock market ultimately demonstrated practically zero dynamics.

Relations with International Financial Organizations. Russia's relations with international financial organizations were quite successful over the year in question. Russia was fulfilling its debt obligations in full and according to the earlier set schedule. In addition, in September 2004, there appeared information of Russia's intention to start consultations with the Paris Club on an early repayment or exchange of its USD 4.7 bln.-worth debt.

In late January, S&P raised Russia's credit rating by its obligations denominated in foreign exchange from "BB" up to "BB+" and those in Rb. equivalent from 'BB+' up to "BBB-". In October, because of the improvement of the macroeconomic situation in the country, Moody's decided to change its forecast of Russia's credit rating for 'positive'. But the major event of 2004 in this respect became the increase of Russia's long-term credit rating in forex and Rb. equivalent by Fitch from 'BB+' up to the investment level "BBB-"; plus, the country's short-term rating was raised, too. The agency representatives stated that it became possible due to the country's considerable progress on the macroeconomic front against high oil prices and a sound tax policy. They believed those factors considered to help the country lower the volume of its public and external debt, as well as substantially complete its foreign reserves and stabilization fund. All that, argued Fitch experts, substantially increased the RF Government's capability to service its debts even in the event of a serious crisis.

Situation on the International Financial Markets. Last year saw the state of affairs on the world stock markets improve insignificantly. For instance, by results of 2004, Dow Jones and NASDAQ Composite grew by 373.16 and 168.76 p., or by 3.58 and 8.41%, respectively vs. the beginning of the year (*Fig.23*). The fact that the volatility of the US stock market was considerably lower than that of the Russian stock market is worth a special attention. The main factors affecting the dynamics of the 2004 market were high oil prices that constrained economic growth in the US and encouraged inflation processes. The danger of the latter compelled the federal administration to revise their policy priorities in the monetary and credit area, which resulted in the repeated raising of the basic interest rate. But that fact did not seriously batter the US stock market, for the rate was raised gradually and market expectations, as a rule, coincided with the Federal Reserve's decisions. So, the effect from raising the rate found itself already mirrored, at least, in part, in prices prior to the respective announcement. The situation in the Middle East and particularly terrorist attacks in Iraq were the investors' headache in 2004. Finally, the US 2004 presidential race outcome gave investors clear evidence that the new Administration would pursue the same political course.

In January, extremely favorable corporate news became yeast for the dynamics of the US stock market – most corporations' performance information overran analysts' expectations, while macroeconomic statistics was basically positive. Since February, however, the quotations began their gradual slide, particularly under effect of the macroeconomic statistics, including unfavorable data on the state of the US labor market. But as most corporate reports proved to be better than expected, there was no drastic fall in quotations.

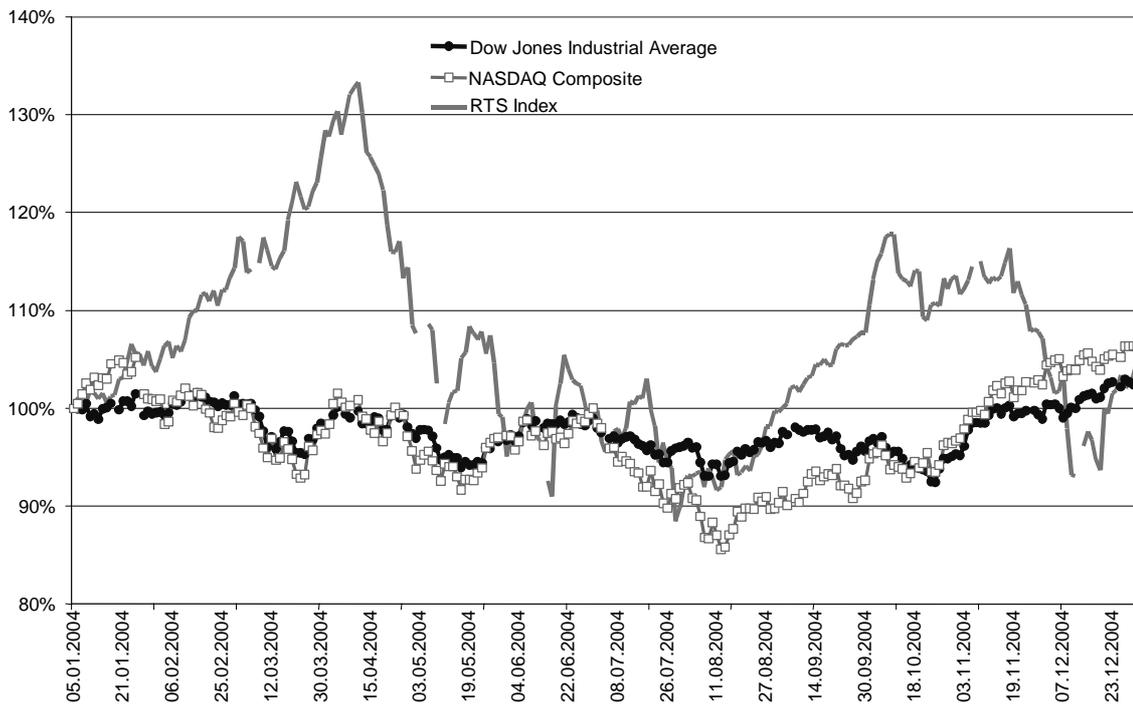


Fig. 23. Dynamics of Dow Jones and NASDAQ in 2004
(December 31, 2003=100%)

The market downturn further intensified in March, because of the deceleration of the US economy, unfavorable data on the labor market, world price rise for oil, and drop in Mr. Bush's popularity. Even the decision made by the omnipotent FRS Committee for Open Markets to keep the basic interest rate unchanged failed to damp the fall on the stock market that was further driven by the terrorist act in Madrid, as investors viewed that as an intensification of the terrorist threat. In April and May the stock market found itself under the impact of opposite factors. While on the one hand, positive macroeconomic statistics that proved an acceleration of the US economic growth and positive corporate news were driving stock indices upwards, high oil prices and the deterioration of the situation in Iraq formed the negative mood, on the other. At this juncture, there was another negative factor associated with the US economy: that is, a possible increase of basic interest rates that would contribute to a revision of then existing stock market price levels towards their decline.

The US stock indices somewhat grew in June. In early June, the market was to a greater extent under the effect of the negative factor associated with the envisaged increase of interest rates, for A. Greenspan unequivocally let everybody know that FRS was ready to raise interest rates due to inflation rates. In late June, however, he somewhat revise his stance, for he argued that inflation did not pose a serious problem in the short run. Plus, the stock market sensed a notable support from some decline in oil prices earlier that month, the publication of a favorable macroeconomic statistics and some decline in yields rates of T-bills.

Despite that, the situation darkened in July and August. In July, the US basic interest rate was raised by 0.25% – up to 1.25%, while negative macroeconomic and corporate news dominated over the market. More specifically, employment indicators fell lower than expected, while oil prices resumed their rise. The US huge trade deficit did not add opti-

mism either, and all the above was driving the US stock indices down. However, a positive adjustment had been noted on the market by late August. Its causes were technical factors coupled with a notable decline in world oil prices.

In September-October the dynamics of the US stock indices on the whole were opposite, while the volatility of quotations was high. While the prices enjoyed a positive support from a relatively low yields rate of T-bills and solidification of the incumbent President's position in the presidential race underway, the discontinuation of the oil price adjustment and the subsequent price rise for oil, negative corporate financial projections, a high probability of the further increase of the interest rate and low activity on trading spots formed the group of negative factors that were driving the markets downhill. Mr. A. Greenspan's testimony to the US Congress Budget Committee proved the general opinion of the deceleration of the US economic growth and the existence of critical problems (a huge budget deficit and employment challenges).

During last two months of 2004 the US stock indices were growing notably, which can be explained by a series of positive factors. Those were, in particular: Mr. Bush's victory and some decrease in the world oil prices, as well as a number of positive macroeconomic and corporate news. The FRS once again raised the basic interest rate by another 0.25% basic points, i.e. up to 2% annualized. That, nonetheless, had a short-term negative impact on the market. In December, the stock market was growing against a substantial downfall in oil prices, while investors found themselves under the negative effect from the rising interest rates that reached 2.25% later that month. The market had been re-galvanized by late December by the news of rather high growth rates of the US economy and relatively low yields rates of T-bills.

Corporate News

A notable progress of some Russian corporations was awarded by granting them with long-term credit ratings or revising already existing ones. To exemplify the above, in late January S&P's rated OAO Rostelecom with a 6.4 corporate governance rating score out of possible 10. According to the agency, the decision was made with account of Rostelecom's progress in the information disclosure policy area and a pro-active approach to investors. The agency believes that so far as the above standards are concerned, Rostelecom is ahead of analogous Russian companies and in this regard is a match for numerous telecom companies overseas.

In early August, Moody's and S&P's announced they had granted Norilsk Nickel with a credit rating. While Moody's decided on "Ba1" grade in forex equivalent, with the forecast of the change for "stable", S&P's went as far as "BB", with the same forecast. The company's credit rating by the national scale became "ruAA".

In October, Moody's changed its forecast of Sberbank's long-term forex-denominated rating "Ba1" from stable to "positive", while the rating of the company's bonds was raised up to "Baa2", i.e. higher than Russia's. The agency representatives argued that those decisions were associated with the Bank's significant role in the national economy and banking system, particularly in the area of private deposits.

In early November, S&P's confirmed the long-term credit rating of RAO UES Russia from "B" to "B+" and its "RuA+" rating by the national scale with the forecast "stable". The agency believes such an increase mirrors the improvement of the company's financial indicators, a gradual progress in characteristics of the markets for electricity and heating against the background of the country's ongoing economic progress.

On November 19, 2004, Fitch raised Sberbank's rating up to the investment one. The decision followed the analogous increase in Russia's sovereign rating. Sberbank's long-term rating was raised from "BB+" up to "BBB-" with the forecast "stable", while the rating of the bank's bonds was likewise raised to the same level. So, all the Bank's ratings presently are on the investment level.

Numerous Russian companies published their 2004 financial reports, of which some deserve a special attention.

On November 19, RAO Gasprom released its non-audited consolidated abridged statement over the first half 2004 drafted in compliance with IFS standards. According to the report, the company's sale proceeds over the first 6 months of 2004 grew by 12% vs. the respective period of 2003 and made up Rb. 474 mln., while net profit over the period in question dropped by 13,797 mln., or 13% vs. its respective period of 1993 and accounted for Rb. 89, 964 mln.

The same day, OAO Norilsk Nickel also produced its interim consolidated financial statement over the first half 2004. According to the report, in the period in question the total production costs of metals sold in USD equivalent grew by 12% vs. the 1st half 2003, while the declared profit over the period in question amounted to USD 889 mln., or practically tripled vs. the respective 2003 indicator.

In November, RAO UES Russia published financial results of its performance drafted according to the Russian and international accounting standards. The latter document was published on 1 November. The group's gains from the profile operations over the period in question grew by Rb. 41.9 bln – up to Rb. 342.7 bln., while expenditures grew by 36.9 bln. and accounted for 342.7 bln. The company's net profit over the first half 2004 was over Rb. 15.4 bln., or at 1.5 bln. down vis-avis the 1st half 2003. The drop in net profit can be explained by the rise in profits that fall on minority stockholders. On 15 November, the company published its accounting report for the nine months of 2004. Its gains reached Rb. 24.77 bln., or down from the respective index of the prior year, while net profit stood at the level of Rb. 17.1 bln. (2.31 bln. down vs. the same period of the prior year).

The same month OAO Rostelecom published results of its performance in the first 9 months of 2004. The document was drafted according to the Russian accounting standards. Thus, the company's gains over the period in question made up Rb. 27.64 bln., or up by 33.2% vs. the respective period of 2003. The company's net profit reached Rb. 6.59 bln., or at 37.8% more than in the first 9 months of 2003.

In the very early 2005, OAO LUKOIL published results of its financial performance over the first 9 months of 2004. The company's net profit made up USD 3,095 mln., or at 1,292 mln. more than over the first 9 months of the prior year (without regard to the accumulated effect from changes in its accounting policy and less the sale of the USD 1, 262 bln.-worth share in Azei-Chirag-Guneshli project). The company reported USD 2.46 bln. in federal taxes (less the corporate profit tax), or at over 40% more than in the respective period of 2003. The rise in the company's net profit became possible thanks to a favorable state of affairs in the world mineral markets and improvement of control over its expenses. However, the rise in profits was constrained by the growing tax burden, Rb. appreciation and a continuous rise in transportation costs.

In 2004, Russian companies continued to acquire new, particularly overseas, assets and establish long-term ties that would enable them to expand their business and enhance its efficiency.

In late January 2004 LUKOIL won a tender on exploration and development of gas and condensate deposits in "Block A" in Saudi Arabia. Experts believe it is the most promising deposit in the area. To implement the project, the company is going to found a

ising deposit in the area. To implement the project, the company is going to found a joint venture with Saudi Aramco, in which LUKOIL is going to have the 80% stake.

In March, OAO Norilsk Nickel announced the purchase for cash via its London-based 100% daughter company Norimet of a. 98.5 mln. ordinary stock of the gold mining company Gold Fields Ltd. The purchase worth a total, in USD equivalent, of USD 1.16 bln., or USD 11.79 per 1 ordinary stock.

One of the critical events of 2004 became the establishment of a large-scale strategic alliance between LUKOIL and ConocoPhillips. It is envisaged that the US giant will become a strategic investor in LUKOIL's capital. The announcement was made after a ConocoPhillips' affiliated structure won in an auction on the purchase of a 7.59% the Russian oil company's declared and issued ordinary stock that had earlier belonged to the federal government. The price of the deal amounted to USD 1.988 bln. (USD 30.76 per 1 share).

By late 2004 the group of companies Slavneft had completed a deal on the purchase of a package of ordinary and preference stock of OAO Slavneft-Megionneftegaz (MNG) from minority stockholders whose interest was represented by Vostok-Nafta. The purchased stake accounts for 6.4% of the OAO Slavneft-Megionneftegaz's authorized capital. As a result of the transaction, the Slavneft's share in the MNG's authorized capital grew up to 56.4%. Slavneft owns 69.12% of the total number of ordinary and 18.11% of the total number of preference stock of OAO Slavneft-Megionneftegaz. Consolidation of the equity capital of Slavneft's daughter companies should help the group improve its corporate structure.

In 2004, Russian companies have been fairly pro-active in attracting an additional volume of investment, particularly from overseas financial markets, and solidified their positions on the global capital markets.

In March, the LUKOIL Board ruled to issue documentary interest non-convertible payable to bearer bonds with the term of maturity of 5 years. The issue included 6 mln. bonds with the face-value of Rb. 1,000 each. Their coupon period is 6 months, and the interest rate by all the coupons is equal and should be set by results of a tender on the date of the start of the placement. The three-year offer is envisaged on the issue. The same month Slavneft repaid in full its Rb. 2.-bln- worth bonded debt, as per the terms of its issuance. At the same time, the company paid out revenues on the 4th coupon on the second-series bonds at the rate of 8.89% annualized, or Rb. 44.33 per each bond with the face-value of Rb. 1,000. The overall bonded debt repayment amounted to Rb. 88.66 mln.

Liquidity of Russian companies on the Western exchanges is worth a separate comment. In particular, in June, there appeared information that the volume of trading with the OAO LUKOIL securities at London Stock Exchange hit the record-breaking USD 2.41 bln. The dynamics of trades evidenced a constantly growing interest in the company's papers. Thus, while in 2003 the average monthly volume of trades was USD 801 mln., it reached 1.52 bln. over the first four months 2004.

In September, OAO Norilsk Nickel appointed Citigroup and Morgan Stanley co-lead-managers of the planned debut issuance of its Eurobonds denominated in USD. The USD 500 mln.- worth issue was placed on September 17, with the yields rate 7.125% and the maturity date September 30, 2009 r. The demand for the issue was more than 4 times greater than the offer. The company will irrevocably and unconditionally guarantee its Eurobonds.

In October, OAO gasporm placed its Rb.-denominated bonds of A5 series with the face-value of Rb. 1,000. The issue was worth a total of Rb. 5 bln. with the maturity term of 3 years. According to results of a tender held at MICEX, the coupon rate payable each 182 days was set at the level of 7.58% annualized. Investors submitted 120 bids worth a total of

Rb. 9 bln., of which 73 bids were accepted. It is intended to spend the attracted capital on funding investment necessary to maintain the existing production capacities, implementation of new promising projects and refinancing the company's short-term debts and optimizing its debt portfolio structure

In mid-October, OAO Norilsk Nickel placed a bond issue worth a total of USD 500 mln. with the yields rate under placement of 7.125% annualized with the maturity date on September 30, 2009. Again, the demand for the issue was over 4-fold greater than the offer.

On November 11, OAO LUKOIL's Board set the repayment price of the documentary interest non-convertible bonds payable to bearer, which the company planned to place until the end of the year. The repayment price was set at the level of 100% of the nominal value. The intended volume of output is – Rb. 6 bln., while the maturity term 5 years. The placement took place on November 23, 2004, at MICEX. the coupon rate payable each 182 days was set at the level of 7.25% annualized 7,25%, which equals the efficient yields to maturity rate of 7.38% annualized. Investors submitted 123 bids worth a total Rb. 11.3 bln.

In early November, OAO Sibneft announced an attraction of a USD 160 mln. –worth syndicated loan with +1.4% LIBOR interest rate. This particular loan thus became the cheapest in the company's history. The 25-month loan was extended against export oil supplies. The loan syndication was arranged by ABN AMRO Bank. The company plans to spend the credit to refinance its debts and liquid capital.

On December 3, 2004 OAO Norilsk Nickel announced its intention to purchase up 12,500,000 of its stock (5.8% of its authorized capital, with the face-value of Rb.1 per 1 share) at a price of Rb. 1,680 pyб. per 1 share. The company planned to spend up to Rb.21 bln. on the deal. ZAO "Natsionalnaya Registratsionnaya Kompania" received 372 duly arranged applications from the company's stockholders on the sale of their stock, of which stockholders –legal entities submitted 207, while private individuals – 165 applications. The total number of stock stipulated in the applications accounted for 59,761,360, of which 57,965,450 shares were offered by legal entities, while the remaining 1,795,910 – by private individuals. As the number of the stock offered for sale proved to be substantially greater than what the company actually was going to buy, the final number of stock it would buy from a shareholder would be computed on the proportional basis.

In December, there appeared information on the market that EBRD was going to disburse a Euro 80 mln. credit to RAO UES Russia's daughter – OAO "Systemny operator CDD-UES". The respective loan agreement was signed in London. As per the agreement, the loan should be disbursed in two tranches: while EBRD would extend the first one, worth Euro 60 mln. and for the 10-year period, to Systemny operator, the other tranche amounted to Euro 20 mln. would be extended, for the period of 7 years, by a cindicate of two banks: namely Raiffeisen Zentralbank Osterreich AG and Bayerische Landesbank.

It is envisaged that Systemny operator would spend the attracted funds to design and introduce a new automated SCADA/EMS (Supervisory Control and Data Acquisition/Energy Management System).

It is the common knowledge that a sound dividend policy is a perfect vehicle of increasing attractiveness of stock. In 2004, some companies declared their eagerness to spend a part of their profit on payment of dividends. In particular, at their early meeting on December 15, 2004, OAO Slavneft's stockholders ruled to distribute intermediate dividends over the 9 months of 2004, with the payment totaled a. Rb. 14.5 bln., or Rb. 3.06 per 1 ordinary share with the face-value of 0.1 kop. The dividends will be paid until December 31, 2004. The list of shareholders to take part in the meeting was made according to the register data as of November 9, 2004.

At its October meeting, the Board of OAO Norilsk Nickel decided to recommend to the early shareholder meeting to distribute intermediate dividends for the 9 months of 2004 at an amount of Rb. 41.4 per 1 share. The early shareholder meeting convened on 23 November consequently approved of the Board's decision. By the 2004 results, the total volume of dividends, including intermediate ones, matches the company's dividend policy (20–25% of net profit computed according to ISA).

In early December, RAO UES Russia announced that the company had completed distribution of its 2003 dividends as scheduled- by December 1, 2004. According to the company's information, the total volume of dividend payments was Rb. 2.39 bln., of which a. 1.9 bln. was paid on ordinary shares (Rb. 0.0469 per 1 share), while Rb. 473 mln. was paid on preference stock (Rb. 0.2283 per 1 share).

2.5. Scenario- Based Macroeconomic Forecast for 2005

This section describes a scenario-based forecast of macroeconomic parameters (GDP, CPI, export, import, USD/RUR exchange rate, gold and foreign exchange reserves, real effective RUR exchange rate, retail turnover, unemployment rate, real incomes of physical bodies) for 2005 performed on the basis of the structural econometric equations. Apart from this, changes in tax revenues to consolidated and federal budgets were assessed under the examined scenarios in relation to the scheduled changes in the tax law since 2005. In addition, we have calculated alternative assessments of basic parameters of the federal budget for 2005 under the same scenario which was used for defining parameters of the same budget.

The equations were assessed on the basis of the quarterly data for the period commencing in the 1st quarter of 1996 thru the 4th quarter of 2004 inclusively. In various cases, the model was assessed only within the interval from the 1st quarter 2000. The data source was represented by the official information obtained from the Federal Service for State Statistics of the Russian Federation, the Bank of Russia, the RF Ministry of Finance and the International Monetary Fund.

The equations describing the middle-term movement of macroeconomic parameters, include variables and their lags having a material and corresponding economically logical effect on the explained variable. The equations were also added with dummy variables allowing quarterly seasonality and structural changes to be taken into account. The members of moving average were used to eliminate autocorrelation of the reminders.

The macroeconomic parameters were calculated on the basis of pre-selected scenarios of exogenous variables movement – Urals oil price, capital investments, M_2 and USD/EURO exchange rate.

Table 25

Scenario of exogenous variables in 2005

	Scenario 1	Scenario 2	Scenario 3
USD/EURO exchange rate	1.21	1.22	1.15
Urals oil price (USD per barrel)	28	36	25
M_2 incremental growth rate, %	28	35	20
Capital investment incremental growth, %	9.8	12.0	8.5

The macroeconomic forecast for 2005 in *Table 25* was calculated for three scenarios of USD/EURO exchange rate, oil prices, growth in M_2 and capital investments. Scenario 1 was drafted in accordance with the initial conditions and the forecasted figures for 2005

obtained by the RF Ministry of Economic Development (MED) (Forecast of socioeconomic development of the Russian Federation till 2007): annual average USD/EURO exchange rate is expected to be 1,21, Urals oil price is expected to be \$28 per barrel, M_2 incremental growth rate is expected to account for 28%, and capital investment incremental growth at the end of the year is expected to account for 9.8%. Scenario 2 is optimistic and forecasting that oil price would be equal to that of 2004 (\$36 per barrel). According to Scenario 2, capital investment growth is expected to account for 12%, average annual USD/EURO exchange rate is expected to be 1,22, M_2 incremental growth rate is expected to account for 35%. Scenario 3 is pessimistic and expecting Urals oil price to gradually decline down to \$22 barrel by the end of 2005, which would cause the average annual Urals oil price to be \$25 per barrel. In addition, according to Scenario 3, USD is expected to strengthen against EURO as compared to the previous year (average annual exchange rate would be USD1,15: EURO1 in 2005 against 1,22 in 2004), capital investments are expected to drop down to 8.5% per year, and M_2 incremental growth rate is expected to account for 20% at the end of 2005.

Table 26

Forecast for 2005

	2005			
	Scenario 1	Scenario 2	Scenario 3	MED's forecast
Real GDP incremental growth, %	5.2	6.0	3.8	6.3
GDP, RUR trillion	18.93	19.12	18.70	18.72
CPI incremental growth, %	9,0	9,3	9,0	8,5
Gold and foreign exchange reserves, USD billion	139	154	127	
Strengthening rates of real effective RUR exchange rate, %	3.3	6.4	2.9	4.4
Strengthening rates of real RUR/USD, % .	4,8	8,2	2,8	4,3
Nominal USD/RUR exchange rate	28,6	27,7	29,2	30,4
Export, USD billion	161	175	155	163,2
Import, USD billion	104	108	102	104,7
Incremental growth in retail turnover, %	9,0	9,1	8,6	8,5
EPE incremental growth, % of the previous quarter	4,7	5,7	3,3	5,5
Share of unemployed persons in total gainfully occupied population, %	7,7	7,6	7,8	8,5
Growth in real cash income of physical entities, %	7,6	8,1	6,7	9

The macroeconomic forecast shows (refer to *Table 26*) that according to the optimistic scenario (Scenario 2), GDP growth rate is expected to decrease down to 6.0% in 2005 as compared to 3.8% in Scenario 3. In 2005, GDP volume in nominal terms is expected to reach: RUR18,93 trillion according to Scenario 1; RUR19,12 trillion According to Scenario 2; and RUR18,7 trillion according to Scenario 3.

In 2005, the rate of inflation is expected to decrease down to 9–9,3% depending on the forecasted changes in money quantity.

Under the lowest oil prices in 2005 (Scenario 3), gold and foreign exchange reserves are expected to grow by \$6 billion, while if the oil price in 2005 would remain equal to that in 2004 (Scenario 2), incremental growth of gold and foreign exchange reserves is expected to reach \$33 billion at the end of 2005.

In 2005, the rate of strengthening of the effective RUR exchange rate is expected to vary from 2.9 to 6.4%, depending on a scenario, with the fastest rate in Scenario 2. In 2005, the rate of strengthening of RUR against USD is expected to be faster under Scenario 1 and 2, i.e. if the USD/EURO exchange rate would remain equal to that in 2004. Under Scenario 3, i.e. in the case of gradual strengthening of USD against EURO during 2005, RUR is expected to strengthen against USD by nearly 2.8% at the end of 2005.

According to the data of the Bank of Russia, export volumes at the end of 2004 amount to USD183 billion. In 2005, export volumes are expected to be below the foregoing figure under each of the Scenarios. In case that oil price in 2005 would be equal to that in 2004 (Scenario 2), export volumes are expected to be nearly USD175 billion, while it would amount to nearly USD155 billion, if oil price goes down to \$22 per barrel by the end of 2005. The forecasted import volumes in 2005 are expected to exceed that in 2004 under each of the Scenarios, correspondingly by USD9 billion under Scenario 1, by USD13 billion under Scenario 2 and by USD7 billion under Scenario 3. Import volumes in 2004 are nearly USD95 billion, according the data of the Bank of Russia. Thus, on the basis of the forecasts obtained, export surplus in 2005 is expected to be below that of the previous year by more than USD20 billion Under each of the Scenarios. Under the pessimistic scenario, export surplus in 2005 is expected to decline by nearly USD35 billion.

The forecasted growth rates of retail turnover, industrial production index and real cash incomes correspond in general to the estimates of GDP growth rates. In the middle-term period, the real growth rates of retail turnover appear to be comparable by volume with the growth rates in available real incomes and are below the GDP growth rates by more than 3 percentage points on the average. The growth rates of industrial production index appear to be slower than the GDP growth rates by 0.4 percentage points on the average.

In 2005, a share of the unemployed in the total number of gainfully occupied population is expected to be reduced down to 7.7% under Scenario 1, 7.6% under the conditions of the most optimistic Scenario, and 7.8% under the pessimistic Scenario, as compared to the previous year.

It should be noted that the obtained forecasts of basic macroeconomic parameters for 2005 (Scenario 1) are generally in line with the similar forecasts obtained by the RF Ministry of Economic Development under the similar initial conditions. The two forecasts disagree mostly in the figures reflecting economic activity. According to the forecast made by the RF Ministry of Economic Development, the GDP growth rate in 2005 appears to be beyond our figures by 1 percentage point. Such disagreement is typical of growth rates in cash incomes of physical entities and industrial output.

We assessed the forecasted changes in tax revenues to the RF federal budget and the RF consolidated budget in relation to the changes in tax law and budget law scheduled by RF Government in 2005 as compared to the previous years. In particular, according to the proposed scenarios of oil prices, we took into account the effects of a heavier tax load imposed on the petroleum industry from 2005: changes in export tax on oil and mineral tax rates. Tax revenues for 2005 were calculated considering the introduction of the "country of destination" principle on the value added tax imposed on hydrocarbons and other products exported to the Republic of Byelorussia. We took into account a decline in export duties by an average of 32 % for all groups in 2005, except for the fuel and energy group, which is also in line with the Ministry of Finance's forecasts conserving reduction in tax revenues. Finally, we calculated changes in revenues from single social tax due to reduction by up to 26% in the basic rate of this tax. With regard to the federal budget, we also took into account the changes in the budget law represented by adding 1.5 percentage

points of profit tax rate to the federal budget, as well as the changes in the standard of payments on mineral tax and regular payments.

The corresponding quantitative changes in the amount of tax revenues (refer to *Table 27*) were calculated on the basis of tax revenues received over the previous year with consideration of the taxation base growth, presented oil price scenarios, obtained forecasts of USD/RUR exchange rate, and growth rates of incomes of physical entities. The assessment of changes in single social tax revenues was based on the data on distribution of number of employees by calculated payroll obtained by the Russian Statistics Agency on the basis of a sample survey for April 2004. This allowed the aggregate effect of changes in the single social tax schedule on such tax revenues to be calculated more correctly.

Table 27

**Forecast of Changes in Tax Revenues of the RF
Consolidated and Federal Budgets in Relation to Changes
in Tax Law and Budget Law since 2005 (RUR billion)**

	Scenario 1	Scenario 2	Scenario 3
Forecast of Changes in Tax Revenues of the RF Consolidated Budget in Relation to Changes in the RF Tax Law			
Profit tax	40.6	0.9	55.9
Mineral Tax	20.8	36.0	15.0
single social tax	-282.4	-283.2	-281.5
VAT	-8.5	-8.6	-8.4
Customs duties	86.3	237.0	27.6
Forecast of Changes in Tax Revenues of the RF Federal Budget in Relation to Changes in the RF Budget Law			
Profit tax	57.4	46.6	61.5
Mineral Tax	63.3	77.0	58.1
single social tax	-282.4	-283.2	-281.5
VAT	-8.5	-8.6	-8.4
Customs duties	86.3	237.0	27.6

It should be emphasized that the presented changes in profit tax revenues are caused primarily by corresponding changes in the tax basis due to growth in mineral tax payments and the reduction of the single social tax rate. Changes in the tax duty are caused by introduction of a new oil export tax schedule and reduction in the rate of import duties imposed on other goods.

Table 28

Forecasted Parameters, Federal Budget for 2005

	Scenario 1	Scenario 2	Scenario 3
Federal budget incomes, RUR billion .	3279	3467	3179
Federal budget incomes, % of GDP	17.3	18.1	17.0
Federal budget surplus, RUR billion	231	419	131
Federal budget surplus, % of GDP	1.2	2.2	0.7

Thus, by adjusting the forecasted figures of the federal budget revenues in 2005 by the value of discretionary changes, the profit side of the federal budget in 2005 looks as follows:

- nearly RUR3279 billion, under the condition of the same scenario which the draft federal budget for 2005 is based on (Scenario 1);
- nearly RUR3467 billion, provided that oil price in 2005 is equal to that in 2004 (Scenario 2);
- nearly RUR3179 billion, provided that oil price decline down to \$22 per barrel by the end of 2005 (Scenario 3).

The forecasted surplus of the federal budget in 2005 under the conditions of the same scenario (Scenario 1) would be RUR47 billion less than that in the draft federal budget (correspondingly RUR231 billion against RUR278 billion). The federal budget surplus may reach 2.2% of GDP, provided that the basic trends of 2004 remain the same.

Section 3. The real sector

3.1. Macrostructure of Production

3.1.1. The GDP: Trends and Factors behind Change in Ultimate Demand

The 1999–2004 period was characterized by dynamic development of nearly all the sectors and branches of the economy. In the past six years, the GDP increased by 48.0%, actual ultimate consumption by households, by 48.1% and investments in fixed capital, by 72.0%. Growth in business activities (based on higher growth rates of investment than those of production and consumption) had a considerable effect on structural changes in formation and allocation of the GDP. In 2004, industrial output and agricultural output increased by 53.4% and 26.4%, respectively, on the 1998 figure. Growth in output of goods was maintained by infrastructure of the services market, which was developed during the period of the reforms. With an increase of 57.5% in output of the physical production sector in the 1998–2004 period, growth in output of market services amounted to 43.3%. Commercial cargo turn-over increased by 37.8% on the 1998 figure, while the output of communication services and retail trade, by 238.7% and 49.3%, respectively (*Table 1*).

Table 1

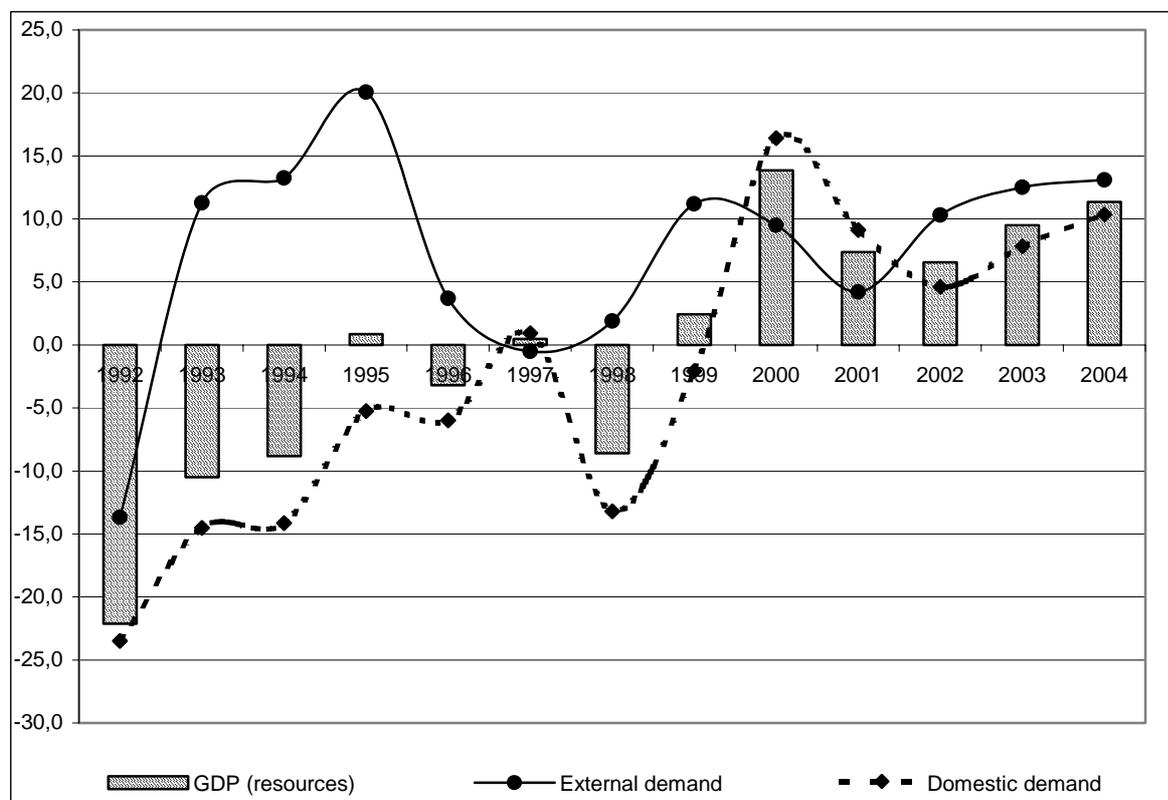
**Major macroeconomic indices in the 1999–2004 period.
(% of the previous year figure)**

	1999	2000	2001	2002	2003	2004
Gross domestic product	106.4	110.0	105.1	104.7	107.3	107.1
Actual ultimate consumption by households	97.1	107.3	109.5	108.5	107.5	111.3
Investments in fixed assets	105.3	117.4	108.7	102.6	112.5	110.9
Industrial output	111.0	111.9	104.9	103.7	107.0	106.1
Agricultural output	104.1	107.7	107.5	101.7	101.5	101.6
Cargo carriage turnover	105.8	104.8	103.2	105.6	107.4	106.2
Communication services	133.1	113.8	119.1	115.6	127.5	127.3
Retail trade turnover	93.9	108.8	110.7	109.1	108.0	112.1
Paid services to households	107.0	105.0	102.8	100.4	105.1	107.1
Foreign-trade turnover	86.7	129.7	105.4	108.1	124.6	131.1
Real cash income	86.4	109.1	108.5	108.8	114.5	107.8
Real wages and salaries	78.0	121.0	119.9	116.6	110.4	110.8
Annual average number of employed persons in the economy	100.5	100.6	100.6	101.0	99.2	101.8
Number of unemployed persons (as of the year end)	102	77	90.0	98.0	106.0	96.4
Price indices:						
Consumer prices	136.5	120.2	118.6	115.1	112.0	111.7
Prices of manufacturers of industrial products	167.3	131.6	110.7	117.1	113.1	128.3

Source: The State Committee for Statistics of Russia; the Federal Service of State Statistics.

In the past few years, a favorable situation on international markets of energy and primary resources definitely had a positive effect on economic development. In the 1999–2004 period, recovery growth was characterized by simultaneous expansion of both the domestic and foreign market. With an increase of 70% in the aggregate demand in the 1999–2004 period, the external demand grew by 78%, while domestic demand, by 55%. It is to be noted that in the 2000–2001 period dominating growth in the domestic market (in a situation where domestic production was aimed at active import substitution) was a key factor behind successful recovery after the 1998 financial crisis. However, in the following

period growth structure was determined by external factors, which started to play a greater role (though some increase in growth rates of domestic demand was observed in the 2003-2004 period).



Source: Data of The Federal Service of State Statistics.

Fig. 1. Rates of growth in domestic and external demand in the 1992–2004 period (% of the previous year figure)

In 2004, unit weight of exports in the GDP amounted to 34.2%, as against 30.7% in the pre-crisis 1997. Impact of exports on recovery growth was determined by a sustained increase in incomes received from hydrocarbon exports.

In 2004, as compared to the 2002–2003 period conditions of trade with other countries improved thanks to higher rates of growth in prices on export commodities and expansion of the demand. According to estimations by the Bank of Russia, in 2004 an increase in international prices on Russia's principal exports amounted to 22.8% on the December 2003 figure. In the above period, prices on energy resources grew on average by 20%, while those on non-energy commodities, by 23.2%, including prices on non-ferrous metals which increased by 29.5%. In 2004, prices on principal raw materials, semi-finished products and products of ferrous industry increased by 100 percent. External factors related to high prices on oil and metals and a considerable increase in exports volumes accounted for over 50% of economic growth in the 2003-2004 period. With a revival of the international economy and growth in demand, there was an increase in export volumes of oil, petroleum, fuel oil, natural gas, aluminum, nickel, wood products, some sorts of ferrous metals, chemical raw materials and mineral fertilizers.

In 2004, Russian export volumes increased by 34.8% on the 2003 figure, while those of imports, by 24.7%. In 2004, in export commodities structure a share of energy products grew by 0.1% on the 2003 figure, while that of ferrous and non-ferrous metals, by 3.1% in a situation where the share of machinery, equipment and transportation vehicles decreased by 1.5%. In the 2003–2004 period, dynamic growth in exports income helped overcome a slow-down of the rates of economic growth. A cumulative effect of dynamic growth in incomes of the export-oriented sector was seen in growing dynamics of related industries and had a dominating effect on changes in conditions and factors behind development of the domestic market.

In 2003–2004 period, growing economic income received from foreign economic activities had a stimulating effect on business. Rates of growth in foreign-trade turnover increased from 108.3% in 2002 to 130.6% in 2004. Foreign-trade balance amounted on average to USD six billion a month. In the past two years, annual average growth rates of the GDP amounted to 7.2%, while those of investments in fixed capital, to 11.7% (in the 1999–2004 period, those indices amounted to 6.7% and 9.5%, respectively) (Fig.2).

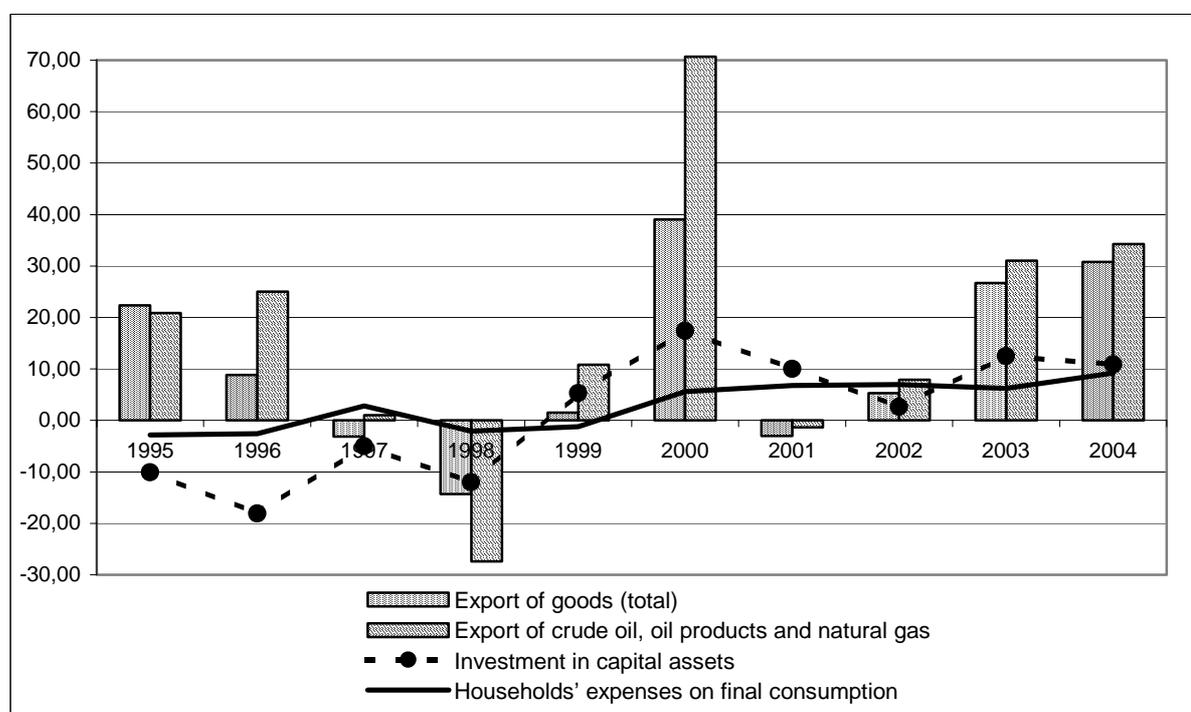


Fig. 2. Change in rates of growth in exports of commodities (including hydrocarbons), ultimate consumption by households and investment in fixed capital in the 1995–2004 period (as a percentage of the previous year figure)

An extremely favorable combination of high business activities at home with high prices on raw materials in international markets contributed to intensive growth in gross savings. In the past six years, the share of gross savings amounted to 31.1%–38.7% of the GDP, as against 24.0% in the pre-crisis 1997. In 2004, thanks to growth in incomes of the economy received from exports and increase in foreign investments, on one hand, and a slow-down of growth in ultimate consumption by households in a situation of prevailing savings trends, on the other hand, national savings amounted to 35.2% of the GDP, as against 31.8% in 2003. It is to be noted that the effect of growing incomes received from

foreign trade operations was limited to a great extent by sectorial priorities of export-oriented industries. As a result, in the 1999–2004 period the share of investments in fixed capital in the GDP remained on average at the level of 16.2% (a decrease of 1.3% on the 1997 figure). The above trends can be explained by lack of both matured investment institutions (which could attract investments to the real sector of the economy) and mechanisms of transformation of savings.

In the past few years, correlation between demand in investment and ultimate consumption were rather sensitive to changes in incomes received from exports and determined the specifics of the domestic market. Dramatic changes in investment expenditure on reproduction of fixed capital were neutralized by smooth dynamics of ultimate consumption. It is to be noted that in 2004 there was less impact on dynamics of ultimate demand of an investment component by the quarter (*Fig. 3*).

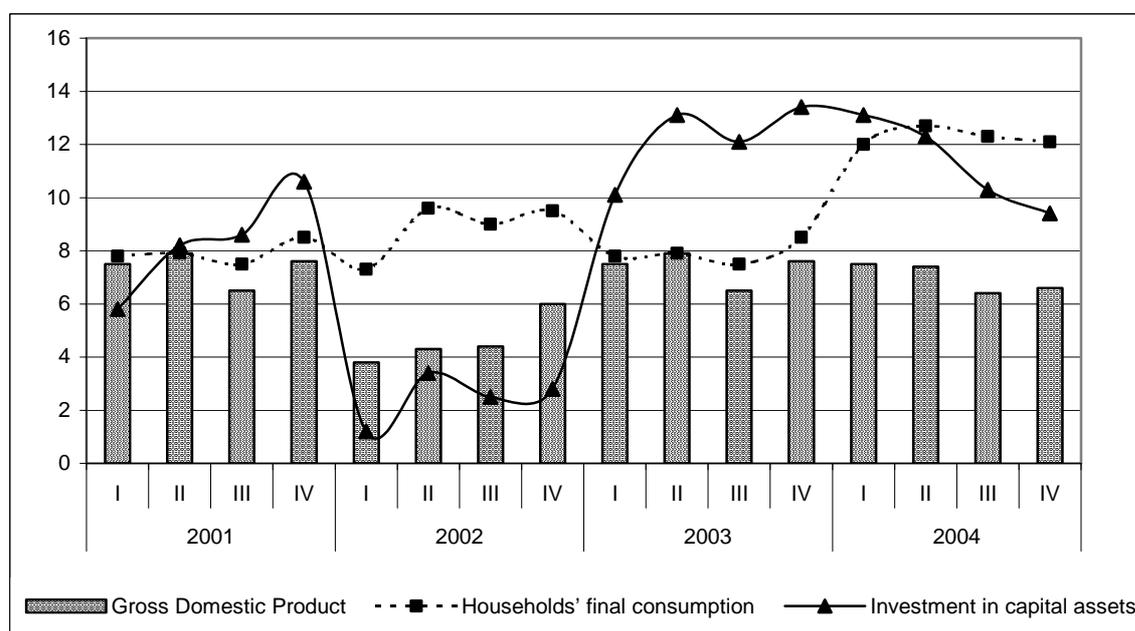


Fig. 3. Change in dynamics of the GDP by the component of ultimate demand in the 1999–2004 period (percentage of the previous year figure)

The phenomenon of economic recovery in Russia is such that with growth in actual export volumes, export-related incomes and investment an increase in centralized accumulation of capital is observed. Analysis of capital accounts also points to growing asymmetry of gross savings, resources of gross savings and investments in fixed capital. As of the beginning of 2005, the Stabilization Fund amounted to approximately 4.4% of the GDP (*Fig. 4*). It permitted Russia to fulfill ahead of schedule its obligations to the International Monetary Fund (Russia paid USD 3.7 billion to the IMF). In addition to the above, in 2005 it is planned to spend another RUR 160 billion out of the Stabilization Fund to repay debts to the Paris Club. According to calculations by the Ministry of Finance of the RF, if resources of the Stabilization Fund were spent in Russia the rate of inflation in 2004 would have grown by another 1.5–2% a year, while the effective rate of RUR, by 1.5%.

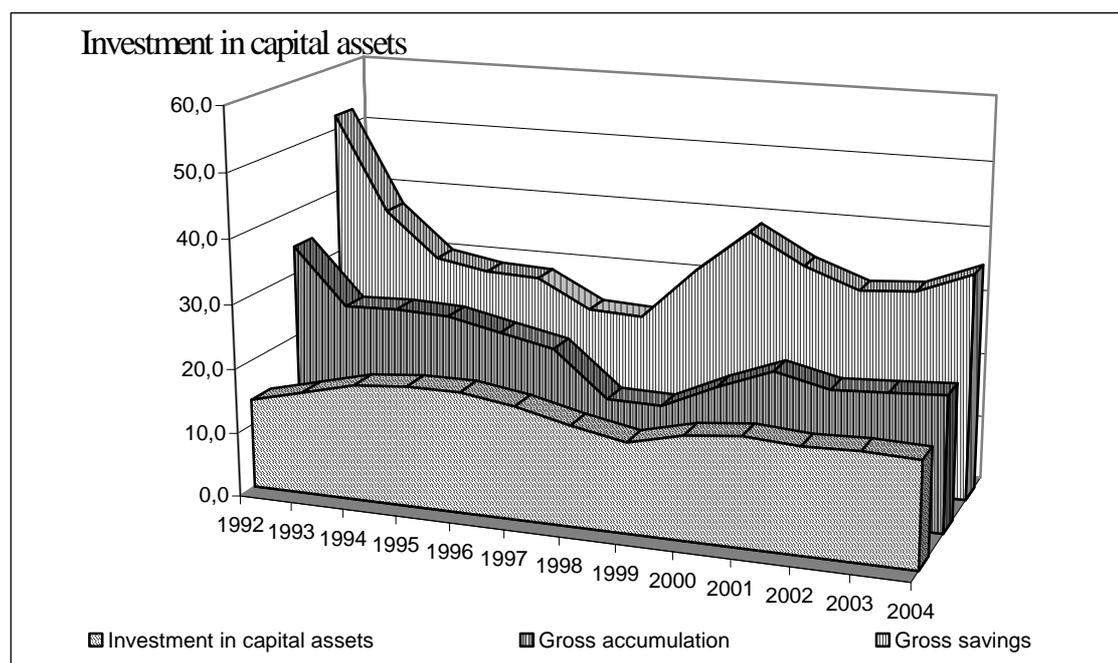


Fig. 4. Share of gross savings and investments in fixed capital in the GDP in 1992–2004 period (% of the GDP)

With an increase in accumulation of “available funds” in the Stabilization Fund, in the past five years investments in fixed capital amounted to less than 50 % of national savings. As a result, with a decrease in extent of transformation of incomes of the economy into investments, in 2004 issues related to redemption of Russia’s foreign debts and fulfillment of social programs started to prevail.

In the 2000–2004 period, positive dynamics of ultimate consumption was a key factor behind development of the domestic market; it is to be noted that in the 2003-2004 period correlation between consumption by households and social transfers received from public institutions and non-profit organizations remained at the same level. However, in 2004 in the structure of allocation of the GDP the share of expenditure on ultimate consumption, including that by households decreased by 2.4% and 1.2%, respectively, on the 2003 figure. Structural changes in allocation of the GDP were caused by high rates of growth in total accumulation (an increase of 1.0% on the 2003 figure) (Table 2).

Table 2

Structure of utilization of the Gross Domestic Product in the 1998-2004 period (percentage of the total)

	1998	1999	2000	2001	2002	2003	2004
Gross domestic product	100	100	100	100	100	100.0	100
Expenditure on ultimate consumption	76.2	68.1	61.3	65.8	68.9	68.1	65.7
Including:							
by households	55.6	52.3	45.1	48.3	50.0	49.7	48.5
by public institutions	18.7	14.6	15.1	16.4	17.6	17.5	16.4
Gross savings	14.9	14.8	18.7	22.0	20.1	20.6	21.6
Including gross accumulation of fixed capital	16.5	14.4	16.9	18.9	17.9	18.3	18.3
Net export of goods and services	6.8	17.1	20.0	12.7	11.8	11.4	12.7

Source: The State Committee for Statistics of Russia; the Federal Service of State Statistics.

Despite an increase in the share of gross savings and accumulation in the GDP, in the past three years no growth was registered in unit weight of investments in fixed capital. A policy aimed at ensuring competitiveness of the economy through allocation of potential investment resources to the Reserve Fund limited prospects for modernization of production and, eventually, made the economy dependent to a greater extent on a situation which prevailed in international markets. Insufficient volumes of investments in the real sector of the economy (considering the existing age, technological and sectorial structure of fixed capital) had a negative effect on the structure of economic growth. It is to be noted that aggregate domestic factors were insufficient to neutralize the impact of the external demand on the rates of economic growth. Whereas in the 2000–2004 period inputs of the domestic demand accounted for 75% of the increase in the GDP, in the 2003–2004 period domestic factors' impact decreased by 20%. In a situation where incomes of businesses and households kept growing, unstable growth in output of goods of final demand stimulated demand in import goods. In 2004, growth in imports amounted to 24.9% as against 24.2% in 2003 and 13.4% in 2002. That trend was also maintained by higher efficiency of imports in a situation of a gradual appreciation of the ruble exchange rate.

In 2004, in the structure of commodity resources of the retail trade, the share of imports stabilized at the 2003 level and amounted to 44%. Rates of mainline imports were hindered by strong competitive positions of Russian food manufacturers. Whereas in the 2002–2003 period the share of imports in the volume of food commodity resources amounted to 34%, in 2004 it went down by 2%. The market of consumer goods was under greater pressure from imports. With such a slow-down of the rates of growth in industries of the consumer's sector as was caused by a permanent recession in light industry, in 2004 the share of domestic production in retail trade in non-food products went down to 46.4%, as against 50.0% in the 2002–2002 period.

A relative decrease in value of import raw materials and material and technical resources had a considerable effect on changes in competitive environment and identified problem zones. Unit weight of imports in the total volume of industrial commodity resources increased by 7.6%, as compared to the beginning of 2004 and amounted to 29.8%. In particular, dynamic growth in investment imports as compared to that in output of domestic engineering industry was accompanied by removal of Russian manufacturers from the market. In 2004, the share of machinery and equipment in the total volume of imports amounted to 41.6%, as against 37.3% in 2003. In the 2002–2003 period, the share of expenditure on purchase of import machinery accounted for nearly 25% of the total volume of investments in machinery, equipment and transportation vehicles. So, as regards general competitive advantages (taking into account a positive impact of growth in production, on one hand, and a negative effect of appreciation of the RUR exchange rate and worsening of correlation ratios between domestic prices and imports, on the other hand) Russian manufacturers backtracked to the pre-crisis 1997 level. (*Fig. 5*).

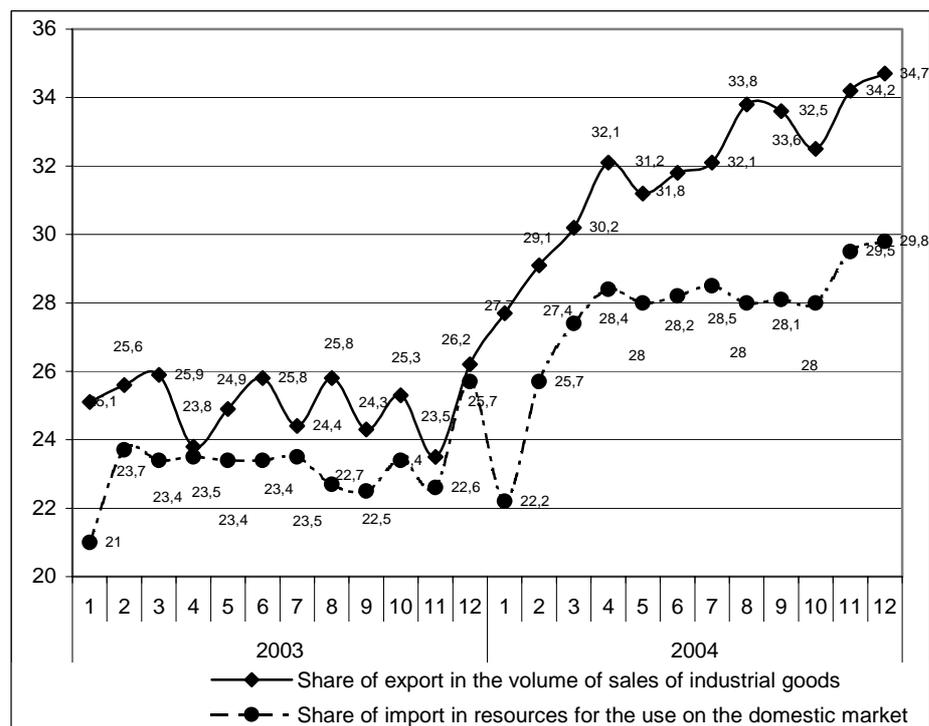


Fig. 5. Change in unit weight of imports (in resources) and exports (in sales volumes) in the 2003–2004 period in prices prevailing in respective months (%)

The principal factor behind a decrease in competitive advantages of Russian commodities is lower efficiency in utilization of production factors. Higher rates of growth in wages and salaries, as compared to those in labor efficiency had a negative effect on quality parameters of economic dynamics. In the 2002-2003 period, real wages increased by 42.8%, while labor efficiency, by 17.7%. Such growth in wages and salaries took place in a situation where the gross profit of the economy in the GDP went down from 42.7% in 2000 to 40.2% in 2004 (Fig. 6).



Fig. 6. Dynamics of labor efficiency and real wages and salaries in the 1999–2004 period (% of the 1998 figure)

In 2003, there was narrowing between the rates of labor efficiency and those of real wages. However, it did not have a significant effect on efficiency indices of enterprises and entities. Dynamics of the domestic market was maintained by growth in real wages and salaries and households' income and was accompanied by reallocation of incomes from industries to households, which situation eventually resulted in growth in production costs and a decrease in profitability. In 2004, growth rates of wages and salaries exceeded those of labor efficiency by four percent. However, further growth in expenditures on wages and salaries was limited by changes in competitive environment on commodities markets due to appreciation of the ruble exchange rate and growing pressures from imports. As a result, in 2004 the share of hired workers' wages in the GDP decreased by 1.0% on the 2003 figure.

Table 3

**Structure of formation of the GDP by the income in the 1999–2004 period
(% of the total)**

	1999	2000	2001	2002	2003	2004*
Gross domestic product	100	100	100	100	100	100
Including:						
wages (including unofficial labor remuneration) of hired workers	40.1	40.2	43.0	46.7	46.9	45.9
Net taxes on production and imports	15.7	17.1	15.7	14.1	13.5	13.9
Gross profit of the economy and gross mixed incomes	44.2	42.7	41.3	39.3	39.6	40.2

* Preliminary data.

Source: the Federal Service of State Statistics.

The specifics of formation of the structure of households' income and the GDP was determined by the structure of the gainfully occupied population: 92.1% of the gainfully employed, as against 7.9% of the self-employed. The share of labor remuneration of hired workers accounted for over 63.3% of households' incomes and 45.9% of the GDP (Table 3). Transformation changes in business environment contributed to growth in activities of small businesses. The number of workers employed by small businesses accounted for 11.3% of the total number of workers gainfully occupied in the economy. In 2004, in the structure of households' cash incomes, the share of income received from business and property grew to 21.0%, which is an increase of 1.2% and 3.9% on the 2003 figure and the 2002 figure, respectively.

High differentiation of average wages and salaries by the branch of the economy and industry was preserved. Dynamic growth in wages and salaries in services industries, financial sector and regulatory bodies was accompanied by smooth slowing of growth rates of accrued wages in the physical production sector as compared to the average level across the economy. The above trend was initiated by moderate growth in average wages in industry as compared to that in building industry. In industry, the extent of differentiation of wages was determined by a growing gap between the rates of labor remuneration in export-oriented industries and those in branches of manufacturing industry. Nominal wages and salaries in oil industry exceeded the average industry-wide level by 120%, in natural gas industry, by 260%, in nonferrous industry, by 70%, while in engineering industry and food industry, they fell below that level by nearly 15%. Sectorial specifics of labor remuneration had a significant effect on employment of labor resources in the economy and formation of the structure of households' incomes and expenditures.

With regaining of social development parameters, significant changes took place on the labor market. In 2004, the annual average number of employed persons in the economy amounted to 67.4 million, as against 65.8 million in 2003 and 63.8 million in 1998. It is to be noted that change in demand in labor was determined by a shift of work force from the physical production sector to the market services sector. At the initial stage of recovery growth, that trend had a powerful effect on quality of life and gave an impetus to rapid development of the services sector. However, in a situation where rates of industrial growth slowed down (while those of imports increased) the annual average number of industrial personnel tended to decline. In the past three years, a drop in the rate of employment was observed with all the branches of industry; the highest redundancy rates were registered in branches of manufacturing industry. Due to low efficiency in use of labor force and fixed capital in the investment sector and consumer's sector, the gap between the rates of growth in manufacturing industry and extracting industry increased and, eventually, resulted in a slow-down of growth rates of the economy.

As a predominant portion of households' income is received from labor remuneration, employment-related issues have become a priority (*Table 4*). The total number of unemployed persons calculated using ILO methods fell from 8.9 million (13.2% of gainfully occupied population) in 1998 to 6.2 million (8.6%) in 2003 and to 5.9 million (7.4%) in 2004. A tension ratio (the number of unemployed persons registered with the employment service per a vacant job) amounted to 2.7 million, as against 2.3 million at the beginning of 2003 (*Fig. 6*). At the same time, with changes in demand in work force working time was used more effectively. In the first six months of 2004, length of a working day across the economy rose by 1.8%, while in industry, by 2.3%. The number of workers employed part-time or being on forced unpaid administrative leaves fell by nearly 33.3%. In addition to the above, the length of workers' unpaid holidays was reduced in compliance with norms of the effective legislation.

Table 4

Structure of households' cash incomes in the 1999–2004 period (%)

	1999	2000	2001	2002	2003	2004
Cash incomes– Total	100	100	100	100	100	100
Labor remuneration, including unofficial pay	66.5	62.8	64.6	65.8	63.9	63.0
Business income	12.4	15.4	12.6	11.9	12.0	11.8
Property income	7.1	6.8	5.7	5.2	7.8	9.2
Social payments	13.1	13.8	15.2	15.2	14.1	13.8
Other income	0.9	1.2	1.9	1.9	2.2	2.2

Source: The State Committee for Statistics of Russia; the Federal Service of State Statistics.

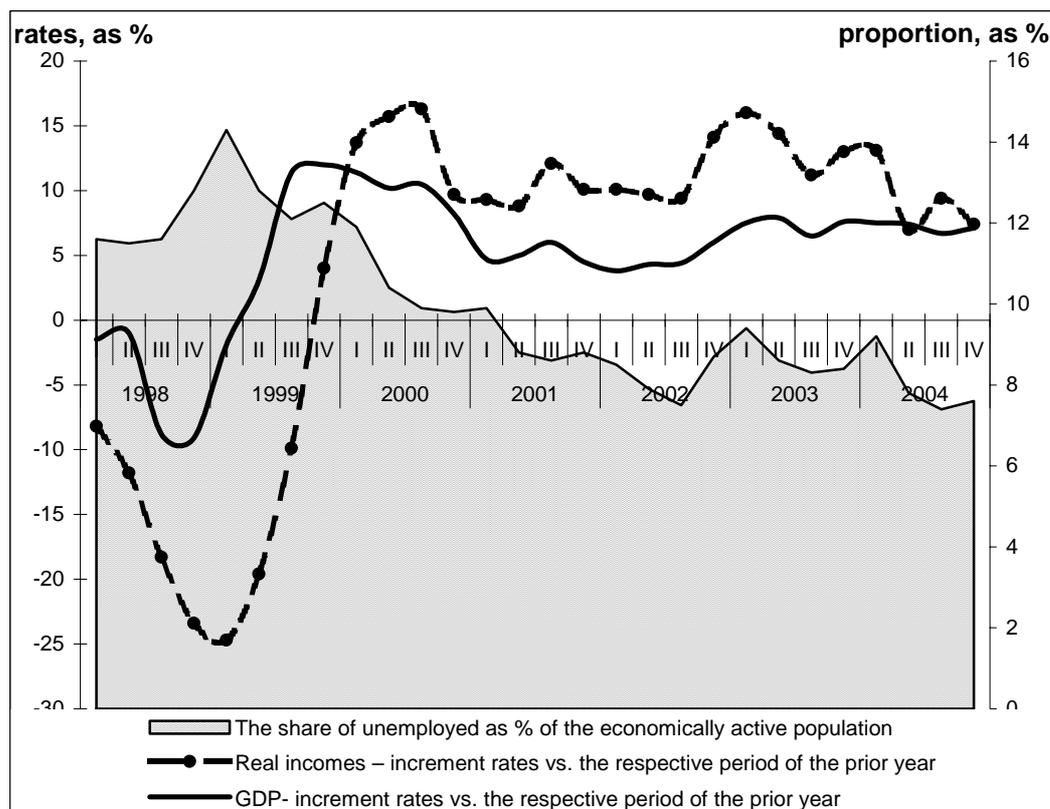


Fig. 7. Change in growth rates of the GDP, real households' income and unit weight of unemployed persons in the 1998-2004 period (%)

In the past four years, there was sustained growth in households' real income, real wages and real accrued pensions. In 2001, ultimate consumption by households regained the pre-crisis 1997 level, while in the past three years it increased by 30.5%. In 2004, growth in households' real income, real wages and real accrued pensions amounted to 7.8%, 10.8% and 5.5%, respectively.

Growth in income has resulted in a substantial reduction in the rate of poverty. The share of persons with incomes below the minimum subsistence level fell to 24.9 million and accounted for 17.3% of the total number of the population, as against 34.6 million (24.2%) in 2002.

There has been a radical change in distribution of households by the value of average per capita income. In 2004, with average per capita income and real wages growing by 122.4% and 125.3%, respectively, on the 2003 figure, the share of households with income over RUR 7000 and the share of households with income between RUR 4000- RUR 7000 increased by 8.6% and 1.7%, respectively, while that of households with income below RUR 4000 fell by more than 10.0%. However, it did not weaken socioeconomic differentiation of households by the income. By estimate, in 2004 the ratio of funds (which characterizes correlation between the value of the highest income and the value of the lowest income of respective decile groups of the population) increased by 1380%, as against 1330% in 2003 and 1300% in the 2001-2002 period, while Gini coefficient (which characterizes the extent of income concentration) rose to 0.406 in 2004, as against 0.400 in 2003 and 0.398 in the 2002-2002 period.

Distribution of income determined dynamics of current expenditures and savings in the households sector. In the past six years, changes in the structure of consumer's expenditure were determined by growth in unit weight of expenses on non-food products and services in a situation where the share of expenses on food products was declining. It is to be noted that with the existing level of income there was a gradual shift towards more expansive food products in food sales and towards better quality import products in non-food sales. As compared to the previous period, in the 2003–2004 period there was a narrowing between growth rates of the volume of paid services rendered to households and those of retail trade turnover despite the fact that there was higher growth in prices and tariffs on paid services than on goods. It is to be noted that in the 2002–2004 period there was sustained higher growth in nonfood sales, than in food sales, as well as an increase in the share of sales carried out by commercial entities. Change in consumer behavior can be explained to a certain extent by slowing of the rate of inflation, as well as structural changes in pricing in respect of principal groups of commodities.

Growth in purchase power of households' incomes ensured high growth rates of retail trade turnover. In 2004, households spent RUR7567.2 billion on goods and services, (an increase of 23.4% on the 2003 figure). In 2004, the retail trade turnover increased by 12.1%, as against 8.4% in 2003. Change in the structure of households' demand and increase in the share of non-food durable goods sales gave an impetus to intensive development of consumer lending. Within a year, the volume of lending to individuals increased by 91% and amounted to RUR573.3 billion as of early December 2004. As of December 1, 2004, the share of loans extended to individuals accounted for 14.4% of the total sum of loans advanced by credit institutions (9.8% a year ago).

In the past few years, there was a shift in gross savings from the non-financial sector to households. With an increase in the share of households' savings and restoration of confidence in savings institutions, growth in deposits by individuals in credit institutions was registered. In 2004, the volume of households' cash income amounted to RUR10,779.5 billion, including savings and purchase of foreign currency which amounted to RUR1983.4 billion (an increase of 11.6% on the 2003 figure). The volume of ruble and foreign currency deposits by individuals in credit institutions amounted to RUR1894.7 billion as of December 1, 2004 (which is an increase of 23.0% as compared to the beginning of 2004, including growth in ruble deposits and foreign-currency deposits by 22.1% and 9.4%, respectively). With growth in a savings portion of households' income, the issue of transformation of savings into investments became of particular importance. From 1999, in the structure of households' cash expenditure sustained growth in the share of expenditure on purchase of real estate was observed. It gave a boost to business activities in housing development and on the secondary housing market. In the 2000–2004 period, the share of housing built by households at their own account and with use of loans amounted on average to 40.5%. In 2004, unit weight of expenditure on purchase of real estate grew by 1.0% on the 2000 figure and accounted for 2.2% of the total value of households' cash income (*Table 5*).

On the basis of analysis of changes in the share of gross profit and entrepreneurial income in the GDP, it can be asserted that average profitability of Russian economy tended to grow. An increase in the share of gross profit of the economy in the GDP was determined by growing efficiency in financial activities of enterprises and entities and a decrease in tax burden on production and imports starting from 2002. In the past five years, balance financial result accounted on average for nearly 12% of the GDP. In January–November 2004, balance financial result of entities of the main branches of the economy amounted to RUR1952.6 billion (an increase of 54% on the same period figure in 2003). It is to be noted that balance financial re-

sult was formed in equal portions through production of goods and rendering of services. However, within sectors there were branches, which had a dominating effect on generation and disposition of profits in national economy.

Table 5

Structure of households' cash incomes in the 1997–2004 period (%)

	1997	1998	1999	2000	2001	2002	2003	2004
Cash expenditure and savings – total	100	100	100	100	100	100	100	100
Including :								
Purchase of goods and payment of services	68.7	77.7	78.5	75.5	74.6	73.2	69.0	69.8
Mandatory payments and contributions	6.3	6.2	6.6	7.8	8.9	8.6	8.3	8.6
Purchase of real estate	0.8	1.3	1.3	1.2	1.4	1.8	2.0	2.2
Growth in financial assets	24.2	14.8	13.6	15.5	15.1	16.4	20.7	19.4
Including increase, decrease (-) in households' cash funds	1.6	1.7	1.8	2.8	2.0	1.7	2.7	0.6

Source: The State Committee for Statistics of Russia; the Federal Service of State Statistics.

Industry preserved its leading positions as regards growth rates of financial performances, which factor was primarily related to an increase in incomes of export-oriented branches of fuel industry and metallurgical sector. According to the preliminary data of the Ministry of Economic Development and Trade, in 2004 balance financial result of oil industry, ferrous industry, non-ferrous industry and chemical industry increased by 140%, 150%, 50% and 70%, respectively, on the 2003 figure. Aggregate unit weight of export-oriented branches in the total financial result of industry rose by 5% on the 2003 figure. Growth in incomes of the export sector had a significant effect on related services industries, such as transport, communications and commerce, while domestic market-oriented branches were left almost unaffected. The situation was less favorable in domestic market-oriented branches of manufacturing industry. Though dynamics of balance result of the investment sector (due to growth in production costs as a result of an increase in expenditure on labor and high domestic prices on energy sources and engineering materials) remained within the domain of positive values, unit weight of engineering industry and building materials industry decreased by 3.2% in industry's financial performance. In a situation of slowing rates of growth in food industry and recession in light industry, income of the consumer's sector of industry fell by nearly 9.0% on the 2003 figure.

Comparison analysis of dynamics and structures of formation and allocation of the GDP has shown that in conditions where growth in external demand exceeds the rates of development of the domestic market there is large scale reallocation of financial, investment and labor resources to a small number of export-oriented branches of extracting industry, processing industry and service industries.

3.1.2. Dynamic and Structure of Production of the GDP

Bellow are factors which had a significant impact on development of Russian economy:

- a higher role of the external demand and export-oriented branches of industry;
- speed-up of growth rates of industries producing capital goods;
- higher growth in investment in fixed capital as compared to dynamics of the GDP and ultimate consumption;
- speed-up of growth in imports of goods of ultimate consumption as compared to that in the domestic demand;

- intensive growth in services sector;
- growing gap between rates of real wages and salaries and those of labor efficiency;
- prevalence of high consumer demand in a situation where households tend to saving;
- speed-up of growth in prices of manufactures of industrial products and tariffs on services.

Services Sector

In the 2002–2004 period, speed-up of rates of growth in market services was observed in Russian economy (*Fig. 8*). With added value in goods-manufacturing sector increasing by 6.3% in 2004, market services rose by 8.7%. Growing indices of the sector closely correlated with the level of business activities and structural changes in the economy. High growth in transportation services, communications, commerce and business activities aimed at ensuring operation of the market and fulfillment of transactions with real estate had a dominating effect on the services market.

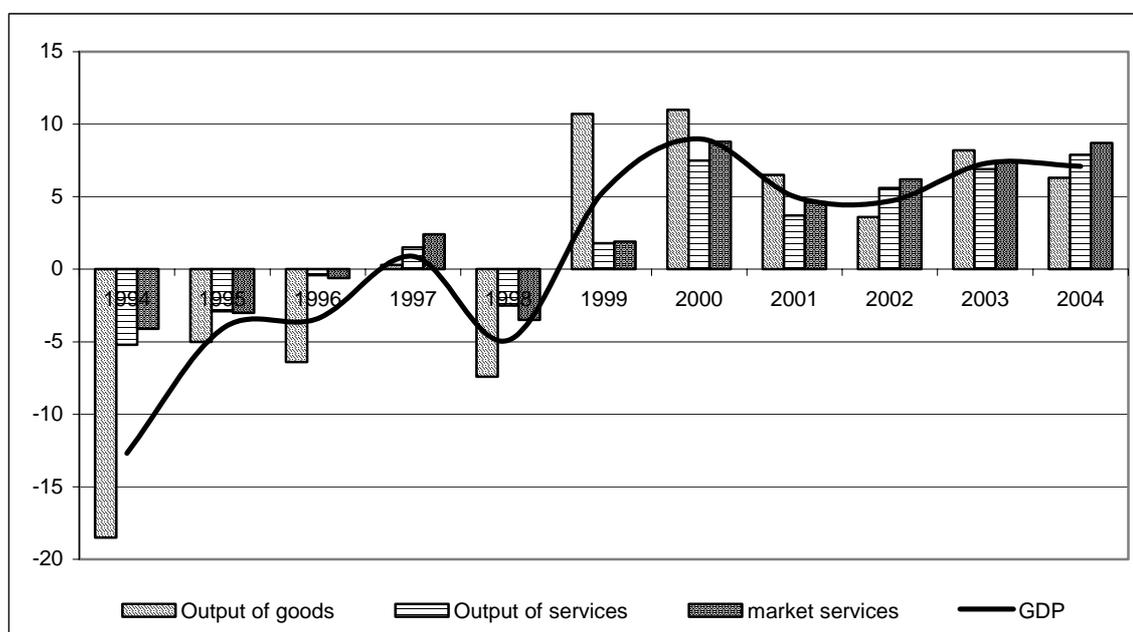


Fig. 8. Change in the rates of production of goods and services by the sector of the economy in the 1994–2004 period (% of the previous year figure)

In 2004, commercial cargo turnover grew by 6.2% with industrial output increasing by 6.1%. Export-oriented industries contributed to a greater extent to growth in demand in transportation services. Growth in cargo turnover of pipeline industry amounted to 6.2% on the 2003 figure. Oil and oil products, ferrous and non-ferrous metals, chemical and mineral fertilizers and wood products were still leaders as regards cargo transportation volumes.

Change in the structure of transportation services was determined by a general economic situation, as well as handling of practical issues of coordination of transport infrastructure. In 2004, volumes of carriage by car, rail and water inside the country increased by 100%, 30% and 4%, respectively, on the 1998 figure. The period of recovery growth was characterized by a decrease in the share of investments in development of rail transport in a situation where in the same period the share of investment expenditure on devel-

opment of highways increased by 13.5% and that of motor transport, by 1.3%. In the period of the reforms, operational length of hard-surface motor roads increased by nearly 200 thousand km with density of motor roads increasing from 23 km per 1000 sq. km in 1990 to 31.7 km per 1000 sq. km in 2003. Motor transport accounted for 75% of cargo carriage volumes and 73% of out of town passenger carriage volumes. Though the condition of Russia's transportation system does not hinder economic growth, its low efficiency leads to higher transportation costs and a loss of incomes from transit carriage.

Communications industry is one of promising and rapidly developing industries of the economy. In 2004, volume of gross added value of communication services increased by 24.7% and amounted to 2.0% of the GDP. In the 2003-2004 period, annual average rates of growth in volumes of communication services amounted to 27.5% and exceeded by 17.2% the 2002 level. New communications operators accounted for nearly 60% of the total volume of communication services and over 50% of services rendered to the population. Telephone service is one of the most widespread services of electrical communication. It accounted for 75% of all the income received from communication services, including mobile communications services (40%). As of January 1, 2005, the total number of cellular phone users amounted to nearly 70 million and increased by 34.5 million (or 97.2%) as compared to the beginning of 2004.

The phenomenon of Russian economy consists in sustained increase in the share of commerce in the structure of national economy. Development of commerce was accompanied by intensive development of its material and technical base and change in the structure of services. Growing role of organized forms of commerce in the structure of goods turnover contributed to intensive growth in sales premises, warehouses and services. Commerce promoted growing demand in equipment, information services, communications services and transport. In 2004, the share of commerce in the GDP amounted to 22%, which corresponded to an average index in the past five years. It is to be noted that development of commerce was characterized by dynamic structural changes. Firstly, favorable changes in demand on international markets contributed to higher growth and increase in unit weight of foreign trade in the structure of sales turnover. Secondly, wholesale trade volumes exceeded by nearly 100% those of retail trade. With increase in business activities, intensive growth in wholesale trade was maintained through expansion of demand in material and technical resources in the domestic market.

In 2004, the situation in retail trade can be characterized as follows:

- small business started to play a greater role in retail trade: it ensured nearly 50% of the retail trade volume, as against 48.7% in 2001 and 46.1% in 2000;
- in 2004, the share of non-food products in the retail trade turnover (an indicator of a quality of life) amounted to 54.4% with an average index amounting to 53.6% in the 2001–2003 period;
- commodity stocks were stable and remained at the level of 34–35 days;
- share of import commodities in the retail trade turnover amounted to 43% and increased by 2% on the 2001 figure;

In 2004, growth rates of prices on consumer goods amounted to 111.7%, as against 112% in 2003. It is to be noted that growth in trade volumes took place in a situation where growth in prices on non-food commodities amounted to 107.4%, as against 109.2, while that in prices on food products, to 112.3%, as against 110.2%.

As a result of the aggregate effect of the above factors, the index of growth in retail trade turnover amounted to 112.1% on the previous year figure with unit weight in the GDP rising to 8.2%. In a situation where rates of economic growth slowed down late in 2004,

speed-up of dynamics of retail trade turnover had a favorable effect on the economic situation in general (Fig. 9).

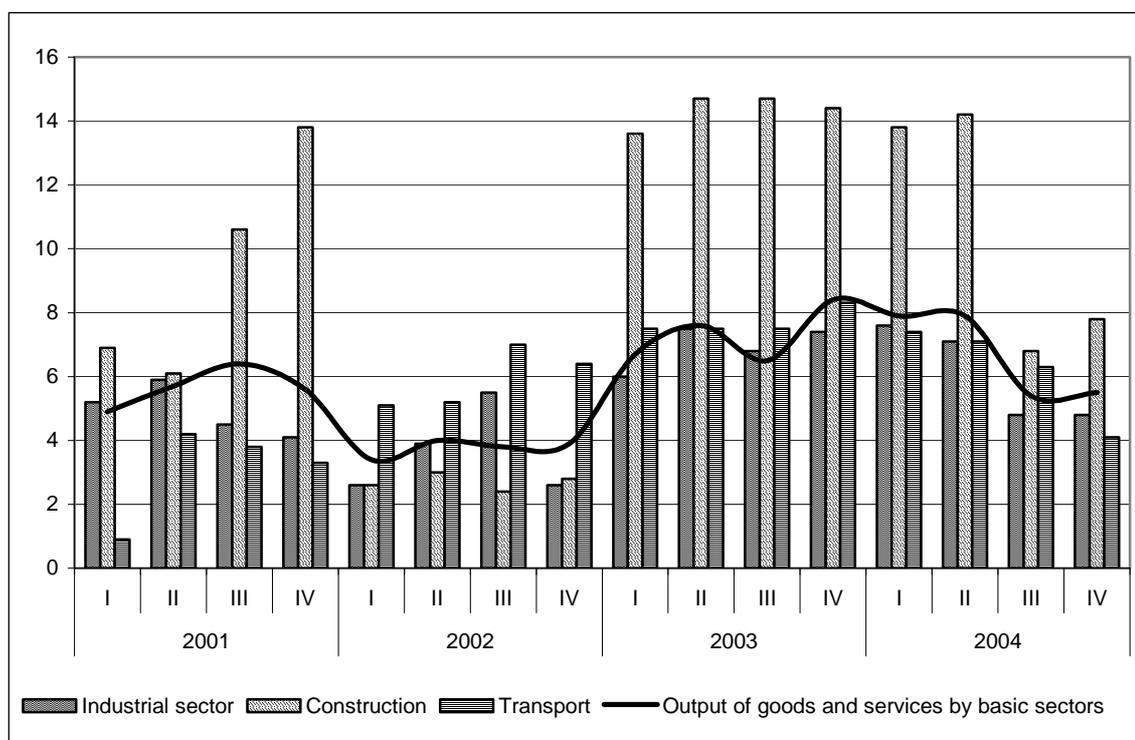


Fig. 9. Change in growth rates by the branch of the economy in the 2001–2004 period (% of the corresponding period figure of the previous year)

Physical Production Sector

In the physical production sector, a ratio between volumes of output in industry and building industry had a significant effect on changes in the structure of production. Sustained growth in incomes of the economy gave an additional impetus to growth in demand in building works. In the 2000–2004 period, annual average growth rates of building works amounted to 10.7%, while those of output of building materials industry, to 6.6%. In the past few years, dynamics of building pointed to strong dependence of the level of business activities in building industry and economic income on foreign economic activities. In 2002, economic income went down due to a drop in prices in international markets; in the same period growth in output of building industry was the lowest during recovery growth and amounted to 2.7%. In the 2003–2004 period, growing economic income gave an additional impetus to growth in building industry. In the past two years, annual average rates of building works amounted to 12.2%. Growth in investment contributed to changes in the structure of recovery growth in the economy.

In conditions of economic recovery, Russian-made equipment was in high demand as a result of upgrading and modernization of production facilities and introduction of competitive capacities.

With annual average growth rates of the investment sector and consumer's sector being at the level of 9.4% and 7.1%, respectively, in the 2000–2004 period, the above in-

dex in the primary sector (which is oriented primarily at foreign markets) amounted to 6.5%. Though in the period under review there were significant fluctuations in correlation between growth rates of industries, a gradual shift from growth (based on natural-resources potential) to formation of the system of investment development was observed (Fig. 10).

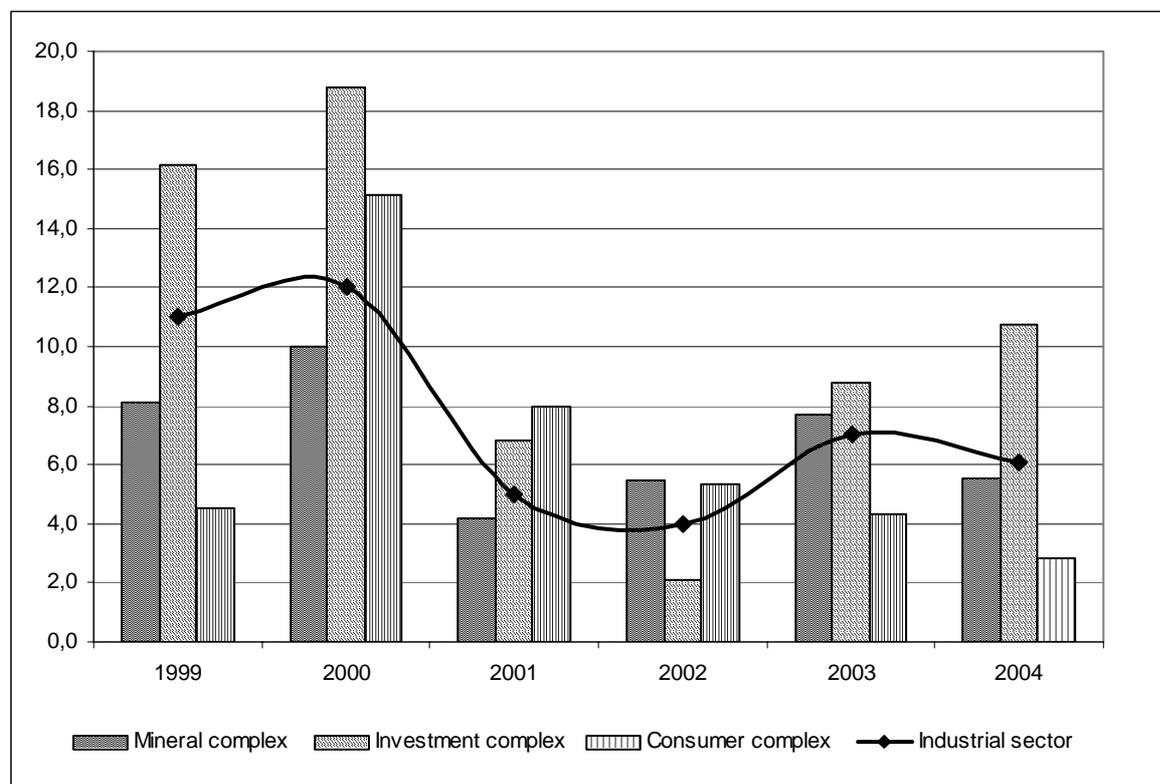


Fig. 10. Growth rates of production by the sector in the 1999–2004 period. (% of the previous year figure)

In the past six years, low-key dynamics of the output of capital goods as compared to the rates of industrial growth was registered in 2002 where growth in output of the investment sector hit its minimum level and amounted to 2.2% against 6.8% in 2001 and 18.9% in 2000. However, as early as 2003 the situation changed radically. As in the 2000–2001 period, the investment sector responded to speed-up of growth in output and income of the export-oriented sector by an intensive increase in production of capital goods. In 2003, output volumes in engineering industry grew by 9.2%, as against 1.9% in 2002, while in building materials industry, by 6.4%, as against 3.0%. Better conditions of trade in Russian-made high-tech products on international markets were an additional factor behind growth in engineering industry.

In 2004, growth in output of the investment sector amounted to 11.7% (an increase of 1.9%) on the 2003 figure. As regards growth in output, engineering industry preserved its leading positions among other branches of industry. At the same time, there were considerable fluctuations in outputs of individual branches of engineering industry. Negative factors which affected the dynamics of engineering industry in the 1999–2004 period included sporadic crises of overproduction in auto industry and fuel industry's unstable investment demand in Russian-made equipment in a situation of growth in import volumes of

machinery and equipment and higher income from exports. High growth rates of machinery and equipment were primarily ensured through expansion of demand in products meant for the domestic market (railway engineering, instrument-making industry and communication industry). In addition to the above, in the past few years there was sustained expansion of demand in machinery and equipment for branches of the consumer's sector.

Analysis of the specifics of formation of the capital goods market is of principal importance, since in the past two years growth in investments in fixed capital was faster than that in ultimate consumption. That factor had a considerable effect on structural changes in the GDP. As regards the rates of output of capital goods, in engineering industry they were faster than those of growth in investment in fixed capital, however, as regards structure and volumes of such output engineering was behind changes in reproduction and technological structures of capital investments in production. In addition to the above, faster growth rates of imports as compared to those of domestic production still had a considerable effect on development of engineering industry. It can be explained by the fact that many types of machinery and equipment were noncompetitive as compared to their foreign analogs (as regards the "price/quality" criterion) and lack of production capacities needed for manufacturing of modern machinery limited to a great extent the market of domestic engineering. With an increase of 11.7% in output of engineering industry, growth in imports of machinery and equipment amounted to 46.2% (Table 6).

Table 6

**Dynamics of production by the branch of engineering in the 1999–2004 period
(% of the previous year figure)**

	1999	2000	2001	2002	2003	2004
Industry – total	108.1	109.0	104.9	103.7	107.1	106.1
Engineering	115.9	115.5	107.2	101.9	109.2	111.7
Including :						
Railway engineering	108.9	107.4	126.0	121.7	135.8	122.8
Metallurgical engineering	91.8	130.2	86.1	82.6	94.0	123.9
Electrical engineering industry	127.0	130.1	112.6	93.8	105.5	106.7
Chemical and oil engineering	120.7	119.5	121.6	96	93.0	105.9
Machine-tool industry and toolmaking industry	99.6	111.5	99.4	81.7	100.5	95.1
Instrument making industry	140.8	118.4	98.0	90.9	144.8	112.7
Auto industry	114.7	103.3	101.7	97.8	106.0	109.3
Communications industry	95.7	330.0	90.0	174.6	118.0	193.0
Tractor and agriculture engineering	159.3	148.4	129.1	77.6	76.4	130.5
Engineering for light industry, food industry and household appliances	115.8	109.5	107.1	115.9	106.6	119.0

Source: the Federal Service of State Statistics.

The condition of branches of investment engineering is a key technological factor, which hinders modernization and upgrading of production on a new technical base. Due to prolonged recession trends in machine-tool industry and low rates of renewal of capital in engineering industry, in particular, servicing of the investment process was carried out on the basis of traditional standard technologies. Though in the 1999–2004 period an increase in investment in engineering industry amounted to nearly 41.8% on the 1998 figure, it did not have a significant effect on technical and economic parameters of fixed capital of engineering industry and industry as a whole. With the average norm of renewal of capital funds in the past three years in engineering industry at the level of 0.9% and in industry, at

1.8%, in the structure of machinery and equipment fleet there was a drop in the share of equipment under the age of ten years old.

Engineering industry is characterized by high fluctuation of workers. In the 1998-2004 period, the number of industrial personnel went down by 8.4%. The industry badly needed skilled workers. With average wages and salaries in engineering industry amounting to 80% of the average level of labor remuneration across industry, engineering industry was not seen on the labor market as an attractive employment opportunity.

Dynamics of building materials industry closely correlated with the volume of building works. In the 2001–2004, commissioning of new housing increased by nearly 35.3%. In 2004, with an increase in building works by 10.1% on the 2003 figure, growth in output of building materials amounted to 5.3%. An increase of 11.3% in growth rates of cement industry was accompanied by higher energy saving; per unit weight of cement production on the basis of energy saving technologies in the total output of industry grew from 13% in 1998 to 14.3% in 2003 and 14.7% in 2004. Intensive growth in output of building ceramic (an increase of 115% on the 2003 figure) and building materials produced out of polymer resources (109.9%) was maintained thanks to modernization and upgrading of production. In 2004, the volume of investment in building materials industry increased by 140% on the 1998 figure.

Industries producing consumer goods were unable to maintain high rates of growth during a long period, which factor was related to a great extent to lack of quality changes in technologies and the structure of production. In 2004, growth in the consumer's sector hit the minimum level in six years and amounted to 2.9%, as against 4.3% in 2003. A recession trend in light industry (registered in 2003) affected to a great extent the structure of production of consumer goods (a decrease of 4% a year). In 2004, investments in the consumer's sector kept going down.

It is to be noted that branches of manufacturing industry (including light industry) are all characterized by a high wear ratio of capital funds. The ratio of disposal of capital funds due dilapidation exceeded by 300% that of renewal of capital funds. In light industry, absolute decrease in the volume of capital funds was registered. The crisis in light industry resulted in a radical drop in demand in labor force. In the past three years, annual average number of industrial personnel in light industry decreased by more than 12%. Light industry became less attractive due to a low level of labor remuneration. Wages and salaries in light industry amounted to nearly 40–45% of the average level of labor remuneration across industry in general. Due to incompatibility of a technical base and labor skills with market criteria, domestic products of light industry were getting less competitive and in a situation of appreciation of the RUR exchange rate more niches opened up for foreign goods. As a result, removal of domestic products from the market intensified.

Factors which neutralized a negative effect of light industry on formation of the market of domestic non-food products included a speed-up of rates of growth in output of household appliances, furniture and other goods for home. Growth in output of furniture and building materials correlated with intensive growth in housing construction. Introduction of new technologies and growth in output of assembly unit products on the basis of import accessory parts had a positive effect on the above industries and their competitive advantages.

No doubt, sound positions of food industry on the domestic consumer's market was a positive factor. In the volume of food products resources, the share of domestic products in the 1st-quarter, 2nd-quarter and 3rd-quarter of 2004 amounted to 66%, 67% and 68%, respectively. At the same time, there was a number of factors which had a negative effect on development of the industry. In the 1999–2004 period, there was a gradual decline in

growth rates of food industry (*Fig 11*). In the 2001–2003 period, intensive flow of investments in fixed capital and creation of new jobs contributed to strengthening of positions of food industry on the Russian market. In the above period, investments in fixed capital in food industry increased by nearly one third. With growth in the ratio of renewal of machinery and equipment up to 4.2% in 2003, as against 2.4% in 1998, in the above period the wear ratio of funds decreased by more than 10% and amounted to 35.7%. However, the created potential was insufficient. In 2004, due to reduction in investment support growth rates of production in food industry fell to 3.7%.

Unfortunately, investment programs on modernization and upgrading of production failed to ensure sustained growth in labor efficiency and effective use of material resources. In a situation of growth in material and labor costs in food industry, profitability decreased by nearly 1.5% on the 2003 figure. In food industry, the index of output growth was somewhat lower than that across industry. In 2004, growth in output of food industry amounted to 4.0%, as against 5.1% in 2003 and 6.5% in 2002. Slow-down of growth rates of food industry as compared to those of retail trade turnover was also registered.

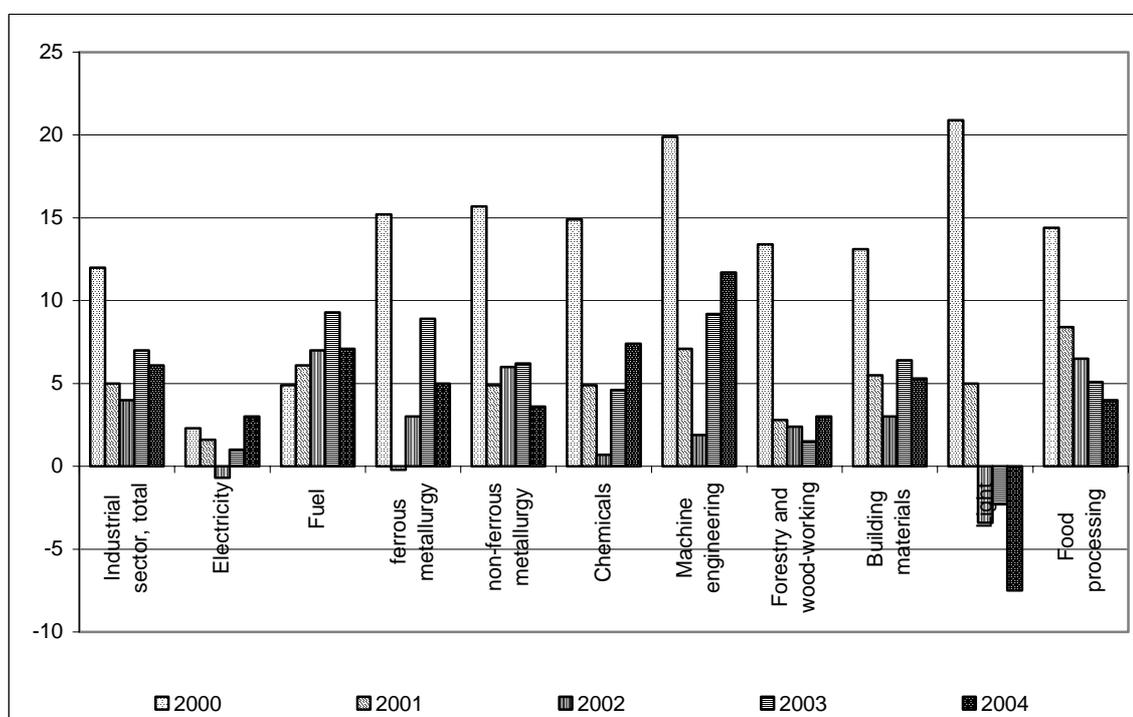


Fig. 11. Change in dynamics of production by the branch of industry in the 2000–2004 period (% of the same period figure in the previous year)

The year 2004 was characterized by growing rates of inflation due to faster growth in producer prices in the industrial sector and building industry. According to the 2004 results, producer price index amounted to 128.3% (an increase of 15.2% on the 2003 figure), while in building industry, to 114.9%, as against 110.3%.

Changes in the price structure of the domestic market had a considerable effect on rates of industrial growth and outputs of financial activities. Though in 2003 growth rates of producer prices were higher than those of consumer prices, the gap was insignificant, since there was administrative regulation of prices and tariffs on products and services by natural monopolies. In 2002, the above factor helped overcome inflationary pressures,

which were caused by growth in natural monopolies' prices and tariffs. In 2003, the price index in electric power industry exceeded by a mere 0.8% prices of manufacturers of industrial products, while in 2002 the gap amounted to 10%. In natural gas industry, a drop of 22.9% in producer prices was registered for the first time since the beginning of the reforms.

In 2004, changes in price ratios in industry were related to intensive growth in prices on products of fuel industry and ferrous industry. In 2004, price index in fuel industry amounted to 164.7%, as against 101.4% in the same period in 2003. Growth in prices on products of fuel industry took place in a situation of a change in the structure of pricing on energy resources. With an increase of 65.4% in oil prices since the beginning of the year, prices on the produce of natural gas industry increased by 90%. Change in gas prices was aimed to a certain extent at equation of price ratio in respect of hydrocarbons (with dynamics of prices in domestic and international oil markets taken into account). In 2003, average gas prices amounted to 6.3% of oil prices, as against 8.5% in 2004 (which corresponded to the ratios in the 2001–2002 period). Growth in gas prices stimulated increase in tariffs on electric power which is one of principal consumers of that fuel. However, in 2004 prices on electric power energy increased by 11.5%. A radical change took place in the ratio between prices on natural gas and electric power. In 2004, tariffs on electric power used by consumers exceeded average prices on gas by 190%, while in 2003 that ratio amounted to 480% and in the period of recovery growth, to 270% on average (*Fig. 12*).

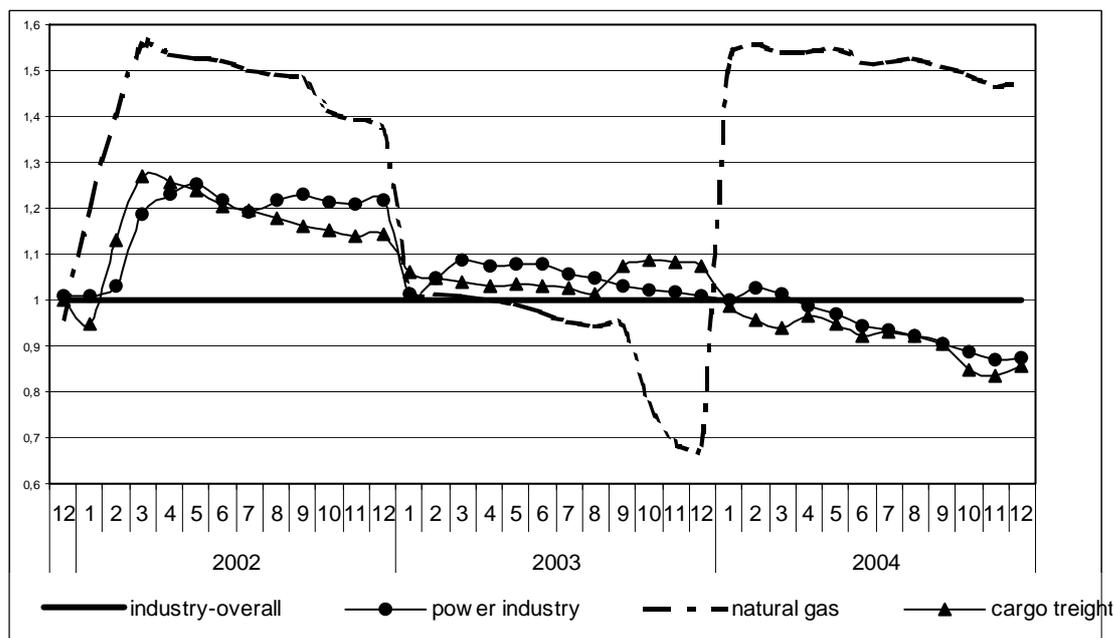


Fig. 12. Dynamics of prices of natural monopolies in the 2002–2004 period as compared to that of prices of manufacturers of industrial products (% of the December figure of the previous year) (industry = 1)

The year 2004 was also characterized by growth in prices on ferrous metals and investment goods. Higher growth in prices in ferrous metallurgy as compared to that in principal consumer-industries was observed since 2002. Extraordinary high demand in ferrous metals, as well as high international prices on such commodities gave an additional impetus to growth in

prices in 2004. Equation of domestic and international prices resulted in growth in producer's prices in ferrous metallurgy by 65.8% in 2004, as against 28.8% in 2003.

The investment sector was the first to respond to growth in prices on metals, since it was the principal consumer of engineering materials. Growth in prices in engineering industry amounted to 15.0% in 2004, as against 11.2% in 2003, in building materials industry, to 16.2% and in building industry, to 14.9%.

In 2004, in consumer's sector a slow-down of rates of growth in prices was observed. In 2004, the producer price index in light industry amounted to 108.1%, as against 115.2% in 2003, while in food industry, to 111.4%, as against 114.8%. Smooth dynamics of growth in prices on consumer foods could be explained by changes in a market situation and decrease in popularity of domestic goods in a situation of appreciation of the RUR and growth in demand in import goods (*Table 7*).

Table 7

**Producer price indexes by the branch of industry in the 1999–2004 period
(December to December of the previous year, %)**

	1999	2000	2001	2002	2003	2004
Industry – total	167.3	131.6	110.7	117.1	113.1	128.3
Electric power industry	114.4	139.9	130.2	127.3	113.9	111.5
Fuel industry	234.9	155.2	102.2	124.3	101.4	164.7
Oil industry	249.2	158.0	97.1	125.6	101.6	165.4
Petroleum refining industry	342.3	147.5	84.5	119.9	114.8	148.9
Natural gas industry	122.1	163.1	141.5	130.2	77.1	188.5
Coal industry	132.2	144.3	122.4	109.1	110.1	151.4
Ferrous industry	189.2	129.2	103.5	123.3	128.8	165.8
Non-ferrous industry	215.8	108.7	89.4	130.1	127.2	113.7
Chemical industry	143.8	126.8	119.8	108.3	115.1	129.4
Petrochemical industry	166.5	135.8	101.2	108.7	111.3	117.4
Engineering industry	149.6	128.0	116.5	110.6	111.2	115.0
Wood industry, woodworking industry and pulp and paper industry	167.7	124.6	107.7	108.2	107.9	111.1
Building materials industry	137.3	136.6	119.5	117.4	117.0	116.2
Light industry	156.0	122.3	110.9	105.3	115.2	108.1
Food industry	162.6	118.6	115.0	105.8	114.8	111.4

Source: the Federal Service of State Statistics.

Export-Oriented Branches of Industry

Both the extent of demand in primary goods and allocation of income from foreign-economic activities are of principal importance to Russian economy. Analysis of post-crisis development of Russian economy suggests that a slow-down of industrial growth (106.1%, as against 107.3% in 2003 and 111.0% in 2000) is caused by slowing rates of development of the primary sector. In formation by fuel and primary industries of nearly 40 % of balance financial result of the economy and 75% of that of industry, both income of economic agents and the situation on the domestic market depended on fluctuations in international markets. Fuel and primary industries produced over 40% of industrial output, used 60% of investments in fixed capital of industry and ensured employment of 20% of industrial personnel. In the 2000–2004 period, the share of added value received from export of primary goods amounted to nearly 20% of the GDP and 40% of output of goods.

Such limitations of primary resources production as were related to the condition of the export infrastructure, decrease in reserve capacities and depletion of competitive advantages (which appeared as a result of the 1998 RUR devaluation) started to affect devel-

opment of the primary sector. With the existing structure of capital funds, further increase in capacity utilization would result in capital intensity of production and decrease in efficiency of utilization of labor and financial resources. A low rate of processing in metallurgy and chemical and wood sectors prevented successful diversification of the structure of production and export. Due to the above factor, the structure of industrial production and changes in demand on the domestic market depended to a great extent on dynamics of output volumes of the export-oriented sector.

In the 2003–2004 period, non-ferrous metallurgy lost its dominating influence on growth dynamics of the metallurgical sector. In 2004, in non-ferrous industry an increase in output amounted to 3.6%, as against 6.2% in 2003. Change in the volume of demand in principal export commodities resulted in a slow-down of growth rates of non-ferrous industry. According to the results of the three-quarters of 2004, growth in export volumes was registered only in respect of unprocessed aluminum. At the same time, in a situation of favorable dynamics of prices on non-ferrous metals manufacturers aimed their efforts at preserving stability on a traditionally volatile and cyclic market of non-ferrous metals, rather than expanding the supply.

With growth rates at the level of 105.0%, ferrous metallurgy occupied leading positions in the sector as a result of simultaneous growth both in domestic and foreign demand. With increase in investment activities in national economy, there was growth both in demand in engineering materials and their sales volumes on the domestic market. A favorable change in a business climate and global market situation gave an additional impetus to growth in ferrous metallurgy. Export of ferrous metals increased by 76.6% on the January–November 2003 figure, while that of ferrous-based alloys, by 24.4%. According to the results of three-quarters of 2004, balance profit in ferrous metallurgy increased by 130%. In the past two years, specifics of ferrous metallurgy were determined by dynamic growth in investment in fixed capital. Though higher rates of renewal of production facilities and removal from service of obsolete equipment resulted in a slow-down of rates of output as compared to 2003, they predetermined future development of ferrous industry.

The Oil and Gas Sector

The oil and gas sector forms a basic sector of Russia's economy and plays a leading role in forming the federal budget revenues and the nation's active balance of payments. In 2004, the oil and gas sector has found itself under the impact of the price situation on the world market for oil. As over 70% of the domestic oil output is exported in the form of crude or refined oil, while domestic sale prices are substantially lower than international, the world price levels form the main factor that determines the national oil sector's proceeds and financial state. Due to high growth rates of the world economy, OPEC's efforts¹ to limit oil production and the fall in Iraqi oil output, the oil prices have been extremely high in 2004. As well, the prices remained high because of the fall in oil output in the Mexico Bay due to a hurricane in September, the unrest in the delta of the Niger, and strikes that had hit the oil sector in Nigeria, Brazil and Norway. As a result, in October 2004 Brent oil hit the level of USD 49.6/barrel, while Russian Urals sky-rocketed up to 42.3 USD/barrel. In 2004, the prices for the OPEC's oil basket has been considerably above the ceiling of the targeted price range of the Organization (USD 22–28/barrel) and made up USD 36.05/barrel on average. The price for Russian Urals on the world (European) market in 2004 reached on average USD 34.45/barrel, or up by 27.4% vis-a-vis its respective level in 2003 (*Table 8*).

¹ According to the decision made by the 2003 (September) OPEC conference, since November 1, 2003 the quota of oil output was reduced by 900,000 barrels a day (from 25.4 to 24.5 mln. barrels), while the February and March 2004 conferences ruled that since April 1, 2004 the quota should be reduced by another 1 mln. barrels a day (to 23.5 mln. barrels).

At the end of 2004 the prices slid slightly, which can be explained by the rise in the OPEC countries' oil output², restoration of the volume of oil output in the Mexico Bay and the growth in oil supplies from the NIS.

Table 8

World Oil Prices in 1997–2004 (USD/barr.)

	1997	1998	1999	2000	2001	2002
Brent, UK	19.12	12.72	17.97	28.50	24.44	25.02
Urals, Russia	18.33	11.83	17.30	26.63	22.97	23.73
OPEC's oil basket	18.68	12.28	17.47	27.60	23.12	24.34

Table 8 (cont'd)

	2003	2004 1st Q.	2004 IInd Q.	2004 IIIrd Q.	2004 IVth Q.	2004
Brent, UK	28.83	31.95	35.36	41.54	44.00	38.21
Urals, Russia	27.04	28.94	32.54	37.41	38.92	34.45
OPEC's oil basket	28.13	30.80	34.41	38.97	40.01	36.05

Source: OECD International Energy Agency, OPEC.

In 2004, the oil and gas sector has seen the trend to a further rise in production of oil, oil products and natural gas that had emerged between 2000–03. In 2004, the oil output, including gas condensate, nearly reached the 1991 level and accounted for 458.8 t. In 2004, the increment in the volume of oil output grew by 8.9% vs. 2003, while the increment in the volume of primary oil refining grew by 2.6%. So, over the past 5 years, i.e. between 2000 through 2004, Russia's oil output rose by 50.4%. In a longer retrospective, the dynamics of Russian oil output in 2004 was at 19.4% lower the pre-crisis maximum of 1987, when the volume of oil output accounted for 569.4 mln.t., while it appeared to be at 52% greater vs. the 1996 minimum level when it was 301.3 mln.t. Interestingly, the output in the oil sector was growing against some decrease in investment activity. While in 2004 the volume of operational oil drilling was close to the prior year's level (the increment was 0.4%), the placement of new oil wells in operation slid by 1.1%, while prospecting drilling dropped by 18.3 (which can be explained by a fairly high sufficiency of the existing reserves). In the oil-refining sector, the production of petroleum derivatives with the use of intensive technologies grew by 1.8%, while the intensity of oil refining grew from 70.3% in 2003 up to 71.5% in 2004. The share of high-octane gasoline in the overall output of automobile gas grew from 53.1% in 2003 to 55.3% in 2004. The rise in the output of natural gas which had started in 2002 made up 1.6% in 2004. (Table 9).

The list of the biggest oil producers in 2004 included YUKOS, LUKOIL, TNK-BP, and Surgutneftegas. The late 2004 saw substantial changes in the structure of the oil sector: more specifically, YUKOS' main oil asset – Yganskneftegas, with its 50 mln.t. plus output was sold at an auction and acquired by Rosneft. Consequently, the latter considerably rose its share in the Russian oil market (from 4.7 up to 16%), while YUKOS' share fell drastically (from 18.7 to 7.4%). So, the proportion of the state-owned companies (Rosneft, including Yuganskneftegas, and Gasprom in the national oil output grew up to 18.6%. By contrast, as long as a company's individual oil production is concerned, Tatneft and Bashneft that operate old oil deposits demonstrated the minimum growth rates, which resulted in their shrinking shares in the market.

² According to decision made by the June (2004) OPEC conference, since July 1, 2004 the quota was increased up to 25.5 mln. barrels a day and consequently to 26.0 mln. barrels a day. The September (2004) conference increased the quota up to 27,0 mln. barrels a day, i.e. by another 1 mln. barrels, effective as of November 1, 2004.

Table 9

**The Output of Oil, Oil Products and Natural Gas in 2000–2004
(as % vs. the Prior Year)**

	2000	2001	2002	2003	2004
Oil, including gas condensate	106.0	107.7	109.0	111.0	108.9
Oil	105.9	107.7	108.7	111.1	108.6
Gas condensate	103.8	106.7	112.8	108.7	116.9
Primary oil refining	102.7	103.2	103.3	102.7	102.6
Automobile gas	103.6	100.6	104.9	101.2	103.8
Diesel fuel	104.9	102.0	104.7	102.0	102.7
Black oil	98.3	104.2	107.1	100.3	97.8
Natural gas, cub.m. bln	98.5	99.2	101.9	103.4	101.6
Oil gas, cub.m. bln	102.5	105.0	110.5	119.3	106.4

Source: the Federal State Statistics Service

Gasprom traditionally dominated over the gas sector. In 2004, according to the RF Ministry of Fuel and Energy, its share in gas production accounted for 85.9%. Russian oil companies showed high growth rates of their gas production, but their overall share in this sector has remained fairly small. The greatest volumes of gas production among oil companies were reported by Surgutneftegas, Rosneft and TNK-BP.

Table 10

The Structure of Oil and Gas Output in 2004*

	Oil, mln.t.	The share in the total output, as %	Gas output, as cub.m. bln.	The share in the total output, as %
Russia, total	458.81	100.0	633.95	100.0
LUKOIL	84.07	18.3	5.02	0.8
Rosneft + Yuganskneftegas	73.39	16.0	10.80	1.7
TNK-BP	70.26	15.3	8.00	1.3
Including:				
Tymenskaya OC	49.49	10.8	5.86	0.9
SIDANCO	20.77	4.5	2.14	0.3
Surgutneftegas	59.62	13.0	14.31	2.3
Sibneft	33.9855.99	7.412.2	1.952.87	0.30.4
YUKOS-				
Yuganskneftegas	33.89	7.4	2.01	0.3
Tatneft	25.10	5.5	0.74	0.1
Slavneft	22.01	4.8	0.92	0.1
Bashneft	12.07	2.6	0.36	0.1
Gasprom	11.96	2.6	544.42	85.9
Russneft	6.60	1.4	0.77	0.1
Other producers	25.86	5.6	44.65	7.0
For reference:				
YUKOS, including Yuganskneftegas	85.68	18.7	3.43	0.5
Yuganskneftegas	51.79	11.3	1.42	0.2
Rosneft	21.60	4.7	9.38	1.5
Gasprom + Rosneft	33.56	7.3	553.80	87.4
Gasprom + Rosneft + Yuganskneftegas	85.35	18.6	555.22	87.6

* By the organizational structure of the sector as of December 31, 2004.

Source: The RF Ministry of Fuel and Energy, authors' calculations.

The companies operating on the production-sharing agreement basis produced 2.37 mln. t. of oil, or just meager 0.5% of Russia's total oil output, while 150 other minor producers' share accounts for just 5.1% (*Table 10*). The 2004 list of the biggest producers of oil products is overtopped by LUKOIL, followed by YUKOS and TNK-BP. As concerns other companies, Surgutnetegas and Sibneft clearly dominate the market for oil products.

In 2004, the domestic prices for oil and oil products have grown drastically, which to a great extent was related to the expanding oil export opportunities. Thanks to high world oil prices, even very costly export transportation arrangements with the use of railroad transport have become efficient. In December 2004, the domestic average price for oil (producer price) in USD equivalent hit USD123.5/t., while the average price for petrol exceeded USD 350/t in November 2004, thus breaking an ever record price level for oil and petrol over the post-reform period. However, there still existed a considerable gap between the domestic and world prices for oil: in 2004 the respective correlation did not exceed 40-50%. In December 2004, there emerged the trend to decrease in the domestic prices for oil products (the prices of oil refineries slid by 5.5% on average vs. the prior month). By contrast, in 2004 the gas prices, for the first time ever, exceeded the pre-devaluation level and reached USD 105/ 1,000 cub.m. by the end of the year (*Table 11*).

Table 11

**Domestic Prices for Oil, Oil Products and Natural Gas in USD Equivalent
in 1997–2004 (average producer prices, USD/t.)**

	1997 (December)	1998 (December)	1999 (December)	2000 (December)	2001 (December)
Oil	63.1	16.4	37.0	54.9	49.9
Automobile petrol	169.6	63.4	171.9	199.3	151.5
Diesel fuel	170.0	52.9	125.0	185.0	158.5
Black oil	73.8	22.0	46.1	79.7	47.1
Gas, USD./Thos. cub.m.	6.6	2.1	2.2	3.1	4.8

Table 11 (cont'd)

	2002 (December)	2003 (December)	2004 (June)	2004 (September)	2004 (December)
Oil	60.7	70.1	87.5	103.0	123.5
Automobile petrol	168.8	236.9	275.1	318.8	333.1
Diesel fuel	153.8	214.3	244.6	300.3	364.3
Black oil	66.1	66.0	94.9	93.2	69.4
Gas, USD./Thos. cub.m.	5.9	4.4	9.7	9.8	10.5

Source: Computed basing on the data by the Federal State Statistics Service

Between January through November 2004 Russia's oil export grew by 13.3%, while that of oil products - by 5.3% vs. the respective period of the prior year (*Table 12*). The share of export in the production of black oil accounted for 70%, diesel fuel – 54.2, petrol-14% (for reference: in 1999, the share of export in the production of petrol accounted just for 7.2%). High world process for oil generated a considerable rise in export proceeds. The oil export in value equivalent reached USD 52.9 bln., or grew by 47.7% between January through November 2004 vs. the respective period of the prior year, thus being 3 times greater than the increment in the physical volume of oil export. The proportional weight of oil export in the total volume of Russian exports over the period in question accounted for 32.6% (vs. 29.7% reported over the respective period of 2003).

Because of the rise in domestic prices for oil products and the Rb. appreciation in real terms, import of oil products showed a notable rise. Overall, over the period in question the respective rate grew 3.3 times vs. the respective period of the prior year, while im-

port of automobile petrol alone grew 7.6 times, with the share of import in petrol resources growing from 0.2 up to 1.7%. The proportional weight of import has remained very low, nevertheless. For instance, in the first half 1998, i.e. prior to the Rb. depreciation, the proportional weight of import in petrol resources was 8.7%.

Natural gas export rates grew vs. the prior year, which can be explained by the growing supplies to the CIS countries (they grew by 19.2% over the period in question).

Table 12

**Export of Oil, Petroleum Derivatives and Natural Gas from Russia
(as % to the Respective Period of the Prior Year)**

	2002	2003	2004 (January-November)
Oil, total	113.9	117.8	113.3
Including: to the non-CIS countries	109.9	118.9	114.4
To the CIS countries	137.3	112.4	107.7
Oil products, total	118.5	103.6	105.3
Including: to the non-CIS countries	119.1	102.6	104.4
To the CIS countries	102.8	132.3	126.1
Gas, total	102.4	102.0	106.1

Source: the Federal State Statistics Service.

As the analysis of the data on output and export of oil and oil products (Table 13) shows, most (over 95%) of extra output of oil was exported (either directly, or in the form of petroleum derivatives). In 2004, according to preliminary assessments, the net export of oil and oil products accounted for 327.7 mln.t., i.e. at 32.3 mln. t. thanks to the rise in the export of oil and 3.8 mln.t. – at the expense of the export of oil products). In other words, as in 2000–03, it was once again the boost of export that determined a considerable rise in the 2004 oil output. As a result, the proportional weight of the net export of oil and oil products in the oil output reached 71.4%, while the net export of oil exceeded 53% of its output. Because of the rise in both domestic and external demand for gas, 2004 saw a continuous boom in the the natural gas output, with the proportional weight of its net export in the output being over 30%.

Table 13

**Correlation between Output, Consumption and Export of Energy Sources
in 1997–2004**

	1997	1998	1999	2000	2001	2002	2003	2004 (estimated)
Oil, mln.t.								
Production	305.6	303.4	305.0	323.2	348.1	379.6	421.4	458.8
Export, total	126.9	137.1	134.5	144.5	159.7	187.5	223.5	253.2
Export to the non-CIS countries	109.8	117.9	115.7	127.6	137.1	154.8	186.4	213.2
Export to the CIS countries	17.1	19.2	18.8	16.9	22.7	32.7	37.1	40.0
Net export	119.0	129.2	128.5	138.7	154.7	181.3	213.4	245.7
Domestic consumption	132.2	125.1	120.5	123.0	122.9	123.5	129.8	131.1
Net export, as % to output	38.8	42.4	42.1	42.9	44.4	47.8	50.6	53.6
Oil products, mln.t.								
Export, total	60.6	53.8	56.9	61.9	70.8	75.0	78.4	82.6
Export to the non-CIS countries	58.4	51.2	53.9	58.4	68.3	72.5	74.9	78.2
Export to the CIS countries	2.2	2.6	3.0	3.5	2.5	2.6	3.5	4.4
Net export	56.6	51.0	50.3	61.5	70.5	74.8	78.2	82.0

	1997	1998	1999	2000	2001	2002	2003	2004 (estimated)
Oil and oil products, mln.t.								
Net export of oil and oil products	173.4	178.3	184.5	200.2	225.2	256.1	291.6	327.7
Net export of oil and oil products, as % to oil output	56.7	58.8	60.5	61.9	64.7	67.5	69.2	71.4
Natural gas, cub.m. billion								
Production	571.1	591.0	590.7	584.2	581.5	594.5	620.3	634.0
Export, total	200.9	200.6	205.4	193.8	180.9	185.5	189.3	200.8
Export to the non-CIS countries	120.9	125.0	131.1	133.8	131.9	134.2	142.0	144.4
Export to the CIS countries	80.0	75.6	74.3	60.0	48.9	51.3	47.3	56.4
Net export	196.4	197.6	201.3	189.7	176.8	178.3	180.5	192.0
Domestic consumption	374.7	393.4	389.4	394.5	404.7	416.2	439.8	442.0
Net export, as % to output	34.4	33.4	34.1	32.5	30.4	30.0	29.1	30.3
Aggregate indicators								
Oil and gas output, as mln. t. of oil equivalent	819.6	835.3	836.6	849.0	871.5	914.7	979.7	1029.4
Net export of oil, oil products and gas, as mln. t. of oil equivalent	350.2	356.1	365.7	370.9	384.3	416.6	454.1	500.5
Domestic consumption of oil and gas, as mln. t. of oil equivalent	469.4	479.2	470.9	478.1	487.2	498.1	525.6	528.9
Net export of oil, oil products and gas, as % to the oil and gas output	42.7	42.6	43.7	43.7	44.1	45.5	46.4	48.6

Source: the Federal State Statistics Service; the RF Ministry of Fuel and Energy, the Federal Customs Service, the authors' calculations.

The total export of oil and oil products grew from 301.9 mln.t. up to 335.8 mln.t. in 2004 (preliminary assessment), or at 11.2%. The structure of the oil export is still dominated by the export of crude oil that accounts for 80% of the overall export of oil and oil products. The export of oil products is consequently dominated by fuel oil, which Europe uses for further refining, and diesel fuel. Between January to November 2004 vs. the respective period of the prior year the export of natural gas grew by 6.1%. Notably, most energy sources (84% of oil, 95% of oil products and 72% of natural gas) was exported to the non-CIS countries.

As the analysis of the dynamics of Russia's oil export over a long period of time shows, the 2004 aggregate net export of oil and oil products has for the first time ever exceeded the 1998 record-breaking level of oil export (291.6 mln.t.). In parallel with the rise in oil export, that of oil products has grown steadily since 1996. As a result, the proportional weight of oil refining products in oil export grew from 18.2% in 1990 up to 25.0% in 2004 (Table 14). Because of the drastic fall in the domestic oil consumption (our computations show it fell from 269.9 mln.t. in 1990 to 131.1 mln.t. in 2004, i.e. more than twice), the proportional weight of export of oil and oil products in the oil output grew from 47.7 up to 71.4% over the period in question. By contrast to the export of oil and oil products, the net export of natural gas and its share in the output has recently remained by the level of late 1990s, while the proportional weight of the net export of natural gas in the respective output has been slightly over the pre-reform level (30.3% in 2004 vs. 28% in 1990).

Table 14

Structure of Net Export of Oil and Oil products

	1990		2002		2003		2004 (estimated)	
	Mln.t.	%	Mln.t.	%	Mln.t.	%	Mln.t.	%
Oil and oil products	246.3	100.0	256.1	100.0	291.6	100.0	327.7	100.0
Oil	201.5	81.8	181.3	70.8	213.4	73.2	245.7	75.0
Oil products	44.8	18.2	74.8	29.2	78.2	26.8	82.0	25.0

Source: the Federal State Statistics Service; the RF Ministry of Fuel and Energy, the International Energy Agency, the authors' calculations

In 2004, the aggregate net export of oil, oil products and natural gas for the second year in line exceeded the 1998 pre-crisis maximum. We estimate its rise from 407.6 mln. t. of oil equivalent in 1990 up to 500.5 mln.t. of oil equivalent in 2004, i.e. at 22.8%, while the proportional weight of the net export in the aggregate oil and gas output grew from 37.3 up to 48.6%. These data evidence a greater orientation of the sector towards export vis-avis the pre-reform period. However, it should be noted that this is explained not solely by the rise in absolute volume of export, but a considerable decline of the domestic consumption of oil and gas.

The high oil prices noted through the whole 2004 have fueled a considerable price rise in the oil sector. The nation's aggregate revenues from the export of oil and main kinds of oil products between January through November 2004 reached USD 67.63 bln., while their proportional weight in Russia's export accounted for 41.6%. The oil sector's (including the oil and oil-refining subsectors) aggregate profit (balance sheet financial results) between January through October 2004 accounted for USD 11.17 bln., accounting, at the same time, for 34.4% of the overall profit of the national industrial sector and 18.6% of the economy as a whole (the peak value was reached in 2001, with these particular indicators accounting for 39.4\$ and 20.7%, respectively). Overall, the revenues of the oil sector secured a high level of tax revenues to the state budget and enabled oil companies to run a relatively low level of accounts payable before their suppliers and the budgets of all levels (Table 15).

Table 15

Financial Indicators of the Oil Sector's Performance in 1997–2004 (USD Bln.)

	1997	1998	1999	2000	2001	2002	2003	2004*
Sale proceeds form export of oil and main kinds of oil products	21.09	13.96	18.82	34.89	33.43	38.72	51.13	67.63
Profit (balance sheet financial result)	3.52	0.60	6.32	10.42	8.14	4.32	6.70	11.17
Outstanding accounts payable (as of end-year)	6.79	2.41	1.61	1.35	1.01	0.90	1.07	1.55
Including: to suppliers	2.38	0.94	0.72	0.55	0.52	0.59	0.85	1.03
To the budget	2.53	0.66	0.43	0.27	0.15	0.10	0.07	0.07

* The data on export –over the period January - November; on profit – January – October; accounts payable – as of late October.

Source: computed basing on the data of the Federal State Statistics Service.

The year 2004 saw the introduction of a number of substantial changes to the system of taxation of the oil and gas sector. They have notably increased the tax burden on the sector, especially under high world prices for oil. Federal law No. 33-FZ of May 7, 2004, "On introduction of amendments to Art. 5 of the law of the Russian Federation "On cus-

toms tariff” and Art. 5 of the federal law “On introduction of amendments to Section II of the Tax Code of the Russian Federation and some other legal statutes of the Russian Federation, as well as on recognition of invalidity of some single legal statutes of the Russian Federation” has modified the order of computation of the marginal (maximum) oil export duty rate. A new, more progressive scale for computation of the oil export duty marginal rate oriented towards withdrawal of an extra profit resulting from exportation of oil under high world prices for oil became effective as of August 1, 2004 (*Table 16*). The amount of the oil export duty reached USD 101/t. by late 2004.

Table 16

Oil Export Duty Rates

World prices for Urals, USD/barrel.	Duty rate, as USD/t.	
	Earlier effective scale (2002 – 31 July 2004)	New scale (effective as of 1 August 2004)
Up to 15	0	0
15 - 20	$0.35 \times (P - 15) \times 7.3$	$0.35 \times (P - 15) \times 7.3$
20 - 25		$12.78 + 0.45 \times (P - 20) \times 7.3$
Over 25	$25.53 + 0.4 \times (P - 25) \times 7.3$	$29.2 + 0.65 \times (P - 25) \times 7.3$

Source: Federal law No. 33-FZ of May 7, 2004, No. 126-FZ of August 8, 2001

Federal law No. 33 FZ of 7 May 2004 has also introduced new rates of the mineral production tax (MPT) for oil and natural gas, effective as of January 1, 2005, and modifications of the formula of computation of the coefficient that characterizes the dynamics of the world oil prices and applied to the basic rate of the tax. As of January 1, 2005, the basic rate of MPT has made up Rb. 419/t. (i.e. 20.7% up vs. 2004), while the coefficient that characterizes the dynamics of the world oil prices is computed according to the following formula:

$$C_p = (P - 9) \times R / 261,$$

where P – the price level for Urals, as USD/barrel averaged over a given tax period;

R – the average Rb/USD exchange rate set by CBR (*Table 17*).

As of January 1, 2005, the MPT rate for natural gas has been increased to Rb. 135/1 thos. cub.m. (from Rb. 107 in 2004, i.e. by 26.2%)

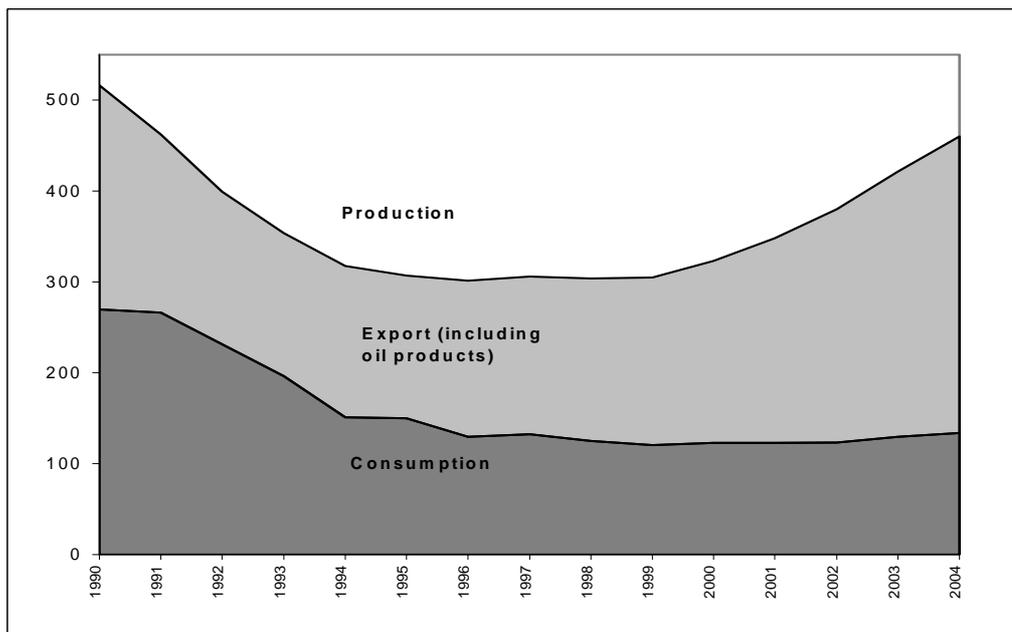
Table 17

MPT Rate on Oil

	2002–2003	2004	2005
MPT basic rate, Rb./t	340	347	419
the coefficient that characterizes the dynamics of the world oil prices (Cp)		$(P - 8) \times R / 252$	$(P - 9) \times R / 261$

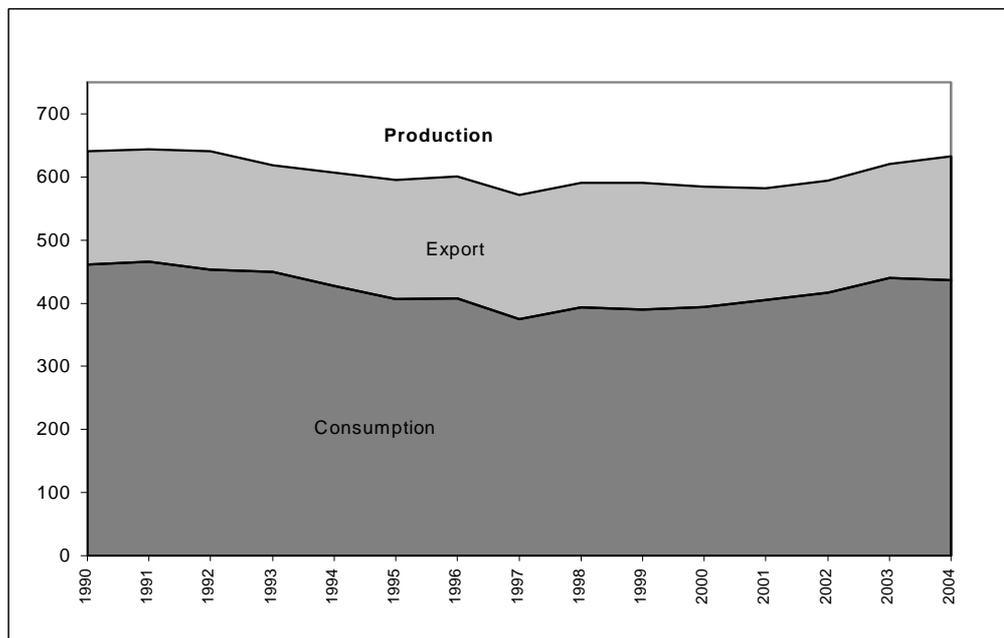
Source: Federal law No. 33-FZ of May 7, 2004, No. 126-FZ of August 8, 2001

The change in main indicators of the oil and gas sector’s development that characterize production, domestic and external sales, prices, investment activity, and the state of payments and settlements is depicted on *Fig. 13–20*.



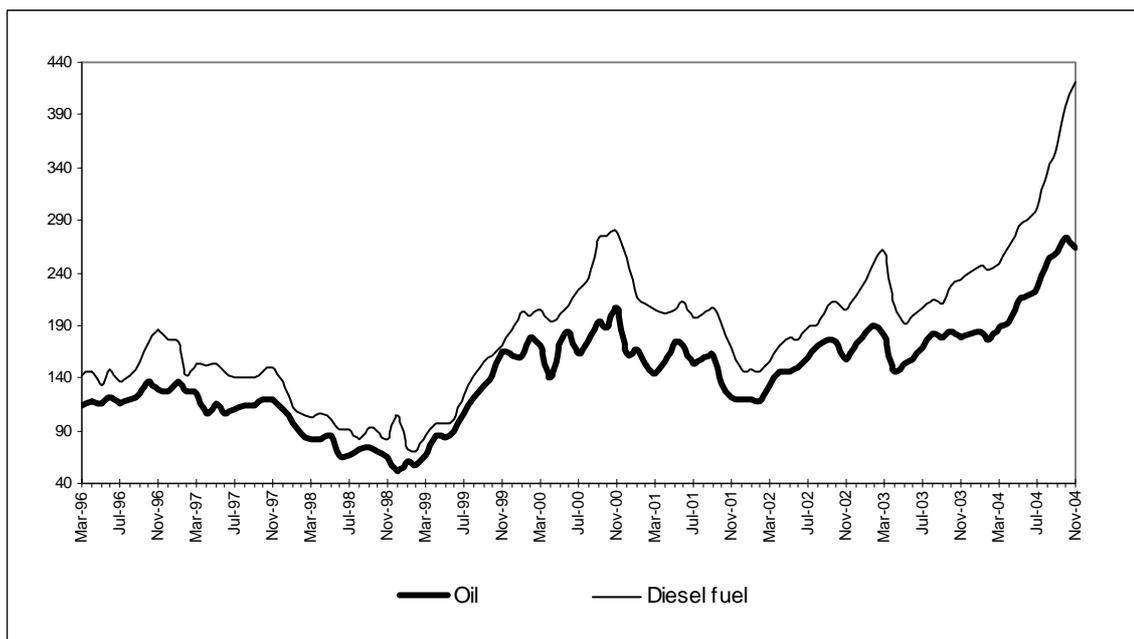
Source: the Federal State Statistics Service; the Federal Customs Service; International Energy Agency; the authors' calculations.

Fig. 13. Production, Consumption and Export of Oil in 1990–2004 (as mln. t.)



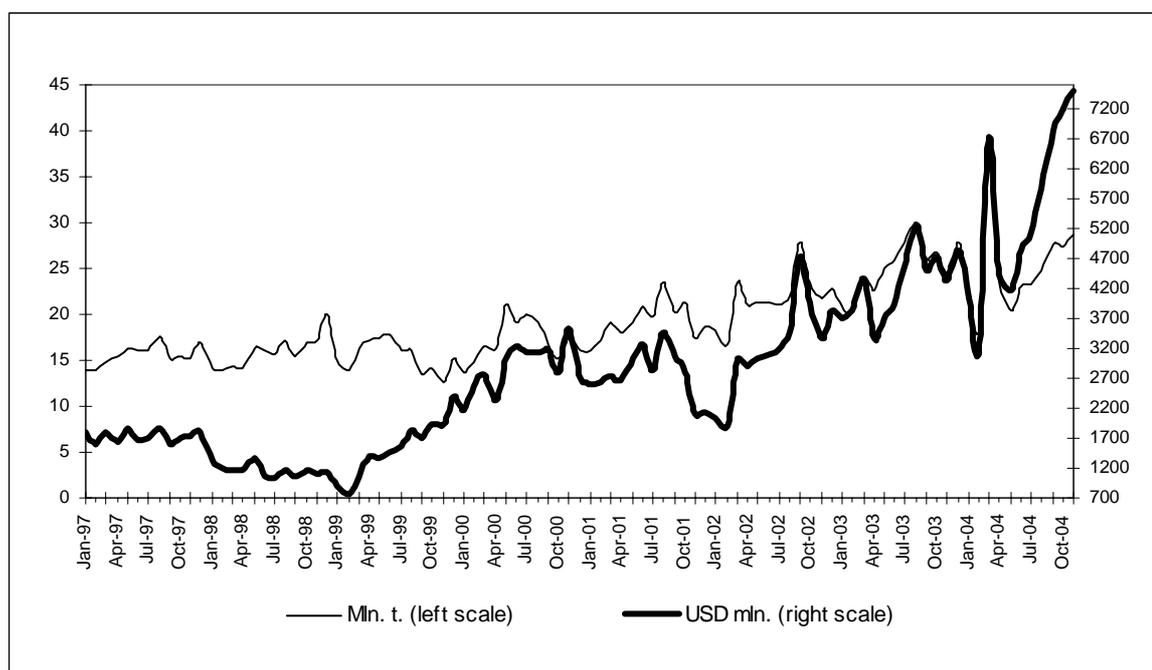
Source: the Federal State Statistics Service; the Federal Customs Service; International Energy Agency; the authors' calculations.

Fig. 14. Production, Consumption and Export of Natural Gas in 1990–2004 (as cub. m. bln.)



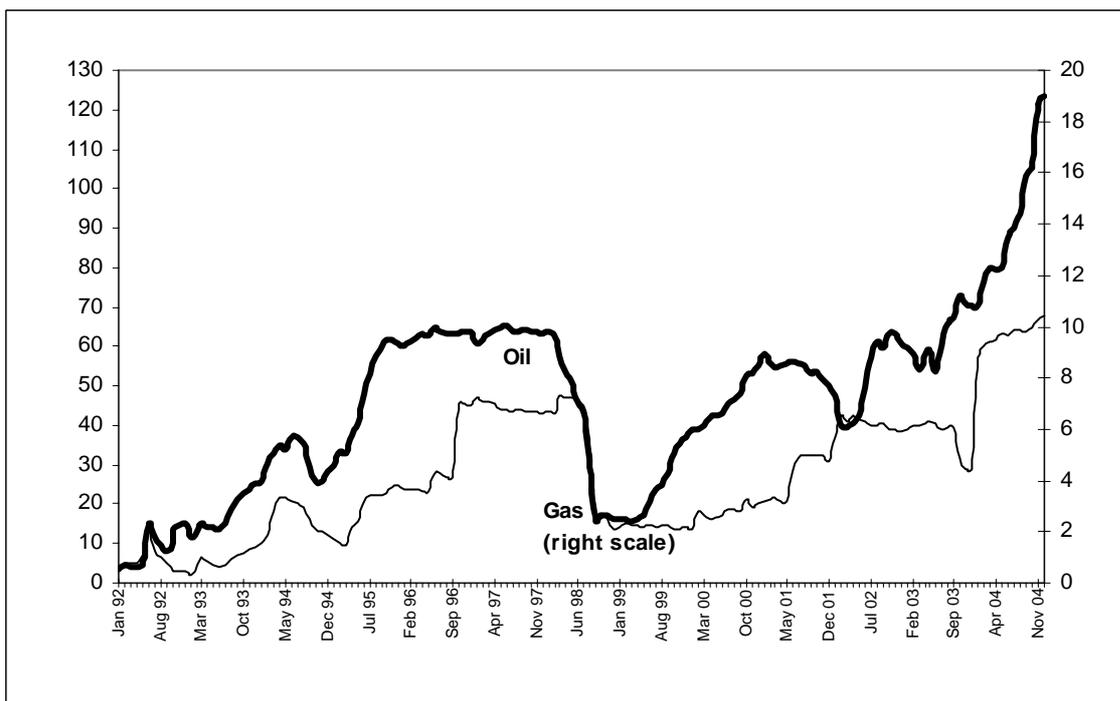
Source: computed basing on data of the Federal State Statistics Service.

Fig. 15. The average Export prices for Oil and Diesel Fuel in 1996–2004 (USD/t)



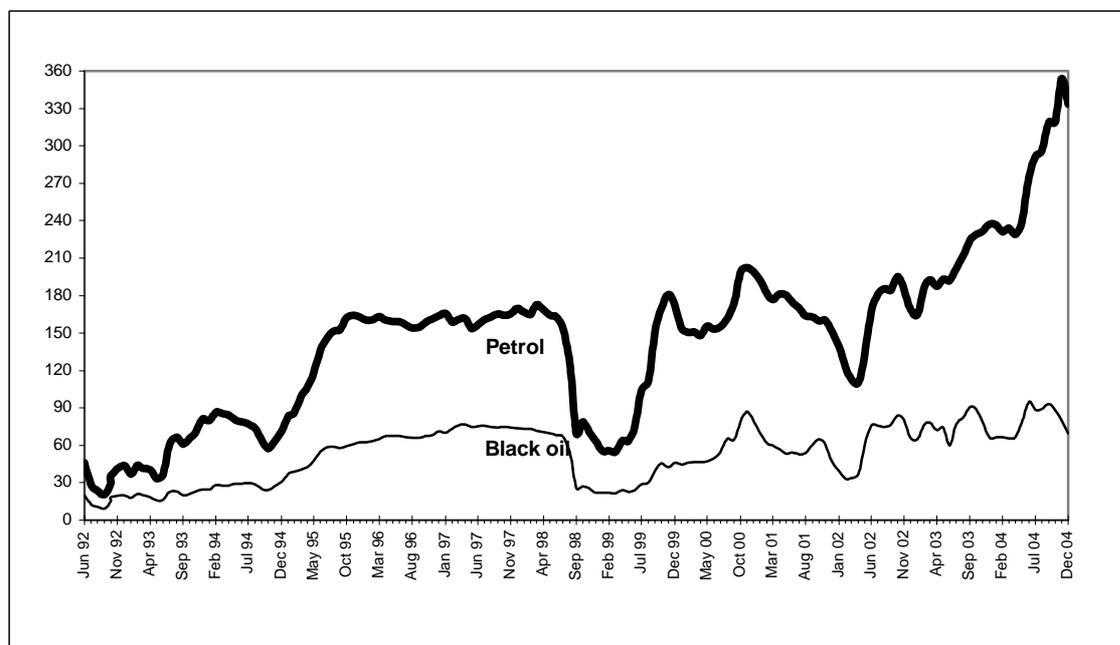
Source: computed basing on data of the Federal State Statistics Service

Fig. 16. Export of Oil and Oil Products in Natural and Value Equivalent in 1997–2004



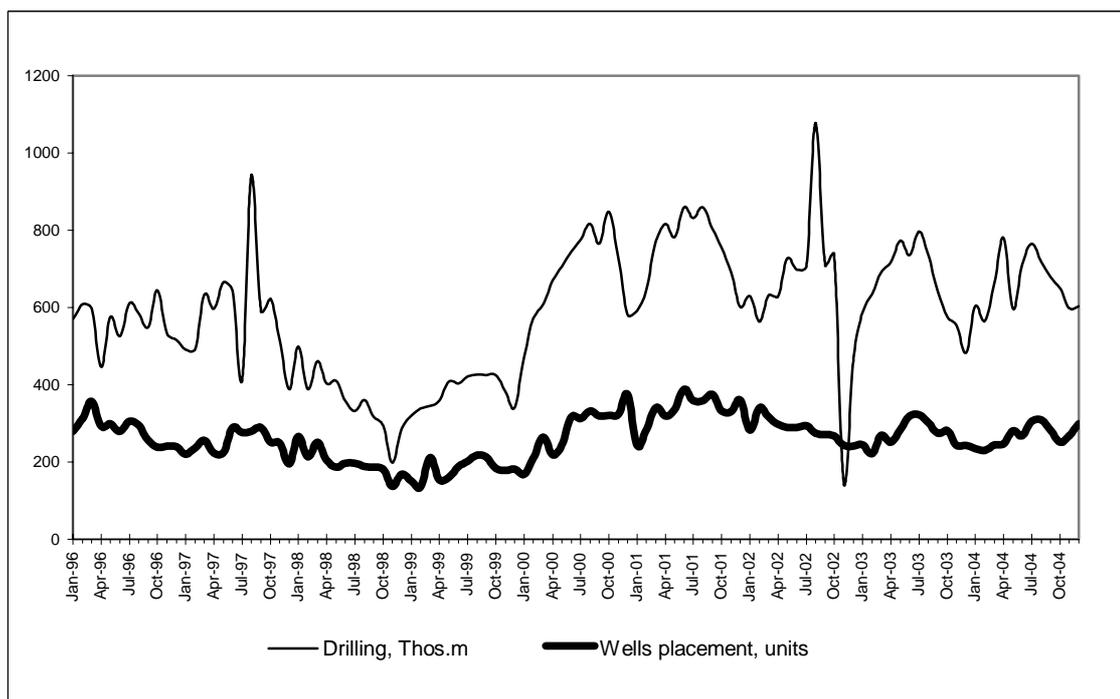
Source: computed basing on data of the Federal State Statistics Service.

Fig. 17. Average Producer Prices for Oil and Gas in USD Equivalent in 1992–2004 as USD/t., USD/Thos. cub.m.



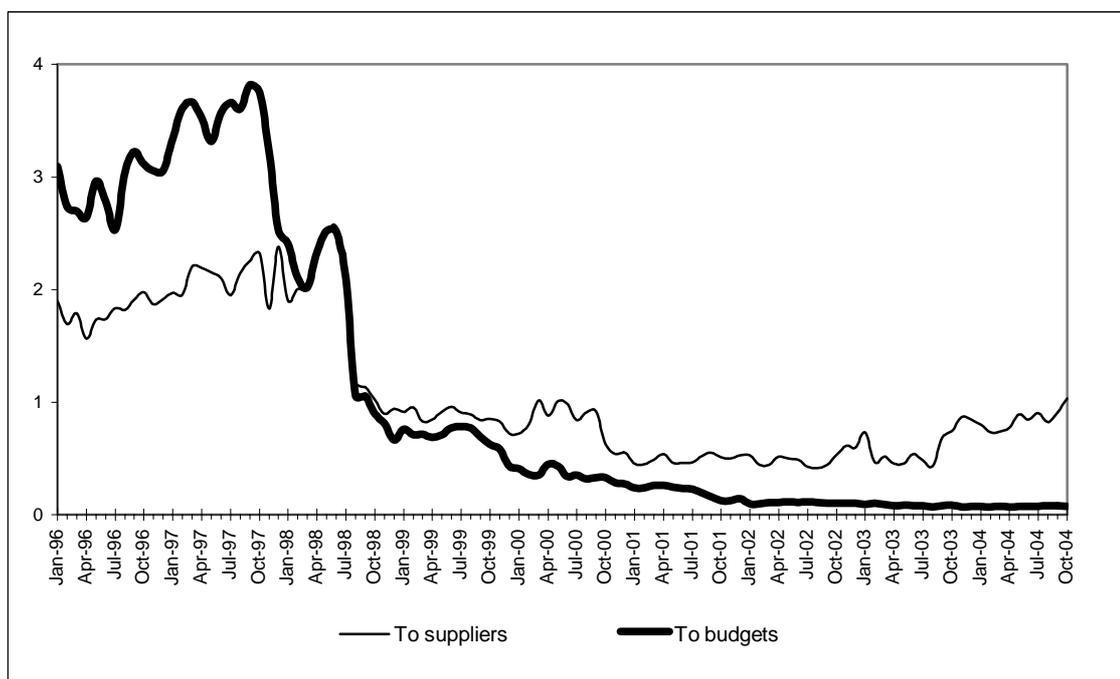
Source: computed basing on data of the Federal State Statistics Service.

Fig. 18. Average Producer Prices for Petrol and Black Oil in USD equivalent in 1992–2004 (USD/t.)



Source: the Federal State Statistics Service.

Fig. 19. Operational Drilling for Oil and Placement of Oil Wells in Operation in 1996–2004



Source: computed basing on data of the Federal State Statistics Service

Fig. 20. Outstanding Arrears of the Oil Sector before Suppliers and Budgets of All Levels in 1996–2004 (USD bln.)

3.2. The IET Business Surveys³

3.2.1. The Dynamics of Demand or Industrial Produce

Late 2003 traditionally became the period of decline in the demand for the domestic industrial produce. The sales growth rates (by balance) had begun to fall since October and by December they dropped to 6%. That meant that enterprises reporting the fall in their output began to dominate over the industrial sector. All the industry branches reported an absolute fall in sales or, at least, a deceleration of growth at the end of the year. The only exception was the food-processing sector that, by contrast, reported, one of the highest growth rates. So, in 2004 the national industrial sector found itself far from the best shape.

The early 2004 likewise did not predict a rapid rise in demand. The January slump proved to be most intense over the past 5 years (Fig. 21). All the industries reported negative balances, except for the one for electricity (again, due to seasonality).

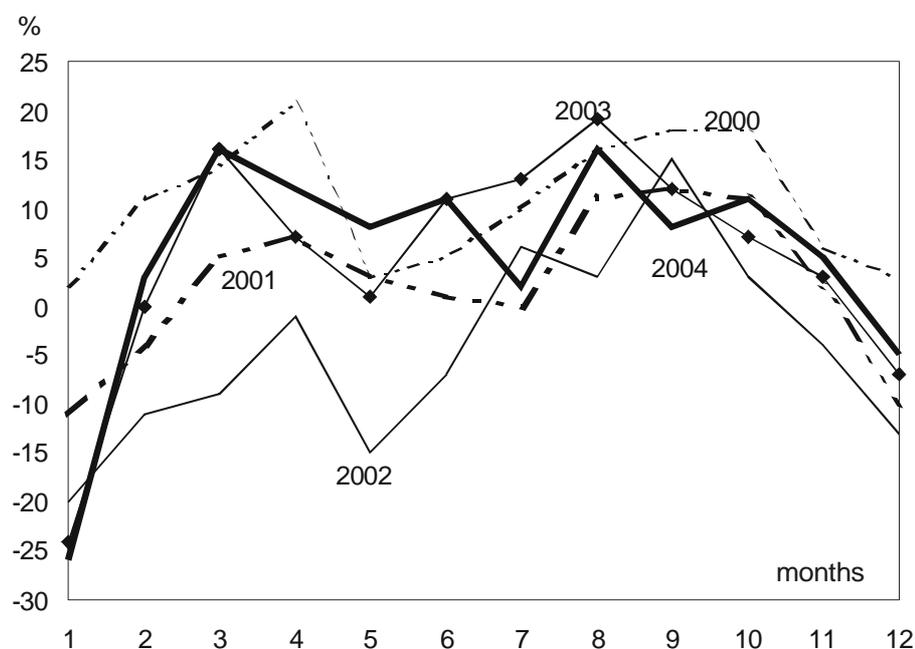


Fig. 21. The Monthly Dynamics of demand in 2000–2004
(Balance = % of Growth – % of Fall)

But as early as in February our surveys registered a rise in sales of industrial produce, which had not happened over the prior 3 years. Notably, it took place (or, at least, the respective decline decelerated) in all the industry branches. It was only the sector for electricity that was undergoing problems with the cash sales, which is an annual phenomenon in the sector, nonetheless. The national industrial sector had been maintaining high rates of sales until the end of the 1st half-year, with balances of changes in demand over this particular period being superior to their respective indices of 2001–2003. It was

³ This section is based upon surveys on heads of industrial enterprises that IET has conducted monthly since September 1992. The surveys cover the whole territory of Russian Federation, with the panel comprising a. 1,200 enterprises with the number of employees accounting for over 20% of those employed in the industrial sector. The panel is biased towards large enterprises by each of 61 singled out subsectors, while the questionnaire return rate is a. 70%.

enterprises of ferrous metallurgy, chemical and petrochemical sectors, and the construction materials industry that reported the most intense growth in demand for their output, while, by contrast, the demand for the light industry produce almost always declined and the intensity of fall in sales would reach very big values (-38...-43% by the balance). Our reports have not registered such high rates of decline in demand for the light industry output since August 1998. (Fig. 22). By contrast, the machine-engineering sector demonstrated absolutely different dynamics of demand – after the seasonal decline in January, it did not fall over the period in question. Even the May (not adjusted) balance proved to be positive, which did not happen both in 2002 and 2003.

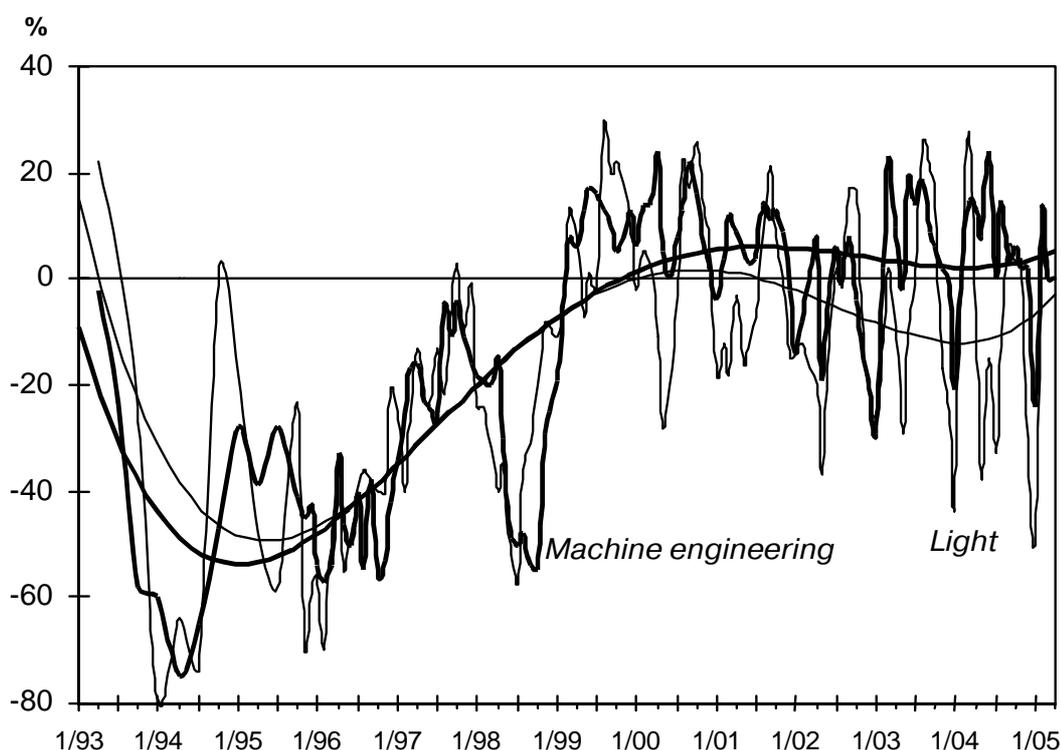


Fig. 22. Change in Effective Demand in the Industry Branches
(Balance = % of Growth – % of Fall)

In the 2nd half-year, the demand growth rates lost their record-breaking momentum vis-avis the preceding years (Fig. 21). The 2004 August growth rates in demand were lower than those of the 4 prior years, while in July – 3 prior years. Once in October, November and December the national economy manifested clear signs of deceleration of its growth (at, least, as evidenced by the official data on the dynamics of output), the growth rates of demand for industrial output were inferior to just the respective index of 2000. So, the monthly dynamics of demand for industrial output does not provide any grounds for pessimistic assessments of sales of industrial output in the 2nd half 2004. This conclusion is back-upped by balances of change in the demand computed by half-years (Table 18). The intensity of change in demand in the 2nd half-year roved to be the greatest one over the last 4 years, while the aggregate result of the 1st half-year also proved to be the best one over the period in question. The demand for its output basically fully enabled Russia's industrial sector to maintain high growth rates of production, at least, not lower than in the preceding years.

Table 18

Changes in Effective Demand by Half-Years in 2000–2004

Year	Half-year	Growth	No change	Decline	No reply	Balance
2000	1	22	65	12	2	9
	2	22	65	11	2	11
2001	1	18	61	18	3	0
	2	19	65	14	2	4
2002	1	15	58	25	1	–9
	2	20	62	18	1	1
2003	1	21	58	20	1	1
	2	22	62	14	2	7
2004	1	22	59	18	1	3
	2	21	66	13	1	8

This thesis is also proved by the dynamics of the frequency of enterprises referring to a low domestic effective demand as an obstacle to production growth. This particular index dropped to 38% by the 4th quarter, which makes up the minimum value since October 1993, while yet in early 2004 it had been 50%. In 2004, it impeded output at just 46% of enterprises on average, which is the best value over the period 2000–04, except for the year of 2000 (Table 19). It was metal producers that had the least problems with domestic sales in 2004 (31%). When compared with 2003, the domestic demand formed a 2-fold lesser impediment to their output. The forestry held the second position in this regard (38%), followed by the light (39%) and food (40%) industries. Thus, an insufficient domestic demand posed a problem to just 39% of Russian textile and sewing enterprises. By contrast, most other industry branches have found themselves in a far worse position. These results compel one to question the thesis of the domestic market being completely lost by the national light industry. Should it be able to solve its other problems (primarily, the lack of liquid assets and qualified staff), its produce would enjoy the domestic demand. Interestingly, the food-processing industry was likewise challenged by the domestic demand roughly to the same extent as the light industry did. The aggregate 2000–2004 results evidence that the domestic demand hampered 46% of food-processing and 43% of textile and sewing companies on average to boost their output. The dynamics of output in these sectors were different though – while the food-processing sector was progressing more or less successfully, the textile industry went downhill. Notwithstanding that, the domestic demand did not appear the most cited cause for the fall in output in the domestic light industry – in their post-default growth stage, other sectors more often suffered from an insufficient domestic effective demand. For instance, in the machine-engineering and metallurgical sectors, over the period in question the domestic demand on average hampered output at 55% enterprises, in the sector for chemicals and petrochemicals – 53%, and in the construction materials industry – 50%.

But high growth rates in demand in the 1st half-year had nearly zero effect on the enterprises satisfaction with their production volumes. The average balance of assessments (above or below norm) proved to be lower than its analogous indicator over the 2nd half 2003. Enterprises either expect greater results, or have failed to adjust their assessments to recent trends. This thesis is proved by the dynamics of satisfaction with demand (its assessment as being normal). In the first 6 months 2004, across the industrial sector 49% of enterprises on average were satisfied with sales of their produce, while the respective index in the 2nd half-year 2003 was 52. In terms of specific industries, the satisfaction with demand in the first half-year 2004 ranged from 75% in the non-ferrous metallurgy to 37%

in the industry of construction materials and the light industry, while in the machine-engineering sector the respective index accounted for 42% and 57% – in the food-processing industry. It should be noted, however, that our survey data evidenced some “revaluation of values” (or demand) in the national industrial sector in 2003 – the balance grew from –65% to –39%, while the proportion of responses “normal” from – c 32 to 55% over the year. There were no such trends in early 2004, albeit a more accurate comparison, following the “a period of one year to the respective period of the prior year” principle shows the presence of positive tendencies in the dynamics of demand assessments, too.

Table 19

**The Frequency of Citation of Domestic Effective Demand
as an Impediment to Growth in Output in Industry Branches
(as % to the Number of Responded Enterprises, the Average Annual Data)**

Industry branches	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
All industries	56	64	61	63	51	45	47	62	58	46
Metallurgy	64	66	57	63	38	35	64	81	61	31
Chemicals and petrochemicals	50	71	69	63	51	47	46	65	54	52
Machine engineering	62	63	62	66	59	54	51	60	62	49
Forestry	49	70	55	45	22	26	32	39	29	38
Construction	55	67	66	73	65	45	44	59	53	50
Light industry	54	58	49	53	42	40	37	53	47	39
Food processing	52	51	62	62	56	52	41	46	49	40

The averaged balances of assessments of the 1st half-year 2004 appear at 10 balance points greater than their 2003 respective values and have proved to be the best ones since 1994. But negative values of the balance of assessments evidence that the enterprises that do not consider the demand for their produce normal mostly are inclined to opt for “below norm” assessments. As the proportion of the “above norm” answers, as a rule, accounts for several per cent, the enterprises’ satisfaction is most visibly characterized by the correlation between the “normal” and “below norm” assessments (*Fig.23*).

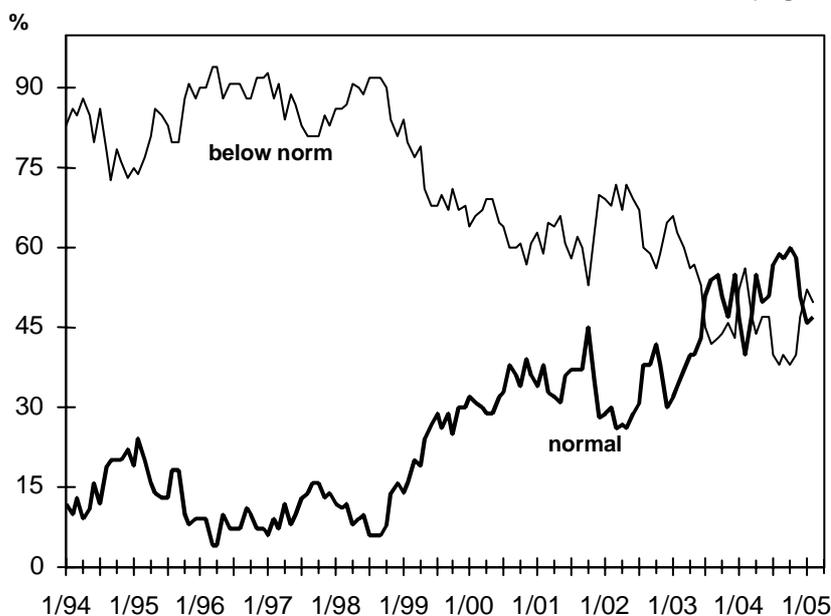


Fig. 23. The Dynamics of Main Assessments of Effective Demand

The excess of the “normal” answers over those “below norm” was first received in mid-2003. In other words, by that time the volumes of cash sales of industrial produce had reached such a volume that the national industrial sector found itself dominated by the enterprises that believed the demand for their produce was normal, rather than by those being not satisfied with the demand. It took the economy 5 years of the post-default rise in effective demand to reach that critical point. This domination had still been in place by late 2003, despite, first, the deceleration of growth rates, followed by their absolute decline in December. It was consequently lost only in January 2004, with the surveys registering a drastic (even for January) fall in sales volumes, and in February, when the restoration of sales proved to be insufficient. In March, once again, there were more enterprises satisfied with the demand for their produce than those dissatisfied with that. This domination remained through the year and by October it reached 22 p.p. already, which became a record value for the whole period of monitoring. But a slowdown of growth rates in demand between November to December compelled enterprises to consequently adjust their demand estimates: the rate of “normal” assessments slid by 2 p.p. in November and by another 7 p.p. – in December, albeit the respective excess over the “below norm” assessments was still there. (Fig. 24).

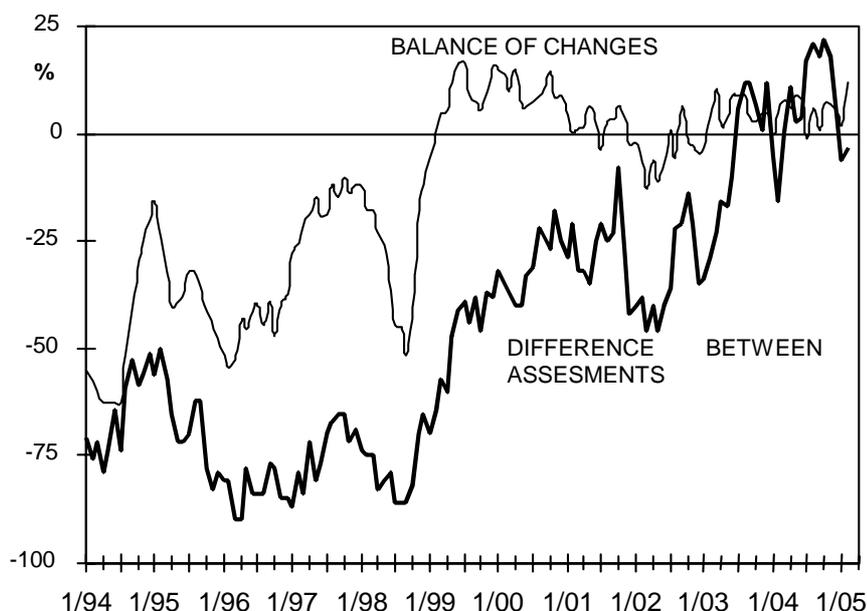


Fig. 24. The Balance of Changes in Effective Demand and Difference between Its Main Assessments

However not all the sectors proved to be capable to reach the volume of sales satisfactory to most enterprises in 2004 (Table. 20). More specifically, the “below norm” assessments were still prevalent in such sectors as machine engineering, construction materials industry and light industry, The greatest demand challenges still face the light industry, where over half of enterprises still consider the demand for their produce “below norm”. It was just in single months when our surveys noted the prevalence of the “normal” assessments in this particular sector. This happened once in 2003 and four times in 2004. So, the positive trends are also present in the light industry – an increasingly greater number of enterprises find a satisfactory balance between their production capacity and market opportunities.

Table 20

**Main Assessments of Volumes of Effective Demand in 2004 Across Sectors
(as % to the Number of Responded Enterprises, the Averaged Annual Data)**

Industry branches	“Normal”	“Below Norm”	Difference between assessments
Fuel	83	14	69
Ferrous metallurgy	71	23	47
Non-ferrous metallurgy	76	24	52
Chemicals and petrochemicals	65	33	32
Machine engineering	45	53	-7
Forestry	62	36	26
Construction	47	50	-3
Light	39	57	-18
Food processing	59	38	21

In the fuel and metallurgical sectors enterprises reached the highest level of satisfaction with effective demand, primarily, thanks to export in the condition of an extremely favorable state of affairs on the world markets. The sector for chemicals and petrochemicals likewise has demonstrated successful performance in 2004, however, it succeeded in becoming “in the black” only in mid-2003, while the forestry and food-processing industries had demonstrated positive results yet in 2002.

Speaking of enterprises of different property forms, it was joint-stock companies that proved to be most successful in their adjustment to market conditions in 2004. While in the prior years both public enterprises and JSC=s mostly shared the “below norm” assessments (albeit, the latter enjoyed a bit better correlation), last year JSC=s managed to quit “the red zone” –they mostly assessed demand as “normal” (*Fig.25*), with the difference between the assessments changing over the year from -5 to + 12 p.p., while public companies over the period in question managed only to decrease the lack of their adjustment to market conditions from -13 to -9 p.p. Most public enterprises (54%) are still dissatisfied with the demand for their output. This indicator peaked its maximum in 1996–1997, when not less than 90% of public companies on average considered the demand for their output insufficient. Post-default, the public segment of the industrial sector succeeded in losing over 30 p.p. of its non-adjustment to market, but it failed to come “into the red”, i.e. to ensure the prevalence of the “normal” answers. In the worst for JSC=s 1996, their dissatisfaction with demand likewise accounted for more than 90%, but post-default, this segment of the sector decreased its dissatisfaction with demand (*alias* market) at 46 p.p., with just 43% of JSC=s currently considering the demand for their produce “below norm”.

Computations of the dynamics of enterprises of different size adjusting to Russian market realities displayed the existence of specific paths and non-coinciding final (by 2004) results (*Fig. 26*). In mid-1990s, while assessing demand, enterprises of all sizes mostly opted for the “below norm” response. It was large enterprises that suffered to a far greater extent than the others from the lack of effective demand. In early 1996 through early 1997 and prior to the default the level of adjustment to market of all enterprises was minimum. In the aftermath of the crisis, with the growth in demand, the share of enterprises satisfied with the demand for their produce began to grow, too, albeit gradually and following different paths.

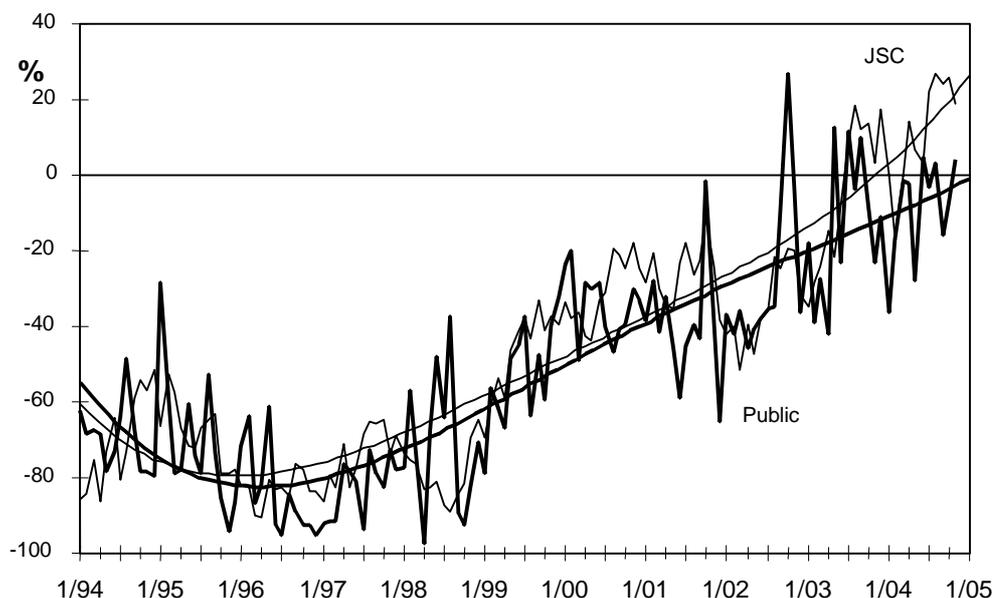


Fig. 25. The Difference between main Assessments of Effective Demand by Property Forms (normal-below norm)

The large enterprises' satisfaction with effective demand was growing at a pace faster than that of medium-size companies and much faster than that of small businesses. In 2001, with the demand growth rates decelerating, enterprises of all sizes sensed the slowdown of their adjustment to market. In 2003, the process was back on track and in July, for the first time ever, the group of big enterprises reported positive values in this regard. They were maintaining the excess of the "normal" assessments (with a sole exception) through late 2004. Interestingly, the excess was growing and reached its historical maximum in October 2004 (+38 p.p.). At the time, 68% of large enterprises were content with effective demand for their output – the results the other groups so far have failed to beat.

Medium-size companies managed to reach just the 50–52% of satisfaction with demand. It happened in August to October 2003. In 2004, their adjustment rate has never been "in the black", with a prevalence, albeit an insignificant one, of the "below norm" replies. The enterprises with up to 500 employees find themselves in a far more unfavorable position. The small (by Russian standards) producers have so far failed to reach an excess of positive assessments of demand. The best result was registered in October 2003 and accounted for – 10 p.p. At the time 43% of the enterprises assessed the demand for their output as "normal" vs. 53% of the "below norm" assessments. In 2004 the adjustment rate to demand in this particular group grew by 3 p. vs. 2003 (from –26 to –23 p.p.), while in the group of medium-size companies – by 4 p. (from –13 to –9 p.p.) and in the group of large companies – by 21 p. (from –2 up to +19 p.p.). In our view, the most probable cause for such differences in satisfaction with demand is a low competitiveness of the national economy in the segment of large enterprises.

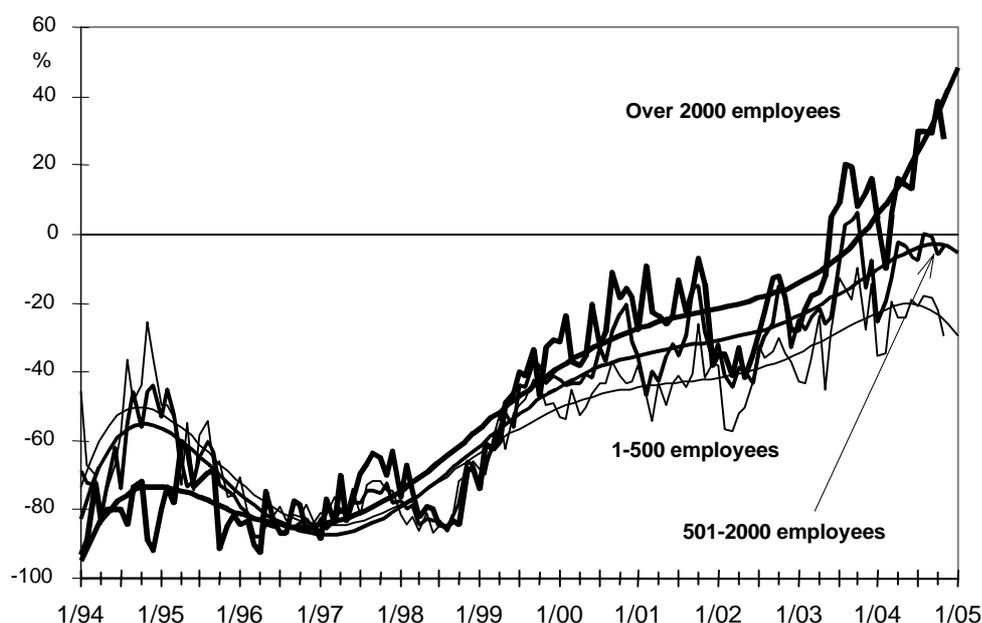


Fig. 26. The Difference between Main Assessments of Effective Demand By Enterprises' Sizes (normal-below norm)

Results of computations with the use of a binary logistical regression that describes the correlation between the dichotomic variable (the assessment of demand by a two-level scale – “normal – “below norm”) and enterprises’ “generic” features in 2000–04 proved the preceding conclusions. The effect of an enterprise’ size has been steadily positive and always significant: with the number of employees growing, the probability of having the “normal” assessments grows. The public property form has almost always decreased the probability of reaching normal volumes of demand. The only exception became 2002, when our surveys registered both an absolute decline in demand volumes and a drop in satisfaction with it. At the time, negative trends were likely to batter to a greater extent privatized enterprises vs. The others. Attaining normal volumes of demand has always posed a problem for electric companies. This is evidenced by coefficients that have always been negative, great by module and almost always appeared significant. The analogous situation is noted both in the machine engineering, construction materials and light industries. By contrast, coefficients of the variable “the survey number” that depicts the dynamics have always been positive and statistically significant, i.e. the probability of formation of the “normal” assessments was growing through all the years in question and particularly in 2003. However, the values of the Nagelkerke Pseudo R-Square (proportion of the explained dispersion) appear relatively small, which testifies to the fact that “generic” features do not appear major ones, as long as the explanation of satisfaction with demand is concerned.

Once the variables that assess the level of domestic competition and the one with overseas rivals was introduced to the model, it was found that competition did not exert a substantial influence on the formation of normal assessments of demand in the national industrial sector. The respective coefficients appeared positive, which speaks in favor of our hypothesis on a low competition level enabling enterprises easier (simpler, faster) attaining acceptable volumes of demand.

The introduction of independent variables, which assess an actual change in main indicators of a given enterprise, to the model allowed to ensure a fundamental increase in the Nagelkerke Pseudo R-Square. The regression equilibrium employed assessments of an actual change in output, employment, demand, finished produce in stock, costs and profit. A given sector's features, size and property form of an enterprise and the survey number were kept in the equilibrium, while assessments of competition were excluded from it. The signs of coefficients of a new model appeared quite correspondent to an intuitional idea of the impact the employed variables have on the probability of formation of a normal satisfaction with demand at a given enterprise. It was only the 2003 and 2004 regressions that have been assessed, as the data on actual changes in employment and profit had been collected only since 2003.

As expected, the actual changes in demand had the strongest impact on the formation of satisfaction with demand. With the demand growing, there exists an increasingly greater probability of the "normal" assessment. It has always been followed by the level of influence by the actual change in employment, i.e. the national industrial sector considers the rise in the number of employees at a given enterprise to be the second critical economic indicator that determines the normality of its position on the market. By contrast, the change in output does not have a substantial impact on the formation of normal assessments of demand. We believe, this particular result may have more than positive interpretation, for it means that domestic enterprises are no longer in favor of focusing on once very popular purely volume-based indicators (gross output). The impact of profit obviously appeared inferior to the influence employment exercises on the formation of satisfactory assessments of demand. The former is substantial and positive, i.e. with the profit rising, the probability of satisfaction with demand grows, too. The satisfaction with demand grows against the fall in the volume of finished produce in stock. This also appears logical, for a fall in the finished goods in stock means that a given enterprise receives spontaneous (not planned) orders that were satisfied by means of shipping the stored stock. The impact of price changes on the formation of satisfactory assessments of demand is contradictory. In 2003, the probability of satisfactory assessments of demand appeared positively correlated with changes in prices (with account of the specificity of the coding of responses), i.e. the possibility for a given enterprise to raise its sale prices resulted in a rise in normal assessments of demand. This correlation was substantial. In 2004, the correlation vector changed and it lost its substantiality.

At the next step of the analysis the regression equilibrium was complemented by assessments of the enterprise's current state – the assessment of finished produce in stock, capacity loading rate, the assessment of excessive (insufficient) capacities and employment, the assessment of the enterprise's economic state. The insertion method that accounts all the variables was replaced by the reverse selection method that step by step excludes from a given model the variables that display a non-substantial correlation with a given dependable variable without a substantial loss of the quality of adjustment of the model. As a result, we received the 2003 and 2004 models that comprised only the variables that had a substantial effect on the formation of satisfactory assessments of demand.

The formation of demand assessments found itself under the strongest impact of the dynamics of sales, assessments of an enterprise's economic state and those of finished products in stock vs. other factors. All these factors are associated with demand, in one way or another, which is why their effect on assessments of its volume appears quite logical. Let us note that the dynamics of finished products in stock does not affect the demand assessments, which evidences that Russian enterprises are developing quite market approach to management of their reserves, with their assessments associated with demand,

rather than the volume of the reserves. The dynamics of output likewise does not affect the demand assessments, which should also be recognized as a positive development, as well as small values of production capacities loading rates – an increase in the use of production equipment has a positive effect on satisfaction with demand, but appears inferior to the other factors. The absence of excessive capacities due to an envisaged demand appears of a far greater importance to the enterprise. The effect of these assessments on satisfaction with demand is greater than the effect from the dynamics of profit. The absence of an excessive staff was important, so long as satisfaction with demand is concerned, in 2003 and lost in significance in 2004, when the industrial sector has already nearly got rid of the excessive workforce and began to increasingly sense its shortage. As usual, an enterprise's size has a positive effect on the probability of the unfolding of normal assessments of demand.

3.2.2. Constraints to the industrial growth in 2004

While the 2004 dynamics of demand bore both positive and negative trends, but overall its impact on the national domestic enterprises was positive (for the time the proportion of enterprises satisfied with demand was over that of dissatisfied with it), the dynamics of output were rather negative. Particularly between May through December (Fig. 27). In the first months of the year, the balance of change in output (less seasonality and other random factors) by changing from 21 to 23 balance points, demonstrated stability, rather than growth. The balance consequently fell to 14 points between June to December, which formed the worst value since early 2003. A long period of the slide or, at least, failure to rise, of the output growth rates evidences that the national industrial sector has encountered new obstacles to the growth in output, with effective demand apparently not being a major challenge in this regard. Indeed, upon stabilization of growth rates in demand between July and August at rather a low level (+3 after clearing from seasonality and random fluctuations), it consequently began to gain its momentum and reached +7 by December, while production at that time was losing its growth rates.

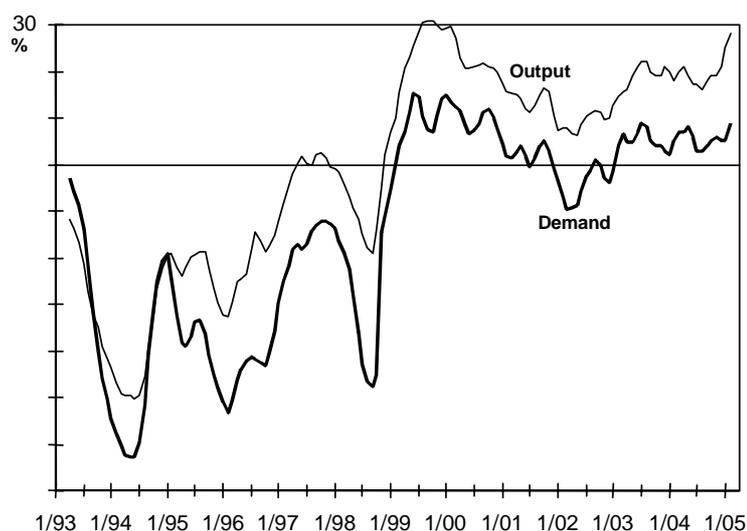


Fig. 27. Change in Demand and Output, Cleared from Seasonality and Random Fluctuations (Balance= % of growth – % of decline)

The quarterly monitoring of constraints to the production growth shows that the Russian industrial sector sees the emergence of a new structure of constraining factors. While the frequency of quotation of most traditional obstacles continues to decline and some of them have reached record-breaking low values, other ones, on the contrary, begin to pose problems to an increasingly greater number of enterprises (*Fig. 28*). Interestingly, such a seldom referring to some impediments that were not so widespread before, can be explained by a certain inertia in assessing their constraining effect. Perhaps, management still finds it hard to get used to the idea that in the upcoming years their enterprise would lack capacities (which have always been in abundance) an qualified staff (that earlier have not left their jobs even being paid poorly and with delays), rather than solvent consumers and accessible credits.

An insufficient domestic effective demand in the 4th quarter 2004 hampers the output at just 38% of enterprises, which forms the best (minimum) value since early 1994. At the time, the respective index was 84%. The most cited constrain in late 2004 was the lack of liquidity (42%), but this particular value also appears nearly minimum for all the surveys (with the absolute 39% minimum registered in January 2004). This impediment is most outspread in machine engineering (in 2004 it was cited by 50% of enterprises on average), followed by the light industry (49%), and the sector for chemicals and petrochemicals (47%). The best sufficiency rate in this regard is demonstrated by metallurgical plants, with just 26% of enterprises tending to believe the lack of liquidity poses a problem to their growth.

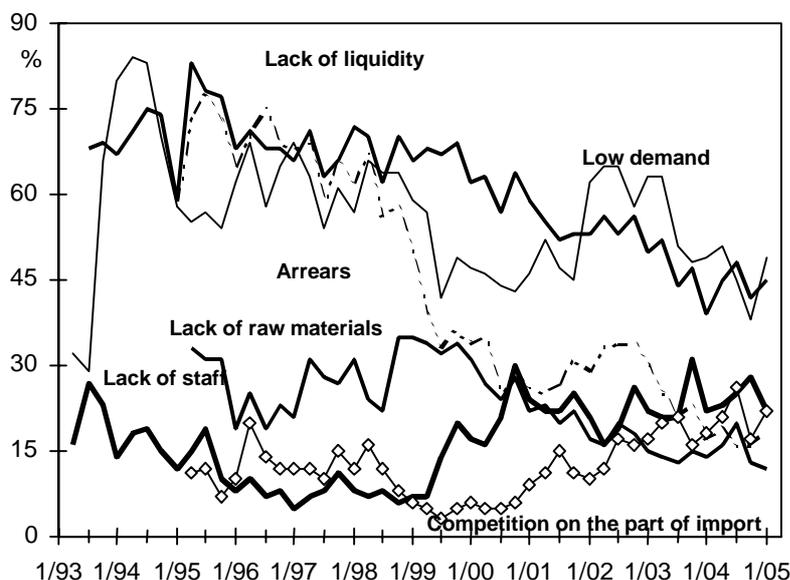


Fig. 28. Impediments to Production Growth

In late 2004, only 16 of enterprises referred to nonpayment's, once the greatest peril to the economy. Last year, the constraining effect of this particular factor slid over 1.5 times: given that in 2003 nonpayment's hampered 26% enterprises' performance, in 2004 – only 17% ones on average. It is the industry of construction materials that currently experiences the greatest settlements problems (29%). Its enterprises have managed to reduce the constraining effect of nonpayment's just by 5 p.p. over the year. The best results in the

timely effecting of settlements were demonstrated by metallurgical and forestry enterprises, with just 6% of them citing nonpayment's. For reference, in 1995 nonpayment's were referred to on average by 74–77% of producers across the national industrial sector.

Against the background of the constraining effect generated by such obstacles as the domestic demand, lack of liquidity and nonpayment's more and more Russian industrial enterprises refer to impediments associated with the resource provision of output and competition on the part of imports.

In 2004, 20% of Russian producers on average consider competing imports to be an obstacle, which is the peak (i.e. worst) annual result. In the 3rd quarter, the reference to it climbed up as high as 26%, which forms an absolute record value through the whole period of monitoring. Imports has not practically posed a problem only to forestry producers and those of the construction material industry (*Fig. 9*) – only 8 and 4% of enterprises on average in these particular sectors referred to this impediment in 2004. By contrast, the light, chemical and petrochemical industries form the opposite pole. For instance, 29% of enterprises in the light industry considered import to be an obstacle in 2004, while immediately after the default (1999) the respective index in the sector accounted for 5%, while the post-default maximum (1996) was 26%. So, the default lowered the pressure of imports on the sectoral output 5-fold, but the pressure consequently grew nearly 6-fold over the 5 post-default years. Accordingly, presently the national light industry experiences the greatest constraining effect on the part of imports.

Post-default, chemical and petrochemical companies likewise were experiencing a growing pressure of competing imports, albeit the range of fluctuations of the pressure was less intense. The pre-default maximum in the sector accounted for 18% and appeared superior to those noted in two sectors (namely, the food-processing – 30% and light – 20% ones). Post-default, the import pressure slid to 8%, but bounced back up to 27% by 2003, thus exceeding its pre-default level. In 2004, import competition affected performance of slightly less number of enterprises (25%).

The default gave Russia's machine engineering a double fall in the import pressure. While in 1998 it had affected 11% of enterprises (notably low level vs. other sectors), in 1999, only 5% of them referred to the import competition. The import pressure on the sector began to grow then and in 2004 as many as 22% of enterprises believed imports hampered their output. So, in the machine-engineering sector, the pressure on the part of competing import has also exceeded the pre-default maximum level.

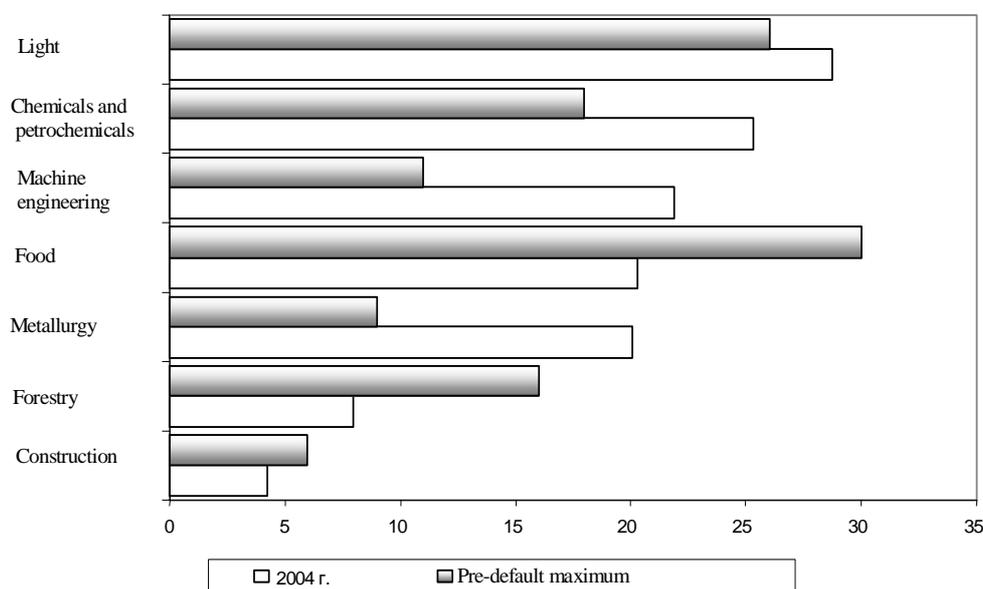


Fig. 29 Frequency of References to Competing Import as an Obstacle to Rise in Output across Industries

According to enterprises' estimates, the pre-default strongest (more precisely, the most widespread) constraining effect of imports was noted in the food-processing sector. In 1997, a. 30% of food-processing companies on average believed imports hampered the growth in their output. In 1999, this index dropped 10 times – down to 3%, but consequently began to gradually regain its position and reached 20% in 2004. This is nearly the 7-fold rise, which none of other Russian industries has ever experienced. The pre-default maximum has not yet been reached, nonetheless, and the industry still enjoys the Rb. depreciation effect. Yet two other industries find themselves in an analogous position: those are the forestry sector and the construction material industry that have not yet “overshot” the pre-default level of the import pressure.

Results of the regression analysis with the employment of logistical regression showed that in 2000–2004 only the reference to the staff and equipment shortages was in fact associated with an actual production decline. Referring to other causes underlying the decline in output that were significantly correlated with the production dynamics had an opposite effect – they lowered the probability of the production contraction. Such a situation, in our view, may be explained as follows: the equipment shortages and lack of qualified staff form very unusual challenges to Russia's transition economy. Traditionally, it is believed that until recently the domestic industrial sector has had an unlimited supply of these production factors and did not consider that they would ever seriously constrain the rise in output. The economic information sources available to industrial enterprises have not tackled the issue either. In other words, there was no “spinning” of these obstacles by the media, government agencies or the enterprises themselves. This allows to assume that the enterprises referred to the noted obstacles only when they actually constrain the rise in their output. Plus, the enterprises did not do that from the very beginning, as they first had to break stereotype and realize that staff and equipment could also form constraints to their

output. By contrast, the situation with such impediments as a low demand, import competition and lack of liquidity was different. These particular problems were “in the air” and, thanks to the media and the limited official statistics, the interest in them (sometimes, perhaps, not so sound one) is still there. This could not help affecting the enterprises’ responses: they traditionally referred to these obstacles, while objectively their constraining affect had faded.

3.2.3. Impediments to rise in output formed by staff problems

While analysts have long kept their watchful eye on the pressure of competing imports on the national industry, the constraining effect of the lack of qualified staff and competitive capacities have not yet moved to the forefront of their debate. The ET surveys evidence, however, that post-default, the lack of qualified staff has always constrained production growth more often than the competition with imports, while the shortage of equipment was referred to more often than imports in 1999–2002 and in 2003–2004 it was just at 1 p. down vs. the import competition in this regard. As a prompt elimination of these obstacles (like a default liquidates the problem of import pressure on the domestic market) is unlikely an hardly possible technically, the analysis of resource constraints is worse a greater attention.

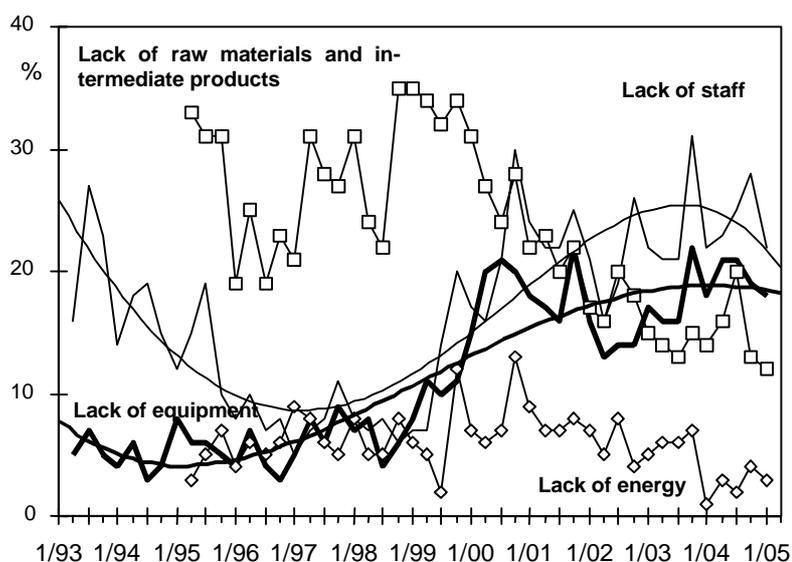


Fig. 30. Resource Obstacles to production Growth

Even in the early 1990s (Fig. 30), the national industrial sector perceived it was falling short of qualified staff. In 1993, this reason was referred to by 23% enterprise on average. The need in employment of qualified staff began to decrease in parallel with the decline in effective demand and, accordingly, output and hit the bottom –7% by 1998. However, prior to the default some industries experienced a minimum need for qualified staff to boost their output. Thus, in 1993 maximum 7% of the food industry enterprises reported such a need, while it dropped to 1% by 1998. A relatively stable demand, “live cash” for produce and wages payable in cash enabled the industry to a maximum extent avoid the “hunger for staff” in 1993–1998. Post-default, the food-processing enterprises also experienced the need in staff to boost their output to a minimum extent. In 2001 and 2004, only 9% of them believed they fell short of staff (Fig. 31).

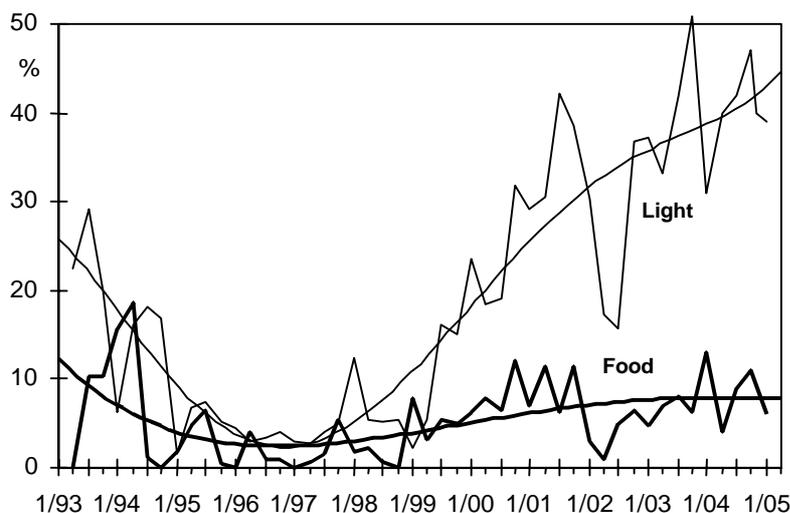


Fig. 31. Frequency of References to Staff Shortages as an Obstacle to Production Growth in Some Sectors, as %

The light industry displayed absolutely different dynamics of the need for staff to boost its output. In 1993 the need for staff was reported by 24% of its enterprises, albeit it was not the greatest 1993 value – the maximum one (40%) was reported by the construction materials industry. The need for staff had been declining, following in the wake of the fall in demand and output, by default. In July 1998, only 5% of enterprises reported the shortage of staff, and during the next 12 months the need for qualified staff had been on the utmost low level. For instance, in January 1999 it fell to 2% and grew back to 16% only in July 1999. The indicator has begun to grow since then (except for 2002) and reached 40% (2003 and 2004). none of other industry branches experienced such a great need in qualified staff in 2003–2004. As concerns the light industry itself, the highest need for qualified staff is presently noted in the cotton (55%) and sewing (40%) subsectors. This situation is unquestionably explained primarily by a hard situation in the sector and, accordingly, poor wages, rather than by an absolute lack of necessary workforce on the labor market.

Yet two another sectors likewise demonstrated in 2004 the maximal over the whole period of monitoring need for staff: those were the construction materials industry and machine engineering – 29 and 34%, respectively. Machine engineering has almost always experienced the greatest need for staff in annualized terms to ensure a boost of its output, and it was only in 2003-04 when the light industry outran it. Presently the following machine- engineering subsectors fall short of staff: shipbuilding (84% of enterprises); power engineering (74%), repair plants (84%). The forestry complex passed through the peak of the need in qualified personnel in 2003, when every third enterprise on average reported the lack of specialists to boost its output. In 2004, the need slid to 31% and it is generated mostly by the timber (44%) and sawing (28%) subsectors.

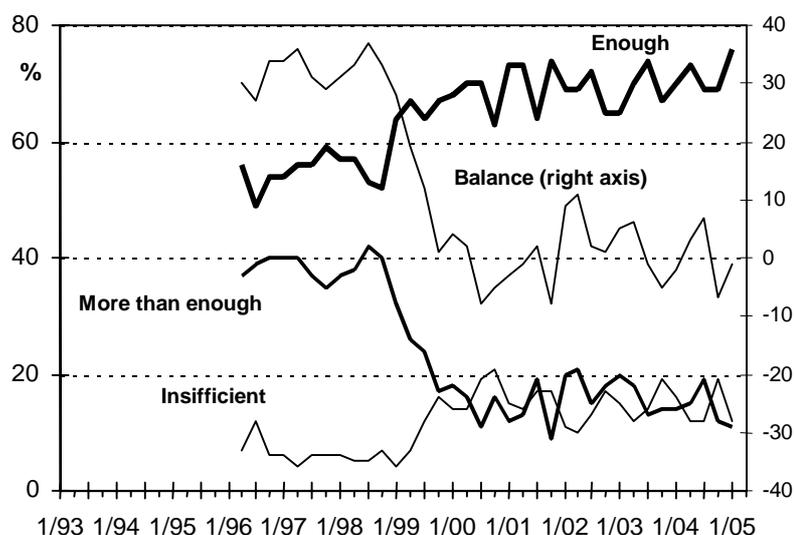


Fig. 32. Respondents' Assessment of an Excessive Number of Employees at an Enterprise and the Balance of Assessments

The need in staff to boost output is combined with an excessive employment in the national industrial sector. According to the IET surveys, prior to the default, the proportion of enterprises that had more than sufficient, due to expected changes in demand, number of staff reached 42%, given that the number of employees in the sector had been declining intensively over the 1990s. Post-default, with the rise in effective demand and the secured by cash output, there started a decline in the share of enterprises whose employment proved to be excessive to output. By the 3rd quarter 2000 an excessive number of employees had been noted at just 11% of national industrial enterprises. This index hits its bottom (9%) in the 4th quarter 2001. In 2004, only 15% of enterprises on average still believed the number of their employees was excessive, with the greatest proportion of such enterprises (18%) noted in the machine-engineering industry.

Most enterprises have always had a sufficient number of employees. The default undoubtedly extended the segment of the industrial sector where employment was sufficient due to envisaged changes, but the extension was not intense, as one could have assume. While in the pre-default period the minimum value of the indicator had been 49%, the post-default maximum sky-rocketed to 74%, i.e. the gap amounted to 25%. Post-default, some industries reported a complete satisfaction with the number of their personnel, and our surveys registered such a situation in the sectors for electricity, fuel and metallurgy, while the machine-engineering and light industry displayed the most modest results over the period in question (74%).

The dynamics of excessiveness of personnel in the industrial sector demonstrates a certain dependence on the size of an enterprise. Large plants have always maintained a greater excessiveness of their personnel vs. medium- and small-size ones. Even post-default the balance of their assessments more often appears positive than negative. Their monopolistic position and a great social significance enabled them both to increase the output and sales volumes at a faster pace pay higher salaries vis-a-vis medium- and small-sized companies, and maintain a certain excess of staff (most likely, with acceptable wages), which could be used in the event of demand and production expansion. In the pe-

riod of the post-default “re-galvanization” that allowed large enterprises to easily solve their problems with staff and experience a smaller need for employing new personnel. In such a situation, an excess of the workforce on hand can be likened to finished products, the immediate availability of which in the storage allows to promptly meet new (unexpected) customers, for a relatively low wages level in the industrial sector makes the associated costs not a heavy burden for the company.

Medium- and small-size enterprises faced an absolutely opposite situation. A more intense competition has not and still does not enable them to achieve satisfactory performance and, accordingly, salaries, which contributed for a faster “washing away” of their personnel. Prior to the default they somehow had been managing to keep “the stock” of workforce to promptly boost their output, but its size rapidly exhausted after 1998. Such enterprise have now experienced a stable shortage of workforce.

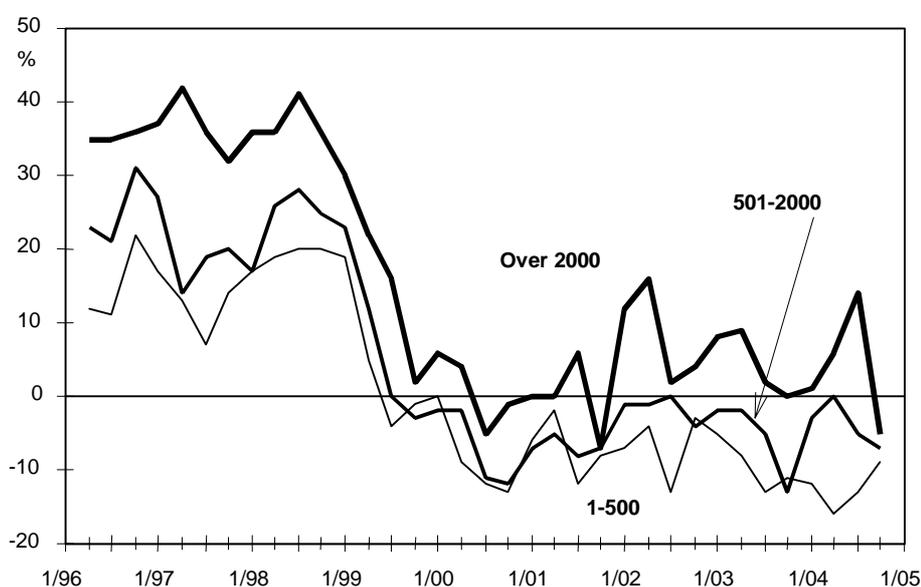


Fig. 33. Balances of Assessments of Staff Numbers due to the Enterprise’s Size
(Balance = Excessive – Insufficient)

But ultimately in 2004 the national industrial sector saw zero balance of assessments of the number of employees, with enterprises with a sufficient employment dominating over the sector (Table. 21). As the question on the assessment of employment has been asked to enterprises for 9 years already, while the Russian industrial sector experienced drastic changes in demand over this period of time and the balance of assessment has fluctuated recently over zero value, it can be argued that at the macrolevel the problem of provision of enterprises appears resolved. To equally solve it on the microlevel requires a greater territorial mobility of workforce.

The combination of assessments of sufficiency of the exiting personnel and the question about the shortage of staff as an obstacle to growth in output allows to assess the correlation between different enterprises’ positions from the perspective of staff sufficiency and possibility for solving the problem with personnel by means of labor market (Fig. 34). As our computations show, the national industrial sector has always been dominated by the enterprises that assess their personnel as sufficient in relation to expected

changes in demand and consider that staffing do not pose a problem to them, as far as the boosting of their output is concerned. It would be logical to assume that this particular group of enterprises finds itself in the state of static equilibrium between their personnel and expected changes in demand and output. They did not suffer from an excessive employment, nor they were in need for additional stuff to boost their output to match the dynamics of demand. Prior to the demand this group comprised on average up to 52% of enterprises, while in 2004 – 58%. In other words, the national industrial sector was anyway dominated by enterprises with a number of employees optimal to ensure their production expansion

Table 21

Assessment of Personnel Sufficiency (as%)

Year	More than enough	Enough	Insufficient	Balance
1996	38	54	8	30
1997	37	57	6	31
1998	39	55	6	33
1999	24	66	10	14
2000	15	68	17	-2
2001	13	71	16	-3
2002	19	68	13	6
2003	16	70	14	2
2004	15	70	15	0

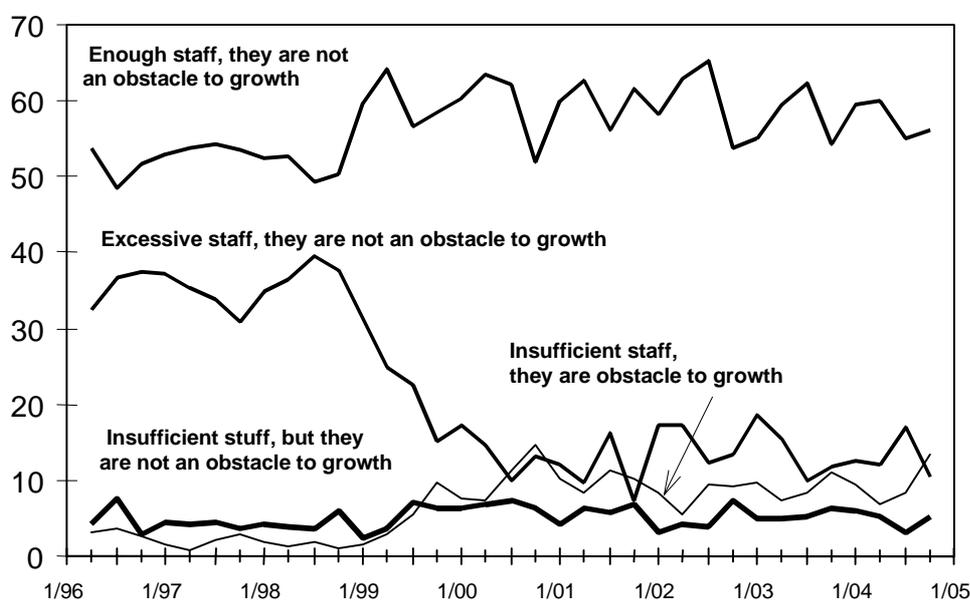


Fig. 34. The Dynamics of Main Positions of Enterprises on the Labor Market

The group of companies with excessive staff but not experiencing problems with personnel while boosting their output holds the second position. They have managed to main-

tain “a qualitative” excess of workforce needed to secure a prompt and painless (from the staffing perspective) production expansion. Indeed, as soon as Russian industrial sector began to boost output in the wake of the default, the proportion of these enterprises started to promptly shrink from 39% (July 1998) to 10% (July 2000), while in 2004 their share accounted on average for 13%. Such an excessiveness and the enterprises policy are, anyway, worth of a positive score, for they allow to keep the most qualified personnel at enterprises, which are ready to immediately take part in the production process, once the respective demand and output grow. These staffing cohorts in a sense can be likened to the industrial sector’s mobilization potential, while the sole fundamental difference between them is that the former are intended to meet effective demand, rather than military needs.

The proportion of the enterprises that lack staff, albeit personnel do not pose a problem to production expansion appears most stable. The lack of personnel due to envisaged changes in demand speaks of the absence of “competitive stock” of workforce at the enterprises, i.e. such an excess that can be used in production, once the demand for a given enterprise’s output grows. But these enterprises do not believe the lack of staff is an obstacle to growth in their output. The surveys evidence that the number of such companies in Russia has always been a. 5%. Most likely, they can solve their staffing problems through the labor market. Small proportion of this particular group is explained chiefly by a unique for the country situation, in which an enterprise has managed to fully get rid of the excessive workforce, but at the same time it enjoys the possibility of prompt staff employment on the labor market.

The enterprises that as well do not possess a sufficient number of their own staff due to envisaged changes in demand, and this staff shortage constraint their output. It can be assumed that likewise the preceding group, having got rid of the excessive workforce and even after going further beyond that, this group of enterprises found itself incapable to receive the lacking workforce from the labor market, either because of the lack of the latter in their respective region, or due to the existence of structural disproportions on that. The dynamics of the sector in question appear quite logical. While prior to the default there were on average 2% of such enterprises in the national industrial sector, after the default their average share grew up to 9%. In 2004, it rose up to 13%.

In conclusion let us results of an assessment of the model that demonstrates which of the available indicators form a situation under which qualified personnel constrain production boom in the national industrial sector. We use the enterprises’ responses to the question as to whether or not the lack of staff forms the factor that constrains the rise in their output as independent variable. It is the dichotomized variable (“forms” – “does not form”). The binary logistical regression enables us to assess the impact independent variables have on the probability of positive answer (“the staff shortages constrain the rise in output”). As concerns conceptual indicators, it was assessments of demand on the scale “over norm – normal – below norm” that have the strongest and steadily significant effect on citing in our surveys personnel shortages as an obstacle. Negative coefficients speak that the probability of the constraining effect on output on the part of personnel grows along with the rise of satisfaction with demand. Another assessment – based characteristics of demand: that is, the assessment of finished products in stock, – began to exert a substantial influence on the emergence of the probability of staffing deficit only in 2004. This impact was correct: the deficit of reserves and the need to boost output to meet an unforeseen rise in demand were increasing the probability. The dynamics of the demand (growth – no changes – decline) did not have a substantial effect on the probability of referring to the obstacle, yet the positive sign of the coefficient appears illogical – staff be-

gins to hamper the rise in output against a lowering demand. But the dynamics of output compel enterprises to recall the staffing problems. The impact of this particular variable, as a rule, appears substantial and expected. The enterprises' intentions to boost their output cause the same reaction: more optimistic production plans raise the probability of staff shortages. However, yet another critical characteristics of the enterprise's production activity, the capacity loading rate, does not affect the staff shortages, perhaps, because the already loaded capacities have been already staffed. But the prospects for a guaranteed sufficiency with work (orders in months) generate the staffing problem in the national industrial sector.

3.2.4. Capacity-related constraints to rising output.

Our surveys show that since 2000 some 18–19% on average of Russian industrial companies have believed the shortages of equipment hamper the rise in their output. The only exception was 2002, when demand discontinued its growth, while output growth rates decelerated (Fig. 35). Prior to the default, 6% of enterprises on average referred to equipment shortages as an impediment to boost in output, while post-default their number grew up to 16%, with the peak value of 22% registered in October 2003.

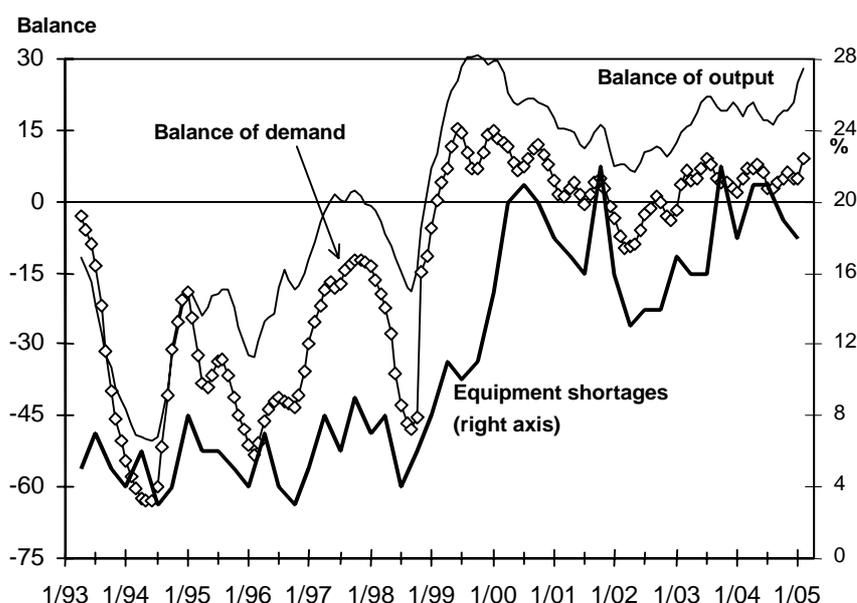


Fig. 35. Balances of Changes in Demand and Output, and the Frequency of Reference to Equipment Shortages

In the 2nd and 3rd quarters 2004, the same number of enterprises (21%) reported equipment shortages, with the forestry complex reporting it for the second year in line. Over one-third companies of the complex lacked equipment to boost their output in order to meet the growing demand. In 2004, the value of the respective index surged up to 38% – an absolute annual maximum, with very likely prospects for its further rise in the future. The construction materials industry and machine engineering hold the second and third positions with the value of the respective indicator accounting for 19% and 18%, respectively. But these two sectors display different paths, so long as the need in equipment to boost their output is concerned. The machine-engineering industry has experienced an annually

rising need in equipment – while prior to the default 3% of its enterprises fell short of equipment, after the default their number grew up to 18%. In 2004, it further rose up to 21%, with the shortage being especially acute in power-engineering, instrument-making sub-sectors, as well as production of metal constructions and means of communication. The construction industry passed its peak shortage of equipment in 2002. At the time, 26% of enterprises reported this problem. In 2004, it hampered just 15% of plants to boost the output of construction materials.

By contrast, the least need in equipment in 2004 was noted in the light industry – only 9% of the respective companies believed they fell short of equipment to ensure their production expansion. Most likely, the reason behind this is a gradual contraction in the respective demand and output, under which even the existing capacity was idle, rather than a considerable volume of investment in the sector. In 2001, when the sector was still capitalizing on the 1998 devaluation effects and hoped for a restoration of its sales, 16% of enterprises experienced the need in equipment to boost their output.

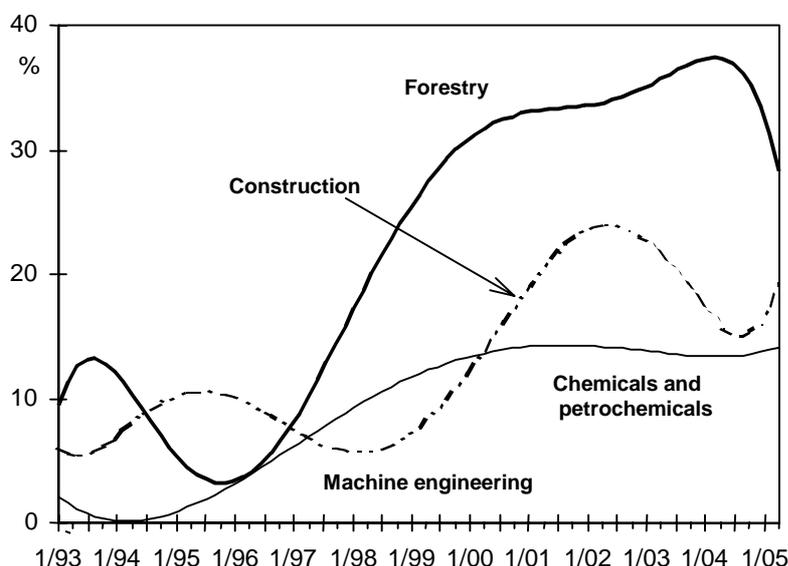


Fig. 36. The Frequency of References to Equipment Shortage as an Obstacle to Production Growth in Some Industries

The capacities loading dynamics also evidence the need in increase of equipment procurements to boost output. This particular indicator surged from 57 in early 2003 to 67% in the 3rd quarter 2004 (*Fig.37*). Such a rapid and long-lasting rise in the use of capacities was earlier registered only right after the default. The loading rate grew from 42% to 56% between July 1998 – April 2000, but already in the 4th quarter 2004 the loading rate remained unchanged. This, of course, can be explained by the stagnating industrial output noted both by our surveys and the official statistics.

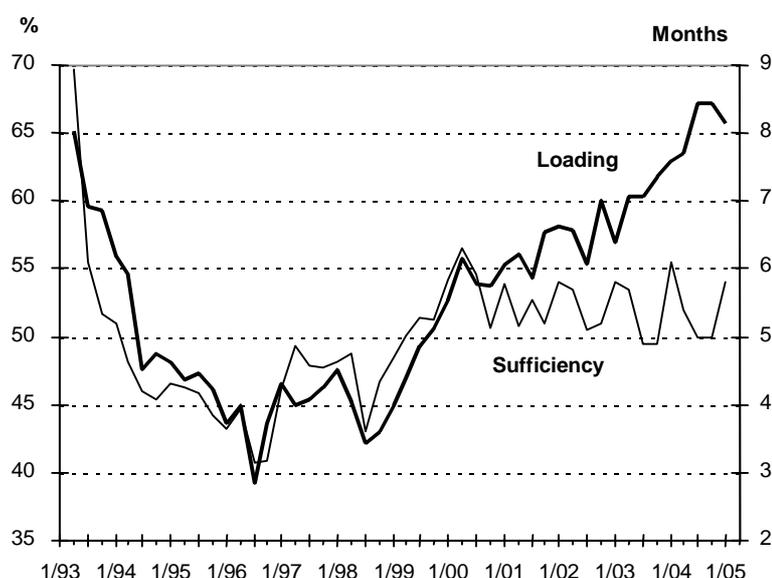


Fig. 37. Capacity Loading Rate (as %) and Sufficiency with Orders (as Months)

However, the dynamics of another survey indicator testifies in favor of an increasing exhaustion by the national industrial sector of a “overhang” (or reserve) of excessive capacities. The enterprises’ assessments of excessiveness, sufficiency and shortage of the existing production capacities due to envisaged changes in demand demonstrated a drastic fall in the proportion of enterprises with excessive capacities right in the 4th quarter 2004 (Fig.38). As a result, a. 20% of enterprises report their capacities be excessive vis-avis the envisaged demand – such low a proportion of enterprises with excessive capacities never noted since 1993. In the second half 2004, the capacities shortage in the industrial sector stabilized at 14%, which beat the preceding record value (13% in 2000) and just by 1 point missed the absolute record of 1993. But as the comparison between 1993 and 2004 seems incorrect, it can be argued that Russian industrial sector presently is in a record-breaking need for production capacities. But overall across the sector there have been more enterprises with excessive capacities than those falling short of them, which is why the respective balance remains positive, albeit it has sunk to its absolute minimum. The capacities overhang has still been there, which leaves some inertia to Russian industries, meaning it for some time would not be in urgent need for investment. Once the overhang fades, the future industrial growth will be limited already by a physical shortage of competitive capacities.

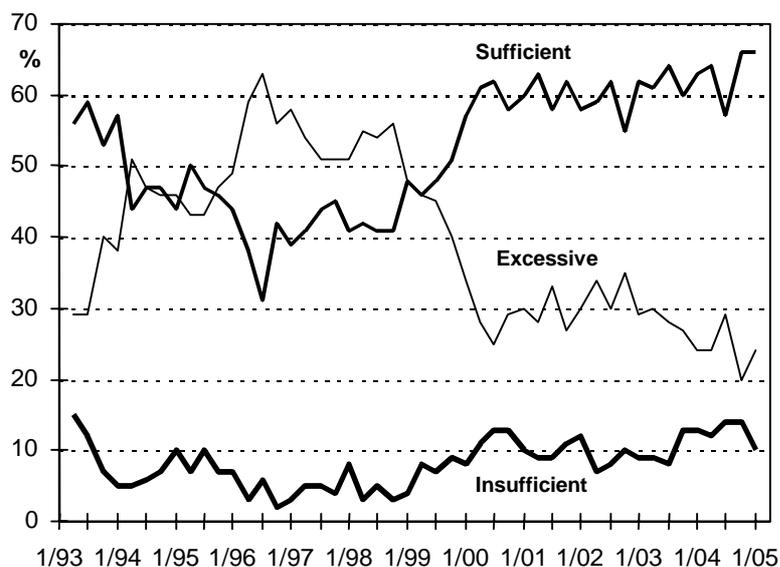


Fig. 38. The Proportion of Enterprises with Sufficient, Excessive and Insufficient Capacities

The post-default rise in the sales volume changes enterprises' view on a normal volume of demand and, accordingly, on sufficiency of their capacities to meet that. The computations of balances of assessments of capacities made for main demand assessments show that the national enterprises have already fallen short of capacities to secure normal demand volumes with their output. The average annual balance of capacities assessments in the group of enterprises with normal demand for their output for the first time became negative in 2004. Thus, the further industrial growth, in all likelihood, will result in a rise in the shortage of capacities capable to meet the demand. Let us note that breaking enterprises into groups by another two parameters (size and property form) did not result in negative balances of the capacities assessments, with considerable negative balances found only while studying into the sectoral specifics of the non-ferrous metallurgy and forestry. As well, they have been noted recently in the ferrous metallurgy.

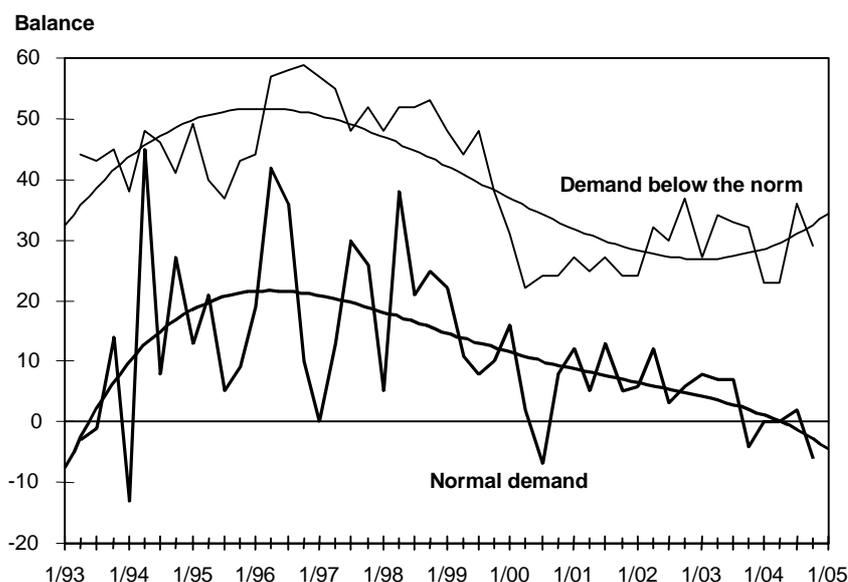


Fig. 39. Balances of Assessments of Capacities for Different Demand Assessments

The binary logistical regression enables us to assess which factors compel Russian industrial enterprises to consider the equipment shortage to form an impediment to production growth. As before, we are going to use enterprises' responses to the question as to whether or not the shortage of equipment forms an impediment to economic growth. It was demand assessments that had the strongest and always substantial impact on the probability of the shortage of equipment. As soon as demand volumes, according to the enterprises assessments, elevated from the "below norm" category to the "normal" one, the enterprises began to face a shortage of equipment, which became especially notable in 2001 and 2004. Thus, "normality" in the domestic industrial sector implies mobilization of all the personnel and equipment available and the possibility of their more intense introduction to production.

The second position by intensity of their effect on the probability of reference to equipment shortages is held by indicators of finished products in stock – actual and expected changes of their volumes, as well as the current assessments of those by the "above norm-normal-below norm" scale. In 2001, the actual changes in the stock of finished products had positive and significant coefficients, which meant that once the volumes lowered, the enterprises were compelled to cite a shortage of equipment as an impediment to growth in its output. That could occur in the event of an unforeseen by enterprises rise in demand, which they had to meet from their stored reserves, while the completing of the latter by means of intensification of output became problematic, because of the shortage of the equipment that could manufacture the much-needed produce. Let us note that it was in 2001 that Russian industrial sector seemed to abandon the mission of minimization of the stock of finished produce in favor of the task of maintaining them in an excessive state, which allows enterprises to meet new consumers' demand in an instant. Most likely, this particular transition compelled enterprise to cite the lack of equipment. The dynamics of the stock of finished products over the subsequent years has not any longer been affecting the probability of referring to equipment shortages as an ob-

stacle to boost of output – the lack of equipment has presently begun to be determined by assessments of finished produce in stock. Positive coefficients for this variable speak that the probability of mentioning equipment shortages as an obstacle grows, providing a given enterprise assesses its stock as insufficient. In 2004, it also was forecasts of changes in the stock of finished produce that forced enterprises to focus on equipment shortages. The projected lowering of volumes of finished produce in stock requires production expansion, but faces the problem of equipment and machinery being in short supply.

Despite the capacities loading and sufficiency with orders have a substantial and logical effect on the problem of equipment shortage, their rates appear very insignificant. The dynamics of demand, as well as the dynamics of output do not substantially affect the probability of citing the impediment in question.

The dynamics of effective demand for the national industrial enterprises' produce quite allowed the domestic industries to maintain high growth rates in 2004, at least, not worse than in the prior years. By the 4th quarter of the year the constraining effect of demand slid to minimum, while the satisfaction with its volume peaked maximum and overshoot the "below norm" assessments. Thus, most Russian enterprises have adapted to market. The factors that determine the level of their market adaptation became the dynamics of demand, assessments of finished produce in stock and enterprises' financial and economic state, the dynamics of profit, and the absence of excessive capacities.

The monitoring of impediments to production growth shows highlighted the emergence of a new structure in the domestic industrial sector. With the frequencies of citing most of traditional impediments continuing their fall, some of them hit record-breaking low values. Some others, by contrast begin to affect an increasingly greater number of enterprises. The regression analysis results showed that in 2000–2004 it was only the reference to the personnel and equipment shortages that was *de-facto* associated with an actual production decline.

At the outset of every year Russia's industrial sector usually demonstrates good growth rates and high optimism of forecasts. The year of 2005 has formed no exception in this respect, with its start being yet even more vigorous than before. Should the industrial sector succeed in overcoming the growing staffing and equipment starvation, as well as the banking system's distrust, the economy growth forecasts could be revised in favor of their increase.

3.3. Investments in the Real Sector of the Economy

In the 2000–2004 period, growth in investment in fixed capital was higher than dynamics of the GDP and output of primary industries. Analysis of dynamics and specifics of formation of demand in investment in the post-crisis period permitted to identify (depending on the impact of factors) the following few stages:

- Mobilization of competitive reserve capacities in a situation of a radical drop in import of capital goods from the 3rd quarter 1998 to the 3rd quarter 1999;
- Growth in domestic demand in Russian investment products from the 3rd quarter 1999 to the 4th quarter 2000 caused by intense growth in domestic production, profitability and income thanks to favorable changes in prices on international markets;
- Slow-down of investment in fixed capital from the 1st quarter 2001 due to intense growth in domestic consumer demand caused by an increase in households' income

- and decrease in income from exports due to a drop both in prices and demand in hydrocarbons on international markets;
- From the second half of 2001, growth in import volumes of machinery and equipment and a share of foreign capital goods in investment expenditure in a situation of slow dynamics of domestic output of engineering industry;
 - Sluggish dynamics of demand in investment in 2002 due to a decrease in income from foreign economic activities, reduction of the domestic market and reduced profitability of production;
 - From the beginning of 2003, resumed higher growth rates of investment in fixed capital as compared to the GDP dynamics because of growth in income from foreign economic activities and business activities at home;
 - Smaller impact of growth rates of investment in fixed capital on dynamics of the domestic market in a situation of growing income from exports and reduced transformation thereof into investment resources from the 2nd quarter 2004.

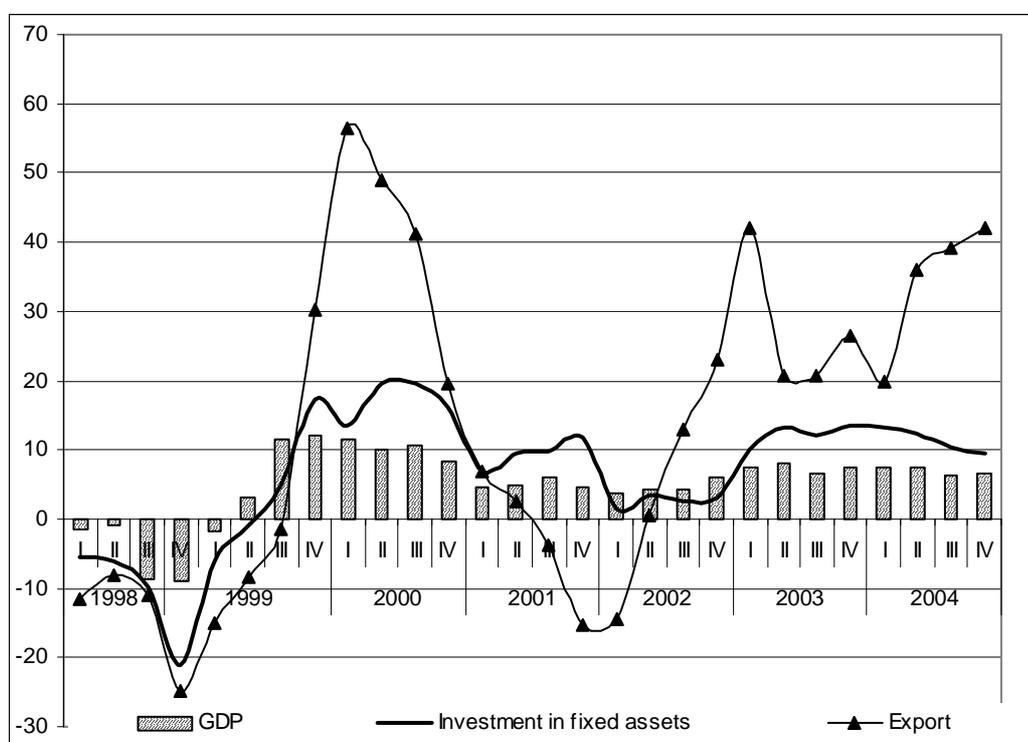


Fig. 40. Rates of growth in the GDP and investment in the fixed capital in the 1998–2004 (% of the respective quarter in the previous year)

From 1999, growth in accumulation and investment was faster than dynamics of GDP. In 2004, growth in investment in fixed capital amounted to 10.9% (the GDP – 7.1%). Growth in demand in investment ensured nearly 25% of an increase in the volume of the GDP.

Intense growth in income of the economy had a significant effect on the specifics of investment activities. It was related, on one hand, to favorable changes in prices on hydrocarbon materials and metals in international markets and, on the other hand, an active policy by the Russian business which was aimed at filling in niches on the domestic market with Russian goods (Fig. 40). Growth in profitability of production and income from foreign

economic activities initiated an expansion of demand in capital goods, which was based on higher rates of output of related industries. Aimed at intensive modernization and upgrading of production, both the export sector and manufacturing industry experienced greater need in machinery and equipment.

In a situation of existing imbalances between dynamics of fixed capital and investment expenditure on the domestic capital market, dynamic growth in import machinery and equipment had a greater role to play (with seasonal factors excluded, a decrease in the share of imports in the volume of consumption of engineering industry's products began in 4th quarter 1998 and was over in the 3rd quarter 1999). A rise in demand in import machinery and equipment took place in 2000; faster growth rates of import machinery and equipment as compared to dynamics of domestic engineering industry became sustained and corresponded to dynamics of investment activities. In the 2000–2004 period, growth in output of engineering industry and building materials industry amounted to nearly 60% and 37.7%, respectively, with volumes of import machinery and equipment and means of transportation increasing by 150% (Fig. 41).

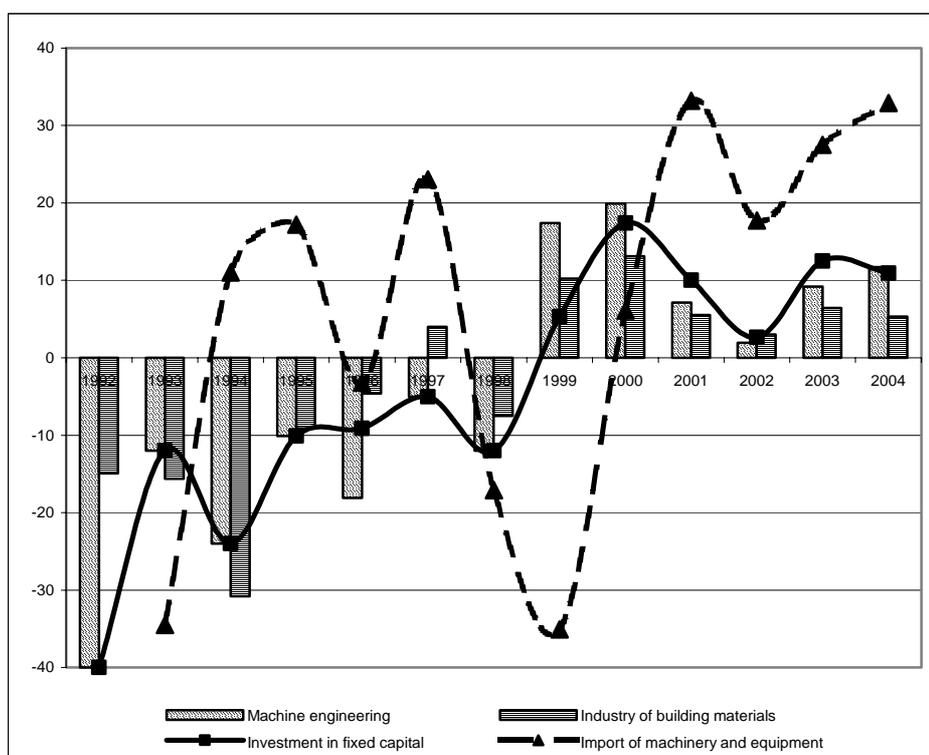


Fig. 41. Growth rates of investment in fixed capital, output and import of capital goods in the 1992–2004 period (% of the previous year figure)

Dynamics of output of capital goods by the branch of engineering industry reflected prompt response by the Russian business to changes in market situation at home. Whereas in the 1992–1997 period, motor industry was a factor, which prevented recession in engineering industry, in the 1999–2004 period it yielded that place to industrial equipment manufacturing. Branches specializing in manufacturing of equipment for oil and chemical industries and domestic market-oriented branches of engineering industry, such as railway engineering and metallurgical engineering were leaders as regards output of investment goods. Intense development of service industries gave an impetus to growth in

output of road building engineering, lifting equipment manufacturing, communication industry and instrument making industry. Higher competitive advantages of domestic engineering as compared to those of foreign analogs (as regards pricing) promoted growth in output of equipment meant for branches of the consumer's sector.

Replacement of worn equipment remained a principal line of investment in fixed capital. In 2004, about 33.3% of entities increased their production capacities with a product range still unchanged. In nearly 40–47% of entities, investment activities were determined by higher efficiency of production related to introduction of new production technologies, reduction of production costs and saving of energy resources. As a result, in 2004 a larger portion of investment in fixed capital was spent on purchase of machinery and equipment. According to the data of the statistical service, 88% of entities bought new Russian-made equipment and machinery, while 60% of entities, import equipment; on the secondary market 22% of entities bought Russian-made equipment, while 5%, import equipment. In January-September 2004, investment in purchase of import equipment amounted to 23% of the total volume of investment in machinery, equipment and means of transportation.

A shift from investment into fixed capital financed at entities' and enterprises' own account to a greater use of borrowed funds was a principally new factor behind economic growth. The above points to quality changes in mechanism of investment development aimed at ensuring greater efficiency of flows of investment resources. In 2004, the share of own funds accounted for 47.2% of the total investment in fixed capital, which corresponded to the 2000 level (the record high demand in investment during the entire period of recovery growth). There were also changes in the structure of borrowing: the share of bank loans and borrowed funds of other institutions increased, while that of budgetary financing went down by 1.9%. In the past few years, the share of federal budget funds in investment financing gradually decreased in a situation of growth in the share of budgets of constituent entities of the Russian Federation. In 2004, the share of the federal budget in the structure of budgetary funds decreased by 3.8% on the 2003 figure.

By estimation, in 2004 growth in lending to enterprises and entities amounted to nearly 31.6%. In 2004, the share of bank loans in investment rose to 7.7%, as against 5.2% in 2003 and 2.9% in 2000. With high economic growth rates in the 2003-2004 period, positive growth dynamics of direct foreign investments in Russian economy were registered. According to the results of the three-quarters of 2004, an increase in foreign investment amounted to 39.1%, while the share of foreign investment in the total volume of investments in national economy, to 5.4%. Industry was getting more and more attractive to foreign investors, followed by commerce, public catering and general commercial market services (*Table 22*).

De-dollarization of households' savings was a factor behind greater role of banks and other entities in advancement of loans. Drop in cash foreign currency holdings by households and conversion thereof into rubles were accompanied by growth in bank deposits. With the existing average level of profitability in the economy, low real value of credit resources contributed to growth in the number of domestic market-oriented borrower-enterprises. With a decrease in the lending rate of refinancing of the Bank of Russia from 16% in 2003 to 13% in June 2004 and an increase in the share of medium and long-term funds accumulated by the banking system, the money market became more attractive.

At the same time, in a situation of economic growth it became clear that investment management was not in line with restructuring processes taking place in Russian economy. Lack of investment financial institutions, underdevelopment of the stock market and legal irregularities made borrowing rather complicated. Also, due to a lack of mechanisms of intersectorial flow of capital, investment at the level of enterprises, branches and re-

gions was complicated. As known from experience, in making of reserve savings taking of investment decisions requires both prudence and efficient management of investment flows. Lack of long-term development strategy and business priorities was a factor behind reduced investment motivation.

Table 22

**Structure of investment in fixed capital
by the source of financing (%)**

	1998	1999	2000	2001	2002	2003	2004*
Investment in fixed capital – total	100	100	100	100	100	100	100
Including by the source of financing:							
<i>Own funds</i>	53.2	52.4	47.7	49.4	48.0	46.2	47.4
Including:							
profit	13.2	15.9	23.4	24.0	20.5	17.2	17.0
<i>Borrowed funds</i>	46.8	47.6	52.5	50.6	52.0	53.8	52.6
Including :							
Bank loans	4.8	4.2	2.9	4.4	4.8	5.2	7.7
Including loans by foreign banks			0.6	0.9	0.5	0.8	1.4
Borrowed funds of other entities	4.3	5.6	7.2	4.9	6.0	8.6	7.3
Budgetary funds:	19.1	17.0	22.0	20.4	19.6	18.8	16.9
federal budget funds	6.5	6.4	6.0	5.8	6.0	6.5	4.9
funds out of budgets of constituent entities of the Russian Federation and local budgets	12.6	10.6	16.0	14.6	13.6	11.5	11.2
foreign investment in the total volume of investment in fixed capital	3.5	6.6	4.7	4.5	4.1	4.7	5.4

* According to the data of January-November 2004 .

Source: The Federal Service of State Statistics.

In 2004, dynamics of demand in investment were determined by an aggregate impact of factors behind changes in sectorial, technological and reproduction structures of national economy. Reallocation of flows of investments was accompanied by an increase in the share of the services sector. In the 1999–2004 period, the share of transport, communication and commerce accounted for 25% of the total volume of investments in fixed capital, as against 15% on average in the 1992–1996 period. Growth in investment activities in service industries and an increase in demand in such services became an indicator of the potential of economic growth, all the more so investment activities in the above sector were primarily aimed at attainment of long-term objectives.

In analyzing of investment inflow by the sector of the economy, it was important to take into account the specifics of dynamics and structure of investment in housing construction. Analysis of the structure of new commissioned housing showed that non-public investors (which accounted for nearly 80% of new commissioned housing) had a greater role to play in that sector. At the same time, in the last decade there was growth in the share of housing financing by households.

There were also changes in the sectorial structure of investment in fixed capital. The total volumes and dynamics of investment were determined to a great extent by natural monopolies' industries and branches of oil industry. With transport, communication industry and fuel industry accounting for 45% of the volume of investment in national economy it was obvious that business activities in the above industries had a significant effect on dynamics and structure of demand in investment. In the 2003-2004 period, growth rates of investment in transport development were positive, which factor permitted to overcome negative implications related to a drop in investments in 2002. In January-September 2004, the share of investment in the transport sector amounted to 20%, as against 21.6%

in 2003. In the past four years, branches of the services sector were characterized by faster growth in investment in fixed capital of communication industry and commerce. From 2001, positive investment growth rates were registered in healthcare, education, culture and science. In the 2002–2004 period, the aggregate unit weight of investment in the above sectors of the economy amounted to nearly 5.8%, which factor permitted stabilization of the rates of service rendering.

In 2004, the share of investment in fixed capital of branches of the physical production sector remained at the previous year's level and amounted to 48.5%, which situation was caused by a low-key growth in investment in industry. Also, a slow down of investment activities was registered both in the export-oriented sector and domestic market-oriented industries.

Investment industries accounted for 9.0% of the total volume of investment in industry, while branches of the consumer's sector, for 7.7%. With the existing age, technological and reproduction structure of fixed capital, low investment rates of branches of manufacturing industry were a factor behind a slow down of economic growth rates (Fig. 42).

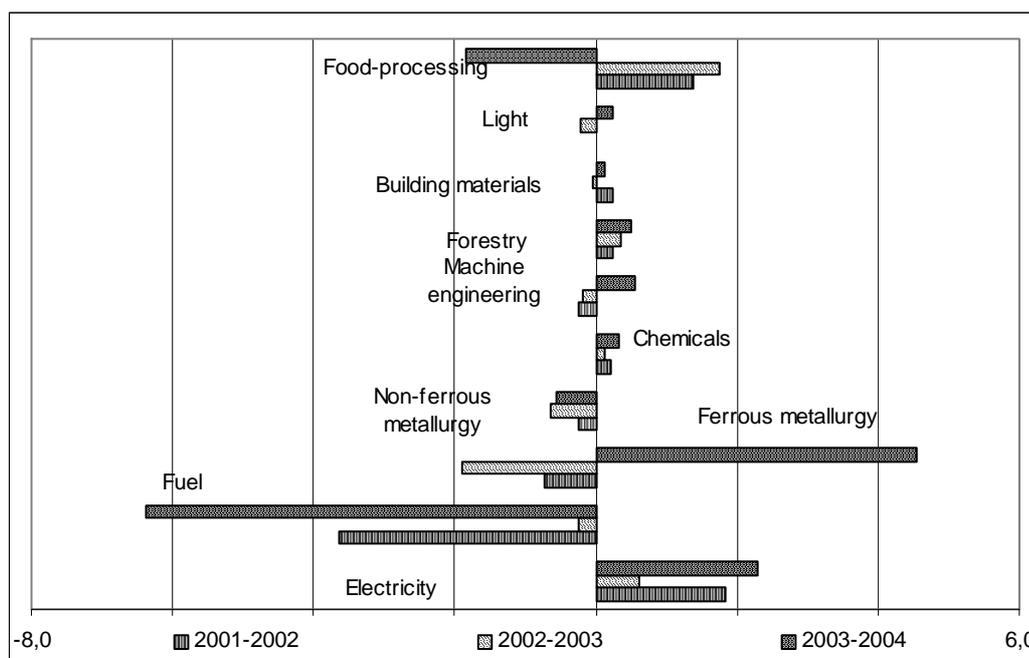


Fig. 42. Change in the structure of investment in fixed capital by the branch of industry in the 2001–2004 period (% of the previous year figure)

Fuel industry kept dominating in the structure of investment; it accounted for over 45% of the investment in industry with over 50% of such investment made in oil industry. However, in the 2003-2004 period the oil sector of the economy was characterized by low-key investment dynamics. In January-September 2004, a share of the fuel sector in the total volume of investment in industry decreased by 2.9% as compared to the same period in 2003.

Prospects for further economic growth depend to a great extent on intensive changes in the structure of investment in favor of domestic-market oriented industries. Implementation of the above suggests coordination of decision-making in fiscal, tax, tariff, customs and monetary policies. A tax system reform and budgetary reform are to promote

diversification processes in the economy and make manufacturing branches more attractive to investors.

For the purpose of ensuring investment into the economy, financial infrastructure and the system of financial intermediation are currently reformed. In September 2004, the Russian Government approved a plan of actions for development of financial markets. The plan included amendment of the legislation on financial markets and was aimed at ensuring of a greater use of derivative financial instruments, further application of self-regulation principles and harmonization of requirements in respect of formation of own capital, placement of funds and composition and structure of assets of financial institutions.

In 2004, the President of the RF signed a number of laws concerning the stock market, including amendments to the Federal Law on Execution Proceeding aimed at protection of funds of client-participants in the securities market and the Federal Law on Joint-Stock Companies aimed at upgrading of investment activities by joint-stock companies through implementation of effective dividend policy and ensuring of financial and business transparency. Also passed were statutory acts dealing with regulation (risk reduction) of activities by professional participants in the securities market, development of new financial instruments (which would help attract foreign and domestic investors), simplification of the securities registration system and development of the system of provision of information by issuers to investors.

In July 2004, the President of RF signed a law on amendment of the Federal Law on Prevention of Legalization (Money Laundering) of Income Received from Criminal Activities and Financing of Terrorism which permitted to control activities by banks and institutional investors, as well as operations with real estate, cash funds and securities.

In August 2004, the Federal Law on Amendment of the Federal Law on Insolvency of Credit Institutions (aimed at upgrading of legal regulation in respect of bankruptcy prevention and bankruptcy proceedings of credit institutions) was passed.

In July 2004, the Government of the RF approved in principle the draft Strategy of Development of the Banking Sector in the RF.

The Federal Law on Amendment of the Federal Law on Insurance Operations in the Russian Federation (aimed at ensuring of a higher share [up to 25%] of foreign capital in the charter capital of Russian insurance companies and removal of a number of limitations imposed on insurance companies in which foreign investment accounted for 49% of the charter capital) contributed to a greater transparency of the insurance market. In addition to the above, within restructuring of the banking sector and implementation of the strategy of development of the banking sector it was planned to ensure a nondiscriminatory access for foreign capital to the Russian banking sector.

Standard&Poor's (an international rating agency) raised Russia's long-term sovereign credit rating in foreign currency from BB+ to BBB-. The last level according to the S&P methods was considered the first one in the so-called investment category. As other international rating agencies, such as Moody's and Fitch Rating raised Russia's rating to the above level, it can be stated that the three leading rating agencies included Russia into the "investment" category. However, recognizing positive changes in dynamics of economic growth, foreign economic activities and fiscal policy S&P experts pointed to existing high political risks, non-transparency of business and slow progress in institutional reforms.

With upgrading of Russia's rating to the investment level, Russia can expect better borrowing terms on international capital markets. Such a situation can permit to a certain extent relieve strain of temporary high foreign debt payments on dynamics of economic growth and adjust a mechanism of investment regulation. Concurrently, real prospects will arise for growth in capital flows in Russia by portfolio institutional investors, which are re-

quired to invest only in instruments having an investment rating. With growth rates within a range of 7% a year, the Russian market is attractive enough to foreign investors. At the same time, with Russia assigned the investment rating new problems may arise. In a situation of a better investment climate (judging by formal factors), the Russian financial market may become dependent to a greater extent on fluctuations on international foreign exchange and securities markets.

Foreign investments in Russian economy

The economic development in the recent four (4) years is characterized by growing volumes of foreign investments into the Russian economy with regard to the GDP dynamics and the business activity indicators of domestic investors. As compared against the year of 2003, the volume of foreign investments experienced a 36.4% growth thus comprising 40.5 bln US dollars (*Table 23*). Positive influence on increasing the investment attractiveness degree of the Russian economy in 2004 was exerted due to raising by the respective international rating agencies of the sovereign crediting rating of Russia up to the level of investing.

Formed in 2003, the trend towards increase in the share of direct investments still remain preserved. The increment of direct foreign investments in 2004 comprised 138.9% and their respective share grew up to 23.3%. The share of other investments in the aggregate foreign investments into the Russian Federation in the year of 2004 remained at the level of 75.8% and the portfolio ones went down to 0.8%.

Table 23

Volume of foreign investments into the non financial sector of the economy of Russia by kinds*

Year	in mln dollars				in % to the preceding year			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
2000	10 958	4 429	145	6 384	114.6	104.0	467.7	121.2
2001	14 258	3 980	451	9 827	130.1	89.9	311.0	153.9
2002	19 780	4 002	472	15 306	138.7	100.6	104.7	155.8
2003	29 699	6 781	401	22 517	150.1	169.4	85.0	147.1
2004	40 509	9 420	333	30 756	136.4	138.9	83.0	136.6

* With no account taken of the money credit regulating bodies and the commercial and saving banks, including the rouble investments, re-counted in the US dollars.

Source: The Federal Service of the state Statistics.

It is for the second year running that the volumes of the foreign investments into the Russian economy outstrip such of the business activities of Russian investors in foreign countries (*Fig. 1*). In 2004, the value of foreign investments in the Russian economy exceeded Russian investments into foreign countries by 6.74 bln US dollars. In 2003, the same indicator was estimated as 6.44 bln US dollars.

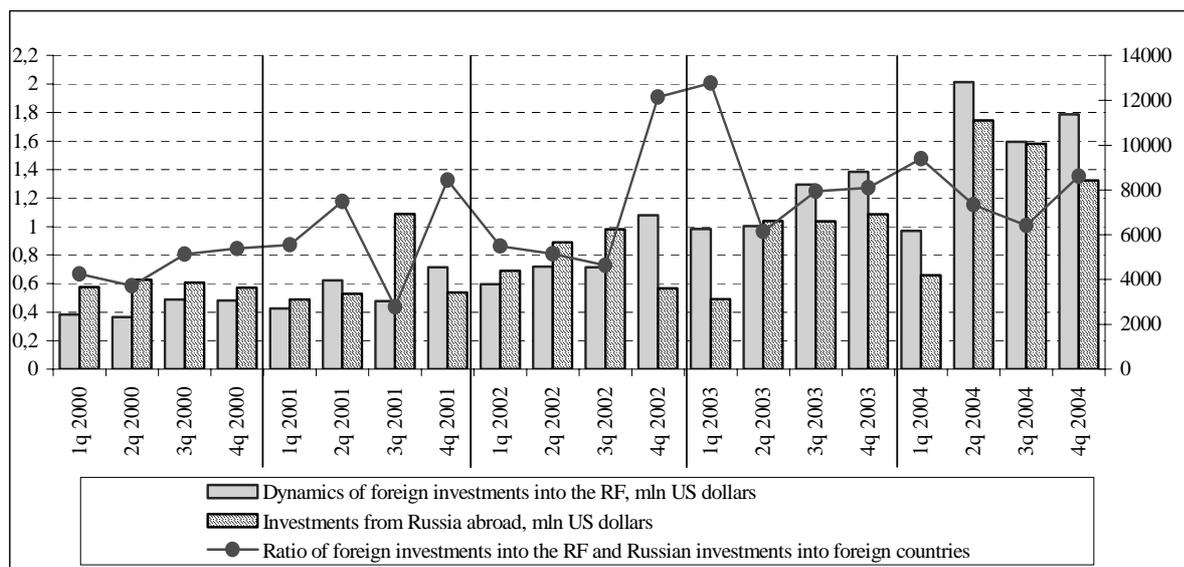


Fig. 43. Foreign investments in the Russian Federation and investments from the Russian Federation abroad in 2000–2004

As of the end of December, 2004, the foreign capital accumulated in the non finance sector of the Russian economy, comprised 82 bln US dollars which is 43.8% higher than the indicator as of January 1, 2004. The structure of foreign investments accumulated as of the end of December, 2004, is predominated by other investments which account for 54.0% (as of January 1, 2004, this indicator was estimated as 51.7%). A similar indicator for the direct foreign investments comprised 44.1% (January 1, 2004 – 45.8%).

According to the results of 2004, the leaders in the total volume of the accumulated foreign investments were Cyprus, Netherlands, Luxembourg, Germany and the Great Britain whose share comprised 67.9% (the year of 2003 – 57.1%) (see Table 24). The top five investing countries also account for 64.5% of direct investments (the year of 2003 – 51.4%), 48.9% of portfolio investments (the year of 2003 – 73.0%) and 71.3% of other investments (the year of 2003 – 61.4%).

Table 24

**Foreign investments in the economy of Russia
by the main countries – investors, in mln US dollars**

	Accumulated by 01.01.2005				Accumulated by 01.01.2004			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
USA	6624	4310	418	1896	5296	4297	41	958
Germany	9324	2550	8	6766	10204	2542	383	7279
France	3 874	433	0.3	3 441	4776	331	0.1	4445
Gr. Britain	8673	1602	142	6929	7220	2828	107	4285
Cyprus	13790	10094	585	3111	8085	5037	547	2501
Netherlands	11996	8805	43	3148	3575	2796	5	774
Luxembourg	11880	263	1	11616	3464	222	1	3241
Other states	15836	8090	396	7350	14394	8078	344.9	5971
Total	81997	36147	593	44257	57014	26131	1429	29454

Source: The Federal service of the state statistics.

In 2004, like in the preceding year, the concentration of foreign investments in the two spheres of the Russian economy, that is in industry and in the sphere of trade and public catering, remained preserved. The highest growth rates of foreign investments in 2004 at that, were observed in the sphere of finance, crediting and insurance. Distribution of foreign investments by the basic industries of the Russian economy is presented in *Table 25*. Definitely positive is the fact that the growth of investments in industry remained preserved in the year of 2004 as well.

Table 25

Branch structure of foreign investments in the Russian economy in 2002–2004

1	In mln dollars.			In % to the total		
	2002	2003	2004	2002	2003	2004
	2	3	4	5	6	7
Industry	7 332	12 330	20 170	37.1	41.5	49.8
Transport & communication	610	1 083	2 033	3.1	3.6	5.0
Trade & public catering e	8 800	10 516	13 037*	44.5	35.4	32.2
Commercial activities for servicing the market	1 355	3 403	2 572**	6.9	11.5	6.3
Finance, credit, insurance provision of pensions	130	640	1 001***	0.7	2.2	2.5
Other branches	1 553	1 727	1 697	7.9	5.8	4.2

* In connection with the changed procedure of providing information by the RF Rosstat (The Federal Service of the State Statistics) in 2005, the column contains data on foreign investments for organizations whose main business activities are “wholesale and retail trade, repair of the transport means, motorcycles, domestic goods and personal usage goods”.

**This column contains data on foreign investments for organisations whose main business activities are “commercial operations with real estate, renting and provision of services”.

*** This column contains data on foreign investments for organizations dealing with financial activities.

Source: Federal Service of the State Statistics.

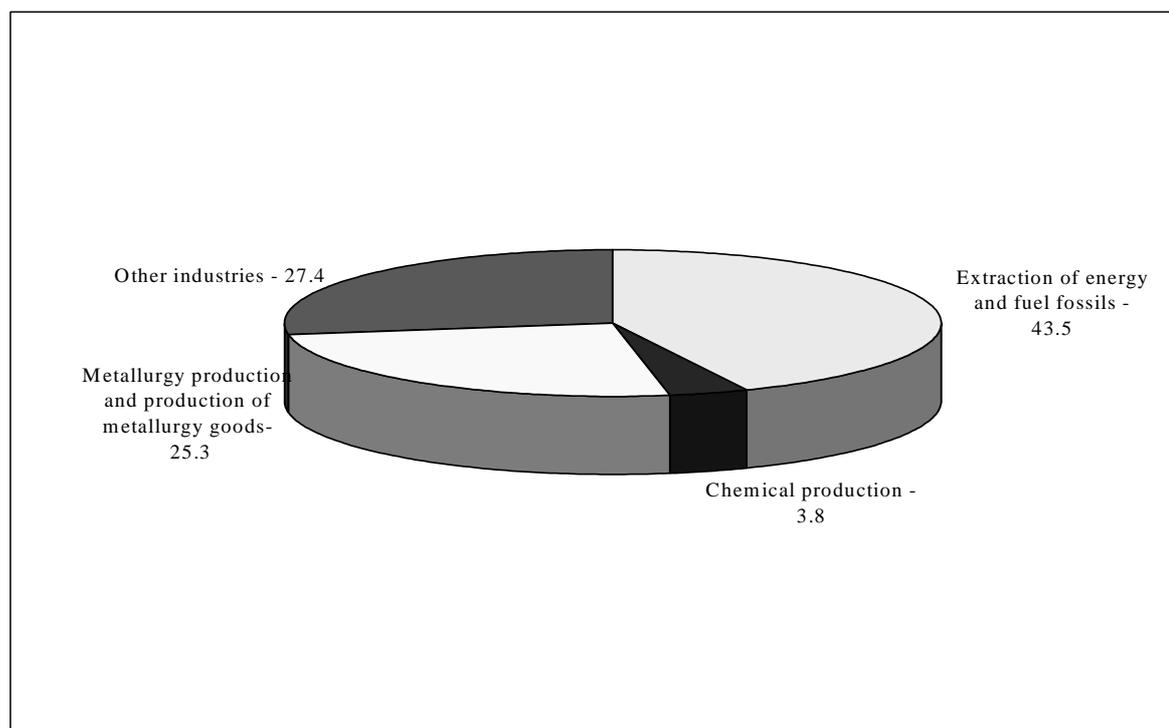


Fig. 44. Branch structure of foreign investments in industry in 2004, %

Like in the year of 2003, the structure of foreign investments into industry is characterized by a higher share of direct investments (the year of 2004 – 34.7%) as compared against the corresponding structure of the total volume of foreign investments into the Russian economy.

Significant changes in the structure of foreign investments in a number of industrial branches were observed in 2004. The specific weight of direct investments in the chemical industry in 2004 grew up to 31.1% while in 2003 it comprised but only 19.1%. A similar situation was observed in the metallurgy industry – the share of direct investments in this industry increased more than 6 times over and comprised 22.4%.

Considerable growth of investments in the fuel industry (about 65%) resulted in changes in the regional structure of foreign investments into the Russian economy. The volume of investments in Moscow, for instance, remained at the level of 2003 while such foreign investments in the Tyumen region within the period of 9 months of the year of 2004 comprised 4.7 bln US dollars which is 3.1 times more as compared against the same period of 2003. A similar indicator for the Khanty – Mansi administrative okrug (AP) is estimated to be in the amount of 3.9 bln US dollars which is 2.7 times higher than such level in 2003. On the whole, foreign investments in Saint Petersburg grew in 2004 by 41.6% as compared against such in 2003 (up to 985.1 mln US dollars) and by 44% in the Littoral Region (up to 65 mln US dollars).

The leading position in the geographic structure of foreign investments into the Russian economy belongs to Luxembourg whose share comprises 20.8% of the total volume of foreign investments in the Russian economy in the year of 2004, the second place takes the Great Britain – 17.3% of the total volume (Fig. 45).

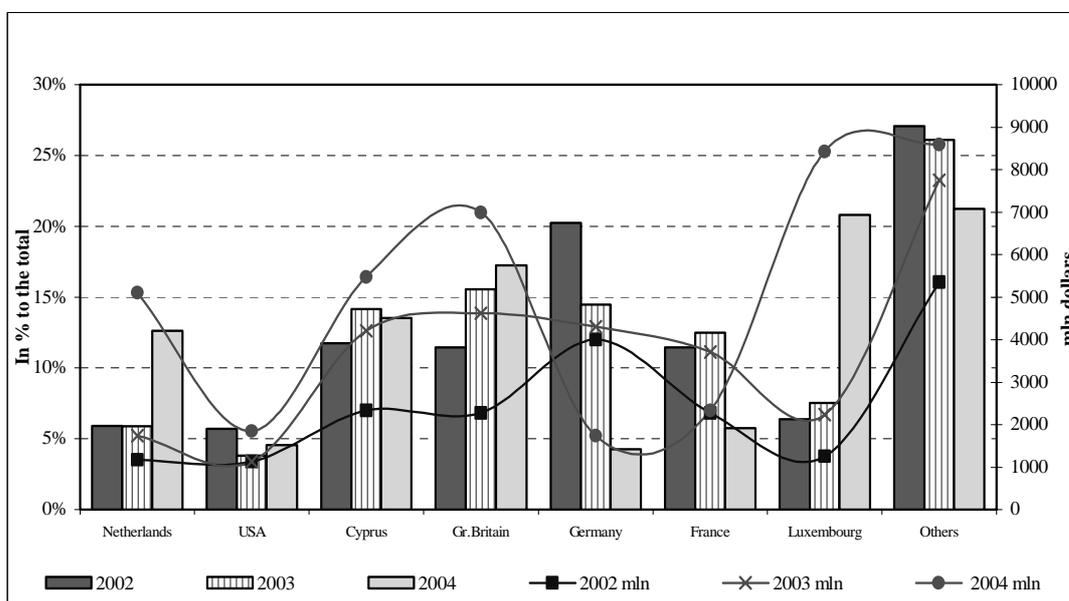


Fig.45. Geographic structure of foreign investments in the Russian economy in 2002–2004

In 2004, investors from Luxembourg increased their investments into Russian economy 3.8 times while investments from Netherlands during the same period grew up to 2.9 times. The most significant reduction of investments in 2004 was observed among the German investors. Relevant investments from Germany in the period under consideration

comprised 1.7 bln US dollars (4.3 bln US dollars in 2003). French investments in Russian economy also reduced down to 2.3 bln US dollars (from 3.7 bln US dollars in 2003). Differences in the dynamics of investments from various countries resulted in significant changes of the geographic structure of foreign investments in Russian economy. The specific weight of Germany, for example, went down from 14.5% in 2003 to 4.3% in 2004, such for France decreased from 12.5% down to 5.8%, Netherlands increased their share from 5.9% up to 12.6%, Luxembourg increased it from 7.5% up to 20.8%.

The year of 2004 also witnessed changes in the branch priorities of foreign investors from different countries. For instance, in the year of 2003, investors from Luxembourg usually invested in the trade public catering (60.1 of total investments from Luxembourg in the Russian Federation in 2003) and in the metallurgy industry (35.2%), but in 2004, they already gave preference to the extractive industry (45.2% of the total investments from Luxembourg into the Russian Federation in 2004), to the communication enterprises and to the sphere of trade (35.4%).

Entrepreneurs from the Great Britain considerably lowered down their investments into the general commercial activities for ensuring market functioning in the year of 2004. At that, they also increased investing into the sphere of trade (from 39.6% in 2003 up to 53.4% in 2004) and in the metallurgy industry (from 10.3% up to 19.8%). The share of the communication industry in the investments from the Great Britain accounts for 6% (any data on investments in communication in the year of 2003 are not available).

In 2003, a priority industry for the investors from France was the fuel industry into which they invested 2.7 bln US dollars or 72.5% of the total investments from France into the RF in 2003. In the year of 2004, the share of trade in the French investments into the Russian economy grew up to 55%.

3.4. Russian agrifood sector: basic trends in 2004

3.4.1. Exhaustion of growth factors and dichotomy forming in the sector

The Russian agrifood sector performance in 2004 definitely indicates that the period of recuperative growth launched by 1998 crisis is over. Both agriculture and food industry stopped growing (*Fig. 1* and *Fig. 2*).

In recent years the basic growth factor in the sector has been the shelter of domestic market from import due to devaluated ruble. Larger exports can also be attributed to this factor (although to a lesser extent). But beginning from 2000 the deficit of agrifood trade started to build up again. Given the agrifood imports' growth rates throughout the last year, their annual value in 2004 will surpass the 1998 indicators. In this situation the government attempts to extend the factor's effect by strengthening trade protectionism. Year after year budget support to agriculture in real terms diminishes while the overall level of protection (estimated by PSE⁴) increases quite intensely. In other words, on the national level the government tries to prolong growth in the sector by protecting it from import. Indeed, in recent years the weighted average import duty⁵ on agrifood items got higher (in 2002 it amounted to 13.2%, in 2003 – to 15.3%⁶), meat quotas, duties on import of rice and other commodities were introduced, cases of non-tariffs barriers to import became more frequent.

⁴ PSE – *producer support estimate* is a complex indicator of state support's level. It includes both *budget transfers* to farm producers and *price transfer* – the result of measures leading to higher prices for agricultural commodities (including trade protectionism tools).

⁵ *Ad valorem* part without specific component.

⁶ IET estimates.

However, all these measures have failed to improve the sector's performance – the average growth rates are falling at a high pace. Production indicators in some agricultural sub-sectors deteriorate. Although the output of many farm crops in 2004 exceeds the level of extremely poor-crop 2003, it still remains quite low as compared with previous years (*Fig. 3*). Production of basic livestock products decreases as well, the only exception being poultry the output of which grows by 15–19% per annum for already several years.

Does this mean that opportunities opened before the Russian agrifood sector after 1998 have been fully missed? We find that it's not exactly so. The above mentioned facts reflect the situation in domestic agrifood sector at large. However, from the Soviet period it inherited quite a lot of marginal producers that long remained afloat due to soft budget constraints, lack of efficient bankruptcy mechanism, non-developed land market and other market reform failures. Actually, the sector is rapidly polarizing: on the one side, we witness the emergence of quite competitive producers that succeeded in modernizing technologies, management and production structure within the short respite after 1998; on the other side, enterprises for which the period of recuperative growth only protracted the dying agony still continue operating.

This process is most apparent in agriculture where bankruptcy of enterprises is coupled with acute social problem and poor legislative basis. One can surely assert that two segments shaped in the sector presently referred to as "agriculture": farm production proper characterized by larger output, higher productivity and modernization, and the segment of former Soviet agricultural enterprises that became marginal producers and currently survive only thanks to state support at all levels having just one goal – to provide a source of income for local population. In fact, the second segment cannot be regarded as a part of the sector, and these are its performance indicators that pull the national averages of growth and productivity down. This assertion is supported by a lot of indirect evidences that will be described below.

First of all, agricultural production is quite clearly concentrating in a limited number of producers (*Table 26*). For instance, the top 100 companies account for the following shares in output: grain – 4% before the crisis and over 8% after the crisis, sugar beets – less than 15% and over 20%, respectively. This concentration is even more apparent in livestock production. Before the crisis the top 50 companies produced 15% of poultry, today – over one half; the top 100 pig producers accounted for 22% of output before 1998, presently – also for over one half.

According to estimates of V.Uzun⁷ slightly over 40% of financially viable farm producers account for about 75% of the sector's commodity output (in 2002 42% of farms were profitable, in 2003 – 49%). The research of M.Grazhdaninova⁸ showed that about one half of agricultural producers is situated on the production possibility frontier while the other half is within this frontier. In other words, the output produced by one half of farm producers using available resources is much smaller than the one currently possible in Russia (i.e. the one produced using similar resources by the other half of producers).

One more interesting sign of production concentration can be detected on the regional level – it's a striking change of grain yields by weeks of harvesting. During the first weeks of harvesting average yield indicators are the highest since they reflect perform-

⁷ V.Uzun. Large and small business in the Russian agriculture: adjustment to market and efficiency. Moscow, 2004. Proceedings of IET conference "Social and economic transformation in the CIS countries: achievements and problems" held on September 13–15, 2004. Mimeo.

⁸ M.Grazhdaninova. Factors of agricultural production efficiency in the Russian transitional economy. Ph.D. dissertation paper. 2004, IET.

ance in the southern, most fertile regions. Later the average starts to encompass indicators of regions situated to the north where yields are lower, and respectively begins to slide down. In previous years the decrease was rather smooth but in 2004 the difference between southern and other regions was very impressive (*Fig. 6*) evidencing a qualitative leap in grain productivity. Production of milk is also gradually concentrating: in 2000 the top 10 regions accounted for 12% of its gross output, in 2004 – for already over 15%.

Investments grow both in agriculture and in food industry (*Fig. 4* and *5*). In case the agrifood sector really plunged into a crisis, it wouldn't attract capital. But given the above mentioned dichotomy of the sector, it becomes clear that investments are made in its efficient part.

Moreover, production of farm machinery again started growing (*Table 27*). Since its export is very limited, this supplement is consumed by the domestic market. Machinery is also purchased by the part of agricultural producers that are most efficient and dynamically developing.

One can draw some conclusions about these producers on the basis of foreign investments' dynamics. *Fig. 5* shows that in the past two years the share of portfolio investments in agriculture noticeably grew – quite a strange phenomenon for traditional farming since shares of major producers are not quoted on the stock market. The matter is that new farm producers named agriholdings emerged in Russia. These are large corporations that among others have agricultural departments in their structure. Shares of such holdings are quite quotable on the stock markets, some of them – even on the world markets (e.g. those of Wimm-Bill-Dann company).

The second – non-efficient – part of farm producers gradually shrinks. Some of these enterprises simply get closed, others either improve efficiency or get into more efficient hands and thus also become more efficient. Before 2003 the number of agricultural enterprises grew, first of all due to the creation of parallel entities to which non-indebted assets were transferred. Loss-making farms were the primary initiators of such new farms' foundation, and accordingly the share of loss-making entities was growing (*Table 28*). In 2003 the number of loss-making farms reduced by 2800: on the one hand, price parity improved helping 1500 more farms to end the year with positive balance and, on the other hand, 1300 failed farms (or 4.5%) were liquidated. As a result the share of profitable farms grew.

As mentioned above, the bulk of liquidated farms are a kind of *bridge* enterprises intended to solve the problem of indebtedness. However, in the current situation mass bankruptcy of marginal farms will soon start leading to their liquidation. The developments in recent years show that agrarian protectionism fails to solve the problem. Thus the present-day agricultural policies should be urgently retargeted at solving problems of this part of agriculture, or, to be more exact, of the former agriculture. First of all, the problems of re-employment and social rehabilitation of people in these areas as well as of efficient use of other released factors of agricultural production should be addressed. But so far the policy is targeted at supporting loss-making farms. For instance, in 2003 subsidies to agriculture exceeded the sector's net result 1.6 fold (in 2002 the ratio was even more striking – 24 fold!). This means that the only sources of covering expenses in some farms were subsidies and credit defaults that in fact are also subsidies.

Table 26

Concentration of agricultural production

	Share of the top 100 farm producers in the commodity output, %	
	2000–2002	1996–1998
Grain	8.3	4
Sunflower seeds	16.6	10
Sugar beets	20.7	14.8
Potatoes	35.5	16.2
Vegetables	54.9	40.4
Milk	9.8	3.9
Beef	9.2	3.5
Pork	54	22.1
Poultry meat (top 50 farms)	58.3	15.5
Eggs	60.8	54.6

Source: V.Uzun. Large and small business in the Russian agriculture: adjustment to market and efficiency. Moscow, 2004. Mimeo.

Table 27

Production of agricultural inputs (as % of the previous year)

	2000	2001	2002	2003	2004	2004 as % of 1990
Tractors	137.2	78.8	63.5	87.3	107.5	4.1
Tractor ploughs	170.8	113	68.9	44.6	124.3	1.4
Tractor seeders	166.9	122	82.2	77.4	137.4	11.2
Grain harvesters	2.2 fold	174.3	83.4	80.4	145.4	12.0
Mineral fertilizers	106.2	106.9	104	103	111.5	98.1

Source: Social and economic situation in Russia (respective years).

Table 28

Financial performance of agricultural enterprises

	2000	2001	2002	2003
Number of farms, thousand	28.5	29.6	29.9	28.6
Number of profitable farms, thousand	13.3	13.0	12.5*	14.0*
Number of loss-making farms, thousand	15.2	16.0	17.4*	14.6
Share of profitable farms in the total number of farms, %	47	44	42	49
Overall profitability (including subsidies and compensations), %	6.7	9.2	0.2	3.0
Net overall income of farms (including budget subsidies), million rubles	13858	23922	621	10128
Including subsidies from the budget, million rubles	8952	12051	15006	16824
Subsidies as % of net income	64.5	50.3	2416	166.1
Returns from marketing all products, billion rubles	232	299	317	362

* The original data is adjusted by 5% as it seems to contain an arithmetic error.

Source: calculated using data at http://www.mcx.ru/dep_doc.html?he_id=797&doc_id=4868

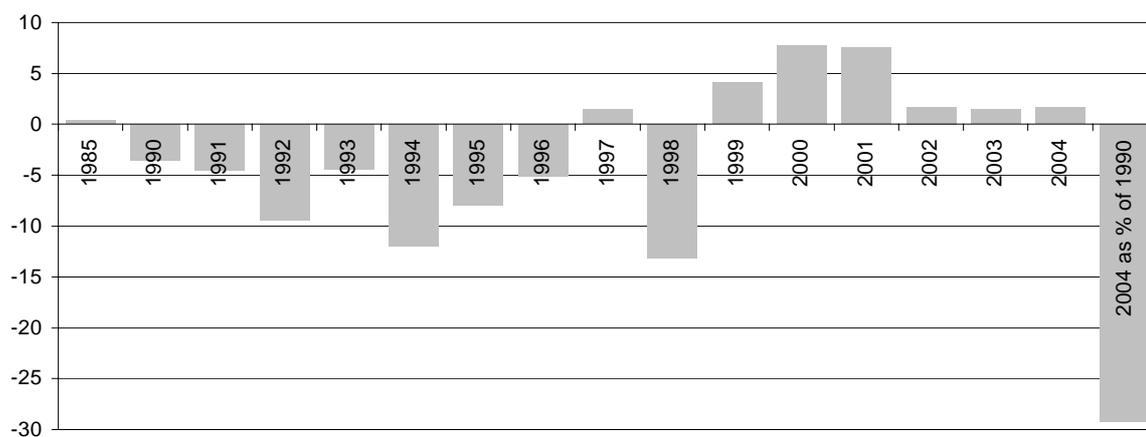
Table 29

The incidence of insured events in the sampled farms

	2002	2003
Number of positive responses	23	33
as % of the total number of insured farms	79	83
Number of negative responses	14	10
including given by insured farms	6	5*
as % of the total number of insured farms	21	12*
including given by non-insured farms	8	5
as % of the total number of non-insured farms	57	83

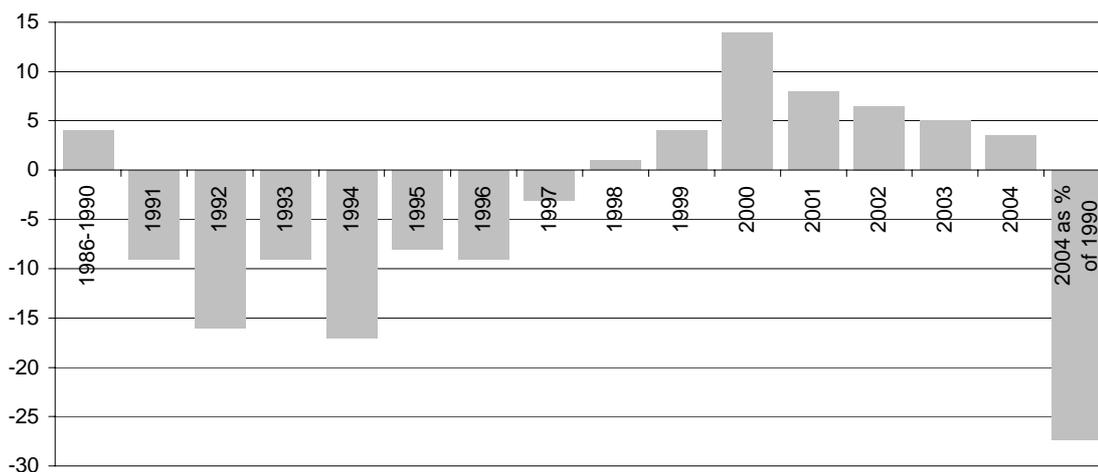
* 4 of the insured farms did not answer this question.

Source: results of the sample survey conducted by the AFE Centre in Perm oblast in 2004, 49 agricultural enterprises.



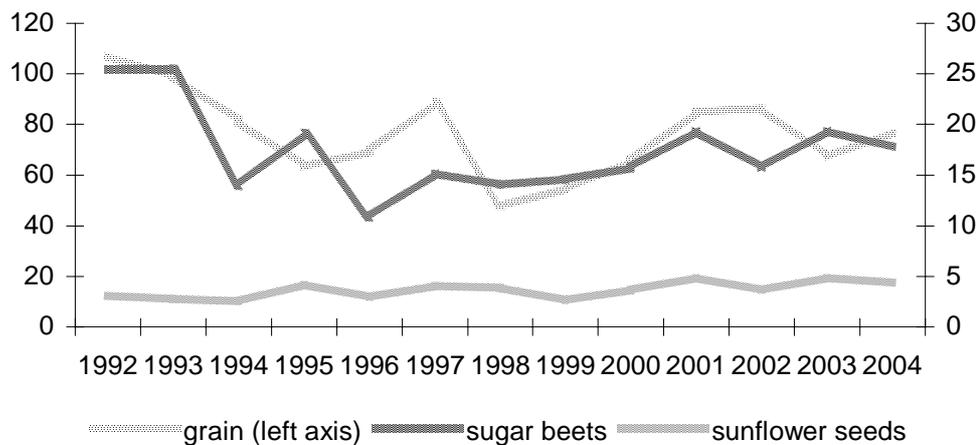
Source: Federal Service of State Statistics.

Fig. 46. Russian agriculture: percent change of annual output in 1985–2004



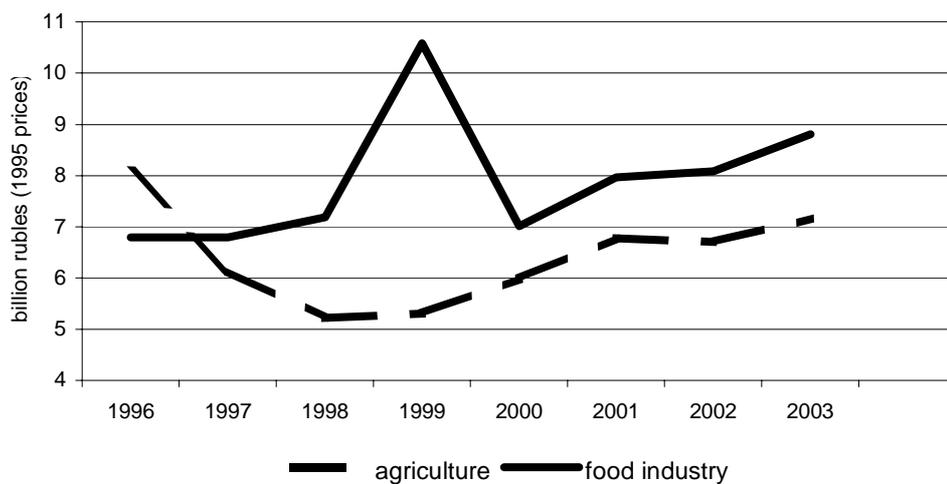
Source: Federal Service of State Statistics.

Fig. 47. Russian food industry: percent change of annual output in 1986–2004



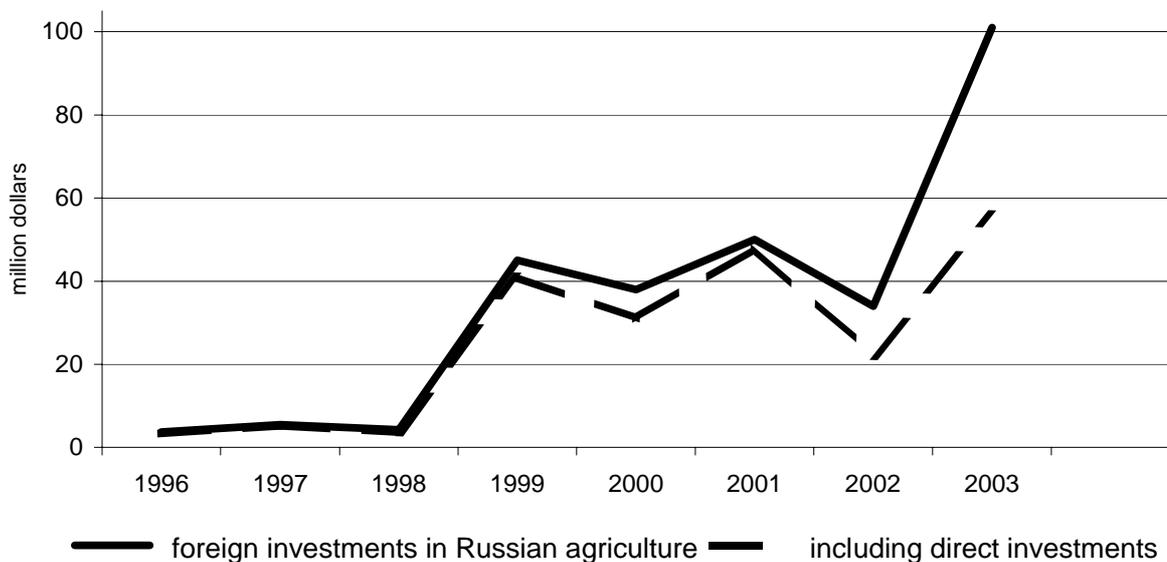
Source: Federal Service of State Statistics.

Fig. 48. Gross output of basic farm crops (million tons)



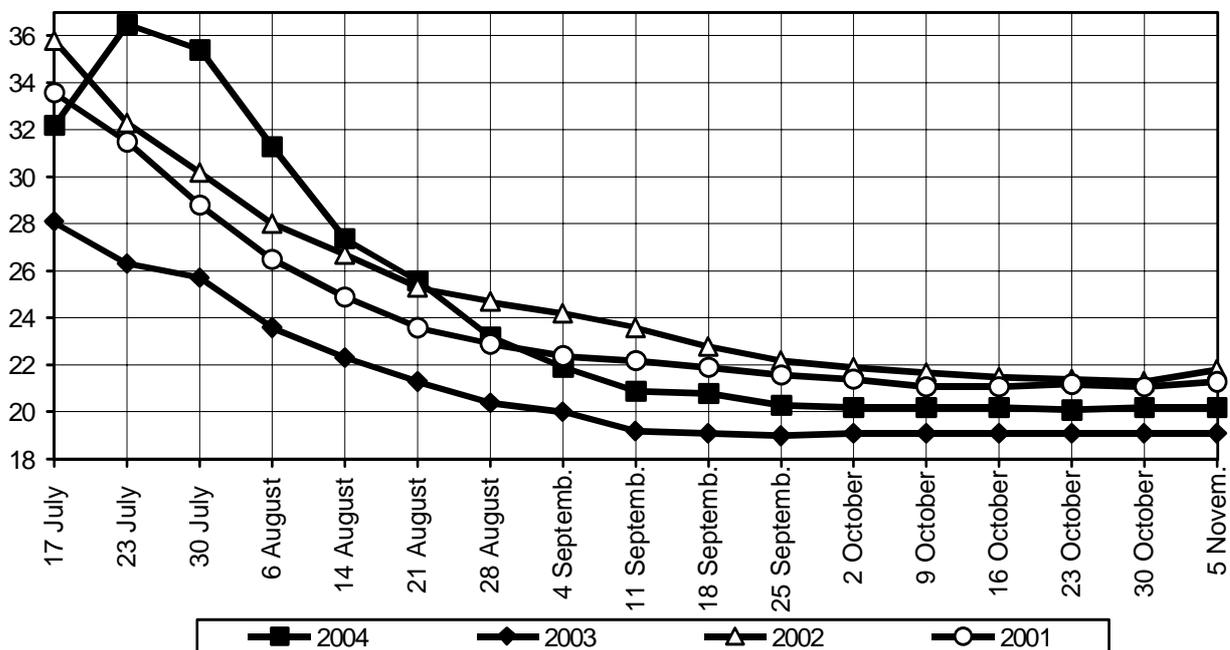
Source: Economic Journal of the Highest School of Economics.

Fig. 49. Investments in agrifood sector's fixed capital (constant 1995 prices)



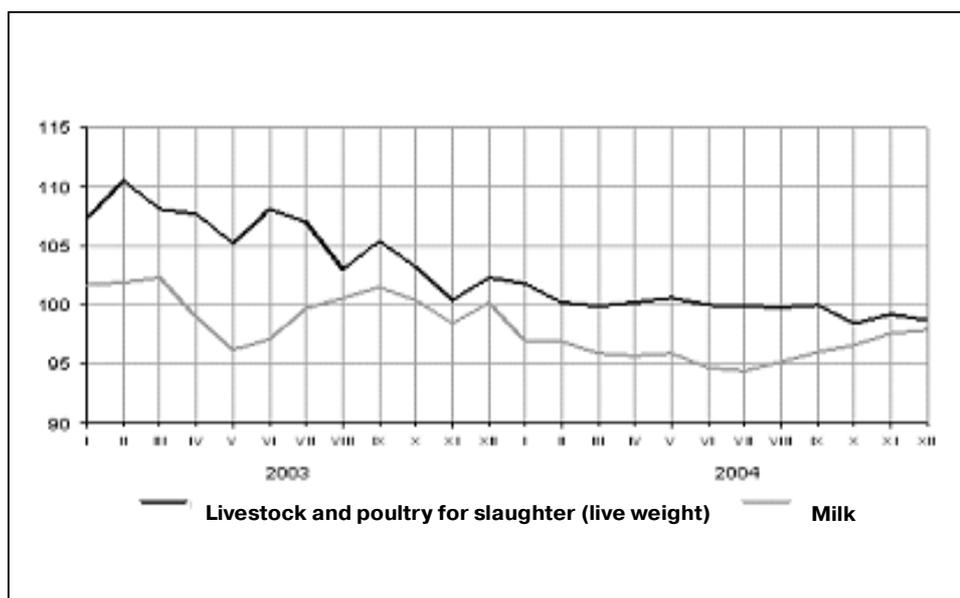
Source: Economic Journal of the Highest School of Economics.

Fig. 50. Foreign investments in Russian agriculture



Source: WJ Review. Weekly Journal. No. 30, November 9, 2004.

Fig. 51. Average grain (except corn) yields in agricultural enterprises by weeks during harvesting, cwt/ha



Source: Federal Service of State Statistics.

Fig. 52. Production of basic livestock products
(as % of the previous month)

3.4.2. Basic shifts in domestic support to agriculture

Transfer of agricultural regulation authority to the regional level

In 2004 the decision was taken to transfer farm support authority to the regional level⁹. As a result only one tool is left for federal bodies to regulate agriculture – implementation of departmental budget programs of supporting the sector. These programs are to become the primary form of state regulation on the federal level. At the same time it's necessary to find ways for limiting those activities of regional administrations that may lead to the destruction of nation-wide market of agricultural and food products. One of such ways was proposed in the draft Federal Law "On agricultural development and agrifood policy". But in 2004 this document hasn't been adopted.

The granting to regions of exclusive powers to regulate agriculture will have the most destructive effect on the sector. First of all, regions-donors able to finance support to agriculture on their territories are primarily located in the climatic zones that are the least fit for farming. Thus the shifting of farm support's gravity center from the federal to regional level implies encouraging of non-efficient resource utilization in agricultural production. Second, for already many years regional support results in "trade wars" between regions, attempts to oust neighbors from the market by means of direct subsidies to local producers, bans on agricultural and food products' transit, etc. In other words, this decision of the RF Government brings in the domestic market all the negative effects of protectionism on the world agricultural markets that the WTO Agreement on Agriculture strives to eliminate (by the way, Russia wants to join this organization with its anti-protectionism principles).

⁹ In compliance with the Federal Law "On introducing amendments to the Federal Law "On general principles of organization of legislative and executive bodies of state power in constituent members of the Russian Federation"" No. 95-FZ.

One more outcome of this decision will be the broadening of state intervention in agrifood markets. In 2004 this trend could already be observed, primarily on the regional level. On the federal level beginning from 2005 the number of applied regulation programs reduced while the share of expenditures on general services is up (*Table 30* and *Table 31*). On the contrary, on the regional level all the increase of expenditures (*Fig. 10*) goes to direct support implying state intervention in agricultural and food markets. The structure of agrifood sector regulation in most regions becomes more complicated, the number of programs and spheres of regulation grows. The hardening of administrative pressure on agrifood markets and the emergence of barriers to inter-regional trade will be the inevitable outcomes of funding authority's transfer to the regional level.

The government's refrain from any long-term commitments as a factor of instability in the sector

The draft Law "On agricultural development and agrifood policy" suggested the shift to medium-term budget planning as an important tool for improving the efficiency of budget expenditures on the agrifood sector. At present some stability has settled in the sector and economic entities plan their activities 3–5 years ahead, while the term of government regulations is only one year and thus they cannot be taken into account when making production decisions. The draft Law suggested the adoption of 3-year-term programs of farm support that would contain principal amounts of budget expenditures under the program, foreign trade regulation baselines for the period of its implementation, intervention prices on the grain market and other essentials needed by the economic entities. At the same time the Ministry of Agriculture would have an opportunity to revise the adopted indicators in case the market situation changes but not more than by 10–15%. Besides, the annual budget provisions would allow 10–15% deviations for meeting changes in the financial situation.

However, the draft Law provisions pertaining to medium-term planning of budget expenditures were not supported by federal bodies, and the passage of the Law was suspended. The main cause thereof was the financial authorities' refrain from any medium-term commitments undermining the sector's stability and hindering the creation of pre-conditions for long-term growth. Besides, when medium-term programs of farm support are not backed up by budget commitments and any concrete figures at all their efficiency cannot be estimated since it depends on the amount of funds that will be spent. This reveals a declarative nature of the administrative reform currently underway and the reform of budget financing both from the point of view of transfer to result-oriented budgeting and of medium-term planning of budget expenditures.

Reform of budget classifier and budget process in the agrifood sector

The reform of budget classifier in force from January 1, 2005 has not solved the problems engendered by the effective system of classifying budget expenditures on agriculture that has long become a hindrance to raising the efficiency of domestic state support to the sector.

The classifier determines the structure of budget expenditures largely focused on direct subsidizing of farm producers that distorts the market. At the same time there are no articles envisaging expenditures on budget services and development of institutional infrastructure; expenditures on science, education, social policy and other measures important for the sector's development but not implying direct government intervention are not transparent. Due to the classifier's non-flexibility, the budget year after year includes pro-

grams the efficiency of which is not appraised and respective expenditures are not revised remaining constant in nominal terms.

The reform of budget classifier in the process of drafting 2005 budget has actually skipped agricultural articles and failed to solve the problems that accumulated in this field. The only positive shift is that specific programs supporting crop and livestock production are no longer named in the budget – such programs as “subsidies to flex and hemp producers”, “subsidies to wool producers”, etc. have long been found non-efficient and got funds only due to the preservation of respective articles in the budget.

Other problems of budget classifier remain unsolved. Its reform is a compulsory condition for Russia’s accession to WTO and for improving the efficiency of budget expenditures on agriculture.

Table 30

Structure of federal budget expenditures on agriculture (thousand rubles)

	2000	2001	2002	2003	2004	2005	2005	2005
	execu- tion	execu- tion	execu- tion	execu- tion	plan	draft	as % of 2004	struc- ture
Agricultural production (subsidies)	6608	12468	20281	22365	24689	22602	92	53
Land resources	6 699	6 959	1 347	1401	1 985	2209	111	5
State support of grain inspection institutions	41	57	98	138	153	0	0	0
Investments in authorized capital of the leasing company				870	2 000	0	0	0
Forming of authorized capital of Rosselkhozbank (Russian Agricultural Bank)		2 000	1 420	850	0	0		0
Science	113	187	172	200	213	301	142	1
Russian Academy of Agricultural Sciences	739	1 056	1 496	1747	1 991	2319	116	5
Education	2 929	3 751	5 350	6461	7 817	8548	109	20
Fixed capital investments (from 2002 – in agricultural production, in 2005 – non-program investments and construction)	711	347	247	1146	0	2435		6
Fixed capital investments / Special federal program “Soil fertility improvement in Russia in 2002–2005”						1884		4
Ministry staff	99	129	142	167	266	378	142	1
International activities		16	0	365	713	10	1	0
Healthcare				12	13	14	107	0
Social policies		4		5	5	0	0	0
Financial assistance to regional and local budgets including: Special federal program “Rural social development till 2010”		374	2	1634	67	0	0	0
Other expenditures	96	33		0.4	0	0		0
Total expenditures on agriculture	18 036	27 349	30 555	37 361	39 911	42 872	107	100

Source: RF Ministry of Finance.

Table 31

Subsidies to agriculture (million rubles)

	2000	2001	2002	2003	2004	2005	2005	2005
	execu- tion	execu- tion	execu- tion	execu- tion	plan	draft	as % of 2004	struc- ture
Support to livestock production	603	945	1 100	1 194	1 195	745	62	3
including:					0			
Pedigree stock-breeding	298	619	703	744	745	745	100	3
Subsidies to wool producers	142	256	327	350	350		0	0
Reindeer breeding		70	70	100	100		0	0
Purchase of formula feeds	162							0
Support to crop production	223	554	622	1 170	2 270	2670	118	12
including:								
Elite seed growing	68	248	270	270	270	770	285	3
Subsidies to producers of flax and hemp	72	85	67	100	100		0	0
Partial compensation of expenditures on crop insurance	–	222	285	800	1 900	1900	100	8
Other expenditures	2 998	686	5 530	2 153	2 733	1754	64	8
including:								
Building of federal reserve of veterinary drugs								0
Subsidies to waste disposal plants	3	39	40	45				0
Centralized delivery of seeds to northern and mountain regions			140	200				0
Subsidies to horticulture and grape growing			300	400				0
Building of pesticide reserve			300	300				0
Creation of leasing fund	2 624	5 500	2 780					0
Building of federal seed reserve	100	150	150			80		0
Fixed capital expenditures			865	864				0
Other	275	647	955	344				0
Maintenance of subordinate institutions	2 505	2 888	6 144	8 964	9 291	9531	103	42
Environment protection		59	100					0
Subsidizing of interest on credits		1 627	2 017	3 200	3 200	5370	168	24
Including: short-term credits			1 400	2 000	0			0
Long-term credits			617	1 200	0			0
out of them: credits on construction of port elevators				130	0			0
Seasonal crediting	–37				0			0
Program “Soil fertility improvement”	–		4 767	4 531	4 530	1683	37	7
including:					0			0

	2000	2001	2002	2003	2004	2005	2005	2005
	execu- tion	execu- tion	execu- tion	execu- tion	plan	draft	as % of 2004	struc- ture
Partial compensation of mineral fertilizers' cost	83*		237	2 100	0			0
Special federal program "Rural social development"				1470	1 470	1**	0	0
Subventions for financing food grain purchase interventions				1152	0	250		1
State administration expenditures						518		
Support to individual farmers	2				0			0
Total	6 297	12 468	20 281	22 365	24 689	22602	92	100

* in 2000 purchase of mineral fertilizers was subsidized not under the program "Soil fertility improvement".

** in 2005 this item includes only direct subsidies in the framework of this program while investment expenditures are presented in Table 33.

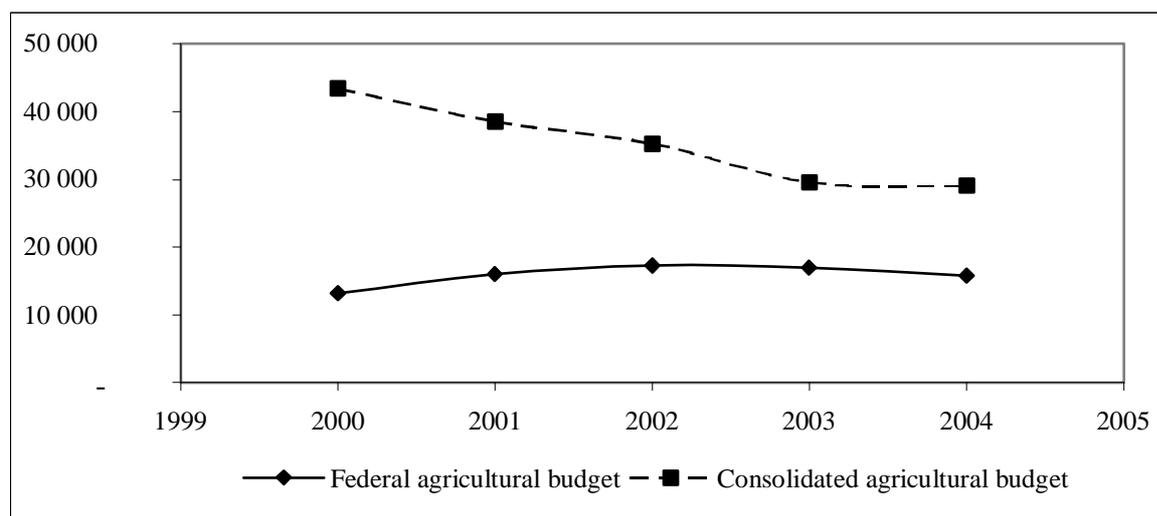
Source: RF Ministry of Finance.

Table 32

**Investments in Leasing fund from the federal budget
(prior to 1997 – billion rubles, after 1998 – million rubles)**

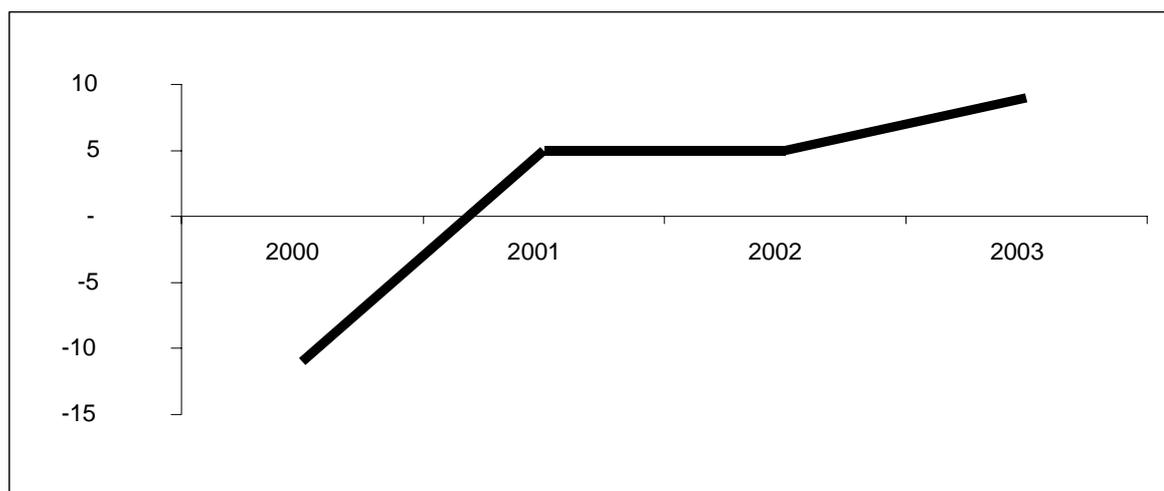
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Plan	1000	1351	2700	2400	2000	2280	2624	3000	0	870	2000
Actual allocations	1053.6	1080.6	1928.9	736.6	1007	2241	2624	5 500	0	870	n.a.

Source: RF Ministry of Finance.



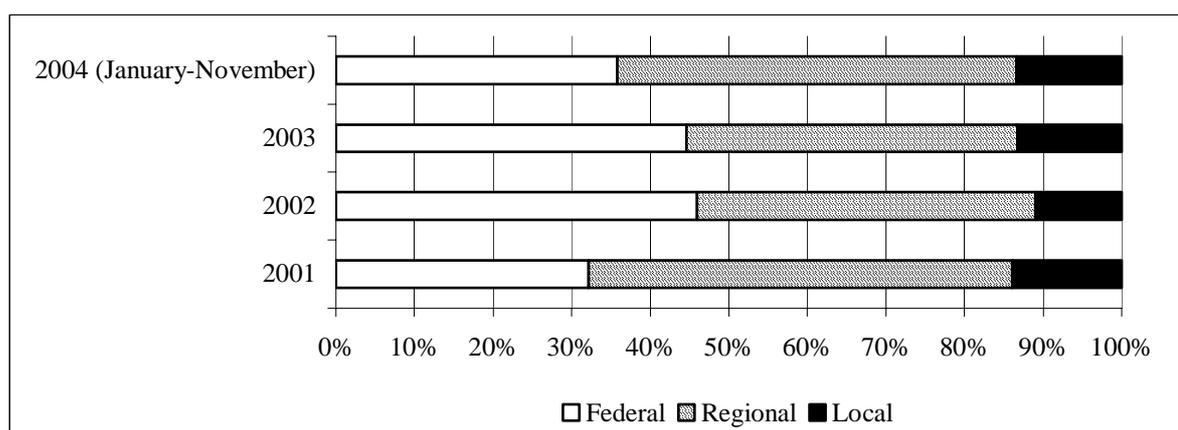
Source: RF Ministry of Finance.

Fig. 53. Consolidated and federal budget expenditures on agriculture, million rubles in constant 1999 prices (2004 - estimate)



Source: IET calculations.

Fig. 54. Producer support estimate (PSE), %



Source: RF Ministry of Finance.

Fig. 55. Structure of consolidated budget support to agriculture

3.4.3. Basic trends in agrifood foreign trade

The persistence of negative trade balance

Russia still remains a net importer of agricultural and food products: in 2004 agrifood imports exceeded respective exports 5.4 fold¹⁰.

Average foreign trade indicators of the sector at large do not demonstrate any apparent trends towards reduction of agrifood trade's negative balance. Imports continued to steadily grow while exports were hampered by toughened export regulations and unfavourable for Russian grain exporters situation on the world market (Fig. 56). In previous years the growth of imports was partially set off by expanding export supplies. In January-

¹⁰ January-September 2004.

September 2004 agrifood exports were 11% below the corresponding 2003 indicator while imports were up 10.8%.

Trade indicators by selected commodities look more optimistic: despite smaller exports Russia continues to be a net exporter of sunflower seeds, wheat and wheat flour (*Table 36*). Exports of chocolate products, condensed milk and cream are growing. Active supplies of sunflower oil to foreign markets shortened the gap between its exports and imports. But from the price point of view Russia is still more competitive in exporting the raw input (sunflower seeds) than in exporting the finished product (sunflower oil). A new trend in the oilseeds market is the growing export of rapeseeds and rapeseed oil from Russia. In 2003/2004 marketing year exports of rapeseeds were up 77.8%¹¹. In recent time the world market of this crop is actively developing. Rapeseeds have become the third by their share in the world production of oilseed crops.

Meat quotas

As mentioned before, the main efforts of the government's agricultural policies are currently targeted at the protection of domestic market from agrifood import. Sugar and meat continued to be the primary objects of foreign trade regulation in 2004.

Quotas on import of meat to Russia (tariff quota on beef and pork and absolute quota on poultry meat) introduced in 2003 were maintained. Meat quotas concern a large number of operators on this market. Meat is a very heterogeneous product and many other products are produced out of it. Thus the distribution of quotas and amending of its mechanism raised a lot of debate on all levels of state governance throughout all the period of their action. Let's examine whether these quotas were efficient and have they really brought the desired result, i.e. the growth of domestic production.

As we have supposed, such a constraint fails to support domestic producers. First, the quota is not applied to meat products and, second, it's not applied to the CIS countries.

Despite the introduction of quotas the decline in livestock production hasn't been halted. Only poultry production is growing but this growth started before the enforcement of quotas and the latter hasn't led to its acceleration.

Imports of raw meat to Russia from the non-CIS countries are falling (*Table 38*). This trend was most obvious in the first year of meat quotas' application (2003). In 2004 imports of pork and beef to the Russian market were down slightly (by 10%) but still remained approximately the same as in the previous years when quotas were not applied.

The introduction of quotas on meat import from the non-CIS countries was accompanied by larger supplies from the CIS. But in 2004 they fell as well. The principal cause thereof is that after a heated discussion of problems entailed by escalating "grey" import of meat from the CIS (in fact originating from other countries) customs bodies stiffened control over supplies from these states. Besides, raw meat supplied by them is much more expensive than that from the non-CIS countries and thus processors' demand for it is limited (*Table 39*).

At the same time the decline of raw meat imports was outweighed by growing supplies of meat products, especially from the CIS countries (*Table 38*). So, Russia has actually introduced a regression scale of import duty. All countries strive to strengthen tariff protection as degree of processing grows while the introduction of meat quotas in Russia stimulated import of processed products and discouraged import of raw meat.

¹¹ WJ Inter Agro.

The result was the increase of CIS share in meat import value from 9% in 2002 (before the introduction of quotas) to 10.5–12% in 2003–2004 (for meat products – up to 37% in the first half of 2004). Since prices for raw meat from the CIS are much higher than those paid to the non-CIS countries (*Table 39*), prices for meat products manufactured out of this input on the average grow.

So, meat quotas introduced by Russia in 2003 have led neither to larger domestic production nor to smaller imports. At the same time they entailed change in the structure of meat import (larger shares of finished meat products and supplies from the CIS) that was one, although not the only, factor of price growth on the domestic market.

Variable import duty on raw sugar

In December 2003 a new mechanism of sugar market regulation was introduced in Russia – the variable import tariff. It actually sets the level of raw sugar support price at 470 US dollars per ton presuming that the basis of “Caribbean Sea – Krasnodar region” deliveries is 100 dollars per ton. The world price is determined on the basis of New York Board of Trade (CSCE/NYCE) quotations. The principal formula for calculating the size of duty is as follows: the support price less delivery basis and less the average monthly price for raw sugar at the exchange. Since the first two variables are fixed, the duty is determined by the world price: the higher it is, the lower is the duty and vice versa. So, the world market fluctuations are mitigated on the domestic market ensuring certain stability for both buyers and sellers.

But in fact the calculation of import duty on raw sugar bases upon price that established at the exchange 2 months ago. This mechanism does help to level off import prices to some extent. But the effect is much smaller than it could be in case of a 1-month span (*Fig. 57*).

Besides, the effect of the variable duty is lessened by the actual lack of constraints on import of sugar from the CIS countries accounting for 90% of the total Russia’s sugar imports. In January-October 2004 the volume of CIS supplies was almost twice above the corresponding previous year indicators. In order to settle the problem customs control over import of sugar from these countries was stiffened by means of taking samples to prove the commodity’s origin. But this measure will hardly solve the problem since in case of a favourable ratio between prices for imported and for domestic sugar countries of the Commonwealth will satisfy their markets’ demand by importing the product while the home-grown sugar will be exported to Russia.

In order to synchronize measures on regulating import of selected sugar-based products the term of tariff thereon (230 EUR/ton) was extended.

Similar to the end of 2003, sugar market operators till the last moment were not sure about the customs regime to be effective in the coming year, and this uncertainty produced a highly destabilizing effect on the market. The Resolution on sugar import regulation in 2005 was adopted only in the middle of December. The new regulation scheme actually copies the previous one with just one exception: the period for calculating the arithmetical mean of exchange price for raw sugar was extended from one to three months. As shown above, even a 2-month span in determining the size of variable duty diminishes its smoothening effect. In case of the 3-month price averaging this effect will be even smaller, i.e. the variable duty will ultimately lose sense and engaged market operators will insist on regaining quota auctions.

Grain market regulation

For the first time since the start of reforms, at the beginning of 2004 Russia introduced temporary export duties on rye, wheat and their mix, the declared reason being growth of domestic prices for bread. However, as shown in the next section this growth was not caused by poor grain supply on the domestic market. At the same time duties on export of grain could not seriously influence its volume since contracts had been signed earlier and traders had to supply grain to foreign markets despite worse price situation. So, the introduced duties have just deteriorated conditions for export of grain. Still, after their abolition in April export of wheat started to expand at a high rate.

Table 33

Export of basic agricultural and food products (thousand tons)*

	2000	2001	2002	2003	9 months 2004	
					As % of 9 months 2003	Export/import ratio
Fish, frozen	290.6	324.1	292.8	255.0	67.8	0.4
Wheat and wheat/rye mix	419.0	1635.7	10259.3	7587.9	43.6	3.1
Wheat flour	165.7	n.a.	122.8	288.6	46.2	1.2
Sunflower oil	194.8	115.3	74.2	84.1	195.3	0.8
Sunflower seeds	1114.9	n.a.	86.8	292.1	117.8	16.7
Bread, bakery products and confectionery	34.3	36.9	38.6	52.6	123.6	0.7
Milk and cream, condensed	73.7	45.6	35.0	11.3	121.4	0.8
Chocolate products	25.7	35.1	35.1	42.2	132.4	0.4

* Less trade with Byelorussia.

Source: Customs statistics of FR foreign trade.

Table 34

Import of basic agricultural and food products (thousand tons)*

	2000	2001	2002	2003	10 months 2004 as% of 10 months 2003**
Beef	282.3	459.2	504.6	507.8	89.3
Pork	212.9	369.6	602.0	535.2	89.6
Poultry meat	687.2	1383.3	1375.2	1190.0	98.8
Butter	45.4	81.4	94.1	114.0	79.0
Sunflower oil	149.5	182.8	175.7	200.8	2.3. fold
Wheat and wheat/rye mix	2631.3	916.2	264.8	640.7	62.2
Raw sugar	4546.6	5410.4	4441.0	4112.0	179.0
White sugar	271.4	143.1	163.2	151.1	105.0
Citrus fruits	472.2	562.1	701.3	781.1	90.7
Coffee	20.3	21.6	25.7	32.0	99.6
Tea	158.3	154.4	165.3	168.9	

* Less trade with Byelorussia.

** Including trade with Byelorussia.

Source: Customs statistics of FR foreign trade, Federal Service of State Statistics.

The import duty on rice and rice products remained in force for the second year. This measure resulted in smaller import supplies and higher import prices. In April-June 2004

the average contract price for imported rice was 30%¹² above the January-March indicator and continued to grow in the second half of the year. In the past two years this is the largest increase of price within a 3-month period. Within 2 years (from December 2002 to September 2004) the retail price for polished rice grew by 128% while the aggregate retail price index for food products within the same period was below 120%. Still, the mechanism is preserved.

Table 35

**Import of raw meat and meat products after the introduction
of meat quotas (%)**

	2003/2002		I-IX 2004/I-IX 2003	
	Total	CIS	Total	CIS
Frozen beef:	106.2	119.1	93.6	69.7
Carcasses and half-carcasses	100.3	101.9	71.5	71.5
Other cuts, non-boned	25.9	100.0	17.7	1.5
Other cuts, boned	119.4	162.8	99.8	67.5
Pork:	88.8	1007.7	82.3	78.0
Carcasses and half-carcasses, fresh or chilled	138.8	-	n.a.	n.a.
Carcasses and half-carcasses, frozen	96.5	1140.0	64.8	30.6
Pork hams, bladebones and cuts, frozen	53.2	-	n.a.	n.a.
Other	88.5	500.0	95.0	405.2
Poultry meat:	87.1	145.5	83.4	15.3
Broilers, frozen	61.7	60.0	n.a.	n.a.
Broiler parts and sub-products, frozen	93.0	12.9	83.4	25.7
Turkey parts and sub-products, frozen	66.3	-	n.a.	n.a.
Meat products:	109.5	286.7	152.5	226.0
Sausages	50.9	60.9	n.a.	n.a.
Finished and canned products out of meat and sub-products	192.2	522.7	152.5	226.0

Source: calculated using data of the RF State Customs Committee.

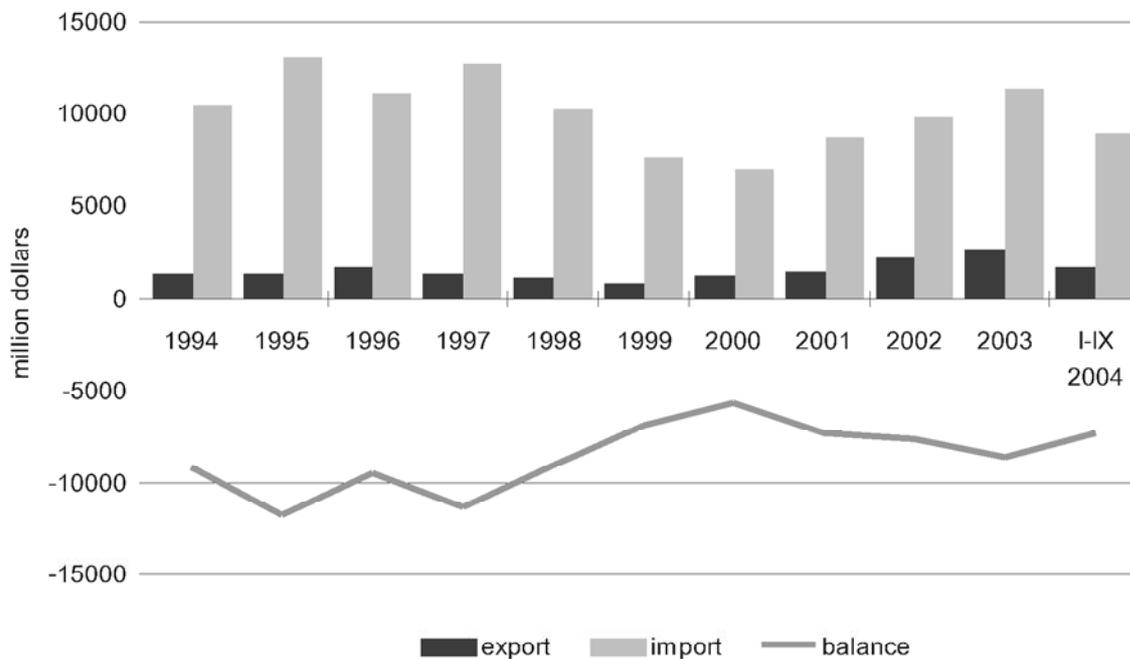
Table 36

Average import prices for meat (dollars per ton)

	1997	1998	1999	2000	2001	2002	2003	I-IX 2004
non-CIS								
Red meat	1436	1471	958	1072	925	1099	1061	1277
Poultry meat	709	691	651	535	546	589	586	595
CIS								
Red meat	1134	1724	1151	1284	1687	1463	1437	1966
Poultry meat	1782	657	1243	816	1340	1108	899	658

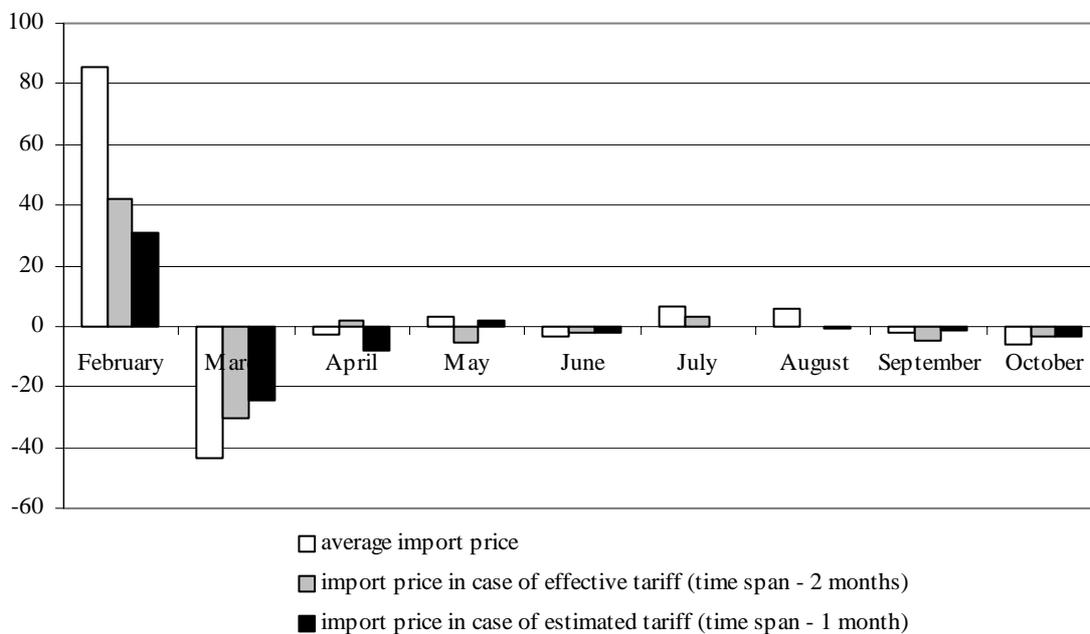
Source: calculated using data of the RF State Customs Committee.

¹² RF State Customs Committee.



Less trade with Byelorussia.
Source: Customs statistics of FR foreign trade .

Fig. 56. Foreign trade in agricultural and food products (million dollars)



Source: Customs statistics of FR foreign trade, Federal Service of State Statistics, IET estimates.

Fig. 57. Increase of average import price for granulated sugar in 2004 (as % of the previous month)

3.4.4. Food markets

In 2004 the retail price rise was the highest for the following products: red meat (especially beef and pork) and poultry, bread, macaroni products and eggs. Price indices for most other products did not deviate much from the aggregate consumer food price index (112.3%), and for some products (sunflower oil, fruits and vegetables, granulated sugar) were even well below it.

Market of bread and bakery products

In 2004 the market of bread and bakery products was greatly influenced by government regulation triggered by accelerated growth of prices for bread and bakery products. This growth started as far back as in April 2003 when price index for these products surpassed the aggregate food price index (*Fig. 58*).

The growth of prices for bread served the cause for a quite noticeable government intervention in this market in 2004. It was effected in two ways:

- Government Resolution No. 749 of December 11, 2003 for the first time since the start of reform introduced temporary export duties on wheat, rye and their mix;
- From February to June 2004 trade interventions were carried out on the grain market in order to lower prices for food grain and thus to constrain growth of prices for bread. Overall, about 1.5 million tons of soft wheat No. 3 and No. 4 and rye no. A were sold – the volume almost equaling monthly consumption of food grain in the country. This means that each month the market received additionally from 20 to 25% of grain.

The period when prices for bread grew faster than prices for food products at large was rather long and lasted till June 2004. In 2003 prices for bread and bakery products were up 30%, in 2004 – 16.7%.

Despite all the efforts made the growth of prices for bread and bakery products was above the aggregate food price index both in 2003 and 2004 (*Table 37*). At the same time if we look at the dynamics of bread prices beginning from 1997, we'll see that these prices were the most constrained ones: during this period food prices grew 5.7 fold while prices for bread – 4.4 fold. It's quite natural that at some moment they had to "catch up" with the general price trend (*Fig. 67*).

The process was triggered by poor grain crop in 2002 and growth of grain prices in 2003. Besides, rising personal incomes, larger GDP and high oil prices formed positive expectations in the economy and to some extent weakened political control of federal and regional authorities over consumer prices. Bread market agents seem to have used grain market fluctuations for liquidating the accumulated arrear of bread prices from the general trend.

The most common explanation for growth of bread prices in 2003-2004 was the growth of prices for grain in poor-crop 2003. Indeed, in March-December 2003 prices for wheat No. 3 did rise 2.5 fold (*Fig. 59*).

Growth of grain prices continued in 2004 and by March they reached their maximum level – about 6500 rubles per ton of wheat No. 3 which is 2.6 fold above the corresponding indicator of March 2003 (*Fig. 60*).

Such an upsurge of grain prices could be an explanation for higher prices for bread and bakery products but following this logic the latter should be lowering in the second half of 2004 after grain prices started to fall (*Fig. 60*). But no such trend was observed. Growth of prices for bread in this period slowed down but hasn't become negative. This is an evidence that the mechanism of price transmission between the market of grain and the market of bread and bakery products is more intricate than a simple linear one.

Noticeable differences between grain and bread price trends are quite natural and comply both with the basic economic postulates and the world practice. Prices on the markets of raw commodities especially the ones quoted on the world commodity exchanges (such as wheat) are much more volatile than prices for perishable day-to-day goods (such as bread) and are shaped by different factors.

The possibility of direct influence of grain prices on the retail prices for bread is also very slim. According to data of the Federal Service of State Statistics the cost of raw materials does not exceed 37% of the retail bread price. In its turn, the cost of raw input (i.e. grain) accounts for only 43% of the cost of flour.

So, even presumed that flour is the only input used for producing bread (such a supposition overvalues the factor's importance), the share of grain cost in the retail price for bread is not more than 16%. This implies the minimum possibility to influence retail prices for bread through regulating grain market in order to cut down prices for grain.

In other words, the cause of higher prices for bread is not the growth of prices for grain due to its shortage. The trend is attributable to factors of other kind, i.e. the specifics of market development and its structure. This conclusion is supported by the fact that production of all other grain products except bread demonstrates quite a steady growth.

Summing up the effect of government regulation of grain market, the introduction of export duties fails to achieve its goal but notably undermines positions of Russian grain traders on the world market that strengthened markedly in 2002/2003. These traders launched large investment projects aimed at creation of export port infrastructure and got support of the government that allocated funds from the federal budget to subsidize interest on credits for construction of port grain loading facilities¹³.

So, export duties on grain, on the one hand, deteriorate positions of Russian exporters and, on the other hand, have minimal chances to produce an economic effect on retail prices for bread, i.e. are an economically senseless measure.

Let's examine some specifics of the market of bread influencing situation thereon. Bread is an inferior commodity characterized by negative income elasticity of demand. As incomes grow its consumption reduces in favor of meat and dairy products, vegetables and fruits.

The comparison of dynamics of bread and bakery production and production of other food products during the period from 1997 to 2003 proves the negative correlation between personal incomes and consumption of bread in the Russian Federation (*Fig. 61* and *Fig. 62*). For instance, in 1999 bakery industry noticeably grew while meat processing declined following the sharp drop of population's real disposable incomes. In 2000 higher personal incomes entailed growth in meat production and decline in production of bread and bakery products.

Consumption of bread greatly differs by income groups. For instance, families with per member income above 7 thousand rubles are likely to eat bread once a day while families with lower incomes do it much more often (several times a day) (*Fig. 63*).

Smaller consumption of bread in the richest income groups goes in line with higher quality and packing requirements and readiness to pay more for the product that better conforms with their preferences. The demand for such products is largely satisfied by mini-bakeries, own bakeries of large trading networks ("Ashan", "Ramstor", etc.) and modernized bakery plants. The price for them is at least 1.5 fold, and sometimes even ten fold above the average published by the Federal Service of State Statistics.

¹³ Supplement No. 36 to Federal Law "On 2003 federal budget".

People with monthly per capita income above 7 thousand rubles tend to buy high quality and respectively more expensive bread and bakery products in supermarkets and large general stores while the poorest consumers prefer to do it at street outlets, city markets and small shops offering standard products of standard quality at an affordable price (Fig. 64).

One should note the growing share of better quality products at higher prices in the total sales of bread and bakery products. According to data of RBC (Russian Business Consulting) the share of supermarkets in the total retail trade turnover in Moscow was up from 0.2% in 1999 to 30% in 2003.

The growth of segment of superior quality products results in higher average prices. However, this process contributes to better satisfaction of solvent consumer demand and signifies a qualitative improvement and development of food market basing on advanced production technologies and innovations, up-to-date packing and product promotion.

Market of meat

The mechanism of foreign trade quotas enforced in the middle of 2003 continued to be the factor determining basic trends on the market of meat.

The principal goal of introducing restrictions on import of meat from non-CIS countries was the encouraging of its domestic production.

Given the high share of import in the national consumption, foreign trade measures targeted at the support of domestic producers should be thoroughly elaborated and balanced in order to achieve the declared goal and not to deteriorate situation on the consumer market.

The introduction of quotas was supposed to foster recovery in the livestock sector that suffered the most in the process of reforms. While the contraction of planted areas remained below 30% even in the worst 1998, the number of livestock on the average more than halved and no positive trend can be observed after 1998.

However, in case of a simple reduction of import supplies no due regard is paid to the sectoral and institutional structure of the market resulting in failure to achieve the desired goal. First of all, corporate farms accounted for only 52.3% of the domestic meat output in 2004 while the rest was dispersed by household plots and individual private farms. This production structure remained rather constant throughout recent years. The share of households' produce equals 44.8% of the total output but due to some reasons (first of all the institutional ones) is rarely used by processors. Production in household plots is mostly subsidiary and intended for satisfying family demand rather than supplying to the market, and thus this producer segment is less responsive to market signals.

Besides, livestock (and especially cattle) production is characterized by a long production cycle that is a serious limitation for rapid increase of output as it is. Given the depth of the sector's decline (actually total perishing of pedigree stock-breeding during years after the start of reforms, long period required for restoring pedigree inventories, large investments needed to increase output) the market could not quickly respond by expanding production.

The 2004 indicators show that constraints on import of red meat have not resulted in growth of domestic production. In January-November 2004 output of livestock and poultry for slaughter (live weight) increased by 2.1% but this increase was due to larger output of poultry that made up for the fall of beef and pork output.

The decline in red meat production went in line with a notable drop in both cattle and pig numbers. By December 1, 2004 inventories of cattle in all farms reduced by 6.5% as

compared with the same date in 2003 (of them cows – by 6.3%), inventories of pigs – by 11.3%. Numbers of sheep and goats grew by 3.4%.

Probably, the shown above negative dynamics reflect the general negative trend of the recent years. However, the rates of livestock inventories' decrease in 2003 and especially in 2004 have notably accelerated as compared with after-1998 averages. Such an accelerated decrease might be a producers' strategy – reduction of livestock numbers in order to maximize sales at high prices.

A natural response of the market to smaller meat supplies is the growth of prices for raw meat and finished meat products as well as the search for alternative supply channels and products-substitutes. The growth of prices for meat on the domestic market started in the middle of 2003 and continued in 2004.

It's a common knowledge that consumption of meat products is very price-elastic. Growth of prices for them negatively affects consumption. But at present this effect is constrained by the increase of disposable personal incomes and is mainly materialized in substitution of poultry meat for red meat in the daily ration. Further substitution of the kind will result in an even bigger consumption's lag behind the physiological norm – 80 kg of meat per capita a year (currently the actual consumption is about 50 kg).

Given growth of prices for raw meat and high price elasticity of demand for finished products, many processors decided to create/expand their own input basis. For instance, "Omsk bacon" produces about 2000 tons of pork monthly; "Cherkizovsky" plant announced the purchase of pig breeding farm in Vologda oblast. High prices for meat attract large businesses to the sector: "Agros" and "Agrico" are engaged in livestock production, "Rusagro" reported having created the biggest pig breeding farm in Belgorod oblast that will produce up to 60 thousand tons of pork annually.

Table 37

Price indices for selected groups of food products by the end of period (%)

	2004 (as % of the previous month)			December 2004 as % of	December
	October	November	December	December 2003	December 2002
Bread and bakery products	100.8	100.4	100.4	116.7	130.4
Cereals and beans	100.7	100.3	100.0	111.6	117.0
Pastas	100.5	100.6	100.5	114.6	114.0
Meat and poultry	102.3	101.7	102.8	119.6	108.9
Fish and sea products	101.7	101.8	102.4	111.5	109.9
Milk and milk products	102.6	103.5	102.5	112.8	113.1
Butter	101.8	102.1	101.8	106.8	111.4
Sunflower oil	100.6	101.0	100.9	102.1	107.6
Fruits and vegetables	97.3	102.2	105.4	103.3	95.8
Granulated sugar	97.9	98.0	99.2	107.5	94.4
Alcoholic beverages	100.6	100.5	100.8	108.7	109.9
Food products	101.4	101.5	101.7	112.6	110.2

Source: Federal Service of State Statistics.

Active investments in domestic livestock production give grounds to forecast an increase of meat output in the medium term. However, it should be noted that the market of meat is so attractive because of the high prices resulting from active foreign trade regulation, i.e. current prices may give a deceptive signal overestimating the market's potential. Growth of domestic meat supply coupled with abolition of import regulation may entail a notable drop of market prices that will question profitability of new large-scale investment projects in livestock production.

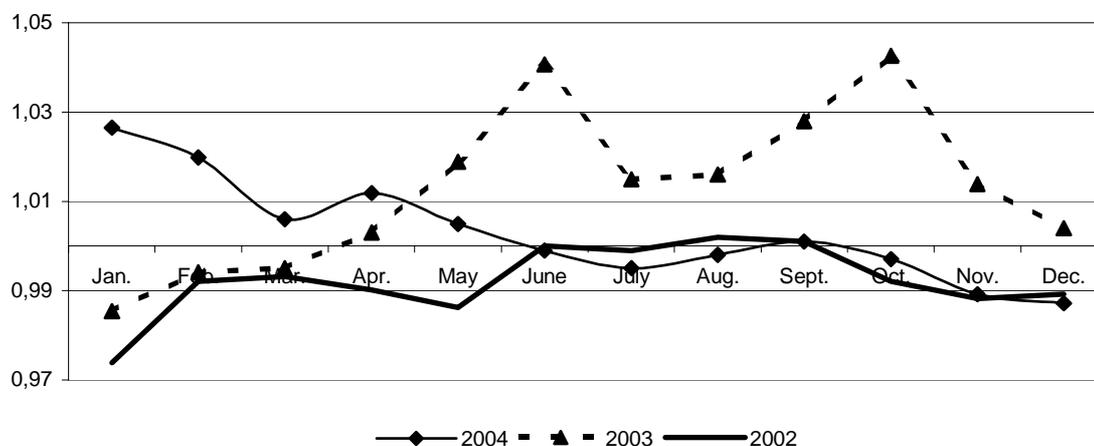
The observed in 2004 downward trends in livestock inventories and output of beef and pork despite the effective mechanisms of foreign trade regulation do not allow to make any optimistic forecasts about domestic production of these products in 2005. As a result, there are no grounds to expect any slowing down of price growth on this market.

Table 38

**Retail price indices for selected groups of food products
(as % of previous December)**

	2002	2003	2004	2004/1997	2004/2002
Food products	111.0	110.2	110.4	533.5	99.5
Meat and poultry	102.7	106.8	119.6	632.0	116.5
Fish products	112.1	107.1	111.5	566.9	99.5
Butter	112.0	107.4	106.8	429.9	95.4
Vegetable oil	106.5	107.6	100.9	512.4	94.7
Milk and milk products	105.9	105.7	102.5	457.1	96.8
Eggs	106.3	110.5	122.1	483.8	114.9
Granulated sugar	130.8	95.2	107.5	666.6	82.2
Bread and bakery products	104.9	125.5	116.7	418.4	111.2
Cereals and beans	126.4	117.1	111.6	554.1	88.3
Pastas	106.5	110.2	114.6	429.7	107.6
Alcoholic beverages	108.9	107.3	108.7	447.6	99.8

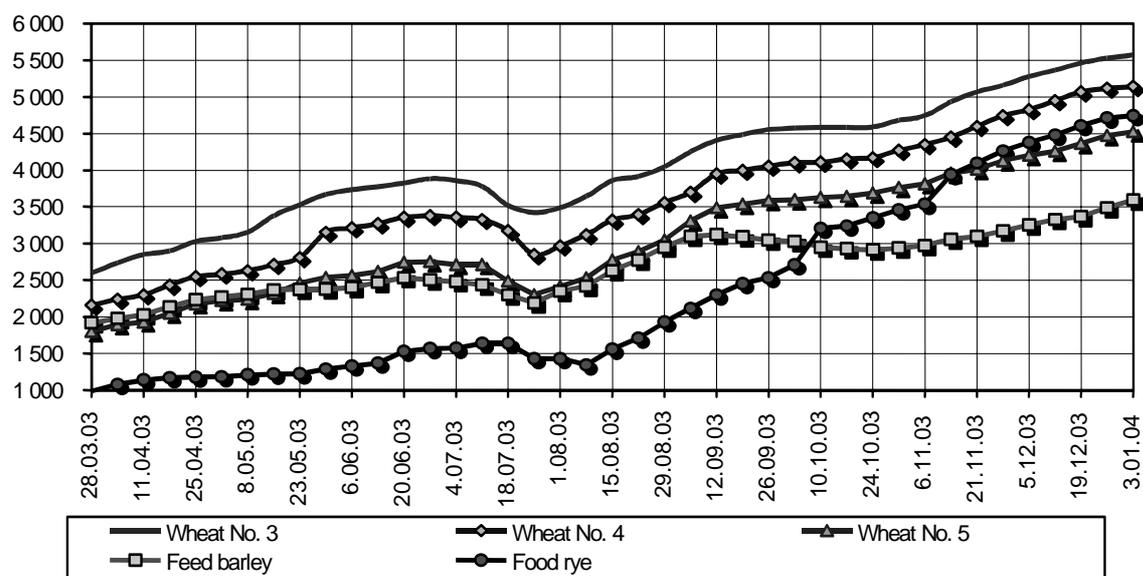
Source: calculated using data of Federal Service of State Statistics.



Source: calculated using data of Federal Service of State Statistics.

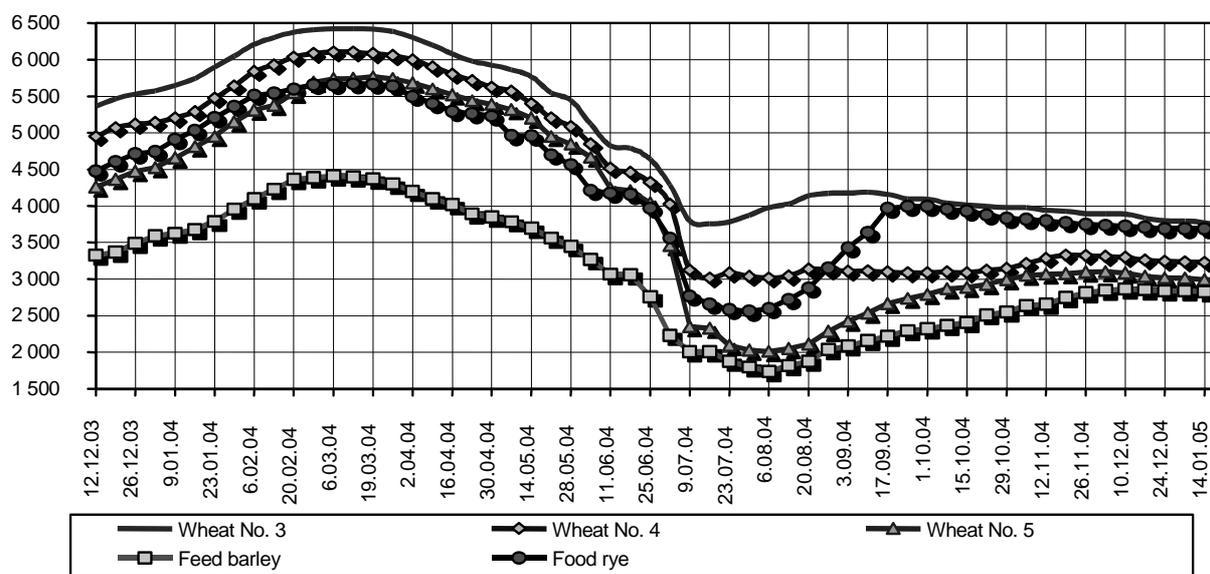
Fig. 58. Ratio of monthly price indices for bread and bakery products and for food products at large

RUSSIAN ECONOMY in 2004
trends and outlooks



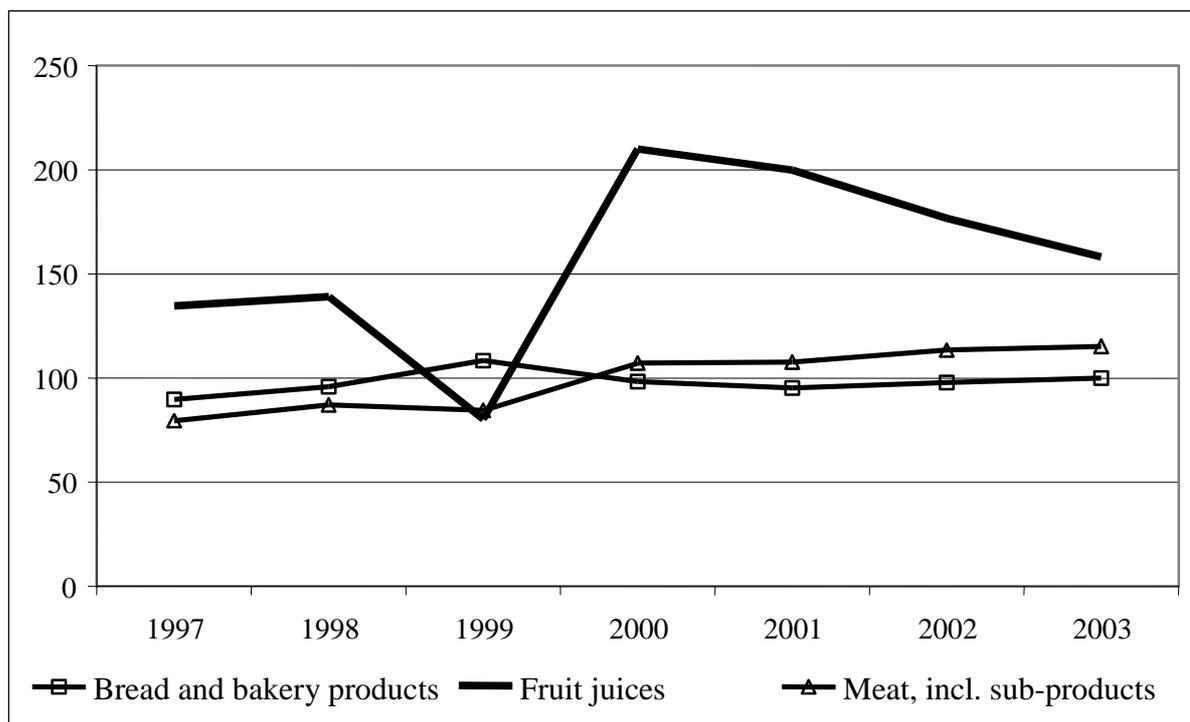
Source: Group of companies "Unidell".

Fig. 59. Russia: prices for grain in 2003 (European part), rubles per ton



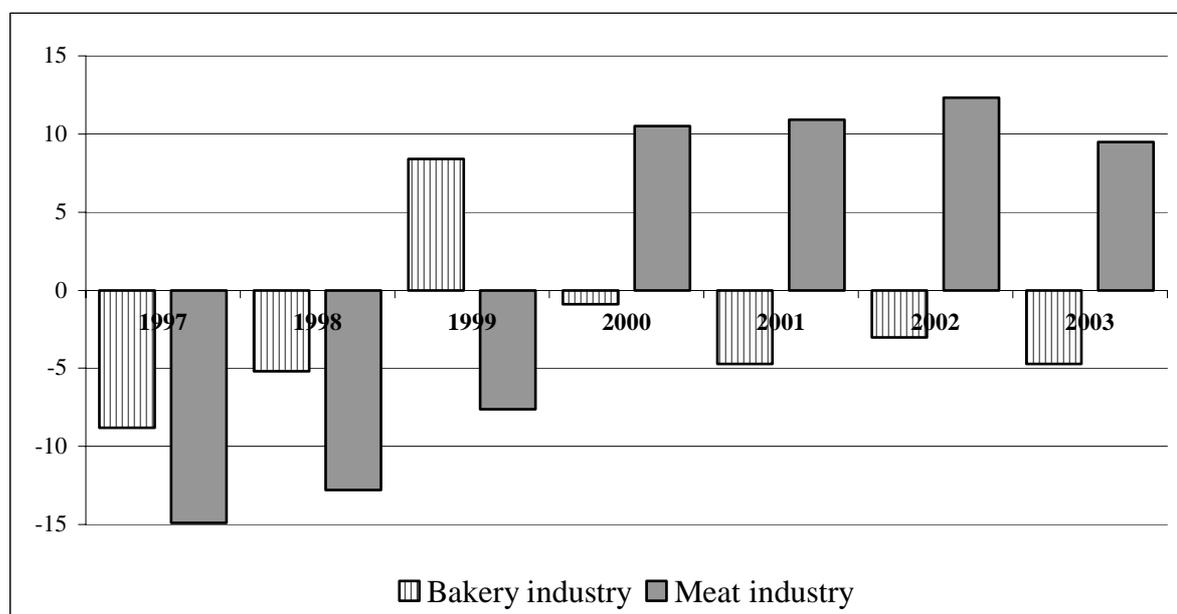
Source: WJ InterAgro.

Fig. 60. Russia: prices for grain in 2004–2005 (European part), rubles per ton



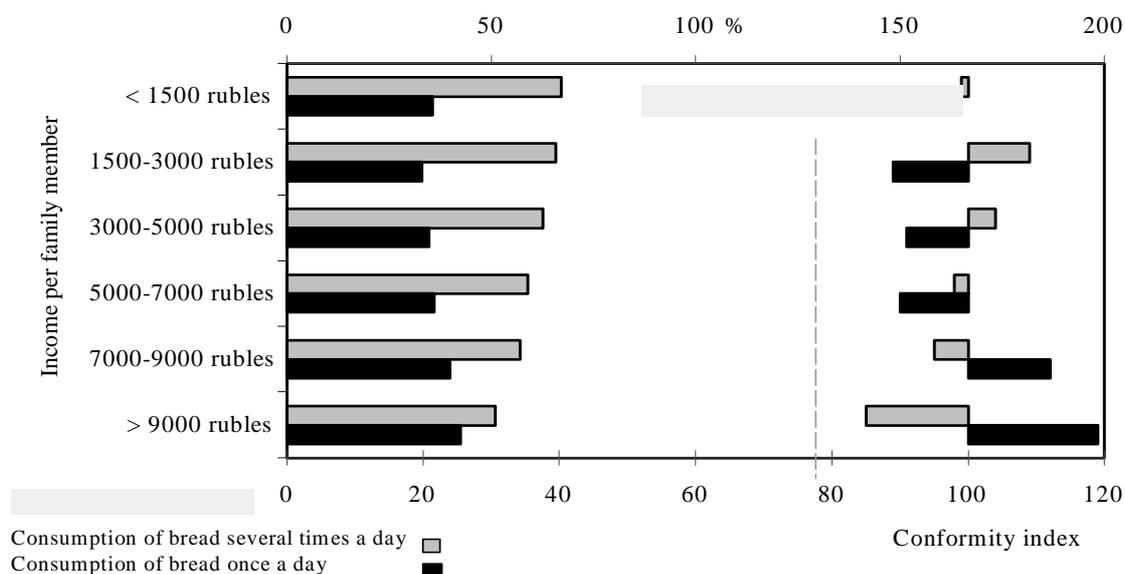
Source: calculated using data of Federal Service of State Statistics.

Fig. 61. Production of selected food products, as % of the previous year



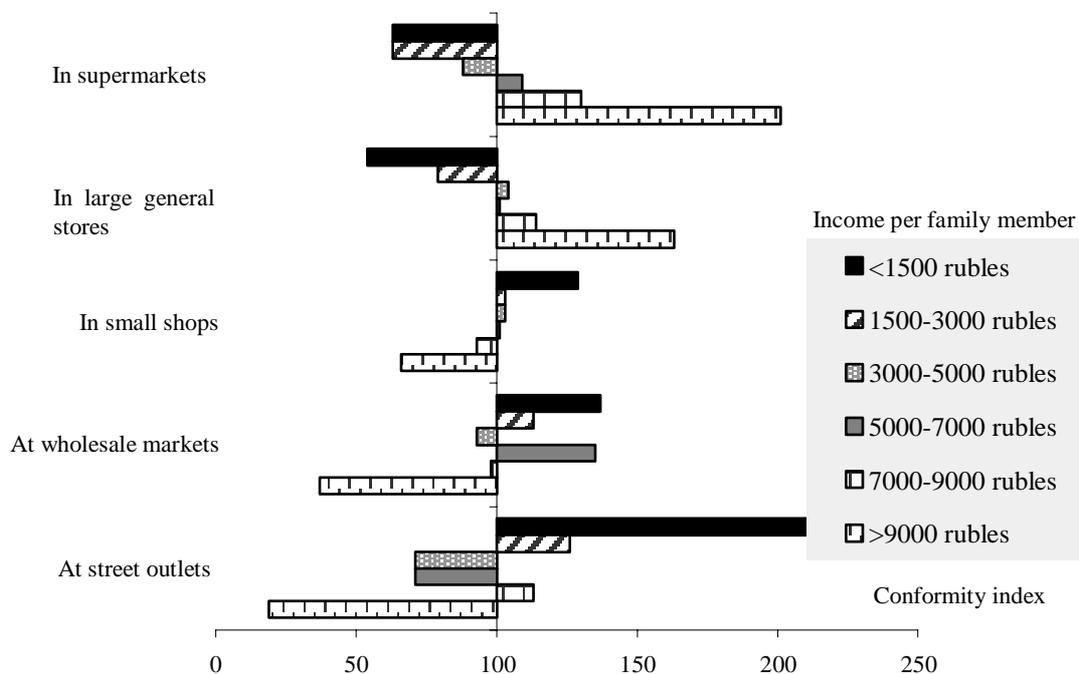
Source: calculated using data of Federal Service of State Statistics.

Fig. 62. Growth rates in bakery and meat industries, %



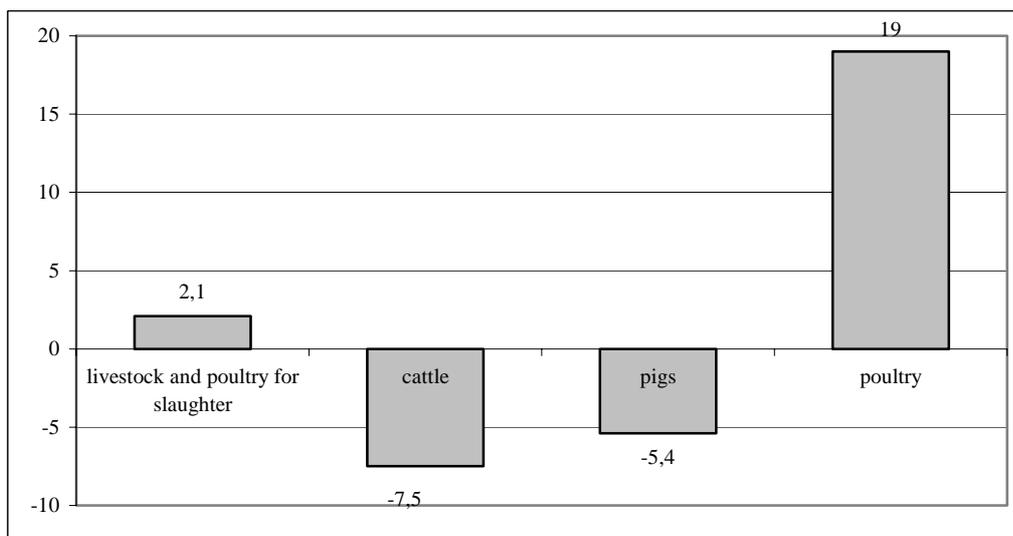
Source: Comcon-2. (R-TGI) – 2004/3.

Fig. 63. Consumption of bread by consumers with different income levels



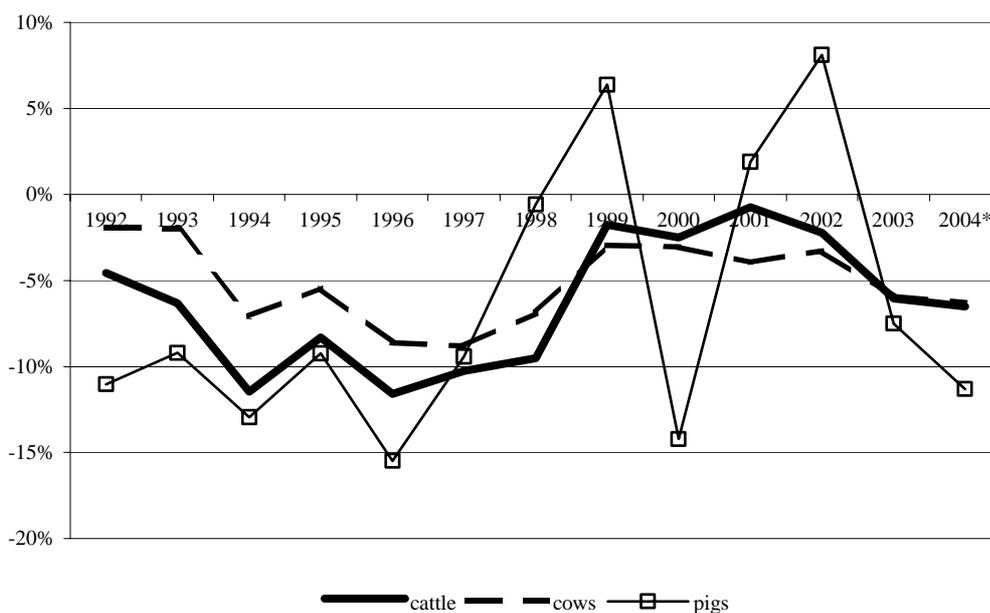
Source: Comcon-2. (R-TGI) – 2004/3.

Fig. 64. Trade outlets where consumers with different income levels purchase bread



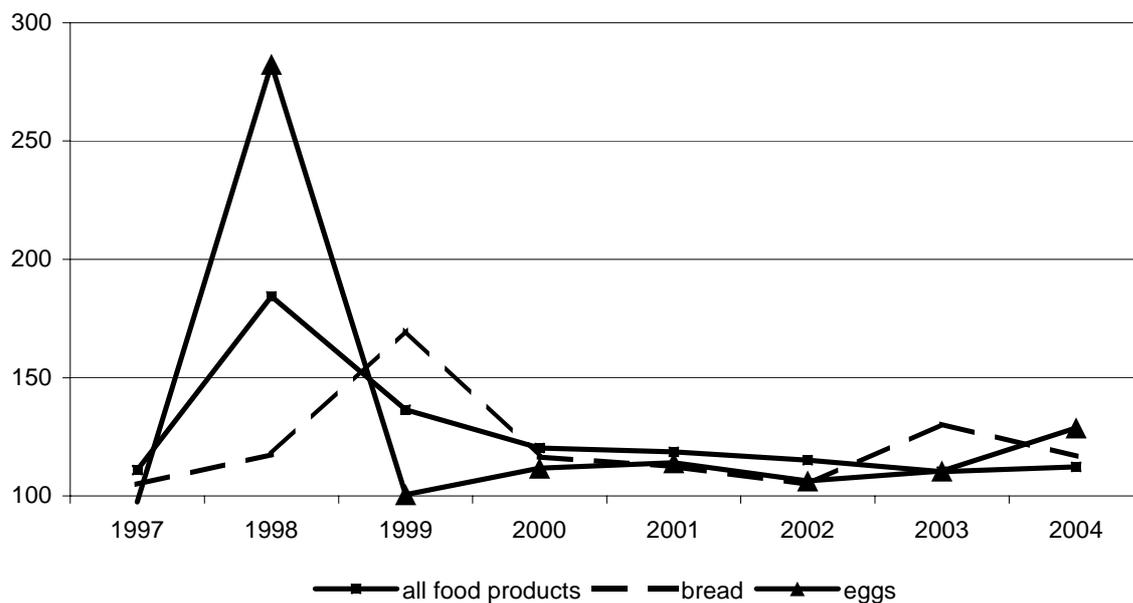
Source: Federal Service of State Statistics.

Fig. 65. Growth of livestock and poultry production in 2004, %



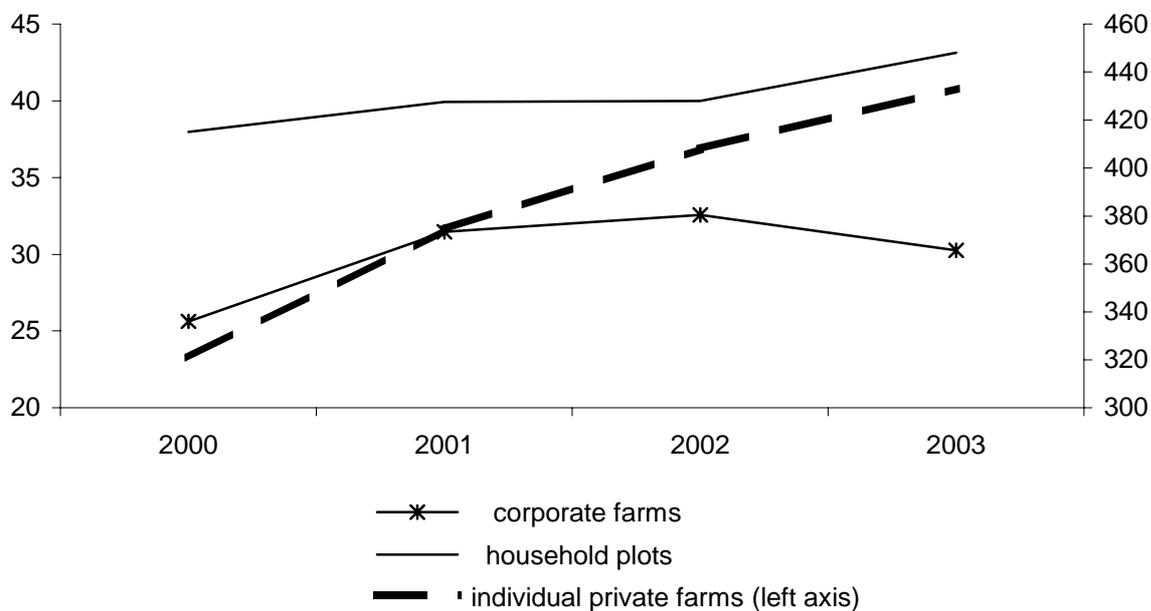
Source: Federal Service of State Statistics.

Fig. 66. Change in the total livestock inventories, as % of the previous year



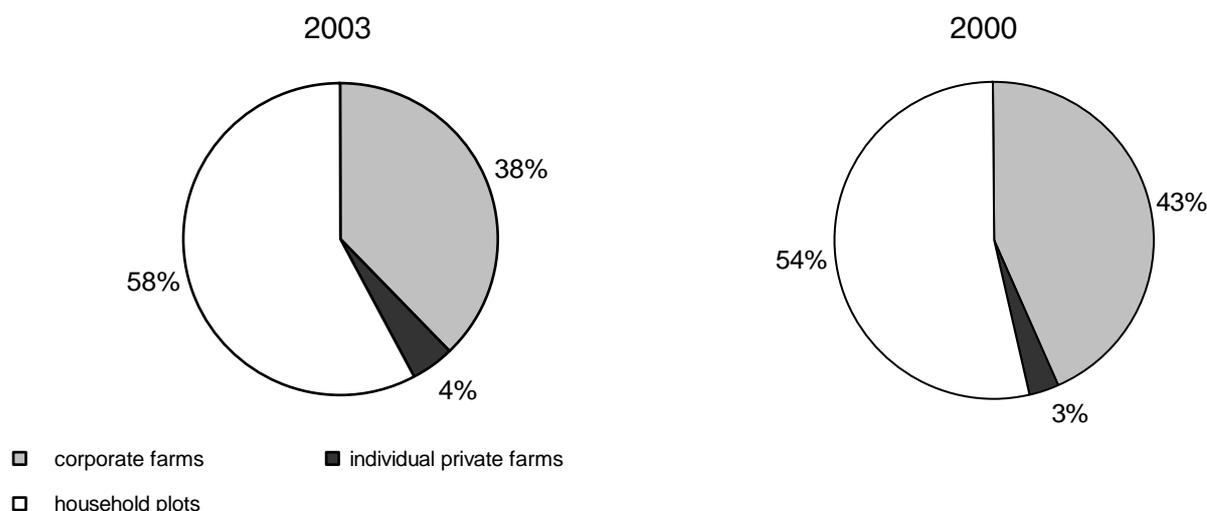
Source: Federal Service of State Statistics.

Fig. 67. Price indices for food products, bread and bakery products and eggs (as % of previous December)



Source: http://www.mcx.ru/dep_doc.html?he_id=797&doc_id=4868

Fig. 68. Gross output produced by different types of farm producers (billion rubles, constant 2000 prices)



Source: http://www.mcx.ru/dep_doc.html?he_id=797&doc_id=4868

Fig. 69. Structure of gross agricultural output by types of farm producers

3.5. Research and Development Sector

2004 is expected to become a year of innovation development as based upon key strategic goals set forth by the Ministry of Industry, Science and Technologies for the same period. The goals, however, have been changed as a result of implementation of administrative reform in March and creation of a single Ministry of Education and Science: the goals have grown in number, while the priority of the decision has become less evident. Various concept and strategic documents were developed and revised (dramatically in some cases) during the year, and the process is still ongoing.

There are several most significant events of the previous year that are worth being focused on:

- reorganizing the system of public management of science and innovations;
- developing a concept of reorganization of scientific institutions;
- making changes in the system of public financing of science, including that related to transition to a new budget classification and performance-based budgeting;
- initializing public initiatives on resolution of HR-related problems;
- expanding business involvement in providing financial support for science, as well as development of private charity;
- developing innovations and focusing on private and public partnership mechanism and indirect regulation.

3.5.1. Administrative Reform in Science

The administrative reform resulted in creating a Ministry of Education and Science as a replacement for the Ministry of Education and the Research and Development Department under the Ministry of Industry, Science and Technologies. Integration of science and education can be considered an advanced step against the former administrative framework, which testifies to the fact that the federal government has been adhering to the integration trend. Creation of the new ministry has shifted priority from scientific and industrial

activity to scientific and educational one. Nevertheless, it is essential that the issues of innovation development were included into the competence of the new ministry¹⁴.

Apart from the single ministry, an advisory body – Council for Science, Technologies and Education under the RF President – emerged¹⁵. It replaced the former Council for Science and IT and took over its functions: provide the President with information on the situation in the sphere of research and education, develop proposals on topical issues of research and educational policy, perform expertise of draft federal laws and other regulations. The Council is to meet at least twice a year. Composition of the Council shows that topical research and educational issues that require a principal emphasis of the President are expected to be selected exclusively by academicians of public academies, primarily the Russian Academy of Sciences (RAS). A share of representatives from industry-based science and public research centers (PRC) in the Council is miserable: wardens account for 20% of the total membership. Such inadequate composition may have a material effect on both the selection and fulfillment of the set tasks.

By the end of 2004, a Strategy of the Russian Federation in Science and Innovation Development for the Period Ending in 2010 (hereinafter referred to as the “Strategy”) emerged as developed by the Ministry of Education and Science. It provides for two of science and innovation development, namely inertial one and active one. It also sets up key goals and Strategy implementation periods. The list of tasks includes all aspects concerning science and innovations, which makes it impossible to prioritize. Listed among the key tasks are to strengthen support for fundamental research, improve research and development performance, provide integration into the global economy, and develop innovation infrastructure. At the same time, some equally ranked technical tasks are also included, namely to develop institution of intellectual property right protection and create “technological corridors”. In general, the text of the Strategy is implying that political choice has already been made for the benefit of fundamental sciences. It is not, however, indicated how to assess whether a fundamental research is a world-class achievement or not. Neither is indicated how one can improve, indirectly through development of fundamental research, capitalization of performance of scientific and technological activity strictly by providing integration of science and education without having direct relationship with business sector.

The section of the Strategy that is dedicated to innovations, provides no mechanisms of interaction between civil and military sectors of science, while only civil science expenditures are considered as a source of financing innovations. In addition, the issues of interaction between innovation process participants (this is the basic weakness of the modern Russian innovation system); neither reorganization prospects in the sector of applied research nor the future development of public scientific centers is described. Finally, it is not only within the scope of the Ministry of Education and Science, which has a direct control of merely 1/4 of civil science expenditures, to provide support to the innovation sector, but also other ministries. The document provides no interaction whatsoever between them.

The Strategy is likely to be updated and become an essential guideline in the development of science and innovations for the nearest five years, provided that it is made coherent to the Strategies of other industries supporting innovations, as well as the Strategy of educational development. To date, however, the text of the Strategy suggests that the government has no clear picture of a consistent model for the scientific and innovation sector.

¹⁴ Issues on the Ministry of Education and Science of the Russian Federation . Resolution of the RF Government of April 6 , 2004 , No..158 .

¹⁵ Decree of the RF President of August 30, 2004, No.1131 “On the Council for Science, Technologies and Education under the RF President” .

An alternative Strategy-plan was somehow presented in the report on human potential development in the Russian Federation prepared as part of the United Nations Development Program (UNDP) named "Towards a Knowledge-Based Society". The report specifies that increasing budget financing of the Russian Academy of Sciences is a key mechanism in transition to an innovation-based economy, because it is the RAS that forms the basis of "innovative breakthrough". In this case, base financing of the RAS is considered as payment for its reputation rather than a state guaranteed order. In general, the budget is expected to grow at the expense of interest contributions generated from export of basic raw materials, namely: crude oil, gas, coal, ferrous and non-ferrous metals, chemical products, lumber, diamonds, etc. The report provides a clear picture of the Russian science as viewed by representatives of the Academy, since the majority of the authors are employed at academic institutions.

One of the material changes in the field of administration is also related to actual abolishment of accreditation of scientific organizations. In 2004, a draft law "On Invalidity of Provisions of RF Regulations Relating to the Issues of Public Accreditation of Scientific Organizations" was developed and approved, under which such accreditation is deemed needless. This resolution is in line with the policy aimed at eliminating needless administrative barriers and reducing the number of activities subject to licensing. At present, the draft law has been submitted to the RF State Duma for consideration.

Public accreditation of scientific organizations was introduced in 1997 primarily for the purpose of providing tax allowances and other benefits. Only accredited organizations were authorized to bid for a state guaranteed order and participate at other types of public tenders. Accreditation was granted subject to the principal criterion, 70:30 ratio, meaning that research and development should account for 70% of the core activity of a scientific organization. This regulation gradually became a barrier for the development of innovative activity. At the same time, a new Tax Code came into force, which terminated a series of former allowances and benefits previously granted to scientific organizations. These circumstances led to an actual abolishment of accreditation.

Abolishment of accreditation provides any organizations with access to budget financing. This is increasing a risk of lobbying and ineffective disbursement of budget funds, unless additional procedures are introduced due to the abolishment (which is in effect de facto) at the stage of tender for state guaranteed orders, which would allow bidders' potential and performance history to be assessed. The practice of preliminary assessment of organizations, bidders for state guaranteed orders, is applied in all developed countries by creating data bases of prospective performers of state guaranteed orders along with lists of corporations and firms which are not supposed to be admitted.

3.5.2. Attempting to Reorganize Scientific Institutions

In the period between summer and fall of 2004, the Ministry of Education and Science developed a Concept of Participation of the Russian Federation in Management of Public Organizations Operating in the Field of Science. Upon publishing, the Concept received a fairly negative review both by the scientific society and especially the Russian Academy of Sciences. A task force was set up by a request of the RAS comprising representatives of the Ministry of Education and Science, the RAS and the Council of Wardens of Russia. Eventually, the task force came up with a new version of the Concept as revised and approved by the three parties. The revised version was named the Concept of Participation of the Russian Federation in Management of Property Complexes of Public Organizations Operating in the Field of Science. It differs largely from the original version.

Originally, the Concept provided methods, most importantly the scope, of the reform of the public research and development sector. Four hundred to 700 scientific organizations are expected to remain in federal ownership by 2008, including 100 to 200 public research and development institutes and 300 to 500 organizations representing an “infrastructural component of public sector of science”. This constitutes a material reduction, since there are more than 450 institutes alone that are currently operating under the Russian Academy of Sciences, let alone departmental research organizations, scientific and research institutes within the framework of institutions of higher education, and public unitary enterprises, all totaling over 2,8 thousand state-owned organizations. It is the reduction figures along with unclear criteria of selection of organizations, that received such a negative review of the Concept among common scientists and managers of scientific organizations. In addition, the Academy perceived the Concept as a new offensive against the RAS’s status, since a drastic reduction of the number of subordinate academic institutions means de facto that the Presidium of the Russian Academy of Sciences will lose the power to dispose of public property.

Only one guideline left as a result of the RAS’s participation in updating the Concept: the number of state-financed scientific institutions is scheduled to be cut down to 800 (by 55%) by 2006. More information emerged with regard to specific figures of financing of the federal scientific sector, which are scheduled for 2008. Minimum budget provision of a single scientist is expected to be RUR700 to 750 thousand a year (in 2004 prices). The number of scientific personnel in state-financed organizations will be defined with consideration of mandatory compliance of this figure. This section can be considered as the only failure committed by the RAS in its struggle for retaining all its powers and privileges: given the fact that budget provision of a single scientist is currently RUR133 thousand a year (according to the estimates of the Ministry of Education and Science), then the foregoing figure of budget provision specified in the Concept would require at least doubled reduction in the number of scientific personnel in the federal sector of science, even though the scheduled growth in budget allocations was considered (up to RUR110 billion by 2008 against RUR46,2 billion in 2004).

The Concept identifies the goals, tasks and principles of participation of the Russian Federation in management of public scientific organizations. The initial and the second options differ largely in composition of goals. For instance, the initial option contains the goals as follows:

- provide breakthrough in the top-priority guidelines of development of science, equipment and technology ;
- achieve competitiveness ;
- develop HR potential of science ;
- optimize organizational and financial expenditures of the federal government in managing scientific organizations ;
- improve budget efficiency in utilizing public property.

As is seen from the list, goals (4) and (5) are showing to a certain extent the purpose of reforming the public sector of science. All things considered, the list provides nothing new as compared to similar documents presented in the previous periods (including those adopted in 2002, Policy Principles of the Russian Federation in Development of Science and Equipment for the Period ending in 2010 and Beyond).

However, the second option moves away from the idea of reforming the public sector and is focused on the need to support science by the federal government in general and strengthen and build up scientific potential and develop fundamental science in particular. Altogether the new 5 goals look even more eclectic in this option :

- build up the role of science in resolving the national task aimed at doubling the gross domestic product ;
- improve quality of fundamental research and development ;
- retain and improve the scientific and technological potential of the country ;
- comprehensive development of the national innovative system ;
- create conditions to develop and improve competitiveness of “HR capital”.

Though the new name of the Concept is focused on management of property complexes, the revised version includes no goal to improve budget efficiency in utilizing public property which was included in the initial version.

Criteria of retaining organizations within the public sector of science appeared to be specified in nothing but general terms. Most substantial failure is the fact that a series of criteria are declarative, and it is not specified who and how would apply these criteria in assessing and selecting particular organizations. It should be noted that the set of options for reforming organizations will shrink: under the new version public organizations can be reorganized only into funds or self-dependant non-profit organization as opposed to the previous idea of them being reorganized into funds, self-dependant non-profit organizations and open joint stock companies, or selling entire property complexes of organizations.

The developed Concept fails to consider two types of public organizations: self-dependant organization and public (municipal) one. At present, a package of corresponding draft laws is under consideration by the Government. These types of organizations play a fairly important role in the field of science and their introduction could substantially optimize reorganization of scientific organizations. In this case, all reorganization schemes described in the Concept would need updating. Since the Concept is a long-term document, it should provide for introduction of new legal and organizational forms.

In general, the Concept provides a narrow view of privatization of scientific organizations, i.e. as a change in the form of ownership. At the same time, privatization may mean loss of the federal government’s function in relation to organizations. Such forms of privatization have been gaining a wider use¹⁶ in the developed countries, as well as serving as the basis of various private and public partnerships, including management of scientific organizations.

The new version of the Concept is distinguished mainly by a new special section dedicated to RAS’s role and place. The section is called Principles of Management of Property Complexes of the Russian Academy of Sciences and State-Owned Sectoral Academies of Sciences. It is evident from this section that the RAS is retaining all its functions and receiving new authorities. It suggests that the RAS is not only a “main center of fundamental research in the country”, but also provides high quality of those trends in applied science which are falling within “the responsibility of the federal government”. In addition, the RAS is becoming a coordinator of fundamental research conducted in institutions of higher education, public research centers, sectoral academies owned by the government. On the basis of a greater number of authorities (even in comparison with the RAS’s Charter), the RAS itself will optimize a composition of subordinate agencies and organizations, and develop not only criteria of efficiency for such institutions but also “a plan of special actions on management of property complexes”.

All things considered, the transformation of the Concept can be deemed a political victory of the RAS in its struggle to maintain a status quo. Though the initial version of the Concept could be criticized for incompleteness, it is still viable option of reforming the pub-

¹⁶ At the Threshold of Knowledge Economics (Global Practice in Research and Innovative Development) / Edit. A.A. Dynkin, A.A. Dagayev. M.: IMEMO, RAS, 2004. C. 180–182.

lic sector, while the updated version is evident of the fact that real reforming is delayed for an uncertain period. Firstly, the academic sector is remaining predominant, while it is a prevailing segment of the “network”. Secondly, according to clarification made by the Ministry of Education and Science, none of the existing institutions will be shut down. They will be integrated with educational and industrial organizations. Such approach seems not to be promising because epidemic integration of organizations will create new problems instead of eliminating the old ones. In particular, integration will not resolve the problem of optimization of personnel of scientific organizations.

Upon adoption of the Concept, the Presidium of the RAS took first steps towards its implementation: in November 2004, a new stage of restructuring was announced. It will include qualification of all scientific personnel employed at the institutions under the RAS. The qualification is scheduled throughout the entire 2005.

3.5.3. Perspective Forms of Integration of Science and Education

One of the trends in reorganization in the field of science deserves a special attention, i.e. integration of science and education.

The need in such integration was stated as one of the national strategic tasks even before the break-up of the Soviet Union. In 2004, however, development of this trend was animated again. As like as not, the need to continue integration of science and education referred to in RF President’s annual letter became one of the catalyzing factors.

The main collision in the first half of the year was represented by emergence of the two alternative and overlapping concepts – leading institutions of higher education and research universities. The administrative reform resulted in only one concept left – research institutes. A new term, “national universities”, emerged at the end of the year.

Elite universities and higher education institutions used to be distinguished in the previous years, as well as various forms of their special support. This is strongly exemplified in the Moscow State University which is financed from a special expenditure item in the federal budget for science. The Concept of a leading higher education institution was developed by the former RF Ministry of Education for the purpose of supporting elite higher education institutes. From 15 to 20 higher education institutes of federal priority were scheduled to receive a status of leading institute, and another 80 to 85 institutes were expected to be distinguished as “leading by research sector”. The selected higher education institutes would receive additional budget financing. The leading institutes are supposed to conduct both research and innovative activity. Skilled scientists and professors should be employed at such higher education institutes, and qualified personnel should be trained beyond the overall average. The leading higher education institutes should have developed relationships with other domestic and foreign organizations, they should represent a center of cultural and social development on its territory. A total of over 50 formalized criteria were identified for selecting leading higher education institutes.

The status of “higher education institute” is similar to the approach that was used in creating public scientific centers early in the ‘90. The idea is the same: maintain the strongest organizations by granting them a special status and additional financing. The experience related to the public scientific centers shows that once such status received, organizations do their best to retain it, and new participants are unlikely to be included into the list of the selected. Such approach is justified only in crisis, when the existing structures need to be maintained and preserved.

The concept of “leading higher education institute” was finalized by the period of administrative reform, when the Ministry of Education ceased to exist. The new Ministry of Education and Science revived the concept of “research institute” which is currently con-

sidered within the framework of the general concept of integration, including the Strategy. The Concept of “research institute” suggests voluntary integration of varying “depth” as based upon interaction between universities and academic institutions, as well as public scientific centers. A total of three “depth” degrees of integration is provided for: full integration of science and education with creation of juridical person, especially a research university; partial integration (scientific and research institutes under higher education institutes, basic departments, basic laboratories); contractual integration (for instance, between legally independent scientific and research institutes and a higher education institute)¹⁷. Criteria of distinguishing higher education institutes as research universities remain unclear. The previously granted statuses are expected to be revised (university–academy–institute). From now on, a higher education institute may receive the status of university provided that it is conducting advanced research.

Since various types of integration of academic organizations and higher education institutes have long been existing and particular experience has been obtained, one can argue that cooperation is normally developing until a certain limit is reached without transition to new qualitative forms. No deep integration takes place, when, for example, organizations can integrate into horizontal or vertical associations. This is partially due to quite moderate financing of integration programs and existing legal and regulatory problems which are interfering with deep integration. Even the new budget classification still contains separate financing of science in general and scientific research conducted at higher education institutes. These expenditures are also administered by various agencies.

Creation of integration structures in the form of “research university” requires amendments to the applicable law, because the notion of “research university” is not existing in Russia from the legal point of view. A package of draft laws on integration and education has been prepared, and initial practical steps on testing a mechanism of deep integration have been taken. The RF Government is preparing a Regulation on integrating the Novosibirsk State University into the scope of the Siberian Department of the RAS¹⁸, and subordination of another university, the Moscow Physicotechnical Institute, under the scope of the RAS is under consideration. A Department on Integration of Science and Education was set up within the framework of the RAS in January 2005¹⁹.

Thus, the statement that fundamental research is a RAS’s prerogative right is prevailing in resolution of the integration issue as well. Indeed, the RAS would like to expand primarily such form of integration as basic departments (there are 360 departments available for the time being, of which scientific personnel of academic institutions account for nearly 8%), as well as establish an Academic Association of Universities which have a close relationship with the RAS institutes²⁰, open its own “academic” universities and reassign some of the existing ones. Emergence of “academic” universities should promote solution of HR problems in the academic sector of science, though such approach has its obvious deficiencies. First, single-purpose training schedules are very likely to be drafted, since it is well known which institutions students are going to be employed at. Second, this a departmental approach with all the costs it implies. Third, since the Academy has no experience in managing large educational organizations, it may have an adverse effect on the quality of organization of educational process.

¹⁷ Strategy of the Russian Federation in Science and Innovation Development for the Period Ending in 2010, the RF Ministry of Education and Science. November 2004, Annex 4 “Forms of Integration of Science and Education”.

¹⁸ Poisk. No. 48. November 26, 2004. P. 2.

¹⁹ Poisk. No. 2–3. January 21, 2005. P. 3.

²⁰ Speech of V. Kozlov, RAS Vice-president, at a meeting of the Council for Science, Technologies and Education under the RF President // Poisk. No. 44. October 29, 2004. P. 4.

Late in 2004, the Ministry of Education and Science announced, along with the intention to establish research universities, that “national universities” would receive a special support. The “national universities” is a sort of modified idea of granting a “leading” status to some institutions. Nearly 100 universities may become “national” ones as well as be the first to receive budget financing. Perhaps, this method is suggested to select public higher education institutions for identifying organizations which would receive state budget financing.

3.5.4. Optimizing Budget Financing of Research and Development

Reorganization of science is closely associated with the issues of optimization of budget funds utilization. Reorganization of budgetary process and development of performance-based budgetary procedures concern both science and innovations.

A new budget classification will come into force with the budget of 2005, which appears to be less transparent than the former one. The new classification allows for only indirect calculations and assessments as compared to the former special item 06, “Fundamental Research and Scientific and Technical Progress Promotion”, which regardless of its well-known deficiencies, reflected clearly enough the size and the trends in financing the Russian civil science, a share of program financing, consistency with the obligations to public scientific funds, etc. now, the first section of the state budget – “General Public Issues” – includes expenditures on financing fundamental and applied research. In addition, another 9 sections of the budget contain an “Applied Research” item. Thus, the budget on science is dispersed, and the first question is how to calculate adequacy of funds’ budgets with public obligations on their financing?

It is well known that the budget of the Russian Fund for Fundamental Research (RFFR) must account for 6% of civil science expenditures, the budget of the Russian Humanitarian Scientific Fund (RHSF) – 1%, the budget of the Promotion Fund for Small Enterprises in Science (the Promotion Fund) – 1.5%. The current situation is opposite to the previous periods when actual amount of financing of the funds was determined in percentage of total financing specified in 06 item : experts have defined planned volumes of civil science financing considering that the money allocated to the funds comply with the obligations approved.

Allocations for fundamental research grew up to account for 22.3%, which is beyond the average incremental growth in financing allocated for civil science, though growth in allocations for applied research can be assessed only roughly. Thus, public academies, primarily the RAS, which are expected to undergo less reorganization, received the biggest share of financing.

In general, the percentage of civil science expenditures continued to decline, while the percentage of military research and development grew up.

The biggest growth, 44.5%, is expected in regard to Federal Targeted Programs (FTP). The budget growth is basically related to the programs like “National Technological Basis” and “Federal Space Program”. A series of FTP are scheduled to be terminated and, unfortunately, biomedical research, which is considered top priority worldwide, is likely to be reduced. In particular, a program on developing remedies against most dangerous pathogens was suspended.

Changes in budget classification in 2004 were accompanied by developing a performance-based method of budgeting, i.e. determining goals, tasks and measures for performance measurement of the subjects involved in budgeting. The Ministry of Education and Science, which is responsible for development of science and innovations in the

structure of federal goals, developed its own vision of goals and methods of their fulfillment. Two goals were determined for the sector of science and innovations :

- create conditions for development and efficient utilization of scientific and technological potential ; and
- create conditions for animation of innovative activity.

Such wording provides no opportunity to assess the degree of achievement of the goals set. In addition, unclear goals make it impossible to determine mechanisms of their implementation. We believe that goals should be more specific as follows:

- develop and improve performance of the research and development sector as a “knowledge generator”; and
- create innovation-sensible medium and promote innovative activity.

Such wording is correlating with the goals and tasks set forth in the Strategy and the Middle-Term Program of Social and Economic Development of the Russian Federation (2005–2008). It is obvious that all these documents should be interrelated and non-contradictory.

A composition of indicators designed to assess achievement of goals is still overloaded with resource and structural measures which could give occasion for requesting more budget funds. The indicator of internal research and development costs in percentage of GDP is the most dramatic example. It is a resource-based indicator. In addition, there is no doubt that this indicator is essential for making comparisons on international level, but it has nothing to do with the scope of the ministry, because it represents aggregate characteristics of economy’s research intensity. For instance, the Ministry of Education and Science bears no responsibility for changes in financing parameters for defense research and development which represent a significant share of internal research and development costs. Including this indicator into a composition of performance-based measures of the ministry would have the effect similar to that previously occurred with the indicator of fixed share of civil science allocations from the disbursement section of the budget, which should account for at least 4%. This regulation was introduced by the Federal Law “On Science and Public Scientific and Technological Policy”, but never was observed. At the same time, this was a basic claim to the Government. The regulation remained in force after changes in the budget structure, GDP volume, but the requirement for 4% allocation for science remained unchanged. The 4% regulation was withdrawn from the Law on Science pursuant to the amendments that came in force from January 1, 2005.

The second material deficiency of the proposed system of indicators is that some of them are outdated and requiring changes in calculation method, while the others are fairly generalized. Their sole advantage is associability, as they are collected by public statistics agencies on an annual basis. Indeed, it is difficult to introduce indicators which require a brand new forms and methods of calculation. However, attempts to build up a system of performance measurement on the basis of outdated and easy-to-collect indicators would be at least ineffective and normally risky for modernization.

It should be noted that all quantitative measures for the science sector are efficient only relatively, since many aspects constituting the essence of scientific work can not be formalized. This is why the foreign system of indicators designed for performance-based budgeting is accompanied by the peer-review system, i.e. expert appraisal of the initiatives originated by the ministry or agency operating in the sector of research and development.

The key issue in measuring performance in the field of science is *what* and *how* to measure. For example, what should be measured to determine the extent to which scientific and industrial centers have an effect on industrial compositeness ? Such traditional

indicators as licensing, mutual agreements, patents etc. can only be used to measure a short-term effect rather than long-term one. Long-term effects, in its turn, normally show a qualitative rather than quantitative value. Thus, there are two specific features of measuring goals and performance which can be emphasized for the sector of science. First, it is difficult to directly relate the performance of a research to the annual investments in science, because a real effect is expected to be evident in several years or even decades to come from the initial investment. Second, performance measurement in science always has a retrospective character and consequently involves skilled experts. In some countries, an alternative method was adopted to measure efficiency of investments in science: qualitative performance measurement rather than quantitative one. Besides, case-study methods are often used in addition to expert appraisal, which can determine how scientific work is promoting a socially essential performance²¹. Utilizing only qualitative indicators is risky in that such approach normally excludes top-priority tasks which can not be reliably measured for quality, as well as it ignores such task components which have no direct effect on values of the indicators set for assessment.

The Ministry plans to implement the task in the field of science and innovations as part of the Program on Research and Development in Top-Priority Trends of Science and Technology, which since 2005 became a single program in the field of scientific, technological and innovative work, including FTP actions, Integration of Science and Higher Education in Russia and top-priority scientific research, including the national key projects on innovative work.

Nevertheless, the federal budget can provide a significant resource to achieve the goals set. This is budget funds allocated to the public academies of sciences. Over the last few years, allocations to these academies have been accounting for 30 to 33% of the total state budget allocations for the benefit of civil science. The biggest volume of fundamental research is provided within the system of institutions subordinate to the Russian Academy of Sciences, which in fact makes the RAS responsible for achievement of a strategic goal of the country: build up potential for future development. In addition, over the last few years, the RAS has been actively participating in innovation work thus justifying its participation (statements and reports) in resolving the issues of innovation development. At present, however, this significant resource is not being in use, as the RAS and other public academies are not the subjects of budgeting due to their special legal status. Thus, a fairly large share of public funds allocated to the development of science appears to be excluded from budgeting.

3.5.5. Public Scientific Funds and Private Charity

Operating conditions gradually deteriorated for scientific funds (RF FI and RHSF) during the year. First, it was caused by the fact that the RAS strengthened its control over their activity. Their reorganization into state-financed organizations as accompanied by changes in the management in the previous year, was followed by a new step, i.e. changes in composition of their Councils. There are currently no scientists representing higher education institutions in the RF FI's Council, while a percentage of representatives of non-academic science is miserable in the RHSF's Council. Thus, the RAS has come to have a decisive effect on decision making in the funds. In addition, the funds have lost the right to self-governance pursuant to a revised version of the Law on Science effective from Janu-

²¹ Roessner D. Outcome measurement in the United States: State of the Art. Paper presented at the Annual Meeting of the AAAS. Boston, MA. February 17. 2002.

ary 1, 2005. This may have an adverse effect on contest-based selection of projects for grant financing.

Under the circumstances, the funds are getting rely upon partnership with ministries and further diversification of their activity. The RF FI and the Federal Agency for Industry entered into an agreement on cooperation. Under the agreement they will conduct joint contests of projects designed to continue applying research and development findings in various industries (in particular, radioelectronics, aviation and shipbuilding).

Second, it is also related to work organization at the funds. Over the last few years, Demands and role of science have gradually been changing which should be taken into account in the criteria of assessment and selection of projects. Being public agencies, the funds have to perform some of the public functions, including reformation in the field of science in Russia. It seems to be expedient to introduce such criteria of project assessment as compliance with the national top-priorities, effect of a proposed project on the development of other sciences, as well as applicability of project's findings beyond fundamental research. To date, both the assessment criteria and the classification of sciences still remain unchanged in spite of a heavy criticism.

Third, there is a problem of an ambiguous interpretation of the "grant" term by the funds, which was not resolved in 2004. Such interpretation plays a decisive role in the entire financing system at the funds. A type of obligations defined as "charity" in clause 582, section 2 of the GC RF is closest to the meaning of "grant". Grant recipients are defined as legal entities (medical, educational, scientific, social and charitable, etc.), as well as public and religious funds. This definition is imposing material limits on Russian legal entities as parties of a grant agreement by classifying them as non-profit organizations, including state-financed ones.

Fourth, there is a problem of taxation of grants. With regard to grants, it is expedient to apply the system of tax allowances which is applicable to foreign grants. Under the applicable RF Tax Law, grants are not identified as monetary funds received from Russian scientific funds, though they are exempted from profit tax²². Subventions, subsidies or transfers received by citizens and organizations of the Russian Federation from the RF FI and the RHSF and allocated for conducting scientific research, holding scientific conferences and implementing other programs realized by these funds should be defined as grants.

No progress was made in private charity in 2004 as judged by the number of new organizations implementing science promotion programs. At the same time, the non-profit organizations established in the previous years expanded their scope and the number of programs for support. This is especially true in regard to such organizations as the Domestic Science Promotion Fund and Dynasty Fund. At the same time, however, the initiatives of YUKOS, a major benefactor, were reduced (for instance, provision of financial support for regional Internet centers).

In the period ending in 2004, the RAO EES (RAO Unified Energy Systems of Russia) and the RAS entered into an agreement on establishing a New Generation Contest for young scientists and students of higher education institutions conducting research in the sector of power energy and related sciences. The RAO EES plans to establish an annual award in the amount of \$100 thousand to the best scientists at the age of up to 35 (\$2.000) and scholarships to the best students (\$1.000 each) whose major is power energy.

Tax imposed on grants of non-profit organizations is one of the problems interfering with the development of private charity. In 2004, corresponding amendments the Tax Code

²² Pursuant to section 1, paragraph 14, clause 251 of the RF Tax Code (the Federal Law as in force since May 29, 2002, No. 57-FZ).

were under consideration, and a draft law passed first reading. From now on, Russian benefactors may provide profit-tax-free grants, provided that such benefactors are registered in the list of such non-profit organizations. The list is subject to approval by the Government of the Russian Federation. Thus, a procedure is suggested which is similar to that applied to foreign organizations operating in Russia. There is a restricted number of well-established and well-known foreign organizations operating in Russia, while any Russian non-profit organization may establish its grant and consequently obtain tax allowance in this country. So far, there is no criteria for selecting non-profit organizations for the list of benefactors. Neither is existing any revision procedure for the list. It seems to be expedient to draft and adopt a special law on grants concerning both public and private funds with a special provision for their scope, rights, possibilities and limitations.

3.5.6. Developing a Program on Foreign Funds and International Organizations

In 2004, the United States, major sponsor, continued to reduce the number of Programs on Russian Science Promotion. In particular, financing pursuant to the US Law, Act in Support of Freedom, was cut off. This means termination of the initiatives of such organizations as AIREX, ASPRAL, the Kennan Institute, the Eurasia Fund. The US Agency for International Development also reduced its allocations for Russia. Such a situation is mostly due to gradual changes in US goals. Initially, large amounts were invested in conversion of military-oriented science into a civil one, preventing brain drain, establishing a civil society, and supporting social sciences. It is admitted for the time being that the majority of the above listed goals have been reached. The British Council has been reducing dramatically its financing the Russian sector of science and innovations, including support for Russian programs and a series of foreign organizations.

At the same time, some initiatives are likely to be enlarged in scale. Consideration is under way of expanding Russian-American initiatives relating to short-term exchange programs, and increasing the number of participants by reducing the term of their staying abroad²³. Another advancing trend in cooperation is commercialization of scientific and technical performance. It is scheduled to be developed by International Scientific and Technical Center (ISTC), organization which in 2004 cancelled the 10-year operation in Russia. During its operation the ISTC provided support for 60 thousand scientists of the CIS countries by having allocated nearly \$600 million. A share of annual allocations from this Center accounts for 5% of budget financing of civil science in Russia. Canada became a member of the ISTC from March 2004, which plans to provide an annual contribution of up to \$18 million to the programs on financing scientists that used to be employed in the former defense sector of science. At its inception, the center provided financing for civil scientific research conducted by the former defense-sector scientists in order to keep them employed in the country. Over the last few years, the ISTC has turning into a "technological broker" by outsourcing private foreign firms for the project and developing partnership projects. At present, the ISTC is providing cooperation between Russian scientists and 229 foreign private companies. Over the last two years, the annual growth rate of private investments has been accounting for nearly 150%²⁴. The ISTC plans to increase its investments in patenting, commercialization of scientific research findings, creating infrastructure of technologies transfer, including former restricted cities, i.e. special research and development cities. Another key aspect is placing focus on supporting special re-

²³ Preparing for a New Decade of Exchange Programs Between Russia and the United States. Materials of the Symposium. M., 2004. P. 25, 37.

²⁴ ISTC – 10 years (1994 – 2004). M. : ISTC, 2004 . P. 3.

search for the benefit of all the parties involved. This is primarily related to terrorism fighting, developing new sources of energy and biological research.

The InTAS, another major international organization, has been developing the similar way. It became obvious in 2004 that provision of the same kind of support to all and each of the CIS countries could not be efficient any longer. This is why the InTAS conducted appraisal of its programs which resulted in developing several scenarios.

Scenario 1 provides for continuing the cooperation programs by placing emphasis on conducting special contests (dedicated to power energy, IT and biology), practical application of the research findings, as well as programs for young scientists. European researchers have been showing less interest in the practice of supporting broad networks of scientists, which forms the basis of InTAS operation. According to assessment of the former initiatives, support for small partnership teams of representatives from 2 to 5 organizations proves more efficient than that of the networks. This (1) insures better compliance with the basics of organization of scientific process and (2), allows administrative costs to be reduced.

Under Scenario 2, the InTAS is expected to broaden its advisory functions in regard to the CIS countries. In doing so, it will rely mostly on top-priorities of the Frame Programs of the European Union.

Finally, Scenario 3 provides for converting the InTAS into nothing but a consultant, which will provide consultancy in the field of science and services for countries-recipients. In this case, Russia will be replaced as the key client with Central Asian and Transcaucasian countries, where scientific and research forecast institutions are poorly developed and need support in establishing and developing.

Final decision on InTAS development strategy still remains to be taken, but experts tend to Scenario 1. Russia is not yet ready to become a full member of the EU projects. First, the EU frame programs are intended to strengthen the European scientific field rather than development of the CIS countries. Second, Russia is incapable to equally participate in contests with the Western European countries. Russian bidders still remain less competitive in formulating a research plan, project management structure, delegation of responsibilities between researches, indicating relationship between them and organizations-participants, as well as describing the expected findings. This is why Russia has achieved a miserable success in contests as part of the Sixth Frame Program: success coefficient averages nearly 12%.

At the background of reduction and reorganization of foreign organizations and funds, pooling of foreign and domestic monetary funds, including private ones, could be a rational decision. It is this approach that was selected by the New Eurasia Fund which began to operate late in 2004.

New Eurasia Fund was established as a partnership project including Russia, the United States and Europe. Russian Dynasty Fund and European Madariaga Fund (headed by J. Solana, Representative on Unified Foreign Policy and Security Policy of the European Union) and American Eurasia Fund are cofounders of New Eurasia Fund. The latter operated in Russia between 1993 and 2004, and its new fund became a sort of "entry strategy".

Basic goals of New Eurasia Fund are to support and strengthen civil society in Russia as well as promote country's integration into the world community of small business, including support to scientific and innovative projects. Fund's budget will total more than \$10 million annually.

3.5.7. HR-Related Problems in Science

In 2004, the brain drain problem came alive again to become a topic of discussion along with measures to be taken to prevent the corresponding losses and prevent young scientists from looking for a job in other countries. The concern of the HR-related problem is somehow substantiated: little has been done to improve the situation of young scientists, young generation of scientists continues to be uncalled, some of them having to search for a job in other countries. The polls conducted in 2004 by specialists of the Science of Science Center of the Institute of History of Science and Techniques under the RAS jointly with sociologists of the Institute of Economics and Industrial Production Organization showed an increased disintegration in the scientific community. Only 5% of the scientists have a business-sector income (i.e. \$500 and more)²⁵. This group of well-paid scientists consists mostly of researchers at the age of 35 to 50. Earnings of the rest of the scientists are comparably lower. Additional earnings are gained mainly through research work (grants of various funds, contracts and agreements with customers) and professorship. Nevertheless, there is a positive trend: only 8% of scientists has non-science business as a principal earner. The figure is less than that of the mid-'90 when up to 70% of researchers were engaged in non-science business²⁶.

At the same time, simultaneous work in various projects, and most often in various organizations, results in poor scientific output, because there are no adequate conditions available for serious research work. This phenomenon was reflected in statistics: over the last three years, a share of Russian authors in the global scientific literature was reduced from 3.6 down to 2.4%²⁷. In addition, Russian scientists are poorly engaged in the global scientific community: according to the Institute of Psychology under the RAS, only 39% of Russian researchers are participating in international programs and projects²⁸. According to polls, 56% of scientists are not expecting changes in their earnings in the years coming. Such situation is not attractive whatsoever for young scientists, and nearly 1/3 of them have plans to find a new high-paying job in the nearest 3 years.

In February 2004, the Council on Science and High Technology under the RF President held a meeting dedicated to the issue of human resources for the research and technology center of the country. Implementation of a Presidential Program on Scientific Human Resource of Russia was expected to be commenced as a result of this meeting, which would have provided for a set of measures aimed at retaining human resources in the field of science, including initiatives on increasing wages and introducing a system of soft-term crediting of housing construction for young scientists²⁹.

However, the meeting resulted only in a Decree of the RF President "On Measures of Supporting Employees Engaged in the RF Defense Industry". Pursuant to this Decree, from March 1, 2004 nearly 400 scientists, designers, technologists and other engineers employed at organizations executing state guaranteed orders and having prominent services to the cause of manufacturing armaments, military and special-purpose equipment, received monthly stipends to the amount of RUR20 thousand. Thus, resolution of the HR-related problem boiled down to the repeatedly tested measure, i.e. selective and temporal salary increments for special group of employees.

²⁵ The sample included 786 persons from various regions of Russia. Refer to : Yurevich A. , Tsapenko I., Prikhodko A., How and How Much Do Our Scientists Earn? // *Naukovedeniye*. 2004. No. 1. , P. 58.

²⁶ Yurevich A., *Smart but Poor: Scientists in Modern Russia*. M.: MONF, 1998., P. 104.

²⁷ Saltykov B., "Designing the Future of Russian Fundamental Science" // www.opec.ru/point_doc.asp?tmpl=point_doc_print&d_No.=53827

²⁸ Yurevich A., "Passive" Integration // *Nezavisimaya Gazeta – Nauka*, 12 January 2005, P. 12.

²⁹ For more details on the draft program refer to: *Russian Economy in 2003. Trends and Outlooks*. Issue 25. M.: IET, 2004. P. 261.

As far as the brain drain concerns, it is not considered as totally negative by the government, since migration of Russian scientist to other countries falls within limits of common migration. Such opinion, however, is argued by many opponents who believe that losses incurred from brain drain are enormous – emigration of a single Russian specialist to other country incurs losses of \$200 to 250 thousand, which is totaling \$25 billion on average.

The issue of brain drain still remains accompanied by various kinds of myths. This is somehow related to the lack of reliable statistics on emigration. There are frightening data showing that 60% of the winners of international scientific Olympiads are getting employed in other countries, and Russian emigrants in the United States provide 20 to 25% of the US high-tech production.

Russia would have incurred approximately \$7,5 billion losses in total over the last thirteen years of post-Soviet emigration on the assumption that the cost of a single specialist's emigration to other country was really \$200 to 250 thousand (this amount is probably calculated by using the cost method proceeding from the assumption that if a young specialist stayed in Russia, his/her monthly production output during his/her career would amount to \$500), and on the basis of official statistics and polls showing that the Russian community in other countries is 20 to 40 thousand persons. no doubt, this figure is far below \$25 billion which is most often referred to in mass media .

Furthermore, by referring to the official statistics, we can see that scientists account for not more than 2% of the total emigrants. Thus, the threat of brain drain is fairly overstated, though emigration of single specialist may shut down a particular research as a whole. Nevertheless, such cases are very uncommon, since emigration has become younger. In addition, external factors that constrain emigration have become stronger. The United States – where the majority of scientists emigrate to – imposed heavy restrictions on obtaining entrance visas in 2004 . The number foreign scientists obtained US entrance visas reduced to 65%³⁰ over the year.

At the same time, the Russian scientific community abroad is actively engaged in stimulating inflow of young Russian scientists. On the one hand, Russian scientists employed at foreign laboratories are trying to support their former compatriots in obtaining grants and entering into contracts on research and development. On the other hand, they monitor and select best students to offer them a job in the future. The scale of such channel has not been measured yet, but it is widely used indeed: those scientists who are currently employed abroad used to work at almost all leading Russian research institutes, and they still maintain relationship with their “parent” organizations.

More intensive is emigration of young scientists from highly potential research teams. For example, outflow of young scientists from scientific and educational centers established at Russian higher education institutes under the auspices of the Ministry of Education and the American Fund of Civil Research and Development accounted for nearly 7% over the last two years, which is notably beyond the overall average in the country. Brain drain is less evident at some very few research centers where all-inclusive conditions have been created to retain young scientists: stable financing with public and foreign sources, sustained relationship with foreign scientific centers, constantly upgraded scientific equipment, career motivation for young scientists.

In order to discourage scientists' emigration, it is essential, besides pay increase, to develop a system of additional science financing. Globally, business sector is considered the key source of financing science.

³⁰ Business Week. October 4, 2004. P. 62.

3.5.8. Expanding Business Participation in Financing Research and Development

Last year businesses continued to pay more interest in supporting research and development. The support was mainly based on two forms of financing :

- establishing their own research and development units or institutes ;
- financing research projects implemented at public scientific organizations and higher education institutes .

Official statistics on innovations in industry (including research and development financing) typically remain very scarce. At the same time, analyses made by some large companies are testifying to the fact that business sector has become more involved in research and development financing, which, however, remains selective by industry so far. At present, annual research and development expenditures by OAO Russian Railroads, RAO Unified Energy Systems (RAO EES) and Gazprom amount to RUR15 billion³¹ which account for nearly 1/3 of the public allocations on civil science in 2004, while research and development expenditures by Norilsk Nickel exceed by 2.5 times those of the Moscow State University³².

Several notable initiatives on research and development financing were advanced by businesses last year :

- System Joint Stock Corporation and the related companies (RTI Systems Concern, Scientific Center Concern and Telecom System) announced about conclusion of a master agreement with the Moscow Bauman Technical University and the Institute of Radioelectronics under the RAS. Under the terms and conditions of the agreement, the companies and higher education institutions will jointly develop innovation infrastructure and implement promising research projects, including expert examination of research and technology developments with a view to utilizing them in commercially promising projects as well as obtaining patent protection on the developments in use.
- The RAS Siberian Affiliation and the Krasnoyarsk Mining and Chemical Plant entered into an agreement for a period between 2005 and 2008 at total value of RUR25 million. Six research institutes of the RAS Siberian Affiliation will participate in research and development for the benefit of the plant.
- An agreement concluded between the RAS and Norilsk Nickel was continued. A Norilsk Palladium Research Center is scheduled to be established on the basis of the United Institute for CO Catalysis under the RAS, which will implement a research program aimed at creating competitive science-intensive materials that could be used in industry. At next stage Norilsk Nickel is ready to play a role of a seed capitalist and continue to support successful projects on a long-term basis.
- A private High-tech Center was opened in Khimki city. The Center is intended to develop new medical remedies for AIDS, cancer, cardiovascular and other diseases. A share of foreign investments accounts for nearly \$5 million. Research personnel of the Center is expected to reach 1500 persons at mean age of 38.

Development of research and innovation activity has become essential for industrial enterprises: according to a poll conducted by the IET³³, 72% of enterprises have outdated plant and equipment, which makes their products less competitive.

More business involvement in research and development projects, establishing new research units and providing more direct orders to research organizations would play a significant role at the background of actual stagnation of the Russian Technological Devel-

³¹ Ideological Bargaining // Rosyiskaya Gazeta. January 23, 2004.

³² Poisk. No. 2 and 3. January 21 2005. P. 8.

³³ IET's poll. No. 145. May 2004 .

opment Fund (RF TDF) which is supposed to support implementation of inter-sectoral projects on the basis of extra budgetary research and development funds.

Extra budgetary sectoral funds were built up by ministries, public agencies, concerns, corporations and associations on the basis of contributions made by enterprises as 1.5% of their products (works, services) cost. The budget of the RF TDF was based upon 25% contributions from extra budgetary funds. Soon after Chapter 25, Part 2 of the RF Tax Code entered in effect and a series of amendments were made to it, extra budgetary research and development funds began to be based on voluntary contributions of enterprises, up to 0.5% of gross profit. The changes in the procedure of contributions to extra budgetary research and development funds implied actually an almost double reduction of contributions to the RF TDF (by industries which make such contributions). As a result, in 2004 the RF TDF had enough money only to be able to comply with its obligations under previously concluded agreements rather than finance new projects.

At the same time, introduction of new criteria of classifying organizations as extra budgetary funds led to changes in composition and number of extra budgetary funds. Unlike previous years when extra budgetary funds were supposed to be established only under federal executive authorities or commercial enterprises or associations of enterprises, in 2004 extra budgetary funds had to be exclusively non-profit organizations in accordance with the new requirements. As a result, the RF TDF's operation was frozen, which may have an adverse effect on innovation activity and applied cross-disciplinary research, while having in mind that the cross-discipline principle is the key development of science.

3.5.9. Private and Public Partnerships

The issue of promoting private and public partnerships (PPP) became more relevant in 2004 than in the previous years. The term "private and public partnership" means using mechanisms to promote private business participation in innovation activity. PPP promote pooling resources, sharing profits and risks, creating a competitive environment and utilizing efficiently budget funds.

The practice of private and public partnerships in various advanced countries shows that such mechanism can be used whenever the government and businesses have complementary interests while being unable to act independently and separately. Among the PPP forms which are most commonly used in research and technology and innovation fields are cofinancing research and development projects at a pre-competitive stage (industrial enterprises are encouraged to be involved on the basis of getting entitled to utilize the findings of the research for business purposes); co financing at initial stages of commercialization (seed financing); establishing joint research centers in the fields which traditionally fall within the scope of the state (healthcare, environmental protection, national defense). Since PPP provide for a fairly complex management, it is essential to initially identify zones of responsibility of the state and the private business, as well as provide for risk-free mechanisms of their revision for each party.

Of most interest is the PPP practice established in the Southeast Asian countries, where an innovation breakthrough took place. PPP was one of the basic initial mechanisms that was used along with building a material infrastructure of innovation activity and licensing patents of foreign technologies. Implementation of two concurrent processes – mastering the methods developed in mature economies and creating conditions for creating domestic environment for innovative development and ensuring a leading role of the private sector in the national system of innovations – resulted in increased financing of the research and innovation sectors by the private business. To date, the ratio of public and

private involvement in the research and development sector is 1:1,5 (Singapore, Malaysia) to 1:3 (Korea, Taiwan)³⁴.

Basic provisions on development of private and public partnerships in the Russian sector of research and innovations were developed last year. The ongoing mega projects, development of infrastructure of the national innovation system and regulation of rights to findings of research and technology activity received top-priority. The latter is fairly important, and a corresponding draft government regulation was developed as early as in January 2004, yet not adopted due to lack of consensus with the RF Ministry of Finance. The approved draft regulation "On the Procedure of Execution of Rights to Outcomes of Research and Technology Activity Obtained Through Federal Budget Financing" contains a provision stating that "an organization shall retain rights to findings of research and technology activity obtained through federal budget financing as subsidies and subventions for grants and financial support. Such financing shall be provided under the condition of affording a right to the Russian Federation to uncompensated non-profit utilization of such findings with a view to performing works or supplying goods for public purposes". The same government regulation provides a legal initiative for the development of Russian laws similar to the Buy-Doule laws and other laws and regulations aimed at improving the regulatory and legal framework related to protection and utilization of findings of intellectual activity obtained through federal budget financing, on the basis of securing rights to these findings for the originators with simultaneous creation of conditions of commercialization. Another federal law is also suggested for development, which would typify the American Stevenson-Widler law.

According to the American practice, the laws should be adopted at one time because of their interdependence. In the United States, both laws were intended to promote commercialization of research and development financed by the government. The Buy-Doule law is applied to the patent rights to research and development findings obtained through public financing, while the Stevenson-Widler is applied to regulate research and development ownership in the case of research jointly conducted by public research laboratories and external partners.

Any delay in adopting laws on intellectual property rights is interfering with efficient utilization of such property. According to the Federal Service for Intellectual Property, Patents and Trade Marks, a share of research and technology findings in Russian economic turnover is 0.4% against 70% at the developed countries.

One of the PPP options utilized in practice is mega projects³⁵ or major innovative projects implemented by teams comprising scientists and industry representatives. The projects were selected primarily on the basis of joint interests of science and business, as well as high economic efficiency of a particular project as judged by representatives of the former Ministry of Industrial Science. The mega projects are based on the idea of risk sharing between the state and businesses in development of new technologies. To date, a total of 12 projects are being financed.

Experts are wary of the mega projects in terms of their implementation. First, there was lobbying in their selection. Second, one question remains to be answered: whether these projects are innovative or it is a mere financing of modernization of production? In other words, it remains to be seen whether public financing of such projects is substantiated, or they are supposed to be financed by business instead?

³⁴ At the Threshold of Knowledge Economics (Global Practice in Research and Innovative Development) / Edit. A. A. Dynkin, A. A. Dagayev. M.: IMEMO, RAS, 2004. P. 86, 90, 93-94.

³⁵ For more details on the mega projects refer to: Dezhina I., Saltykov B. Promotion Mechanisms of Research and Development Commercialization. Scientific Works, No. 72- P. M.: IET, 2004. P. 107-108.

Foreign experience testifies to the fact that subject matter is always considered in allocating budget funds to applied research and development as part of a PPP. Projects considered for financing must comply with national priorities or be highly potential in terms of social impact. In this case, private sector's profit from development of such projects should not be evident in the period of assessment.

Neither field of research nor its social significance are essential in the Russian version of selecting mega projects. Initial findings were expected to be assessed at the end of 2004, while total effect of the program on mega projects unless 2006. These terms, however, were extended, and the initial findings still remain to be published. Upon introduction of a new budget classification, the item of expenditures on mega projects was divided between two ministries. Now, 72% of total financing of mega projects goes through the Ministry of Education and Science, while the remainder funds – through the Ministry of Industrial Energy³⁶. It remains to be specified how the development of the program on mega projects will be coordinated in general.

A Seed Innovation Fund or “Fund of Funds” which was established in 2000, can be considered as a form of PPP, whose funds may form the basis for establishing sectoral and regional seed funds. To date, efficiency of the Seed Innovation Fund has been poor in terms of the funds established (two funds were established in total). Not much success has been achieved in the experience of seed financing in supporting promising innovation projects through the mechanisms of seed fairs supported by the Ministry of Education and Science. As a result of 5 seed fairs, less than 1% of the participants could find investors and nearly 6% of them are conducting negotiations.

In 2004, there was a down ward trend in seed financing of high-tech on the part of Russian investors at the background of dominating foreign investments. Total volume of seed investments also declined as compared to 2003. Due to undeveloped conditions for seed financing in Russia, there is a widely applied scheme under which research and development is financed in Russia and further commercialized in other countries. Promotion of private and public partnerships is therefore becoming one of the topical measures in creating a favorable innovation environment.

3.5.10. Shaping Infrastructure of Innovation Activity

In 2004, both financial and physical infrastructures developed, which are primarily designed to support small innovation business. However, the number of small enterprises registered in industry as “science and scientific service“, remained steadily negative. Small innovation firms are concentrated not only in the “science and scientific service” sector used for statistical recording, but also in other sector of economy. According the estimates of the Fund for Small Business Promotion in Science and Technology, nearly 120 thousand small enterprises are operating in the industrial sector. Supposing that at least nearly 1/4 of them were innovative ones, the assessment of total number of small innovative forms should be doubled. However, these figures are tentative. The problem of inadequacy of statistical base in the field of science is getting greater, since the lack of clear picture of an object may compromise any attempts in making a reform.

In 2004, the IET conducted a pilot survey of 25 successful small innovative enterprises. The firms included into the survey were selected among the winners of the “Russian Innovations Contest” which is regularly held since 2001 by Expert magazine under the auspices of the RF Ministry of Industry, Science and Technologies and the RF Ministry of

³⁶ Berdashkevich A. On Organization of Financing in Science and Education in 2005 // Innovations 2004. No. 8. P. 5.

Nuclear Industry. The survey was intended to study the conditions for development of small innovative business³⁷.

Analysis of companies' profiles showed that a small science-intensive company can grow on the basis of one of the following four basic options: where scientists and engineers quit their research institute and retain the right to their research work (1) or already patented technology (2); where former researchers return to science-intensive business on the basis of initial capital they gained in other type of business (3); by creating an alliance of scientist and businessman (4).

Option 1 is most common, i.e. this is a classic situation of "technology push", when the process is started from the development rather than market demand. Option 4 is most infrequent, when businessmen who are interested in starting manufacturing science-intensive products perform the following actions: marketing research, search for developers, provide research and development and finally private production. Option 4 is opposite to option 1. In this case the demand is dictating the order of technological research works (demand pull), and this approach normally appears to be success. Thus, so far the from-research-towards-market approach remains dominating rather than visa versa. In this case, new research works may not always result in innovative advance and improved competitiveness, since they may find no demand. Even the "technology" term differs in meaning for scientists and businessmen: the former define the term as new knowledge, while the latter define it as a debugged production line.

The survey revealed that innovation infrastructure established with participation of the state for promoting small innovation businesses is inconsistent: representatives of small firms focused on the importance of the existing innovation promotion funds rather than physical infrastructure. So far, such elements of infrastructure as technological parks and innovation and technology centers (ITC) are considered by managers of small companies more as nice premises for rent rather than structures enabling to promote small enterprises renting these premises. There is a good reason for scepticism in regard to the ability of industrial infrastructure: it is well known that many technological parks and ITC were established exclusively for the purpose of receiving additional budget allocations without market evaluation of the potential of an infrastructure being created.

In 2004, an issue of creating new elements, clusters, of the innovation structure was brought up. The clusters have been gaining a wide usage worldwide as a form of network interaction due to growing interdisciplinarity and interdependence between all participants of innovative process. The clusters normally mean a network of independent enterprises, scientific organizations, universities, services for interaction of science and production, professional consultants and brokers, as well as customers united in a single production chain producing any value added³⁸. It is agreed that the clusters can improve significantly labor productivity. At present, innovation clusters are being spontaneously developed in a limited number of regions. The clusters can be formed both by initiative of regional authorities and business. The Ministry of Industrial Science jointly with the RF TDF also launched an experiment on establishing two new industrial clusters in Saint-Petersburg and Zelenograd, but the initiative was suspended due to reorganization of the Ministry of Industrial Science and frozen operation of the RF TDF³⁹.

³⁷ Dezhina I., Saltykov B. Promotion Mechanisms of Research and Development Commercialization. Scientific Works, No. 72-P. M.: IET, 2004. P. 94–103.

³⁸ Boosting Innovations: The Cluster Approach. Paris: OECD, 1999.

³⁹ Fomichev Yu., Naumov A. Involving Intellectual Property Objects into Economic Turnover: Challenges and Solutions // Intellectual Property. Industrial Property. 2004. No. 3. P. 9.

An example of a cluster is found in a research-city in some cases. Yet, this form of innovation promotion is not efficient enough. Four years of implementation of a development program on the first research-city (city of Obninsk) showed that stable, grant-free and self-financed development of the city failed, no integration between the science and industrial sectors was achieved, the number of young researchers failed to grow at the background of scientific labor outflow of Obninsk. Such situation was caused by organizational and administrative failures committed in particular by the municipal executive authorities acting as the general contractor of the program, who consider the current matters of municipal economy as top-priority, not innovative development. In addition, no mechanisms of monitoring and adjustment of the program were developed⁴⁰.

Due to poor efficiency of the existing infrastructure (research-cities, technological parks, incubators), the government has been seeking new and highly efficient types of innovation infrastructure. In particular, late in 2004, the issue of special economic zones (SEZ) in Russia was brought up again. A Federal Law "On Special Economic Zones in the Russian Federation" is to be submitted to the State Duma for consideration not later than on March 1. One of the two types of zones – technological and commissioning ones – should be established on the territory within not more than 2 square kilometers which a view to establishing and industrial commissioning research and technological products. The first practical step in establishing SEZ was formulated as a national task of creating several technological parks in the field of information technologies (IT). The case in point is to establish 4 technological parks till 2010 in Dubna, Chernogolovka, Saint-Petersburg and Nizhy Novgorod. Tomsk Region is being considered as a construction site of such technological park.

Construction of an IT technological park was commenced in Dubna prior to the date when it became a strategic task of innovation development. A group of companies Information Business Systems (IBS) was the originator of such technological park. Ten thousand Russian software specialists are expected to participate. Boeing Company expressed its intension to invest in development of the technological park as well as the infrastructure being under development at Saint-Petersburg .

A Nizhny Novgorod technological park will be established on the basis of the Sarov Federal Nuclear Center. AFK System will be the investor of record. The regional government has already allocated a site for the project, and AFK has purchased a controlling interest from Sarov System Technologies Transfer Center management company, as well as invested nearly \$1 million in first-stage construction of the technological park. Sarov System is currently negotiating on participation of international corporations in the technological park. Intel may be one of the first ones.

It should seem that IT sector has been selected due to a short-term return. The Indian experience is also worth considering. India has achieved a share of up to 12.5% in the world export market of software products. The Russian share still accounts for 0.7%. Such selection, however, is ambiguous because IT can not be included into the list of industries in which Russia has competitive advantage. Since high qualification of Russian software specialists is universally accepted and their wages are higher than that of their Indian or Chinese counterparts, it is quite natural that Russia is occupying a sophisticated software niche in the market. However, the market share of software is objectively small, which provides no reserves for future growth. This is why IT technological parks is a continuation of offshore outsourcing as well as further development of the scheme under which the country is selling research and development rather than ready-to-use technologies.

⁴⁰ According to the materials of the Committee of Social Council for Research-City Issues, city of Obninsk .

Though a new law on SEZ is expected to reflect specific features of the IT industry (including taxes and customs duties), elimination of administrative barriers would be one of the basic incentives for innovation development within the framework of technological parks. According to the Ministry of Economic Development and Trade, creation of a single zone infrastructure is estimated to cost \$100 to 150 million. These figures seem to be overestimated as compared to the foreign practice in establishing technological parks: the average costs incurred on technological park development in the United States and Great Britain is \$10 to 12 million, and nearly \$100 to 200 thousand in Poland. In addition, the existing estimates on the Nizhy Novgorod technological park show that it would cost \$28 to 29 million. In doing so, it is important that SEZ should comprise various types of infrastructure, including developing lines, social sector and utilities sector, road network. Efficiency of new technological parks will depend on the principles representing the mechanism of companies selection, as well as the criteria applied.

There are several amendments to the applicable law that could interfere with the development of the clusters, research-cities and other elements of the infrastructure. The Federal Law "On Amendments to Laws of the Russian Federation and Invalidity of Various Laws of the Russian Federation in Relation to Adoption of Federal Laws "On Amendments to the Federal Law "On General Principles of Organization of Public Legislative (Representative) and Executive Agencies of Constituent Entities of the Russian Federation" and "On General Principles of Organization of Local Self-Government in the Russian Federation"⁴¹ is almost excluding from the Federal Law On Science all issues related to the authorities of a constituent entity of the Russian Federation concerning general issues of science which are constitutionally delegated to joint administration of the RF and constituent entities of the RF. Science is not included in the list of issues of joint administration on which RF constituent entities may utilize their budget funds. Innovation structure is established on the basis of cofinancing by the federal and local budgets. Moreover, according to a revised version of the Law on Science, only "procurement and financial provision of scientific and technological activity of government agencies of RF constituent entities shall fall within the authorities of government bodies of RF constituent entities" (paragraph 3, clause 12)". Since no scientific organizations fall within the authorities of RF constituent entities, it means that RF constituent entities are not supposed to finance scientific and innovation activity. Some clauses of the provision were amended late in 2004, when a Federal Law "On Amendments to the Law of the Russian Federation In Relation to Accretion of Powers of Government Authorities of RF Constituent Entities On the Issues of Joint Administration of the RF and RF Constituent Entities, As Well As In Relation to Enlargement of the List of Local Issues of Municipalities "⁴² was adopted. Pursuant to the Law, RF constituent entities may initiate and implement regional scientific and technological programs and projects (paragraph 53, clause 11).

In 2004, the RAS conducted preliminary actions and made organizational changes for establishing its own innovation infrastructure. At present, the RAS framework includes several structures intended to provide centralized record keeping of the ongoing innovation process at institutes within the RAS, namely a Working Committee for Intellectual Property under the RAS Presidium, Steering Committee for Innovation Activity under the RAS, Innovation Agency under the RAS, ITC Association under the RAS. A Department for Intellectual Property is under development with the RAS framework. It will specialize in building up a data base of most promising and commercially potential research works,

⁴¹ Federal Law of August 22, 2004, No. 122-FL.

⁴² Federal Law of December 29, 2004, No. 199-FL.

monitoring intellectual property turnover at RAS institutes, developing major innovation projects under the supervision of the RAS, patenting-related activity. In addition, a concept creating an “innovation belt ” around the RAS is under dynamic development, which would comprise technologies promotion centers (TPC), technological parks, research-and-development-based cities and other elements of infrastructure, and for commercialization of research works “ under RAS copyright ”⁴³.

Technologies promotion centers were established both within the framework of the RAS and other sectors of science. To date, the majority of TPC have been operating for a period of one year or so. Most common challenges that are facing almost all TPC in the inception period are as follows. First, on the one hand, scientists are poorly prepared for commercialization of the findings of their research, quite often they have no desire to conduct this kind of work. On the other hand, some believe that they have sufficient resources to do everything autonomously, while TPC may help only through supplementary financing. Second, the majority of research and development findings are poorly designed for commercial utilization: a model is normally made rather than the end product. Third, there are problems related to legal provision, especially in regulating relationship between employees and employers on a contractual basis. As a consequence, organizations have no information on the research work performed by their employees. There is another material loophole in the law regarding regulation of rights to intellectual property. Finally, forth, there is a general lack of information on findings of research works at different organizations. Some TPC started to establish information networks due to this problem.

At present, TPC are operating at the stage of revision of research works of those institutes they were developed at, or organizations of the regions they are located in. Corporate markets survey is less intensive due to lack of qualified managers of these centers. The share of commercial services accounts for not more than 5% of total TPC works performed, yet there is no such profit item for TPC as revenues from licensing of revenues. Basic revenues sources in TPC’s budgets are public budget allocations, financial support from the “parent” institute or region, and grants. Efficiency of the established TPC remains to be measured, however the Ministry of Education and Science made a decision to finance establishing of another 10 centers. General practice of supporting TPC is that the government provides them with financing for a period of 7 to 8 years, whereupon such structures should become self-financed.

Managers of such centers believe that their further development will be related with more involvement in a START program implemented by the Promotion Fund for Small Enterprises in Science. In 2004, 474 projects on small innovation enterprises were financed to a total amount of RUR375 million as part of the START program ⁴⁴. There were approximately 6 bidders per grant. The program should end up as follows: establishing and developing a new small enterprise employing 5 to 20 persons by the end of the third year of operation, a volume of sales of innovation products is supposed to reach at least RUR600 thousand as per 1 employee per year. Another 400 projects within the framework of the START program are scheduled for financing in 2005.

The START program received a complex respond by scientific environment. So, managers of various RAS institutes and universities consider it as destruction of scientific organizations which top researches would resign from to get employed at small innovation business enterprises. Their opponents argue that a combination of research work or professorship at a

⁴³ According to the materials of the Conference on Innovative Management in Global Environment, September 22, 2004 . M. : the RAS , 2004.

⁴⁴ For description of the Start Program refer to : Russian Economy in 2003. Trends and Outlooks. Issue 25. M.: IET, 2004. C. 269–270 .

higher education institution and establishing a small business company should be permitted. Such requirements are likely to give evidence of poor viability of the institutes that can be adversely effected by resignation of several researches. According to the practice of foreign countries, implementation of similar programs always requires either a full resignation of a researcher from his/ her scientific organization or his/ her temporal employment at a small enterprise over a fixed period of time (2 to 3 years in general).

Both effectiveness and impact of the START program on development of small innovation business remains to be seen, because it takes at least one year until definite findings are revealed thus enabling success to be assessed: by this time small enterprises are expected to find an investor for further development. Only 3% of the candidates had found an investor by the time of selection of offers, while 12% had preliminary arrangements with potential investors⁴⁵. In addition, only nearly 5% of the bidders had rights to objects of intellectual property. The general picture is expected to be improved in one year of the START program. The estimated success of the program seems to be reliable, nearly 10%.

Besides the START program, the Promotion Fund announced inception of a new TEMP program. The program is intended to stimulate innovations in industry and simultaneously promote development of relationships between small enterprises and large and medium-size businesses. The Fund intends to support small enterprises in irrevocable and grant financing of research and development to be conducted upon purchasing a license from scientific organizations, higher education institutions or physical entities. Thus, research and development that holder of license (basically) and licensor need to conduct for license utilization will be payable. The Fund is ready to consider proposals on participation in a program of medium-size and large enterprises provided that they organize work with participation of a small enterprise and ensure production capacity for manufacturing licensed products for the same purpose. In general there are two options to select: either a license is purchased and utilized autonomously or jointly with small and large (medium-size) enterprises. In this case, a small enterprise is acting as research and development performer, developer of technology and, maybe, series of trial products, and production supporter.

Great care should be taken when allowing large enterprises to get involved in the program, because the government in the name of the Fund is likely to start financing the costs that should be covered by the enterprise if the latter is interested in purchasing a license for real. There is a high risk of the government performing private business's functions.

Implementation of the TEMP program is expected to reorient enterprises from importing equipment towards purchasing research solutions developed by domestic scientists. The Fund expressed its interest in promoting commercialization of the rights to such intellectual property that was developed with federal budget financing. Therein lies the key problem. The period of several months since the announcement of the program showed that it was facing a big problem of unregulated rights to intellectual property. This is the main reason for having no offers for the tender as of February 1, 2005.

There is another initiative being under consideration – establishment of an Investment Seed Fund which would operate along with the existing Innovation Seed Fund. The new Fund is primarily intended to finance innovative and infrastructural projects related to industries' development strategies.

The idea of establishing a new fund was born at the Ministry of Economic Development and Trade. It represents the old idea of creating a development budget within the federal budget. The fund is expected to be based upon financing with the Stabilization Fund, its budget being at least RUR60 billion, but it would be granted the status of extra

⁴⁵ Soloviova O., Shubin M. First Round Findings of the Start Program. (2003 to 2004) // Innovations 2004. No. 8. P. 21 .

budgetary fund. Such status is needed for borrowing private funds and receiving revenues from investments.

The current model of the new Fund is nothing but conceptual one, since neither management form nor key supervising agencies have been determined yet, nor procedures of budget funds utilization have been specified. At the same time, the idea of inter-connecting infrastructural and innovative projects is considered promising. Creating a favorable innovation environment (in clusters and other similar structures) implies simultaneous formation of all types of infrastructure. For example, it is simultaneous development of transport, public utilities and innovative infrastructures that makes special economic zones successful in China .

3.5.11. Considering Mechanisms of Indirect Regulation in Science and Technology

In 2004, the Ministry of Education and Science proposed a set of measures, primarily taxation initiatives, aimed at indirect promoting research and development activity. The Strategy contains a list of corresponding initiatives, though too many of them. For example, it is suggested: to simultaneously introduce accelerated and additional depreciation; to charge research and development costs to product cost to the amount not more than 100% of research and development costs; to differentiate rates of single social tax and VAT for innovation enterprises and introduce tax allowances at the initial stage of their operation; and to simplify tax collection procedures. Tax preferences are suggested to be concentrated at technological parks, innovation and technological centers, technological clusters. In particular, the single social tax rate is scheduled to be reduced from 26 to 14% at IT technological parks as part of the Law On Special Economic Zones which is under development. Local taxes are expected to be reduced as well. This is one the conditions for SEZ formation.

The proposed measures on tax incentives are not based on careful calculations, since neither comparative nor introduction priorities were determined by type of tax initiatives. It was not specified whether the proposed tax allowances may be applicable to seed investments. In addition, it was not indicated how the proposed VAT allowances agree with the government's plans on further reduction of the VAT rate.

General legislative environment in the research and technological field has great loopholes, which is interfering with introduction of indirect regulation measures. Up to now, no decision has been made on whether a special law on innovation activity is needed (there was a prevailing opinion last year that such law is needed), and how basic definitions and terms related to innovation activity and specific forms of their financing could be legalized. Tax allowances can not be introduced for this type of activity until the "innovations" term is clearly defined by the law.

The foreign practice shows that a great care should be taken in applying indirect regulation mechanisms in research and technological field, as well as tax allowances should be introduced step by step. Tax initiatives are in common use in stable economies, since tax incentives offer a variety of advantages over direct budget financing. It keeps the public sector autonomous and ensures its economic responsibility for selection of research trends and implementation of such research. Furthermore, it requires less bureaucratic paper work at all governmental levels and is not tied to annual budgeting process involving mandatory approvals of allocations and coordination of interests of various departments. Finally, indirect regulation offers political advantages as represented by less social resistance against general tax allowances as compared to subsidies for selected companies. This is why tax allowances, which are originally introduced on a temporal basis, are maintained and extended in the majority of countries.

Over the last 20 years, a great number of macro and micro-level scientific research have been performed at various countries to study effects of introducing tax allowances in the field of research and technology. Specialists of the majority of countries where tax allowances are being in effect agree on a positive impact of such as based on the findings obtained. It has not been proved, however, that tax allowances are always an effective mechanism of borrowing private investments for research and development⁴⁶.

The recent research conducted in Great Britain shows that introduction of a new crediting system – tax credit – in the field of innovation and technologies has not proved effective yet. Therefore, it has been decided neither to expand tax allowances nor introduce new ones until the impact of the existing tax allowances is carefully analyzed⁴⁷.

The issue of introduction of tax credit in the research and development field was brought up in Russia as well. The RF Ministry of Economic Development and Trade, which proposed to introduce this type of tax allowances, believes that it could be feasible for research and development despite the fact that such experience has not revealed much success in this country.

In spite of the fact that introduction of the proposed tax allowances seem to have not been substantiated, the fact the Strategy was updated with a section dedicated to indirect regulatory measures for research organizations rather than innovation enterprises is noteworthy. In addition, it should be noted that innovation activity can be promoted not only through direct financing and tax regulation. Introducing a system of standards, including environmental ones, which force the business to perform innovations, is a universally accepted mechanism.

* * *

Innovation development trends are indicative of two ongoing processes: businesses have been starting to build up their own research data base and developing cooperation with research organizations, while the government has been creating an infrastructure which is not always in demand as was originally expected. Governmental influence on development of innovation activity in industry remains minimum. At the same time, development of various forms and volumes of support for science by the business sector are indicative of the fact that nonparticipation of the government has a positive impact against its attempts in regulating or even cofinancing various projects. However, new signs of interest in direct stimulation emerged in 2004 in spite of dominance of such form of support as direct government financing of selected initiatives.

The year 2004 also showed that legal regulation problems related to the research and innovation sector remained unresolved, or any corresponding decisions were delayed, or amendments to the law were found to be ill-considered and needed urgent correction. At present, there is no governmental structure which would represent interests of the research and innovation sector in general and be able to assume key coordination functions in this field.

⁴⁶ At the Threshold of Knowledge Economics (Global Practice in Research and Innovative Development) / Edit. A.A. Dynkin, A.A. Dagayev. M.: IMEMO, RAS, 2004. P. 168.

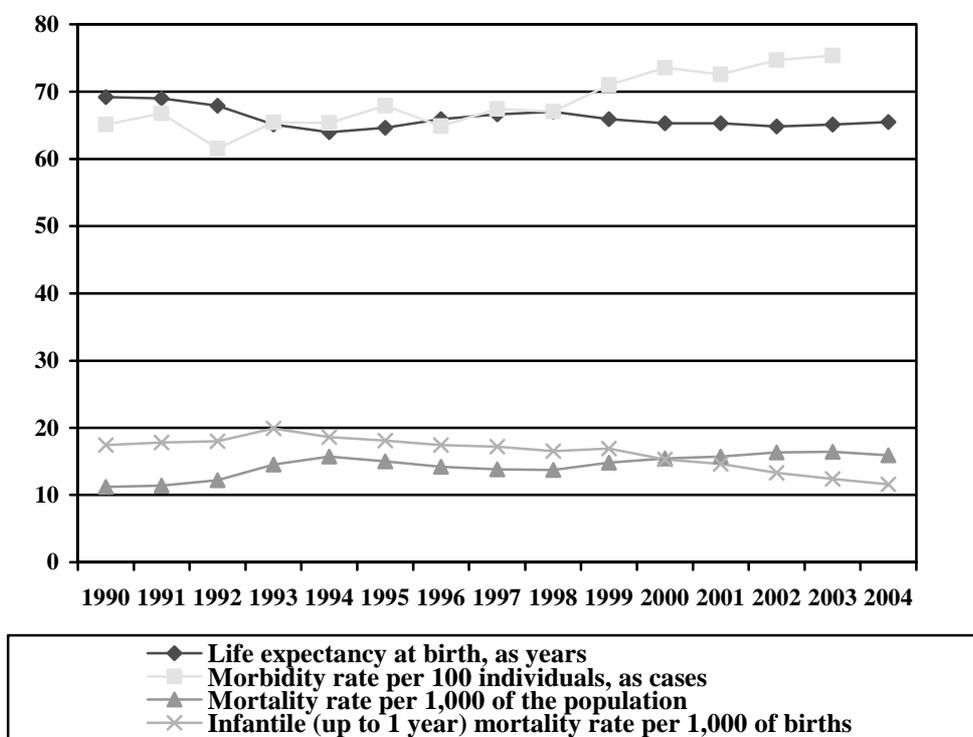
⁴⁷ Review of Cooperation Between Universities and Businesses in Great Britain. R. Lambert's report. London. December 2003. P. 15.

3.6. Sub-sectors of the Socio-Cultural Sphere

3.6.1. Health Care

Main Indicators of the Health Care Institutions' Performance

The Russian population's morbidity and mortality rates tend to grow (Fig. 70). However, in 2004, it was the first time over the last five years the mortality rate per 1,000 reduced (from 16.4 in 2003 to 15.9 in 2004). Besides, infantile mortality rate decreased essentially over the last five years: from 16.9 in 1999 to 11.6 with per 1,000 births. Life expectancy indicators at birth have stabilized, albeit on an extremely low level. In 2003, this value equaled 65.5 years, for men – 59.1 years and for women – 72.5 years.



Source: according to the Russian Statistics Agency data.

Fig. 70. Indicators of the State of Russia's Populations Health

So far as fundamental principles of provision of medical assistance are concerned, the Russian health care system has not much changed vis-avis the Soviet times. Nowadays it comprises a countrywide medical-preventive institutions network, a great number of hospital beds, and a great number of medical doctors. Over the last 15 years volume indicators of the hospital system were declining (Table 39). The number of beds per 10,000 of the population in 2003 accounted for 81% vis-a-vis 1990. The number of medical institutions has fallen by 21% since 1990, but the number of polyclinic institutions did not change that much. By contrast, the number of medical doctors was steadily growing: in 2003 it at 7% exceeded the respective 1990 level and accounted for 48 medical doctors per 10,000

of the population. By contrast to that, the number of the nurses per 10,000 residents fell approximately by 13% during the 1999–2003.

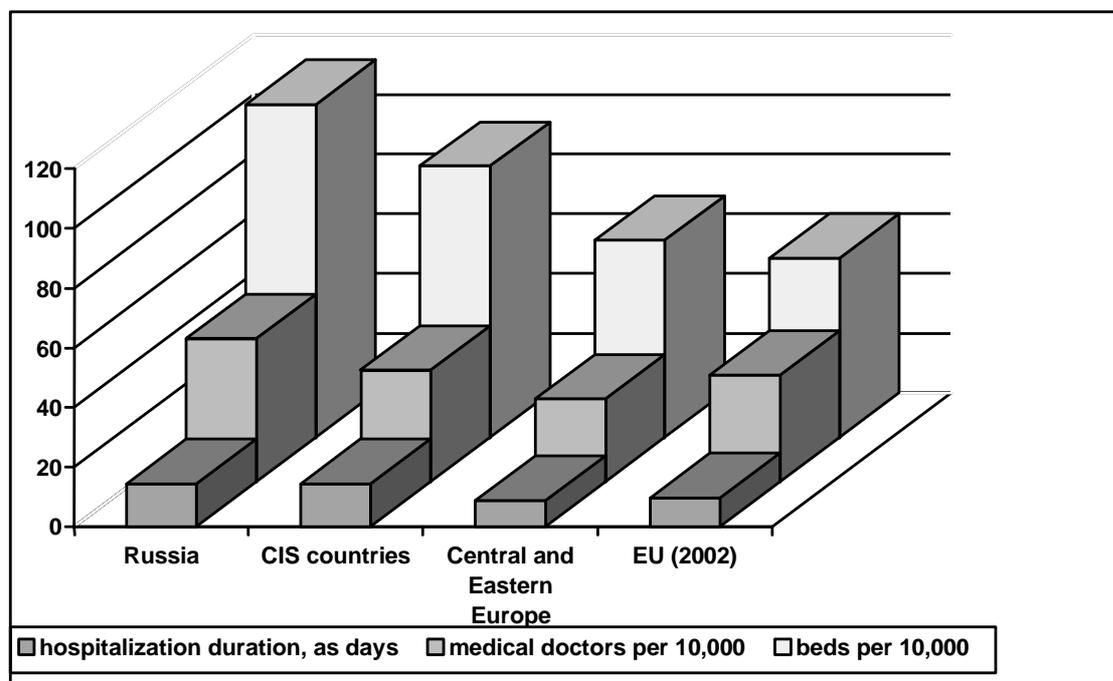
Table 39

The Medical-Preventive Institutions Network in Russia

	1990	1995	2000	2001	2002	2003
The number of polyclinic institutions, as Thos.	12,8	12,1	10,7	10,6	10,3	10,1
The number of hospital beds per 10,000 residents (as of the end of the year)	137,5	126,1	115,9	115,4	113,7	111,6
The number of polyclinic institutions (independent and belonged to other institutions), as Thos.	21,5	21,1	21,3	21,3	21,4	21,5
Capacity of medical polyclinic institutions per 10,000 residents (as of the end of the year), as visits per shift	217,4	235,6	245,0	247,6	250,2	248,7
The number of doctors per 10,000 residents (as of the end of the year), as persons	45,0	44,5	47,2	47,3	47,9	48,0
The number of nurses per 10,000 residents (as of the end of the year), as persons	124,5	111,0	108,4	107,8	109,3	108,5

Sources: Rossiysky Statistichesky Yezhegodnik. M.: Rosstat, 2004; WHO Regional Office for Europe health for all database.

In spite of the above-mentioned reductions, the Russian health care vis-à-vis European countries and even CIS countries still enjoys greater indicators of provision of the population with doctors and hospital beds. But the efficiency of the use of the available resource potential is low. A great sufficiency of beds goes in pair with a longer duration of hospitalization (Fig. 71).



Sources: Rossiysky Statistichesky Yezhegodnik. M.: Rosstat, 2004; WHO Regional Office for Europe health for all database.

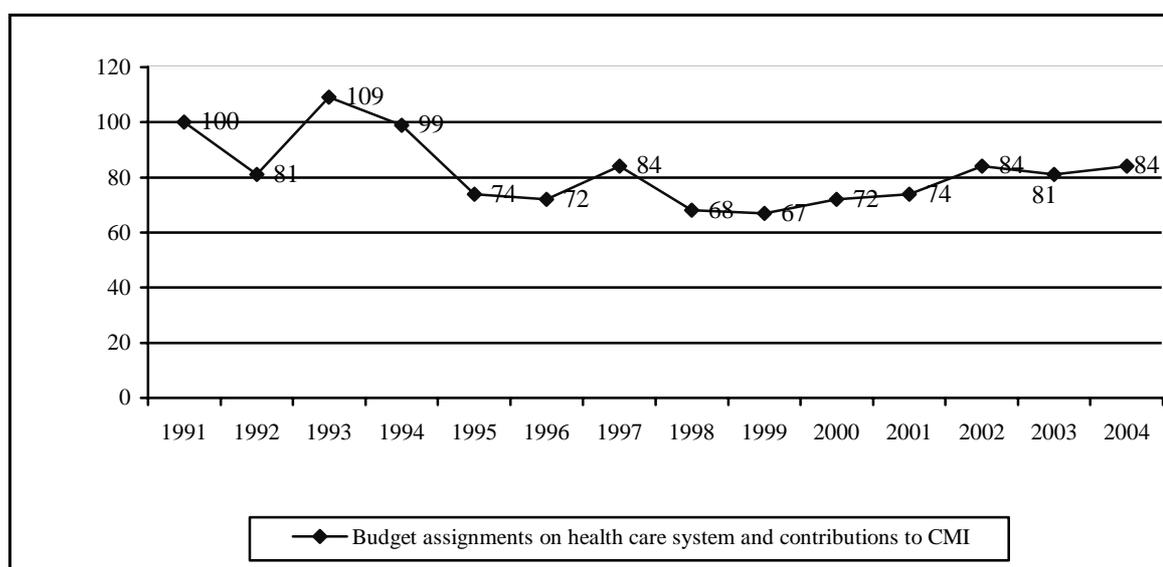
Fig. 71. Indicators of Health Care Systems, 2003

Stationary medical assistance prevails over the system of medical services in the country. Meanwhile, according to the assessments of the RF Ministry of Health Care, more than 30% of hospital patients could receive an effective medical assistance on the outpatient basis. According to insurance company “ROSNO-MS”, 24% of hospital patients as a minimum had diagnoses that did not require a stationary treatment. When checking the validity of the medical bills submitted by hospitals, the insurance company exposed shortcomings of the organization of medical assistance in 10% of stationary treatment cases. The main causes underlying the inefficiency of medical services are extension of treatment term and hospitalization without sufficient medical diagnoses.

The health care system comprises a complex of fundamental economic problems that reproduced themselves over the last 10 years:

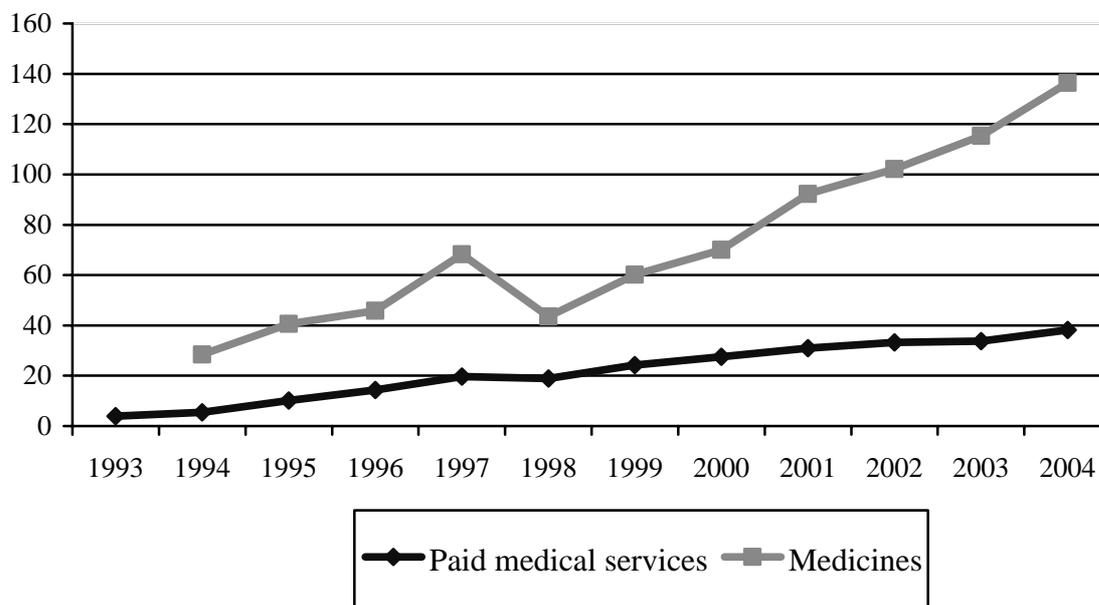
- financial insufficiency of the state guarantees of medical assistance to the population;
- unregulated replacement of the state expenses by private ones without revision of guarantees;
- incompleteness of introduction of the compulsory medical insurance system;
- considerable differentiation of the amounts of the state financing across regions;
- absence of economic mechanisms that encourage participants in the health care system to increase the effectiveness of the use of public resources.

The volume of the government financing of the health care system that had reduced by more than one-third in the 90-s began increasing since 2000, but has still failed to reach the level registered 15 years ago (*Fig. 72*). In addition to that, the public guarantees, as in the Soviet times, provide for medical assistance being free for the population at the public and municipal health care institutions, albeit the volume of such guarantees for single individual has not been defined as yet. The divergence between the population’s expected volumes of their provision and real capabilities of the state is immanent for such guarantees. Given the reduced government financing, this divergence transforms into the gap between the declared and real economic conditions of receiving medical assistance.



Source: Calculated basing on the Russia’s Rosstat data

Fig. 72. The Dynamics of the Government Expenses on the Health Care System (1991=100%)



Source: Calculated basing on the Russia's Rosstat data

Fig. 73. The Population's Expenses on Health Care System, as Rb. billion in the 2000 prices

Financing of the medical assistance to a greater extent is shifted onto households and employers. The population's spending on medicines and medical services grows steadily at a high pace, which has not reduced over the last years, in spite of the growth of the government financing, but outstrip it (Fig. 72 and 73). The replacement of the government expenses by private spending is a spontaneous process. The attempts to regulate the process are undertaken on the micro, rather than macrolevel. A high real level of the population's contribution to paying for medical assistance does not go together with a revision of inadequately fulfilled guarantees.

Compulsory Medical Insurance

The existing system of compulsory medical insurance (CMI) suffers a number of serious shortcomings that need to be overcome through changing the CMI model itself.

There is no coordination between the CMI programs and the amounts of insurance premiums. This is the fundamental shortcoming. The CMI system accumulates 46% of the aggregate volume of the public health care insurance, while the value of the basic CMI program accounts for 63% of the value of the government guarantees program on free medical assistance to the population. This problem is mainly associated with the breach of obligations with regard to insurance contributions for the non-working population by RF Subjects and local authorities.

In 2004, the government proceeded with its 2003 experiment on the Pension Fund's participation in co-financing of the CMI contributions on behalf of the unemployed pensioners. The amount of resources allocated from the Pension Fund's budget for these purposes has grown from 1.5 billion rubles in 2003 up to 6 billion in 2004. It is intended to increase the amount up to 10 billion in 2005. The experiment and the process of intensifi-

cation of governors' dependence on the federal center have recently contributed to a considerable growth of the amount of contributions for the non-working population, but that does not fundamentally change the situation in the CMI area.

The current CMI model has failed to exert an essential influence on the efficiency of the use of health care resources. The original expectations of the emergence of a competition between the insurers, which was envisaged to have a stimulating effect on their proactive stance in regard to protection of insurants' rights and optimization of placement of orders among suppliers of the medical services, have vanished. The population can hardly choose an insurer. In addition to that, insurers are not subjected to any financial risks in regard to the payment of medical assistance. So they are not interested in selecting more efficient options of organization of provision of medical assistance for insurants.

The basic rate of the social tax that is directed in part to CMI was reduced from 3.6% to 2.8% but its centralized part was simultaneously increased from 0.2% to 0.8%. The 2005 federal budget provides for subventions at the amount of 3 Rb. bln. that are envisaged to be forwarded to the CMI Federal Fund to co-finance insurance contributions on compulsory medical assistance for the non-working population (children). In fact, this forms a compensation for the revenue losses of the CMI system resulting from the reduction of the social tax rate. So, the CMI Federal Fund receives considerable resources to equalize the financial sufficiency of the territorial CMI programs.

The economic mechanisms presently existing in the health care system do not create incentives for its participants to enhance the efficiency of use of public resources. The duality of sources and methods of the public and municipal health care institutions' financing for provision of medical assistance to the population that are envisaged by the basic CMI program pose a main problem, so long as procedures of their financing are concerned. According to the CMI system's design, such kinds of assistance should have been paid only at the expense of the CMI funds, but in practice they continue to be financed both from the CMI system and from the budget. Public and municipal medical-preventive institutions (MPI) receive approximately 50-60% of their resources in the form of the budget financing of maintenance of the institution, about 30-50% from the CMI system in the form of payment for the provided medical assistance and from 5 to 15% in the form of incomes from provision of the population with paid medical services. According to the federal recommendations, the budget and insurance resources should be employed for reimbursement of different expenditure items. In practice, however, some single expenditure items of the MPI are simultaneously covered from the two above-mentioned sources of financing. This creates the institutions' eagerness to spend more, rather than to use the resources in a more efficient manner.

Development of the Health Care Reform Guidelines

The discussion on the guidelines of the much-needed health care reform has been under way in the government since 1997. Between the 2000-2003 the Ministry for Economic Development played a leading role in designing of the respective proposals. The bill on CMI had been developed by March, 2004. It was coordinated with all the agencies concerned⁴⁸. The consequent government reform has changed the configuration of positions. The new leadership of the RF Ministry for Health Care and Social Development began to play a principal role in the preparation of the health care reform proposals.

In 2004, the preparation of the health care reform developed into a new phase. It is worthwhile noting that in official documents the wording "health care reform" was substi-

⁴⁸ For the Concept of this bill see: Rossiyskaya Ekonomika v 2003 godu. Tendentsii i perspektivy. M.: IET, 2004. P. 282-283

tuted by “health care modernization”. In 2004, the Presidential Address highlighted some key avenues of the health care modernization:

- specification of guarantees of free medical assistance basing on development of standards of medical services, which include an array of medical-diagnostic procedures and medicines, and minimal requirements to conditions of provisions of medical assistance;
- transition from the estimate-based principle of maintenance of medical institutions to the payment for the provided volume and quality of medical assistance produced in compliance with the principles of the compulsory insurance;
- fostering incentives for voluntary insurance.

During 2004 the RF Ministry for Health Care and Social Development with the assistance of experts of the Center of Strategic Development was working on the preparation of two bills designated to form a legal base of the health care modernization:⁴⁹

- “On state guaranties of medical assistance”;
- “On compulsory medical insurance”.

The first bill sets kinds of the guaranteed medical assistance. Their current array that should be provided at no cost remains almost invariable. In contrast to the current system of state guarantees of medical assistance, the bill provides for specification of these guarantees across volumes, conditions and procedures of provision of medical services at different stages of medical assistance.

The guaranteed volumes of medical assistance are specified on the basis of standardization of medical technologies. Clinical protocols (sectoral standards) are designed for every kind of morbidity on the federal level. They comprise lists of medical services suggested (doses and application recurrence, levels of provision of medical assistance, etc.). In the framework of the respective list and algorithms of fulfillment of the protocols are common for the whole country.

Basing on the clinical protocols the RF Subjects design clinical-economic standards (CES=s), which specify requirements of clinical protocols and comprise an assessment of the value of the pre-set “package”. CES=s determine actual volumes of medical assistance across every illness with account of peculiarities of the employed medical technologies (both what to do and how to do) and prices of resources. Every RF Subject adopts and employs its own clinical-economic standards.

Clinical protocols and CES=s comprise two parts. The fixed part is formed by a set of medical services and medicines that is compulsory for all patients with a given illness. A volume of services of the fixed part is equal for all patients with the same illness. The variable part is formed by a set of medical services needed for the part of patients with a given illness, depending on peculiarities of its anamnesis. The volume of services of the variable part is computed on account of an aggregate of patients (for example, 60 ultrasonic examinations are required per 100 patients with the diagnosis “Cholecystitis”).

The fixed part of services is guaranteed to every patient, while the variable one is delivered according to medical diagnoses. So far the variable part is concerned, the medical doctor takes a decision in an order that is set by a head of a given medical organization. In case of medical contra-indications to the use of services and medicines included in CES, medical assistance, which is not envisaged by the standard, is guaranteed. But this implies a higher level of decision-making – by a clinical-expert commission under the medical institution.

⁴⁹ Slepnev A.A., Shevskiy V.I., Sheiman I.M., Shishkin S.V. Modernizatsiya sistemy zdravookhraneniya: poisk resheniy//Manager zdravookhraneniya. 2004. №11.

Such a structure of the standard, on the one hand, provides for a specification of the set of medical services and medicines its patients receive, while on the other, it ensures a medical doctor freedom necessary to take decision under conditions of the variety of manifestation of the same illness by different patients.

The procedures of provision for medical assistance in the framework of the public guarantees are based on the following principle: the provision of medical assistance is guaranteed, providing there exists a pre-set “route” of the patient across the levels of provision of medical assistance. A local medical doctor and a general-practice doctor play the roles of an organizer and coordinator, respectively, of provision of medical assistance on other stages. The planned particularized medical assistance on an outpatient basis and in hospital conditions is delivered according to their prescriptions. In case of the absence of the respective prescriptions, the planned medical assistance provides for a direct payment by the patient.

The procedures set a “queue” of the planned particularized medical assistance and maintenance of a list of patients. The queue is to be kept under control.

The bill envisages setting quotas on high-tech kinds of medical assistance delivered both at the federal medical institutions (for the RF Subjects) and at the RF Subjects’ medical institutions of the tertiary level (for municipal institutions). The RF Subjects can introduce additional guaranties in regard to such kinds of assistance – on the basis of direct agreements with federal medical organizations at tariffs that are set for the medical assistance subject to quotas. The lists and amounts of quotas of the respective kinds of provided medical assistance and lists of medical organizations are set annually, according to the federal and territorial programs of state guaranties.

The government agencies of the RF Subjects set the guaranteed conditions of provision of medical assistance on the level not lower than the one set by the federal program of state guarantees of medical assistance. The latter sets requirements to standards of patients’ length of stay and provision with food in hospitals, as well as to the marginal term of waiting for the planned medical assistance.

The state guaranties of medical assistance should be implemented through the compulsory medical insurance system. The bill “On compulsory medical insurance” envisages its modernization.

In order to increase the manageability of the CMI system and the state control over targeted and rational employment of the CMI funds, the bill establishes the principle of subordination of the municipal CMI funds to the Federal CMI Fund. The head of a territorial CMI fund is appointed by the head of the Federal CMI Fund upon consent of the supreme executive body of the RF Subject. Thus created vertical is to ensure the integrity of the system and its financial stability.

In addition to this, the proposed structural modifications ensure that the RF Subjects’ administrative bodies preserve control over the functioning of municipal CMI funds. The representative body of the RF Subject approves of the municipal CMI fund’s budget. The municipal CMI fund sets the standards of the per capita financing of insurers upon consent with the executive body of the RF Subject.

The bill provides for an introduction of social partnership institutions to the CMI system’s administration. The RF agencies, associations of Russian trade unions and employers form the territorial CMI Fund’s supervisory board. The Supervisory boards control the performance of such Funds’ budgets.

The executive body of the respective RF Subject, basing on an agreement with the municipal CMI fund, as well as associations of medical organizations, professional unions

of employers and insurance medical organizations set tariffs on medical assistance of the medical institutions provide to the insureds.

The bill sets a number of requirements and mechanisms that ensure a balance between the CMI programs and financial resources. Insurance premiums of the RF Subject on CMI on behalf of the non-working population should be set at an amount not lesser than that, which provides the balance of the amount formed by all sources designated for financing the basic CMI program and its value. The procedure of calculation of the value of the basic CMI program in the RF Subjects and the methodology of calculation of amount of premiums on CMI on behalf of the non-working population are approved by the RF Government.

The CMI tariffs that are pre-set in the calculation of the price of the basic CMI program cannot be lower than the values computed according to the methodology of computation of minimal tariffs on the guaranteed medical assistance approved by the federal executive agency in compliance with the law on public guarantees of medical assistance, providing the said agency conducts legal regulation in the health care area. As a result, this should increase requirements to the resource-based provision of medical assistance and on this basis help overcome the regions' eagerness to synthetically lower the value of the CMI program and, consequently, the amount of the CMI premiums on behalf of the non-working population.

The equalization of conditions of financing of the basic CMI program in the RF Subjects is made at the expense of both Federal CMI Fund and subsidies and subventions from the federal budget. The CMI financial resources are distributed at the expense of subsidies from the Federal CMI Fund in favor of regions that are unable to collect funds sufficient for the provision of the basic value of the CMI program due to objective social and economic reasons. One calculates the amount of subsidies with a due account of levels of the RF Subjects' budget sufficiency and sets it in the structure of the RF Federal CMI Fund's budget expenditures across single regions.

The subsidies from the Federal CMI Fund are earmarked under the following conditions:

- compliance of a CMI program in a given RF Subject with the requirements to its formation;
- absence of unsettled debts of the RF Subject on insurance premiums on CMI on behalf of the non-working population.

The bill reads that it is insurance medical institutions (IMI) can serve as the CMI insurers. But at the same time the conditions of their functioning are subject to substantial modifications.

1. The bill grants insureds with the right to select an insurer company by themselves, rather than by their employer, as it *de-facto* happens today. This right is fixed in the current legislation on medical insurance and it is secured by the current procedures of change of the insurer, as well as by personified accounting in the compulsory medical insurance system. As a result, the intensifying competition between IMI=s should encourage them to re-galvanize their operations on protection of patients' rights and control over the quality of medical assistance.
2. The bill increases IMI's responsibility for organization of provision of medical assistance: in the event the insured finds it impossible to receive the necessary medical assistance at a selected medical institution (in the frame of a territorial IMI program), the insurer is bound to immediately undertake steps on securing the provision of the insured with the required medical assistance.

3. The bill sets the IMI's obligation to plan volumes of medical assistance delivered as per contract on provision of the medical assistance by CMI, to ensure the consistency of overall volumes of medical assistance to insurants with indicators of volumes stipulated in the territorial CMI program. The insurers are accountable to the territorial office with respect to fulfillment of their contract on provision of medical assistance. These requirements are aimed at an increase of efficiency of the use of CMI funds. Accordingly, the insurant's operations are evaluated on the basis of his contribution to the increase of the efficiency of the use of CMI funds.
4. The bill introduces a system of division of financial risks between the territorial IMI's fund and insurants: the latter will undertake the part of risks associated with the bias in actual spending on provision of insurants with medical assistance from the planned ones. Accordingly, while interacting with medical institutions, IMI=s will not be able to limit their respective functions with the "cashier" one. This should increase their motivation to search for a more efficient structure of provision of insurants with medical assistance.

The bill provides for a possibility of a targeted setting of additional guarantees in the CMI system. The basic CMI program can be complemented with federal and territorial programs of additional medical insurance funded at the expense of additional insurants premiums payable by the RF and/or the RF Subjects, as well as by other entities.

The framework of the effective law bears the problem of duplication of funding the compulsory and voluntary medical insurance and the departmental medical services. At many enterprises, the employers have to arrange a parallel system of medical assistance for their employees, either by using their own medical treatment basis and funding it out of the enterprise' proceeds or by applying the voluntary medical insurance (VMI), thus paying twice for the same risks.

For the purpose of liquidation of the above-mentioned duplication, the bill suggests an introduction of a mechanism of compensations for the part of insurance premium from the CMI funds payable by insurers according to medical insurance contracts.⁵⁰ The provision of premium is conditioned by the conformity between CMI and insurance programs to a medical insurance contract. The premium is provided at the amount of the per capita financing standard per 1 insurant in CMI system. The provision of the premium in such an amount and the simultaneous reassignment of obligations to an insurer, who has entered in a medical insurance contract on financing medical assistance in the volume as per the basic CMI program, will not result in a financial destabilization of the CMI system and will not infringe upon the rights of other insurants under the CMI system. Moreover, the availability of VMI should rise considerably thanks to compensating for a part of the insurance premium as per the medical insurance contract. This will secure additional proceeds in the health care system and foster the transition to more solidary and legal forms of the population's participation in paying for medical assistance.

The CMI requirements, particularly, an introduction of the system of personified accounting of insurants, control over the volume, quality, terms, conditions and validity of provision of medical assistance to insurants, protection of their rights, etc. apply to insurers that exercise their mission in compliance with such medical assurance contract.

According to the noted medical insurance contract, an insurant has the right to resort to the CMI system in emergency cases, which require an urgent interference, while being

⁵⁰ IET introduced and developed this approach over years. (see: Shishkin S.V. Reforma finansirovaniya rossiyskogo zdравookhraneniya. M.: IET; Teis, 2000 // www.iet.ru. P. 316-318; Gudkov A.A., Popovich L.D., Shishkin S.V. Perspektivy sochetaniya obyazatel'nogo i dobrovol'nogo meditsinskogo i sotsialnogo strakhovaniya v Rossii. Sotsial'noye obespecheniye ekonomicheskikh reform M.: Institute for the Economy in Transition, 2002. P. 128-150.

away from their permanent residence, in the event they are in need for provision of a specialized high-tech medical assistance and impossibility to receive the much-needed medical assistance in medical institutions, with which the insurer has contractual relations as per to the respective medical insurance contract. In these cases medical services delivered in the CMI system are payable for to the given medical institution by territorial departments with the consequent reimbursement for these sums by an insurer as per the respective medical insurance contract.

The designing of the bills has been underway until the late 2004. They have not been presented to the Government for consideration. So, disagreements between the Ministry of Health Care and Social Development, the Ministry of Finance and the Ministry of Economic Development across single positions were not removed.

A New Mechanism of Provision of Medicines to “Beneficiaries”

The design of mechanisms of implementation of provisions of Federal Law No. 122 of August, 22, 2004, which envisaged the modification of social benefits delivered in kind for an array of categories of the population (war invalids and participants, veterans; members of families of the deceased war veterans, survivors of the Leningrad blockade, disabled, etc.) became a priority task of the Ministry for Health Care and Social Development (MHCS D) in late 2004. Such benefits also comprise a beneficial provision of medicines (free or with the 50% discount) and the sanatorium and rehabilitation treatment. Since 2005 the mechanism of delivery of medicines, the sanatorium and rehabilitation treatment and traveling to the treatment spots has changed for the respective categories of the population. These kinds of services account for an independent set of social services (the so-called “social package”) that is equal across all the above-mentioned categories and amounts to 450 rubles per month. Expenses associated with provision of the given social package are compensated from the Federal Budget. In 2006, citizens will be able to opt for either compensation in cash, equivalent of the cost of the social package or receipt of services included therein.

The main part of the social package is the provision of medicines equivalent of 350 rubles per month. Free medicines are provided for all the respective categories of “beneficiaries” (earlier just a part of the recipients of benefits enjoyed only the 50% discount for the purchased medicines). MHCS D approved a list of medicines that can be delivered to beneficiaries. It comprises 352 international unlicensed brands, or over 2,000 commercial brands. Basing on the method of qualified selection without tender, the Federal Service for supervision in the sphere of health care and social development under the Ministry selected distributor pharmaceutical institutions that were assigned to supply medicines to distribution centers (drugstores) for the individuals entitled for benefits. The Federal Service made the ability to supply all kinds of medicines included in the list the principal selection criterion. As many as 5 distributor companies matched the given criterion. Each of them has monopolized a given federal district and regional market and become a sole supplier of medicines to the recipients of benefits there. “Proteck” supplies medicines to the Central and North-Western federal districts, “SIA – International” – to the Southern and Ural districts, “Biotech” – to Volga district, and ZAO ROSTA – to the Far-Eastern and Siberian districts. “Farmimeks” company supplies medicines to Ingushetia and Chechnya’s drugstores. In late February 2005, ZAO “Apteka-Holding”, the sixth distributor, was permitted to participate in supplying medicines to beneficiaries.

The network of drugstores provides medicines to the beneficiary categories of the population. The networks are selected by the RF Subjects and local agencies. Medicines

provided to beneficiary categories of the population should be paid for through the CMI system. The Federal Budget funds are forwarded to the Federal CMI Fund, which distributes them across territorial CMI funds as per their requests.

The federal agencies failed to explain to all participants the new mechanism of financing the provision of medicines to beneficiaries. It is worthwhile noting that until November 2004 MHCS D mainly focused on designing the set of medicines, negotiations with their manufacturers and selection of suppliers. The procedures of interaction between all participants in the system have been quickly worked out over the two last months of the year. Legal acts that regulate the procedures of contracts on supply of medicines to individuals entitled for benefits and conduct of the respective calculations arrived in regions only in the last decade 2004.

Originally, it was intended to include insurers who participated in the CMI system in the system of payments. The insurers were to receive resources from territorial CMI. Insurers were to sign contracts on supply of medicines to beneficiaries with the distributors and exercise control over validity of the respective prescriptions by medical institutions. The participation of insurers in provision of medicines to beneficiaries was conditioned by MHCS D. The Ministry demanded that they should obtain a special license on the provision of the respective insurance services. Using the insider information, 12 out of 348 medical insurance institutions that participated in CMI, succeeded in getting such licenses until early 2005. The list of such organizations comprises Alfastrakhovaniye-MS, Gazprommedstrakh-M, Ingosstrakh-M, Maks-M, Kapital, Meditsinskoye strakhovaniye, Krasnyy Krest, ROSNO-MS, Soglaskiye-Vita, Solidarnost' dlya zhizni.

Under control on the part of the Ministry for Health Care and Social Development, insurers identified regions for their further operations and started to conclude contracts with pharmaceutical distributors. The insurers' attempts to intrude into regions where they had not ever operated caused conflicts with local governors, who desired to reassign rights of payment for medicine supplies to the regional insurance companies. The Mayor of Moscow was the strongest opponent and he objected the insurers' participation in this program. As a result, in early February 2005, it was decided to exclude insurers from participation in the payment arrangements for medicines and to use for this purpose solely the Federal and territorial CMI funds. However, 8 insurance companies opposed this ruling in their joint statement.

Distributors started supplying medicines to beneficiaries without a fore-payment, i.e. in the form of commodity credit. The procedural arrangements envisaged that the payment was to be effected upon the end of the first quarter against bills for medicines de facto supplied to beneficiaries. This particular arrangement emerged because the absence of accurate data on real volumes of needs in securing for those entitled for benefits with medicines and, consequently, the impossibility to hold tenders on their supply. Such a decision gave a rise to high risks of emergence of problems with price levels and ensuring the general match between the assortment and volumes of supplies of medicines and the respective demand for them.

The above-mentioned procedure quite naturally gives incentives to distributors to include risk premiums in the prices set by them. According to the Ministry for Health Care and Social Development, it agreed with the manufacturers of medicines on marginal levels of registered prices for medicines that are included in the list at the level lower than the producer prices sales of medicines. The amounts of price caps set by distributors producers and importers' prices were not subject to regulation. Meanwhile, January and February saw numerous cases when the amounts of the pre-set prices on the medicines for beneficiaries were higher than those for the same medicines sold on the commercial basis. In

response to that, MHCS D proposed to conclude agreements with manufacturers (importers) of medicines on additional obligations to exercise control over prices and quality of medicines. By late February 2005, 170 out of 324 manufacturers of medicines included in the list signed such agreements.

Lack of maturity of regulation of the volume of demand for the respective medicines is Achilles' heel of the new mechanism. Medical doctors independently determine the volumes of the prescribed medicines. Insurers were supposed to exercise control over the accuracy and validity in respect to prescriptions medical institutions produced for beneficiaries. But they failed to start this work. MHCS D deliberately refused to impose any restrictions on the volumes of the prescribed medicines during the first months of implementation of the new system. This can be easily explained by the fact that it was keen to exhaust the delayed demand of the individuals entitled for benefits for much-needed medicines and by means of an experiment to find a real volume of the beneficiaries' needs for their provision. According to the Ministry of Health Care and Social Development, the 50.8 Rb. bln allocated in the 2005 Federal Budget in for these purposes (which is much greater than the respective 2004 budget allocations) and honoring agreements with suppliers about the price levels for medicines for beneficiaries will allow to cope with the rise in the delayed demand for the medicines that had earlier been in short supply to the benefit recipients due to regional budgets falling short of funds to pay for them. It was suggested to work out mechanisms of adjustment of the volumes of the prescribed medicines upon the first months of the attempt to implement the new provision arrangement.

During the first two months of the year, the number of medical prescriptions for beneficiaries grew more than 2.5 times vis-a-vis the analogous period of 2004.

There immediately began to arise with benefit recipients failing to get prescribed medicines. However, that was a countrywide phenomenon. MHCS D, along with subordinated institutions, had to fine-tune the procedures of provision of medicines and to intensify administrative efforts to ensure their effectiveness. The Federal Fund formed a centralized pool of resources, which were going to be earmarked between regions in an immediate-reaction mode, once an emergency associated with payment for medicines arose. Mr. M. Zyrabov happened to move from one region to other investigating into causes of the faults with supplies of medicines. According to the Ministry's data, until mid-February beneficiaries received 6.6 mln. prescriptions. About 88% of them were fulfilled.

The new procedures of provision of medicines to beneficiaries made the federal agencies responsible for paying for all the volume of the prescribed medicines, which they do not control. The beginning of payment to suppliers for the sold medicines will form the X-hour. If the government fails to design mechanisms of adjustment of prescription and there remains the procedure of payment against the actual amount of sales of medicines, this would entail either the necessity for the Federal Budget to further raise in its expenditures on these purposes, or in a rise in social tensions fueled by the impossibility to deliver the prescribed medicines in full.

3.6.2. Education

The development of Russian educational system has recently been conditioned by changes in the demographic situation, the dynamics of demands of the labor market, processes of redistribution of powers between government levels, as well as attempts to pursue reforms in this sphere. As concerns considerable changes in this sector, one should note, first of all, the rise in the number of university and secondary polytechnic insti-

tutions students (*Table 40*). The higher education has actually become broadly available in this country.⁵¹

Table 40

Educational Institutions Network in Russia

No	Indicators	1998	1999	2000	2001	2002	2003
1	Quantity of pre-school institutions, as thousand	56,6	53,9	51,3	50,0	48,9	47,8
	A number of children, as thousands	4379	4225	4263	4246	4267	4321
	– as % of children of the respective age	53,9	54,9	56,0	57,2	58,1	57,6
2	Quantity of institutions of general education, as thousand. Including:	67,9	67,5	67,0	66,9	65,7	64,5
	– in public and municipal	67,3	66,9	66,4	66,2	65,0	63,8
	– in non-government	0,6	0,6	0,6	0,7	0,7	0,7
3	Quantity of students of institutions of general education, as thousand	21479	20879	20074	19429	18440	17323
	– in public and municipal	21429	20826	20013	19363	18372	17254
	– in non-government	50	53	61	66	68	69
4	Quantity of elementary polytechnic institutions. Quantity of students, as thousand	3954	3911	3893	3872	3843	3798
		1676	1694	1679	1649	1651	1649
5	Quantity of secondary polytechnic institutions	2631	2649	2703	2684	2816	2809
6	Quantity of students in secondary polytechnic institutions, as thousand	2069	2175	2361	2470	2586	2613
	– total quantity on public and municipal institutions, as thousand	2052	2147	2309	2410	2489	2502
	– per 10.000 of the population	141	148	160	167	173	174
7	Quantity of higher educational institutions	914	939	965	1008	1039	1046
	– public and municipal	580	590	607	621	655	654
	– non-government	334	349	358	387	384	392
8	Quantity of students in the higher educational institutions, as thousand	3598	4073	4742	5427	5948	6456
	– per 10.000 of the population	229	256	294	332	364	388
	– in non-government institutions	251	345	471	630	719	860

Source: Rossiyskiy Statisticheskiy Yezhegodnik. 2004: Stat. sb. M.: Rosstat, 2004. p.227.

The analysis of financing of the system of education shows that the Federal Budget has maintained a fairly high growth rate of spending on education. Between 1999 and 2002 the spending was not lower than 43% annually in nominal terms. In 2003, growth rates reduced, with the rise in expenditures on education accounting 24.6% vis-a-vis 2002, while in 2004 – 21.5% vis-a-vis 2003 (*Table 41*). But the 2003–2004 budgets did not take into account the recommendation of the RF State Council to increase the amount of financing of education by not less than 25% annually. Nevertheless, the share of expenditures on education is growing in the structure of the Federal Budget as well as in Gross Domestic Product (GDP) from 0.73% in 2002 to 0.76% in 2004.

⁵¹ Dostupnost' vysshego obrazovaniya v Rossii / Otv. red. S.V. Shishkin. M.: Independent Institute for Social Policy, 2004.

Table 41

Expenditures on Education in the Federal Budget

	1998	1999	2000	2001	2002	2003	2004
The Federal Budget, as Rb. bln.	388,9	664,7	1029,2	1325,7	1947,4	2354,9	2659,4
Expenditures on education:							
– Rb. bln.	14,6	20,9	38,1	54,5	80,1	99,8	121,3
– as % to the prior year		143,1	182,2	143,0	147,0	124,6	121,5
The share of expenditures one education in the Federal Budget, as %	3,7	3,1	3,7	4,11	4,11	4,24	4,56

Source: Calculated basing on the Rosstat data.

According to the 2004 results, the level of the average monthly wages of employees in the sphere of education remains lower vis-avis the health care and culture spheres (4,824 and 4,747, respectively). Moreover, during the year one noted a slight decline in the level of average monthly wages in the sphere of education relative to the nation-wide average level of wages. The same tendency is typical of the health care and culture spheres (Table 42). The volume of budgetary wages arrears in the social-cultural sub-sectors plunged as much as 2.8 times by late 2004, with the greatest volume of the arrears falling on the educational sphere (Table 42).

Table 42

The Average Monthly Wages Due in the Social-Cultural Sub-Sectors (Less Social Contributions) per 1 Employee, as Rubles

	January	March	June	September	December
Total	5932	6428	7003	6918	7344
Education	3832	4126	4885	4231	4614
– To the nationwide average wages level, as %	65	64	70	61	63
Health Care	4254	4485	5259	4700	4824
– To the nationwide average wages level, as %	72	70	75	68	66
Culture	3927	4132	4595	4265	4747
– To the nationwide average wages level, as %	66	64	66	62	65

Source: Calculated basing on the Russian Rosstat data.

The 2004 educational policy involved the continuation of an experimental refining of an instrument of the combined assessment of the final and enrollment examination, *alias* The Uniform State Examination (USE), mechanisms of funding of the higher education on the basis of State Individual Financial Obligations (SIFO). In addition to the above, the government adopts a series of strategic documents and legal statutes that substantially affect the essence and vector of the Russian educational reform efforts.

Table 43

**The Outstanding Budget Wages Arrears in the Social-Cultural Sub-Sectors
(Except for Small Businesses), as Rb. Mln.**

	01.02.04	01.04.04	01.07.04	01.10.04	01.01.05
Total	2730	2652	2924	2654	1005
Of which:					
Social Sub-sectors – total	1741	1601	1821	1602	618
Including:					
– from the Federal Budget	10	9,5	12	10	5
– from the budgets of the RF Subjects and local budgets	1731	1591	1809	1592	613
Education – total	308	263	384	326	94
Including:					
– from the Federal Budget	7	7	9	8	4
– from the budgets of the RF Subjects and local budgets	301	256	375	318	90
Health Care - total	174	177	225	249	49
Including:					
– from the Federal Budget	0,3	1	0,3	0,3	0,1
– from the budgets of the RF Subjects and local budgets	174	176	224	249	49
Culture - total	64	66	96	72	19
Including:					
– from the Federal Budget	0,0	0,0	–	–	–
– from the budgets of the RF Subjects and local budgets	64	66	96	72	19

Source: According to the Russian Rosstat data.

**Outcomes of, and Prospects for the Nationwide
Transition to USE**

In 2004, in compliance with government Resolution of 16 January 2004 No. 725 “On Prolongation for 2004 of the Term of Conduct of the Experiment on Introduction of the Uniform State Examination”, the Russian educational system proceeded with the given experiment. Last year, the accent was put on probation of a few technologies of its conduct and enhancement of the quality of control measuring materials by expanding the participation of representatives of the polytechnic education in their design and evaluation. In addition to that, the government stressed the need for improvement of informational orientation available to those enrolling to the higher education and secondary specialized educational institutions.

As many as 65 RF Subjects voluntarily took part in the USE experiment, with some regions holding it by all 14 subjects. Notably, the number of participants in the experiment hit the record-breaking 982,000, or at 1.3 times more than in the prior year. As many as 29 federal ministries and agencies that have subordinated higher education and secondary polytechnic education institutions have expressed their consent to participate in USE. When compared with 2003, the number of universities accepting students by their USE scores more than doubled, while the number of secondary polytechnic educational institutions recognizing the USE scores accounted for 1,530 (*Table 44*).

Table 44

The Progress in the USE Experiment

	2001	2002	2003	2004
The number of the RF Subjects taking part in the USE experiment	5	16	47	65
The number of students that passed USE, as thousand	30	300	752	982
The number of USE subjects	8	9	12	14
The number of universities and their branches participating in the USE experiment	16	117	464	946
The number of secondary polytechnic educational institutions participating in the USE experiment	–	79	928	1530

Source: Basing on the data of the RF Ministry for education and Science.

The rise in the number of participants in the experiment evidences that regions and universities are keen to benefit from its results. That said the progress with the experiment owes its success to order of 10 February 2004 No. 560 of the RF Ministry for education and Science on the mandatory account of the USE scores by the universities of the federal subordination (except for the Moscow Lomonosov University) located in Moscow and Moscow oblast. They were ordered to identify, as a rule, not less than 50% of the overall specialties across which the 2004 enrollment with account of the USE scores was consequently conducted.

Single regional educational agencies (the Moscow City Department of Education among them) were not in a position to ensure a full-scale conduct of the experiment. That created certain complexities with regard to securing the quality of rights of graduates from the public secondary institutions in Moscow and those of other Subjects in the course of enrollment to the Moscow-based universities. To overcome this contradiction, upon a submission by the Moscow City Department of Education, on 11 February 2004 the RF Ministry for Education and Science issued its order No. 584. The order reads that for graduates from the 11th (12th) forms of public secondary educational institutions based in the city of Moscow that their participation in the USE is voluntary, while the examination is conducted by 5 subjects.

In 2004, the Ministry of Education specified methodological documents that regulated the procedure and the content of USE, the procedure of functioning of the state examination and arbitration commissions of the RF Subjects, the procedure of enrollment to higher educational and secondary polytechnic institutions. In addition to that, the Ministry created an informational infrastructure on the basis of the federal and 63 regional information processing centers. The higher education and secondary polytechnic institutions were allowed to check evidences of the USE outcomes in the Federal Base of Evidences.

In October 2004, IV Russian Conference on the experiment outcomes and setting tasks for the 2005 experiment was held. The conference positively assessed the USE experiment.

In 2005–2006, it is intended to complete the approbation of the procedure and technology of USE in all the RF Subjects, while reserving the right for them to select patterns of participation (quantity of subjects, obligatory/voluntary participation in USE by graduates and institutions). In 2005, it is planned to introduce USE in full across 16 regions where the USE experiment lasted not less than 3 years. In 2005, as many as 78 regions expressed

their intention to participate in the USE experiment. So, about 83% of Russian secondary school graduates are going to take USE next year.

It is planned to ensure a step-by-step transformation of USE into a sole examination instrument throughout Russia in 2006–2008. So, the deadline for the compulsory introduction of USE across the country is postponed from the originally scheduled 2006 to 2008.

Meanwhile, the RF Ministry of Education and Science's stand is that USE should not be considered the only instrument of examination for the graduates enrolling for universities. The Ministry calls for alternative forms of the entrance examinations. According to the head of the Federal Service for Supervision in the sphere of education, universities will undoubtedly maintain the right to carry out competitions, whose results allow graduates to enroll for the leading universities. The competitions presently exist in the pyramidal form: school – city – oblast – okrug – the federation. It is intended to somewhat modify this arrangement to ensure the winners of regional competitions are accepted by all Russian universities on a non-competition basis. Besides, universities will be able to hold additional examinations for graduates with USE certificates.

Approbation of New Mechanisms of University Financing

In compliance with RF government Resolution of 26 June 2004 No 313, the experiment on transition to the financing of single universities by means of state nominal financial obligations (SNFO) was prolonged through 2004. The structure of universities participating in the experiment approved by order of 30 June 2004 No. 37 of the Federal Agency for Education under the RF Ministry for Education and Science remained unchanged vis-avis 2003. It comprises 6 universities: Mari State University, Mari State Polytechnic University, Chuvash State University, Yakut State University, Mari State Teachers' Training University, Chuvash State Teachers' Training University. The overall number of students using SNFO accounts for 12,548 in 2004 of which 11,657 had a SNFO of a regular amount, while the remaining 891 enjoyed an increased amount of SNFO.

Those were the students whose specialties are especially significant for social and economic development of regions, albeit not demonstrating a sufficient demand for them on the part of the population.

The methodological basis of the experiment that determines conditions and procedures of its implementation remained practically unchanged in 2004, albeit in the late 2003, according to the outcomes of the first stage of the experiment, the RF Ministry for Education prepared a number of proposals on its improvement.

In 2004, the value of the budget funds earmarked for the SNFO purposes as per order of the RF Ministry for Education of 22 July 2004 No. 26 remained unchanged vis-avis 2003. The average proportional costs across the SNFO items in universities accounted for 11,800 rubles. Such an approach against the background of the overall growth of costs for university education essentially means a reduction in the budgetary financing of the universities' current spending. The dynamics of distribution across SNFO categories in universities testifies to the growth in 2004 of the share of the 3rd and 4th SNFO categories and some drop in the share of the 1st – 2nd SNFO categories.

It is worthwhile noting that in the universities that participate in the experiment the correlation between the first-year students whose education was paid for from the federal budget and those who co-financed their education has slightly changed in favor of the former group over the past three years (*Table 45*).

Table 45

**Distribution by SNFO Categories in the Universities Participating
in the Experiment (Across All the Forms of Education), as %**

	2002	2003	2004
1 st category	8,0	11,6	8,8
2 nd category	39,0	27,5	27,4
3 rd category	37,6	42,7	46,9
4th category	10,8	12,5	12,7
5th category	4,7	5,7	4,4

Source: Basing on the data of the State University – the Higher School of Economics.

Table 46

**The Share of the First-Year Students in the Universities Participating
in the Experiment at the Expense of the Federal Budget
and Co-Funding Their Education, as %**

	2002	2003	2004
Across all the forms of tuition:			
– at the expense of the federal budget ^{3a}	58,7	59,7	61,7
– co-funding	41,3	40,3	38,3
Regular tuition:			
– at the expense of the federal budget ^a	58,8	58,6	60,0
– co-funding	41,2	41,4	40,0
By correspondence:			
– at the expense of the federal budget ^a	58,6	64,0	66,5
– co-funding	41,3	36,0	33,5

Source: Basing on the data of the State University – the Higher School of Economics.

To extend the information base of the SNFO experiment with its order of 13 August 2004 No. 51 the Federal Agency for Education bound a number of universities that were not participating in the experiment to submit data necessary for conducting model computations of the SNFO functioning. Notwithstanding the above, 2004 did not witness any real steps on the experiment modification, while all the above deficiencies of the approved new mechanism of university funding⁵² essentially were still there. That concerns, primarily, an increase of the SNFO amount across all the categories, reduction in their number from 5 to 3, awarding the winners of the nationwide school competitions and participants in international school competitions with the highest SNFO category to ensure the possibility for them to enroll for the respective departments of the public universities, introducing a greater amount of SNFO for the specialties that objectively appear more costly than the others. As well, one should ensure the possibility for changing the originally granted SNFO category according to the student's performance and examination results.

Given the scope of the experiments underway, they address single avenues of the education system reform and do not form an integral complex strategy of modernization of all elements of the Russian education system. This has not allowed for a much-needed mass support of the reforms underway and making their goals clear and shared by the majority of the educational community and society on the whole.

⁵² Rossiyskaya Ekonomika v 2003. Tendentsii i perspektivy. M.: IET, 2004. P. 289–290.

Modifications in the Education Legislation

In compliance with Federal Law No. 122-FZ of summer 2004, the education legislation underwent substantial modifications. Consequently, a number of provisions of the Law "On Education" that envisaged public guarantees of priority of education, particularly, the higher education (on issues of financing the education system including the universities' social sphere, provision of tax and other benefits, etc.) was abolished.

As per the Law, the provisions that regulated the standardized financing of educational institutions were modified. The Law formulates a new content of the concepts of the federal, regional and local standards of financing educational institutions. Thus, the federal standard concerns financing institutions of the federal subordination, the regional standard - those of the regional subordination. So far the local standard is concerned, it is related to institutions of the local subordination. In addition to that, item 41 of the Law "On Education" reads that the financing of public educational institutions under the RF Subjects and municipal educational institutions is exercised basing on the federal standards and those of the RF Subjects. However, the Law does not stipulate the procedure of approving of the respective federal standards.

Meanwhile, the Law maintained the provision, which provides for the setting of standards of financial costs for small rural and considered as such by government and educational agencies institutions. These costs do not depend on the quantity of students therein.

Hence, in compliance with the Law the procedure of regulation of issues associated with organization of control and financing of the education system was fundamentally modified. This primarily concerns assignment of competence in the education sphere between levels of government and exclusion of the possibility for an additional financial support from the budgets of other levels. Division of powers between the levels of government is chiefly made basing on the principle of a strict tying to the level of financing of educational institutions. This would result in a restriction of possibilities for an additional financial support of institutions, their employees and student as well.

The Law has lifted restrictions on the paid-for enrollment of students for their training in the sphere of jurisprudence, economics, management (the share of students who paid for educational services could not earlier exceed 50% of their respective number at a given department). The abolition of this restriction, on the one hand, allows to meet the population's effective demand for educational services and solidify the financial state of universities, while, on the other, to intensify the urgency of the task of provision of a proper control over the quality of education.

The legal modifications also concerned the practice of co-founding of educational institutions. The Law "On Education" had earlier permitted the co-founding, but now such possibility is excluded, because it contradicted to the Civil Code. The system of co-founding of educational institutions was rather efficiently employed in Samara oblast in the course of organization of a two-level financing of schools, with educational expenses being covered from the regional budget, while communal expenses and those on the real estate maintenance from the municipal budget. The removal of this provision intensifies the urgency of the task of development of new integration forms of provision of educational institutions with resources.

In compliance with the new legislation, the procedure of provision of social protection to students from the budget funds is replaced by a mechanism of implementation of social support measures. It is provided that this particular mission will fall under the competence of educational institutions themselves. Given the above, the current legislation cancels the students' meals and transportation benefits, particularly, for those trained at the publicly

accredited non-government educational institutions that are deprived of the right for benefits that the RF law set for students of public and municipal educational institutions.

The Law substantially modified labor compensations to the budget employees and, particularly, those in the education sphere. The minimal amount of tariff rate (wages) of the budget employees is no longer recognized as a uniform and mandatory one nationwide. Besides, it became the differentiated (depending on the level of the budget financing and residence) instrument of regulation of labor compensations in the regions, which considerably lowered the level of employees' labor rights. Moreover, the Law abolished the government obligations on adjustment of the level of teachers' wages by means of setting labor compensation standards in the form of the labor compensations in the educational sector to those in the industrial sector ratio.

Resulting from the abolishment of RSFSR Law of 21 December 1990 No 438-1 "On Social Development of the Countryside", rural teachers have lost their right for the extra 25% wages and tariff rates vis-avis their urban colleagues. The abolishment of the given benefit substantially deteriorates their economic state of and will have an extremely negative effect on the staffing capacity of the sector. As well, this will derail the teachers' professional prestige, which presently has already sunk considerably.

It is worth noting that in the course of debates of legislative innovations associated with changes in the teachers' social status the trade unions have succeeded in keeping the provision on the pedagogical staff's right for a free housing with heating and lighting in the countryside and settlements of urban type, and for a priority provision of housing to them. But the amount, conditions and procedure of compensation for the costs associated with provision of the noted social support measures have to be set by the RF Subjects' legal statutes, which raises doubts about the actual provision of these rights.

The aforementioned amendments to the educational law have formally brought it in a due consistence with the Civil and Budget Codes of RF, Federal Law of 4 July 2003 No 95-FZ "On Introducing Amendments to the Federal Law "On General Principles of Organization of Legislative (Representative) and Executive Bodies of State Power of Subjects of the Russian Federation, Federal Law of 6 October 2003 No 131-FZ "On General Principles of Organization of Local Self-Governance in the Russian Federation". Notwithstanding this, the priority of education declared by numerous program documents has failed to find the respective legislative fundamentals in the new version of the law "On Education".

Identification of the Future Government Policy Priorities

At its meeting on December 9, 2004, the RF Government considered the present educational reform priority avenues until 2010 for the purpose of securing the country's socio-economic development on the basis of the capacity and by means of the educational sphere. As well, the Government concluded interim results of the 2001 Concept for Modernization⁵³. It was noted that the implementation of the Concept for Modernization through 2001–2004 has allowed:

- to secure the growth of budget expenditures on educational needs;
- to intensify the work on the legislative and legal provision of development of the education system;
- to conduct a number of large-scale experiments on introduction of new mechanisms of financing, assessment of students' progress, provision of accessibility of the higher education.

⁵³ The 2001 Concept for Modernization of Russian Education through 2010 identified enhancement of the quality, accessibility and efficiency of education as principal objectives of its development.

At the government meeting it was also noted that the Russian education system does not meet the respective requirements due to the following reasons:

- an insufficient orientation of vocational training to labor market demands;
- lack of consistency education;
- absence of due connection between education and science;
- an insufficient level of public and government control over the quality of education;
- a low level of teachers' labor compensations;
- an insufficient participation of the general public in the educational reform underway;
- a poor integration of Russian education into the international educational community.

The Government also identified priorities of the present government educational policy, which would allow to successfully find solutions to the objectives set by the Concept for Modernization of the Russian education, as follows:

- development of a modern system of the consistent vocational training;
- improvement of quality of vocational training;
- provision of accessibility of a qualitative general education;
- increasing investment attractiveness of the sphere of education.

It was also noted that one of the most promising avenues of creation of conditions of increasing of economic independence of educational institutions is to encourage the variety of their organizational and legal forms.

Transformation of financial-economic mechanisms that provide for conditions of implementation of the noted priorities, is primarily associated with the attempt to refuse the estimate-based procedure of the budget financing of educational institutions, because this procedure hamper incentives to improve the quality and efficiency of educational services. In the budget reform framework, it is proposed to finance the education system basing on the "performance-oriented management" principle. Such an approach requires from any education development program funded from the budget to comprise a strict list of performance indicators, which would allow to increase the efficiency of the budget spending.

The strategy of the government implies the development and employment of various mechanisms of financing educational institutions from the budget, particularly: 1) standardized per capita financing that allows to secure transparency of allocation of budget funds and to tie the volume of financing directly with the consumer of a given educational service; 2) universities financing on the basis of state nominal financial obligations (SNFO).

A complete transition to the standardized per capita financing is mainly impeded by the absence of the much-needed legislative basis, practical methodologies of calculation of standards across educational levels, types and kinds of educational institutions. In addition to that, some Russian regions' (Samara oblast, Chuvash Republic, Yroslavl oblast) positive experience in this sphere allows to argue about the efficiency of application of the given financing mechanism and the necessity of its further extension to other regions.

In compliance with the government recommendations that were discussed at the government meeting in December 2004, it is proposed to approve the system of differentiated standards of budget financing within the framework of application of standardized per capita budget financing: according to the USE results, international, nationwide, regional competitions; across training avenues, with account of regional specifics.

Due to its complexity and scathing criticism on the part of some rectors of leading universities, the ongoing experiment on universities financing on the SNFO basis requires further specification and suggests inclusion of a greater number of participating universities.

The fundamental institutional modifications in the area of regulation of organizational-legal and financial-economic relations in the sphere of education that were approved by the strategic government documents compel this particular sphere to focus on a

more pro-active integration in market relations. This requires a thorough monitoring of on-going changes and evaluation of socio-economic risks associated with the planned reforms.

3.6.3. The Start of Restructuring the Budgetary Institutions Network

The task of reforming the budgetary institutions network was formulated in the RF Presidential Address to the RF Federal Assembly of RF in May 2003. It was further specified in "Principles of the Budget Sector Restructuring in the Russian Federation in 2003-2004 and for the period until 2006", drafted by the RF Ministry of Finance and approved by the RF Government in September 2003.

In 2004, the Government made attempts to implement this mission by starting with the federal institutions network.

Since July 2004 the RF Government has initiated an intense discussion on measures on optimization of the federal budgetary institutions network and reorganization of budget institutions. The Government worked out proposals on two new organizational-legal forms: autonomous institution and public (municipal) autonomous non-profit organization.

In July 2004, the Government Commission on administrative reform approved the procedure of organization of work on optimization of the network of federal state unitary enterprises and federal public institutions subordinated to federal executive agencies.⁵⁴ The Government Commission suggested to break the noted organizations into groups and prepare, accordingly, four arrays of organizations subjected to: 1) remaining in the federal property; 2) transfer to the RF Subjects' and municipal property; 3) step-by-step privatization; 4) an additional consideration after adoption of legal acts on the procedure of privatization of federal public institutions or their transformation into other organizational-legal forms.

The Government Commission paid a special attention to public educational institutions. It also emphasized appropriateness of a transfer of educational institutions that currently remain in the federal property, as a rule, to the purview of the Federal Agency for Education. However, the RF Ministry of Health Care and Social Development and the RF Ministry of Culture have succeeded to save medical universities and universities of culture and arts from this lot.

The Government Commission suggested to include in list (3) organizations that managed real estate and other property fixed with the federal agencies, in list (4) – organizations exercised functions on the material-technical and social-household provision of civil servants' operations and institutions whose operations were funded from the budget, albeit these funds appeared extrabudgetary, as they result from contracts between such institutions and public agencies.

Overall, the government has demonstrated rather modest progress in this particular reform area. The majority of federal public institutions fell under list (1), while the main part of institutions of elementary and secondary vocational education that had earlier belonged to the federal property is currently included in list (2).

In late October 2004, the RF Government approved the list of institutions of elementary and secondary vocational education (EVE and SVE, respectively) assigned under the regions' competence. Consequently, the Government started the process of assignment of these institutions to the regional level. By 1 January 2005 as many as 2,517 institutions of elementary and 299 ones of secondary vocational education were assigned to the RF Subjects. In all likelihood, the assignment process would result in the restructuring of the

⁵⁴ Minutes of the meeting of the RF Government Commission on administrative reform of 13 July 2004. No 18.

EVE and SVE institutions network with account of budget capacity of the RF Subject and actual needs in the respective qualified staff demonstrated by regional labor markets.

Basing on the experiences of Nizhniy Novgorod oblast, Novgorod oblast, Samara oblast and the city of St. Petersburg that had taken EVE and SVE institutions under their competence in late 90-s, the RF Ministry of Education and Science expects positive changes the given innovation should generate nationwide. The experience of Nizhniy Novgorod oblast exemplifies such a model of the EVE and SVE regional system, under which regional enterprises by themselves select the needed specialists, provide for a production base and tutors, set regional increments to their labor compensations and, consequently, have qualified workers. In addition to that, the oblast has preserved the vocational colleges network, implemented their partial optimization by means of their integration with NVE institutions and regional universities. As a result, during their training students already receive labor compensations up to 5,000 Rubles.

Design of Forms of New Public Organizations

The design of proposals on transformation of budgetary institutions into other organizational-legal forms became an independent critical avenue of the preparation for the budgetary sector reform.

In the 90-s, prior to the implementation of the new Budget Code, budget institutions *de-facto* had enjoyed a high degree of independence in exercising their economic operations, capital attraction and spending budgetary and extrabudgetary resources. The situation has started to change recently. With the government pursuing the policy aimed at strengthening the financial discipline in planning and spending budget funds, the implacable logic compels it to restrict the independence of public institutions. The government has consistently attempted to bring this array of rights in conformity to the model of budget organization laid down in the organizational-legal form of a given institution. The milestones of this process became: the transition to the treasury execution of operations with the budget funds of public institutions; the adoption of a new, detailed, classification of budget expenditures, in compliance with which the budget financing of institutions and approval of their expenditure estimate are executed; and, finally, the likewise transition of institutions' extrabudgetary revenue and expenditure operations to the treasury execution, which implies a strict control over every item of the institution's revenue and expenditure estimate on the part of its founder.

For the majority of budgetary institutions such the above will lead to the gap between the volume of rights they will enjoy and requirements to their efficiency caused by actual conditions of their functioning. This concerns the institutions whose revenues are formed by compensations from the budgetary and extrabudgetary sources for the services they provide. The array of such institutions comprises health care institutions that participate in the compulsory medical insurance system and receive funds from it according to the volume and quality of the medical assistance delivered; vocational education institutions and institutions of culture and arts, whose revenues to a significant extent are formed by extrabudgetary receipts, etc.

Excessive restrictions of such institutions' operations will result in a weaker motivation to adequate accounting of demands of consumers of their services and efficient utilization of their capacity. That is why there exists an actual need in the public sector having both administratively controlled budget institutions and those that enjoy the legislatively set right for independent economic operations.

The document entitled “Principles of restructuring of the RF budget sector” presents two variants of transformation of budget institutions:

- 1) into a specialized public or municipal non-profit organization;
- 2) into a public or municipal autonomous non-profit organization.

The RF Ministry of Economic Development, the State University-the Higher School of Economics, Institute for the Economy in Transition⁵⁵ designed the above variants. Each of the latter grants a public organization with a broader range of powers versus public institution, while at the same time, discharge a part of obligations from the state with regard to the economic provision of its operations.

In spring 2004, on the basis of earlier drafts, the Center of Private Law designed the following bills:

- “On autonomous institutions”;
- “On public (municipal) non-profit organizations”;
- “On setting the procedure, conditions and criteria of reorganization of public and municipal institutions in the form of transformation”;
- on amendments to the Civil and Budget Codes of RF, the Federal Law “On non-profit organizations”.

Since summer the revision of these bills has been conducted under the aegis of the RF Ministry of Economic Development. These draft laws envisage a special kind of the right for operative property management, which the founder of the public (municipal) autonomous institution fixes with that. By contrast to the existing institutional form, the owner does not bear subsidiary responsibility for the autonomous institution’s obligations. As concerns the autonomous institution itself, it is liable by all its obligations with the property it has under its operative control, except for real estate and particularly valuable movables. The power to identify particularly valuable movables falls under the RF Government’s competence.

The autonomous institution independently controls other property (including real estate) that it purchased for revenues from its operations.

The noted revenues are subject to the institution’s independent control and are used to fulfill its principal mission.

The owner of the autonomous institution has a right to assign tasks to autonomous institutions, the fulfillment of which he is bound to finance. While granting a broader independence to the autonomous institution, the state should have more transparent mechanisms of control over its operations. A form of control alternative to the administrative control over the organization on the part of a superior government agency is the establishment of the board of trustees with the autonomous institution. It should comprise individuals appointed by the founder, albeit not employed and receiving compensations for their contribution to the board’s activity. The board will oversee the consistency of the organization’s operations to its mission as per its Charter, particularly, review its plans and reports, approve of large deals, etc.

The form of a public (municipal) autonomous non-profit organization suggests that its property, particularly, that the founder transfer to it upon its establishment belongs to the organization in question. Should the public (municipal) autonomous non-profit organization have any revenues and spend those particularly to acquire any property, the said revenues and property become subject to its independent control.

⁵⁵ Povysheniye effektivnosti bjudgetnogo finansirovaniya gosudarstvennykh uchrejeniy i upravleniya gosudarstvennymi unitarnymi predpriyatiyami T. I. M.: IET, 2003. C. 151–250.

The government maintains control over operations of such an organization by means of the board of trustees, established in a manner analogous to the board of trustees of the autonomous institution. But this particular case this collective board is granted with both supervisory powers and the rights to make certain decision: approval of organization's annual financial plans and the respective reports; consideration of the organization's financial performance over shorter periods of time (half year, quarter); making decisions as to whether or not these or those kinds of its commercial operations other than the principal ones are in consistency with its statutory objectives.

It is suggested that these forms should complement, rather than replace, the current form of the institution. While some existing public budgetary organizations are going to remain in their current form, the others will be transformed into new forms. Economic conditions of various kinds of operations of social institutions, the correlation between their various revenue sources, the extent to which the institutions find themselves dependable on budget appropriations appear substantially different across the sectors of the social sphere and within single sectors.

Decision-making with respect to the appropriateness of the transformation of the institutions into new forms should be exercised with account of economic conditions of their operations (revenue and expenditure structure, presence of an actual and potential competition, etc.).

Transformation from the current form of an institution into the one of the autonomous institution poses an urgent challenge to pre-school institutions and schools in medium-size towns and big cities as well as most public vocational education organizations, and urban outpatient-policlinic and hospital institutions. As their operations combine the provision of free and paid services to consumers, or insurers pay for these services, the consumers or insurers have a right to exert economic influence on their operations.

Some public vocational education and health care organizations find themselves under an intense competition and pressure on the part of consumers. This primarily concerns economic, law, linguistic universities, computer and communication training centers, primary and secondary vocational training institutions, medical institutions of the same profile located in the same city, among others. These organizations face an urgent challenge of transformation into public autonomous non-profit organizations.

However, the coordination of the above bills with the agencies concerned has been delayed. The property regime proposed for an autonomous institution has formed the major sticking point. While the RF Ministry of Economic Development and Trade advocate the stand formulated by the Center of Private Law: that is, the property regime in question is a kind of the right for operative control, the stance of the Chief Legal Department of the presidential Administration is that the respective volume of powers falls beyond the operative control framework, which is why it may not be considered as a kind of it.

In November 2004, the debate on the bills in question gained a new hue. More specifically, the leadership of the All-Russia Theatre Union speculated that the above proposals were an attempt to impose an administrative control over Russian theatres' creative and economic operations. They undertook a number of actions highlighted by the national media. The numerous appeals to the government cited the collapse of the Russian repertoire theatre, should theatres be transformed into the aforementioned new forms and demanded to protect the national treasure. In reality, however, theatre directors propone the existing practice, which grants them with an uncontrollable right to manage the property fixed with the theatre and the respective revenues, along with a minimum economic responsibility for their independent economic performance.

3.7. Foreign Economic Activity

3.7.1. Main Trends in Russia's Foreign Trade

Growth rates of the world economy were boosted in 2004 to account for 4%, according to the World Bank. The general global economic situation was animated mainly by a substantial growth in Chinese economy (8%) as well as improved economic situation in Japan and the United States. GDP growth rates in these countries exceeded 4%. The US economic growth was caused mainly by increased investments and consumer spendings. European countries showed slower economic growth rates. Economic growth in Western Europe and Japan was caused mainly by export growth due to increased demand in developing countries.

According to the World Bank, the world trade volume increased by 10.2% in 2004 due to a rapid growth in industrial output. China accounted for over 20% of the world trade volume of goods. Considerable growth in foreign trade turnover in China was caused by a positive impact from its accession to the World Trade Organization, as well as high growth in investments and consumer demand .

Raw goods trade demonstrated the fastest growth rates due to a great demand in such goods, which served as a material incentive for expanding commercial business at a variety of developing countries. In addition, investment goods trade was growing rapidly thus promoting export expansion in Germany and Japan which are specializing in manufacturing machinery and equipment.

In 2005, production growth is expected to slow down due to a price rise of fuel and raw materials. Export volumes have been declining. According to the forecast of the World Bank , the world economic growth is estimated to drop to 3.2%, and the world trade is expected to decline to 8.5% in 2005. World trade flows will be governed by, besides prices of raw goods, the size of budget deficit in the United States affecting the USD exchange rate, as well as a likelihood of economic decline in China.

In 2003, the Russian Federation was ranked 17th in the world on export volumes with a share accounting for 1.8% in the world export. Russia may come 15th on goods export volumes according to the results achieved in 2004. Last year, the Russian Federation was ranked 23rd in import volume in the world with a share accounting for nearly 1% of the total world import. Russia is included in the list of top forty leading countries in terms of sales turnover.

Russian growth rates in foreign trade turnover is by more than 4 times ahead of its economic growth rates. In 2004, sales turnover grew by 31.1%, and GDP – by 7.1%.

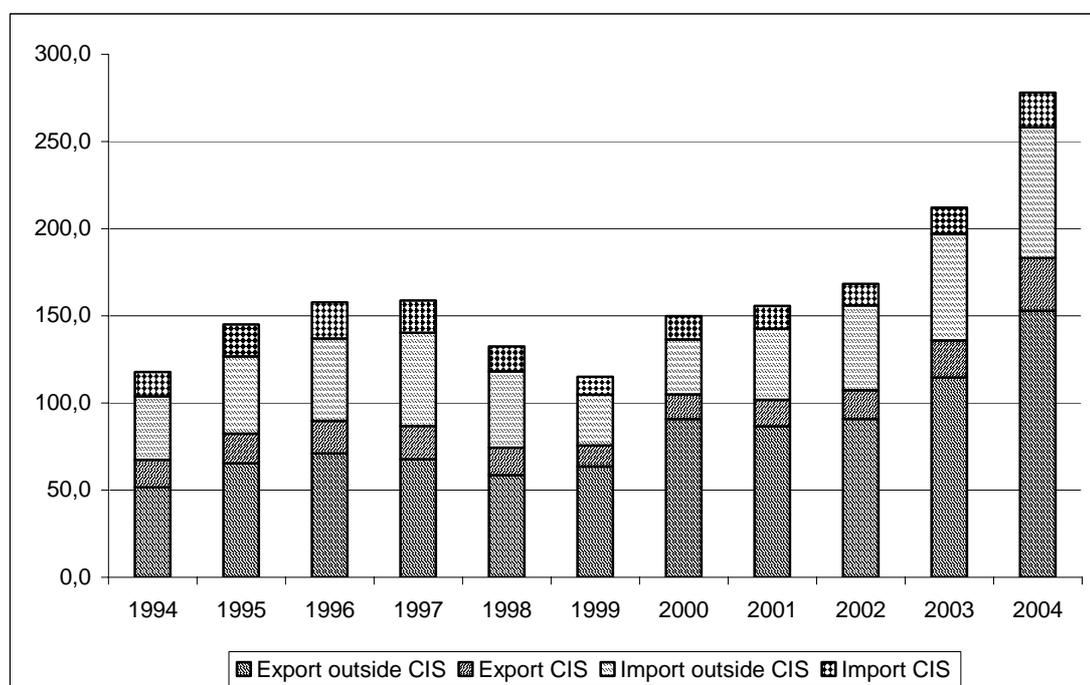
At the same time, Russia is falling behind in service trade. For example, it is 29th in the world in terms of service trade with a share accounting for less than 1% of the world volume. Russia comes 22nd in the world in terms of service import, its share accounting for slightly more than 1%.

In regard to foreign trade, in 2004 the Russian Federation showed record-breaking growth ever achieved over the last 15 years in terms of monetary volumes of both export and import of goods, with export supply growing faster thus promoting together with foreign trade turnover growth a substantial growth in positive trade balance .

Favorable world market situation for Russian exporters, RUR strengthening, as well as expanding domestic consumer and investment demand had a basic positive impact on foreign trade turnover growth in the Russian Federation in 2004.

In 2004, the Russian foreign trade turnover amounted to \$278,0 billion as calculated by using the method of balance of payments, which exceeds by 31.1% that of the previous

year (Fig. 71). Sales turnover with CIS countries grew faster to reach \$49,99 billion, which is by 37.2% higher than that in 2003. Russian sales turnover with foreign countries other than CIS countries increased by 29.9% to amount to \$228,03 billion.



Source: the RF Central Bank .

Fig. 71. Russian Foreign Trade Turnover (USD billion)

It was primarily the price factor that had an impact on import growth of Russian goods in 2004 (Table 71). According to the Bank of Russia, incremental growth of world prices of basic Russian export goods accounted for 20% on the average in 2004 as compared to 2003, while volume export index was 111.1% (correspondingly 114.6 and 110.5% in 2003).

Table 47

	Average Annual Prices								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Oil (Brent), USD per barrel	21.33	17.4	14.1	15.9	28.19	24.84	25.02	28.83	37.4
Natural gas, USD/1 million . BTU	-	1.9642	2.5469	2.1876	4.3442	3.9764	3.3857	5.461	5.993
Gas, USD per gallon	0.71	0.615	0.511	0.529	0.887	0.7922	0.755	0.891	1.197
Copper, USD per ton	2574.9	2369.7	1775.3	1539.9	1863.9	1613.6	1592.9	1785.6	2808.2
Aluminum, USD per ton	1590.2	1554.0	1413.5	1318.0	1550.0	1444.7	1350.7	1424.7	1693.2
Nikel, USD per ton	8053.9	7312.4	5352.5	5239.5	8624.0	5966.0	6175.1	9580.8	13756.8

Source: calculated on the basis of the data of London Metal Exchange (Great Britain, London), International Oil Stock Exchange (London).

World oil prices were maintained at a record level in 2004, which was caused by slightly increased demand for oil over the last 24 year at the background of geopolitical instability in oil producing countries. For example, the average world price of Urals oil was \$ 28,86 per barrel in January, \$ 38,11 per barrel (growth by 32.1%) in September, and \$ 42,26 per barrel in October (growth by 46.4% as compared to January and by 10.9% as compared to September 2004).

Average monthly oil price of the same oil in 2004 was \$ 34,4 per barrel (growth by 25.9% as compared to 2003). In October 2004, oil prices at the New York Stock Exchange reached \$55 per barrel .

The OPEC decreased substantially oil production in accordance with the decision approved at its meeting held in September: from 27,69 million barrels daily in September to 30,61 million barrels daily in October , which reduced tension in the world oil market along with oil prices. However, OPEC's oil production reached its maximum over the last 25 years. Saudi Arabia showed the highest oil production as compared to other oil producers, and it still has reserves to further increase its capacity. Other OPEC countries are very close to reach their full oil-production capacity.

Natural gas prices in Europe increased by 9.7% against the previous year, gasoline prices grew by 34.3%, diesel fuel increased by 26.6%, fuel oil by 2.8%. The average price of energy resources increased by 15% and non-energy goods by 23% in 2004.

Non-ferrous metals were in great demand in 2004. Price rise on plumb, zinc, copper, tin and aluminum was found to be substantial as compared to that in 2003. The price explosion was caused basically, besides general factors, by a growing demand for these products in rapidly developing Asian countries. In addition, metal supply to the world market was reduced due to increased metal consumption in metal producing countries. There was a marked downward trend in reserves of several groups of metals (aluminum, tin, copper, plumb) at warehouses of the leading world commodity exchanges. The majority of metals reached their price maximum in fall. Non-ferrous metals were more expensive by average of 34% in 2004 against 2003 (aluminum by 18.8%, copper by 57.3%, nickel by 43.6%), iron ore by 19%, price index of steel production increased by 54%.

Prices of aluminum remain high mainly due to growing demand for aluminum in China, as well as deficit in alumina and electric power. According to Metal Bulletin Research, deficit in aluminum in the world market was 460 to 550 thousand tons by the end of 2004 . Aluminum consumption in China increased by 16 to 17%.

In last January, price of nickel reached its maximum over the last 14 years. World nickel production volumes do not meet the demand yet, primarily in Asian countries. The world nickel supply will not be able equal the demand until 2006–2007, provided that major nickel mines are put into operation in Canada и Australia.

The world copper market situation was quite favorable for copper producers in 2004. Prices of cooper have steadily been growing over the last three years. the world market prices copper prices grew by merely 8.4% in 2002, by 38% in 2003 , and by 42.9% more in 2004 .

Copper prices were changed due to a variety of factors :

- first, deficit in copper in the world market. Though the copper supply met and even exceeded the growing demand in the market in 2002, there was a deficit of 376 thousand tons in 2003 and 701 thousand tons in 2004, which resulted in price rise ;
- second, growing copper production costs (mainly due to increasing prices of raw materials) ;
- third, transition of product markets to new price levels that was under way throughout a period between 2003 and 2004.

In 2005, the copper market situation will become more attractive than in 2004. In particular, copper production is expected to increase by 7.7% (up to 17 094 thousand tons) with simultaneous growth in demand by 4.1% (up to 17 146 thousand tons). This is expected to improve the balance of the world copper market and reduce substantially the deficit in copper in the market.

With this situation in mind, one can forecast in 2005 a growth in prices of the metals traded at stock exchanges due to growing demand in several countries, primarily in the United States and China. There is no reason, however, for expecting growth rates similar to those of the previous year, because the growing demand resulted in boosted production of the metals being in shortage, which provides no stability whatsoever for the world market in general.

As a result of unfavorable world market situation, unprecedented high growth rates in Russian exports was noted during 2004, its monetary volume being increased by 34.8% against 2003 to break the record over the last decade – \$183.2 billion (*Table 48*).

Table 48

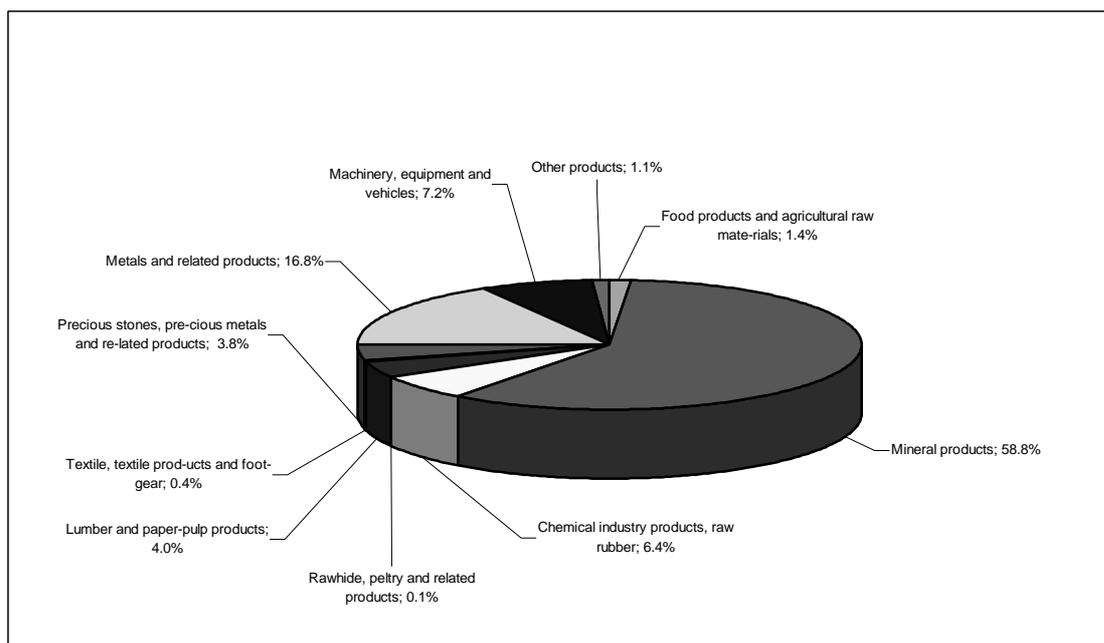
Russian Exports Movement									
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Export, USD billion .	89.7	86.9	74.4	75.6	105.0	101.9	107.2	135.4	183.2
Including :									
Foreign countries other than CIS countries .	71.1	67.8	58.7	63.6	90.8	86.6	91.0	113.9	152.9
Growth rates, % of the previous year									
Volume of exports index .	100.1	101.8	99.7	109.4	110.2	104.2	115.0	109.5	111.1
Price Index .	108.6	98.1	84.2	92.1	128.2	93.8	86.0	113.4	120.5

Source: the RF Central Bank.

However, the quantitative growth had no impact whatsoever on the quality of Russian exports still facing a major problem of inefficient structure of goods. Though several mature economies (for example, Canada and Norway) have a substantial share of raw materials in their export, they also export end products, including high technology products. A share of processed goods in Russian exports is miserable. Furthermore, this share is getting smaller (according to the corresponding parameter calculated for Russia by using the World Bank's method, the share is not over 30% over the last few years). The share of Russia in the world sales volume of machinery and technological equipment accounts for 0.3%, vehicles – 0.1%, electronic goods – 0.04%.

Thus, Russian specialization in raw materials trade, which can be deemed applicable at a certain period of time and under certain conditions, is not evolving into more developed forms related to raw materials processing thus interfering with increasing Russia's share in the world market.

Russian export growth still remain based mainly on the two product groups: fuel and energy products whose export increased by 34.9% in value terms in 2004 as compared to 2003, as well as metals and metal-based products which grew to 64.8% (*Fig. 72*).



Source: the RF Federal Customs Service .

Fig. 72. Russian Export Structure in 2004 (%)

In 2004, a share of fuel and energy products accounted for 58.2% of the total Russian export structure, which is slightly bigger than that in the previous year (57.8%).

Foreign exchange proceeding from exports of Russian oil amounted to \$55,0 billion in 2004 and exceeded by 49.3% that in 2003. Total oil production in Russia in 2004 amounted to 459,0 million tons and exceeded by 8.9% that in the previous year. Oil sales in the domestic market increased by 2.1% up to 177,6 million tons; export supplies increased by 13.3% up to 239,6 million tons.

A share of export in total oil export volume in Russia in 2004 accounted for 32.3%, and 55.5% in export of fuel and energy products (in 2003, the figures were 29.2 and 50.5% correspondingly).

A share of supply volume in export of oil-products grew by 4.5%, from 77,4 million tons up to 80,9 million tons. Export volume in money terms increased by 35.4%, up to \$19,0 billion against \$14,03 billion in 2003.

2004 saw the highest growth rates in prices of metals since 1992 . This was responsible for an increase from 14 up to 16.8% in a share of the group of goods (metals and related products) which is the second one in order of importance in Russian export (mainly through export of ferrous metals to foreign countries other than CIS countries, which grew by 82.1%).

A share of exports of machinery and equipment (7.2%), chemical products (6.4%), and lumber (4%) in total export volume of products in the Russian Federation remained the same as in the previous year.

Negative effect in the Russian export movement was caused by a 16% decrease in value of food products and related raw materials which resulted mainly from reduction in export supplies of grains.

High prices in the world market fostered growth in contract prices almost of all basic range of Russian export products (*Table 49*).

Table 49

**Average Contractual Prices of Basic Russian Export Products
(supplies to foreign countries other than CIS countries, USD/ton)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Crude oil	133,5	118,5	74,4	110,9	179,9	156,4	162,4	181,2	231,4
Oil products	129,9	115,7	75,7	94,5	171,9	145,2	147,9	180,2	230,3
Natural gas, thousand cubic meters	84,2	88,6	72,2	55,31	85,91	105,21	91,4	112,3	113,6
Hydrogen nitride	125,6	113,0	83,1	53,0	97,5	81,7	72,4	118,5	158,3
Nitrogen manure	128,0	90,3	58,3	36,8	57,9	61,8	60,6	76,0	103,1
Potassic menure	7,2	79,7	87,4	86,4	86,6	76,8	74,9	77,8	94,3
Lumber, cubic meters	59,4	57,5	46,9	43,5	43,4	45,6	44,8	47,8	56,2
Cellulose	407,3	373,5	342,9	274,0	352,2	293,4	300,0	321,7	371,9
Newsprint paper	473,7	383,4	394,0	349,5	386,6	421,7	332,2	338,3	387,9
Cast iron	136,8	124,2	104,3	66,8	80,7	86,2	91,1	126,8	242,7
Ferrous-based alloys	1114	819,2	740,8	548,2	625,6	601,7	625,7	634,6	1097,8
Copper	2143	2099	1655	1495	1675	1465,3	1371,4	1564,9	2587,6
Nickel	7272	6733	5140	5761	8629	5730,9	6143,9	8584,0	1266,0
Aluminum	1500	1401	1352	1157	1296	1176,3	1036,9	1050,0	1162,1

Source: Customs statistical data .

A share of export is nearly 1/3 of total sales volume of industrial products (considering transportation costs and trade markup). The share of export is exceeding substantially the average figure in a variety of industries.

Raw materials industry and primary process industries, primarily fuel industry, metallurgical industry and timber-and-paper industry, as well as in production of special types of basic chemical products and mineral fertilizers, are most oriented at and dependant on export.

A share of export in industries of high-level processing is normally smaller due to poor competitiveness of the manufactured products (Table 50).

Table 50

Export Share in Production of Essential Goods (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Crude oil	41,5	41,7	41,6	45,2	44,2	44,7	45,9	50,3	53,0	53,9
Oil products	25,8	32,4	34,7	32,9	33,6	36,0	39,8	40,9	41,3	52,4
Natural gas	32,2	33,1	35,2	34,5	34,6	33,2	32,8	33,1	32,6	34,4
Coal	17,1	15,8	14,5	15,7	16,7	25,7	39,7	37,2	48,9	25,0
Mineral fertilizers	83,9	85,9	80,6	86,5	83,2	82,9	81,8	78,1	75,2	
Raw wood	22,3	23,2	29,3	34,1	40,1	42,4	53,4	51,0	50,9	42,1
Wood pulp	74,8	85,7	82,8	77,6	79,1	82,4	83,7	85,1	83,3	74,9
Newsprint paper	71,1	72,2	70,1	74,6	70,6	69,0	67,4	68,6	66,6	63,9
Plywood	71,4	63,2	67,0	67,2	69,2	65,8	64,5	64,2	61,4	61,8
Flat-rolled steel and iron products	53,1	59,7	58,6	63,5	60,6	55,3	43,0	50,5	47,1	44,7
Cars	16,7	10,4	4,9	8,3	7,3	12,2	10,1	12,3	11,7	11,5
Trucks	25,4	17,4	10,7	9,6	8,3	7,0	12,3	20,8	19,2	21,2

Source: the RF State Statistics Committee; Customs statistical data.

Restricted access of Russian goods to foreign markets constitutes is a serious obstacle for export growth.

Russia is ranked second after China in the list of countries on which antidumping measures were imposed by the WTO countries in the first half of. As of October 1, 2004, 107 restrictions were imposed on Russian goods, including 53 antidumping duties, 10 quota restrictions, 6 price restrictions, 1 product range restriction, 3 import prohibitions, 2 additional taxes, and 1 protective duty.

According to the Central Bank of Russia, the export transitions efficiency index (ETEI) for an aggregate of goods including nearly 65% of the Russian export value, was estimated as 1,11 in January – October 2004 (in was 1,12 in January thru October 2003). The decrease in the index was mostly caused by growth in prices of goods exported in the domestic market, which ran ahead of contact prices, as well as increased duties on oil and oil products.

Import movement was characterized by growing rates. Volumes import supplies increased by 24.7%, up to \$94,8 billion, which a record-breaking figure over the last decade.

Growth in import volumes were basically responsible for import growth in 2004 (*Table 51*), which reached 120.8% against a moderate growth in prices, 103.1%.

Table 51

Russian Import (USD billion)									
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total import	68.1	72.0	58.0	39.5	44.9	53.8	60.5	75.4	94.8
Including :									
Foreign countries other than CIS countries	47.3	53.4	43.7	29.2	31.4	40.3	48.2	60.0	75.1
	Growth rates, % of the previous year								
Import volume index	98.1	121.1	89.0	84.4	129.2	129.1	117.6	119.2	120.8
Price index	100.2	94.8	92.3	82.1	86.7	94.3	93.4	98.7	103.1

Data source: Bank of Russia.

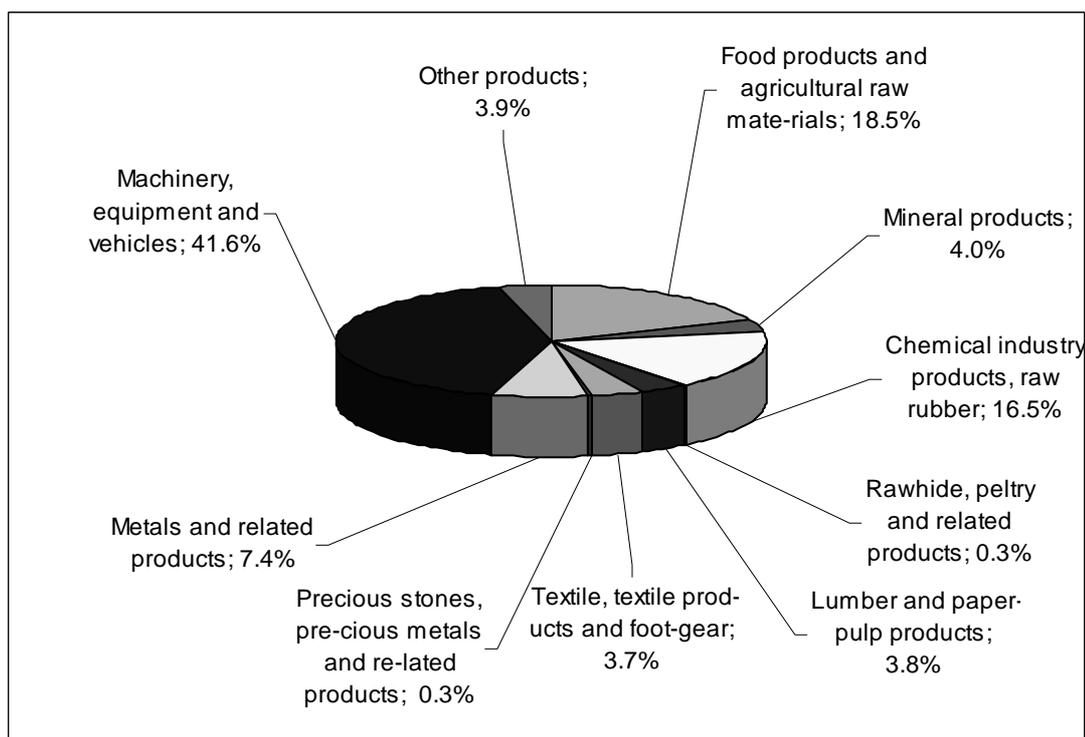
The Russian import growth was mainly based on real RUR strengthening and good figures of economic growth which slowed down by the end of the year though. According tot the Bank of Russia, in 2004, the RUR became stronger by 15.0% against the USD (4.2% were achieved in quarter IV), by 5.6% against the EURO and by 6.1% against the currency basket. By comparison, in 2003 a real strengthening of the RUR against the USD accounted for 13.6%, while by 0.8% to the currency basket.

The ongoing economic growth and relatively low inflation fostered real monetary personal income, which increased by 9% (by 13.6% in 2003) in 2004 against 2003. This results in consumer demand by individuals and industrial enterprises.

Growth in import of goods was mainly based on increased number of machinery and equipment (by 47.8%). Their share in total import of products increased from 37% in 2003 up to 41.6% in 2004, and from 40.8 up to 45.7% in the volume of goods imported from foreign countries other than CIS countries. Increased volumes of land transportation means (their value increased by 1,9 times) was responsible for a half of the growth achieved.

Reduction in volumes of purchases of meet products and sugar and consequent decrease in monetary volumes (by 9 and 25% correspondingly) had an effect on the decrease in a share of food products and related raw materials in total volume of foreign imported goods from 21.2 to 18.5%.

A share of products of chemical industry and related industries accounted for 16.5%, which is almost equal to that in the previous year (*Fig. 73*). This item is ranked 3rd in the Russian import structure.



Source: the RF Federal Customs Service .

Fig.73. Russian Import Structure in 2004 (%)

Growth in import supplies has most adverse affect on Russian motorcar factories. They have been suffering from the consequences of RUR strengthening and competition improvement. The demand for Russian motor vehicles has gradually been declining since the middle of 2003 against growing demand for imported motor. In 2004, import of light motor vehicles to Russia grew by 2,3 times as compared to 2003, its volume reached \$5 163,5 million.

The policy aimed at protecting domestic manufacturers by way of introducing import duties on foreign motor vehicles failed to achieve the expected efficiency. Neither quality of Russian vehicles nor output volumes have been improved over a period of two years of the customs duties imposed. Consequently, the RF Government plans to rely on using imported auto parts to assemble vehicles in Russia .

The Interdepartmental Commission for Protection Measures in Foreign Trade and Tariff Policy made a decision on its meeting held on January 27, 2005 to recommend the RF Government to abolish the import duty on a part of the auto parts imported to the Russian Federation for car assembly, as well as reduce it for several types of auto parts by 3 to 5%. Auto parts imported for free trading in the secondary market would be subject to the applicable rates of duties.

Reducing import duties on auto parts has a direct relationship with integration of the Russian automobile industry into the world automobile industry. This is an objective process which will help to improve quality of motor vehicles. At the same time, domestic manufacturers will not suffer from a decrease in duties on auto parts. At present, almost all modern car assembly enterprises enter into investment agreements with the RF Govern-

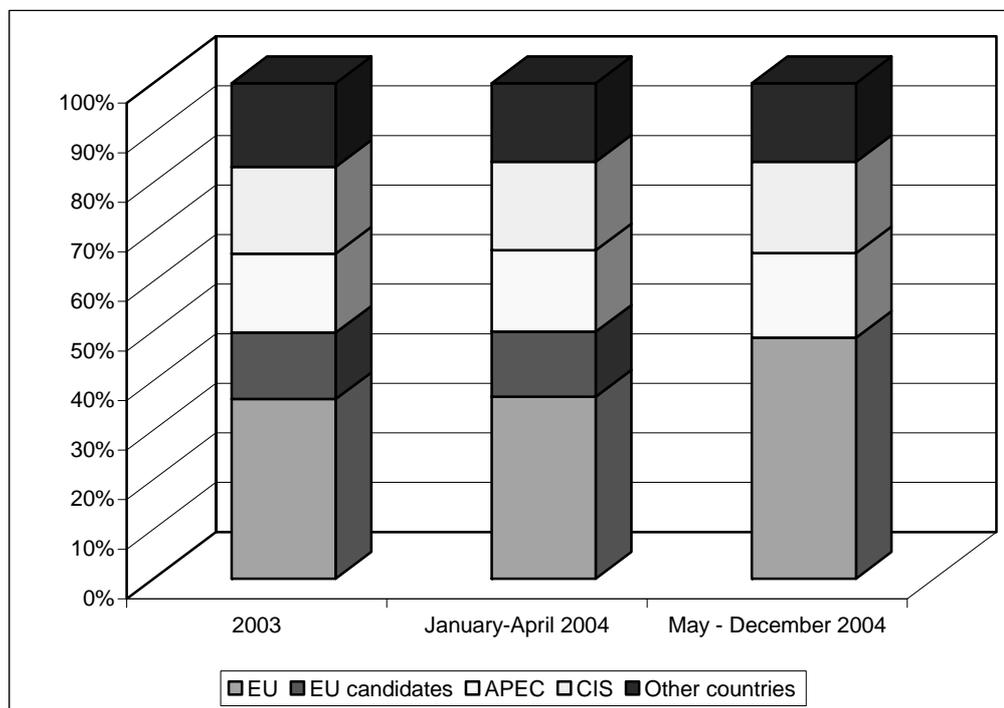
ment , which specify zero rates of customs duties on all auto parts. Thus, the new decision will create equal conditions for all automobile manufacturers.

At the same time, the duties on imported foreign cars will remain high enough. Russia has achieved agreements with almost all countries with advanced automobile industries (except for Japan) on supply of motor vehicles to Russia after its accession to the WTO . The duties imposed on import of second-hand light motor vehicles, trucks, auto-buses being in service more than 7 years will remain unchanged, i.e. banned in fact. Duties on new vehicles will be reduced from 25 to 15%. The decrease, however, will continue within a period of 7 years. The rates will remain the same over the first 4 years out of the 7 ones. Customs duties on import of foreign light cars being in service from 3 to 7 years from the production date will be reduced insignificantly, however, they must not exceed the duties on import of new motor vehicles by a least 5%.

Foreign trade conditions improved for the Russian Federation on the majority of product lines in 2004. Average growth in export prices exceeded the growth in import ones by 12 percentage points.

Export surplus was positive in 2004, \$88,3 billion (\$59,9 billion in 2003).

Geographical structure of Russian foreign trade was slightly changed in 2004 (Fig. 74). Due to the accession of 10 new countries to the European Union in May 2004, a share of this group in the gross volume of Russian foreign trade increased from 36.7% in January thru April up to 48.8% in May thru December 2004. Thus, in analyzing foreign trade transactions of Russia with the European Union, we will consider new EU countries apart from the old ones.



Source: the RF Federal Customs Service .

Fig. 74. Geographical structure of Russian foreign trade

In 2004, Russian foreign trade turnover with the old EU members increased by 36.6% as compared to the previous years, including export by 40.5% and import by 28.4%. For-

foreign trade turnover with the new EU countries increased by 21.7%, including export by 20.6% and import by 26.8%.

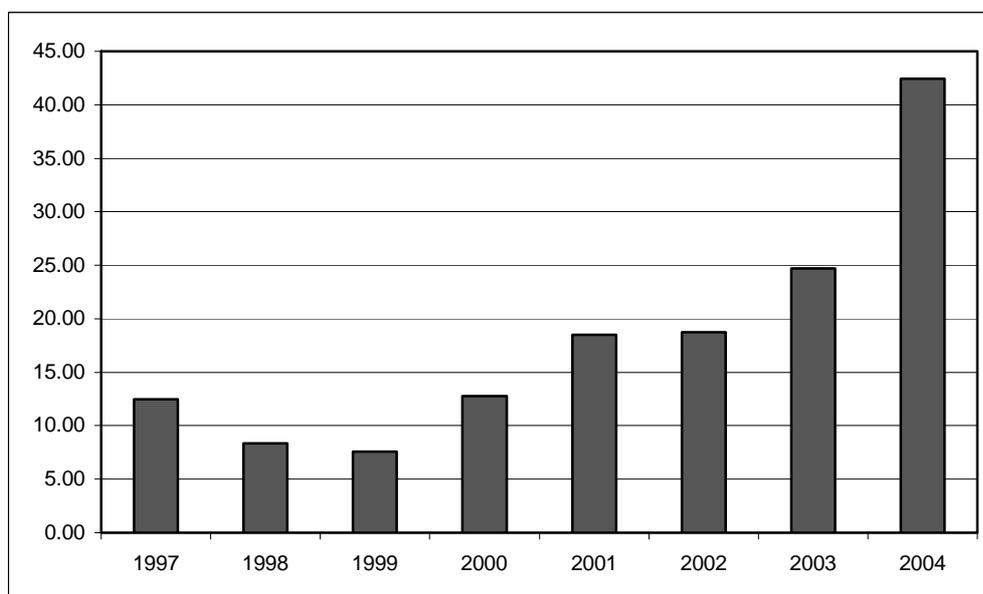
It should be noted that a share of the old EU countries in the foreign trade turnover structure increased by 0,5 percentage points in 2004 as compared to that in 2003. At the same time, a share of this group of countries increased by 1,2 percentage points in the Russian export structure, and decreased by 1,1 percentage points in the import structure. A share of the countries newly accessed to the European Union decreased by 1 percentage point, a share in the export structure decreased by 1,2 percentage points, and by 0,3 percentage points in the import structure.

CIS countries remain second in the structure of foreign trade turnover volume and import. Other countries come second in export volumes, export to the APEC (Asian Pacific Economic Cooperation) countries and the new members of the European Union is nearly equal in volume.

Analysis of the foreign trade turnover structure revealed the following trends: a share of the old EU countries and CIS countries is increasing in the geographical structure of Russian export, while a share of the countries accessed to the European Union in May 2004 and a group of other countries is decreasing.

A share of the APEC and CIS countries increased in the geographical structure of Russian import at the background of decreasing share of the old and new members of the European Union .

Russian foreign trade represents an important factor in financial stabilization of the national economy. Revenues from foreign economic activity have a substantial impact on the revenues of the Russian budget. In 2004, the federal budget received RUR1 219,5 billion in revenues, which is by 61% more than that received in 2003 (*Fig. 75*). Customs payments accounted for 5.65% of GDP in 2003, and nearly 8% of GDP in 2004. The increase in federal budget revenues was caused mainly by growth in prices of energy sources as well as increased import volume.



Source: the RF Federal Customs Service .

Fig. 75. Customs Revenues Inflow to the RF Budget (USD billion)

A share of revenues from export of goods increased in 2004 against the previous year. In 2003 a share of export revenues accounted for 39% against 54% in 2004. However, though a share of import revenues (import duties, VAT, excises, customs duties) decreased, there was an upward movement in import revenues.

Basic import revenues are received from goods imported from foreign countries other than CIS countries. Transportation means come first (group 87). In 2004, import of these goods accounted for 19% of import revenues (12% in 2003), primarily motor vehicles. Other types of equipment come second (groups 84 and 85). Meat products come third (group 2) whose import volumes remain substantial in spite of the introduced quotas. Plastic materials and related products come forth (group 39). Such goods as sugar (group 17) and pharmaceutical products (group 30) are also considered as basic goods generating import revenues.

3.7.2. Establishing a Single Economic Zone for Russia, Ukraine, Byelorussia and Kazakhstan

Creating a Single Economic Zone (SEZ) for Russia, Byelorussia, Kazakhstan and Ukraine is one of the top priorities for Russia for the time being. A search for new and optimal ways of economic integration resulted in an Agreement and Concepts of Establishing a Single Economic Zone signed on September 19, 2003 in Yalta.

The Single Economic Zone means an economic zone which is integrating customs zones of the member-countries for the purpose of ensuring free movement of goods, services, cash and labor force and pursuing a single foreign trade, financial and foreign exchange policies.

In the long term, the four countries are expected to use a single currency. Most importantly, the SEZ is nothing but economic organization meeting the vital interests of all its members.

It was agreed that the SEZ would be created on a stage-by-stage basis, each stage including fulfillment of certain obligations on achievement of a particular stage of integration. A new stage can not be approved until obligations of the previous stage are fulfilled.

The primary goals are to establish a free-trade regime for imported goods of the SEZ members, create conditions for establishing a customs union and a single competitive environment, take measures on harmonization of national laws. Next step is to create a free-trade zone without exceptions and restrictions, conduct a coordinated competition policy, and establish the customs union providing a single tariff. Finally, to ensure a free movement of goods, services, cash and labor force as a result of joints efforts of all the members.

It is proposed to establish a single regulatory body which could assume some powers from the SEZ countries. Decisions of the body would be approved by a weighted voting and mandatory for all the four members. A Council of Heads of States would be a supreme body of the organization. Decisions of the Council would be taken on a consensus basis.

At present, there is a High-Level Group acting as working body of the SEZ, which is represented by Deputies Prime Minister of the member countries. Russia is represented by V.B. Khristenko, Minister of Industry and Power Industry and a special representative of the RF President on integration cooperation issues with CIS countries. The High-Level Group includes 7 task groups working in various segments:

1. Customs and tariff regulation, non-tariff regulation, customs administration ;
2. Competition policy, natural monopolies, subsidies, government purchases, privatization ;
3. Technical regulations, intellectual property ;

4. Tax, budget and monetary policy. Foreign exchange regulation and control, macroeconomic performances ;
5. Services ;
6. Cash flow, investments ;
7. Labor force movement.

A meeting of the heads of the SEZ countries that was held on September 15, 2004 in Astana (Kazakhstan) actually initiated a practical implementation of the provisions of the Agreement and Concepts of Establishing a Single Economic Zone. In particular, a list of 25 top-priority international regulatory documents aimed at substantial liberalization of mutual trade and creating conditions for further advance towards the customs union and a single competition environment as drafted by the High-Level Group was approved. These agreements are scheduled for signing before July 2005.

Humanitarian issues are also among the vital ones. A series of agreements were developed for the purpose of simplifying formalities in crossing state borders by citizens of the SEZ countries.

The experience gained as part of the bilateral relations established between our countries is widely used in creating the SEZ. For example, a series of bilateral agreements were signed in Astana to ensure that VAT is collected on the "country of destination" principle without exceptions as early as January 1, 2005 in the member countries. To date, the High-Level Group has developed a draft basic set of international agreements (more than 80 ones) which represent a legal and regulatory basis of the SEZ has been drafted by .

The Agreement and Concepts of Establishing a Single Economic Zone is open for accession of other countries sharing its principles, provided that they meet the established macroeconomic and institutional criteria. It should be borne in mind, however, that it is the Single Economic Zone that should be established first, primarily its contractual and legal basis, to ensure that every SEZ membership-seeker be able to measure its compliance and capacity provided for by the aforementioned documents.

Accession to the WTO of all the four countries is evidently one of the key issues effecting the entire process of SEZ establishment. The SEZ countries have already established a mechanism of coordination in regard to their accession to the WTO.

3.7.3. Regulating Foreign Trade

In 2004, measures on improvement of tariff and non-tariff regulation in the Russian foreign trade were continued to develop.

In regard to tariff regulation in 2004, a wide range of issues was considered on adjusting export (in particular, asbestos and bleached sulfate pulp) and import (for example, various types of meat, cheese, sodium sulfite, digital audio and video equipment) customs duties.

Rates of export duties on oil and oil products were changed several times due to a price growth of energy resources. A new regulation took effect in February 2002 specifying that the rate of export duty on Russian oil must be determined on the basis of its price in the world markets. The oil export duty was revised once on a two-month basis (*Table 52*). The rate of duty on oil products was adopted together with the rate of duty on oil. It accounted for 90% of the export duty on oil until 1 August 2004, and 65% after 1 August.

Table 52

Rates of Export Duties on Oil and Oil Products in 2004 (USD/tons)

	Oil	Oil products
January	31.2	28.1
since February 1	33.9	30.5
since April 1	35.2	31.7
since June 1	41.6	37.5
since August 1	69.9	45.4
since October 1	87.9	
since November 20		57.0
since December 1	101.0	

Data source: regulations issued by the RF Government

Rates of export duty on oil products became differentiated from November 2004. Now they are calculated on the basis of world oil prices and will average nearly 65% of the oil export tariff. Inside the “oil products basket”, however, export of fuel oil will be twice as cheap as export of refined oil products. For example, with general rate of duty on the “oil products basket” is 15% of export value, the duty on fuel oil is 10%, while that on other oil-based products is 20%.

On the basis of the foregoing, the RF Government approved on October 18 a new rate of customs duties to be imposed on oil-based products exported from the Russian Federation to countries other than the customs union’s member countries. Benzol, toluene, xylol, lubrication oils, oil product residues , propane, butane and other condensed gazes are subject to the rate of duty of \$57 per ton. Since November 20, the same rate was applied to export from Russia of xylols, distillates, gas oils, residues from refining of oil and oil products produced from bituminous rocks. Crude oil products and calcined oil char are exempted from export duty.

The Interdepartmental Commission for Protection Measures in Foreign Trade and Customs and Tariff Policy approved in general the new procedure of export duties on oil products at its meeting held on January 27, 2005 . Export duties on oil products will be calculated concurrently with oil duties for a period of 2 months on the basis of monitoring of oil prices in the world market. The following equation will be used :

For oil products (except for fuel oil):

- $0,416 * (P \text{ is } 109,5)$

for fuel oil:

- $0,224 * (P \text{ is } 109,5),$

where P is oil price , according to the conducted monitoring; 109,5 is oil price per ton, tax exempted.

New export duties on oil products will be determined on April 1, 2005 .

In 2004, measures of protection of domestic manufacturers were based on two guidelines as follows.

First guideline: improving and developing a legal and regulatory basis regulating application of protective measures in the internal market:

- a concept and terms of reference for the Federal Draft Law “On Amendments to the Customs Code the Russian Federation” was developed. The documents were submitted to federal executive agencies for coordination. The Draft Law provides for updating a procedure of declaring various names of goods contained in a single shipment as specified in Clause 128 of the RF Customs Code, as well as a procedure of paying and refunding preliminary special , antidumping and compensatory duties ;

- Regulation No. 546 “On Approval of Rules of Calculation of Specific Subsidy of Foreign Country (Union of Foreign Countries) and On Invalidity of Various Laws of the RF Government Regulating Application of Special Protection, Antidumping and Compensatory Measures in Import of Goods” was prepared and adopted by the RF Government.

Second guideline: providing protection of domestic manufacturers by applying special protection, antidumping or compensatory measures.

The following measures and duties were applied in 2004 on the basis of findings of the previous studies: special protective measures were applied against growing import to the Russian Federation of potato and corn starch, caramel, refrigerating compressors, poultry meat, as well as a compensatory duty was imposed on subsidized import of reinforced concrete rounds from Ukraine.

The effect of the Agreement On Regulation of Black Pipes Supply concluded on April 10, 2001 between the Ministry of Economic Development and Trade of Russia and the Ministry of Economy of Ukraine was extended for the period of 2004 for the purpose of regulating black pipes supply from Ukraine to the Russian Federation.

As a result of negotiations, an Agreement on Regulation of Galvanized Rolled Iron Supply from Ukraine to the Russian Federation was concluded on January 23, 2004 between the Ministry of Economic Development and Trade of Russia and the Ministry of Economy of Ukraine.

Monitoring of effectiveness of special protective measures against import of potato and corn starch, caramel, refrigerating compressors, poultry meat to the Russian Federation and the compensatory duty on import of reinforced concrete rounds to the Russian Federation from Ukraine were monitored throughout 2004. Furthermore, the situation of the Russian caramel market was analyzed.

The monitoring resulted in decisions aimed at reducing the applicable duty on potato starch import and updating the rate of import customs duties on native and modified starches by introducing combined duty rates with a specific component in order to prevent understatement of the customs value.

Growth of imported dried yeasts in the Russian market as well as dumping import of channel beams to Russia from Ukraine were investigated into.

Investigations into dumping import of asynchronous motors to the Russian Federation from the Republic of Belarus and Ukraine and various types of pipes from Ukraine, flat-rolled products from the European Union, as well as increased import of white sugar and electric bulbs to the Russian market were commenced.

Negotiations on conditions of Russia’s accession to the World Trade Organization (WTO) were animated in 2004.

The Task Group held its 22nd meeting on February 5, 2004 in Geneva. The meeting was dedicated to further consideration of the Final Report made by the Task Group, which represents a basic element of the final package of documents for the accession. The meeting resulted in consideration of another 10 sections of the Final Report, including collection of excises and import VAT, export duties, government purchases, regulation of trade in cases of transit, etc.

In addition, two-day bilateral negotiations were held on the subject matter of market access of goods and services. As a result, agreements on tariffs were finalized with 13 countries, however, 1 to 2 items remain to be agreed with 10 countries; agreements on services are expected to be achieved with 11–12 countries. In addition, multilateral consultations on the new RF Customs Code, agricultural issues and tariff quotas were held. The consultations covered mostly technical issues.

The Task Group held its 23rd meeting on March 29 thru April 2, 2004. Ten updated sections of the draft report were considered and coordinated during the meeting. In addition, a series of bilateral arrangements were conducted, including representatives of foreign business communities.

The Task Group held its 24th meeting on Russia's accession to the WTO on July 15 thru 16, 2004 in Geneva. Sections of the Final Report dedicated to customs clearance, foreign trade licensing and intellectual property protection in Russia were considered.

The meeting was dedicated to the issues related to customs. Most of the WTO members express their concern about the new RF Customs Code, especially in regard to shipment clearance at customs stations and customs value determination.

The Task Group held its 25th official meeting dedicated to Russia's accession to the WTO on November 18, 2004 in Geneva. The third revision of the Final Report on Russia's accession to the WTO which was substantially updated as compared to the previous one, was considered.

Customs service is one of the most delicate issues at the negotiations, especially customs value determination, law enforcement, several agricultural problems, sanitary and phytosanitary control and technical regulation in general, as well as intellectual property protection.

Furthermore, the United States and Canada continue express their high concern of the issue related to double pricing of energy sources. Russia, however, is not ready to offer substantial concessions in this field.

The progress is as follows. Russia finalized negotiations on terms and conditions of mutual access to product markets with 14 countries (in particular, major trade partners of Russia : nearly 50% of trade turnover with the European Union, 10% with China, 4% with South Korea). A total of 46 countries (in addition, over 10 countries have been negotiating on services only, other WTO members have no claims whatsoever to Russia as they have no economic relationship) expressed their desire to negotiate with Russia. It is important that all of them should agree on Russia's accession to the WTO, because decisions on accession of a new member to the WTO must be made by common consent of the existing WTO members. Russian negotiators expect to finalize negotiations with Australia in spring of 2005.

The hardest part upon achieving an agreement with the European Union and China is to do the same with the United States. Prospects of the Russian aircraft industry is the issue that still remains unresolved. Accession to the WTO has various impact on various industrial sectors . Some of them (telecommunications, banking, insurance services, etc.) has an up-to-date institutional and technological base, but anticipate a sever competition upon opening of the market, though they are competitive and even have an advantage over their competitors in the Russian market. Others, above all processing industries, recognize their poor competitiveness against importers and consequently tend to a harder protective policy. Aircraft industry is the "hardest" one: it needs huge investments, secured leasing treatment and more to make it catch up with the contemporary market of passenger air jets. This industry must continue for strategic purposes.

Copyright is the second complicated problem in the negotiations with the United States. Russia is ranked second in the world in production of illegal copies (software, video and audio products). At a press conference held recently in Moscow, the US party has demonstrated DVD movies that haven't been released in the United States yet.

Thus, the Russian Federation has reached the final stage in accession to the WTO, when most complicated issues are to be resolved. Potential obligations on all parameters of the accession (tariffs, agricultural obligations, service market access, system-based

issues) will be based on current and future economic situation and ensure the required protection of domestic manufacturers and adequate competitive environment.

Construction of legal and regulatory framework regulating foreign economic activity is expected to be finalized soon. A lot of work has been performed to bring the Russian customs legislation in compliance with the WTO's regulations. A total of fifteen laws and draft laws were considered in the previous year. The RF Customs Code took effect on January 1, 2004; RF Law "On Regulation in Foreign Trade" came into force on July 15, 2004. RF Antidumping Law and Law on Technical Regulation regulating a minimum set of standards and reducing the number of required licenses were adopted. A foundation of legal protection of intellectual property was laid.

The applicable legal base regulating Russian foreign trade includes the new RF Customs Code, 12 regulations and 2 instructions issued by the RF Government, more than 80 regulations of the RF Federal Customs Service issued in elaboration of the RF Customs Code.

However, the initial year of operation under the new the RF Customs Code revealed that several of the RF Customs Code need to be more clear-cut, certain and legally elaborated. The same is true with the regulations issued on the basis of the RF Customs Code and orders of the RF Government, as well as law enforcement. In addition, nearly 30% of more than 10 000 different regulations, orders and instructions issued on the basis of the RF Customs Code of 1993 are still effective. RF Law "On Customs Tariff" needs to be brought in compliance with the new RF Customs Code and the requirements of the World Trade Organization . No amendments were made to the RF Tax Code the Russian Federation in regard to value added tax refund, in particular processing products exported from the customs territory of Russia. Provisions of the RF Customs Code and the RF Tax Law remain to be correlated . Altogether this is evident of the fact that legal basis of customs regulation still remains to be finalized.

Application of simplified customs clearance mechanisms to special types of entities is one of the essential new developments of the RF Customs Code. Such mechanisms provide for faster customs clearance for the entities which respect customs regulations in good faith.

However, special simplified procedures of customs clearance came to be applied only in May 2004 pursuant to Federal Law "On Amendments to Various Regulations of the Russian Federation and Invalidation of Various Regulations of the Russian Federation Due To Application of Measures on Public Administration" of June 29, 2004 No. 58-FL. This is caused by the fact that the RF Customs Code neither specifies clear application mechanisms of such procedures nor authorizes departments to establish such procedures. So, amendments were made to the RF Customs Code authorizing the Ministry of Economic Development and Trade of the Russian Federation to establish such procedures.

There is another new and essential development provided for by the RF Customs Code – computer-based declaring of goods – that needs to be finalized too. The RF Customs Code permits provision of electronic documents. However, neither list of electronic documents which may be submitted nor their forms have been specified to date. The required software and hardware are not available yet.

Foreign trade operators are facing serious economic, legal and administrative problems caused by expanding practice of the RF Federal Customs Service aimed at restricting the number of customs clearance stations for declaring certain categories of goods.

There were 34 regulations restricting the number of customs clearance stations for declaring certain categories of goods before the new the RF Customs Code came into effect. Such measures allowed declared goods to become legal in trade and increased in

number: electronic household appliances by 1,5 to 2 times and meat by 2,5 times, with insignificant changes in export of such goods to the Russian Federation .

Article 125 of the RF Customs Code provides for submission of customs declarations to any customs clearance station. However, practical application of this Clause by agencies under the RF Federal Customs Service makes this provision ineffective in regard to numerous categories of goods by underlying a new category: "goods related to frequent violations of the RF Customs Law". Such practice is governed by Clause 2(3), Article 125 of the RF Customs Code which is uncertain and referential in essence, thus allowing the RF Federal Customs Service to restrict by internal regulations the number of customs clearance stations for declaring numerous categories of goods. Such practice of application of Article 125 of the RF Customs Code received a fairly negative response from the Task Group on Russia's accession the WTO as being considered a form of non-tariff protectionism.

At the same time, maintaining such authorities of federal government agencies complies with the international practice (standard rule 3.20 of the General Schedule attached to the Kyoto Convention 1999) and is aimed at improving control efficiency. Unlike the former regulation, the new RF Customs Code Russia provides for clear-cut criteria for restricting the number of customs clearance stations. Such measures must be justified and based on risk analysis, and abolished if they prove inefficient and have an adverse effect on operation of foreign trade participants. The number of customs clearance stations for certain categories of goods will gradually be increasing under liberalized customs regulations and due to a wide use of IT-based customs clearance and supervision procedures, as well as introduction of a system of risk assessment and management. At present, the RF Federal Customs Service has prepared proposals on reduction of restrictions imposed on the number of customs clearance stations for declaring goods imported to the customs territory in accordance with the plan coordinated with the Ministry of Economic Development and Trade Russia .

The new RF Customs Code resulted in substantial changes in composition of the so-called customs-related organizations (customs brokers, customs carriers, owners of interim storage facilities).

Establishing large amounts of security for entities which run the customs-related business, has already ousted small and medium-size companies from the market, which are unable to secure their responsibility to customs authorities. For example, 1469 organizations provided services on interim storage of goods before the RF Customs Code came into force, while 1116 companies appeared to be listed in the corresponding Register of owners of interim storage facilities at the end of 2004. The number of companies operating as owners of customs warehouses and providing storage services at these warehouse was reduced from 219 (including 4 organizations established by customs authorities), as of January 1, 2004, to 168 (including 3 warehouses established by customs authorities).

A monitoring conducted late in 2004 of the changes in the market of services provided by customs brokers (representatives) showed that such services were rendered by 278 organizations listed in the Customs Broker Register (representatives) and qualified for being included in such Register, as well as 122 organizations operating as customs brokers with licenses (prior to the end of license period) issued by customs authorities prior to January 1, 2004. Thus, total number of customs brokers was 400. Prior to the new RF Customs Code took effect, 843 customs brokerage licenses were issued, while the number of customs brokers was reduced by 2,1 in 2004.

There is a threat of monopolization of broker services by a dozen of large brokers. This may entail monopolized prices of brokerage services, encourage corruption trends in this environment, increase costs incurred by trade operators and boost up prices of imported consumer goods. The same is true with the market of customs carriers and storage services.

Thus, a series of problems were revealed during the initial year under the new RF Customs Code, which could be resolved by making amendments to the regulatory documents and, in special cases, updating corresponding provisions of the RF Customs Code .

The following problems are worth mentioning:

- to date, no amendments were made to the customs-related laws and regulations of the Russian Federation ;
- RF Law “On Customs Tariff” was neither brought in compliance with the new RF Customs Code nor the requirements of the World Trade Organization ;
- no amendments were made to the RF Tax Code in regard to VAT refund, in particular on processing products exported from the customs territory of Russia ;
- problems still can be found in incompliance of provisions of the RF Customs Code Russia with the Tax Law the Russian Federation in regard to tax base determination for assessing customs duties and taxes, as well as in incompliance of limitation periods of customs payments enforcement with integrity checks of data provided for customs clearance after products are manufactured.

Invoice processing rules established pursuant to RF Law On Taxes and Duties, make no allowance for the fact that goods may be produced prior to submission of a customs declaration, when a state customs number is not yet assigned and consequently can not be indicated in an invoice so that the goods can be sold in the domestic market.

Tax authorities may face problems after January 1, 2005 in applying the provisions of the RF Customs Code referring to the Law On Taxes and Duties, due to the amendments made by the Federal Law of July 29, 2004 to Article 13 of the RF Tax Code under which the customs duty is excluded from the list of federal taxes .

At the same time, it should be noted that some amendments to the RF Customs Code were already made. RF Law “On Amendments to the RF Customs Code” was adopted, which added a new Chapter (“Customs Duties”) to the RF Customs Code. This was done for the purpose of ensuring a legal support in collecting customs duties.

Article 33.1 (“Customs Duties”) provides definition of the “customs duties” term and specifies a list limiting their categories: customs duties on customs clearance, carrying and storage. The Draft Law specifies the maximum rate of customs clearance duty: RUR100 thousand. It also specifies fixed rates of customs carrying and storage of goods at interim storage facility or customs warehouses owned by customs authorities. The Draft Law specifies fixed rates of special categories of customs duties thus making it a direct-effect law.

For example, customs duty for escort of goods is RUR2000 per each vehicle and each unit of rolling stock at a carrying distance of up to 50 km and RUR3 000 for that at a distance of 51 to 100 km. However, customs duty for escort of goods at a distance more than 200 km is RUR1000 per every 100 km of the road, but not less than RUR6000. The amount of customs escort duty is RUR20 000 per every sea vessel, river craft or aircraft regardless of carrying distance.

Making amendments to the Code will help Russia to meet its commitments in the field of customs duty at the negotiations on its accession to the WTO : pursuant to Article VIII of the General Agreement on Tariffs and Trade (GATT), customs duties must be collected as compensation for customs costs rather than for fiscal purposes.

Federal Laws "On Basic Principles of Public Regulation in Foreign Trade" and "On Foreign Exchange Regulation and Control" took effect in June 2004, which play an important role in regulating foreign economic activity. These laws underwent expertise confirming their compliance with the corresponding WTO regulations .

RF Law "On Basic Principles of Public Regulation in Foreign Trade" provides updated definitions of basic terms (foreign trade, import, export, etc.) and introduces a series of new terms and definitions (transit, free trade zone, customs union). The Law contains provisions on separate public regulation of foreign trade in goods, services and intellectual property. It also includes new provisions on regulation of foreign barter trade and on pre-shipment inspection. A new procedure on counter measures is introduced.

The Law specifies basic principles of public regulation of foreign trade on the basis customs-tariff and non-tariff methods, including the following ones measures: establishing and abolishing import and export customs duties and dues; imposing and withdrawing restrictions and limitations in international trade in products, services and intellectual property; arranging and withdrawing economic and administrative measures promoting development of foreign trade; concluding international trade agreements as well as agreements on customs unions, free trade zones or regional economic integration.

The Law ensures that the Russian legislation meet the provisions of Articles I, III, V, XI, XIII, and XXIV of the GAAT of 1994 as well as the WTO Agreements on import licensing and pre-shipment inspection.

Furthermore, the Law specifies regulations on imposing restrictions and limitations provided for by Articles XX and XXI of the GAAT of 1994. Special provisions of the Law are intended to ensure transparency in accordance with Article X of the GAAT of 1994.

Developing new regulations and making amendments to the applicable ones is one of the basic tasks of the present period in implementing provisions of Federal Law "On Basic Principles of Public Regulation in Foreign Trade", in particular measures of non-tariff regulations.

FR Law "On Foreign Exchange Regulation and Control" excludes precious metals and precious stones from the list of currency valuables, which provides for liberalization in this field and makes the Russian legislation compliant with Article XX of the GAAT of 1994 in this respect.

The Law also specifies the term for abolishing the existing restrictions, as well as reduces the number of capital transactions requiring permission of the Bank of Russia, with consideration of international agreements of the Russian Federation, including Article. VIII of the Agreement with the IMF.

The list of non-commercial operations classified as current exchange transactions is largely expanded. The list is open, which provides for further liberalization of foreign exchange regulations.

In November 2002 , when a new revision of RF Law "On Foreign Exchange Regulation and Control" was prepared, RF Minister of Finance A. Kudrin pointed out that the standard of compulsory disposal by exporters of a share of foreign exchange earnings might range from 0 to 30% subject to the RF Central Bank. This standard should be reduced on a regular basis, while it also may be increased provided that Urals oil price drop to \$12 USD per barrel. In last July, the RF Central Bank already used its right to change the standard by reducing it half as much, down to 25%.

At the end of November 2004, the RF Central Bank made a decision to sharply reduce the standard of compulsory disposal of a share of foreign exchange export earnings from 25 to 10%. This is a decision of major importance, because it was this standard that

the Russian Government was using for a long period a tool to influence inflation and USD/RUR exchange rate.

The standard of compulsory disposal by exporters of a share of foreign exchange earnings came into force on January 1, 1992 pursuant to a Regulation On Liberalization of Foreign Economic Activity issued by President B. Yeltsin. The mechanism worked as follows: a republican foreign exchange reserve received 40% of foreign exchange earnings at a special exchange rate, and a foreign exchange stabilization fund of the RF Central Bank was built up on the basis of 10%. The foreign exchange reserve and special exchange rate were abolished on 1 July 1992 : the entire 50% of foreign exchange earnings was supposed to be sold in the domestic foreign exchange market according to the procedure established by the RF Central Bank: 20% in the domestic foreign exchange market and 30% directly to the RF Central Bank to replenish its foreign exchange reserves. It was only a year after, on July 1, 1993, when the RF Central Bank allowed the entire 50% of earnings to be sold in the foreign exchange market. Economic situation of that time was undoubtedly complex: downward trend in RUR exchange rate, huge inflation and short supply of consumer goods.

The RF Government again brought up the issue after the post-crisis period in 1998. The State Duma approved a decision to increase the standard from 50 to 75% in December of the same year.

In 2001 the standard was reduced from 75 to 50% due to high oil prices. In 2004 the standard was reduced to 10% as result of ultra high oil prices in the world market .

Thus, in 2004, the Russian Government continued to bring the RF law in compliance with the WTO requirements, which above all meets the Russian national interests and is conditioned by intensive expansion of foreign trade relationships with other countries, Russia's integration into the world economy and consequently the need to develop an up-to-date and adequate mechanism of trade policy as based on the principles and rules of international trade.

3.8. Military Security of Russia under Present Conditions: Economic Problems

3.8.1. Military policies and military-economic activities in the Russian Federation

The bases of the RF state policies in the field of military organization for the period of up to the year of 2010 were determined by the Supreme Commander- in-Chief, the RF President, as far back as 2002 and such policies are further specified by the President in his annual addresses to the Federal Assembly. Jointly with the National Security Concept and the RF Military Doctrine, these documents define objectives and tasks of both military organization and military activities in general. Concrete programs, the Federal Target-Oriented Program (FTP) for transition to a new system of army recruitment in particular, were respectively approved by the RF Government.

Adoption of the federal budget by the early 2004 permitted timely approval of the state defense order as well.

Thus, positive solution of the RF military security tasks, it would seem, was to be supported with all the necessary resources which did not augur any faults in functioning of the respective "power bodies".

However, analysis of the Defense Ministry activities in 2004 construes an impression that its governing bodies proceeded basically from their own understanding of the objectives and tasks of the said activities as stated in the "Development the RF Armed Forces:

Topical Tasks” (the so called “White Book” of the Defense Ministry, October, 2003). This is mostly attributable to a strong wish of the Defense Ministry governing bodies to close down the question of the Russian military reform as though it has already been fully, successfully and finally completed.

Yet, even if double failure of the submarines’ strategic missiles during the exemplary 2004 naval maneuvers, attended also by V.V. Putin, RF president, was indeed quite accidental but at that accidental rather demonstrative. It once again graphically showed that with their *de facto* results being neither compared against the respective costs nor estimated with regard to the economic expediency, the administration system of the “power bodies” is simply liable to have low efficiency. Another significant factor was lack of due civilian control.

A number of facts are leading to a conclusion that the military-political leadership of Russia began at last to understand this situation which in turn brought about the appearance of political will to overcome such. So it is not by any chance that early last year a group of top ranking Defense Ministry officials, for the first time during many years, made a special trip to visit their colleagues in Great Britain just in order to study their practical experience in the area of defense financing. However, there was something more important here – the RF administrative reform which started in April, did not pass the “power bodies” by. So the necessity of their participation in this reform once again graphically demonstrated unlikeness of the defense ministry’s thesis that the military reform had already been fully, successfully and finally completed.

Results of ensuring RF military security on the international arena in the last year do not at all seem to be unambiguous. On the whole, these may be considered as successful with regard to foreign countries. For instance, Russia was able to preserve its principle position in the Iraqi question and rejected insistent invitations to join the US military effort in this country. At the same time, however, because of its own national interests, Russia continued to support international forces in Afghanistan by providing for transit of military and other respective cargo through its territory. Stronger became its cooperation with the NATO: 34 joint actions took place during the year, including military games in the headquarters of NATO in Brussels, joint naval maneuvers in the Ionian Sea and the Northern Atlantic Ocean, the first entry of a Russian A-submarine into the French sea port of Brest and maneuvers simulating defense of nuclear objectives on the Kola Peninsula.

Steadily maintained is a sufficiently high level of Russia’s military and technical cooperation with foreign countries. As officially declared, the volume of military exports for the said year exceeded 6 (six) bln US dollars. In the same period, however, claims were for the first time openly made to Russia in connection with her inability to complement all the supplied armaments with the necessary spare parts. Besides, there still remains the problem of money deductions for the intellectual property in the Indians-made Russian armaments models.

Quite positive results were also achieved in both military and military and technical cooperation with the former Soviet republics. Successful were the “Border 2004” anti-terrorist maneuvers conducted in Kirghizia within the framework of the Agreement on the CIS Collective Security. At the same time, however, a number of observers openly expressed their opinion that Russian peace-keeping forces did not at all act in the best way during the aggravation stage of the July 2004 international conflict in the Southern Ossetia.

In the Russian Federation itself, in 2004, its armed forces were used in Chechnya, Ingushetia and the Northern Ossetia. The special forces and anti-mine engineering units combat operations in Chechnya are considered as sufficiently efficient. The troops own

losses somewhat decreased as compared with the previous years. Yet, any attempts to free the territory of this republic from the terrorist bands and catch their leaders were rather unsuccessful. And although withdrawal of the airborne units from Chechnya by the end of November basically completed the reduction process of the troops strength on its territory, almost simultaneously plans were published to form two mountaineering-rifle brigades in the Northern Caucasus. It is noteworthy that stationing one of them on the territory of the mountainous Daghestan was confronted with active protestations of the local population caused, as reported, by plans of the military to alienate certain agricultural lands.

Of particular significance is the fact that actions of all “power bodies” during the criminal sally of the terrorist fighters in Ingushetia on June 22 and the Beslan tragedy on September 1–3 were extremely unsuccessful. The latter were in both cases able to take initiative at least for a certain period of time.

Last year, the composition, organization and functions of the Defense Ministry were significantly changed – the General Staff of the RF Armed Forces lost a number of administrative functions as regards direct control of troops and was placed under the authority of the Defense Minister which, as expected, should enable him to concentrate on matters of strategic planning and perspective development of the RF Armed Forces.

Practically completed is the change-over to a unified inter-departmental supply system under which the Armed Forces Logistics Services were made responsible for supplying the troops of all the “power bodies” with the Defense Minister controlling financing of the nuclear defense system.

In July, 2004, the system of military education experienced another change of names which, on the one hand, to some extent returned it to its former state (with military academies and military schools) but, on the other, it was accompanied with the lowest graduation rate of officers from the respective military institutions for the recent years. In the course of three years alone, this graduation rate decreased from 24 thousand down to 14 thousand military servicemen. Accordingly, plans were worked out to draft 15 thousand graduates of civilian higher educational institutions to serve as officers. At that, the Defense Ministry considers the resultant full strength of officers in the RF Armed Forces to be about 88% of the “optimum”. The Defense Ministry also started a three-year experiment on the competitive distribution of the respective funding between civilian educational establishments intended for training officers with humanitarian specialization. Although the main funds of the Federal Target-Oriented Program (FTP) for reforming the system of military education in 2004 were allocated to certification of the military educational institutions, their connection to Internet and renewing the stock of the respective libraries’ educational materials.

One of really significant events in the area of military and technical policies and purchases of armaments was the document: “Main Development Directions of Armaments, Military and Special Machinery for the Period of up to the Year of 2020” adopted at the Defense Ministry Collegium in late March, 2004.

According to the “Red Star” newspaper, more than 300 armaments and military machinery models were added to the RF armory in the period from 2001 which somewhat contradicts frequent complaints about insufficient financing of the R&D by the state. But the situation, possibly, is rather reverse. The said R&D problems, it seems, are primarily caused by exceptional privacy of R&D, poor connection with requirements of different army branches, flourishing corruption and excessive abuses.

In the year of 2004, there still was no positive solution of the defense industry problems. To somewhat facilitate its reforming process, the list of strategic industrial enter-

prises was cut down from 3 thousand to 1059. Attempts were also continued to administratively introduce vertical structures: for example, the end of the year saw setting up of a helicopter-construction corporation headed by the "OPK Oboronprom" Open Joint Stock Society and consisting of the Mil Moscow Helicopter Plant, the Ulan-Ude and Kazan aviation plants which "Rosvertola" (with 51% federal share in the corporation) is expected to join in future. However, a number of observers have strong doubts that such measures are capable of positively solving of the so called "disproportion" problem. Besides, of major significance is becoming the quality of the armaments and military machinery produced – the number of claims for product replacement has grown 10 times on the domestic and 20 times on the foreign markets.

Not everything is going well enough with transition of the RF military organization to the new system of recruitment for the army.

The previous year of 2004 was the first to see the start of implementing the "Transition to Recruiting Contracted Servicemen for a Number of Military Units and Formations" FTP for the period from 2004 to 2007. Besides, an attempt was made to attract the CIS citizenry to contract servicing but so far with little positive results.

Fully contracted in the Defense Ministry already is the 76th Guards Airborne Division (the city of Pskov). Intensively being re-equipped are the barracks and hostels where the military units and formations are stationed which are preparing for transition to the new recruitment system for the army in 2005.

As has been officially declared, there are no more drafted RF Defense Ministry servicemen in Chechnya. Yet, there still remain in Chechnya 3.8 thousand Ministry of Internal Affairs Forces (MIAF) drafted servicemen and that contributes neither to better efficiency of the troops nor to decreasing negative attitudes of the public as concerns the draft system of recruitment for the army.

As different either from the RF Armed Forces top officials who do not intend to give up draft recruitment in full, or the MIA Internal troops which have not yet determined their position on this matter, the Frontier Troops have already firmly decided in favor of such transition to contracted service of all their servicemen by the year of 2008 and in 2004 even rejected 6 thousand of drafted servicemen.

On the whole, the situation with compulsory drafting in the Russian Federation does remain rather problematic. Abundant is corruption which fact is graphically evidenced by bringing to criminal account of a number of functionaries from the military registration and enlistment offices: all in all, 27 men were brought to criminal account during the year of 2004 alone.

No more joyful were the social results of 2004 for professional military servicemen. Not everybody was quite happy with regard to abolition of privileges. Attitudes towards the mortgage system to provide living accommodations for military servicemen remains rather suspicious since such a system does not directly concern most of those with no living accommodations. There is a lot of criticism regarding indexation of servicemen's money allowances and wages of the civilian personnel.

It is quite difficult for military servicemen to understand the Defense Ministry policy in this respect – it is neither sufficiently transparent nor any logically consistent. Which is, in particular, evident from analyzing the situation concerning practical implementation of the above said FTP. Appearing in the mass media means, Yu. N. Baluevsky, the new Head of the RF DM General Staff, frequently noted the low quality of the citizenry who agree to serve on the contract basis, explaining it by the fact that "*most of our countrymen consider payment for military labor as definitely insufficient*" – 6200 roubles a month (outside Chechnya) including all the due bonuses. Obviously, this is too little, particularly so if ac-

count is taken of the fact that the average monthly wages/salaries in the country already comprise something about 7000 roubles. However, fully in accordance with Article 13, Clause 9, "On the Status of Military Servicemen" of the Federal Law, any increments to the basic money allowance are determined by none else than the "Defense Minister of the Russian Federation (Head of another federal body of executive power in which the federal law provides for military service)". As stated in the said law, "within the limits of the funds allocated" but nevertheless by these very persons. It is their direct duty to strive for allocation of such funding.

However, actions of the Defense Ministry during the last two years insistently demonstrate quite a different policy. As far back as early 2003, when the inter-departmental Working Group was set up to prepare the FTP, all members of the Group were given a document signed by the Defense Minister. This document set up the calculated level of the money allowance for the contracted servicemen – 4000 roubles a month. Any reasonable objections of some Group members that this level does not correspond to the results of the respective sociologic polls and is grossly understated were simply ignored. Moreover, while the RF Government were preparing a Resolution on the FTP (the formal approval took place on August 25) the Defense Minister signed Order No 245, dated 9.07.03, on establishing monthly extra pay "to certain categories of military servicemen for the importance degree of the tasks performed". Such "*certain categories*" included officers of the DM central bodies of administration and the said extra pay comprised 75% of their basic salaries.

It was only in December 2003 that the same minister, on the same grounds and fully in accordance with the approved FTP that Order No 450 was finally signed introducing extra pay "for special conditions of combat training" to contracted servicemen in military units and formations to be transferred to the new system of recruitment for the army. The Order instructs to introduce significant extra pay to those serving in the 42nd Guards Division, stationed in Chechnya, and extra pay in the amount from 2700 roubles to 3300 roubles in other military units and formations to be transferred to the new system of recruitment for the army, the guiding principle being: the higher the rank, the higher the extra pay. Yet, the respective payments started not right away but only "beginning from the day of assumption of an office but not earlier than the date when the commander of the respective military unit by his order officially declared transition of such unit to the new system of recruitment for the army". In the result, the money allowance level of contracted privates and junior rank officers in the permanent alert military units and formations turned out to be lower than the average wages/salaries in the country. Moreover, totally forgotten were contracted servicemen in other military units and formations not being transferred to the new system of recruitment for the army. Such turned out to be market motivation for joining the army on the contract basis!

A year later, when it became clear that with this level of payment RF citizenry are not very willing to become contracted servicemen on a voluntary basis and that such level indeed needs to be raised, functionaries of the Defense Ministry just repeated the approach efficiently tested in the previous year: they just prepared a new Order - No 346, dated 30.10.04, which increased the said extra payment up to 120% of the basic money allowance but... only to military servicemen in the central administration.

It is also noteworthy that the said extra payments in the military units and formations are eventually determined by the commanding officers thus opening the way for possible arbitrariness with regard to military servicemen.

3.8.2. Military expenditures of the federal budget

Since the federal budget for the year of 2004, military expenditures of the state included, was approved in due time it enabled all the executive bodies to practically immediately start its implementation. And although growth of prices on fuels and lubricants, electrical energy and housing and communal services during the year required that the corresponding expenditure articles be increased, profit of the federal budget permitted such increases which was practically done in November 2004.

Due to changes in the law on the Federal Budget, its expenditures were increased up to 2 768.1 bln roubles (or by 4.1%) which allowed to increase military expenditures as well. Finally, the defense expenditures grew by 3.9% on the whole; at that, the military program of Minatom (Ministry of Atomic Energy) went up by 8.9% and expenditures on the military reform grew by 16.5%. Expenditures on pensions to military servicemen remained at the same level and on pensions in the law enforcement bodies even went down by 7.7%. Thus, growth of the military budget turned out to be less than such of the federal budget on the whole. No indexation of the money allowance for the military servicemen or of salaries for the civilian personnel were provided. In view of the regular indexation of salaries for the federal state employees, it was understood in the military servicemen community as intention of the state's military and political elite to solve macroeconomic stabilization problems at the expense of worsening the social status of families of military servicemen, military pensioners and civilian personnel of the "power bodies".

Absolute and relative indicators of the basic military expenses in accordance with the final version of the federal budget are represented in *Tables 53* and *54*.

Table 53

Direct military expenditures of the federal budget for "National defense"

#	Name of the section and subsections	2004, mln roub./the same in prices of 2003	Changes in 2004 as com- pared against 2003, mln roub/ growth rates %	Share of expenditures/its changes as compared against 2003, %	
				in Fed. Budget 2004	GNP
1	National defense	427 376	27 704	15.44	2.65
		382 610	7.24	0.74	-0.03
1.1	Building and maintaining of RF Armed Forces	403 376	25 026	14.59	2.50
		361 504	6.92	0.65	-0.04
1.2	Military program of Minatom	18 326	3 395	0.66	0.11
		16 407	20.69	0.12	0.02
1.3	Mobilization and military training for civilians	4 696	34	0.17	0.03
		4 204	0.82	0.00	0.00
1.4	Collective security and peace keep- ing (preparation 189 and participa- tion)	211	-706	0.01	0.00
		189	-373.43	-0.03	-0.01
1.5	Branches for the national de- fense	343	-46	0.01	0.00
		307	-14.93	0.00	0.00

Table 54

Direct and indirect military expenditures for other federal budget sections

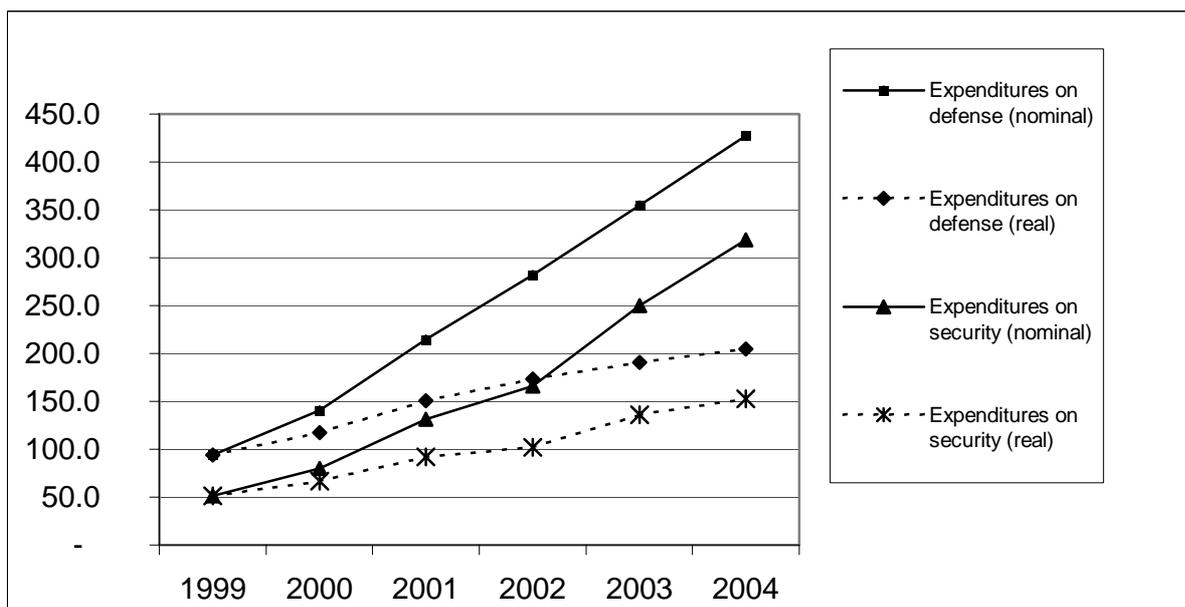
No	Name of the section and subsections	2004, mln rouble/the same in prices of	Changes in 2004 as compared against 2003 mln roub	Share of expenditures/its changes as compared against 2003,%	
				in Fed. Budget	GNP
2	Expenditures on military organization in "Law enforcement and state security"				
		<u>23 347</u>	<u>1 680</u>	<u>0.84</u>	<u>0.14</u>
2.1	Internal troops of RF MIA	20 902	8.04	0.05	0.00
		<u>53 571</u>	<u>-216</u>	<u>1.94</u>	<u>0.33</u>
2.2	State security bodies	47 960	-0.45	-0.06	-0.03
		<u>31 272</u>	<u>1 797</u>	<u>1.13</u>	<u>0.19</u>
2.3	Bodies of border services	27 996	6.42	0.04	0.00
3	Military and related expenditures provided for in other sections of the federal budget				
		<u>6 630</u>	<u>422</u>	<u>0.24</u>	<u>0.04</u>
3.1	Men, combat training, material and technical supply of MES forces (without fire service)	5 935	7.11	0.01	0.00
		<u>1 093</u>	<u>-49</u>	<u>0.04</u>	<u>0.01</u>
3.2	Maintenance of special construction bodies	979	-4.99	0.00	0.00
		<u>1 100</u>	<u>500</u>	<u>0.04</u>	<u>0.01</u>
3.3	Mobilization preparation of economy	985	49.23	0.02	0.00
		<u>67</u>	<u>-7</u>	<u>0.00</u>	<u>0.00</u>
3.4	Civil defense	60	-11.70	0.00	0.00
		<u>8 438</u>	<u>-10 100</u>	<u>0.30</u>	<u>0.05</u>
3.5	Military reform	7 554	-133.70	-0.43	-0.08
		<u>18</u>	<u>-43</u>	<u>0.00</u>	<u>0.00</u>
3.6	Russian defensive sports-technical organization	16	-266.55	0.00	0.00

It is noteworthy that growth of military expenditures of the Russian Federation after the 1998 crisis is of a stable character. However, as shown in *Table 55* and *Fig. 76*, in constant prices of 1999 this growth is of a fading character.

Table 55

Dynamics of expenditures on defense and security in 1999–2004

Sections of the federal budget	Years					
	1999	2000	2001	2002	2003	2004
Expenditures on "National defense" in prices of the budget year (1999, mln roubles)	<u>93 702</u>	<u>140 852</u>	<u>214 688</u>	<u>281 970</u>	<u>354 907</u>	<u>427 376</u>
Increment as compared against the previous year, %	–	25.1	28.5	15.2	10.1	7.2
Increment as compared against 1999, %	–	25.1	60.7	85.2	103.8	118.6
Expenditures on "Law enforcement and state security" In prices of the budget year (1999, mln roubles)	<u>51 324</u>	<u>79 802</u>	<u>131 621</u>	<u>165 999</u>	<u>249 799</u>	<u>318 543</u>
Increment as compared against the previous year, %	–	29.4	39.1	10.6	32.8	12.4
Increment as compared against 1999, %	–	29.4	79.9	99.0	164.2	197.0



Source: Calculations of IET

Fig. 76. Dynamics of expenditures on defense and state security, bln roubles

As to indirect military expenditures (*Table 56*), noteworthy is their stabilization which is determined by completion of the main processes of transition of Russia's military organization to a new system. There also took place further decrease of the real (5%) expenditures on pensions to military servicemen which is stimulating loss of the military service prestige.

Table 56

Indirect military expenditures connected with previous military service

№	Name of the section and subsections	2004, mln roub./the same in prices of 2003	Changes in 2004 as compared against 2003 mln roub/growth rates %	Share of expenditures/its changes as compared against 2003, %	
				in Fed. Budget 2004	GNP
4.1	Pensions to military servicemen	66 606	-2 969	2.41	0.41
		59 629	-4.98	-0.19	-0.06
4.2	Utilization and liquidation of armaments, including performance of international agreements	10 944	-962	0.40	0.07
		9 797	-9.82	-0.05	-0.01
4.3	Conversion of defense industry	190	-80	0.01	0.00
		170	-46.97	0.00	0.00

Table 57

**Summary indicators of military
and related expenditures**

No	Name of expenditures	Expenditures (mln roubles)	Share of expenditures/its changes as compared against 2003, %	
			In federal budget 2004	GNP
1	Summary direct military expenditures	544 474	<u>19.67</u>	<u>3.38</u>
			0.80	-0.06
2	Summary direct and indirect military expenditures connected with the present and past military service	630 651	<u>22.78</u>	<u>3.91</u>
			0.13	-0.22
3	Total expenditures on national defense, law enforcement and national security	745 919	<u>26.95</u>	<u>4.62</u>
			1.90	0.06
4	Summary direct and indirect federal expenditures connected with the present and past military and law enforcement and state security	881 768	<u>31.85</u>	<u>5.47</u>
			1.20	-0.12

Data on performance of the military and related expenditures, based on Ministry of Finance monthly reports concerning performance of the consolidated budget, are represented in *Table 58* and *Fig. 77*. When analyzing them, account should be taken of the fact that in 2004, the Ministry of Finance turned to quarterly allocation of expenditure quotas whereas in 2003, such quotas were determined on a monthly basis. Effect of such innovation seems to be rather doubtful because, for example, with the general excess of the planned level of expenditures on "Building and maintenance of the Armed Forces" in the amount of 3.2 bln roubles, indebtedness to the Defense Ministry's suppliers comprised in the end of the year more than 5 bln roubles. Accordingly, it seems somewhat paradoxical that significant financial effect was achieved with regard to articles "State security bodies", "Pensions to servicemen of the RF Defense Ministry" and "Military reform" where savings comprised 1.7, 1.7 and 2.2 bln roubles, respectively.

Table 58

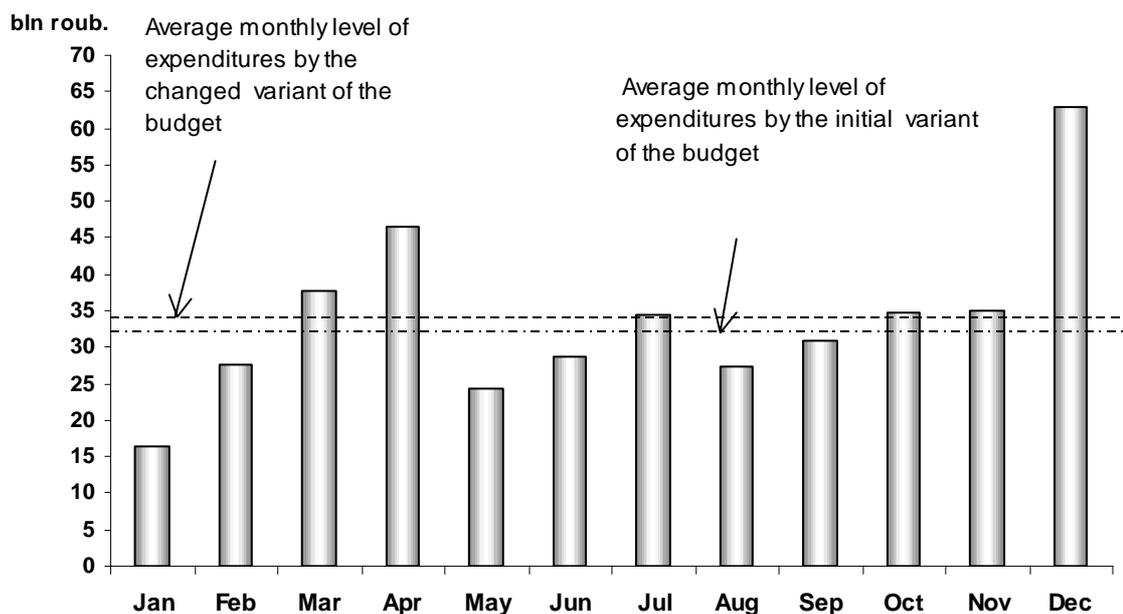
**Performance of military and related expenditures in the federal budget
by months, mln roubles**

No	Expenditures	Plan/Plan with corrections	January	February	March	April	May	June	July	August	September	October	November	December	Saving (over-expenditure)
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	National defense	<u>411</u>	18 432	30 310	40 597	96 218	22 084	29 158	37 042	28 888	32 511	36 217	36 868	65 806	(2 586)
		<u>473</u>													
1.1	Building and maintaining of RF Armed Forces	<u>427</u>	16 467	27 670	37 610	46 581	24 457	28 727	34 479	27 424	31 026	34 795	34 984	62 801	(3 222)
		<u>376</u>													
1.2	Military program of Minatom	<u>389</u>	1 842	2 346	2 539	1 092	1 122	-	2 189	1 148	1 157	1 097	1 519	2 275	
		<u>402</u>													
1.3	Mobilization and military training of civilians	<u>403</u>	119	254	397	398	330	413	356	308	317	301	298	591	614
		<u>800</u>													
		<u>16 826</u>													
		<u>18 326</u>													
		<u>4 687</u>													
		<u>4 696</u>													

RUSSIAN ECONOMY in 2004
trends and outlooks

No	Expenditures	Plan/Plan with corrections	January	February	March	April	May	June	July	August	September	October	November	December	Saving (over-expenditure)
1.4	Collective security and peace keeping (preparation and participation)	215 211	2	16	15	17	25	18	18	8	10	25	22	16	21
1.5	Branches for the national defense	343 343 310	2	24	36	43	68	-	-	-	-	-	45	341	1
2	Law enforcement and	577 318 543	11 189	22 435	26 656	27 650	20 970	27 870	25 085	22 409	27 344	25 688	28 246	49 809	3 192
2.1	Internal troops	21 531 23 347	720	1 397	1 868	1 927	1 725	2 206	1 888	1 836	1 990	1 981	2 467	3 575	(233)
2.2	State security bodies	49 737 53 571	2 536	3 634	3 915	4 258	3 498	4 045	4 558	3 391	4 170	4 001	3 710	10 146	1 709
2.3	Bodies of border services	29 993 31 272	803	1 355	2 035	2 683	1 896	2 538	2 028	2 768	2 586	2 626	3 016	6 377	561
3.1	Conversion of defense	190 190	15	19	-	56	16	-	-	-	-	-	81	4	
3.2	Maintenance of special construction bodies	1 089 1 093	19	89	84	101	82	95	93	69	74	62	64	142	119
4.1	Prevention and liquidation of consequences of	15 705 15 977	713	1 054	1 250	1 708	1 005	1 429	1 343	1 302	1 285	1 304	1 393	2 083	106
4.2	Civil defense	67 67	-	-	13	3	8	3	5	14	-	10	2	8	
5	Pensions to military servicemen	66 606 66 606	5 225	5 253	5 381	8 127	2 676	5 382	5 396	5 515	5 475	5 500	5 448	5 480	1 747
6	Utilization and liquidation of armaments, including performance of international agreements	10 365 10 944	457	844	1 453	310	1 653	79	588	1 201	528	1 075	1 106	1 632	17
7	Mobilization of economy	1 100 1 100	17	36	124	258 067	257 860	7	37	13	45	103	252	252	8
8	Military reform	7 246 8 458	328	594	713	561	379	586	546	325	743	393	364	739	2 185

As can be seen from the comparative analysis of the defense expenditures structure of a number of foreign countries (*Fig. 78*), a rather popular opinion about an insufficient level of the investment component in Russia's military expenditures is most likely just a habitually wrong understanding. Should the decision of the RF Security Council on the "optimum" share of expenditures on the respective development equaling 40%, be implemented, then Russia will be among the top in this indicator category leaving behind the USA, the Great Britain and Germany. Whether this is really needed and what the effect of such "optimality" will be, to a considerable extent still remains a question with no answer. Neither the criterion of optimization nor its methodology are yet known to the Russian scientific community. So far, the funding of the investment component, for instance, in the Defense Ministry are to a considerable extent formed at the expense of expenditures on the money allowances and salaries what its governing bodies are absolutely not shy to officially and regularly declare in different mass media means.



Source: Calculations of IET based on the RF Ministry of Finance data.

Fig. 77 Expenditures on building and maintenance of RF Armed Forces in 2004.

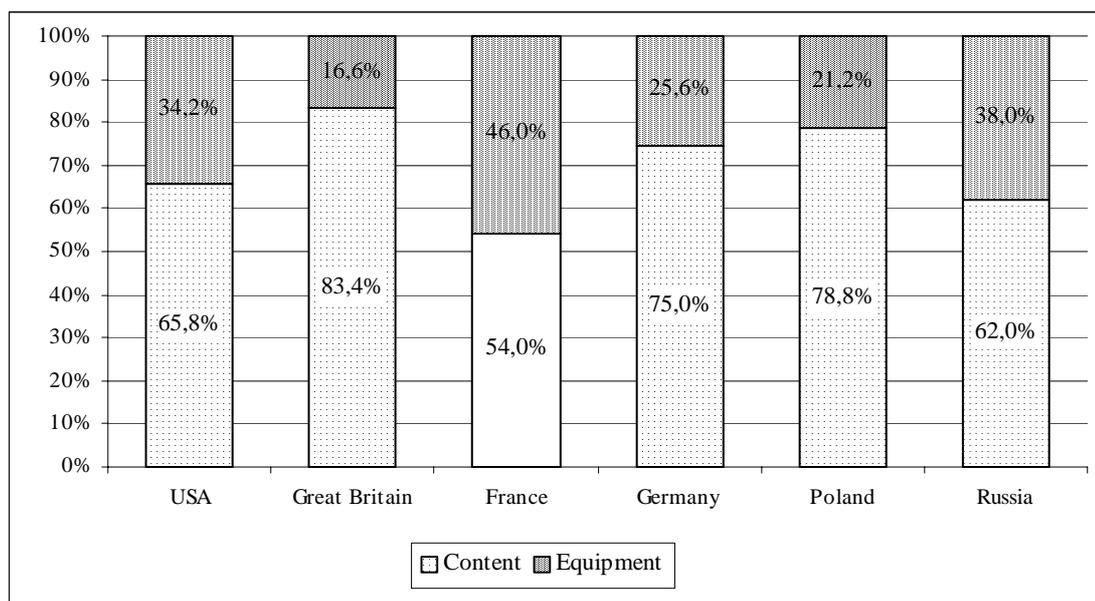


Fig. 78 Structure of expenditures on equipment and maintenance of armed forces of a number of countries in 2004.

Sources: 1. Der Verteidigungsetat 2004. Einzelplan 14/2004 im Vergleich zum Haushalt 2003 (in der vom Parlament verabschiedeten Fassung, Stand 28.11.2003);
 2. UK Defence Statistics Factsheet 2003 Edition. – London: The Stationery Office, 2003;
 3. Budget of the United States Government Fiscal Year 2006;
 4. Budget de la defense pour 2004. Novembre 2003;
 5. Podstawowe informacje o budziecie MON na 2004 rok. – Warszawa: Ministerstwo obrony narodowej, 2004.

3.8.3. Problems of further modernization of Russia's military organization

Within the executive power reform which started in the year of 2004, a principally new, the main and a priority element in the activities of the RF Defense Ministry and other "power bodies", as the respective state government organs, in 2005 will most likely be restructuring the budget planning activity, the routine activity itself and the respective accounting procedures. To be put to good order are to be the following activity parameters of all subjects of planning, the "power block" included:

1. Objectives and tasks of activities;
2. Obligations with regard to expenditures and formation of returns;
3. Results of activities;
4. Distribution of expenditures by objectives, tasks and programs;
5. Results of the budget expenditures.

Accordingly, these parameters determine the section names of a special document called: "Report on the Results and the Main Directions of Activities of the Budget Planning Subjects". Actually, some of the above parameters were also formulated in such documents as: "The National Security Concept" (NSC), "The Military Doctrine" (MD), "The Fundamentals of the RF State Policies in the Field of the Military Organization" (Fundamentals) and others. Distribution of expenditures by objectives, tasks and programs as well as estimating the results of the respective activities in close coordination with expenditures for the RF Defense Ministry on the whole is a principally new task, which is but only partially familiar to the RF Defense Ministry administration officers, for example, from the experience they gained when working out the State Program of Armaments" (SPA).

If we take the first group of the above parameters of activities alone, even then close coordination of *strategic objectives*, *tactical tasks*, and *targeted programs*, as required by the Government, will nevertheless turn out to be quite problematic. No less problematic seems to be coordination of a number of indicators in time.

The published methodological recommendations (MR) do contain an approximate list of Russia's strategic objectives to be used in working out the said Reports but it is neither exhaustively full nor sufficiently enough satisfies the requirements to formulating such objectives by the MR themselves. Besides, the corresponding objectives of the budget planning subjects, in particular such for the Defense Ministry's activities, are to be worked out for each strategic objective of the country. This approximate list does have certain notional faults as well, such as, for example, division of threats into external and internal ones although the difference between them consists only in the fact that aggression is initiated not by foreign states but by transnational centers which usually tend to operate in secret and under cover.

Noteworthy is also one more requirement with regard to the objectives and tasks which determine activities of the budget planning subjects. This is conditioned by a simple fact that one of the most important sections of the Report, namely "Distribution of expenditures by objectives, tasks and programs" (see above, p. 4, in the list of parameters and sections), must be first worked out and then practically used. However, in accordance with both the Budget Code and the Law on the Budget Classification, expenditures must be distributed according to the officially approved classification groupings of expenditures, primarily so by sections, subsections, specialized articles and expenditure types of the budget functional classification.

The structure of two expenditure sections and their subsections in the Federal Budget for the year of 2005 (FB – 2005), to such or other extent connected with ensuring the national military security, is presented in *Table 59*. This *table* also contains the ap-

proved values of respective expenditures as well as shares of expenditures by subsections in each section.

Values of future military expenditures permit to make the following conclusion: Expenditures on the “national defense” have grown in the absolute value and are expected to comprise the figure of 533.1 bln roubles or about 16% of the FB expenditures. In relation to the GNP, the level of expenditures will change rather insignificantly.

The structure of expenditures does not clearly show what part of such will be allocated to the technical equipping of the RF Armed Forces although, according to official declarations of the Defense Minister, it equals 186.9 bln roubles (35.2% of the total expenditures). The said structure includes expenditures on R&D (33.7%), on purchasing new and modernized models of MAT (60%) and on repairing MAT (6.3%). Any proof as to how optimal such expenditures distribution is, or may be, is not yet known either.

The social component of the military expenditures still continues to be criticized by both military servicemen and civilian personnel. No indexation of the basic pay is provided for in the budget, nor many people seem to be very happy about the increasing special allowances. To avoid social protests, early in 2005, the RF President instructed the RF Government to find a positive solution for these social problems of all those connected with the country’s military security at the expense of the expected additional revenues.

Comparison of the budget expenditure groupings, as represented in *Table 59*, with the strategic aims (both shown in the said methodological recommendations and those mentioned earlier in the approved conceptual documents) inevitably leads to a conclusion that *they do not correspond with each other*.

Moreover, such classification structure of the military expenditures in the RF was different in the earlier years (it is changed almost every year) which will make analysis of expenditures for the period of six years, including the previous years, undoubtedly much more difficult. Suggestions contained in the said methodological recommendations, i.e. to group expenditures of the functional and economic classification by objectives and tasks, are actually rather hard to practically implement. Sufficiently accurate in this case can only be presentation of such expenditures by objectives and by the budget classification groups simultaneously.

Little doubt causes something else: if all the state spending is to be put under control then the same should be extended to the so called “non budget returns” of the RF Defense Ministry and other “power bodies” as well. These must become sufficiently obvious for the budget and be put under control.

Moreover, the problem of inconsistencies is not at all exhausted with that. For, there is a number of by-laws setting aims and objectives of the budgetary planning subjects. This primarily concerns the so called “power bodies” – subjects of the budgetary planning.

For instance, in the Regulations on the RF Defense Ministry, by the Decree of the President of the Russian Federation, dated 16.08.04, functions of this ministry are set as consisting of:

1. working out and implementing state policy in the field of defense;
2. normative and legislative regulation in the field of defense;
3. performing other functions in the same area as established by the respective RF laws, presidential Acts and the Government of the Russian Federation.

Table 59

Structure of budget expenditures connected with ensuring the national security

Name of section and subsection	Amount (mln rouble).	Share in summary expendi- tures %
National defense	531 139.2	100
Armed Forces of the Russian Federation	388 028.8	73.1
Mobilization and military training of civilians	1 895.4	0.4
Mobilization preparation of economy	3 500.0	0.7
Collective security and peace keeping (preparation and participation)	61.1	0.0
Nuclear and weapons complex	8 693.1	1.6
International obligations in the area of military and technical cooperation	6 231.0	1.2
Applied scientific research in the field of national defense	79 189.9	14.9
Other matters in the area of national defense	43 539.9	8.2
National security and law enforcement	398 889.5	100
Internal troops	23 893.8	6.0
Security bodies	62 315.8	15.6
Border services	31 685.0	7.9
Prevention and liquidation of consequences of emergencies and natural calamities, civil defense	22 054.7	5.5
Applied scientific research in the field of national security and law enforcement	2 654.3	0.7
Other matters in the area of national security and law enforcement	19 100.1	4.8

The said Regulations contain neither directions nor formulations of the objectives to be reached which needs implementing of the said functions. So, on the face of it, there can be no contradictions with any suggestions concerning activities of the RF Defense Ministry. However, further on, the Regulations explicitly state the tasks of the Defense Ministry and if these are considered as tasks of the budgetary planning subject, then, due to the absence of respective objectives, these tasks turn out to be, figuratively speaking, pointless. Of the ten tasks, enumerated in the Regulations on the RF Defense Ministry, the first three and the tenth one apply to working out the policy and the respective normative and legislative regulation but in the most general form. Accordingly, estimating the solution of these tasks can be only strictly formal. Hence, there will be no practical possibility either to evaluate the degree of solving such tasks or to make workable conclusions as to rationality of the respective military expenditures.

Very much the same can be said about tasks of the Defense Ministry in the field of coordination. The said formulation of the tasks make it practically impossible to understand the exact purpose of such coordination or where it is actually leading to. To give an account of their performance is indeed possible but again – in a strictly formal form. Which will undoubtedly contradict the very idea of the said reforming the system of state governance.

The above analysis results of documents which do not sufficiently enough coincide with each other, permit at this stage to work out but only some *proposals of conceptual nature* which are connected with the reform of the state governance in the RF and relate to the sphere of activities of the RF Defense Ministry.

1. First of all, in our opinion, we must change our understanding as to the practical use of the RF Armed Forces in the present, relatively peaceful time. This relates, for example, to the intelligence and analytical activities of the Main Intelligence Department of the

General Staff and other departments of the RF Defense Ministry aimed mainly at timely revealing of military threats and ways to efficiently parry them back. Novelty of the present situation lies in the transnational nature of military threats and their merging with the terrorist separatism in the Russian Federation.

2. The objective of technically equipping the RF Armed Forces must be made and kept contentually adequate and fully in accordance with the changes in the tactical and technical parameters (TTP) of the armed struggle means and principally new features of the contemporary period in the economic development of humanity.
3. Content of the task connected with solving social problems of military servicemen, must be tied up with ensuring a high social status for all categories of such servicemen and full exclusion of the compulsory military service in regular military forces in peaceful time.
4. The most radical changes must be made in the content of the basic military tasks in peaceful time. For, the main for many combat branches now is not combat readiness for possible hypothetical military actions but combat watch, force determent of aggression and solution of other concrete military tasks aimed at preventing any aggression. *Later on, these kinds of activities must become main for all kinds and branches of the Armed Forces.*

Analysis of the Regulations on the RF Ministry of Internal Affairs (MIA), approved by the RF President in his Decree, dated 19.07.04, resulted in the following conclusions: the established functions of this ministry consist in working out and practically implementing the state policy as well as in the normative and legislative regulation in the sphere of internal affairs, matters of migration included.

One of the MIA tasks is that of controlling its internal troops (IT MIA) and organizing their practical functioning. But the nature of such activities is not at all specified in the said Regulations. Nor there is any confirmation of the task which was posed to the troops in the previous version of the "Fundamentals of the State Policy in the Field of Military Organization", namely "suppression, localization and neutralization of internal armed conflicts on the territory of the Russian Federation". There is only one clause of authorities determining participation of the RF MIA in "securing the wartime regime" as well as in "conducting measures of the wartime regime".

Accordingly, to plan the budget spending on the MIA internal troops as well as to estimate the efficiency of their activities on the basis of such task setting can hardly be deemed possible.

Such situation with determining the role of *other troops and military formations* in other bodies having them at their command, is quite similar.

Section 4. Institutional and Macroeconomic Challenges

4.1. Policies in the sphere of property relations

4.1.1. Privatization and federal property administration: some results of the year of 2004

Initiated in 2003, the gradual implementation of the key elements in the new “Concept of the Federal Property Administration”¹ began to steadily acquire ever more and more fragmentary character in the year of 2004. One of the most obvious and objective reasons for such a development was the reorganization of the executive power structure which included liquidation of the RF Ministry of Federal Property (RF MFP) replacing it with setting up the Federal Agency for Federal Property Administration (FAFPA or “Rosimushestvo”) with its further subordination to the RF Ministry of Economic Development endowing it with norm setting functions in the sphere of privatization². The necessity in a rather lengthy adaptive period during and after the said reorganization, the attendant changes in the personnel structure and composition (primarily so departure of a significant part of the former RF Ministry of Federal Property employees), further sophistication of the administration structure followed with the inevitable attending problems of coordination (along with preservation of the RF MFP) although but only functions of the seller were left to the latter, possibility for a new FAFPA re-subordination (for instance, directly under the RF Chairman of the Government) – all these logically led to the indisputable fact that in the year of 2004, respective activities of the state in the sphere of its own property administration were mostly of a rather inertial and spontaneous character.

In fact, the only component of the new “Concept of the Federal Property Administration” which was in such or other way being practically implemented in the year of 2004, was the *3-year long program of privatization*. Such a document (“Prognostic plan of privatizing the federal property for the year of 2004 and the main directions of privatizing the federal property up to the year of 2006” was approved by the Instructions of the RF Government, dated August 15, 2003, No. 1165-p. In particular, the following sequence of actions was intended:

- 2003 – privatization of the state owned packages of shares in the amount of up to 2% of the authorized capital;
- 2004 – the state terminates its participation in all joint stock societies where the share of the state comprises less than 25%;
- 2005 – the state terminates its participation in all joint stock societies where the share of the state comprises from 25% to 50% (in particular, it terminates its participation in the capital belonging to companies engaged in the energy supply complex, fishery, foreign economic activities, machine-building and cinematography);
- 2006 – the state terminates its participation in all the companies where it owns more than 50% of the share packages but which are not listed among the strategic ones (in particular, those of the civil aviation whose business activities are directly connected with ensuring security of both the respective flights and the state, the chemical and the

¹ Although the “Concept” was approved at the meeting of the RF Government on February 6, 2003, in the period from 2003 to 2004, however, it did not yet receive the status of an official document (as different from the respective “Concept” of 1999). For more details see: Radygin A., Malginov G., Privatization and Federal Policy Administration. Russian economy in 2003. Trends and perspectives. M.: IET, 2004. Pp. 327 – 339.

² Decree of the RF President, dated March 9, 2004, No. 314 “On the System and Structure of the Federal Executive Power bodies”.

petrochemical industries, geology and a number of branches of agriculture), including sale of shares of such joint stock societies which were set up during the transformation process of the FPUEs (Federal Public Unitary Enterprises);

- by the year of 2008 – completion of privatizing the federal property which is not practically used for performing the state functions of the Russian Federation, final formation of the management system over the property in the state sector, doubling of incomes from the practical use of the federal property.

According to the estimations made by the RF Ministry of Federal Property in 2003, practical implementation of this program required annual sales of shares belonging to 4000 joint stock societies (including the reorganized FPUEs). To practically reorganize something about six thousand (6000) FPUEs by the year of 2006 (as was evidently implied in the said plan), it was necessary to simultaneously make changes in the respective normative and legal acts lifting off the current limitations on privatization for over three thousand (3000) existing FPUEs. Accordingly, no more than two thousand (2000) FPUEs and five hundred (500) different packages of shares are expected to remain in the state ownership by the end of 2008. Thus, we can talk about quite a radical scenario of completing the property reform in Russia.

Nevertheless, unreality of the set up time terms stated was quite obvious already when the said program was being adopted and the practical steps undertaken during the year of 2004, became but only an additional confirmation of that fact (*Table 1*). The basic limitations to practical implementation of such a large – scale program within the time terms stated, still remain valid as well:

- demand for the overwhelming majority of the objects to be privatized remain extremely low; moreover, the rest of the unsold objects which successfully “transit” from one year into the other, only keep on increasing;
- risks of bringing about certain instability factors into the stock market and of selling the state property cheaper than such could take place under a smooth, time extended process of privatization;
- rather high probability of permanent corrections introduced in the lists of the respective packages of shares and enterprises due to various objective and subjective reasons;
- organizational facilities of the respective management bodies for fast enough reforming the state sector are in strong contradiction with the existing quantitative limitation – its scope;
- although the quantity of the state owned minority packages was such or otherwise getting reduced during the recent ten years, the rate of such reductions, however, does not substantiate any reasonable forecast of full solution of the problem within the three year span of time³;
- demand for new implementation mechanisms of not quite attractive minority packages (in particular, rejection of estimating the minority packages put up for sale and determining the starting price at the face – value of the shares to be sold) unless such has been practically confirmed⁴;

³ The *de facto* sales of the packages of shares in the recent years comprised but only from 10 to 30 per cent of those planned for a year. For example, 1 965 packages of shares were planned to be sold but nevertheless no respective auctions were officially declared for 571 of them, nor there was any decision on excluding the given enterprise from the said strategic list for 103 of them, and 158 enterprises faced the standard bankruptcy procedures initiated against them (although the latter could easily be viewed as a sort of a spontaneous privatization).

⁴ As a sufficiently radical instrument, it probably seems sensible to suggest reducing the authorized capital in the amounts equal to the state share in such JSS where several attempts to sell the state package definitely and unequivocally failed and their management does not have reasonable financial, managerial or strategic perspectives. However, this practical step will

- resistance of the branch ministries and primarily so with regard to reforming the PUEs [Public Unitary Enterprises] (mostly due to various financial and administrative reasons);
- drastic reductions in the quantity of unitary enterprises at all levels with their possible transforming into open joint stock societies (OJSS) which, while evidently increasing the loads on the public governance bodies, is hardly demonstrating any better efficiency in the capacity of public representatives during this particular time period as well;
- using the property of the respective unitary enterprises in order to set up an appreciable sector of public enterprises legally functioning as operative managerial units which simultaneously implies increase of financial risks of the state as connected with the subsidiary responsibility with regard to obligations of such enterprises;
- sufficiently significant remains to be the problem of executing full – fledged property rights of the respective enterprises on land plots (overcharged prices of redemption and rent, different methods of cadastral estimations and determining the real market price, administrative barriers, regional policies and so on and so forth).⁵
- general and not at all simple problems of ensuring the required level of quantitative normative and legislative support.

A significant factor, as noted above, was the 2004 administrative reform the influence of which on the processes of managing the state property simply can not be considered as unambiguous. On the one hand, for example, although revision and redistribution of functions between the respective ministries and departments evidently do stimulate more favourable conditions for radical reductions in the FPUE sector, there, nevertheless, also takes place certain general weakening of control over the said FPUEs as caused by the absence of sufficiently clear and distinct division of functions and authority functions between the FAFPA and the respective agencies under the branch ministries. On the other hand, however, reorganization of the system of managing the federal property often creates quite serious problems for the current representation of the state in governance bodies of the JSS with the state package including the said list consisting of 27 largest strategic JSS. According to the available data, the Charter stipulated meetings of the shareholders in most of these companies were conducted in the year of 2004 without the compulsory instructions and directives, as approved by the RF Government, or the position as formulated by the Rosimushestvo. Another problem to be dealt with is prolonged legal proceedings as connected with the state property management where of particular significance is the succession of the state position⁶.

indeed require solid legislative support. A positive incentive for potential buyers could become, for instance, consolidation of the residual state and municipal packages of shares for simultaneous sale.

⁵ In December 2003, the President of the Russian Federation signed the law (amendments to the Law “On the Practical Implementation of the RF Land Code”) extending the time term for compulsory re-registration of the right of using the respective land plots by privatized enterprises into the right of ownership or rent in the period from January 1, 2004 to January 1, 2006. As to payments for such land plots, no more than just consideration of the respective projects was taking place during the whole year of 2004.

⁶ Russian Focus, 2004. July 5 – 11. p. 8.

Table 1

**Basic Objects of the Federal Property
and the Privatization Program for the 2000s**

	1999*	2000	2001	2002	2003	2004	2005
Total quantity of FPUes**	13 786	11 200	9394	9846	9275	8820	–
Privatized FPUes during a year:							
– forecasted	–	–	–	1652	970	1063	1325
– de facto	–	2	5	78	571	455	–
whose packages of shares are in the ownership of the RF**	3611	3524	4407	4 222	4 035	3905	–
Including, <i>inter alia</i> , the respective share in the authorized capital:							
– 100%	382	61	90	99	124	273	–
– 50–100%	470	506	646	589	552	499	–
– 25–50%	1601	1211	1401	1 382	1308	1183	–
– less than 25%	863	1746	2270	2152	2051	1950	–
– the “golden” share	580	–	750	958	640	–	–
Federal packages of shares sold during a year:							
– forecasted	–	–	–	1126	1965	719	566
– de facto***	–	87	216	185	638	150	–

*For the end of each year. The year of 1999 is used here as the respective basis with due account taken of the adoption of the “Concept of Administrating the State Property and privatization in the Russian Federation” (officially approved by the Resolution of the RF Government, dated September 9, 1999, No 1024).

** The total quantity of unitary enterprises in the early 2000s comprised about 80 000, including about 20 000 of the state enterprises and about 65 000 of the municipal ones. In 1995, the state owned not less than 15 000–17 000 different size packages of shares but in 1999 – about 3 100 of “fixed” packages and from 7 000 to 8 000 of unsold ones (remaining on the balance of the respective regional property funds). In the year of 1995, 1004 joint stock societies already had the said “golden” share.

***Data on the packages of shares annual privatization yield to no correct interpretation for a whole number of reasons: (1) absence of sufficiently regular information from the RF Ministry of Property and the RF MFP; (2) transference of packages of shares from the RF Minimushestvo to the RF MFP and its divisions for further sales which actually never takes place (as a rule, only 10 to 20 per cent of the deals are considered as completed); (3) a “counter” FPUe corporatization process and other methods to increase the quantity of packages in the ownership of the state. As to the FPUes, the respective data on privatization appear to be rather relative since the official values probably include a number of FPUes which were subjected only to the primary corporatization. In January 2005, the RF Ministry of Economic Development suggested to include 42 FPUes and 63 JSS in the privatization plan for the year of 2005 additionally.

Source: Data of the RF Ministry of Economic Development, FAFPA.

The necessity of correcting the respective time – terms to complete the privatization process of the federal property, as provided for in the “Forecast plan (Program) for privatizing the federal property for the year of 2004 and the main directions of the federal property privatization up to the year of 2006”, was determined by the problems mentioned above. According to the “Forecast plan (Program) for privatizing the federal property for the year of 2005 and for the period of up to the year of 2007”⁷, the following corrections are

⁷ The project for the years of 2005 – 2007 was considered at the meeting of the RF Government on July 29, 2004, “The forecast plan for the year of 2005” to be then officially approved by the Decision of the RF Government, dated August 26, 2004, No. 1124-p.

provided for in the main directions of the respective privatization process of the federal property for the medium – term period (2005 – 2007):

- prolonging the perspectives of the federal property privatization through the year of 2007;
- completing the privatization process for the federally owned packages of the respective JSS shares comprising less than 25 % of the authorized capital, in the year of 2005;
- changing the structure of the federal property branch-wise privatized;
- introducing such notion as a “*perspective financial plan*” in the planning concept of the federal property privatization.

The working assumption here also is that decision - taking in accordance with the directions of the state policies in the sphere of privatization currently under consideration, will make it quite possible, already in 2007, to set fully in motion the plan providing for the maximum liberalization of the economy from the state through privatizing the whole federal property which actually is not quite necessary for ensuring the respective functions of the state.

De facto failure of the plan to sell the remaining minority packages of shares *en masse* in the 2000s actually determined the need in searching for additional (to the current law on privatization, 2002) solutions – these possibly include modernization of the privatization infrastructure, lifting off a number of limitations imposed on the privatization process of strategic enterprises, modification of procedures for conducting special auctions and the system of sales on the whole, empowering the FAFPA with the rights of control over the deals and the right to fire the managerial personnel of the respective enterprises, etc. A separate task consists in reducing the list of strategic enterprises (see below) as well as in revising of any other legislative limitations on privatization.⁸

Failures with the sales of the remaining packages of shares resulted also in certain reconsidering of the respective accents – e.g., growing attention to the FPUE reform. In terms of quantity (data as of October 2004), the number of the FPUEs retained, should comprise in the perspective about 1000, the number of the respective federal bodies – about 10 000, that is 50% of the currently existing ones (about 5500 of them are to be privatized or liquidated, about 4000 of them are to be passed over to the respective regions). In terms of quality, reanimated again are the ideas as to introducing the institute of private management for the state unitary enterprises which proved to be inefficient in the period from the 90s to the 2000s. Obviously much greater interest of the RF Ministry of Economic Development to such an institution can probably be connected with the failure (in 2004) to drastically cut down the number of the PUEs still remaining in the respective strategic lists. Yet, this decision does seem quite disputable. Firstly, there is certain substitution of notions (the PUE problem consists not so much in the efficiency level but rather in the fallaciousness of the very legal structure for the right to carry out economic activities. Secondly, certain difficulties arise when trying to solve problems connected with payments for the private management and for the attendant control over such. To practically organize the latter is not at all any easier than to control activities of the state functionaries.

A real novelty (as compared against the 2003 “Concept”) was the suggestion to start transforming the respective unitary enterprises in three main directions: open joint stock societies, public enterprises (provided they do perform state functions) and non-commercial organizations. Rejection of the compulsory transforming of the said PUEs into JSSs with 100 per cent participation of the state (which takes, on average, from nine [9] months to two [2] years) and selling the PUEs unchanged, that is prior to any transforma-

⁸ Materials to the meeting of the RF Government on July 29, 2004.

tions (just as a property complex calculated per one buyer) can become one of the possible methods aimed at speeding up the privatization process. The RF Ministry of Economic Development is now planning to prepare and then to practically introduce the Law “On Non Commercial State Organizations” (i.e. establishing new legislative frame-works for the respective state bodies), further modification of the respective legislation on the estimating activities (to specify procedures for transferring the intellectual property rights), liquidation of such odious institution as the right for economic management of the federal PUEs. The newly raised question of establishing a qualitatively better Federal Property Register (including the relevant information on the balances and efficiency indicators) graphically illustrates the true state of affairs in this particular sphere of activity.

The plan for incomes in the year of 2004, in spite of all the current problems and limitations, was nevertheless significantly overfulfilled. However, there is not any contradiction here as to the cited above thesis on the inertia and spontaneity character of the state activities in the sphere of privatization during the year of 2004. Firstly, similar to the preceding years, a triumphant report about “*the fact exceeding the plan*” was ensured by the so called one-time large deals. Secondly, the amount of monies planned for the year of 2000 (about 35 to 40 bln roubles), was traditionally and intentionally understated in view of possible breakdown of the expected sales and/or creation of favorable conditions for the next “overfulfilment” of the plan for incomes.

If proceeded from the viewpoint of the budget incomes, then the positive trends of 2000 – 2003 as connected with greater share of incomes obtainable from using the state property (that is renewable returns), retained their positive values in 2004 as well. According to the respective data of FAFPA, the total returns to the federal budget from privatization and practical use of the respective state property for the year of 2004 comprised 118 bln roubles (preliminary estimations with no account taken of the profits from selling the shares of the Magnitogorsk Metallurgy Plant which are to be directed to the budget of 2005).

Winner of the auction in selling the last state package of the “LookOil” oil company (7.59%, the starting price was 1. 928 bln USD) had in all probability secured the *a priory* approval of the respective state authorities and, accordingly, was known well beforehand. One of such, on September 29, 2004, became the “ConocoPhillips” company (USA) which paid the said 1. 988 bln US dollars necessary for bringing its share up to 10% of the authorized capital. The latter, fully in accordance with the terms and conditions of the respective agreement, enables *ConocoPhillips* to obtain the rights of the “blocking shareholder” as well as one vote in the Board of Directors. Certain limitations were also set up – 4 year ban on selling shares and a limited (20%) participation in the company’s shareholding capital.

Another large deal in the year of 2004, traditionally put off for the end of the year, was the auction in one lot selling of 17.82% shares of the largest steel mill of Russia – the Magnitogorsk Metallurgy Plant (MMP) which was, in fact, the last large asset of the state in this particular industry. As different from the deal with the shares of “LookOil”, there were several competing groups there – contenders for the package, and the end result of this competitive race remained quite unclear up to the very closing time of the said auction. Privatization of this particular package was in such or other way under discussion since the year of 1997. During several more recent years, the said package was simultaneously present both in the “strategic” and the “privatization” lists while the most acute struggle between several large metallurgy groups eventually came down to the question of blocking such sales. Accordingly, in August of 2004, the said enterprise was excluded from the said strategic list and the struggle logically turned into another phase with the situation becoming

further complicated due to a very amorphous structure of the respective property and relevant control.

According to some estimations, such acuteness of the competition was to a considerable extent caused by the very fact that selling the package of the MMP shares was the first absolutely open tender in the history of the Russian privatization which had ever been carried out in the raw materials industry.⁹ Some “methods” should nevertheless be mentioned here which were used in the process of such contending struggle. In November 2004, the RF Ministry of Federal Property (RF MFP) demanded that the MMP pay the intermediary dividends for the nine (9) months for the package under privatization. This decision is primarily to the advantage of the MMP management which can use these monies to finance the deal itself (either directly or for purposes of repaying the respective credit). After the auction which the management did, no doubt, win, a decision was taken not to pay the said intermediary dividends (the formal grounds being absence of such clause in the Charter). Accordingly, two versions of the investment strategy for the year of 2005 were prepared by the management but the choice between them was to be made already after the auction. The optimistic version (in case the management wins) assumed investments of about 800 mln US dollars in development of the raw materials and certain coal projects. The pessimistic version (victory of “Mechel”) assumed directing of up to 70% of free monies to paying the dividends and, probably, other ways of taking MMP’s profits out.¹⁰⁽¹⁰⁾ In December, a search was conducted in the offices of “Mechel” even though no official charges against the Group were brought. Almost simultaneously, the MMP management initiated a massive PR campaign, including also organization of visits of the RF President (the formal grounds being the World Championship in Judo) and of R. Juliani, ex-mayor of New York (the formal grounds being the Road Show in connection with the issue of the ADR). The necessary psychological pressure instruments can include unofficial information on readiness of the MMP management to pay the sum of up to 2.5 bln US dollars for the said package. Obviously, the administrative and financial positions of the MMP management turned out to be really the strongest therefore participation of the “Mechel” Group in the auction was interpreted, *inter alia*, not so much as a desire to acquire the said package but rather as a wish to try to maximally undermine the MMP’s financial resources in other competing projects. According to the available data, the “Mechel” Group finally gave up and at the junction of the years of 2004 – 2005, sold its package to the structures which were affiliated with the MMP management.

The expected returns from the sale of the said package was to comprise something about 0.5 – 0.6 bln US dollars and the final scheme provided for selling the whole package as a single lot at an open auction on December 22, 2004, at the starting price of 790.15 mln US dollars (the net profit normative price of the package for the three years was set in the amount of 320 mln US dollars). Although the deal was completed already in the year of 2004, the incomes from it will be entered in the budget no later than the year of 2005 which, like in the case with a number of big deals of the past years, makes it possible to use “double” accounting for the privatization results for the current year.

But it was not only the triumphant victory of the said management with the MMP Director General in the head, that became the qualitative result of this auction. In February 2005, respective information appeared that V. Rashnikov, the virtual owner of the MMP as well as its beneficiary, even though having brought the control over almost 100% of the shares, is nevertheless planning to resign his post while reserving for himself a vote in the

⁹ Aggravation of the pre-auctionary competition // Expert. 2004. No 47. p. 8.

¹⁰ Molina M. Magnitka Will Leave No Money to the Competitors// Commersant, 2004, December 22

Board of Directors and thus concentrating his efforts on the raw materials projects which still remain a weak link in the MMP chain.

This situation is indicative from the viewpoint of real prerequisites for respective division of property and management with regard to the Russian experience in corporate management.

The expected returns to the federal budget from privatization must comprise in the year of 2005 not less than 42.7 bln roubles. Not relying on any financial illusions with regard to sales of the overwhelming majority of the packages of shares, the government nevertheless expects to get the said amount primarily from selling shares of the “Sviazinvest” holding.

Selling the package of shares of the “Sviazinvest” telecommunications holding was in the respective plans during practically all the recent years so inclusion of this particular object in the privatization lists for the year of 2005 does not at all imply taking any final decisions. Firstly, further privatization is directly connected with completing of the reorganization processes in the said holding, the tariff reform, solving the social loads problems of regional business companies and providing communications for the respective power bodies. Secondly, in view of the growing attractiveness of the telecommunication shares, any urgent sale of the holding’s securities does not seem to have much sense at all. However, there is an opposite (counter) trend here as well. According to the respective estimations of the RF Ministry of Economic Development, in spite of the fact that this holding owns both the controlling and the blocking packages of shares belonging to the regional wire – communication operators, the necessary operative control over the latter has already been lost. Thirdly, serious work over is required by the concrete variant of the planned sale. In 2001 – 2003, the privatization model standardly assumed 25% minus two (2) shares. In 2004, under intensive discussion, *inter alia*, was the variant of selling the packages of shares of the holding’s regional companies (at least four [4] inter – regional daughter companies were included in the list for the year of 2004). In the middle of 2004, the Federal Agency for Federal Property Administration (FAFPA) considered three (3) main variants of the sale: 25%, 50% or 75% minus one (1) share. Yet, no one – time sale of the respective packages of shares of the daughter companies (with all the attendant consequences similar to the “double” privatization of the oil industry in the 90s, mentioned above) can be excluded. In particular, quite possible is selling 28% of the MGTS shares to the current majority owner of the AFK “System” which practically means that this holding is leaving the Moscow market and that it will inevitably tell on the terms of its capitalization. The terms of selling the holding will also depend on the quantity of prospective contenders, their relationships with the respective authorities and the intensity of competition between them.

In August 2004, 1325 FPUEs and 556 JSS packages of shares (see *Table 1*) were included in the basic list of objects to be privatized in the year of 2005. The largest privatization projects of the next year, apart from “Sviazinvest”, may be transforming the “Rosspirtrom” FPUE into a joint stock society with the following sale of its shares (200 enterprises, 80% of the Russian market), the “Domodedovo avialines” (25% of the shares), the Novorossyisk and the Tuapse sea freight ports (about 20% of the shares), “Rosgosstrakh” (25% plus 1 share) and others. Further privatization of the “Aeroflot – Russian Avialines” OJSS (51.2% of the controlling package of shares) is steadily put off from year to year. In 2004, in particular, arguments of the RF Ministry of Transport on the necessity of preliminary regulation of the so called “*fly over money*” (that is collection of payments for flying of the foreign air companies’ planes over the territory of the Russian Federation) were accepted which automatically requires reconsideration of about 100 current agreements in force.

Another problem is financial and leasing contracts in the amount of about 1.5 bln US dollars which can be cancelled in case of their consequent privatization.

Considerable activation of the privatization process in the recent years was often connected with perspective privatization of the wholesale generating companies (WGC) created during the reorganization process of the "UES of Russia" RJSS. According to the statement of V. Khrystenko, Head of the Minpromenergo, made officially known in November 2004, the nearest hypothetical date to start privatizing the WGCs seems to be the year of 2006 by which time the interested parties (the state, the management of the "UES of Russia" RJSS, the "Gasprom" OJSS, the aluminum as well as other groups) are expected to work out certain compromise variants including not only auction sales but possible passing the state WGCs over for private management or privatization through distributing the respective WGC shares among the already existing shareholders of the "UES of Russia" RJSS as well. Reforming of the nuclear energy systems is intended rather for the long – term perspective. The Federal Atomic Energy Agency (the "Rosatom") does accept the impossibility of attracting adequate investments under the existing legislatively consolidated ownership model. Accordingly, almost inevitable appears to be first consequent transforming the "Rosenergoatom" FPUE into a corporation with 100% state participation followed then with attraction of private minority shareholders and company managers.

4.1.2. Changes in the normative – legal basis and federal property management

The past year of 2004 was marked with adoption of the new normative – legal acts as regulating the respective activities of the said economic societies with the state participation in their capital as well as the state unitary enterprises.

Participation in the shareholding and other societies. It is first of all necessary to mention here the Decree of the RF President "On approving the list of the strategic enterprises and strategic joint stock societies", dated August 4, 2004, No 1009. As such, 514 FPUEs and 549 open joint stock societies (OJSS) were determined in it with different shares of the state in their respective authorized capital¹¹.

It is not to be forgotten, however, that formal approval of such a list requires the respective norm of the Law "On privatization of the state and municipal property", dated December 21, 2001, No 178 – FZ. As stipulated in Article 6 of the said Law, in order to practically and efficiently implement a single and universal system of the state policies in the sphere of privatization, the RF Government shall present to the RF President for respective approval, proposals on forming the said list of strategic enterprises and including federal state unitary enterprises (FPUEs) whose end products (work, services, etc) are of strategic significance for assuring the defense ability and respective security of the state, protection of the nation's morality, health, rights and legitimate interests of the citizens of the Russian Federation (hereinafter called as "strategic enterprises"), open joint stock societies (OJSS) whose shares are in the federal ownership and participation of the Russian Federation in their management duly ensures the strategic interests of the state, its defense ability and security, protection of the nation's morality, health, rights and legitimate interests of the citizens of the Russian Federation (hereinafter called as "strategic joint stock societies")¹².

¹¹ According to the available data of the RF Ministry of Economic Development for July 2004, the original list of the strategic enterprises was first cut down from 3000 to 200 but then it again grew up to 1200 (672 JSS and 528 FPUEs).

¹² Earlier, in the capacity of such enterprises considered were usually those already included in one of the lists approved by the respective Decisions of the RF Government "On the list of the defense complex enterprises and organizations privatization of which is prohibited", dated July 12, 1996, No 802, and "On the list of whose products (commodities, services, etc) are of strategic significance for ensuring the national security of the state as fixed in the federal ownership whose shares are not

Similarly, proposals are presented to the RF President as connected with introducing into the respective list of the strategic enterprises and that of the strategic joint stock societies of certain changes concerning composition of the FPUEs in the lists of respective strategic enterprises, including their consequent privatization (turning into open joint stock societies), as well as the need and the participation degree of the Russian Federation in the said OJSS (the strategic joint stock societies) and, *inter alia*, for further privatization of the shares owned by the said joined stock societies.

After decisions on cutting down the participation degree of the state in the management of the said strategic or on excluding of the respective enterprises from the strategic enterprises list have been formally taken by the RF President, these category objects may then be included in the so called privatization of federal property “forecast” plan (or program).

The Decree of the RF President, No 1514, issued at practically the same time as the said law, established that until the respective lists of the strategic enterprises and of the strategic joint stock societies were approved by the RF President fully in accordance with Article 6 of the Federal Law “On privatization of the State and Municipal Property”, any changes in or amendments to the list of those whose end products (commodities, services, etc) are of strategic significance for ensuring the national security of the state and fixed in the federal ownership whose shares are not subject to any pre – term sale, as approved by the RF Government on July 17, 1998, No 784, shall be implemented through the respective RF Government Regulations based on the RF President’s Decrees. However, although the RF Government was duly instructed to present for the approval of the RF President the said lists of the respective strategic enterprises and the strategic joint stock societies before March 1, 2002, this question, like many others, was not solved on the date fixed.

Removal of this sufficiently important gap in the RF legislation took more than two years from the moment the said law came into force. This Decree also permits the RF Government to include the listed enterprises and the respective OJSS’s packages of shares in the privatization program after the RF President has taken decision on their exclusion from the corresponding lists.¹³ This document *de facto* determines the only way to privatize the strategic FPUEs – their transformation into OJSSs 100% shares of which are in the federal ownership. The Decree also contained instruction to the RF Government to provide for including the said enterprises and in the list of the strategic enterprises and organizations which was approved in January 2004 for the purposes of efficient legal use of the respective bankruptcy law.

Quite noteworthy in this context is also another list of the strategic enterprises and organizations approved by the RF Government’s Instructions No 22-p, dated January 9, 2004. Formal adoption of this document logically follows from Article 190 of the Federal Law “On insolvency (bankruptcy)”. It’s not at all unnecessary to remind in this connection that practically the whole paragraph 5 (Art. 190 – 196) of the third law on bankruptcy is devoted to regulating bankruptcies of the strategic enterprises and organisations.¹⁴ Accord-

subject for any pre-term sale”, dated July 17, 1998, No 784, (in multiple subsequent versions). At that, neither the criteria nor the principles for including (or excluding) respective enterprises in such or other list were present.

¹³ Literal interpretation of the RF President’s Decree leads to the logical conclusion on the appearance of a legal collision here because according to the new 2001 law on privatization, shares of companies and enterprises functioning in the natural monopolies sector, can be included in the said privatization program only on the basis of a special law, as was the case, for example, with adopting the package of laws on restructuring the electrical energy and railway transport industries.

¹⁴ These articles contain legal norms taking the said enterprises outside the confines of the standard procedures applied in case of insolvency of the said economic subjects, raising the requirements level to the bankruptcy participants thus allowing for the repeated interference of the state in its undergoing process.

ing to the said law, such list of the strategic enterprises and organisations is subject to its formal approval by the RF Government only provided it has been duly and officially published.

The said Instructions of the RF Government prescribed that all concerned bodies of the federal executive power shall present, each year in February, sufficiently grounded proposals on introducing such or other changes in and amendments to the said list of the respective strategic enterprises and organizations to the RF Ministry of Economic Development and the latter, in its turn, shall present, each year in March, proposals, duly coordinated with the federal executive power bodies concerned, on introducing changes in or amendments to the said list of the respective strategic enterprises and organizations to the RF Government. At present, this said list consists of 591 FPUEs, 494 open joint stock societies and 46 other enterprises (including 37 state enterprises and business associations,¹⁵ 8 closed and 1 Ltd. society). However, the document does not yet make quite clear the degree of the state participation in the capital of the strategic enterprises and organizations making this said list, except for the federal property unitary enterprises.

Adoption of the two above mentioned lists logically resulted in certain renewal of the respective normative and legal bases of the state property policies with regard to the economic societies where it (the state) participates in their respective capitals which step should have been made long ago as required by the legal norms of the said laws on privatization and insolvency (bankruptcy). This was accompanied with further increases in the quantity of various lists of the economic societies with state participation in their respective capitals and whose activities are governed by different legal norms and different regulating instrumentation.

It is quite noteworthy in this connection that, apart from general provisions and schemes applied with regard to the cases where all the voting shares belong to the Russian Federation, "The Regulations on Implementing the Rights of the Russian Federation as a Shareholder", approved by the Order of the RF Ministry for Property Relations No 260, dated November 26, 2001, have five (5) supplements each of them including various lists of the respective joint stock societies (see *Table 2*).

Table 2

Structure and content of the supplements to the "Regulations on implementing the rights of the Russian Federation as a shareholder", the year of 2001

Direction of regulation	No of Splnt	Regulating norms
Order of introducing by the Russian Federation of questions to the agendas of shareholders yearly meetings and proposing candidates to the governance and	1	1. Candidatures for General Director and Auditing Committee members require approvals of the RF Government only. 2. The schedules of sending to the said business societies letters with questions for the agenda and candidatures to be approved by the respective Deputy Ministers, apart from the dispatch data, also contain data of sending the said proposals to the RF Ministry of Property Relations* (hereinafter called as "Ministry") and to the RF Government.

¹⁵ It is not quite clear why all these enterprises and business associations were not included in the said list of the respective FPUEs although 21 such enterprises were confirmed to be PUEs. Probably, the state or unitary enterprises of the Federal property subjects are also meant here but no direct indication of that can yet be found in the said document.

public control bodies (Art. 2)	2	<p>1. Candidatures for the Board of Directors require approvals of the RF Government only.</p> <p>2. The schedules of sending to the said joint stock societies letters with questions for the agenda and candidatures to be approved by the respective Deputy Ministers, apart from the dispatch data, also contain data of sending the said proposals to the Ministry and to the RF Government.</p>
	3	<p>1. Candidatures for the Board of Directors members require approvals of both the RF Government and the Administration of the RF President.</p> <p>2. The schedules of sending to the said joint stock societies letters with questions for the agenda and candidatures to be approved by the respective Deputy Ministers, apart from the dispatch data, also contain data of sending the said proposals to both the Administration of the RF President and the RF Government.</p> <p>3. The said letter to the RF Government must contain a copy of the official approval of the candidatures for the Board of Directors members by the Administration of the RF President.</p>
Order of initiating by the Russian Federation of the extraordinary meetings of shareholders and moving forward, be such a case, of candidatures from the Russian Federation for the bodies of governance and public control (Art. 4).	1-3	<p>Moving forward candidatures for the Council of Directors membership, the Auditing Committees and General Directors requires the respective approvals by the RF Government and (or) the Administration of the RF President (apart from Moving forward candidatures for the Council of bodies which are responsible for coordinating and regulating in the corresponding industries [hereinafter called as "Federal bodies"] as well as executive power bodies of the subjects of the Federation on whose territory such joint stock societies are situated).</p>
Order of ensuring participation of the Russian Federation representatives in the respective shareholders' meetings (Art. 5).	2	<p>Letter of attorney from the Ministry to vote at the shareholders' meetings is issued only on the basis of the RF Government's individual decisions on appointing these representatives. Draft projects of such decisions are sent by the Ministry to the RF Government, as a rule, within five (5) days since the appointed day of the said shareholders' meeting but not later than ten (10) days since the date it has been conducted. The proxy of the Ministry for voting at such shareholders' meeting is issued on the day of the RF Government's respective decision but provided it was taken less than five (5) days prior to the date of such shareholders' meeting.</p>

3	<p>1. Should the agenda of such shareholders' meeting contain the question of electing the General Director, then, simultaneously with the draft project of the RF Government's directives, a respective letter of the Ministry shall be sent to the Administration of the RF President with proposals as to the order of voting for this particular matter as well as with official mention that the said directives shall in this case be approved by the RF Government.</p> <p>2. Subject to respective approvals of the RF Government and the Administration of the RF President are also directives of the Ministry to the representatives of the Russian Federation concerning the question of electing the General Directors of the respective economic societies. The corresponding draft projects of the said directives shall be sent to the RF Government and to the Administration of the RF President fifteen (15) days prior to the appointed date of such meeting. Attached to the said draft projects of the directives must be the filled in questionnaire form of the prospective candidate, and should it be his/her re-nomination, then data on his/her activities as the General Director during the previous period, brief reasoning for his/her election, the appointed date for conducting such meeting as well as information on the quantity of the voting shares of such joint stock society duly belonging to the Russian Federation.</p> <p>In cases, when the necessary approvals of the RF Government and/or the Administration of the RF President were not yet received one (1) week prior to the appointed date of the respective shareholders' meeting, then the said directives of the Ministry on the matter of electing the General Director shall be issued on the day when the required approvals of the RF Government and the Administration of the RF President are received in the Ministry – separately from directives of the Ministry for any other matters.</p>
4	<p>The order of voting is approved as determined in the RF Government's respective directives</p>
3	<p>The order of ensuring participation of the Russian Federation in the respective shareholders' meetings in the format of voting <i>in absentia</i> (Art. 6).</p> <p>No <i>in absentia</i> voting of the Ministry is permitted at any extraordinary meetings of shareholders convoked either as requested by the Ministry or directly by the Ministry itself provided that their elected format permits to vote both direct and <i>in absentia</i>.</p>
5	<p>Order of sequences in the annual forecast activity results of such business society's activities in the year come (Art. 8).</p> <p>1. The economic efficiency indicators, as presented by the respective federal bodies, shall be within three (3) days directed for consideration by the Ministry's branch structures to the respective structure of the Ministry which is responsible for the financial monitoring of the respective enterprises and JSS, to be accordingly considered with due account taken of a number of respective materials.**</p> <p>2. Should any differences arise with the respective federal bodies as to whether these be removed (or not) by the respective Deputy Minister provided they have been preliminarily approved by the First Deputy Minister, then such final decisions shall be taken on the basis of which they approve the respective indicators of the business society's economic efficiency.</p> <p>3. Structural units of the Ministry shall ensure (not later than April 1) daily direct to the respective joint stock societies letters requesting them to send a number of the necessary documents*** to both the respective federal bodies and the Ministry itself (not later than June 1).</p>

<p>Order of sequences in preparing annual proposals for dividend returns to the Draft project of the Russian Federation budget for the year to come (Art. 9).</p>	5	<p>1. Based on the proposals of the federal bodies which were sent prior to March 1, the forecast of dividend returns for the year to come is annually compiled prior to April 15. Dividends thus forecasted, are cited by the federal bodies separately for each of the joint stock societies included in Supplement 5.</p> <p>2. In case of any censorious remarks as to the amount of the dividends with regard to some joint stock societies (included in the said Supplement 5), the respective branch structures of the Ministry shall specify the position of the said federal body. Should any principle differences are found, then the respective Deputy Ministers shall be informed about such within a one-day period and further on the said branch structures shall be guided by their respective directives. The final decision in such cases shall be taken by the respective Deputy Ministers provided it has been approved by the First Deputy Minister.</p>
<p>Order of sequences in preparing to practically implement the expected dividend returns as planned by the budget of the Russian Federation (Art. 10).</p>	5	<p>1. Based on the proposals from the respective federal bodies (made prior to November 1), the forecast of the expected dividend returns for the year to come shall be specified annually prior to December 1. Such forecast dividends are shown separately for each of the respective joint stock societies which are included in the said Supplement 5.</p> <p>2. According to the results of the respective considering the proposals offered by the federal bodies, the branch structures of the Ministry compile more specified forecasts of dividend returns for the year to come and then direct them (prior to November 20) to the respective structural unit of the Ministry which is responsible for financial monitoring of the respective enterprises and joint stock societies. The said forecast dividends are shown separately for each of the joint stock societies duly included in Supplement 5.</p>
<p>Order of sequences for practical implementing the planned annual dividend returns as planned by the budget of the Russian Federation for the current year (Art. 11).</p>	5	<p>1. Based on the federal bodies proposals which came prior to February 1, the respective Deputy Ministers annually approve (prior to March 1) plans – schedules of dividend returns for each respective industry in the current year to be then sent to the respective federal bodies.</p> <p>2. In case of any censorious remarks as to amounts of the dividend returns with regard to some joint stock societies. (included in Supplement 5), clauses are applied as typically used in such situations concerning dividend amounts for some joint stock societies at the stage of preparing respective forecasts of annual dividend returns.</p>

*In the course of a large – scale reorganization of the RF Government during the spring of 2004, functions of the Ministry of State Property were transferred to the Federal Agency for Federal Property Administration (FAFPA).

** (1). Blank-forms 1 – 5, approved by the Order of the RF Ministry of Finance “On Forms of the Book-Keeping Accounting of Organizations”, dated January 13, 2000, No 4н (for the recent three years), with explanations of certain accounts and lines (accounts No No 26, 58, 73, 84, 99; line 480) and in case there are subsidiaries as well as annual consolidated balances of such a group (for the recent three years). (2). The planned indicators of financial activities for the current year including the amount of the net profits. (3). Forecasts of the respective financial and economic development for the year to come (forecasts by profits from the main activities, forecasts by expenditures including the currently planned investments projects with respective calculations of their respective ROI and the time – terms of repayment, description of the financing sources, the expected annual net profits) with the respective substantiating materials attached. (4). Middle – term targets of managing packages of shares owned by the respective joint stock societies (worked out by the respective federal bodies and are to be approved by the Ministry). (5) Forecasting the social and economic development of the Russian economy both as a whole and with regard to its corresponding industries for the middle – term perspective.

***(1). Blank-forms 1 – 5, approved by the Order of the RF Ministry of Finance “On forms of the book-keeping accounting of organizations”, dated January 13, 2000, No 4н (for the recent three years), with explanations of certain accounts and lines (accounts No No 26, 58, 73, 84, 99; line 480) and in case there are subsidiaries as well as annual consolidated balances of such a group (for the recent three years). (2). The planned indicators of financial activities for the current year including the amount of the net profits. (3). Forecasts of the financial and economic development for the year to come (forecasts by profits from the main activities, forecasts by expenditures including the currently planned investments projects with respective calculations of their respective ROI and the time – terms of repayment, description of the financing sources, the expected annual net profits) with the respective substantiating materials attached.

Since the above - mentioned Supplements to the said regulations have never been openly published, quite an interesting and so far totally unanswered remains the question of how intersect are the lists of the respective open joint stock societies they contain.

After legal adoption of the new Law on Privatization which came into force on April 26, 2002, certain additional novelties were introduced into the administration process of the state – owned packages of shares as well.

Resolution of the RF Government No 44, dated January 23, 2003, approved the Regulation on the order of managing the federally – owned shares of open joint stock societies as well as using a special right of the Russian Federation to participate in the management of open joint stock societies (the “golden share”). It replaced the RF Government Resolution “On the Order of Appointing and Functioning of the Russian Federation Representatives in the Management Bodies and the Auditing Committees of Open Joint Stock Societies Set up in the Process of Privatization Whose Shares are in Federal Ownership and with Regard to Which a Decision Was Taken on Using a Special Right for Participation of the Russian Federation in Controlling them (the “golden share”)”. The text of this document also contains mention of two more lists of the respective joint stock societies.

In the first place, this is a special list of separate joint stock societies, duly approved by the RF Government, with regard to which the respective position of the state as a shareholder is determined by the decision of the RF Government itself, its Chairman or by the Deputy Chairman of the RF Government, acting on his instructions, for the following matters:

- submission of questions into the agenda of the general meeting of the shareholders and nominating prospective candidates to be elected to the respective management bodies, the auditing or to the accounting commissions of such joint stock society;
- demanding convening of an extraordinary general meeting of the shareholders and actual convocation of such extraordinary general meeting of the shareholders;
- voting on the agenda items of such general meeting of the shareholders and appointment of the representative for voting at the general meeting of the shareholders.

It is not quite clear from the document whether this list is sufficiently identical to that of the open joint stock societies in accordance with which nomination of prospective candidates to the Board of Directors, to the Auditing Committee as well as to the OJSS executive bodies, should the solution of such questions be referred by its Charter to the competence of the shareholders general meetings, appointment of respective representatives of the Russian Federation for voting at the said general meetings with shares being in the ownership of the Russian Federation, replacement of those Board of Directors (the Observation Council) members who represent the interests of the Russian Federation – these all were performed by the RF Government in accordance with its Resolution No 195, dated March 7, 2000, which adoption of the said Resolution under consideration automatically made invalid.

Apart from this particular list, the document also contains mention of a *special* list (to be approved by the RF Government) of the joint stock societies taking into account the re-

spective estimations of such basic finance and economic indicators, including the volume of earnings, the cost of the fixed assets, the balance profits for the respective period of accounting, their share in the market of commodities (services) having a strategic significance for ensuring the defense ability and security of the state, and other relevant economic indicators. It was logically assumed that, having got the necessary approvals from both the federal bodies of executive power and the RF Ministry of Federal Property (MFP), the RF Ministry of State Property (Minimushestvo) shall direct to the RF Government the respective proposals on making changes in and introducing amendments to such. Although it remains not quite clear yet how exactly this list, once again mentioned in the said Resolution of the RF Government, dated January 23, 2003, should correlate with that of the strategic joint stock societies which, in accordance with the 2001 Law on Privatization, must be duly approved by the RF President which was the case not later than in the August of 2004. No information on approving by the RF Government of any lists of the respective joint stock societies in accordance with the said Resolution of 2003, was then available.

According to the information of the Minimushestvo Press – Service on February 3, 2004¹⁶, the state moved forward as candidates to the Boards of Directors (the Observation Councils) and the Auditing Committees, 43 Russian companies with the respective state participation: the “ALROSA” CJSS, the “Iliushin Finance Co” OJSS, the “KamazAZ” OJSS, the “Finance leasing company” OJSS, the “N.I. Sazykin *Progress* Arseniev aviation company” OJSS, the “*Molot* Viatka – Poliansk Machine-building Plant” OJSS, the “Kovrov Electro-mechanical plant” OJSS, the “S.A. Zverev Krasnogorsk plant” OJSS, the “*Vympel* Interstate Shareholding Corporation” OJSS, the “*Elara* Cheboksar Research and Production Instrumental Plant” OJSS, the “*Amber* Baltic Ship – Building Plant” OJSS, the “Amur Ship – Building Plant” OJSS, the “Irkutskenergo” OJSS, the “*Nefteotdacha* Russian Inter – Industry Complex” OJSS, the *Iliushin* Inter – State Avia-construction company” OJSS, the “*Aerocosmic Equipment Corporation*” OJSS, the “*M.L. Mill* Moscow Helicopter Plant” OJSS, the “*Tupolev*” OJSS, the “*Aviadvigatel*” OJSS, the “Ulan - Ude Aviation Plant” OJSS, the “Academician *V.P. Glushko* NPO Energomash” OJSS, the “*Saturn* Scientific and Production Trust” OJSS, the “*Avtodizel*” OJSS (the Yaroslavl motor plant), the “*Moskvich*” OJSS, the “Tver Carriage – Building Plant” OJSS, the “*Motorostroitel*” (Samara) OJSS, the “*Khimprom*” (Volgograd) OJSS, the “*S. Ordjonikidze* Kolchugin Non Ferrous Metals Processing” OJSS, the “Novorossyisk Bakery Combine” OJSS, the “*Novoship* Novorossyisk Sea Steamship Lines” OJSS, the “Murmansk Sea Steamship Lines” OJSS, the “Enisei River Steamship Lines” OJSS, the “*Volga – Fleet* Shipping Company” OJSS, the “Novorossyisk Sea Commercial Port” OJSS, the “Murmansk Sea Commercial Port” OJSS, the “Tuapse Sea Commercial Port” OJSS, the “Krasnoyarsk Avialines (*KrasAir*)” OJSS, the “Domodedovo Avialines Company” OJSS, the “*Koltsovo* Airport” OJSS, the “Rosagroleasing” OJSS, the “Rosgosstrakh” OJSS, the “Rosselkhozbank” OJSS, the “Russian Bank of Development” OJSS.

After the reorganization of the RF Government in the spring of 2004, the RF Ministry of Property Relations in the system of the state administration bodies was replaced with the Federal Agency for Federal Property Administration (FAFPA). But on the whole, a transition to the three – level system of the power bodies took place within the administrative framework at the federal level: *ministries – agencies – services*. As to the FAFPA, it went under the jurisdiction of the RF Ministry of Economic Development and Trade (MEDT). This all indeed stimulated a new spiral of the legislative norm setting in the sphere of the state property administration.

¹⁶ www.rosim.ru

The Resolution of the RF Government No 738, dated December 3, 2004, approved the new Regulations on managing the federally owned shares of open joint stock societies (OJSS) and using a special right for participation of the Russian Federation in such management of the open joint stock societies (the “golden share”). But although this document replaced a similar one approved by the former Cabinet of Ministers (Resolution of the RF Government No 44, dated January 23, 2003) it did not any significantly differ from its predecessor, its main provisions being as follows.

Rights of the OJSS shareholders, whose shares are in the federal ownership of the Russian Federation, shall be exercised in the name of Russia by the Federal Agency for Federal Property Administration (FAFPA). It is this governance body which implements with regard to the respective OJSS (with the exception of those all voting shares of which are in the federal ownership)¹⁷ submission of questions to the agenda of the shareholders meetings, nomination of candidates to the respective governance bodies, moving forward demands to convoke and to actually conduct an extraordinary general meeting of shareholders, appointment of the respective representative (duly issuing the letter of attorney) for voting at the said general meeting of shareholders, determining the position of the state as a legitimate shareholder with regard to matters contained in the agenda for the said general meeting of shareholders.

The official position of the Russian Federation as a legitimate shareholder with regard to matters contained in the agenda of the said general meetings of shareholders, shall be reflected in the respective written directives issued by the FAFPA to the officially appointed representative for voting at the said general meetings of shareholders, which acts on the basis of the written directives and the letter of attorney issued by the said Federal Agency for Federal Property Administration.

The legitimate rights of the state, as a legal shareholder, shall be exercised by the FAFPA proceeding from the following three-category classification of all the OJSS with a federal share in the respective capital:

- in the joint stock societies included in the said special list, as approved either by the respective federal ministry or by the respective federal body of executive power duly authorised to manage state property, whose activities are controlled either by the RF President or by the RF Government (hereinafter called as the “Federal Body”)¹⁸;
- in the joint stock societies included in the said list of the strategic joint stock societies as approved by the RF President (hereinafter called as the “Strategic List”)¹⁹, except for those joint stock societies which are included in the said special list on the basis of proposals made by the respective federal agency under the federal ministry (hereinafter called as the “Federal Agency”) or under the respective Federal Body;
- in other joint stock societies – independently but should the said Federal Agency or the said Federal Body make duly executed proposals with regard to determining the shareholder position, then – with due account taken of such proposals.

¹⁷ Be such a case, the authority of the general meetings of shareholders is then exercised by the FAFPA and decisions of the general meetings shall be duly executed by its respective Instructions. At that, inapplicable become the legal norms concerning the procedure, time-terms, convocation and actual conducting of the said general meetings of shareholders. Should such an OJSS be included in the special list, as officially approved by the RF Government, then the position of the state as a legal shareholder, shall be determined by the corresponding Decision of the RF Government, the Chairman of the RF Government or by the respective Deputy Chairman of the RF Government acting on the instructions of the latter.

¹⁸ With regard to the joint stock societies included in the said special list: should the respective federal ministry have the said Federal Agencies under it, then such proposals as presented to the FAFPA for each particular matter, shall reflect a consolidated position of both such federal ministry and the respective Federal Agency under it.

¹⁹ Approved by the RF President on August 4, 2004, No 1009.

Should the federal ministries, agencies or other respective federal bodies have any proposals on convening and/or conducting such extraordinary general meetings of shareholders then they shall direct such proposals to the FAFPA not later than twenty (20) days prior the assumed date. In case the agenda of such extraordinary general meeting of shareholders includes questions connected with re-election of members of the Board of Directors or of the OJSS Observation Committee, then such time – terms will comprise thirty (30) and forty (40) days, respectively.

The above proposals are to contain sufficiently precise formulations of the questions which are subject for entering in the agenda of the extraordinary general meeting of shareholders, those for consequent decisions on such as well as proposals concerning the format of conducting such extraordinary general meeting of shareholders. The said proposals shall be submitted along with some explanatory note containing a reasonable justification for entering such proposal in the agenda and the materials necessary for the respective decision making. When proposing to include into the agenda of the said extraordinary general meeting of shareholders the question on changing the composition of the respective governance bodies, the auditing and the accounting committees, presented also must be respective information on the prospective candidates to be elected to the said governance bodies, the auditing and the accounting committees of the said joint stock society (official references from the personnel departments of the candidates' previous jobs).

The preparation procedure for the annual general meeting of the shareholders clearly implies that the respective federal ministry (body or agency) shall direct to the FAFPA its proposals with regard to questions to be entered in the agenda of the meeting and the candidates to be elected at the said general meeting to the respective governance bodies, the auditing and the accounting committees prior to December 1 of the year preceding the one when the said annual general meeting of shareholders is to be conducted.

The said proposals shall contain the position as regards voting for or against the matters suggested, formulations of decisions to be taken; attached should also be the explanatory note, the necessary materials and the respective information on the candidates to be elected to the said governance bodies, the auditing and the accounting committees of this particular joint stock society (official references from the personnel departments of the candidates' previous jobs).

Upon receiving information on conducting the general meeting of shareholders, the respective federal ministry (body or agency) shall direct to the FAFPA its proposals with regard to voting on the matters of the agenda of the said general meeting of shareholders and appointment of the representative for voting at the general meetings of shareholders (with regard to the joint stock societies included in the said special list) within three (3) days but not later than fifteen (15) days prior to the date of the said general meeting of shareholders and should the agenda of the said general meeting of shareholders contain the question on prospective reorganization of such joint stock society then – not later than twenty (20) days prior the said date.

Should no information on conducting the said general meeting of shareholders has been received in due time, the proposals may be formulated on the basis of the agenda of such general meeting of shareholders as approved by the respective Board of Directors.

The proposals shall be presented with the accompanying explanatory note containing reasonable justifications of the decisions proposed as well as with all the necessary materials attached.

These proposals can be prepared on the basis of the protocol of the respective Board of Directors' meeting where the agenda for the said general meeting of shareholders

ers was determined, and then directed to the FAFPA well in advance of the time officially set up.

The quantity of candidates to be included in the list for being elected to the Board of Directors membership, directed then by the FAFPA to the respective OJSS, must exceed the number of candidates by three (3) which corresponds to the share of the state in the authorised capital of the said joint stock society. The quantity of candidates to be included in the list for being elected to members of the Board of Directors, the Auditing and the Accounting committees of this OJSS, should not exceed the quantitative composition of such bodies as determined by the general meeting of shareholders.

As to the joint stock societies included neither in the said special nor the strategic lists, the respective federal agency or body have a right to direct to the FAFPA their own proposals (including those with regard to prospective candidates to be included in the voting list for electing to the Board of Directors membership).

Respective directives to the representatives of the state for voting at the said general meetings of shareholders shall be duly executed by the FAFPA.

According to the procedure for determining position of the state as a legitimate shareholder of the joint stock society which is included in the special list (Art. 12 – 15 of the Regulations), proposals on nominating candidates to be elected to the governance bodies, the Auditing and the Accounting committees of the said joint stock society as well as on entering some other matters in the agenda of the annual general shareholders meeting, except for the questions as specified in Par. 1 Art. 47 of the Federal Law “On Joint Stock Societies”²⁰, shall be proposed by the RF

Ministry of Economic Development and Trade not later than December 1 of the year preceding the date of conducting the annual general meeting of shareholders (in case of conducting an extraordinary general meeting of shareholders – not later than 10 days prior to the end date of their submission to the respective joint stock society) with all the necessary materials attached. These include:

- proposals from the respective federal ministry (body);
- information on candidates to be elected to the respective OJSS governance bodies, the Auditing and the Accounting committees (official references from the personnel departments of the candidates’ previous jobs);
- relevant information on the OJSS (share of the state in the authorized capital, composition of the respective governance bodies, the Auditing and the Accounting committees, the main financial and economic indicators and other necessary data);
- copies of the constituent documents and the accounting materials for the last year duly certified by the notary or by the MEDT.

Proposals with regard to demanding the conduct of an extraordinary general meeting of shareholders shall be presented by the MEDT to the RF Government not later than ten (10) days prior to the intended date of producing such demand with all the necessary materials attached.

Proposals with regard to voting on the agenda questions of the general meeting of shareholders shall be presented by the MEDT to the RF Government not later than ten (10) days prior to the intended date of holding such general meeting of shareholders with all the necessary materials presented by the said joint stock society when preparing for holding such general meeting of shareholders as well as any other relevant materials attached.

²⁰ Implied here are matters obligatory for the annual general meetings of shareholders such as electing the Board of Directors (the Observation Council) of the Society, the Auditing and the Accounting committees, official approval of the annual and the annual accounting reports.

Proposals with regard to the agenda matters of the general meeting of shareholders included in the said special list, all voting shares of which are in the federal ownership shall be presented by the MEDT to the RF Government not later than thirty (30) days prior to the intended date of holding such annual general meeting of shareholders and in case of holding an extraordinary general meeting of shareholders – not later than ten (10) days prior to the intended date of taking the respective decision.

Table 3

Some procedures used by the state with regard to joint stock societies included in the respective special and strategic lists in accordance with the Provisions approved by the Resolution of the RF Government No 738, dated December 3, 2004

Direction of regulation	With regard to OJSS included in the special list	With regard to OJSS included in the strategic list
<p>Procedure for expressing the shareholder will of the Russian Federation</p>	<p>In order to prepare the respective shareholder position of the Russian Federation, the Federal Agency for Federal Property Administration (FAFPA) directs the respective notification on holding the general meeting of shareholders with the agenda and all other materials, obtained from the said joint stock society attached, within the three (3) days term from the date of its receipt but not later than twenty (20) days prior to the intended date of holding such general meeting of shareholders and in case the said agenda includes the questions of this society's reorganization – not later than twenty five (25) days prior to the said date:</p> <p style="text-align: center;"><i>to the federal ministry (body)</i></p> <p>the federal ministry (body, agency) directs to the FAFPA its proposals on the agenda and nomination of candidates to be elected at the given general meeting of shareholders to the respective governance bodies, the Auditing and the Accounting committees prior to November 15 of the year preceding the year when the respective annual general meeting of shareholders was held.</p> <p>Upon receiving such notification on holding the general meeting of shareholders, the federal ministry (body, agency) shall direct to the FAFPA its proposals with regard to voting on the respective agenda and appointment of the representative for voting at the said general meeting of shareholders within three (3) days but not later than twenty (20) days since the day such general meeting of shareholders was held, and in case the said agenda contains questions of reorganizing the society, then not later than twentyfive (25) days prior to the said date.</p> <p>The advance presenting of the said proposals to the FAFPA based on the minutes of the Board of Directors meeting where the agenda of the said general meeting of shareholders was determined, is obligatory when respectively directing them not later than twenty five (25) days prior to holding such general meeting of shareholders.</p>	<p style="text-align: center;"><i>to the federal agency (body)</i></p>

In case certain differences arise between the federal ministry (body) and the Federal Agency for Federal Property Administration (FAFPA) with regard to the OJSS included in the respective special list, or between the federal agency (body) and the FAFPA with regard to the OJSS included in the respective strategic list, then it is the responsibility of the FAFPA Head (the respective Deputy Head) to provide for holding a conciliatory meeting regarding:

a). making demands for holding an extraordinary general meeting of shareholders – not later than fifteen (15) days prior to the date of its actual presenting (in case the agenda of such extraordinary meeting of shareholders includes the question of electing the Board of Directors members, then the said time – term shall comprise twenty five (25) days);

b). inclusion into the respective agenda of the annual general meeting of shareholders of proposals regarding nomination of candidates to be elected to the governance bodies, the Auditing and the Accounting committees of the said joint stock society, and other matters – not later than prior to December 10 of the year preceding the year of holding the annual general meeting of shareholders, with regard to the joint stock societies included in the said special list – prior to November 25 of the year preceding the year of holding the annual general meeting of shareholders (in case of an extraordinary general meeting of shareholders - no– later than fifteen [15] days prior to final day of presenting such notification to the said joint stock society);

c). voting on the respective agenda matters of the general meeting of shareholders – not later than fifteen (15) days prior to the day of its holding.

Should the said conciliatory meeting fail to reach a mutually agreed position then the Head of the FAFPA (not later than the day following the day of holding the said conciliatory meeting) shall present to the RF Ministry of Economic Development and Trade (RF MEDT) all the necessary materials, including the list of differences with reasonably substantiated justification of the positions of the respective parties and proposals of the federal ministry (body, agency) duly attached.

Be such a case, the position of the Russian Federation as a legitimate shareholder of the joint stock societies included in the said strategic list, or the respective proposals with regard to such position of the said shareholder (the Russian Federation) included in the said special list, presented to the RF Government in accordance with the pp. 12 – 15 of these present Provisions, shall be formed by the RF MEDT as mutually agreed with the respective federal; ministry (body).

Order of activities of the said representatives of the Russian Federation in the Board of Directors

The FAFPA directs the notification on the agenda for the meeting of the Board of Directors of the said joint stock society with all the necessary materials attached, to the respective federal ministry (body) not later than 15 days prior to the date of its actual holding. In case this information on holding the said meeting of the Board of Directors reached the FAFPA later than the stipulated date, then the said notification shall be directed on the day of its actual receipt.

Beforehand direction to the FAFPA by the said federal ministry (body) of respective proposals as based on the data obtained from the representatives of the state in the Board of Directors, is obligatory.

The FAFPA directs the notification on the agenda for the meeting of the Board of Directors of the said joint stock society with all the necessary materials attached, to the respective on federal agency (body) and the RF MEDT not later than 15 days prior to the date of its actual holding. In case this information on holding the said meeting of the Board of Directors reached the FAFPA later than the stipulated date, then the said notification shall be directed on the day of its actual receipt.

In case of differences with regard to the said directives to the representatives of the Russian Federation in the Board of Directors of the OJSS included in either the special or the strategic lists, then the Head (or the respective Deputy Head) of the FAFPA shall provide for holding a conciliatory meeting not later than twelve (12) days prior to the date of holding the said meeting of the Board of Directors. Should the said conciliatory meeting fail to reach a mutually agreed position then the Head of the FAFPA shall present to the RF Ministry of Economic Development and Trade (RF MEDT) all the necessary materials, including the list of differences with reasonably substantiated justification of the positions of the respective parties and proposals of the federal ministry (body, agency) duly attached.

Be such a case, the directives to the legitimate representative of the Russian Federation in the respective Board of Directors shall be duly formed by the RF MEDT in accordance with the respective federal ministry (body).

Interests of the Russian Federation in the Board of Directors of the respective OJSS shall be represented by persons duly elected to the said Board of Directors of the number of candidates duly nominated by the state.

It is therefore stipulated that the said representatives of the state in the Board of Directors of the respective OJSS shall vote on the agenda matters on the basis of the written directives of the FAFPA whose expressed duty it is to issue these directives with regard to matters as stated in sub-paragraph 1 (determining the priority directions in the activities of the respective OJSS), sub-paragraph 2 (convening the annual and extraordinary general meetings of shareholders except for the cases when the target dates of convening such extraordinary general meeting of shareholders have not been duly observed or when holding of such extraordinary general meeting of shareholders has for such or other reasons not been allowed), sub-paragraph 3 (approval of the agenda of the general meeting of shareholders), sub-paragraph 5 (increasing the authorized capital of the respective joint stock society through placing by the society of additional shares within the quantitative and category confines of thus declared shares provided the respective Charter of this society, strictly in compliance with the law, refers this to the competence of the Board of Directors), sub-paragraph 6 (placement by the society of bonds and other emissive securities in cases as stipulated by the respective legislation), sub-paragraph 7 (determining the price [monetary estimation] of the property, the price of the placement and repurchase of the said emissive securities in cases as stipulated by the respective legislation), sub-paragraph 9 (forming of the executive body of the joint stock society and its pre-scheduled termination if such prerogative is referred to the competence of the Board of Directors by the Charter of this society), sub-paragraph 11 (recommendation with regard to the sizes and payment order for the respective dividends of the shares) and sub-paragraph 15 (approval of large deals) of paragraph 1 art. 65 of the Federal Law "On Joint Stock Societies" as well as on the matter of electing (re-electing) the Chairman of the Board of Directors.²¹ The Federal Agency for Federal Property Administration is entitled to issue to the respective representatives of the state in the respective Boards of Directors directives on other matters as well.

The said directives to the representatives of the state in the respective Boards of Directors shall be formed with due account taken of the said classification of all the OJSS with the respective federal share in their capital:

²¹ For the representatives of the state in the Boards of Directors of those joint stock societies which are included in the said special list, the question as mentioned in sub-paragraph 2 of paragraph 1, art. 65 of the Federal Law "On Joint Stock Societies", is not contained in the list of questions for which the respective directives are to be issued.

- joint stock societies included in the said special list – in accordance with the respective federal ministry (body);
- joint stock societies included in the said strategic list – based on proposals of the respective federal agency (body);
- other joint stock societies – independently but in case the respective federal agency (body) presents duly executed proposals, then with due account taken of such proposals.

As to the joint stock societies which are included in the said special list, should the respective federal ministry have the respective federal agencies under it, then such proposals, presented to the FAFPA, shall reflect a consolidated position of both the federal ministry itself and the respective federal agency subordinated to it for each particular question.

The federal ministry (body, agency) shall direct their proposals to the FAFPA within three (3) days since the date of receiving all the necessary materials but not later than twelve (12) days prior to the intended meeting of the Board of Directors. The said proposals may be duly prepared and directed to the FAFPA well in advance as based on the data obtained from the respective representatives of the state in the respective Boards of Directors. The federal agency (body) is entitled to direct to the FAFPA proposals for the agenda of Board of Directors' meetings of other joint stock societies as well.

Directives for the representatives of the state in the Boards of Directors of those joint stock societies which are included in the said special list, with regard to questions as mentioned in sub-paragraphs 1, 3, 5, 6, 7, 9, 11 and 15 of paragraph 1 art. 65 of the Law "On joint stock societies", shall be approved either by the Chairman of the RF Government or by the respective Deputy Chairman of the RF Government acting on the expressed instructions of the latter.

Draft projects of the directives for the representatives of the Russian Federation in the respective Boards of Directors prepared fully in accordance with the said Provisions, shall be presented by the MEDT to the RF Government not later than seven (7) days prior to the date of meeting of such Board of Directors.

It is assumed from the order of appointments and consequent activities of the respective representatives of the state in the Boards of Directors and the Auditing committee of the Open Joint Stock Society in whose regard a decision has been taken on using the special right for participation of the Russian Federation in the respective management (the "golden share"), that such persons shall be appointed by the RF Government, as recommended by the RF MEDT and prepared by the FAFPA fully in accordance with the respective federal agency (body). The opinion of the respective federal agency, at that, must be coordinated with the respective federal ministry under which it functions. Representatives of the state in the respective Boards of Directors and the Auditing committees of such joint stock societies exercise their authority on the basis of the FAFPA's written directives. Like in the case with the OJSS which are included in the said special list for the matters as pointed out in sub-paragraphs 1, 3, 5, 6, 7, 9, 11 and 15 of paragraph 1, art. 65 of the Law "On Joint Stock Societies", such representatives shall be approved by the Chairman of the RF Government or by the respective Deputy Chairman of the RF Government acting on the expressed instructions of the latter.

Besides, in accordance with the said Provisions, the federally owned OJSS shares handed over to the RF Ministry of Federal Property (RF MFP) for further selling, are subject to be transferred to the Federal Agency for Federal Property Administration within one (1) month from the date of introducing the respective changes in the RF MFP Charter with the exception of those shares which are subject to be handed over to the respective buyers

fully in accordance with the purchase and sale contracts concluded. The RF MFP is obliged then to present to the RF Government (annually, prior to March 31) a report on the management of the federally owned OJSS shares as well as on practical using the said special right for the Russian Federation to participate in the management of the respective OJSS (the “golden share”).

The unitary enterprises. As to the unitary enterprises, in the spring of 2004, the new management of the Federal Agency for Federal Property Administration came out with an initiative to strive for transferring half of their net profits to the state budget motivating it with the fact that a number of such enterprises no more than just imitate modernization of production accordingly using the said profits for purposes off the main stream of their respective production activities.²² This initiative quite fits the previous proposals of the Accounting Chamber, made known in 2001 – 2002, on the necessity of transferring by the unitary enterprises of no less than 95% of their net profits to the state budget.

An alternative viewpoint, as expressed in this respect by top functionaries of the branch management bodies as well as by the representatives of the so called “directors corps”, comes down in the long run to the proposal that the deduction of the profits normatives should be differentiated either by industries or by enterprises on an individual basis. Under the present conditions of a rather stable profit, the budget does not seem to experience any acute need in such source of incomes and comparatively high normatives of the said deductions in the context of non-existent centralized investments may turn modernization of production quite a questionable matter, create incentives for artificial underestimation of profits, fake bankruptcy and so on and so forth. It makes sense to remind in this connection that it was relatively recently that getting the amount of the monies transferred to the state budget, to each federal public unitary enterprise (FPUE) followed with further approval of its program of activities by the respective federal property management body (prior to the spring of 2003 - by the RF Ministry of Property) in coordination with the respective curatorial ministry or department started to be practically implemented. The corresponding provisions were adopted by the RF Government Regulations No 228, dated April 10, 2002.

It was also confirmed by the new management of the FAFPA that such organizational and legal form as the FPUE should be retained but only in single cases (for example, when such an enterprise works in the interests of the state security or defense).

In practical terms, the major novelty in the property policies of the state in respect of unitary enterprises was the Decision of the RF Government No 739, dated December 3, 2004, “On the Authority of the Federal Executive Power Bodies to Exercise the Ownership Rights on Property of the Federal State Unitary Enterprises”.

It was established that as regards the federal state unitary enterprises which are subject to be retained in the federal ownership or have been included in the forecast plan (program) of the federal property privatization, if the respective OJSS shares created through their respective transformation are planned to be contributed in the authorized capital of other joint stock societies or to be retained in the federal ownership, the respective federal executive power bodies then implement the following functions²³:

- approving the Charter of the enterprise (except for the respective federal public enterprises);

²² www.rosim.ru

²³ As to *other enterprises*, the said authority is exercised by the Federal Agency for Federal Property Administration with due account taken of proposals from the respective federal executive power bodies.

- appointing Head of the enterprise, concluding, making changes in and termination of the respective labor agreement with such;
- measures necessary for ensuring due attestation of Head of such enterprise; - approvals necessary for giving employment to the Chief Accountant of the enterprise, conclusion of, making changes in and/or termination of such labor agreement with him/her;
- approving the program of the enterprise's business activities, determining the part of the enterprise's profits subject to transference to the federal budget;
- coordinating of large deals as well as those connected with granting loans, guarantees, banking guarantees, other burdens, concession to demands, transference of debts, making borrowings;
- coordinating business deals in which the Head of such enterprise is obviously interested;
- coordinating business deals connected with decision – making with regard to the respective contribution in the authorized capital of such economic societies or partnerships or with shares belonging to the said enterprise;
- coordinating of the respective affiliations and representations set ups;
- approving the reports of the respective financial accounting and of the enterprise Head;
- coordinating the decisions on participation of the said enterprise in both commercial and non-commercial organizations as well as on concluding of simple partnership agreements.

Decisions on coordinating business deals which are connected with handling contributions (shares) in the authorized capital of economic societies or partnerships as well as such shares which belong to the said enterprise, decisions on participation of such enterprise in both commercial and/or non-commercial organizations as well as on concluding simple partnership agreements shall be taken by the respective federal executive power bodies as mutually and duly agreed upon with the Federal Agency for Federal Property Administration. The latter must also be kept fully informed on decisions taken with regard to matters of coordinating large deals as well as those connected with granting respective loans, guarantees, banking guarantees, other burdens, concessions to demands, transference of debts, making borrowings within twenty four (24) hours from taking such decisions.

The business activities of such federal public unitary enterprise as well as the report of its Head shall be directed, within three (3) days since their respective approval, to the FAFPA which performs with regard to them:

- formal approval of the respective auditor and determination of remuneration for his/her professional services;
- coordination with due account taken of proposals from the respective federal executive power body which is responsible for this given enterprise and business deals connected with the real estate property;
- forming of the enterprises' authorized capital;
- formal approval of the transfer act or the separating balance when reorganizing such enterprise or the liquidation balance when liquidating such enterprise;
- concluding of, changes in and termination in the established order of the labor agreement with Head of the given enterprise beginning from the date of including of such enterprise in the forecast privatization plan (program) of the federal property except for the cases when the shares created through its transformation of the joint stock society, are planned to be contributed to the authorized capital of other joint stock societies or to be retained in the federal ownership.

Any decisions on establishing, reorganization in the form of dividing, singling out of FPUEs based on the right of economic operation, and transforming them into federal state enterprises as well as on changing the type of such enterprises into federal public ones, shall be taken by the RF Government. The respective draft project on its establishment and/or reorganization must envisage the aims, subject and main types of its business activities. Also, it is presented to the RF Government by the respective federal ministry, federal agency or federal service whose professional activities are under control of either the RF President or the RF Government, fully in accordance with the RF Ministry of Economic Development and Trade.

Reorganization of the FPUEs based on the said right of economic operation, in the form of merger and/or association as well as their respective liquidation shall be implemented by the decision of the FAFPA on the basis of the respective proposal from the federal executive power body under whose responsibility such respective enterprise is operating.

Liquidation and reorganization of such FPUEs which have been included in the list of the strategic enterprises or the strategic joint stock societies and approved by the Decree of the RF President No 1009, dated August 4, 2004, shall be implemented by the RF Government on the basis of the respective decision of the RF President.

When attesting Heads of such FPUEs functioning under the jurisdiction of the respective federal executive power bodies whose activities, in their turn, are under direct control of either the RF President or the RF Government, formation of the said attestation commissions shall be practically executed by the said bodies. As to the FPUEs which are under the jurisdiction of the respective federal executive power bodies which are subordinate to the federal ministries, the said attestation commissions shall be formed by the respective federal ministries.

The RF MEDT was duly instructed to approve (within a three month period since the date of the official publication of the said Regulations) a sample labor agreement with Head of such FPUE and a sample Charter of such FPUE established on the said right of economic operation²⁴ as well as to present to the RF Government (within a two months period and in the established order) proposals on bringing the existing normative legal acts of the RF Government to conformity with this present Resolution.

Further changes. As to the practical aspect in the respective policies of the state with regard to its own property, rather noteworthy seems to be the fact that it was not too much later after the said list of the strategic enterprises and the joint stock societies was officially approved in August of 2004, that it became the subject of certain changes.

Most notable of them was exclusion from this list (by the Decree of the RF President No 1502, dated December 7, 2004) of the “Rosneft Oil Company” OJSS as connected with adoption of the GR Government’s proposal to include 100% of this federally owned joint stock society’s shares as a contribution of the Russian Federation into the authorized capital of the “Rosneftegas” open joint stock society which only added to the strategic OJSS list. It is also to be reminded here that the state’s initial intention was to exchange the “Rosneft” for 10.7% of the “Gasprom” OJSS necessary for consolidating the control package of the gas holding in its property which, in its turn, permitted to liberalize the respective market of the “Gasprom” shares without any damages brought to the majority control over the company. As to “Rosneftegas”, its creation was intended to serve as a temporary eco-

²⁴ It is quite noteworthy that the present Sample Labor Agreement with Head of FPUE and the Sample Charter of such FPUE were officially approved rather recently – by the orders of the RF Minimushestvo NoNo 6946-p and 6945-p, dated December 11, 2003, respectively.

conomic entity whose framework would enable functional exchange of the respective assets. A new element appeared in the position of "Gasprom" while preparing for such a maneuver, which came down to a simple fact that 100% of the "Rosneft" shares will not be enough for the state to acquire the "Gasprom" package of shares of the desired size and that some other assets should be added to this, for example, the "Zarubezhneft" RFTS FPUE whose turning into a OJSS was started as far back as the spring of 2004. Further perspectives of the said "Rosneftegas" OJSS (after the "Yuganskneftegas" OJSS has been purchased by the "Rosneft") indeed seem to be rather uncertain.

In addition to the "Rosneft" OJSS, fully in accordance with the Decrees of the RF President No 1483, dated November 29, 2004, and No 41, dated January 19, 2005, respectively, twelve (12) unitary enterprises and eight (8) joint stock societies of the machine-building and defense industries were also excluded from the said lists of strategic enterprises. Instead, the "RIA - *Novosti*" Russian International Information Agency was included into such list of strategic enterprises by the Decree of the RF President No 1470, dated November 22, 2004.

Apart from a possible merger of "Gasprom" and "Rosneft" (through skilful maneuvering with the state owned assets of these two corporations which, because of their substantial scale and size, were of a general national significance), quite noteworthy are the plans of the RF Government, made publicly known in February 2004, to amalgamate by the end of this year the "Pulkovo" FPUAC (the third largest air carrier in the country) and the "Russia" State Transporting Company (GTC) into one unitary enterprise dealing in air shipping. However, because of the ongoing administrative reform, the said amalgamation project was stopped and another confirmation that such amalgamation would indeed be completed appeared only in the autumn months. The current plan is that practically all of the respective GTC stock (except for the property necessary to ensure carriage of the country's first persons) shall be passed over to the new company. As well as the assets of the "Pulkovo" FPUAC not connected with the airport business. This may very well lead to the appearance of the second large air-carrier after the "Aeroflot – Russian Avialines" OJSS. True, early in the year of 2004, there were rumors about possible including in the said structure of the "Kavminvodyavia", the "Dalavia" and a number of other public unitary air carriage enterprises.

Thus, analysis of the property policies of the state in the area of the federal property administration in the year of 2004 permits to make the following **conclusions**.

The respective normative – legislative basis has been significantly renewed; the legislative gaps at the junction with the respective privatization and insolvency legislation have been successfully liquidated; presence of at least three lists (the special, which has not yet been published, the strategic and the specific insolvency regimes) of companies with different degrees of the property control (e.g., economic societies and unitary enterprises) with regard to which the state applies a special regulation, in fact, means nothing but early stages in forming a particular legal field for the enterprises of the state (public) economic sector. Hence, it remains rather unclear where the said lists of the joint stock societies, contained in the respective supplements to the "Regulations on the Rights of the Russian Federation as a Shareholder" (2001), really fit the system.

An additional functional quality in the capacity of a new subject of the property policies with regard to the state economic sector enterprises was acquired by the RF Ministry of Economic Development and Trade which is now called upon to act as a sort of an arbiter between the Federal Agency for Federal Property Administration (FAFPA) and the branch management bodies in many managerial aspects of the economic societies with such or other degree of state participation in the capital and the respective unitary enterprises. In

practical terms, there are certain indications that the trend towards enlargement of the state sector enterprises through their integration, which appeared in the year of 2000, is still going on. Although concrete implementation of such projects, as but too often demonstrated in real life (for instance, certain enlargement plans for the military and industrial complex, absorption of “Rosneft” by “Gasprom”, etc) in the long run seems to be quite problematic.

4.2. Ownership Rights Protection and Collapse of YUKOS

In the period between 2000 and 2004, the RF Government expanded its influence on ownership rights, attempted to establish (expand) control over major cash flows in the Russian economy and, more generally, made efforts to make the Russian business community dependant on public institutions in spite of decisions on economic deregulation and further privatization²⁵. Such policy is most likely to result in *creating a “state capitalism” model* (keeping in mind conditionality of this term) which is distinguished by a combination of the following elements :

- strengthening (widening the scope of application) firmly standard elements of public entrepreneurship, which seems to be viewed as a component providing the national interests of Russia (which is quite arguable) ;
- creating favorable (or at least neutral) conditions for a small group of loyal companies, including private ones, which have gained a reputation of “government supporters” and based themselves upon a highly centralized state machine which is subordinate to the RF President (including law making structures and judicial authorities) ;
- applying (selectively) demonstratively punitive actions (represented by administrative and criminal cases) against powerful economic subjects which fail to suit the model under construction ;
- asymmetry of goals and approaches. The goals which have been assigned, most of them quite reasonably, with a view to regaining assets, making property structures transparent, returning profit centers to Russia, abolishing ineffective tax schemes, etc., are being implemented by using approaches which have nothing to do with such issues, rather than making reforms in the relevant sectors ;
- making distinctions between the national interests of Russia and the principle of private property integrity.

Though the foregoing trends developed as the new order strengthened itself throughout the entire period of 2000 thru 2004, the YUKOS case of 2003 – 2005 became a point of reference for understanding a full picture of ongoing processes. Obviously, the case should be interpreted in terms of creation of public “centers of power” in the strategic industries (GAZPROM – ROSNEFT – YUGANSKNEFTEGAZ – power supply industry), public control over resources of the Eastern Siberia where YUKOS used to be quite powerful²⁶, geopolitical aspects (selection of pipeline options between China and Japan), etc., rather than the collapse of disgraced tycoon’s empire (YUKOS). Such interpretation provides a better picture of the real criteria to be relied upon in developing a concept of “partnership between the state and the business” which is currently so popular among senior public servants.

²⁵ For more details please refer to Radygina A. Russia in 2000 – 2004 : The Way to State Capitalism? // Voprosy Ekonomiki. 2004. No. 4. p. 42 – 65.

²⁶ It is only in 2005 – upon the sale of YUGANSKNEFTEGAZ to a state-owned company – when the government has brought up the issue of multifold increase of budget allocations on geologic exploration and eastward reorientation of the industry from the Western regions of Russia. A series of license auctions on natural resource development in this region are expected to be held in the long term. However, it is public companies that are to be granted preferences at these auctions.

The model under construction can be better pictured from the point of view of a series of "small" effects that emerged in the YUKOS case to become a general alarm signal for major businesses in Russia. In 2003 the experts were mostly interested in real motives of the government in the YUKOS case, while in 2004 they focused on other aspects. It is almost obvious that YUKOS will not exist in the way it did until late in 2004, and the company will continue to break up in 2005. In regard to M. Khodorkovsky and other shareholders and staff members being under arrest in Russia, there is probably no way to achieve compromise like "property in exchange of freedom"²⁷. In spite of all procedural costs involved, major criminal cases will be brought to their final judgment which is unpredictable as it will depend not only on the provisions of the RF Criminal Code. In general, it is the unbiased assessment of strategic effects of the YUKOS case for the Russian economic and legal systems that will matter, rather than destiny of the company itself and its owner²⁸. More importantly, potential impacts of the YUKOS case have recently been emerging.

4.2.1. Selling YUGANSKNEFTEGAZ

It is our opinion that the sale of YUGANSKNEFTEGAZ, basic YUKOS's oil producing asset, in December 2004 (refer to Annex) is one of the most alarming signs for the Russian business.

According to the history of YUGANSKNEFTEGAZ, the provisions of RF Law "On Execution of Legal Process" were sufficient to take control over the company²⁹. In particular, RF Federal Law "On Execution of Legal Process" provides no prohibition of preferential forfeiture and sales of shares of a company integrated into a holding company. The order of forfeiting debtor's property is supposed be determined unilaterally by an officer of justice who is entitled to discretionary conceive debtor's specification of the property to be forfeited first. Altogether, this creates conditions for abuse of power by law enforcement officers in executing legal processes, as well as provides for a case when a single person is empowered at his own or any other government entity's discretion (including the government itself) seal fate of a major company. The sale of YUGANSKNEFTEGAZ also demonstrated that the applicable law enforcement process is not only far from being perfect but also selective thus violating the principle of equality before the law and justice, i.e. one of the fundamental principles of the RF Constitution.

The sale of YUGANSKNEFTEGAZ had an ambiguous effect. Referring to the chronicle of events specified in Annex, the stock market responded by some growth. Furthermore, as seen in Section 4, empirical data provide no support for the prevailing opinion that the Russian stock market was driven to London by the risks caused by the YUKOS case and political and economic uncertainty in Russia. Indeed, the conflict concerning YUKOS oil company created concerns of non-residents about protection of their participation in Russian companies. This factor, however, caused no capital outflow from the MICEX to London because a share of non-residents trading in Russian shares at the MICEX is insignificant. More likely the YUKOS case had an adverse impact on volatility of trade volumes of depositary receipts at the London Stock Exchange which fluctuated substantially on a monthly basis.

However, almost all stock market analytics point out that foreign investors and business community at large have a more negative perception of Russia. In addition, the following aspects should be taken into account in this respect: (1) the current situation in the

²⁷ The staff members have a chance to achieve the freedom-in-exchange-of-information compromise.

²⁸ However, the YUKOS case should be broken down into two components from the very beginning: claims on the company and legal prosecution of its owners as physical bodies.

²⁹ YUKOS still remains in business, as was promised at the top governmental level in fall of 2004.

Russian "domestic" stock market is commonly assessed as fairly speculative and poorly relying on the fundamental parameters of the Russian economy; (2) the fact that basic risks related to YUKOS case were created by investors as early as 2003. The latter is fully supported by the data on comparative movement of stock indices. For example, the RTS index and the MICEX index grew by only 7% at the background of a general growth by 18% in the consolidated stock index of emerging markets in 2004, while in 2003 the consolidated stock index of emerging markets and the RTS index and the MICEX index showed nearly similar growth, correspondingly by 52, 58 and 61% (*Table 4*).

Table 4

Changes in Priorities of Foreign Portfolio Investors

	1997	1998	1999	2000	2001	2002	2003	2004
Emerging markets consolidated stock index, %	-13	-28	+64	-32	-5	-4	+52	+18
RTS stock index, %	+98	-85	+197	-20	+98	+34	+58	+7
MICEX stock index, %	-	-	+77,6	-4,7	+65,5	+34	+61,6	+7,3

Note. In 2004, incremental growth in the stock market in Russia came to be close to zero, while other countries – raw materials exporters – demonstrated different results: Venezuela +52%, Indonesia +47%, Mexico +36%, Republic of South Africa +35%. According to the IIF (21 countries in January 2005), private investment inflow to the emerging markets grew by 32% to reach its maximum in 2004 since 1997 (\$279 billion).

Source: according to the data of *Vedi* analytical laboratory (seminar on "Changes in the Russian Economy", Higher School of Economics, January 26, 2005); Institute of International Finance (IIF); authors' estimates.

Moreover, assessments of the "input" of the transaction with YUGANSKNEFTEGAZ's equity and the YUKOS case in overall investment process in 2004 are quite ambiguous. This is due to different approaches employed at various socio-economic institutions. On the one hand, almost all liberals, including senior government executives, expressed their negative attitude towards the transaction in terms of violation of ownership rights, creating unfavorable investment environment, collapse of confidence in the government, moving towards an autocratic regime, etc. The arrest and sales of YUGANSKNEFTEGAZ were directly associated with (drastic) deterioration of the investment climate in Russia and increased capital outflow (export)³⁰ in 2004. A regular polling by Expert analytical center of 50 top managers of the western investment banks, companies and funds operating in Russia, revealed less importance of such factors as investment attractiveness as law enforcement, protection of ownership rights in general and those of minority shareholders in particular, enhanced administrative pressure upon the business community and corruption³¹. A monthly polling conducted by the Association of Managers of Russia (in January 2005)³² revealed the following distribution of answers to the question of the reasons for capital outflow from Russia in 2004: 47% – poor protection of ownership rights, 38.6% – the YUKOS case, 14.5% – search for new investment objects, 1.2% – USD fall, 1.2% – the summer (2004) banking crisis.

On the other hand, there were some positive assessments as early as 2005. For example, in February 2005, according to Standard & Poor's, one of the most conservative rating agencies, ranked "B-" for Russia with "stable" forecast (with the proviso, however, that political decisions and actions of regulatory agencies are unpredictable), which provides for investments from long-term conservative investors. In spite of deteriorated in-

³⁰ According to A. Illarionov, adviser to the RF President, specified \$27 billion of "capital export" in 2004 against \$10 billion in 2001. The Deputy Minister of Economic Development and Trade A. Sharonov specified four-time growth in "capital outflow" in 2004, but his total amount is more moderate, \$8 billion.

³¹ Shokhina E. Investors Feel Uncomfortable in Russia // Expert. 2005. No. 4. p. 43.

³² According to the data of the Association of Managers of Russia (www.amr.ru).

vestment environment for a certain part of business community, the RF Ministry of Economic Development and Trade has forecasted investment demand in 2005, which may potentially be created in high-tech industries and aircraft industry. Nevertheless, credit balance deficit of net foreign capital inflow is expected in 2005 as it was in 2004³³. The Expert's analytics also provided a fairly optimistic forecast of a new wave of economic growth as based on interpreting the data of the Russian Agency for Statistics on investments in fixed assets in 2004. They believe that there were two basic factors that worked for animation of investments in 2004: the government made its intentions more clear and transparent in regard to YUKOS and the economy at large (the government intends to gain control over the sector of raw materials exports as well as get "compensation" from the "first wave" tycoons who got hold of their assets on the tide of uncivilized privatization, which made a clear picture of most risky political areas as well as those economic areas under minimum risk: small and medium-size businesses, high-tech industries, consumer sector), and substantial amount of idle funds in the economy³⁴.

There is another unique material aspect which is worth mentioning. The transaction with YUGANSKNEFTEGAZ's equity demonstrated clearly that there was a, putting it mildly, foreign economic issue (or the most important task) about the entire YUKOS case. This was evidenced by a fairly contradictory and poorly designed process of establishing a *public oil company on the basis of GAZPROM OJSC*.

The idea of setting up a public oil company (conditionally GOSNEFT) was discussed as early as at the beginning of the 2000'. This company (if established) was supposed to become a foothold for more active participation of the government in the industry along with consolidation of all remained state-owned assets in this industry. As early as 2003, the hypothetic GOSNEFT (on a par with ROSNEFT and SURGUTNEFTEGAZ) was considered by analytics as a candidate manager of the nationalized package of YUKOS's equity in the name of the government.

In 2004 this idea was implemented in practice. In spite of a relatively wide range of options of increasing public share in GAZPROM OJSC's equity, the final choice was made in favor of combining assets of a series of companies with government participation. In September 2004, a future acquisition of JSC NK ROSNEFT was announced – exchange of 100% OJSC ROSNEFT's shares for 10.47% "treasury" stocks of GAZPROM OJSC available on the balances of its subsidiaries (presumably 4.83% of GAZPROM's shares are on the balance of Gazprominvestholding, 3.64% – Gazprombank, 1.5% – gas producing enterprises, as well as 1.74% out of 4.58% shares owned by Gazprom Finance BV). On November 1, 2004, the Chairman of the Board of GAZPROM OJSC signed an initiator's decision on establishing LLC GAZPROMNEFT with a 100% participation of GAZPROM. Director of ROSNEFT³⁵ S. Bogdanchikov was appointed as the Director General of the company. Oil and gas condensate production, transportation and storage were supposed to be core business of the company.

As far as we know, the following scheme was officially approved by mid- December 2004 :

- the Russian Federation establishes JSC ROSNEFTEGAZ in the name of an authorized body and invests 100% shares of JSC NK ROSNEFT owned by the federal government in its authorized capital ;

³³ Press conference of A. Klepach, Head of Macroeconomic Forecast Department under the RF Ministry of Economic Development and Trade February 1, 2005 . (www.economy.gov.ru).

³⁴ The worse is behind. Editorial // Expert . 2005. No. 4. P. 11.

³⁵ Data from official website OJSC GAZPROM www.gazprom.ru. The issues of corporate risks and assessment of combined assets are not considered.

- OJSC GAZPROM's subsidiaries transfer 10.74% of GAZPROM OJSC shares owned by them to LLC GAZPROMNEFT's balance ;
- JSC ROSNEFTEGAZ transfer to LLC GAZPROMNEFT 100% shares of JSC NK ROSNEFT in exchange for 10.74% of OJSC GAZPROM's shares.

Implementation of the scheme was started late in 2004. The Russian Federation established JSC ROSNEFTEGAZ. On December 7, 2004, the RF President issued a Regulation in which he excluded JSC NK ROSNEFT³⁶ from and included JSC ROSNEFTEGAZ into the list of strategic enterprises and joint stock companies, as well as ordered to accept the proposal of the RF Government to invest 100% shares of JSC NK ROSNEFT owned by the federal government in the authorized capital of JSC ROSNEFTEGAZ.

The scheme of establishing a public energy giant was supposed to be finalized by purchasing a block of stocks of YUGANSKNEFTEGAZ by GAZPROMNEFT (and consequently making the former a subsidiary to GAZPROM OJSC) at an auction to be held on December 19, 2004. However, it encountered a strong opposition of YUKOS shareholders (refer to Annex) and failed: in order to avoid potential legal risks abroad, OJSC GAZPROM had to sell 100% of its participation in LLC GAZPROMNEFT to unknown persons which are not affiliated to JSC GAZPROM. ROSNEFT OJSC won through an intermediary which assumed all risks at the auction, thus increasing its capitalization by several times.

Further prospects of merging oil assets of GAZPROM and ROSNEFT or making the government a majority shareholder of GAZPROM OJSC still remain uncertain. In spite of large financial liabilities arisen from transactional payments (existing debts plus debts related transactional financing and debts due to YUGANSKNEFTEGAZ), ROSNEFT OJSC may become a leading player in the petroleum industry (such position is enhanced by major contracts on oil supply to China till 2010). However, various options are possible: a 100% integration of ROSNEFT into GAZPROM OJSC without a block of shares of YUGANSKNEFTEGAZ; exchange of shares between GAZPROM OJSC and ROSNEFT considering the value of the latter (GAZPROM OJSC may come to have a minority share); establishing direct control over GAZPROM – ROSNEFT – Baikal Finance Group – YUGANSKNEFTEGAZ; and unconditional refusal of merger.

For example, according to the option of the RF Ministry of Industrial Energy, it would be expedient to transfer YUGANSKNEFTEGAZ's assets from a corresponding joint stock company to an independent company owned (100%) by the government (it could be previously established ROSNEFTEGAZ). Twenty percent of shares of the new company may be sold to CNPC (China). GAZPROM should acquire ROSNEFT without participation of assets of YUGANSKNEFTEGAZ. It is obvious that this scheme is intended to prevent legal risks abroad: the new public company may become an oil supplier to the domestic market, ROSNEFT will become the key public oil exporter after integration into GAZPROM³⁷. On January 19, 2005, A. Miller, Chairman of the Board of GAZPROM OJSC, announced that development of the merger scheme of GAZPROM and ROSNEFT, which reportedly makes no provision for including YUGANSKNEFTEGAZ's assets, had been completed and packages of stocks would be exchanged at the end of January 2005. However, early in Febru-

³⁶ JSC NK ROSNEFT was included into the list of strategic enterprises and joint stock companies by a Decree of the RF President "On Approval of the List of Strategic Enterprises and Strategic Joint Stock Companies" of August 4, 2004 No. 1009. Strategic enterprises and joint stock companies must not be privatized unless they are excluded from this list as provide for by Federal Law "On Privatization of Public and Municipal property" of 21 December 2001 , No. 178 - FL.

³⁷ This option was presented by D. Medvedev, Head of RF President's Administration on December 30, 2005 (see : YUGANSKNEFTEGAZ Is Designated a Great Public Future // Kommersant. January 11, 2005). The option of the RF Ministry of Economic Development and Trade presented in January 2005 by G. Gref (privatization of ROSNEFT and YUGANSKNEFTEGAZ), as well as the option of A. Illarionov, Advisory to the RF President, (YUGANSKNEFTEGAZ remains with YUKOS) are very unlikely to be applied in practice.

ary 2005, the idea of ROSNEFT independency and its transformation into a major public oil exporter was reanimated again (in this case, YUGANSKNEFTEGAS would remain integrated into ROSNEFT). According to this option, GAZPROM would not acquire 100% of ROSNEFT. Instead, “treasury” shares of GAZPROM would be assigned to the government in exchange for the minority share in independent ROSNEFT³⁸.

Ultimately, *three basic criteria should be relied on in selecting other options*: the government should obtain a controlling stake in GAZPROM OJSC; key participants in the events associated with YUGANSKNEFTEGAS should be protected from legal risks (on the part of the purchaser) ; the balance of influences and interests in the RF President’s Office and its projection on GAZPROM and ROSNEFT should be maintained. Such balance is most likely to determine a critical decision regardless of whether ROSNEFT is going to become an independent oil player. It is our opinion that this is the main challenge which governs, first, prevalence of foreign economic criteria in planning acquisition in prejudice of corporate interests (both for GAZPROM OJSC and ROSNEFT); second, incompetence in take-over represented by using illegal techniques, especially in estimating purely economic effects and risks; third , it is necessary to make responsible decisions (which are worth billions of dollars and reputation) in the “fire-squad” mode. Responsible strategic decisions, for which parties have to get prepared over years in common world practice, are made and revoked within several hours subject to the current political situation and quite a flexible balance of administrative influences.

4.2.2. *Economic Rent, Licensing and Fiscal Policy*

The issues of economic rent and fiscal policy are fundamental. The YUKOS case of 2003 – 2004 is most likely to have impact on this field. There are two interconnected trends that are worth mentioning.

On the one hand, the large Russian businesses demonstrated their almost unanimous tolerance (absolutely demonstrative though) to various government’s innovations and “goodwill” in relation to tax load (in 2003, a series of oil companies declared that they would employ no tax minimization schemes, in 2004 LUKOIL announced a “voluntary” decrease of gasoline prices by 5%, etc.). The subject of “corporate social responsibility” became a popular topic for discussions. However, the idea of such subject seems to be quite cloudy for any business organization which pays all taxes in good faith.

At the same time, in the period between 2003 and 2004, *the business community found itself to be able to protect its interests with the government*. In fact, the existing business associations (RSPP, OPORA Rossii, Delovaya Rossiya, etc.) accepted the rules of the game and acted as applicants rather than independent political force.

In the 90’, the mechanism of relationship between large businesses and the government was distinguished by the possibility for major financial and industrial groups to directly participate in developing and imposing upon the government vital political decisions which surely served for the benefit of these groups. The 2000’ saw quite an opposite situation, when the government began to deliberately disregard the interests of private business in general and enforced new rules of the game to be observed by the business community through a wide range of enforcement techniques. The YUKOS case draw a line under the era of “tycoons”. However, one cannot but take into consideration that pursuing the policy of “state capitalism for insiders” may logically create the situation of the 90’, because the model under construction means that new potential “tycoons” may emerge.

³⁸ Press conference of S. Oganessian, Head of the Federal Agency for Power Engineering (member of the Board of Directors of ROSNEFT, former vice-president) on February 1, 2005 . (www.lin.ru).

“At present, there are two interdependent forces existing in the country, each climbing to power. One is represented by advocates of capitalism, i.e. a party of governmental bourgeoisie. It is currently being in power, alone. Obviously, there should be another party of independent bourgeoisie, business”³⁹. Establishing a political party to represent the interests of the Russian independent bourgeoisie (not only large business) would be a civilized option, but such party is very unlikely to emerge at the present time. In addition, one should understand whether there is any business in this country which is totally independent from the government, and what are the chances to establish a true political party rather than a dummy one. The existing business associations are unlikely to fit this role.

On the other hand, the government continued its policy aimed at tightening “the rules of the game” for large businesses in 2004 and early in 2005. Late in 2004 and early in 2005, practical testing of the “tax arrears compensation”⁴⁰ extra-bankruptcy schemes was accompanied by introducing a series of *tax innovations in regard to business*. Though some of the rules seem to be quite positive, that is not the point. It is our opinion that the measures discussed at the beginning of 2005 (rationalizing tax audit mechanisms, regulating transfer costs in the RF Tax Code, making confiscation amendments to the RF Criminal Code, imposing restrictions for offshore companies at natural resources auctions, etc.) *were too alien in terms of expected effects* to be conceived as a reasonable and comprehensive system of measures.

In substance, the only proposal that was found favorable for the private business was an initiative of the RF Ministry of Finance presented on February 8, 2005 at a meeting on rationalizing tax audit mechanisms chaired by the President of the Russian Federation. It was proposed to approve a full list of documents requested for the purposes of tax audit; to establish a fixed number of tax audits for a certain period; to approve large amounts in arrears by superior bodies; to perform additional tax audits only in exceptional circumstances⁴¹; and to set up a special body to consider conflicts arising during tax audits.

The issues of tax amnesty (especially establishing a limited period to make additional tax payments) are not considered by the government. Instead, the RF President made an amendment to the RF Tax Code (in January 2005) allowing the RF Federal Tax Service to collect tax penalties (from legal entities and physical bodies) without any judgment.

In January 2005, (upon five years of discussion of this issue at different levels) the RF Ministry of Finance submitted a package of draft amendments to Article 20 and 40 of the RF Tax Code on regulating market prices (transfer pricing) for taxation purposes. In particular, they determine specific features of interdependent entities and principles of pricing of goods, works and services for taxation purposes, as well as circumstances when additional tax payments should be made in case of transfer prices overshooting the market ones, etc.

There is a point of view that the idea of such regulation is insignificant for the time being due to introduction of fixed tax rates in RUR for oil companies, the use of export duties and other methods of skimming of excess profits, and liquidation of internal offshore companies. The idea, however, is not rejected, since it is widely employed in the world practice, and transfer prices are used in a variety of other industries. The fact that transfer prices are employed not only for tax evasion but also simply for optimizing the management system

³⁹ Rodionov I., Need for a Swing // Expert . 2004. No. 35. P. 42.

⁴⁰ We believe, however, that other well-known (by mid- February 2005) major claims by the Federal Tax Service on large companies (Sibneft, Vimpelkom, Dalsvyaz) should not yet be bracketed with the YUKOS case. These cases along with a variety of other ones may be based on quite different motives: from execution of duties in good faith to settlement of accounts between senior government officials and a company, trivial incompetence or intention to prove political loyalty.

⁴¹ It were additional (second) tax audits that caused basic additional tax payments with regard to the YUKOS case.

within a group of companies, creates a serious problem which can not be settled legislatively. This is accompanied by another objective problem which lies in the fact that, on the one hand, it is impossible to determine legislatively all types of interdependence and hence is subject to judicial decision. On the other hand, according to the practice, courts are not qualified to provide judgment to such specific issues, while it is not only availability of precedents but also effective and non-commercialized judicial system at large that is critical for identifying specific features of interdependence "according to other grounds". The foregoing problem will also be encountered by tax agencies in making decisions on additional tax payments, because it is extremely difficult to determine price "deviations". Therefore, a new material risk of subjectivity is arising in the context of relationship between the government and the business in relation to the latter. Another material risk is represented by emergence of a new tool of exerting pressure upon competitors by using administrative mechanisms.

Amendments to the RF Criminal Code (Article 104.1) proposed by the RF President at the beginning of 2005 may become another serious innovation. Virtually, the question at issue concerns restoration of "forfeiture" regulations which were excluded from the RF Criminal Code on the initiative of the RF President as early as 2003. Forfeiture is expected to be applied to all types of criminal offences, and provision is made for forfeiture of property for the benefit of the government. It may also include:

- earnings and revenues generated from criminally made property (in order to confiscate all assets of a company, it is sufficient to prove a criminal origin of the initial "million" of a capital or unlawfulness of privatization transactions) ;
- property intended to finance organized criminal groups or criminal activity (it is well known that YUKOS's principal shareholders were also accused of creating such a group) ;
- property assigned by a convicted person to other person, provided that the latter has evidence to suggest that it has been obtained by criminal activity (in January 2005, M. Khodorkovsky announced that he transferred 59.9% shares of MENATEP Group to other shareholder, L. Nevzlin⁴². According to the estimates, such innovation allows even wages of employees of a company to be seized assuming that they suspect the management of criminal actions)⁴³.

Adoption of a revised RF Law "On Mineral Resources" is an essential factor of government's attitude towards economic rent and the related issues of strengthening public control⁴⁴. The following key issues were considered in 2004: participation of local governments in distributing rights to mineral resources (this is specified in the Constitution of the Russian Federation), searching an alternative to licenses (for example, "exclusive right to utilize the area of mineral resources" purchased at an auction), terms and conditions of granting rights to mineral resources, and geologic exploration issues. Most likely a concessionary mechanism of mineral resources utilization is going to be introduced to impose restrictions on private sector operations in this field. In 2004, however, licensing was used

⁴² 50% of shares of Gibraltar MENATEP Group are allocated in a special trust. M. Khodorkovsky was its manager and beneficiary prior to the legal against YUKOS. L. Nevzlin became a beneficiary of the trust (under the terms and conditions of the trust) upon M. Khodorkovsky was put under arrest in October 2003. L. Nevzlin was granted the right to dispose 50% of shares in trust according to the terms and conditions of the trust upon the loss of the principal asset – YUGANSKNEFTEGAZ – on December 19, 2004. Certain rights to 9.5% of shares held by M. Khodorkovsky were transferred directly L. Nevzlin in addition to the shares in trust.

⁴³ Refer to : Tightening // Trade secret. February 7 thru 13, 2005. P. 8 – 9.

⁴⁴ RF Law "Mineral Resources" of February 21, 1992. No. 2395-1 is currently effective. Latest updates of June 29, 2004, No. 58- FL and August 22, 2004, No. 122- FL were related to the changes caused by adoption of a series of other laws and made no changes in the previously accepted approaches.

quite extensively as a mechanism of public regulation in oil and gas sector (both for the purposes of direct redistribution of control and trivial competitive pressure). In doing so, however, no transparency of procedures and claims was provided. According to the RF Ministry of Natural Resources, 50 out of 110 examined license agreements were revoked in 2004 .

A proposal of the RF Ministry of Natural Resources ⁴⁵ to tighten the procedure allowing extractive companies to participate in field development auctions became an innovation at the beginning of 2005. This means that *offshore companies* will be excluded from the list of participants in future auctions as a soft option, or licenses of these companies will be revoked⁴⁶ as a hard option. Unconditional registration of at least subsidiaries of foreign (foreign *de jure* and Russian *de facto*) offshore and other holding companies in the Russian Federation is proposed as the only alternative, while transparency of ownership structure and tax and judicial jurisdictions of the Russian Federation are presented as a positive effect. Such initiative also provides an ambiguous character.

Historically, (the end of the 80' with abolished foreign trade monopoly thru the first half of the 90') offshore companies were registered in the name of real owners, relatives, front parties, etc. The most commonly used scheme didn't seem sophisticated: Russian company is offshore holding. However, the fact of holding these shares (of foreign companies) was a violation of the Russian Law. In a sense, the modern Russian law on affiliated entities (groups of entities) evolved mechanically from the simple schemes that used to be employed in the 90', which are practically outdated. The shares of many offshore companies were then transferred to "non-name" trusts (the simplicity of this scheme was assessed relatively later). The scheme is currently typical of a the overwhelming majority of large enterprises (groups). Such "innovation" in creating non-transparent ownership structures and deriving tax-free revenues from property is linked to a gradual recognition (by many Russian majority shareholders) of multiple advantages: tax benefits, political risk protection, inheritance security, manipulation (switch) with assets/blocks of shares for construction (reorganization) of their corporate groups, etc. According to the assessments available, it is "non-transparency" of an offshore for law enforcement agencies of a non-resident (i.e. "insecure" rating according to Financial Stability Forum) that is most important criterion in selecting a jurisdiction.

Offshore companies (established both by Russian physical bodies and legal entities) were booming in the period between 1992 and 1995. Late in the 90', the number of Russian offshore companies in foreign countries accounted for tens of thousands (there is no exact data available). Nearly 2000 companies were established annually. Geography of foreign offshore companies used by Russian physical bodies and companies is quite ample. There are countries that were preferred most. For example, as of 2002, 8% of GDP of Cyprus fell at offshore companies, including 60% ones of Russian origin. A total of over 52 thousand offshore companies were incorporated in Cyprus at that period. From 18 to 25 thousand companies (i.e. up to 40%) belonged to Russian residents, according to various assessments. Cyprus-based offshore companies were widely used by stock market participants, insurance and trade companies as well as for assets protection on the basis of sophisticated schemes. Many large Russian companies utilized offshore companies incorporated in Gibraltar, British Virgin Isles, holding companies at Denmark, Luxemburg, Netherlands, etc. There were several scandals associated with offshore companies estab-

⁴⁵ A report of the RF Minister of Natural Resources Yu. Trutnev at the State Duma on February 11, 2005 .

⁴⁶ In this case , foreign (offshore) companies, groups, groups of entities (according to the terminology of the RF Ministry of Natural Resources) mean companies in which participation of Russian residents accounts for not less than 51%.

lished for money laundry. The offshore mechanism is typical of the banking sector of Russia .

It is not for the first time that the issue of tightening the treatment of offshore companies has been brought up⁴⁷. Attempts to interpret the “real owner” concept as applied to banks and amendments made to RF Law “On Banks and Banking Business” in terms of restricting a share of offshore companies in authorized capital of Russian banks up to 10% (in 2003 thru 2004) are worth mentioning. At the beginning of 2005, the RF Ministry of Finance put forward an initiative (corresponding amendments were made to the RF Tax Code) on additional tax payments due by companies with offshore management (i.e. in cases when a group have a management company in offshore zones located in foreign countries). The latest innovations of the RF Ministry of Natural Resources will be indisputably positive from the point of view of making transparent the information on ownership structure and beneficiaries. However, both world and Russian practice shows that legal requirements alone will bring no positive *general economic* effect unless supported by “confidential relations” (this classic term of a new institutional theory is appropriate here as never before) and effective international cooperation.

4.2.3. International Expansion Boundaries

There was another essential trend that emerged in regard to the YUKOS case: *boundaries of international expansion of Russian corporate groups* were determined quite explicitly, especially those based on extracting industries of the economy. The divide line is most likely to be represented by trans- or multinational nature of possible strategic international business alliances.

Drastically enhanced ownership-driven expansion of the largest Russian groups in foreign countries, which is typical of the period of 2004 – 2005 , has been faced no restrictive counter measures yet. As an example we refer to attempts made by a series of major oil companies in keeping industrial vertical “fixed” on the consumer (by purchasing oil refineries and gas station chains in foreign countries, etc.): NORILSKY NICKEL in gold mining, SEVERSTAL with Canadian Stelco and Italian Lucchini and other ferrous metallurgy companies, BAZOVY ELEMENT with aluminous production enterprises, SUAL with a variety of projects in non-ferrous metallurgy, telecommunications and diamond production business, etc.

In doing so, however, any options of including foreign companies into the list of principal shareholders of the largest Russian extractive-industry groups are subject to approval by the government. Recently, all major transactions related to purchase of Russian assets by foreign companies are subject to be submitted to the RF President for preliminary consideration (TNK-BP in 2003 , Silovye Mashiny and Siemens, LUKOIL and Conoco-Phillips in 2004). Most likely such approval was also needed by ROSNEFT to obtain a loan from a syndicate of Chinese banks to the amount of \$6 billion, which will be repaid by oil supplies to CNPC, Chinese oil company (48,4 million tons till 2010). According to the estimates, this loan was obtained to effect settlements on YUGANSKNEFTEGAZ⁴⁸, though ROSNEFT doesn't consider this transaction a loan and specifies that the funds are in-

⁴⁷ Refer to, for example, : Apel A., Gunko V., Sokolov I. *Cashing and Offshore Business in Schemes*. St.Petersburg : PITER , 2002 ; Kabir L.S. *Organizing Offshore Business*. M.: Finances and Statistics, 2002; Ushakov D.L. *Offshre Zones in Practice of Russian Taxpayers*. M.: Yurist, 1999; Radygin A. *Disclosing Information on Beneficiary Ownership // Records of an OECD “round table” on corporate management*. Moscow .

October 2 thru 3, 2003 .; *Behind the Corporate Veil. Using corporate entities for illicit purposes*. Paris: OECD, 2001 .

⁴⁸ Kommersant Publishing House (www.kommersant.ru). July 22, 2004 .; *Finansy*. 2005. No. 5. P. 52.

tended to “make investments in industrial and economic activity and implementation of capital-intensive projects”.

4.2.4. *Revising Privatization Results*

The issue of *revision of privatization results* is the most important tool intended to exert psychological pressure upon large businesses. Though almost all senior government officials expressed, at least once, their non-acceptance of such methods on a large-scale basis, the true intentions of the government are represented by *uncertainty* in this field. None of the relatively efficient solutions (public political decision on moratorium in revising privatization results; reduction in limitation periods; differentiation of possible approaches in revising transactions subject to a criminal component; adoption of clearly-defined rules of nationalization, etc.) that were put forward in the period between 1999 and 2004, has been adopted.

A report made by the RF Accounting Chamber, “Analysis of Public Property Privatization in the Russian Federation Over the Period Between 1993 and 2003”, which was drafted in 2004 and scheduled for discussion (after several delays) at the State Duma during its spring session in 2005, received a wide discussion. It is our opinion that the report itself provides no innovations in regard to Russian privatization, which in neither event would have been analyzed by Russian and foreign experts in the 90’ – 2000’ (the literature contains thousands of articles and monographs on the subject). Tens, if not thousands, of evidences of nontransparent or questionable privatization transactions were reported by all-Russian and regional mass media (in this case, it is not important whether these materials are invited or not). It is generally recognized that almost every privatization transaction performed within the 90’ – 2000’ might be impeached on the ground of at least formal (procedural) evidences. Furthermore, since its inception in 1995, the RF Accounting Chamber itself performed several audits on privatization both at separate enterprises and objects and particular industries and regions. As far as we know, its audit reports received no serious response (though quite unreasonably in several cases) until the mid-2000’.

The authors of the report reasonably identified some adverse affects in the analysis of the three visible stages of Russian privatization: large-scale privatization in the period between 1993 and 1994, monetary privatization in the period between 1994 and 1999, and current privatization, which started from the adoption of the “Concept” 1999 :

- losses sustained from investment tenders ;
- biased evaluation (including undervaluation) of privatized objects and blocks of shares;
- assets are not classified into tangible and financial ones ;
- intangible assets are not included into evaluation of enterprises ;
- abuse of power by executive authorities in the process of privatization ;
- illicit sales of objects which are not subject to privatization ;
- dilution of public blocks of shares ;
- lack of a procedure of termination and damage recovery in case of violation of investment terms and conditions by a purchaser , etc.

There are three issues to be underlined as disputable: *first*, “negative” impact of privatization on structural reconstruction and efficiency, investment attraction, competitive advantages and, in a general sense, real earnings growth (the latter is most questionable in the context of privatization alone); *second* , suspension of the State Duma from decision-making on privatization (a well-known problem related to the privatization forecast plan) at the monetary stage; *third* , share-for-loans auctions.

It is impossible to make unambiguous conclusions in the first case (which is also evidenced by a series of empirical studies of interaction between privatization and efficiency that were conducted in the 2000's). It is our opinion that in the second case the government reasonably avoided cooperation with the State Duma for the benefit of further privatization, however, this problem was eliminated by a new law on privatization adopted in 2002. The case of share-for-loans auctions is more complicated. In spite of the fact that formal judicial structure of share-for-loans auctions managed to withstand numerous court proceedings, their odium and non-transparency are generally recognized. Therefore, public (not legal ones) claims can be laid to the actual creators of the regulatory and legal framework rather than its practical users.

The authors of the report emphasized that it is the legal problems that are responsible for most of the deficiencies related to Russian privatization. It is our opinion that both political context and system-based corruption and employment of the notorious "administrative mechanism" in the process of privatization were poorly covered in the report⁴⁹. Nevertheless, the key conclusions of the RF Accounting Chamber are undisputable: "Privatization assisted in fulfilling the task aimed at changing the patterns of ownership: almost 60% of enterprises became private, new market institutions were established, namely joint stock companies, stock market, institutional investors system, commercial banks, insurance companies, whereas privatization itself was accompanied by a minimum of social conflicts", "many enterprises are currently efficient", "*the results of privatization of 1993 – 2003 must neither be abolished nor revised on the ground of imperfection and incompleteness of the legislative base*", it is useful to analyze the deficiencies of the previous stages of privatization in order to avoid mistakes in privatizing mineral resources, land, electric-power industry and railroads in the future⁵⁰.

Obviously, the RF Accounting Chamber is supposed to focus on the issues related to the losses sustained by the government during privatization, as it is mainly responsible for monitoring utilization of public funds and public property (however, it is supposed to do the same in analyzing utilization of budgetary funds, export of weapons, operation of public banks, etc., -- privatization is not the case here). In spite of that the RF Accounting Chamber's aggregate estimates of potential losses from privatization (nearly \$45 billion over ten years) are quite conditional and adequately unjustifiable, there were identified the fields where regulation still remains the weakest. These are as follows:

- law-based settlement of issues related to restitution of government's rights as a public property owner (the relevant recommendation is not a novelty – a Federal Law "On the Procedure of Nationalization and Municipalization" should be adopted)⁵¹ (foot-note);
- law-based identification of the criteria of strategic enterprises involved in providing national security, as well as lack of mechanisms prohibiting or restricting foreign capital participation in privatization of strategic objects ;
- in spite of adoption (with nearly 10-year delay) of Federal Law "On Public and Municipal Unitary Enterprises", the existing institution of unitary enterprises remains inefficient ;
- inefficient management of the blocks of shares held by the government ;
- lack of both legal base for privatization of foreign property of the Russian Federation and control mechanisms over its current utilization by public agencies and other organizations.

⁴⁹ This is most readily illustrated by the following data of the RF Accounting Chamber : 89% (of those disclosed by the RF Accounting Chamber) of violations during privatization were caused by government authorities, whereas private businesses were responsible for only 11%.

⁵⁰ An interview with S. Stepashin, Chairman of the RF Accounting Chamber // Rosyiskaya Gazeta . December 20, 2004.

In fact, these “problem issues” also represent *comprehensive recommendations* of the RF Accounting Chamber for the future, which are undisputable with few exceptions. For example, the thesis on further “thorough examination of privatization practice ” and “restoration of violated ownership rights of the government at law on the basis of obtained and proved evidence” can not be rejected. It is quite another matter that such facts as illicit privatization, undervaluation of property during privatization, inobservance of investment terms and conditions, etc. can be “detected”, as the need arises, in any privatization transaction for any Russian enterprise. Most likely Article 301 of the RF Civil Code (legitimate owner’s right to reclaim its property from illicit possession by other entity) is referred to here to resolve the problem of limitation period related to privatization transactions.

Eventually, the need for open political moratorium in revision of the results of privatization has been manifesting itself. Such moratorium must be applied to all privatization transactions, except for those involving flat violation of the laws applicable at that moment (also as an element of corruption) as well as material elements of criminal offence. The list of the latter should be well-defined in a special regulation. Such a decision could seriously restrict any attempts to of pseudo-legitimate redistribution of assets on a large-scale basis subject to objective law enforcement practice.

In addition, effectiveness of *practical recommendation* on redressing the situation which is most advocated by the RF Accounting Chamber, is questionable. It suggests to utilize an “independent, i.e. external public financial control” body. It is not so much as “strengthened independent control” as the range of possible interpretations of such strengthening that arises concern. The most revealing example of it as follows. At a meeting with British top-managers of TNK-BP in 2004, the Chairman of the RF Accounting Chamber S. Stepashin unambiguously classified large businesses into those investing in the Russian economy and observing tax liabilities and others. As applied to TNK-BP, this could mean discontent with both the merging transaction of 2003 and profit centers available outside Russia (the merging resulted in establishing TNK-BP Ltd. which was incorporated in British Virgin Isles, well-known offshore zone). At the same meeting, the Chairman of the RF Accounting Chamber provided assessment of the results of privatization over a decade⁵². A statement of “corporate structure optimization” – merger of THK, SIDANKO and ONAKO – was first response of TNK-BP. However, restructuring plan was announced in 2005 (two-stage consolidation of 17 principal Russian assets of JSC TNK-BP HOLDING located in Tyumen).

Eventually, the assessment of the results of privatization in Russia produces no negative response and is objective within certain context and typical not only of Russia but also a variety of other countries with economies under transition⁵³. As noted above, the report provides no discoveries whatsoever with regard to Russian privatization .

The question at issue is complex: *who is the formal author of the report?* (private or public entity), *who is the informal customer?* (unless the report was a politically correct initiative by the RF Accounting Chamber itself), *which socio-political environment is it replicated in?* and, consequently, *who is going to need such conclusions for practical application?* According to practice of the mid-2000’, there is demand for negative assessment of the results of privatization. It is our opinion, however, that the companies mentioned in the report of the RF Accounting Chamber will not necessarily be selected as most likely candidates for deprivatization.

⁵² Refer to : *Russkiy Fokus*. 2004. No. 3. , P. 9.

⁵³ An illustrative example is notorious scandals related to funneling assets from Czech privatized enterprises (the scheme is called the “tunneling effect”), though Czechia used to be considered a benchmark in terms of large-scale privatization.

From all appearances, the primary political task of the report (perhaps, the authors of the report had no such desire whatsoever) is to a priori increase uncertainty for all subjects, whereas certain sanctions will be imposed on selected ones by authorities other than auditors of the RF Accounting Chamber . It is obvious that under the circumstances large businesses will be treated strictly on the basis of the three criteria as follows: whether a company is a government supporter or cosmopolitan, whether it is politically loyal and whether it can be selected to become a "new tycoon". At the same time, the transaction with the shares of YUGANSKNEFTEGAZ revealed quite effective and legal options of seizing property at any level by using non-judicial methods and bypassing regulations on companies, bankruptcy and nationalization.

* * *

Hence one can assume that the *issue of protection of ownership rights has evolved to a qualitatively new level*, which is a long-lasting problem for modern Russia. Referring to the analysis provided in *Annex* to the present section, the issue of illicit sale of shares during the YUGANSKNEFTEGAZ transaction is not so much a case as the antithetic situation when the shares were most probably sold on a formally legitimate basis. And, paradoxically as it is, this is the key ground for basic risks in terms of protection of business-related ownership rights in Russia .

First, the YUKOS case, in particular the sale of its primary oil production asset YUGANSKNEFTEGAZ, has demonstrated that the applicable Russian regulations provide a formally legitimate basis for taking over the control of any company. Second, taking a legitimate control over YUGANSKNEFTEGAZ by a public company is a revealing example of assets reassignment by bypassing bankruptcy procedure and avoiding corporate wars. All the aforesaid means that the present Russian legislation and the law enforcement system provide for no protection of private ownership by the government to the full extent. Finally, the sale of YUGANSKNEFTEGAZ and, as a consequence, collapse of a major Russian company YUKOS may become a threshold of a new stage of reassignment of assets in Russia.

Third, the aforementioned latest innovations of the Russian law proposed in 2005 are quite illustrative in this context. Positive effect from restrictions imposed on tax audits of the RF Federal Tax Service (the only innovation that is favorable for the business) will be compensated multiply by new measures tightening business operations and enabling the government to subjectively interfere in private sector's affairs. The liberal government officials seem to be well aware of that as well. Tax regulations (above all tax amnesty) would not be eased and privatization transactions would be subject to revision, acknowledged G. Gref, Head of the RF Ministry of Economic Development and Trade, at a meeting of the Soviet of the Federation in February 2005. "Rights of the business community and the government are distributed in prejudice of the former, whereas liberal rhetoric of several government officials is accompanied by a rigorous administration which is incompatible with the principle of free-market economy. In doing so, intervention by the government has an adverse effect rather than positive one. The government intends to keep asset holders in fear instead of fostering enlargement of output"⁵⁴, said V. Reznik, Chairman of the Committee for Credit Organizations and Financial Markets of the RF State Duma .

The period between the beginning of the 90' and the 2000' was distinguished by a relatively developed economy legislation, while the law enforcement system was in critical state. The situation seemed to be changed in the mid-2000': though the diseases of the

⁵⁴ Reznik V. A Threat of Administrative Assaults Impending Over All Business Entities // Kommersant . February 2, 2005 .

Russian law enforcement system remained uncured⁵⁵, there was a certain advance in the economy legislation (and its interpretation) which, on the one hand, enhanced substantially uncertainty of the effects of economic decisions related to the business community in terms of retaliatory measures by the government, and, on the other hand, made more rigorous relationships between the government and private businesses. *The problems related to the law enforcement system in Russia, as being reinforced by the move towards reestablishment of rigorous legislative regulations, are notably enlarging the range of risks in terms of ownership rights.* Consequently, the only way to avoid a dead-end and provide a distinct picture of the government's intentions is to revise the legislation of the Russian Federation in order to remove ambiguous interpretations in terms of rights of private ownership, refrain from reestablishing the punitive regulations removed as early as the post-communist period, and refrain from replacing civilized law enforcement actions with forcing tactics.

Annex

Selling JSC YUGANSKNEFTEGAZ: legislative aspects

As is well known, in May 2004, the RF Federal Tax Service won a legal action against NK YUKOS for recovery of RUR99,4 billion (\$3,4 billion), which according to the RF Federal Tax Service were illegally received by using tax evasion schemes in 2000. In July, the RF Federal Tax Service made tax claims against YUKOS for the period of 2001 to the amount of RUR98 billion (of which tax arrears accounted for RUR50,8 billion, penalties – RUR20,3 billion, fines – RUR27,2 billion). By the end of December 2004, tax claims against YUKOS and its subsidiaries exceeded \$23 billion, of which \$8,6 billion was due by YUGANSKNEFTEGAZ. Later on, the legal office service levied a distraintment upon 76.79% of YUGANSKNEFTEGAZ's shares held by YUKOS with a view to sell them as discharge of tax arrears. The transaction was prepared according to the timing follows⁵⁶ :

On October 12, 2004, the RF Ministry of Justice made a decision on sale of NK YUKOS in order to discharge debts of its primary subsidiary YUGANSKNEFTEGAZ. The initial price was \$10,4 billion which figured as minimum on the basis of the assessment performed by Dresdner Kleinwort Wasserstein bank.

On October 17, the RF Ministry of Justice forwarded to the Russian Federal Property Fund an order of sale of YUGANSKNEFTEGAZ's shares and a draft agreement specifying terms and conditions of the sale.

On November 19, the Russian Federal Property Fund announced an auction of sale of the arrested YUGANSKNEFTEGAZ's shares accounting for 76.79% of the authorized capital, as based on the decision of legal officers. The auction was set on December 19.

On November 30, S. Bogdanchikov, Director of GAZPROMNEFT, announced that his company would take part at the auction.

On December 5, the International Energy Agency (IEA) announced that purchase of YUGANSKNEFTEGAZ by GAZPROM would cause jeopardize the energy security of Europe.

⁵⁵ Typical assessments of the judicial system (except for the opinions of official government representatives of the judicial power in Russia) are basically varying from "inefficient and corrupted" (in regard to the entire system) to "judicial service market" and "close to catastrophe". The same was stated by senior public officials representing various government agencies in Russia. In particular, the system-related corruption was mentioned by V. Zorkin, Chairman of the RF Constitutional Court (2004), while catastrophic and threatening situation in the judicial system was announced D. Kozak, a representative of RF President in the South Federal District (2005), who used to supervise the judicial system in the pervious periods.

⁵⁶ These materials were obtained from Kommersant Publishing House (www.kommersant.ru), December 2004 – February 2005) and Russian information agencies in the period between 2004 and 2005.

On December 7, Reuters announced that a group of six western banks headed by Deutsche Bank had prepared a syndicated loan of up to \$10 billion to JSC GAZPROM to take part in the auction.

On December 7, the RF President issued an order excluding JSC NK ROSNEFT from the list of strategic enterprises and joint stock companies and including JSC ROSNEFTEGAZ into the list, as well as decreed to adopt the proposal of the RF Government on making a contribution of 100% shares of JSC NK ROSNEFT held by the government to the authorized capital of JSC ROSNEFTEGAZ.

On December 8, the Board of Directors GAZPROM approved participation of GAZPROMNEFT at the auction.

On December 10, the Federal Antimonopoly Service reported receipt of three applications for taking control over YUGANSKNEFTEGAZ: from GAZPROMNEFT, LLC Pervaya Venchurnaya Kompaniya and CJSC INTERCOM.

On December 13, MENATEP Group announced that it would initiate legal proceedings not only against purchasers of YUGANSKNEFTEGAZ's shares but also those who would extend a loan to the winner at the auction.

On December 15, YUKOS filed an application to the Houston Court for Bankruptcies (USA) with the request to suspend all transactions with assets of the company and cancel the auction.

On December 16, the group of banks rejected to sign a loan agreement with GAZPROMNEFT until the decision of the Houston Court for Bankruptcies was made.

On December 16, LLC BAIKALFINACEGROUP submitted its application for participation at the auction.

On December 17, GAZPROMNEFT submitted its application for participation at the auction. At the same day the Houston Court for Bankruptcies made a legal decision to prohibit all transactions with YUKOS's assets, including the YUGANSKNEFTEGAZ auction.

On December 18, the group of banks made a final decision to refuse to extend the syndicated loan to GAZPROM. 100% participation of LLC GAZPROMNEFT was sold to unknown entities not affiliated with GAZPROM OJSC.

On December 19, GAZPROMNEFT and BAIKALFINACEGROUP were qualified to participate in the auction on sale of 76.79% of the authorized capital of YUGANSKNEFTEGAZ or 100% voting shares held by YUKOS. LLC Pervaya Venchurnaya Kompaniya failed to apply for participation at the auction, CJSC INTERCOM failed to provide the required \$1,7 billion deposit. The initial price of the foregoing block of shares was RUR246,75 billion. The auction's step was RUR2,8 billion. LLC BAIKALFINACEGROUP made its initial bid of RUR260,7 billion for YUGANSKNEFTEGAZ's shares to become the winner. The remainder (upon granting a deposit) of \$7,65 billion due was to be transferred before January 18, 2005. GAZPROMNEFT made no bid.

On the night of December 22 to 23, 2004, NK ROSNEFT announced that it had repurchased a 100% equity of BAIKALFINACEGROUP thus taking possession of 76.6% of YUGANSKNEFTEGAZ (and getting entitled to purchase YUGANSKNEFTEGAZ together with the winner). "YUGANSKNEFTEGAZ's shares were purchased as part of ROSNEFT development plans providing for its transition into a national energy corporation through the development of production facilities". Neither terms and conditions nor the value of the transaction were disclosed.

On December 23, 2004, RF President V. Putin announced at a press conference: "In fact, ROSNEFT, a 100% public company, has purchased a well-known asset, YUGANSKNEFTEGAZ. In my opinion, it has been done by using purely market mechanisms. You all are well aware of how privatization was performed in this country in the beginning of

the 90', and how many market participants took possession of public assets which are worth a billions of dollars by utilizing various tricks, including those violating the law applicable even at that time. Today, the government is securing its interests through absolutely legal market mechanisms Referring to this very transaction, I believe that it has been performed in severe conformity to the Russian law and all standards of international law and international commitments assumed by the Russian Federation as part of the documents which we sign with our counterparts at the international level”.

On December 23, 2004, the RTS index grew by more than 2% and got close to 600 points by the middle of the day. Shares of ROSNEFT's subsidiaries grew by nearly 10%, GAZPROM's shares by 3% (with the value of ROSNEFT ranging within \$6 – 8,5 billion, while the value of acquired YUGANSKNEFTEGAZ is estimated not less than \$9,35 billion with nearly \$8 billion of debt, the settlements required for the transaction on YUGANSKNEFTEGAZ's shares are raising ROSNEFT's debt).

At the end of December 2004, ROSNEFT obtained a \$6 billion loan from a syndicate of Chinese banks. According to the official data, the loan was obtained to “invest in production and economic activity and implementation of capital-intensive strategic projects ” which were not disclosed.

On December 30, 2004, D. Medvediev, Head of the RF President Office and Chairman of the Board of Directors of GAZPROM OJSC announced that GAZPROM and ROSNEFT would merge without YUGANSKNEFTEGAZ's assets .

On January 6, 2005, Italian Ministry of Industry A. Marzani announced to Reuters that it kept interested in YUKOS's assets.

On January 7, 2005, Chinese mass media released information that Chinese public oil company CNPC assessed it possible to purchase 20% shares of YUGANSKNEFTEGAZ .

On January 10, 2005, Indian oil company ONGC announced its intention to purchase a block of shares of YUGANSKNEFTEGAZ by means of the Indian government.

On February 8, 2005, MENATEP Group laid a legal action for \$28 billion against the Russian Federation to the International Committee for Settlement of Trade Disputes in relation to expropriation of the group, YUGANSKNEFTEGAZ. Financial claims were laid against Energy Charter according to an Agreement. Membership of the Charter includes mostly European countries (Russia signed it in 1994 but not ratified).

On February 9, 2005, Deputy Minister of Finance T. Golikova announced that proceeds from the sale of YUGANSKNEFTEGAZ (RUR213 billion) were allocated to the consolidated budget (RUR138 billion to the federal budget, the remainder to the budgets of constituent entities of the Russian Federation).

On February 9, 2005, Arbitration Court of Appeal No. 9 (Moscow) confirmed that the decision of the Major Taxpayers Interregional Inspection No. 1 (under the RF Federal Tax Service) obliging YUKOS to pay additional RUR115,4 billion of tax arrears for the period of 2001 was legitimate.

Negative legal evaluation of the transaction relied upon determination of a fact of illicit sale of shares, because YUGANSKNEFTEGAZ is the principal oil production asset of YUKOS *holding* company. The similar line of arguments was presented in the previous periods: the arrest of YUGANSKNEFTEGAZ's shares was baseless, since NK YUKOS should be considered as a holding company, and it is specified in the law that securities of subsidiaries held by a holding company shall not be first to forfeit. Law enforcement officers shall first to forfeit the property that is not utilized in production ⁵⁷.

⁵⁷ Egorova T., Tutushkin A. Yukos Subsidiaries Remain Under Arrest // Vedomosti . August 10, 2004 .

It is our opinion that *the key problem of the transaction with YUGANSKNEFTEGAZ's shares is not so much an illicit sale as a directly opposite case: the sale was performed on absolutely formal legitimate grounds. And, paradoxical as it may appear, it is the very case that creates principal risks in terms of protection of ownership rights of the business in Russia. We will try to analyze in details the sale of YUGANSKNEFTEGAZ's shares in terms of its legitimacy*⁵⁸.

1. Debtor's Assets Arrest Procedure

Federal Law "On Law Enforcement Proceedings" of July 21, 1997 FL -119 specifies a procedure of forfeiture of debtor's (organization's) assets . In particular, Article 59 of the Law specifies that debtor's assets must be seized and sold in order of priorities as follows: first priority: assets which are not directly utilized in production (securities, deposit funds and funds on other accounts of a debtor, foreign exchange assets, passenger cars, office design items and other assets); second priority: final products (goods) as well as other tangible assets which are neither directly utilized in production nor intended to be directly utilized in production; third priority: immovable property as well as raw materials, plant and equipment, other fixed assets designed for direct utilization in production.

Hence, pursuant to Federal Law "On Law Enforcement Proceedings", the securities (YUGANSKNEFTEGAZ's shares in this case) held by NK YUKOS are neither considered the assets which are directly utilized in production nor subject to first-priority seizure and sale. Nevertheless, pursuant to Clause 3 of a Regulation issued by a Plenary Meeting of the RF Superior Arbitral Court on March 3, 1999 No. 4 "On Various Issues Related to Imposing a Recovery on Shares", " the following should be taken into account in making a decision on order of priorities of imposing recovery actions on assets of a debtor acting as a holding company or other type of company established during privatization of public assets pursuant to a Decree of the President of the Russian Federation or a regulation of the Government of the Russian Federation, whose authorized capital is built up by contributing a controlling block of shares of subsidiaries held by the government.

The foregoing companies are established by the government as single economic bodies for the purpose of coordination and cooperation of operational and commercial activity of integrated subsidiaries, and operation of such company may come to be impaired or discontinued if one or several such subsidiaries would be withdrawn from the company as a result of recovery imposed upon the relevant blocks of shares. Article 59 of Federal Law "On Law Enforcement Proceedings" specifies the order of priorities of levying an execution upon debtor's (organization) assets so that it may not be unreasonably forced to discontinue its core activity (production or any other activity the organization is established for) upon liquidation of debt due to seizure and sales of its assets (including shares). In this connection, the blocks of shares of subsidiaries contributed to the authorized capital of the foregoing companies can not be subject to first-priority recovery. Pursuant to Sub-Paragraph 3, Article 59 of Federal Law "On Law Enforcement Proceedings», such blocks of shares should be considered as assets which are critical for maintaining production activity of the company and subject to third-priority recovery".

⁵⁸ It should be noted, however, that the key issue related to the sale of YUGANSKNEFTEGAZ's shares is *justification of tax claims* laid against YUGANSKNEFTEGAZ and its parent company YUKOS. For some obvious reasons we cannot make a comprehensive analysis of tax claims against these and other companies integrated into YUKOS. It is also worth noticing that, in judging the YUKOS case, *the courts relied upon the materials provided by the Federal Tax Service* and refused the defense to file reports of independent expertise of the tax claims made by request of the defendant with other documents of the case. Apparently, the right to unconditional filing of at least the independent expertise (appraisal) reports with the tax arrears documents must be undisputable.

Hence, a Plenary Meeting of the RF Superior Arbitral Court specified the following conditions under which blocks of shares of subsidiaries are not subject to first-priority recovery:

- authorized capital of a corresponding holding company or other type of company was built up during privatization of public assets by contributing a controlling block of shares of subsidiaries held by the government ;
- a parent company was established by the government as a single economic body for the purpose of coordination and cooperation of operational and commercial activity of its integrated subsidiaries, and operation of such company may come to be impaired or discontinued if one or several such subsidiaries would be withdrawn from the company as a result of recovery imposed upon the relevant blocks of shares.

To which extent the foregoing provisos of Federal Law “On Law Enforcement Proceedings” can be applied to YUKOS and YUGANSKNEFTEGAZ ? In 1993, pursuant to a Decree of the RF President of November 17, 1992⁵⁹, the authorized capital of YUKOS oil company 38% was supplemented by shares of YUGANSKNEFTEGAZ joint stock company established during reorganization of PO YUGANSKNEFTEGAZ. Later, the share of YUKOS in the authorized capital of YUGANSKNEFTEGAZ was increased up to 100%. On the one hand , YUGANSKNEFTEGAZ was actually integrated into YUKOS during privatization. YUGANSKNEFTEGAZ is owned by YUKOS, hence operation of the entire holding company may come to be impaired or discontinued due its withdrawal from YUKOS⁶⁰. On the other hand, as was noted above, the shares of subsidiaries held by the parent company are not subject to first-priority recovery provided that the authorized capital of the parent company is built up by including *controlling* blocks of shares of its subsidiaries. The foregoing statement, which is included into the ruling issued at a Plenary Meeting of the RF Superior Arbitral Court, can be interpreted both as restrictive and expansive. In case of restrictive interpretation, one may suppose that the authorized capital of a corresponding company must be built up *exclusively* by including controlling blocks of shares of its subsidiaries. However, in case of expanding interpretation, one may conclude that the authorized capital of a corresponding holding company may be built up both of majority and minority blocks of shares of its subsidiaries. In addition, as was noted above, the authorized capital of YUKOS was initially supplemented by only 38% shares of YUGANSKNEFTEGAZ (i.e., a share of YUKOS in the authorized capital of YUGANSKNEFTEGAZ was initially less than the value of controlling block of shares of YUGANSKNEFTEGAZ).

From the aforesaid, it might be assumed that the foregoing provision as part of a the regulation of the Plenary Meeting of the RF Superior Arbitral Court on exclusion of recovery on holding companies from the order of priorities is applicable to the sale of YUGANSKNEFTEGAZ’s block of shares held by YUKOS. In addition, it should be noted that the provision of the Plenary Meeting of the RF Superior Arbitral Court actually provides for exclusion of Clause 59, Article 1 of Federal Law “On Law Enforcement Proceedings”. However, according to the applicable law, the Plenary Meeting of the RF Superior Arbitral Court is not vested with legislative functions. In particular, pursuant to Clause 1, Article 13 of Federal Law “On Arbitration Courts of the Russian Federation”⁶¹, the competence of the

⁵⁹ RF President’s Decree No. 1403 “On Specifics of Privatization and Reorganization of Public Enterprises, Production and Research Associations of Petroleum and Petroleum Refinery Industries and Oil-Product Supply”.

⁶⁰ In 2003, YUGANSKNEFTEGAZ’s output accounted for 49,7 million tons of crude oil, or 62% of total oil production by YUKOS. Production totaled 25,6 million tons of crude oil within the first half of 2004 . The company has 26 oil and gas production licenses at the fields located in Nefteyugansk, Surgut and Khanty-Mansyisk regions with the reserves totaling (according to the SPE methodology) 16,2 billion tons of crude oil, or 73% of reserves proved by YUKOS (refer to: “Rock Bottom Price” by Reznik I., Bushuyeva Yu.,. YUGANSKNEFTEGAZ can be sold at \$3 billion // Vedomosti . October 15, 2004).

⁶¹ Federal Law of April 28, 1995 . No. 1- FL.

Plenary Meeting of the RF Superior Arbitral Court includes reviewing materials of study and generalization of enforcement of laws and other regulations of courts of arbitration and providing consultancy on judicial practice. The Plenary Meeting of the RF Superior Arbitral Court issued regulations on its proceedings being mandatory for all courts of arbitration in the Russian Federation pursuant to Clause 2, Article 13 of Federal Law "On Arbitration Courts of the Russian Federation". In addition, regulations specified in the federal law are superior to the provisions issued at the Plenary Meeting of the RF Superior Arbitral Court.

From the aforesaid, it might be assumed that according to the language of law applied to the sale of YUGANSKNEFTEGAZ's shares held by YUKOS, the law enforcement officers service lawfully qualified debtor's shares as assets subject to first-priority seizure and sale under RF Law "On Law Enforcement Proceedings".

2. First Priority Sale of YUGANSKNEFTEGAZ's Shares

Ambiguous assessments were also caused by the fact that the law enforcement officers made a decision on first-priority sale of YUGANSKNEFTEGAZ, principal oil production subsidiary of YUKOS. In particular, according to some opinions, the very selection of YUGANSKNEFTEGAZ's shares suggests that the RF government intends to ultimately destroy YUKOS⁶².

Pursuant to Article 46 of Federal Law "On Law Enforcement Proceedings", in case the debtor has no funds sufficient to settle recoverer's claims, debtor's assets are subject to recovery, except for the assets which are not subject to recovery under the federal law. In addition, the debtor is entitled to specify those types of assets or items which are subject to first-priority recovery.

JSC YUKOS was entitled to do the same, as evidenced from available public materials. In particular, the company made a list of enterprises which could be sold (YUGANSKNEFTEGAZ's shares were not included into the list). Nevertheless, since Article 46 of Federal Law "On Law Enforcement Proceedings" specifies that it the law enforcement officer who is to determine the order of priority for recovering debtor's assets, the law enforcement officers acted within their competence in the YUKOS case in qualifying YUGANSKNEFTEGAZ's shares held by YUKOS as first-priority assets to sell. From the above said it appears that the law enforcement officers had the right to impose first-priority recovery upon YUGANSKNEFTEGAZ's shares held by YUKOS on a pro forma basis.

3. Front Bidder de facto at the Auction

An unknown company, LLC BAIKALFINANCEGROUP, won at the auction on sale of YUGANSKNEFTEGAZ's shares held by YUKOS. Neither official data bases nor registers nor the Federal Tax Service website made any reference to this company. According to the documents submitted to the Russian Federal Property Fund, the LLC BAIKALFINANCEGROUP appeared to be incorporated in Tver (Russia). In this connection, many experts asked a question as to how an unknown company was admitted to the auction and hence whether the results of the auction were legitimate.

Pursuant to RF Law "On Law Enforcement Proceedings", the bidding procedure during law enforcement shall be specified in the RF Civil Code . Pursuant to Article 447 of the RF Civil Code , the entity offered the highest bid shall be deemed the winner at an auction. Any entity may participate at an open auction. In addition, the regulation issued by Russian Federal Property Fund on November 29, 2001, No. 418 "On Approval of the Procedure of

⁶² Reznik I. They Started from Key Issues // Vedomosti . July 21, 2004 .

Organization and Conducting of Bidding on Arrested and Seized Assets As Well As Confiscated, Unprocessed and Other Assets Appropriated by the Russian Federation” provides no special requirements to participants at auctions on a block of shares.

Pursuant to RF Law “On Mineral Resources”, both changes in the authorized capital structure and replacement of a majority shareholder shall not be deemed a reasonable justification for license redistribution, early termination of the right of utilization of mineral resources on the basis of a license issued to a corresponding company. Hence the law provides no special requirements to entities participating at an auction on sale of shares. From the above said it follows that the unknown LLC BAIKALFINANCEGROUP participated at the auction on a legitimate basis and in conformity with the Russian law and met all formal conditions and requirements.

4. Legal Action in the United States

It is known that YUKOS filed a bankruptcy claim with the United States Court of Bankruptcy in connection to the recovery of tax arrears. YUKOS moved for prohibition of the auction on sale of YUGANSKNEFTEGAZ as a security for the claim. On December 16, 2004, the United States Court of Bankruptcy, South District, Houston, Texas, issued a provisional prohibitory injunction on YUKOS’s claim on suspension of the auction on sale of YUGANSKNEFTEGAZ’s shares . The court ordered to perform no further transactions for the time being related to YUGANSKNEFTEGAZ’s shares, including but not limited to the auction on sale of the shares in question⁶³.

Later, on December 30, 2004, YUKOS published an notice through mass media: “pursuant to § 541, Section 11 of the Code of the Laws of the United States, the shares shall be deemed assets included into the bankruptcy assets of NK YUKOS pursuant to Chapter 11. The United States Court of Bankruptcy has an exclusive jurisdiction pursuant § 1334 (e), Section 28 of the Code of the Laws of the United States in relation to the bankruptcy assets of NK YUKOS “wherever they are located ” (pursuant to Chapter 11). YUKOS notified the parties concerned that “should the shares have been sold, NK YUKOS would sustain losses to the amount beyond \$20 billion ”. In addition, the company specified that it “would apply all available legal mechanisms in order to claim compensation for the losses against any legal entities or physical bodies which would: 1) take part at the auction on sale or purchase of the shares, encourage or finance such sale or purchase; 2) interfere with the relationship between NK YUKOS and its staff members; 3) dispute NK YUKOS’s assets representing the bankruptcy assets pursuant to Chapter 11; 4) intend to recover on claims against NK YUKOS which raised prior to petition in bankruptcy⁶⁴.

Of course, the question now arises on whether the jurisdiction of the aforementioned American court may be applied to a bankruptcy case of the Russian company. One of the documents filed with the American court in regard to the YUKOS case provides the following justification of the American court’s jurisdiction for this particular case. YUKOS is an open joint stock company established in compliance with the legislation of the Russian Federation . According to B.Mizamor, Financial Director of the company, Debtor’s subsidiary deposited nearly \$2 million to funds on the accounts with the Texas South-Western Bank located at the South District of Texas. The Debtor also deposited nearly \$6 million on the trust account of lawyers from Fubright & Jaworsky L.L.P as an advance fee for the provision of legal services and administrative costs which would be incurred in regard to the case in question. The foregoing funds are Debtor’s fixed assets in the United States. In ad-

⁶³ Notice concerning the automatic stay. Case No. 04-47742-H3-11, Chapter 11. 20.12.2004 (www.yukosbankruptcy.com).

⁶⁴ In particular, the “Notification of NK YUKOS” was published by Izvestiya newspaper on December 30, 2004 .

dition, B. Mizamor specified that American institutional investors held nearly 15% of Debtor's shares. Eventually, the American court issued the tentative prohibitory injunction at YUKOS's request to suspend the auction on sale of YUGANSKNEFTEGAZ's shares⁶⁵.

Pursuant to Article 27 of the RF Arbitration Practice Code, the jurisdiction of courts of arbitration of the Russian Federation also includes cases related to Russian business organizations, except as otherwise provided for by an international agreement with the Russian Federation. According to the regulations of the RF Arbitration Practice Code, the YUKOS bankruptcy case is subject to the exclusive jurisdiction of Russian courts of arbitration. Furthermore, for the time being there is no international agreement with the Russian Federation that would provide for otherwise.

In fact, there is a formal conflict of jurisdictions. On the one hand, pursuant to the Russian law, the YUKOS bankruptcy case is subject to the jurisdiction of Russian courts of arbitration. On the other hand, pursuant to the American law, the company may move the corresponding American court, since it certain assets of the company are allocated on the territory of the United States of America. Nevertheless, the ruling in question may be executed on the territory of the Russian Federation, provided that the corresponding ruling is issued by a Russian court of arbitration pursuant to the procedure specified in Chapter 31 of the RF Arbitration Practice Code. Pursuant to Article 244 the RF Arbitration Practice Code, arbitration court shall deny in full or in part the ruling on a case issued by a court of a foreign country, provided that such case is subject to the exclusive jurisdiction of the Russian court pursuant to an international agreement of the Russian Federation or the federal law. However, as was noted above, pursuant to the Russian law, bankruptcy cases of Russian legal entities are subject to the exclusive jurisdiction of Russian courts of arbitration, and there is no agreement concluded between Russia and the United States that would provide for otherwise. In addition, there is no public information on whether YUKOS applied to a Russian court of arbitration for adoption and execution of the aforementioned ruling issued by the American court. Consequently, the aforesaid ruling imposing a temporal injunction on sale of YUGANSKNEFTEGAZ' shares, is currently effective only on the territory of the United States of America.

4.3. The third law on insolvency: the first results and prospects of improvement

By present, in Russia there have formed all key elements of the institution of insolvency. However, the institution of bankruptcy in Russia can not be seen yet as a stable and efficient mechanism aimed at the rehabilitation of management and finances of companies. The existing institution of insolvency, in spite of a growth in the number of bankruptcy cases, is only of a "point" scale as concerns its application, and fails to settle the problem of withdrawal of inefficient enterprises from the market and repayment of debts to creditors at the macro-level. On the whole, the institution of bankruptcy fails to ensure the predictable distribution of risks faced by creditors. Moreover, in the 1990s and early 2000s, the institution of bankruptcy in Russia was used either as a method of redistribution (take-over, retention, and privatization) of property, or a highly selective way to put political and economic pressure on enterprises on the part of the state. At the same time, there is observed a significant underdevelopment of the infrastructure related to the implementation

⁶⁵ Pursuant to 28 & U.S.C. &1334 (a), district courts have primary and exclusive jurisdiction in regard the case pursuant to Title 11. A foreign company may be deemed a debtor pursuant to 11 U.S.C. & 109 (a), provided that a part of its assets is located on the territory of the United States of America. Refer to "Memorandum opinion" of the United States Courts Southern District of Texas. 16.12.2004.

of the bankruptcy legislation. However, in spite of all costs of implementation of the institution of insolvency, the “catastrophic” tone of statements implying that exactly bankruptcy is the root of all evil should not be shared. For instance, in absolute terms there are much more offences and abuses in the framework of corporate law. There is little doubt that in the sphere of small and medium sized businesses a positive influence of the institution of bankruptcy has already been felt by now. In Russia, the bulk of criticism is related to the practices of bankruptcy of large enterprises.

4.3.1. Legislation on bankruptcy in 1990s through 2000s: specifics of formation

In foreign countries, regulation of insolvency is a most dynamically developing sphere of law, since the economies of states require constant modernization of the respective provisions. In theory, the legal norms governing the regulation of bankruptcy of enterprises may be aimed at the settlement of the following problems:

- at the macro-level it is reduction of the level of economic risks in the economy by the way of liquidation of inefficient enterprises and redistribution of industrial assets in favor of efficiently operating economic agents, as well as development of a competitive environment;
- at the micro-level it is protection of the rights of creditors, instilment of financial discipline, enhancement of reliability of the credit circulation, carrying out of reorganization of enterprises and their financial restructuring, improvement of the quality of corporate governance, redistribution of property in favor of “efficient” owners, replacement of inefficient managers, introduction of a rational management system at enterprises⁶⁶.

The experience of developed foreign countries does not unambiguously indicate that the regulation of insolvency should be formed exclusively proceeding from the priority of creditors. There are examples, where the respective regulations are primarily aimed at protection of the interests of debtors or the state. All specifics of legislation are determined by the concrete economic policies pursued by the states and are closely associated with the sizes of public sectors in the respective economies and the attitudes as concerns the necessity of these sectors. A characteristic feature of the majority of modern developed systems aimed at regulation of insolvency is that they include and develop rehabilitation procedures aimed at the preservation of businesses in addition to such a classical mechanism of bankruptcy as the closing down sale of debtors’ assets in the course of bankruptcy proceedings.

The role of bankruptcy as a means to put pressure on managers of corporations in market economies is well known, and all aspects of the problem are described in a large number of studies. The threat of bankruptcy of a corporation due to managerial errors on markets (or, as the extreme variant, the cases where creditors intercept control) is traditionally seen as the most important external tool of corporate governance. Apparently, it is expected that the application of such a mechanism (notwithstanding the pluses and minuses of the models (pro-creditor or pro-debtor) used in different countries) should result in rehabilitation of finances and enhancement of efficiency of operations carried out by the corporation being the object of the respective procedures.

⁶⁶ For details see: Radygin A., Swain H., Simachev Yu., Entov R. et al. Institut bankrotstva: stanovleniye, problemy, napravleniya reformirovaniya (The institution of bankruptcy: it’s rise, challenges, and reform avenues). M., IET – CEPRA, 2005.

In principle, all systems of insolvency and bankruptcy may be classified in two extreme groups: those oriented towards the debtor (USA, France), and those oriented towards the creditor (Great Britain, Germany)⁶⁷.

Thus, the model formed in Germany is oriented towards an increase in the efficiency of satisfaction of creditors' claims, at the same time, the rehabilitation procedures are aimed at the maximization of debtors' assets for further distribution among creditors. A typical UK model is aimed at the protection of credit circulation, creation of efficient and rapid mechanisms of distribution of debtors' assets among creditors. Over the time, when the bankruptcy procedures are applied, the control over the enterprise is transferred to a third party acting on behalf of the creditors. An apparent flaw of this model is the fact that it is aimed at the liquidation of enterprises rather than their rehabilitation, since creditors are primarily interested in the sale of the assets of companies experiencing differences and not their rescue.

The models adopted in the USA and especially in France are based on a combination of the solution of macroeconomic problems as concerns the ensuring of stability and sustained growth of the economy, and the objectives of creation of efficient mechanisms of distribution of debtors' assets. For instance, in France the institution of insolvency is to a considerable extent aimed at the protection of the debtor's interests and restructuring of debtors' enterprises. The US legislation permits debtors to keep control of insolvent legal entities and grants the debtor the exclusive right to propose own plans with respect to the reorganization of the company for a certain period of time. The distribution of rights biased in favor of the debtor is to a considerable extent a policy choice, since the preservation of companies subject to bankruptcy proceedings as functioning enterprises, and not the cessation of their activities via liquidation, is seen as the priority. A significant flaw of this model is that the debtor has the possibility to abuse its rights.

All intermediate models primarily differ primarily as concerns the ratio (balance) between the infringement on the rights of creditors and preservation of operating enterprises.

According to the estimates presented by EBRD, the bankruptcy legislation of countries with transitional economies is underdeveloped in comparison with other spheres of commercial law⁶⁸. It is especially true with respect to the efficiency of enforcement of this legislation. Short duration of the bankruptcy procedures permits to avoid delays, which could negatively affect both the debtor, and creditors, as well as overload the judiciary system. Nevertheless, bankruptcy proceedings often are protracted and bring no results. There are doubts as concerns the competence of the assigned external managers, as well as their powers. In spite of the fact that in the recent years the countries of Central and Eastern Europe, the Baltic States and member countries of the CIS have been taking serious steps towards the improvement of both the respective legislation, and practices in the sphere of bankruptcy of companies, there are no apparent changes to the better.

At the same time, the specific objective constraints, which render difficult the efficient and large scale application of this mechanism in Russia and a number of other transitional economies, are well known. These constraints include:

- unfavorable financial standing of a significant part of newly created corporations;

⁶⁷ See, for instance, Telyukina M. *Osnovy konkursnogo prava (Principles of bankruptcy law)*. M.: Wolters Kluwer, 2004; Stepanov V. *Nesostoyatnost (bankrotstvo) v Rossii, Frantsii, Anglii, Germanii (Insolvency (bankruptcy) in Russia, France, England, Germany)*. M.: Statut, 1999.

⁶⁸ See: EBRD Transition Reports. 1999–2003. EBRD. See also: Radygin A. D., Gontmaher A. E., Mezheraups I. V., Turuntseva M. Yu. *Ekonomiko-pravovye faktory i ogranicheniya v stanovlenii modelei korporativnogo upravleniya (Economico-legal factors and restrictions in formation of corporate governance models)*. M.: IET, 2004.

- the traditions of soft budgetary constraints;
- persistence of a considerable number of corporations with state participation;
- the lack of an adequate and competent executive and judicial infrastructure;
- social and political barriers preventing implementation of real bankruptcy proceedings of with respect to loss making corporations, especially as concerns the largest enterprises, or enterprises in single company towns;
- technical difficulties associated with the objective assessment of the financial standing of potential bankrupts;
- corruption and other criminal aspects of this problem, including those associated with the property redistribution processes.

Bankruptcy legislation biased towards debtors is typical with respect to Uzbekistan, Moldova, Lithuania, and Ukraine (although in the latter case the general pro-debtor bias is combined with certain serious pro-creditor provisions). The legal frameworks of bankruptcy in Azerbaijan, Kazakhstan, and Georgia may be defined as systems biased towards creditors. Significant pro-creditor elements are present in the legislation of Latvia, Estonia, and Ukraine. Initially, the countries of Central and Eastern Europe and the CIS member states faced the choice between these two models. However, since the majority of developed countries applies mixed models, which include elements of both the American and British models, these countries attempt to find a balance between the rights of creditors and debtors (thus, for instance, the management of the enterprises subject to bankruptcy proceedings is usually transferred to a neutral manager biased neither towards the debtor, nor creditors), therefore many countries with transitional economies also chose this way. The modern (since 2002) system of the Russian bankruptcy law may be defined as a neutral system with a significant pro-debtor bias⁶⁹.

In all fairness, it should be noted that the legal basis of insolvency in Russia had been set forth yet before the beginning of the first stage of its development indicated below⁷⁰. Nevertheless, at present there may be singled out 3 major stages as concerns the development of the institution of bankruptcy in Russia:

- from the end of 1992 to the beginning of 1998, the period, when law of the Russian Federation No. 3929-1 of November 19, 1992, "On insolvency (bankruptcy) of enterprises", hereinafter referred to as the first law on bankruptcy, was in force;
- from the beginning of 1998 to the end of 2002, the period, when federal law No. 6 FZ "On insolvency (bankruptcy)", hereinafter referred to as the second law on bankruptcy, was in force;
- from the end of 2002 till present time, the period, when federal law No. 127 FZ "On insolvency (bankruptcy)", hereinafter referred to as the third law on bankruptcy, is in force.

The first law on bankruptcy was adopted in Russia at about the same time as in other countries with transitional economies. Although in 1995 through 1997 the number of bankruptcy related claims submitted to arbitration courts significantly increased, bankruptcy proceedings did not become as widespread as in other countries with transitional economies. This law was based on the "inability to pay" principle, which in turn based on the analysis of the ratio between the values of assets and liabilities and in the case the amount

⁶⁹ See: Telyukina M. *Osnovy konkursnogo prava* (Principles of bankruptcy law). M.: Wolters Kluwer, 2004, pp. 77 – 79.

⁷⁰ Decree of the RF President No. 623 of June 14, 1992, "On measures aimed at the support and rehabilitation of insolvent state owned enterprises (bankrupts) and implementation of special measures with respect to such enterprises"; Resolution of the RF State Committee for Management of State Property No. 717 r of November 5, 1992, "On the approval of the model rules governing the bankruptcy procedures with respect to the sale of bankrupt enterprises and property thereof."

of creditor indebtedness exceeded the value of property owned by the enterprise, it was considered to be insolvent on the basis of its balance sheet indicators.

At this stage, the most significant external factors determining the interests of the parties in the sphere of insolvency were as follows:

- the excess of the amount of debt over the value of the debtor's property was set as the criterion permitting to declare the enterprise bankrupt, what caused significant difficulties with respect to the initiation of bankruptcy proceedings;
- a significant number of large attractive enterprises remained in the state or mixed ownership;
- the economy was characterized by a high level of barter payments and there existed an acute problem of non-payments, which also concerned tax and other mandatory payments due to the state.

The first law on bankruptcy is as a rule characterized as a rather imperfect document. The overwhelming majority of authors agree that this law was too biased towards debtors. The law defined insolvency (bankruptcy) as the inability of the debtor to meet creditors' claims to pay goods (works, services), including the inability to make mandatory payments due to the budget and extra-budgetary funds due to the fact that the debtor's liabilities exceeded the value of its property, or in relation to the unsatisfactory structure of the debtor's balance sheet. The practical enforcement of the law revealed that the rights of creditors were significantly limited due to the difficulties associated with the appraisal of the real value of property by arbitration courts and respective delays of decisions ruling the debtor bankrupt. The legal terms and indications of bankruptcy, which were in force at that time, protected mala fide debtors, thus destroying the principles of property circulation⁷¹.

Among the reasons of insufficiently active enforcement of the first law on bankruptcy there were also indicated the lack of systematic implementation of bankruptcy proceedings on the part of the state in capacity of the tax creditor and its orientation towards such tools as the imposition of penalties for delays of payments. Ordinary creditors had no incentives to initiate bankruptcy proceedings, since all liquid assets were used in order to repay the debts to the state as a privileged creditor.

The serious flaws of the first law on bankruptcy accounted for the fact that this law had failed to produce any significant impact on the Russian economy⁷². As a result, in this period bankruptcy was neither a serious threat to inefficient managers of the majority of Russian enterprises, nor a means to ensure the rights of external creditors.

The lack of efficiency of the first law on bankruptcy resulting from its excessive bias towards debtors is most often named as the key factor behind the adoption of the *second law* on bankruptcy. It is believed that the key innovation in the second law was the radical change in the approach to the determination of criteria of insolvency (bankruptcy) as concerns the debtors in the form of legal entities, which had significantly strengthened the positions of creditors. The second law on bankruptcy was based on the *insolvency principle*: the inability of an enterprise to meet its liabilities was determined at the time the respective payments were due, therefore enterprises were deemed insolvent on the cash basis. This innovation had significantly reduced the barriers preventing initiation of bankruptcy proceedings.

⁷¹ See: Vitryanski V. Novoye zakonodatelstvo o nesostoyatelnosti (bankrotstve) (New legislation on insolvency (bankruptcy)) // Khozyaistvo i pravo. 1998. No. 3.

⁷² See: Sonin K., Zhuravskaya E. Bankrotstvo v Rossii: ni zashchity kreditorov, ni restrukturizatsii (Bankruptcy in Russia: Away From Creditor Protection and Restructuring), Special report. Russian Economic Trends. 2000. Transl. from English. M.: RECEP, 2000, Volume 9: Issue 1, 2000.

As a result, the scale of the application of insolvency proceedings in the economy started to increase intensively (see Fig. 1). The growth in the number of bankruptcy cases was viewed in particular as a result of toughening of budgetary constraints with respect to Russian enterprises related to the enactment of the second law on bankruptcy. In other words, a sharp increase in the number of bankruptcies was associated with the fact that due to the absence of an efficient legal framework of bankruptcies until 1998 the majority of Russian firms had accumulated significant debts to the federal and regional budgets and private creditors.

At the same time, the practice of enforcement of the second law on bankruptcy had demonstrated that bankruptcy proceedings could be easily initiated with respect to large enterprises, where the levels of indebtedness were insignificant in comparison with the scales of their businesses. In accordance with the second law on bankruptcy, the creditor could submit to the arbitration court the claim to declare the debtor bankrupt in the case the latter failed to meet its obligations within 3 months and the amount of indebtedness was above 500 minimal wages. As it had turned out, the principle of insolvency was significantly more efficient as concerned the instilment of payment discipline; it ensured equal opportunities as concerns the initiation of bankruptcy on the part of creditors; in principle, it did not required that judges had special highly professional training in order to take decisions concerning the substance of claims. However, this principle failed to take into account the scale of businesses and possible cash gaps, which were not indicative of the inefficiency of enterprises.

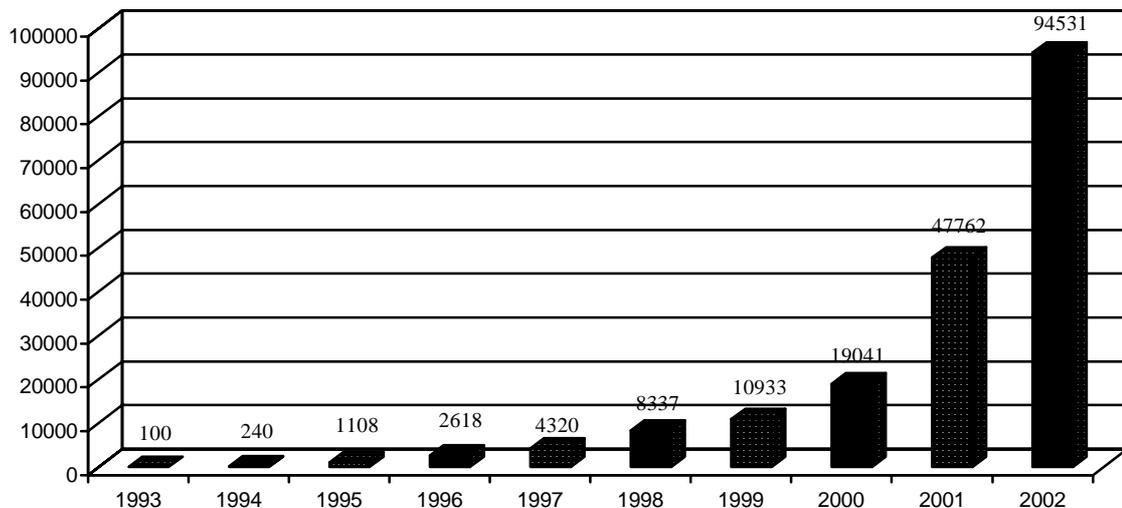


Fig. 1. The dynamics of claims resulted in initiation of bankruptcy proceedings (the first and second laws on bankruptcy)

The second stage of development of the institution of bankruptcy, especially after the financial crisis of 1998, was characterized by significant changes in the complex of key factors affecting the implementation of bankruptcy proceedings:

- the threshold permitting to start bankruptcy proceedings was sharply lowered;
- the processes of industrial integration intensified alongside with the law-making activities aimed at protection of minority shareholders;

- the stock market crisis of the late 1990s resulted in a search for alternative low cost tools of interception of corporate control;
- at a significant number of enterprises there was observed a growth in production; however, the high level of indebtedness of enterprises associated with tax payments persisted⁷³;
- the state was deprived of voting rights with respect to the most important decisions at the meetings of creditors;
- the problems related to the training of bankruptcy commissioners and their affiliation to certain creditors became more urgent.

While in the period in which the first law on insolvency was in force (1992 through 1998), the institution of bankruptcy was rather of the imitation nature, the second law (1998 through 2002) had even more distorted the situation turning the institution of bankruptcy from a method to instill financial discipline into a tool of redistribution of property and withdrawal of assets⁷⁴. There was observed a paradoxical situation: the enterprises of rather safe financial standing were involved in bankruptcy procedures (since there existed the favorable chance to seize control over such enterprises on the part of competitors), while hopelessly loss making enterprises avoided these proceedings (since there was no one wishing to seize these enterprises and there were low chances to collect debts in the course of bankruptcy proceedings).

In fact, in 1998 through 2002 initiation of bankruptcy proceedings was a low cost (in the case of a potential collusion of the bankruptcy commissioner and creditors, arbiters, and FSFR officials) alternative to hostile takeovers carried out via the buy up of shares on the secondary market. In this relation it is interesting to suggest that there was a direct connection between the enactment of the law "On insolvency (bankruptcy) in 1998 and the low level of the resistance demonstrated by the Russian stock market in 1998 through 2000⁷⁵. It is significant that the law "On joint stock companies" provides numerous legal opportunities to efficiently repulse corporate aggressors in the framework of corporate law, while the bankruptcy proceedings existing in 1998 through 2002 practically ensured the success of the aggressors.

The analysis of 100 bankruptcy cases carried out by FSFR revealed that with respect to about one third of enterprises creditors were interested to change owners rather than collect the debts. In 2000, FSFR and its territorial agencies carried out 388 expert appraisals aimed at the detection of fraudulent and fictitious bankruptcies, and in 156 cases there were revealed the respective indications⁷⁶. Such offences were also directly related to the tax payment situation. According to FSFR⁷⁷ evaluations, each fifth bankruptcy case had the indications of premeditated criminal actions (in particular bankruptcies aimed at write down of debts). At the same time, in accordance with the data collected in 2002, only 5 out of 2000 initiated bankruptcy cases resulted in convictions⁷⁸.

⁷³ A systemic toughening of budget constraints started only in the second half of 2001 in relation to the launch of a campaign for restructuring of the debts of enterprises related to mandatory payments.

⁷⁴ See: Radygin A., Simachev Yu. Bankrotstva (Bankruptcies). – In: *Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii 1998 – 2002*. M., Delo, 2003, pp. 498 – 512.

⁷⁵ See: Volkov A., Privalov A. A nu-ka otnimu! (Why Don't I Try To Take It Away!) – In: *Ekspert*, 2001, No. 1 – 2, pp. 28 – 29.

⁷⁶ See: FSFR final report for year 2000.

⁷⁷ Since September of 1993, in Russia there had been operating the Federal Administration for Insolvency (Bankruptcy) (FAIB) under the RF State Committee for Management of State Property, in March of 1997 there was set up the Russian Federal Service for Insolvencies and Financial Rehabilitation (FSIFR), which in June of 1999 was reorganized as the Russian Federal Service for Financial Rehabilitation and Bankruptcies (FSFR). Since March of 2004 the FSFR functions were distributed across several state bodies.

⁷⁸ See: *Sliyaniya i pogloshcheniya (Mergers and takeovers) // Zhurnal dlya aktsionerov*. 2002. No. 6. P. 15.

It should be noted that sometimes the state also used the threat of bankruptcy as a tool to exert pressure on enterprises in order to make them repay the tax related debts or for other non-economic purposes. On the whole, the state actively used the institution of bankruptcy in the 2000s. The state, as represented by the tax authorities, attempted to “clear the field” of abandoned enterprises, and, as represented by FSFR, to intimidate the debtors defaulting on payments to budgets and other mandatory payments. In 2002, the state authorities submitted 90 per cent of bankruptcy claims against debtors. It seems that the tax authorities made haste to take advantage of the opportunities, yet available in 2002, to use bankruptcy proceedings for the liquidation of “empty” enterprises.

FSFR still played a considerable role as concerns the initiation of bankruptcy proceedings. According to our estimates, in 2002 in the case the bankruptcy claims submitted by the tax authorities were excluded, the share of FSFR in the total number of claims against “substantive” debtors made about 30 per cent.

However, private structures rather used the institution of insolvency as a tool of redistribution of property, reorganization of enterprises, and interception of control. The first two ways of the use of the institution of insolvency were determined by dynamically progressing integration processes, the necessity to carry out organizational restructuring of enterprises, and lower (as compared to other methods) costs associated with the application of bankruptcy procedures. The third method could be used due to a large number of opportunities for falsifications and machinations in the framework of management procedures. The significant shifts occurring in the sphere of protection of the rights of minority shareholders generated additional demand for bankruptcies as an efficient tool suitable for the settlement of various corporate problems: from ensuring the protection of managers from owners to carrying out hostile takeovers.

However, in spite of the fact that on the whole the Russian law “On insolvency (bankruptcy),” which was in force in 1998 through 2002, was a rather progressive document from the viewpoint of international practices and maintained a certain balance of interests of debtors and creditors, the practical implementation of its provisions became one of the most odious manifestations of discrimination of the rights of certain participants of the process (depending on the concrete situation it could be owners of enterprises or various creditors, including the state). Over the last few years, the major substantive criticism of the Russian institution of insolvency was aimed at the practices of bankruptcy of large economically and socially important enterprises, the large scale use of bankruptcy procedures for mala fide purposes, and infringements on the interests of the state as a creditor and owner.

Evidently, it was necessary, on one hand, to ensure protection of creditors’ rights in the process of bankruptcy of enterprises, but also, on the other hand, to prevent the use of simplified schemes of mala fide interception of control over debtor enterprises (or parts of their assets) via bankruptcy procedures. During the whole period, when the second law on insolvency was in force, there were being taken attempts to improve its provisions⁷⁹. A considerable part of proposals concerning the reform of the legislation resulted from the insufficiently developed enforcement infrastructure (dependence of arbitration courts of local governments, the professional level of judges, etc) rather than the imperfection of the regulations being in force at that time.

⁷⁹ See, for instance: Radygin A. Soprotivleniye korporativnomu agressoru (Resisting a corporate aggressor) // *Dlya aktsionerov*. 2002. No. 4. P. 26 – 28.

In the second half of 2001, there were formed the prerequisites for a radical reform of the institution (legislation on) insolvency. At the governmental level, there were registered the following most urgent problems in the sphere of bankruptcy (insolvency):

- infringement on the rights of debtors and founders of debtor enterprise (initiation of bankruptcy proceeding on the basis of false documents or an insignificant amount of debt without giving debtors a chance to repay these indebtednesses, the fact that founders of debtor enterprises were deprived of the opportunity to carry out creditor-controlled rehabilitation after the initiation of bankruptcy proceedings);
- infringement on the rights of the state as the creditor with respect to tax payments;
- withdrawal of debtors' assets in the interests of certain groups of creditors in the framework of external management and bankruptcy proceedings;
- insufficient protection of the rights of creditors;
- widespread practices involving the use of premeditated bankruptcies as a tool of uncivilized seizure of property;
- non-transparency and insufficient regulation of bankruptcy proceeding permitting bankruptcy commissioners and other participants of bankruptcy proceedings to abuse the respective flaws;
- absence of efficient mechanisms bringing to responsibility mala fide and inefficient bankruptcy commissioners;
- insufficiently clearly defined status of self-regulating organizations of bankruptcy commissioners, terms of membership, guarantee funds;
- possibility of emergence of conflicts of interests as concerns authorized state agencies, the lawfulness and consequences of proposed broader powers;
- settlement of such an issue as the complete elimination of the powers of arbitration courts (which should bear no responsibility) powers to take any decisions concerning the selection and professional level of bankruptcy commissioners and decisions (approval of decisions) with respect to the assets of enterprises;
- settlement of the issue of the principal exclusion of such procedures as "external management" and "financial rehabilitation";
- existence of unfair specifics of bankruptcy as concerns all enterprises of the fuel and energy complex in the absence of legislatively fixed specifics of bankruptcy;
- absence of reasonable mechanisms of bankruptcy as concerns the enterprises of the defense industrial complex and natural monopolies;

At the same time, in many cases the ideas about possible ways to settle the problems indicated above turned out to be antipodal. The state authorities had no common concept with respect to the transformation of insolvency regulations.

The heated discussion concerning the new – already third – law on bankruptcy was primarily related to the flaws of this law (as of any other law) in the general institutional context of problems of corruption, redistribution of property, arbitrary administration, and incompetence of various state structures. As a result, the new – *third* – federal law No. 127 FZ approved on October 26, 2002, "On insolvency (bankruptcy)" contains the following principal innovations.

1. *Reduction of risks of misuse of the rights on the part of creditors.* Initiation of bankruptcy proceedings on the basis of creditors' claims is possible only in the case the creditor presents the writ of execution indicating that the creditor has taken an attempt to collect the debt in the framework of executive proceedings and that all attempts taken by the bailiffs within 30 days after the court ruling about the recovery of the debt have failed, so the bankruptcy proceedings with respect to the debtor is the means of last resort for the creditor to collect the debt.

2. *Granting of equal rights to the state and other creditors in the course of bankruptcy proceedings, consolidation of state claims.* The law equalized the rights of the state and the rights of other creditors in the course of bankruptcy proceedings. The state had obtained the rights to vote at all meetings of shareholders via its authorized agency and participate in the meetings of the creditors' committees, at the same time, the priority of the claims of the state was made equal to that of other creditors in the course of bankruptcy proceedings.

3. *Enhancement of the mechanisms aimed at the protection of bona fide owners.* Owners of debtor enterprises were accepted as participants of bankruptcy proceedings. The law stipulates the right of representatives of owners of debtor enterprises to appeal against the claims of creditors, as well as the right of the debtors, owners of debtor enterprises, and any third parties on the condition of approval on the part of bankruptcy commissioners, to stop bankruptcy proceedings at any stage by repaying the debts of debtor enterprises.

4. *Introduction of a new procedure - financial rehabilitation.* In certain situations, this procedure should permit the founders (partners) of the debtor to keep control over the fate of the enterprises even in the case there are initiated bankruptcy proceedings. There were enhanced mechanisms of support of the debtor's business, in particular, there was envisaged the option to revert bankruptcy proceedings to external management in the case there is a real opportunity of restoration of solvency and additional issue of stocks during external management on condition of approval of such an issue by the debtor's owner.

5. *Protection of bona fide participants of bankruptcy proceedings from mala fide actions taken by third parties.* There are envisaged the following innovations: it is prohibited to initiate new bankruptcy proceedings against the debtor within 3 months since the date of conclusion of the amicable settlement; there is introduced the possibility to appeal against determinations issued in the course of bankruptcy proceedings basing on the results of disputes between the parties participating in the case; there is improved the procedure governing the sale of debtors' properties; there is stipulated that in the cases where the balance sheet value of property confirmed by an independent appraiser exceeds a certain level, the tender for the sale of the debtor's property should be public on the mandatory basis.

6. *Enhancement of efficiency of control over the actions of bankruptcy commissioners.* One of the most important objectives is the introduction of efficient supervision over the actions of bankruptcy commissioners due to the abolition of licensing of such activities. The whole system of responsibility and supervision of bankruptcy commissioners' activities is radically changed. The supervisory functions with respect to bankruptcy commissioners were transferred from the state as represented by FSFR to non-for-profit self-regulating organizations (SRO). The law vests with SRO the right to take disciplinary measures with respect to their members, including the expulsion from the number of members of SRO, and to submit to arbitration courts applications to suspend their members from participation in bankruptcy proceedings in the capacity of arbitration commissioners. The law introduces property qualification with respect to bankruptcy commissioners – the amount of the lump sum fee each bankruptcy commissioner should pay to the compensatory fund of the SRO the commissioner joins. The law stipulates that the civil liability of bankruptcy commissioners should be on mandatory basis insured by the insurance companies accredited by SRO.

7. *Setting of specifics of bankruptcy of certain debtors' categories in one law.* The law envisages certain specifics of bankruptcy for organizations related to defense industry and subjects of natural monopolies. The law has abolished the "inability to pay" criterion

applicable to subjects of natural monopolies; however, it does not set forth any special insolvency criteria with respect to organizations of the military industrial complex, subjects of natural monopolies, and other organizations of serious social, economic, and strategic importance. Therefore, the latter will be subject of the same criteria of insolvency based on the “inability to pay” principle as other categories of debtors. The specific feature here is the external indications of insolvency: bankruptcy proceedings with respect to such organizations should be initiated if their indebtedness makes Rub. 500 thousand delayed by 6 months. Besides, as concerns strategic enterprises, the law grants the state the right to suspend the sales of property for a certain period in order to elaborate proposals aimed at the restoration of such organizations’ solvency, including the switching to the procedures of financial rehabilitation.

8. *Constrains on too broad use of bankruptcy proceedings as concerns liquidation of absent debtors.* The law stipulates that bankruptcy procedures with respect to absent debtors should be applied only in the case the budget has available the respective funds.

In 2004, the alignment of forces of the respective authorities engaged in the regulation and practical enforcement of bankruptcy procedures principally changed⁸⁰. Accordingly, the problem of further division (coordination) of the functions performed by different authorities in the sphere of insolvency became more urgent. The distribution of key functions and powers concerning the regulation and practical implementation of the institution of bankruptcy among executive authorities is presented in *Table 5*⁸¹. In 2004 and 2005, there were observed two most pronounced trends: first, the trend towards a reduction in the number of “poles” of regulation in this sphere after their “atomization” in the course of the liquidation of the Federal Service of Financial Rehabilitation (FSFR)⁸², and, second, towards an enhancement of Federal Tax Service (FTS) powers.

Table 5

**Modification of functions and powers of executive authorities
in the sphere of insolvency in 2004 and 2005**

Functions	01.01.2004	01.01.2005
Regulation in the sphere of insolvency of enterprises	FSFR of Russia	RF Ministry of Economic Development and Trade FTS of Russia
Decisions about submission of bankruptcy claims against debtors	As concerns debtors of Category A – <u>the RF Government, the Chairman of the RF Government, or the Deputy Chairman of the RF Government</u> acting on instructions of the Chairman of the RF Government,	The procedures governing the process of taking of decisions with respect to bankruptcy claims referring to the debtor included in the list of strategic enterprises and organizations is set forth by the <u>RF Ministry of Economic</u>

⁸⁰ Decree of the RF President No. 314 of March 9, 2004, “On the system and structure of federal executive authorities” in particular envisaged the liquidation of FSFR and the RF State Property Ministry, creation of the Federal Agency for Management of Federal Property (FAMFP) and transfer of certain FSFR functions to FAMFP, transfer of the functions related to the approval of regulatory legal acts on the issues being in the FSFR competence to the RF Ministry of Economic Development and Trade, reorganization of the RF Tax Ministry in the Federal Tax Service, transfer of the FSFR functions relating to the representation of the interests of the Russian Federation with respect to creditors in bankruptcy proceedings to the Federal Tax Service.

⁸¹ Prepared by M. G. Kuzyk.

⁸² In a certain sense, this situation may be interpreted in terms of the theorem on the minimal production of entropy advanced by I. Prigozhin (1945), according to which any system always tend to a “stationary state corresponding to the minimal production of entropy compensating the impact of external relationships producing negative entropy.” (For details see, for instance, Alekseyev N. S. *Teoriya upravleniya “Epokhi bez zakonomernosti”* (Theory of management in the “Age without regularities”) // *Menedzhment v Rossii i za rubezhom*. 2000. No. 3). In other words, each system (in this case the system of regulation of the institution of bankruptcy) in accordance with the principle of internal resource conservation tends to the state of equilibrium with the maximal level of disorganization permitted by external destructive impacts, to which the system has to withstand.

	As concerns debtors of Category B – <u>FSFR of Russia</u> on the basis of decisions taken by the interdepartmental commission	<u>Development and Trade</u>
Choice of SRO in the case of submission of bankruptcy claims against debtors	FSFR of Russia	FTS of Russia In accordance with the procedures set forth by the RF Ministry of Economic Development and Trade
Voting at meetings of creditors	FSFR of Russia As concerns the choice of bankruptcy proceedings – taking into account the opinion the respective <u>executive authority of the RF subject</u> and the <u>local government</u>	<u>FTS of Russia</u> In accordance with the procedures set forth by the <u>RF Ministry of Economic Development and Trade</u> As concerns the choice of bankruptcy proceedings – taking into account the opinion the respective <u>executive authority of the RF subject</u> and the <u>local government</u>
Execution of the powers of the owner of the debtor’s property (as concerns federal state unitary enterprises (FSUE) in the course of bankruptcy proceedings)	RF State Property Ministry	Federal Agency for Management of Federal Property (FAMFP)
Supervision of SRO activities	RF Ministry of Justice *	Federal Registration Service (Rosregistratsiya)

* By 2005, the RF Ministry of Justice retained only rather modest powers as concerns the formation of commissions for organization and carrying out of theoretical examinations in accordance with the unified training program for bankruptcy commissioners.

The approval of a new law on bankruptcy, which has significantly modified the institution of insolvency, determined the necessity to revise the regulatory bylaws in this sphere. In 2002 through 2005, different state authorities issued more than 20 bylaws pertaining to the sphere of bankruptcy, however, the “tuning” of the new legislative mechanisms continues. At the same time, after the enactment of the new bankruptcy law there is required a period for formation of the respective infrastructure and its adaptation to new legislative regulations. It is also apparent that such “tuning” requires to take into account the specifics of real demand for institutional innovations, which would be adequate to the existing economic realities⁸³. However, the practices of 2003 and 2004 indicate significant changes in the dynamics of respective cases, appearance of new important trends in the sphere of bankruptcy, revision of the significance of certain problems observed in the preceding period.

4.3.2. Practical implementation of the third law on bankruptcy (2003 and 2004)

Basing on the results of implementation of bankruptcy proceedings in 2003, there may be made certain preliminary remarks with respect to the problems related to the enforcement of the new law on insolvency. Naturally, due to the lack of formed court practices of enforcement of the provisions of the third law on insolvency, it may be considered that its potential is far from being exhausted; however, even now it is possible to form a judgment on the most noticeable miscalculations relating to the evaluation of the situation

⁸³ See: Golikova V., Dolgopyatova T., Kuznetsov B., Simachev Yu. Spros na pravo v oblasti korporativnogo upravleniya: empiricheskiye svidetelstva (Demand for corporate law: empirical evidence). Working papers series: independent economic analysis. No. 148. M.: MONF, 2003; Simachev Yu. Institut nesostoyatelnosti v Rossii: spros, osnovnyye tendetsii i problemy razvitiya (Institution of insolvency in Russia: demand, trends, and major problems) // Voprosy ekonomiki. 2003. No. 4.

in the sphere of enforcement of insolvency procedures and certain flaws in the provisions of the new law. Certain general trends are presented in *Table 6*⁸⁴.

Table 6

**The dynamics of bankruptcy cases in Russia in 1998 through 2003
(second and third laws)**

	1998	1999	2000	2001	2002	2003
Total number of bankruptcy claims against debtors	12 781	15 583	24 874	55 934	106647	14 277
Total number of bankruptcy claims against debtors with the exception of claims against absent debtors	11 604	12 367	15 523	21 170	25 396	12 148
Total number of initiated bankruptcy cases	10 000	11 000	19 000	48 000	94 531	9 695
Including monitored bankruptcy cases	4 893	5 940	7 959	8 548	10 739	5 351

Source: data presented by RF SAC, FSR.

In 2003, the scale of application of bankruptcy proceedings sharply declined: the number of bankruptcy claims against debtors declined 7.5 times from 106647 cases in 2002 to 14277 cases in 2003 (see Fig. 2). Even a more dramatic decline was observed with respect to the claims resulted in initiation of bankruptcy proceedings – the number of such claims decreased 9.8 times from 94531 in 2002 to 9695 in 2003 (see Fig. 3).

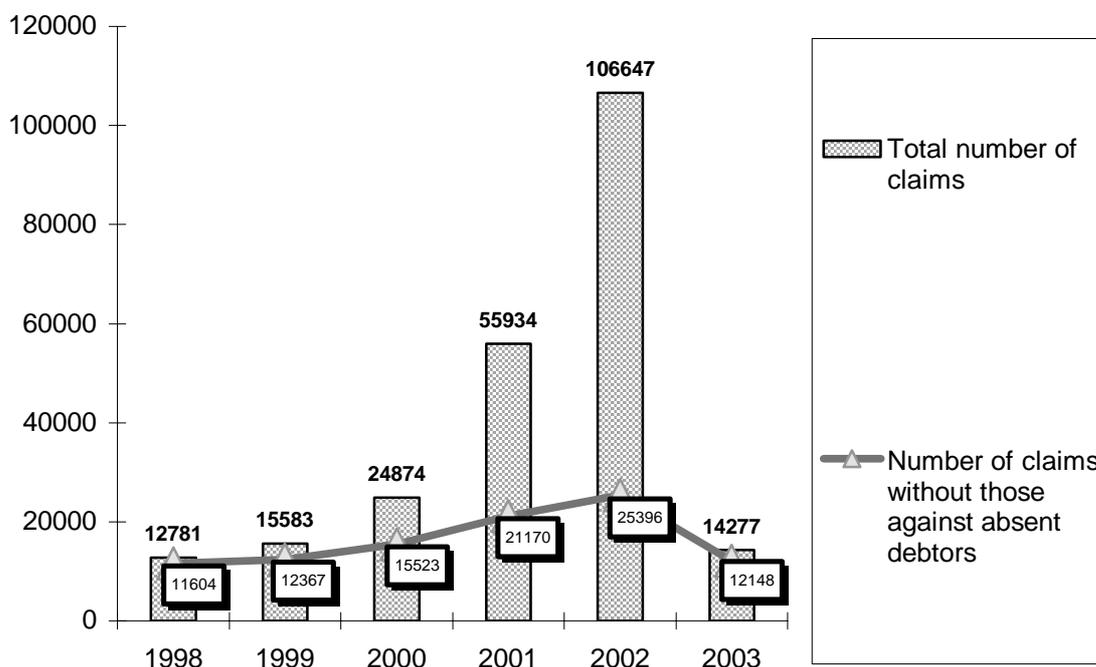


Fig. 2. The dynamics of bankruptcy claims against debtors

⁸⁴ At the moment the work with this material was completed, the official statistics for year 2004 (RF Supreme Arbitration Court, etc) was not available.

The fact that tax authorities have practically stopped to accept *bankruptcy claims against absent debtors* accounts for about 85 per cent of this radical reduction in the number of bankruptcy claims. In 2003, there were registered only 2129 claims against absent debtors as compared with 81251 claims registered in 2002. It is an illustrative demonstration of the enforcement of the provisions of the third law on insolvency, which stipulates that bankruptcy procedures with respect to absent debtors should be applied only in the case budgets have available the respective funds; however, as it should be expected, no such funds were provided in the budget for year 2003.

On the whole, this result may be positively appraised, since it reduced the irrational burden on the system of arbitration courts. However, the problem of absent debtors has not been resolved by a legislation envisaging methods other than bankruptcy procedures. However, the problem of absent debtors *per se* has not been settled yet in the framework of legislation other than that concerning bankruptcies. Accordingly, the top officials of the RF Supreme Arbitration Court evaluate the nearest perspectives as rather pessimistic presupposing that in the near future there may be resumed actions aimed at the liquidation of about 1.5 million of actually absent enterprises and organizations by the application of simplified bankruptcy proceedings⁸⁵.

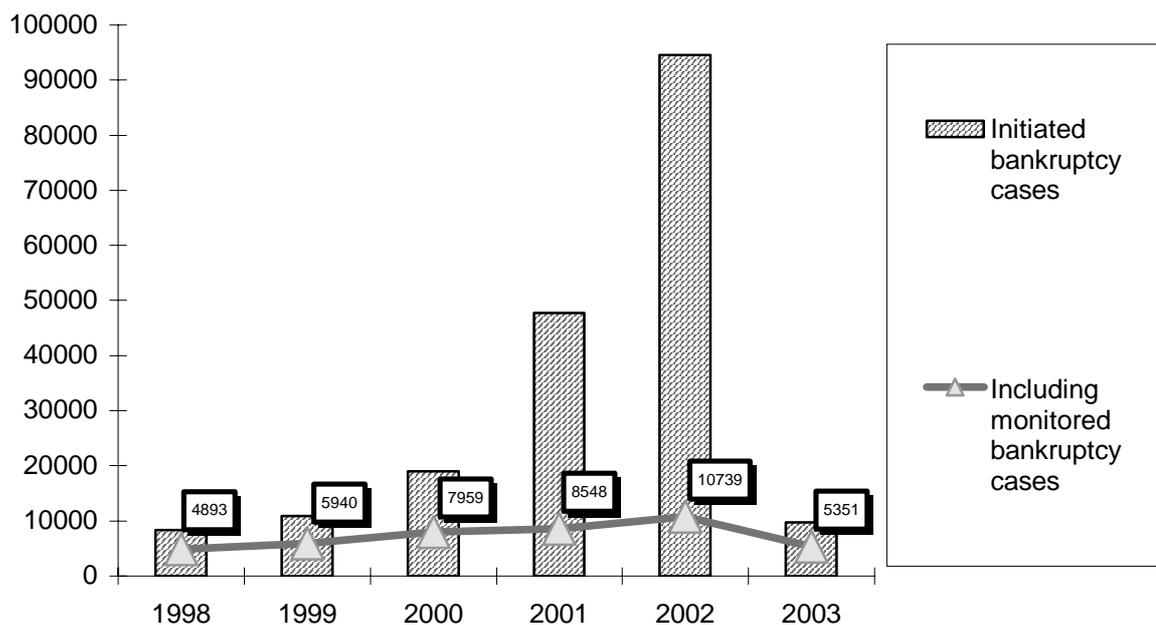


Fig. 3. The dynamics of initiated bankruptcy cases

At the background of such a massive reduction of claims against absent debtors, *the decline in the number of claims against "substantive" debtors* does not look very significant; however, in reality the number of such claims decreased about two times. The number of initiated bankruptcy cases involving monitoring made 5351 in 2003 as compared

⁸⁵ Yakovlev V. F. Itogi raboty arbitrazhnykh sudov v 2003 g. Osnovnye zadachi na 2004 g. (Arbitration courts: the results of work in 2003. Major objectives in 2004.) Verbatim record of the conference of heads of arbitration courts of the Russian Federation (February 11, 2004).

with 10739 cases registered in 2002. It seems that these developments resulted from more strict conditions of the registration of claims concerning insolvency. However, it is expected that this would be a rather short term effect as it is probable that many creditors have not yet subjected their debtors to executive proceedings.

On the face of it, a more sharp reduction of the number of initiated bankruptcy cases in comparison with the decline in the number of bankruptcy claims against debtors may be interpreted as a more strict approach of courts to the submitted claims (see Fig. 4). However, the growth in the number of initiated bankruptcy proceedings observed in 1999 through 2002 was related to the increase in the specific weight of the number of claims against absent debtors; therefore, in 2003 the activity related to the initiation of cases governed by simplified procedures sharply declined, while the share of dismissed claims increased.

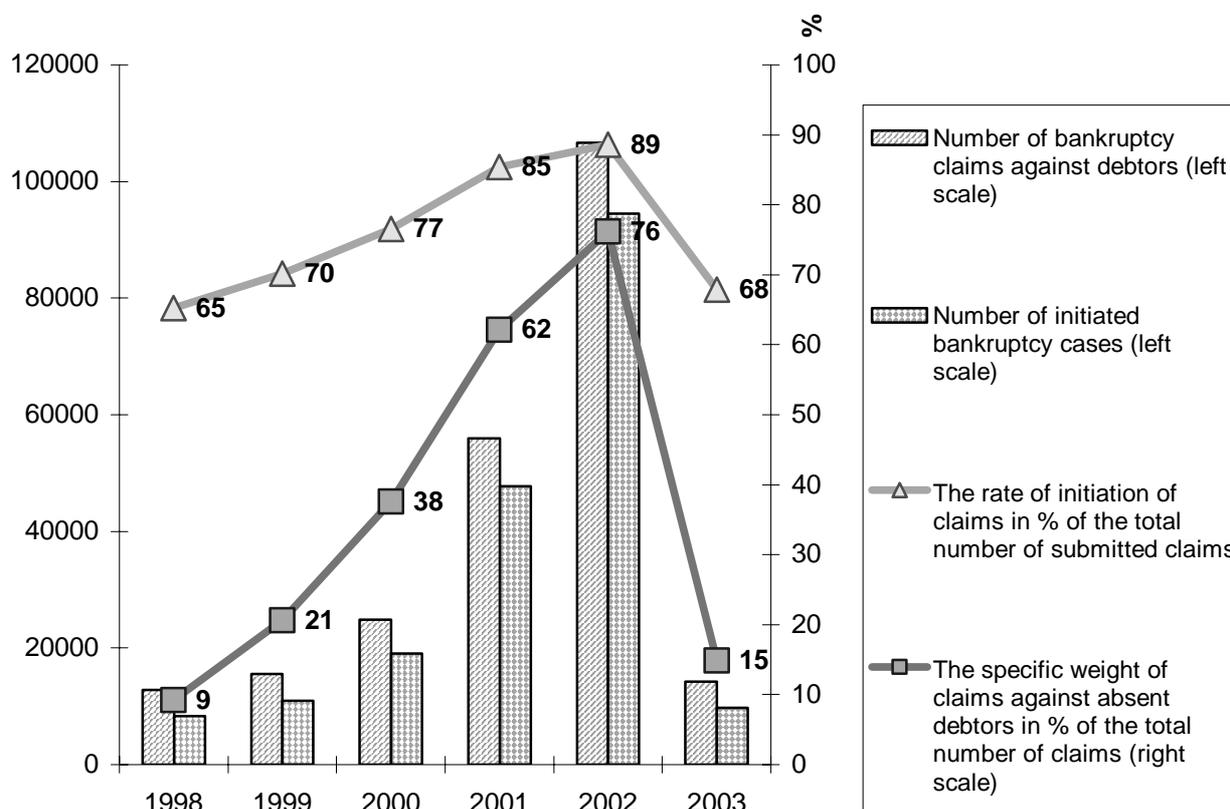


Fig. 4. The rate of initiation of bankruptcy proceedings against debtors

On the whole, the “exclusiveness” of the application of bankruptcy procedures has significantly increased. On the face of it (judging by the number of submitted claims and the share of claims against absent debtors in this number), the scale of application of bankruptcy procedures in 2003 reminds of the situation existing in 1998 and 1999.

The law on insolvency continues to rather successfully “compete” with the Law on privatization as concerns the liquidation of unitary enterprises⁸⁶. Although in 2003 the number of bankruptcy claims initiated against “substantive” debtors declined two times in comparison with the figures registered in 2002, the number of SUEs, with respect to which there were taken decisions to initiate bankruptcy proceedings, did not decreased so significantly – from 643 in 2002 to 511 in 2003 (see Fig. 5). According to the top officials of the Federal Agency for Management of Federal Property⁸⁷, as soon as there appear plans to privatize a SUE, its assets are diluted, and its managers themselves initiate its bankruptcy.

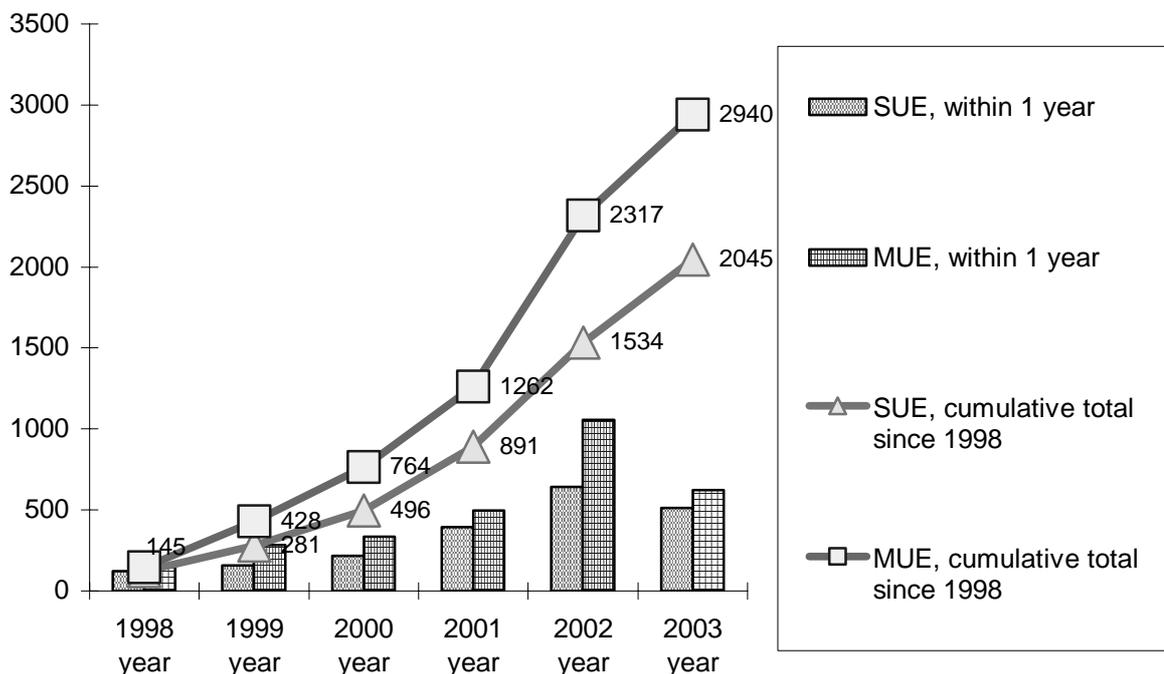


Fig. 5. The dynamics of bankruptcy proceedings with respect to unitary enterprises

The practices of enforcement of the third law on insolvency in 2003 do not permit to indicate any positive shifts in the solution of reorganization and rehabilitation problems in the course of implementation of bankruptcy procedures (see Fig. 6 – 7). In about 70 per cent of cases, the monitoring procedures resulted in the initiation of bankruptcy proceedings. The trend towards a decline in the both the number, and the share of rulings initiating external administration persisted (547 cases in 2003 as compared with 931 cases in 2002). There was observed a significant decline in the number of approved amicable settlements: from 145 in 2002 to 54 in 2003.

At the same time, there was observed a significant increase in the share of rulings dismissing bankruptcy claims against debtors and the share of rulings terminating proceedings related to bankruptcy cases, what is an evidence of a growing role played by arbitration courts as concerns the protection of interests of potentially solvent enterprises.

⁸⁶ In 2000 through 2003, there were privatized about 500 FSUEs.

⁸⁷ Interview of V. Nazarov, the Head of the Federal Agency for Management of Federal Property // Vedomosti. 2004. May 18.

Only due to these factors the bankruptcy bias of monitoring procedures has somewhat diminished.

The procedures of external administration proved to be even less suitable both for the achievement of amicable settlements, and for recovery of enterprises' paying capacities. In 2003, more than 90 per cent of external administration procedures resulted in rulings initiating bankruptcy proceedings. The trend towards a decline in the number of amicable settlements persisted (53 cases in 2003 as compared with 121 cases in 2002), while financial rehabilitation of enterprises was achieved only in few cases (only 28 cases).

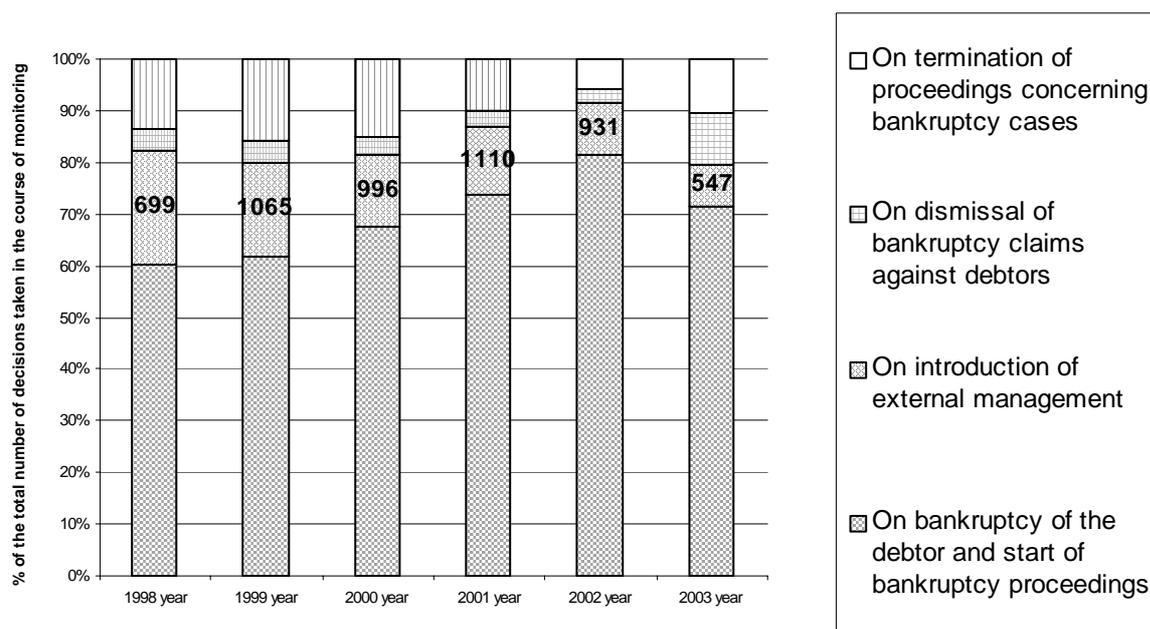


Fig. 6. Monitoring: the structure of decisions taken

On the whole, taking into account all "stages" of bankruptcy proceedings, in 2003 there were registered about 230 cases where businesses were "rehabilitated": 170 proceedings were terminated after the conclusion of amicable settlements and 56 bankruptcy proceedings resulted in the rehabilitation of debtors and satisfaction of debtors' claims.

Therefore, in spite of enhancement of the mechanisms aimed at the preservation of the debtors' businesses (the third law on bankruptcy in particular envisages the option to revert bankruptcy proceedings to external management in the case there is a real opportunity of restoration of solvency and additional issue of stocks during external management on condition of approval of such an issue by the debtor's owner) there are hardly observed positive shifts. *The practice of enforcement of insolvency procedures in 2003 indicates that the bankruptcy bias persists and even increases.*

It is apparent that in the course of elaboration of the provisions of the third law on bankruptcy the wish of owners to rehabilitate and develop debtors' businesses was overestimated. It has been assumed that the major part of bankruptcies does not result in amicable settlements only due to the fact that owners have no possibility to repay the indebtedness of enterprises and carry out their rehabilitation. Provisions of the third law on insolvency introduced owners of debtor enterprises as participants of the process. Besides, the law stipulates the right of the debtors, owners of debtor enterprises, and any third parties on the condition of approval on the part of bankruptcy commissioners, to stop bankruptcy proceedings at any stage by repaying the debts of debtor enterprises. The law

introduced a new procedure - financial rehabilitation, which in certain situations should permit the founders (partners) of the debtor to keep control over the fate of the enterprises even in the case there are initiated bankruptcy proceedings. However, it seems that all these innovations are in low demand. The procedures of financial rehabilitation have been introduced only in 10 cases. The procedures of external management have resulted in satisfaction of the claims filed by creditors only in 28 cases. Only in 19 cases the bankruptcy proceedings have been reverted to external management.

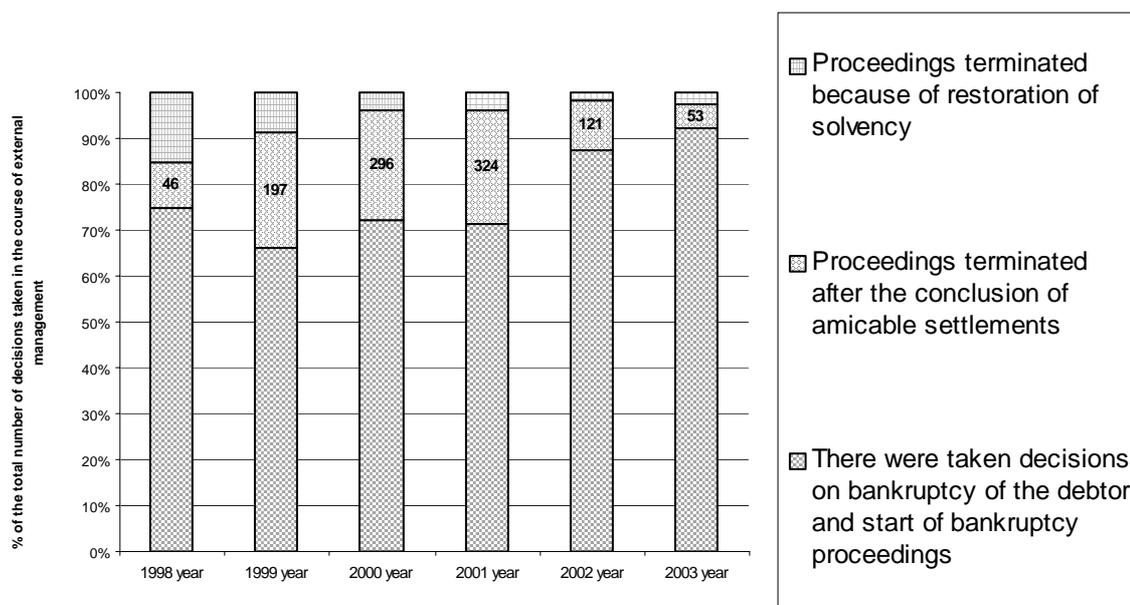


Fig. 7. External management: the structure of decisions taken

From the authors' point of view, the practical implementation of the third law on insolvency in 2003 indicates the fallibility of the actively discussed in 2001 and 2002 assumption that in the framework of bankruptcy proceedings there occur mass infringements on the rights of debtors and their owners, who are "prevented" to rehabilitate enterprises and repay the debts.

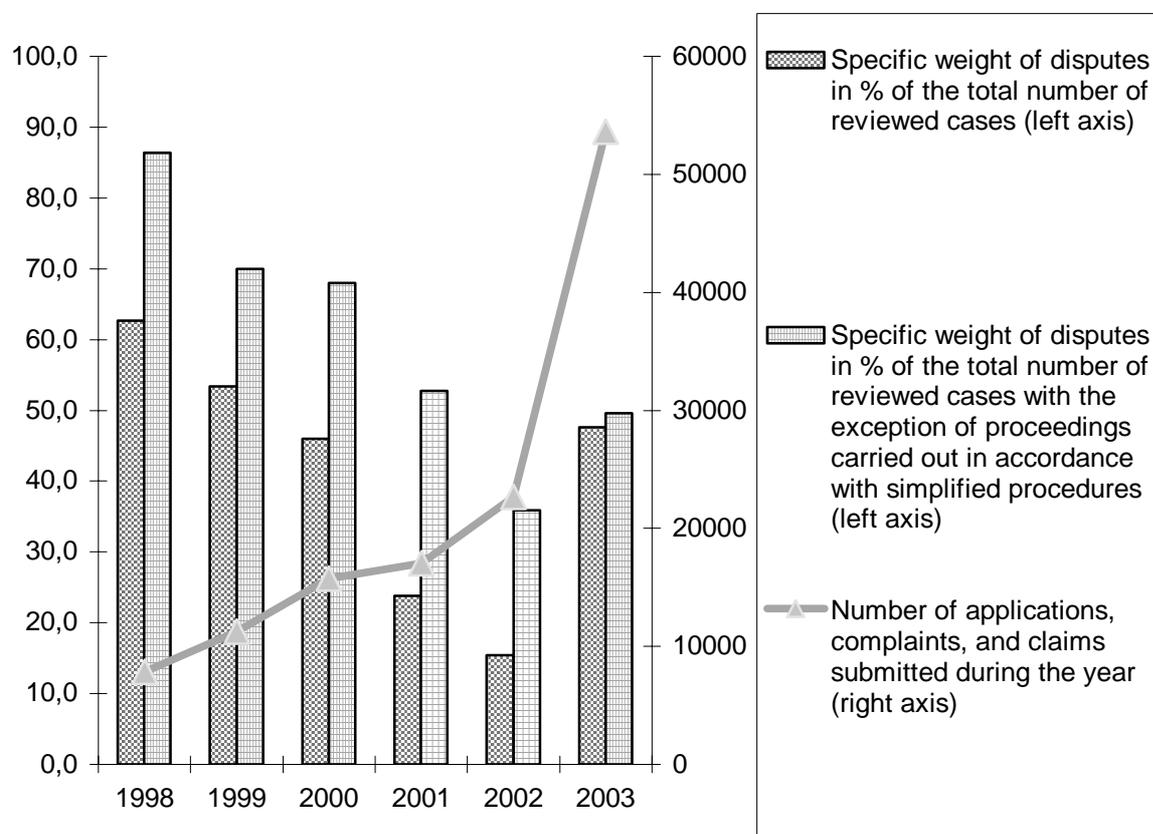


Fig. 8. Evaluation of the disputableness of bankruptcy proceedings

In 2003, there was registered a sharp increase in the number applications and complaints in the framework of bankruptcy cases, there was also observed an increase in the level of “disputableness” of insolvency cases; however, it was the result of not only the “innovation nature” of the law on insolvency (see Fig. 8). The provisions of the third law on bankruptcy have significantly enhanced the possibility to appeal in the course of conduct of bankruptcy cases, for instance, there has been introduced the right of representative of owners of debtor enterprises to appeal against the claims of creditors and stipulated the possibility to appeal against the determinations issued in the course of bankruptcy proceedings basing on the results of disputes between the parties participating in the case.

At the same time, it should be noted that out of the total number of appellations and complaints submitted in the course of the conduct of bankruptcy cases 60 per cent of such appellations and complaints concerned the determination of the amounts of creditors’ claims. Therefore, *in spite of the declared purposes, the third law on insolvency retained a rather wide field for different interpretations of principles set forth with respect to the determination of creditors’ claims.*

The trends noted above were also characteristic in 2004. According to the data presented by the RF Ministry of Economic Development and Trade, as on September 1, 2004, the number of bankruptcy cases examined by Russian arbitration courts declined two times (to 48833) as compared with the respective figure registered in 2002. As it has been

noted above, a sharp decline (including the data for year 2004) of the number of bankruptcy claims against debtors was to a significant extent related to the “freezing” of the state activity as concerns the initiation of bankruptcy procedures since March of 2004 because of the administrative reform and the necessity to provide budgetary funds for the payment of bankruptcy procedures related costs. At the same time, about 50 per cent to 60 per cent of the consolidated debts of enterprises undergoing the bankruptcy procedures are due to the state. The changes in this situation (including the solution of administrative, legal, and financial issues) *will result in a sharp increase in the number of bankruptcies*.

In particular, this also means that in the near future the state will become the major “contractor” of bankruptcies and the issues relating to the criteria of initiation of such cases become extremely urgent at present. For instance, in the autumn of 2004 there started a heightened discussion concerning the plans of FTS to initiate bankruptcy of 170 “strategic” enterprises related to the defense and military complex and double purpose technologies. At the same time, in the process of transfer of powers in the sphere of bankruptcy from FSFR to FTS the latter refused to accept the elaboration of expert reports about the presence or absence of indications of deliberate bankruptcy. The extreme statements in this discussion implied that FTS wished to initiate artificial bankruptcies for the purposes of redistribution of property⁸⁸.

The problem of fraudulent and deliberate bankruptcies remained urgent in 2003 and 2004. According to the data presented by FSFR, in 2002 there were revealed 457 cases of deliberate and fraudulent bankruptcies and 417 such cases in 2003. It should be noted that in 2002 through 2004 there were initiated about 300 respective criminal cases, however, only 20 were examined in courts, and only 12 of them resulted in convictions. Due to the introduction of more complicated procedures governing the initiation of bankruptcy proceedings and restriction of the discretion of bankruptcy commissioners, since 2003 the number of “contracted” bankruptcies (according to the FSFR estimates) has significantly declined in 2003 and 2004⁸⁹; however, there were implemented corporate procedures (withdrawal of assets is carried out prior to bankruptcy). This problem is rather urgent as concerns state unitary enterprises, especially those included in yearly privatization plans. According to certain estimates, up to 10 per cent of such state unitary enterprises (included in privatization plans) go bankrupt within a year, while 70 per cent to 80 per cent of assets of such enterprises are withdrawn prior to bankruptcies⁹⁰.

As a result, as it is demonstrated by the practices of 2003 and 2004, since the enactment of the provisions of the new law on bankruptcy the role of this institution in the sphere of seizure of assets has significantly declined. However, it means only that the *respective “burden” was transferred* to the traditional market of corporate control (hostile takeovers via purchase of shares or other actions related to the company’s shares) and the sphere of executive proceedings. According to the provisions of the new law, the creditor has the right to submit the bankruptcy claim against the debtor only in the case the law enforcement officers failed to exact the

⁸⁸ Bankrotstva i skandaly (Bankruptcies and scandals) // Sliyaniya i pogloshcheniya. 2004. No. 12. P. 15.

⁸⁹ According to the FSFR data for year 2001, after the “sifting out” of the cases of absent debtors there remained about 21 000 “substantive” cases, one third of which (i.e. 7 000) were of “contracted” nature. (An interview with T. Trefilova – Kommersant, 2004, February 13).

⁹⁰ Pervyi god deistviya novogo zakona o bankrotstve: rezultaty i perspektivy. (The first year of enforcement of the new law on bankruptcy: results and perspectives). The materials of the conference of the RF Commerce Chamber, the RF SAC, and the RF State Duma, February 24, 2004.

debt. There is formed a situation, where all assets of a company may be purchased via bailiffs without initiation of the bankruptcy proceedings⁹¹.

Below, there are presented certain *general evaluations of the impact of the insolvency institution on the demography of organizations* (see Table 7)⁹². On the whole, about 145 thousand of organizations ceased their operations in the period from July 1, 2002 till July 1, 2004; at the same period there were created almost 600 thousand of organizations. In 77 per cent of these cases, the cessation of operations of legal entities related to their liquidation and only in 20 per cent of cases – to reorganization. In the majority of cases, the liquidation of organizations (72 per cent of the total number of such organizations) was related to bankruptcy procedures. *On the whole, in 2 years 4.7 per cent of the total number of organizations as on July 1, 2002, was liquidated via bankruptcy procedures.*

Table 7

Liquidations involving bankruptcy procedures

	Number of legal entities liquidated via bankruptcy procedures in the period:		The share of organizations liquidated via bankruptcy procedures in % of the number of organizations at the beginning of the period:	
	July 1, 2002 – September 30, 2003	October 1, 2003 – July 1, 2004	July 1, 2002 – September 30, 2003	October 1, 2003 – July 1, 2004
All legal entities	47 531	32 729	2,8	1,6
Limited liability companies	14 035	9 575	1,6	0,8
Joint stock companies (open, closed)	3 760	3 223	2,5	1,9
Production cooperatives	1 346	1 302	5,5	5,1
Unitary enterprises	241	228	1,7	1,4

As concerns the sectoral structure (basing on the data for the first ten months of 2004), the largest number of bankruptcies was registered in the sector of trade, public catering, and consumer services (what is not surprising taking into account the fact of the absolute quantitative domination of these enterprises). These enterprises were followed by agricultural and industrial enterprises. The significance of bankruptcy procedures in the course of liquidation of organizations depend on their *organizational and legal forms*: the bankruptcy processes were more intensive among production cooperatives and joint stock companies. The observed decline in the significance of bankruptcy procedures and liquidation of enterprises in the period from October 1, 2003 till July 1, 2004, is related to both a lesser duration of the observation period, and the fact that over all this period (in contradistinction to the first period) there was in force the third law on bankruptcy. Accordingly, in this period there was most clearly indicated the sharp reduction of practices of submission of bankruptcy claims against absent debtors. It should be noted that this decline of the role played by bankruptcy procedures and liquidation of enterprises were not proportional across the groups of legal entities depending on their organizational and legal forms. The less intensive use of bankruptcy procedures became the most significant for limited liability companies (in this group there were observed much more “abandoned” firms and eph-

⁹¹ See: Vyshegorodtsev I. Chto budet s bankrotstvami (What will happen to bankruptcies) // Sliyaniya I Pogloshcheniya, 2005, No. 1, p. 59.

⁹² For evaluations, there were used the data on the state registration of legal entities in the Single State Registry of Legal Entities carried out in 2002 through 2004 presented by the Russian Tax Ministry.

emerid companies) and least significant for production cooperatives and unitary enterprises.

4.3.3. Perspectives of modification of the institution of bankruptcy

The problem of protection of the rights of both debtors and creditors in the course of bankruptcy proceedings is of the principal importance as concerns the creation of incentives for investment activities of Russian enterprises. This problem should be settled in an integrated way in the framework of contractual law, bankruptcy proceedings, tax regulation, and executive proceedings.

However, it should be noted that there are no ideal laws, which could settle the problem in a moment, instantly. Experts in the field of law note that in foreign countries regulation of insolvency is a most dynamically developing sphere of law, since the economies of states require constant modernization of the respective provisions. Moreover, a similar approach is the objective necessity for the transitional economy of Russia.

In about one year after the enactment of the new law on bankruptcy there was started a work on its improvement and, what is equally important, the harmonization of other legal acts with this law. For instance, in 2003 and 2004, the RF Government approved on the whole the following areas of modification of the bankruptcy law presented by the RF Ministry of Economic Development and Trade and the RF Justice Ministry:

- improvement of the criminal and administrative legislation and bankruptcy legislation as concerns the responsibility for offences and crimes related to bankruptcy;
- determination of the procedures and terms of participation of the authorized agencies in the procedures of financial rehabilitation and amicable settlement of bankruptcy cases;
- modification of the law on bankruptcy as concerns the more clear definition of current payments, requirements pertaining to the bankruptcy commissioner, consequences of the dismissal of the bankruptcy commissioner, the status of compensatory funds and mutual insurance societies, the procedures governing the sale of property in the framework of financial rehabilitation or external administration, development of self-regulation;
- creation of the legal framework of the procedures of bankruptcy, financial rehabilitation, and amicable settlements;
- introduction of the option of the amicable settlement in bankruptcy cases, where the Russian Federation is the major creditor;
- expansion of the circle of legal entities subject to bankruptcy procedures;
- harmonization of the issues of priority of satisfaction of creditors' claims with the bankruptcy legislation currently in force;
- protection of property from criminal offences, prevention of crimes and offences via the improvement of provisions of the RF Criminal Code and RF Code of Administrative Offences setting forth the responsibility for offences related to bankruptcy procedures and pre-bankruptcy operations.

The same guidelines were indicated in the Program of social and economic development of the RF in a medium term outlook (2005 through 2008) worked out by the RF Ministry of Economic Development and Trade and being elaborated in November of 2004 through January of 2005. In January of 2005, the RF Government approved a package of draft laws aimed at the improvement of the legislation on bankruptcy and introducing amendments to the law "On insolvency (bankruptcy)," the RF Criminal Code, the RF Code

of Administrative Offences, the RF Tax and Budget Codes. Among the approved innovations, there should be noted the following:

- more precise definition of provisions of the RF Criminal Code concerning premeditated (deliberate creation of insolvency by the manager or owner of an enterprise for personal gain) and fictitious bankruptcies, as well as and mala fide actions taken in the course of bankruptcies (for instance, concealment of information about property liabilities of the debtor);
- toughening of criminal responsibility of managers (the term of imprisonment for premeditated bankruptcy was increased from 3 to 6 years);
- introduction of responsibility for obstruction of actions taken by bankruptcy commissioners;
- introduction of provisions permitting FTS to grant debtors deferrals or respites with respect to tax arrears for periods up to 1 year in the case of amicable settlements in the RF Tax Code (at present the state has no rights to grant such deferrals, what brings to naught the possibility to start the procedures of financial rehabilitation);
- introduction of responsibility of self-regulating organizations (SRO) of bankruptcy commissioners, including material responsibility, as concerns the conscientious of commissioners and correctness of bankruptcy proceedings.

In perspective (in 2005 and 2006), it is envisaged to introduce such innovations as subsidiary property liabilities of debtors' managers and imposition of the burden of proof of innocence on managers (for instance, in the cases where withdrawal of assets from bankrupt enterprises was ordered by owners). At present, creditors should prove in courts the unlawfulness of transactions provoking bankruptcies. Among other problems, which should be settled, there are the following: dispute of transactions in the framework of bankruptcy cases, detection of interdependent persons in bankruptcy proceedings, bankruptcies of agricultural organizations, broker companies, insurance firms, private pension funds, etc⁹³.

A separate problem is the bankruptcy of so called strategic enterprises. Although official lists of strategic enterprises intensively change every year, the total number of such enterprises traditionally remains at a high level, and it is hardly adequate to real requirements as concerns such restrictions. According to evaluations presented by the RF Ministry of Economic Development and Trade, some of these enterprises are "phantoms" absent even in the register of legal persons, while the share of the state in such enterprises makes 4 per cent. In this connection, the primary objective is to shorten this list. However, the more precise definition of the lists of strategic enterprises and more detailed determination of respective bankruptcy proceedings are traditionally delayed, although the lack of clear procedures apparently will not permit to apply measures envisaged in the legislation on bankruptcy to this group.

A special problem is so called subjects of natural monopolies in the fuel and energy complex. According to the law "On bankruptcy" being in force since January 1, 2005, the law "On the specifics of insolvency (bankruptcy) of subjects of natural monopolies in the fuel and energy complex" should be abolished and the provisions of item 6, article IX, of the law "On bankruptcy," which stipulate respective procedures applicable to the subjects of natural monopolies, enacted. In December of 2004, the State Duma Property Committee recommended that the law "On the specifics of insolvency (bankruptcy) of subjects of natural monopolies in the fuel and energy complex" should be in force until July 1, 2009.

⁹³ There were used the materials presented at the official web site of the RF Ministry of Foreign Development and Trade (www.economy.gov.ru), PD Kommersant of January 20, 2005 (www.kommersant.ru), and the LIN.RU project (www.lin.ru).

According to the Committee, this time horizon is needed because of the estimated terms of reorganization in electrical power engineering and natural gas industry.

The planned changes seem to embrace a rather wide range of flaws and gaps of the law on bankruptcy and in the case these amendments are approved, they may significantly improve the quality of the new law. However, there remain significant possibilities for further modification of the law.

First, in the framework of the third law on bankruptcy there remains the risk of rise in corruption due to the “trade” with the state votes as concerns the decisions taken at the meetings of creditors, as well as the risk of higher activity of local governments as concerns hidden nationalization and redistribution of enterprises’ property in favor of third parties. From the authors’ point of view, in the cases of state participation in bankruptcy proceedings concerning large economically and socially important enterprises it would be feasible to envisage the creation of Boards of authorized representatives of the state in order to ensure the balanced representation of different state interests.

Second, direct participation of the state in amicable settlements may significantly increase the risk of bias in favor of certain enterprises. In this connection, it is necessary to create a transparent and exhaustive legal framework (the Tax and Budget Codes) of the terms, on which the state may participate in amicable settlements.

Third, as concerns the initiation of bankruptcy proceedings, at present the state (the executive authorities) is guided by the principles, which are non-transparent not only for market operators, but for the executive authorities as well, what sharply increases investment risks due to the unpredictable results of application of bankruptcy proceedings with respect to concrete enterprises. It is necessary that the state works out its own criteria of initiation of bankruptcy proceedings with respect to debtor enterprises, which would concern only a limited number of industrial enterprises and could be consistently implemented in practice.

Fourth, the problem of state debts to enterprises, for instance, as concerns the payments related to state procurement, remains partially unsettled. In a number of cases, this resulted in enterprises’ indebtedness to budgets. It seems feasible to supplement the law on bankruptcy with provisions stipulating that authorized agencies or local government should have no right to submit to arbitration courts creditor claims on behalf of the Russian Federation, RF subjects, or municipal entities in the case the debtor has debtor indebtedness to the budget of the respective level. However, this way is possible only on condition that interbudgetary liabilities are fully met, otherwise there are inevitable conflicts, where local governments might claim that they could not make respective payments to enterprises due to delayed and (or) not full transfers from the federal budget.

Fifth, the new law on insolvency, similarly to the previous one, contains provisions on pretrial rehabilitation, which have not been implemented in practice yet (article 31). Although the new law on bankruptcy does not contain provisions envisaging that the state should include the respective expenditures in the federal budget does not mean that such expenditures should not be preliminary estimated in the budget. Therefore, there arises the problem of evaluation of the minimal amount of expenditures to be included in the budgets for the purposes of pretrial rehabilitation. Besides, there should be determined the limited group of enterprises, with respect to which the state is ready to carry out the pretrial rehabilitation in a certain unfavorable situation and, what is very important, there should be preliminary determined the amount of liabilities of the debtors to the state in the course of pretrial rehabilitation.

Sixth, the new law on insolvency introduces the new bankruptcy procedure – financial rehabilitation (Section 5, articles 76 – 92). This procedure may become an important

tool of rehabilitation and reform of enterprises under control of their owners (including the state as a shareholder). At the same time, it should be taken into account that this procedure may be introduced by arbitration courts without consent of creditors (items 2, 3 of article 75, item 1 of article 80). However, at the same time the plans of financial rehabilitation and the schedule of debt repayment prepared by owners should be approved by the meeting of creditors. It is necessary to correct the following principle flaw of the law: it fails to stipulate, *what possible decisions may be taken in the case the meeting of creditors refuses to approve the plan of financial rehabilitation (what is highly probable in the case the meeting of creditors is against the introduction of this procedure).*

Seventh, in the course of bankruptcy proceedings the exchange of enterprises' debts for the shares transferred to creditors could become a rather efficient mechanism aimed at the preservation of businesses of large economically and socially important enterprises. The previous law on insolvency did not determine the questions of additional issues of shares. However, this mechanism was applied in practice: in certain cases creditors received shares in newly created enterprises (to which there were transferred assets of debtor enterprises cleared of debts), and in other cases additionally issued shares of debtor enterprises. As concerns the regulation of additional issues in the framework of external management, in accordance with the new law on insolvency shareholders should have the preferential right to purchase the placed shares, the placement should be carried out exclusively on conditions of closed subscription, while the payment for additional shares should be made only in money. However, *the law failed to paid attention to the situations, where the state is a shareholder.*

Eight, as concerns the sales of strategic enterprises in the course of bankruptcy proceedings, it is important to note the following provision of the new law on bankruptcy: in accordance with item 8 of article 195, bankrupt's creditors and the respective affiliated persons. Although the concept of this norm is rational, in the present Russian situation it may create a number of serious problems as concerns bankruptcies of large companies. In particular, as it is demonstrated by the practices of activities of antimonopoly agencies, the detection if person is affiliated or not is a labor intensive, disputable, and long process.

Ninth, there has not been yet settled the problems of integrated financial rehabilitation of several enterprises making technological chains of an industry or a region. In a number of cases, the successful rehabilitation of one enterprise may produce only a short time effect, since the inefficiency of operations of concrete enterprises may be primarily determined not by their internal problems, but the situations at their partner enterprises.

Tenth, one of the efficient forms of preservation of business may be the sale of the enterprises (the single property complexes) of organizations in the single company towns. The respective terms of sale the previous law set forth with respect to the buyer (article 137) were too burdensome; therefore this form was not widespread. More soft requirements to the buyer set forth in article 175 of the new law on insolvency (the requirement to keep not 70 per cent but 50 per cent of jobs, introduction of the time limit on this requirement (3 years), enhancement of the options to change the core activities of such enterprises) will permit to render the enterprises in single company towns more attractive for purchase as single property complexes.

At the same time, there persists the formality (non-economic character) of requirements to buyers. Indeed, mala fide buyers may insignificantly reduce the number of jobs and sharply reduce the average wages and salaries at the enterprise. In fact it may result in persistence or even an increase in the scale of "hidden unemployment." It seems to be also necessary to set forth the framework regulating the changes in the wage bills at enterprises, while enhancing possibilities to reduce personnel.

At last, it is necessary to more precisely define the specifics of bankruptcy of enterprises in single company towns (articles 168 – 176). The “modification” of the criteria according to which enterprises may be included in this category is rather arguable. Although these criteria of definition of enterprises were toughened, the formal approach here persisted. It would be feasible to use such criteria as the share of tax payments made by the enterprise in the total amount of taxes collected in the respective town, the fact of dominating position of the enterprise on the commodity market, etc. Besides, the new law on insolvency sharply reduces the possibilities to rehabilitate enterprises in single company towns because financial rehabilitation or external management may be prolonged for only one year (article 172), and the terms of even so insignificant prolongation have been toughened. At the same time, it should be noted that enterprises in single company towns are probably the most difficult object of financial rehabilitation.

Special regulation is required with respect to the problem of protection of minority shareholders in the process of bankruptcy proceedings. This problem is even more urgent in the cases, where the state is the largest creditor of the enterprise.

From the authors’ point of view, as concerns bankruptcy there is necessary the whole range of innovations in the sphere of enforcement and technical procedures of conduct of bankruptcy cases. The same is true with respect to the procedures governing initiation of bankruptcy proceedings; the order of appointment and activities of bankruptcy commissioners; the procedures governing financial rehabilitation, external management, and bankruptcy proceedings; regulation of amicable settlements; the procedures governing bankruptcies of absent and liquidated debtors. It would be feasible to amend article 224 of the law “On bankruptcy” by adding a provision, in accordance with which creditors should also have the right to submit bankruptcy petitions with respect to liquidated debtors. At the same time, as it has been demonstrated by the practice of bringing of culprits to civil, administrative, and criminal responsibility for offences of the bankruptcy legislation, the respective provisions of article 10 of the law “On bankruptcy,” as well as articles 14.12, 14.13 of the RF Code of Administrative Violations and articles 195 – 197 of the RF Criminal Code practically have not been enforced; in this connection all these provisions should be radically and conceptually revised in stead of being subjected to fragmented changes⁹⁴.

It is also necessary to note that in spite of a number of apparent achievements, the new law on insolvency has principally failed to settle *a number of principal problems being outside the framework of technical procedures*.

First, since the state is granted the same rights as other creditors, it will require the creation of a respective infrastructure necessary for representation of its interests. It is unlikely that the necessary resources will be available. Therefore, while at several hundreds of enterprises the progress and control of bankruptcy proceedings may be really improved, at the majority of other enterprises these actions will result in an increase in corruption and interest to the buying up of “administrative resources.” The latter is very probable also because the state has the better possibility to initiate bankruptcy proceedings: it is not required to confirm its claims in courts.

Second, more tough terms, on which there can be initiated bankruptcy proceedings will not result in a significant restriction of the processes of redistribution of property. It is an objective process and even if it was not reflected in the law on joint stock companies it will continue, but now in the framework of executive proceedings.

⁹⁴ For details see: Radygin A., Swain H., Simachev Yu., Entov R. et al. Institut bankrotstva: stanovleniye, problemy, napravleniya reformirovaniya (The institution of bankruptcy: it’s rise, challenges, and reform avenues). M., IET – CEPRA, 2005.

Third, in the case there are set specific features of insolvency in certain sectors, there originate prerequisites for dumping of debts to such sectors. At the same time, if it is not done, there increase social costs. Besides, the issue of classification of enterprises as natural monopolies, enterprises in single company towns, or strategic enterprises is rather complicated.

Fourth, A considerable part of proposals concerning the reform of the legislation resulted from the insufficiently developed enforcement infrastructure (dependence of arbitration courts of local governments, the professional level of judges, etc) rather than the imperfection of the regulations being in force at that time. One of the most important problems in this sphere is the dependence of arbitration courts on local authorities and insufficient level of professional skills of the judges required to examine complex economic disputes.

Fifth, a significant part of changes in the legislation on insolvency resulted from overestimation of certain problems; therefore, some provisions of the new law on insolvency have not been in demand yet.

Important, although rather distant prospects are related with the improvement of judicial practices at large. For instance, in the interests of protection of enterprises from mala fide interception of control over them (or a part of their assets) via bankruptcy proceedings it is necessary to develop the practice of enforcement of article 10 of the RF Civil Code (misuse of a right) and envisage both the transparency of judicial procedures, and responsibility of the judges. It is necessary to make additional efforts in order to develop self-regulating organizations of bankruptcy commissioners and nongovernmental enforcement institutions, including those applicable to the sphere of bankruptcies.

Accordingly, time is needed in order to form an adequate infrastructure and its adaptation to new legislative regulations. As it turned out, the institution of bankruptcy has been in demand as a tool of redistribution of property. In this connection, speaking about large enterprises, it is more often applied with respect to potentially attractive businesses. Recently, there have been observed significant shifts as concerns the protection of the rights of minority shareholders. Therefore, for a long time yet bankruptcy will remain a tool of settlement of different corporate problems: from protection of the rights of managers from owners to carrying out hostile takeovers. Therefore, there can not be excluded the possibility of further expansion of the practices of bankruptcy of large potentially attractive enterprises. Most probably, in the nearest future the ambiguous impact of bankruptcies on economic development will be even more apparent.

4.4. Problems of competitiveness of the Russian stock market

An indispensable condition of competitive economy is competitiveness of its market institutions. In this case, competitiveness of institutions is regarded here as “correspondence of formal and informal institutions of the country – legislation, behavioral norms and traditions, exercising power, range of discretion, degree of confidence to requirements of production of competitive goods and services”⁹⁵. The stock market may be considered as one of institutions of the market economy, which competitiveness has an overall impact on the country’s national economy.

The stock market may be regarded as an aggregate of specific segments, to dominate which different structures are engaged in competition. By a market niche is meant a demand for securities on the part of different groups of investors or offering securities on

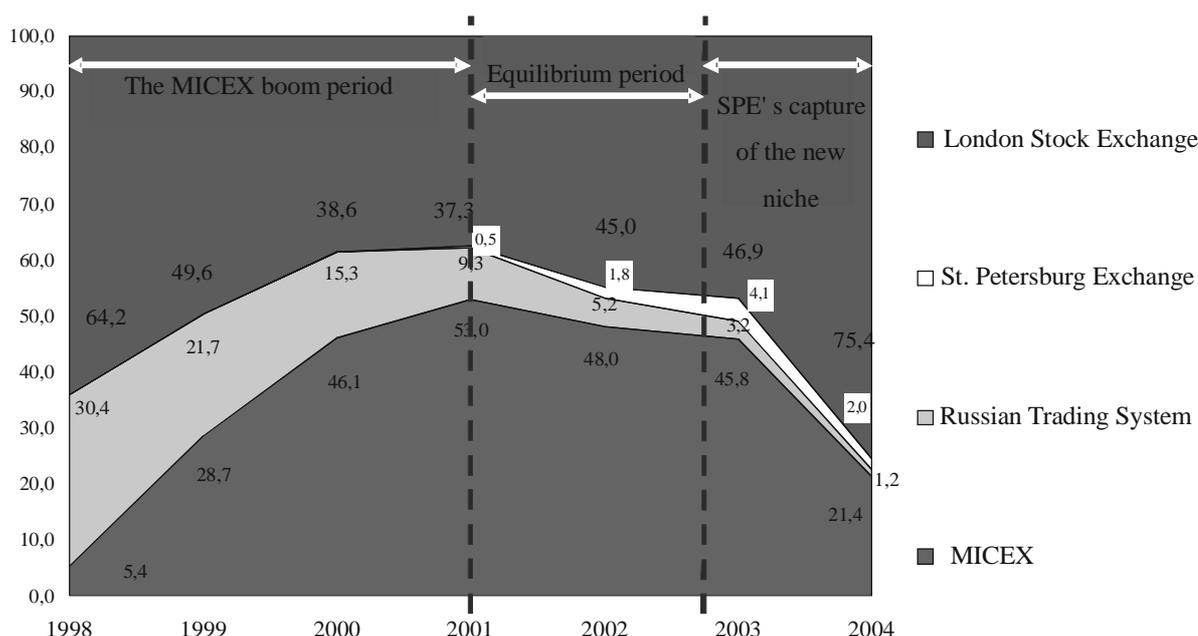
⁹⁵ Yasin E.G. Report at the 5th International Conference of the the State University – Higher School of Economics “Competitiveness and Modernization of the Economy”. April 6, 2004. Internet www.hse.ru.

the part of a certain group of issuers. An analysis had been made by the example of exchanges, which play the leading role among the infrastructure organizations, – a group of companies of the Moscow Interbank Currency Exchange (MICEX), Russian Trading System (RTS), and foreign organizers of trade with the stock of Russian joint-stock companies in the form of depositary receipts – these are London Stock Exchange (LSE), German stock exchanges, and the New York Stock Exchange.

Note that, in itself, the presence of competition of trade organizers' services on both international capital market and domestic stock market is an important instrument contributing to raising the quality of those services and reducing the operational costs of market participants .

4.4.1. Russian issuers' stock market

The stock market of Russian issuers encompasses the two main segments: circulation of stocks issued directly by Russian companies, and the market of depositary receipts for the above stock issued by depositaries abroad. To analyze internal mechanisms of the stock market development of Russian issuers, we may single out three phases of its evolution, during which considerable changes took place concerning the competitors' standing on the market (Fig. 9)⁹⁶.



Source: Stock exchange data.

Fig.9. The proportional weights of exchanges in the volumes of trading with the stocks of Russian JSC

The first period spans 1998–2001. This period is characterized by growth of the share of MICEX (Moscow Interbank Currency Exchange) as organizer of trade with the

⁹⁶ Here and in what follows the volume of exchange trading is calculated by totaling the stock turnovers on Russian exchanges and depositary receipts turnovers on foreign exchanges (in USD million).

stock of Russian JSC=s from 5,4% in 1998 to 52,0% in 2001. Such growth occurred against cutting of RTS market share from 30,4% in 1998 to 9,3% in 2001, and also the share of London Stock Exchange from 64,2% in 1998 to 37,3% in 2001.

The second period refers to 2002–2003. It may be characterized as a period of temporary balance of forces of the competitors. In those years, the share of MICEX, as organizer of trade with the stock of Russian issuers, decreased, but negligibly – from 52,0 to 45,8%, while the share of LSE (London Stock Exchange) increased from 37,3% in 2002 to 46,9% in 2003. At the same time, RTS competitiveness at the stock market noticeably weakened, the exchange share in the market decreased from 9,3% in 2002 to 3,2% in 2003.

The third period of evolution of the stock market of Russian JSC began in late 2003 and was characterized by qualitative changes in the balance of forces on the market of services of organizers of trade with the stock of Russian issuers. In 2004, the share of LSE on the stock market of Russian JSC=s reached 75,4%, the share of MICEX decreased to 21,4%. The RTS share, as organizer of trade, reached the critical level 1,2% of the volume of exchange trade.

Reasons for such profound alterations in the balance of forces on the stock market of Russian issuers can be found in new priorities of issuers and investors in the capital markets, which caused changes in the balance of supply and demand for the stock of Russian JSC=s.

The priority rates of volumes of exchange trade with the stock of Russian companies on MICEX during the **first period** is explained by emergence of an interest of new owners of the Russian largest companies, which received control over them during the privatization, in establishing a liquid stock exchange market of those companies, as an instrument of building up their capitalization to the market level, appearance on the Russian stock market of a number of domestic speculative investors, after the crisis of 1998, and introducing modern technologies of the exchange trade and settlements on MICEX.

Based on the data of “Russian economic barometer”, since the mid-1990s, 3 stable trends could be observed in the structure of privatized companies’ property: passing of a title from workers to managers, from insider (of the same management) to outsiders (financial groups and non-resident), and from the state to private persons. In 1995–2003, the share of insiders decreased from 54,8 to 46,6%, and outsiders – increased from 35,2 to 44,0%⁹⁷.

The privatization gave rise to active development of extra-exchange trading with stocks, within the frame of which buying the stock of privatized companies had been carried out in regions from their employees and from the citizens, who received stock in exchange for vouchers from the financial intermediaries acting in interests of the outsiders and companies’ management. The development of extra-exchange market gave an impulse to growth of volumes of stock exchange trade, where each exchange occupies its own niche. On MICEX, brokers bought small blocks of stock and sold them, after consolidation, via RTS (in currency) to non-residents, including the off-shore companies established by the Russian participants of the market.

In 1999, an inter-depositary interaction (“bridge”) had been organized between the settlement depositaries of MICEX and RTS, which allowed to noticeably facilitate the counter flows of shares between the Russian and foreign markets. “High” and “low tides”

⁹⁷ From the report of R. Kapelyushnikov “The Impact of Property Concentration on the Economic Activity of Industrial Enterprises” at the international conference “Socio-Economic Transformation in CIS Countries: Achievements and Problems”, organized by IET on September 13-14, 2004.

of shares on the Russian market occurred in accordance with clearly defined regularities. Rise in prices of shares, including the depositary receipts of Russian issuers on global markets, caused additional demand for the stock of Russian issuers. To satisfy the demand, Russian brokers bought “blue chips” on MICEX, and using a “bridge”, withdrew packages from MICEX settlement depositary to RTS settlement depositary. Then, the shares were sold in RTS or the extra-exchange market, and moved abroad. On the other hand, in falling of prices on global markets, the shares of Russian issuers returned, in the same way, to the MICEX settlement depositary and were sold on exchange in small packages.

Changes in the behavior of big business, which followed the privatization, also contributed to the development of domestic capital market. During the 2000, as far as the economic efficiency had grown, an interest of the largest privatized companies increased in formation of long-term development strategy and entering the strategic alliance with transnational corporations⁹⁸. For Russian business, the condition of forming such alliances on competitive terms was - bringing the market capitalization of the companies in its possession to a level equal to intrinsic value of shares. Oligarchs wished to operate on Russian exchanges. Access to circulation on MICEX and RTS of the companies' blocks of stock, amounted to several percent of the total volume of issuance, made possible to get a quick growth of companies' capitalization. In the following, selling at the market price of big packages to outsider investors would bring holders of controlling stakes a real compensation for the “privatization risks” and possibility of transformation of “fictitious” stock capital to its more real liquid forms. It is to be noted that the usage of similar strategies should not be regarded as negative phenomenon. This is a regular and typical (for transition economies) process of stage by stage building an efficient private business.

As an illustration of strategies of accelerated building up the capitalization, data are given in *Fig. 10* on the proportion of capitalization and the share of “blue chips”, circulating on exchanges, in the total volume of their issuance, as of 2003.

The rate of effective capitalization of most liquid shares, excluding the shares of the RAO UES Russia was, in 2003, in inverse ratio to proportion of free circulating shares (reserved here for trading in the settlement depositary of MICEX). Most capitalized are issuers (primarily oil companies), who had insignificant participation of free circulating blocks of shares on the exchange: such were, for example, “YUKOS” – 0,7% of shares, “Surgutneftegas” – 1,2%, “LUKOIL” – 2,2% and mining-and-metallurgical integrated works “Norilsk Nickel” – 1,4% of shares.

⁹⁸ At present such alliances began to be formed, while at the end of the 1990s – the early 2000s such plans were only conceived. As an example of an alliance between Russian and foreign business may be mentioned “Severstal-Group”, which general director, A. Mordashov, told in an interview to “Vedomosti” of an intention to “to establish, on “Severstal” basis a global mining-and-metallurgical company ...” “with Russian control” (Vedomosti. October 21, 2004). Another example is acquisition of a big block of stocks of the JSC LUKOIL by ConocoPhillips. An illustration of Russia's big business intention to stand equal in such alliances is the statement of LUKOIL's vice-president and the company's board member L. Fedun that LUKOIL's managers should never sell their shares, not to loose control over the company (Vedomosti. October 25, 2004).

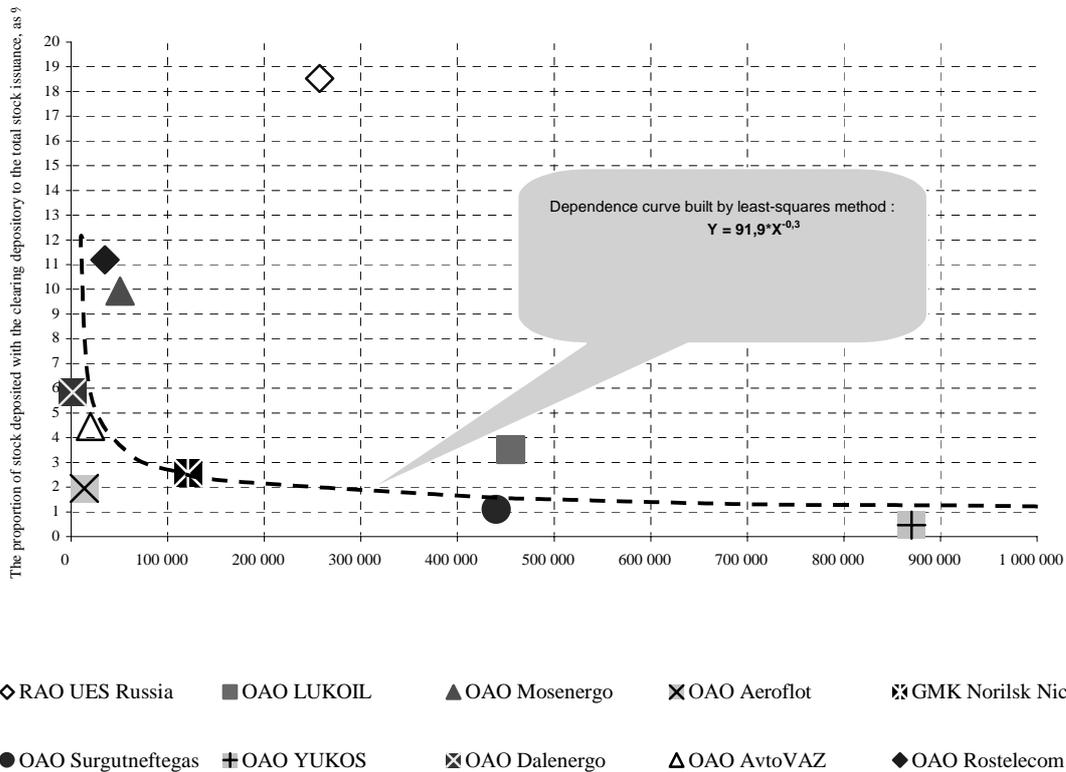
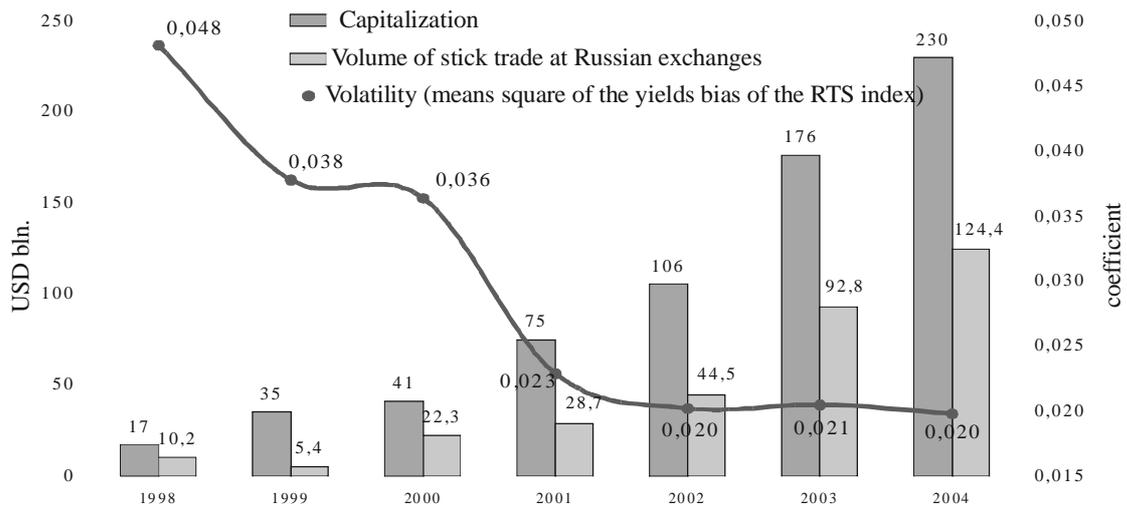


Fig. 10. Stock capitalization and their proportion in free circulation (according to MICEX data for January–September 2003)

Fig. 11 shows the data of growth of Russian companies' capitalization and the volumes of trade on Russian exchanges.



Source: Calculated according to the data of MICEX, RTS, and St. Petersburg stock exchanges.

Fig. 11. Capitalization, liquidity and volatility of the Russian stock market

Enhancing the capitalization of Russian companies and increase in the volumes of trade on the stock exchange market occurred simultaneously. And still the capitalization grew in a faster pace than the volumes of trade, which met the needs of the largest issuers interested in increasing the cost of their business. In 1998–2004, the capitalization of Russian companies increased from USD 17 bn to USD 230 bn or 13,5 times. The volume of trade with shares on Russian exchanges (MICEX, RTS, St. Petersburg stock exchange) increased from USD 10 bn in 1998 to USD 101.2 bn 2004, i.e. 10 times. To a large extent, lessening of risks, changed by index of standard deviation of relative price changes of assets contributed to growth of the Russian stock market, especially in the early 2000s.

Striving of big business to increase the capitalization meant arising on Russian exchanges, primarily on MICEX, an additional demand for “blue chips” on the part of privatized companies and their related financial intermediaries. Such transactions led to raising the share of MICEX on the stock market of Russian companies.

The third factor of growth of demand on the domestic stock market in 1998–2001 was emergence on the market of domestic small investors, inclined to short-term and speculative equity in conditions of increased risks. The above became possible because of quick growth of earning power of the Russian issuers' equity investment, happened in 2000 after two years of negative effective yield of shares as a result of crisis of 1998. Though, in 1998, proceeding from its annual average the value the RTS index resulted in negative yield amounting to -54,0% annualized, and in 1999 to -46,2% annualized, in 2000, the earning power of investment in this index made up +99,9%.

An important growth factor, in 1998–2001, of the share of MICEX in the market, as compared to RTS and LSE, became implementing of new technologies of exchange trade and settlements. A project had been implemented on the exchange increasing the number of those involved in exchange trade by means of using the Internet technologies. Using Internet, small investors, being the clients of brokers, got a chance to participate in the exchange trade on a real-time basis, to receive information about the course of trading and on their own to make requests for purchase and sale of papers, which, via interface with broker, were promptly entered in the trading system. According to MICEX, 70% of the exchange transactions are performed via Internet. At present, the Internet trading systems have been developed on RTS and MICEX in equal proportion, but the structure, which succeeded to occupy the niche earlier found itself in a more valued position.

MICEX became a leader on development of the electronic document management between participants of the stock exchange market. After the crisis, considerable demand arose (on the part of investors) on the stock market, concerned with granted by MICEX guarantees of settlements on “delivery against payment” (DAP) terms with preliminary depositing securities and funds reservation by the participants of trade. All this helped MICEX occupy a new niche on the stock market, where investors dominate with ruble demand for shares, interested in settlements on DAP deals.

Thus, during the first period of the development of the stock exchange market MICEX success had been achieved due to more prompt response to arising an additional demand for the stock of Russian JSC=s on the part of the companies' management, the financial groups interested in growth of their companies' capitalization, and small domestic investors inclined to short-term speculative transactions⁹⁹.

⁹⁹ According to the head of FSFM O. Vyugin in 2005, “on the structure of investors the market ... has not considerably changed for the last five years”; “according to different estimates, about half of the market participants – are foreign investors, next are Russian investors, who earn money by short-term operations”, “the proportion of conservative institutional investors is not too large – 10%” (see: Vyugin O. Uncertainty hampers to take decisions // Vedomosti. 2005. January 31).

However, by its nature, the new sources of demand for the stocks of Russian companies were short-term. The purchase of stock by management could not be everlasting, the volumes of such transactions decreased with concentration in the hand of those persons controlling stakes. Financial groups and other holders, interested in original increasing the capitalization, sooner or later will sell their packages to strategic investors. Meanwhile, the joint stock companies that became transnational corporations will inevitably go to global capital markets to maintain their competitive ability. As a rule, the resources of domestic speculative investors are limited, and on their own cannot maintain the high demand for the stock of Russian companies.

At the **second stage** of stock market development – from the beginning of 2002 to October 2003 – a period of temporary balance became on the domestic stock market. It was characterized by absence of noticeable coming to the stock market of new categories of domestic investors, primarily physical persons and collective investors. The number of exchange trade participants practically did not increase over that period, basically, on the stock market they were represented by domestic investors inclined to short-term speculative strategies.

The RTS exchange continues to compete with MICEX for organized stock market with settlements on DAP terms, but, up until now there are no clear results of such competition. At the same time, RTS could find more effective solutions on the futures market and the stock market of the JSC Gazprom, succeeded to be the first in occupying new market niches. The lesson to be learned from the experience - most efficient strategies on the market are those directed to forming new market niches, rather than fighting for already occupied market segments.

At that time, the stock market of Russian companies and that of depositary receipts for those shares developed in parallel, complementing each other. It should be said that the Russian stock market fulfilled the functions of a liquidity and price formation center, while the external market allowed the foreign portfolio investors, who are not ready to bear “ruble” risks and legal risks of the country of issuers registration to invest, by means of depositary receipts, in shares. The arbitrage between the domestic and external stock markets raised attractiveness of both market segments in the eyes of financial intermediaries and investors.

The third stage of stock market development started from October 2003. Granting to Russia by Moody's agency of the investment rating led to forming a new niche on the stock market of Russian companies, concerned with additional demand for the stock of Russian issuers on the part of non-residents. This opened possibilities for investing in the stock of Russian companies large volume of means by conservative foreign investors, who are allowed, in accordance with the law, to form portfolios using only papers with the investment rating. But the investors were not ready to acquire shares with settlements in rubles, as ruble is not a recognized investment currency.

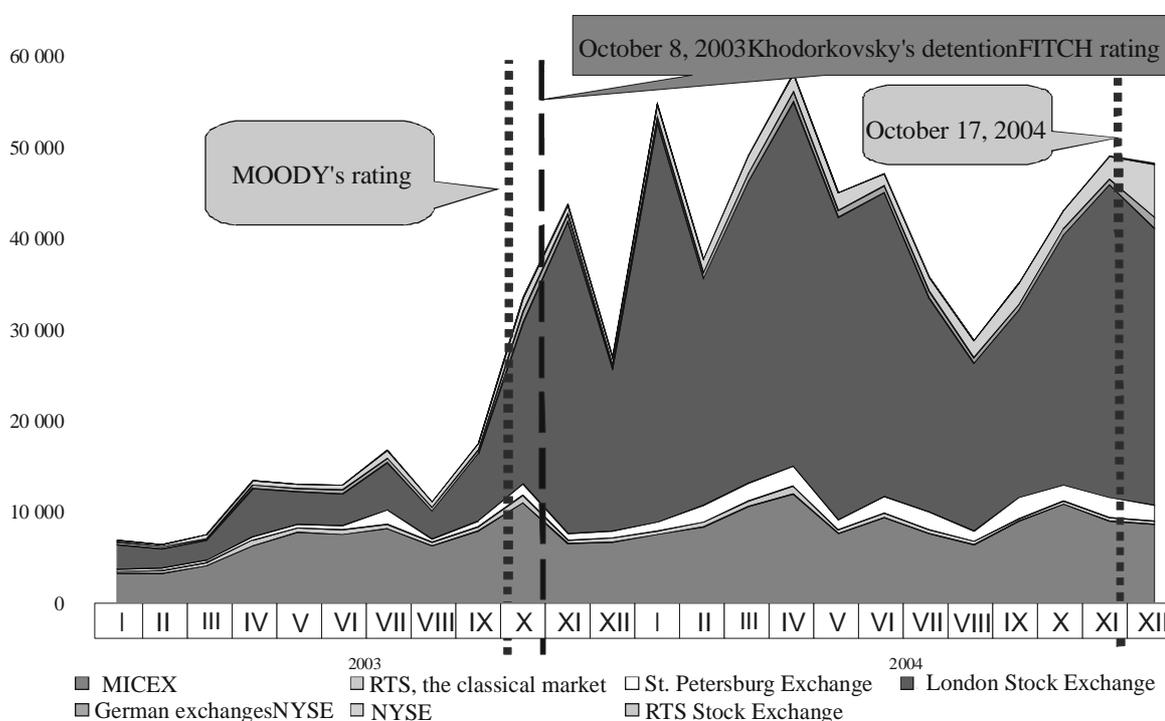
At this stage the Russian stock market needed taking the agreed decisions by market participants and regulatory bodies, which made possible to form the competitive strategy of Russian exchanges regarding additional demand for the stock of Russian JSC=s on the part of foreign conservative investors. Many years heretofore, the problems of forming an international financial center based on Moscow exchanges raised by the experts of the stock market and scientific community representatives¹⁰⁰. The idea of establishing such a

¹⁰⁰ See, for example: Mirkin Ya.M. The Securities Market of Russia: the impact of fundamental factors, forecast and development policy. M.: Alpina Publisher, 2002.

center suggested formation in Russia of a securities exchange market with settlements in foreign currency between its participants.

Unfortunately, the Russian stock exchange market could not make an adequate decision. Instead, a new federal law had been adopted in Russia on currency control and currency regulation, which retained for all non-residents, without restriction, a possibility to acquire the stock of Russian JSC=s in rubles and repatriation of profits from their sale, and also restrictions for residents in purchasing securities with settlements in foreign currency. The Russian infrastructure, that by the amount of risks and operational costs was substantially behind its competitors was not ready to serve the conservative foreign investors.

As a result, the new niche, concerned with additional demand for the stock of Russian issuers in currency, had been developed by London Stock Exchange. Fig. 12 shows, how changed changed, since October 2003, the balance of forces between the competitive stock markets of Russian JSC=s.



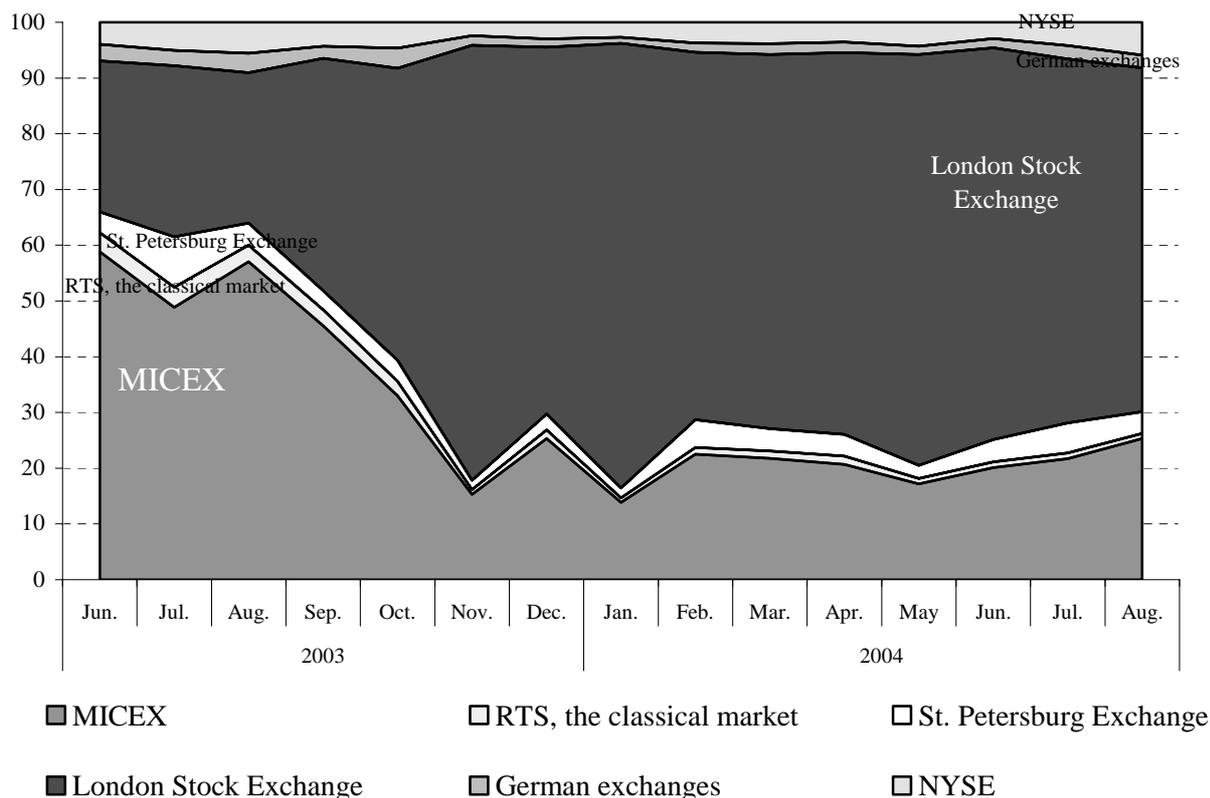
Source: According to the stock exchange data .

Fig. 12. Volumes of secondary exchange trade with the stock of Russian JSC=s (USD million)

The data of Fig. 12 contradict the prevailing opinion that under the influence of risks caused by Yukos case and the political and economical uncertainties in Russia, the Russian stock market moved to London. According to the volume of exchange trade with shares, the MICEX market retained positive dynamics. According to MICEX, in 2004, the volume of trade with shares on MICEX increased by 35% in comparison with previous year. At the same time, the volume of trade with receipts for the stock of Russian companies in London over the same period increased 4,7 times, which is explained by emergence on the market of new investors-non-residents, as a result of improvement of the investment climate in Russia.

The conflict around YUKOS oil company caused fears of non-residents in protectability of their property rights to the stock of Russian companies, but this factor did not cause capital outflow from the MICEX market to London, as proportion of non-residents, trading with the stock of Russian JSC=s on MICEX is negligible. The YUKOS case rather told on volatility of volumes of trade with depositary receipts on LSE, which, as is seen in Fig. 12, were changing significantly from month to month.

The more detailed proportional weights of exchanges on the stock market of Russian companies and depositary receipts on them are shown in Fig. 13.



Source: According to the data of MICEX, RTS, St. Petersburg, London, New-York, German and Berlin stock exchanges.

Fig. 13. The proportional weights of exchanges in the volumes of secondary trading with the stock of Russian JSC=s (%)

In 2004, the share of MICEX in the volumes of trade with the stock of Russian JSC=s varied from 14 to 26%, the share of LSE – from 58 to 80%. In December 2004, by volume of trade, the New-York stock exchange, where depositary receipts were circulated for the stock of only 6 Russian JSC=s, came close to MiCEX; the share of NYSE in the volumes of trade with financial instruments for the stock of Russian issuers reached 12% of the market, while MICEX share for the same month was 18,2%. On NYSE the main participants of transactions with ADR are institutional portfolio investors, NYSE advancement, in comparison with MICEX, is explained by their greater interest in receipts for the stock of Russian companies.

The successful marketing policy of the London stock exchange, which offered the market participants a new electronic system, to conclude transactions on anonymous basis, played the important part in forming a liquid market of depositary receipts for the stock

of Russian companies. However, influence of this factor should not be overestimated, as it cannot explain the following: of all the developing economies there were just the stock of Russian issuers that caused rapid increase of the volumes of trade with depositary receipts on LSE, the volumes of trade with which reach now about 70% of volumes of all transactions with depositary receipts for the shares of issuers from the developing countries on that exchange.

Depositary receipts for the shares of Russian companies proved to be the more practical financial instrument than shares themselves, which issuance and circulation is regulated by legislation of the Russian Federation. Acquisition of depositary receipts reduces the risks of private investors determined by possession of basic shares of Russian companies in conditions, where the Russian law and enforcement cannot ensure reliable protection of property rights. In the scheme of depositary receipts violator of rights of stockholders will have to do not with an isolated small investor, who often simply does not know Russian legislation, but with one of one of the largest world custodians, which represent the collective interests of owners of depositary receipts. The rights of owners of depositary receipts are protected not by Russian but the American legislation, which, among other things, provides for criminal responsibility of the officials of Russian joint stock companies before the USA for the crimes committed against owners of depositary receipts. In addition, participants of the market of depositary receipts make transactions with them according to the legislation and exchange rules of a foreign state, not to be subjected to restrictions laid in accord with the Russian legislation on exchange control and currency regulation for participants of the domestic securities market.

The problems of deterioration of competitive positions of the Russian exchanges on the stock market are clearly realized by the regulatory body – FSFM (Federal Service on Financial Markets). According to the head of this department, reorganization of infrastructure of the stock market, in particular, establishing a central depositary institution will contribute to overcoming those negative trends on the market, which will help raise the economic efficiency of operations and reduce the investors' operational risks¹⁰¹. FSFM promises to simplify IPO shares procedures on the Russian exchanges, including substantial reduction of the period of time between the state registration of stock issues and conducting auctions for their placement¹⁰².

However, such measures will hardly be able to radically change those trends. Going of Russian largest companies to global markets is an objective process, and changing the procedures of share issuance in the Russian legislation is not of vital importance here. Global exchanges are more suitable for non-residents, as allow to make deals with the securities of issuers from different countries, not assuming the risks of settlements in national currencies. It is known by experience that it is by far more difficult to win competitors in the niche that had already been occupied. Progressive advance of the domestic stock exchange market and its infrastructure is possible only if it will be supported by the long-term investment resources of domestic investors – investment and pension funds, insurance organizations, households and non-financial companies. For this, it is required to solve problems of Russian portfolio investors entering into international capital markets and establishing efficient systems for distribution of their products within Russia. In this area, no significant regulating activities have been observed as yet.

Therefore, since October 2003, a qualitative decrease in the share of local exchanges happened as organizer of trade with Russian “blue chips”, which raise a question

¹⁰¹ Vyugin O. Uncertainty hampers to take decisions // *Vedomosti*. 2005. January 31.

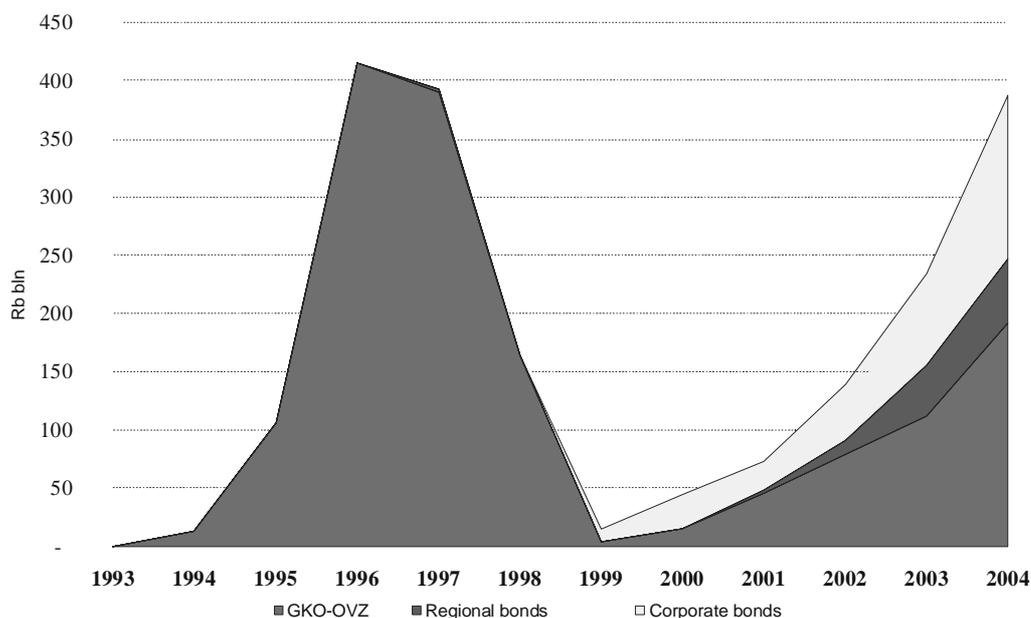
¹⁰² Kozitsyn S. Priglasheniye regulyatora FSFR khochet oblegchit provedeniye IPO v Rossii // *Vedomosti*. 2005. January 28.

about moving the centers of price formation of the stock of Russian issuers to global capital markets. The main problem of Russian exchanges on the stock market is absence of sufficient number of domestic investors oriented to long-range investments. In conditions where main investors on the market of Russian “blue chips” are non-residents, it is difficult for Russian exchanges to hold positions in competition with global markets. Movement for attraction of no-residents to the domestic stock exchange market is complicated by the fact that this niche has already been occupied by global exchanges. In order to convince non-residents to go from the global markets of the stock of Russian issuers, weighty arguments are needed, which are so far absent.

4.4.2. Problems of development of ruble bond market

In contrast to the Russian stock market, on which the Russian exchanges could not form in 2002 new significant niches, since 2001 the ruble bond market experiences a period of rapid growth. Development of the market of regional and corporate bonds is recognized as one of major successes of MICEX for the past years. Using the market of corporate bonds, the Russian exchanges for the first time realized their potential for funding real sector of economy. In 2000–2004, by placing corporate bonds, Russian companies drew from the market over USD 10 bn of investment resources.

The scales of a new segment of the Russian market reached, and for some parameters exceeded, the indices of GKO-OФЗ market in the period of its prosperity, which is seen in Fig. 14, 15.



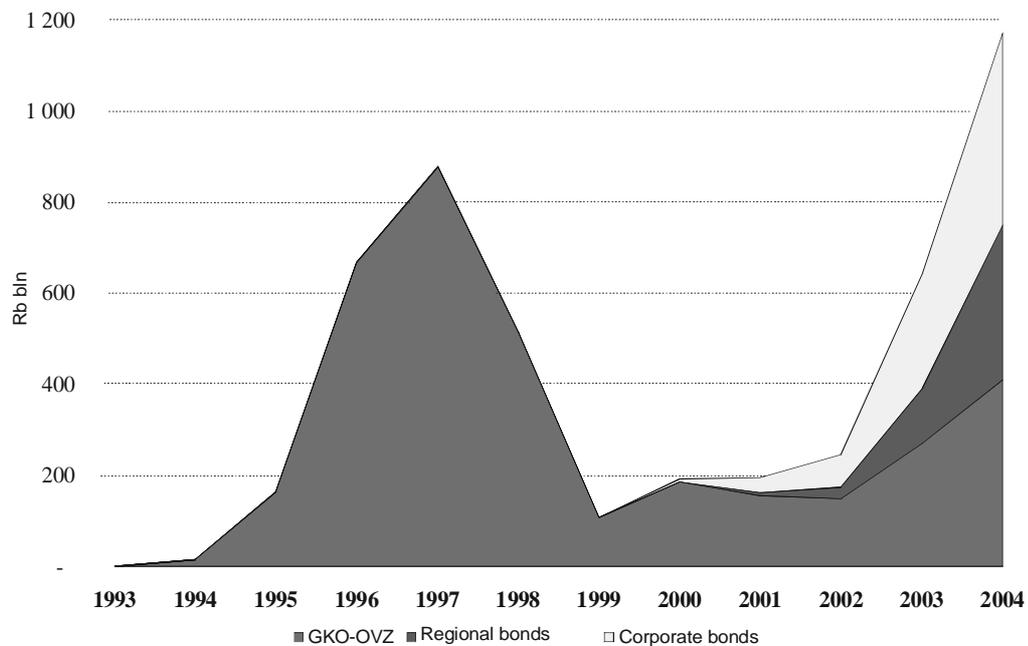
Source: According to MICEX data.

Fig. 14. Volume of bond placement

According to the volume of placement in 2004, the market of ruble bonds made up Rb 387.5 bn and almost reached “historical” maximum of bonds placed for a year, which had been fixed in 1996 on GKO-OФЗ in the amount of Rb 415.1 bn (with account of denominations). But, in contrast to GKO-OФЗ market, which collapsed, the market of ruble bonds is now growing not only because of placement of federal securities, but, primarily, due to issuance of corporate and regional bonds. In 2004, on MICEX there were placed

OFZ for a total of Rb 192 bn; the volumes of issuance of corporate and regional bonds made up Rb 140.4 bn and Rb 55.1 bn correspondingly, i.e., totally, a little more than the issuance of federal securities.

In 2004, the volume of secondary exchange trade with bonds on MICEX exceeded maximum indicators of liquidity of the GKO-OFZ market in 1995–1997, which is seen from *Fig. 15*.



Source: According to MICEX data.

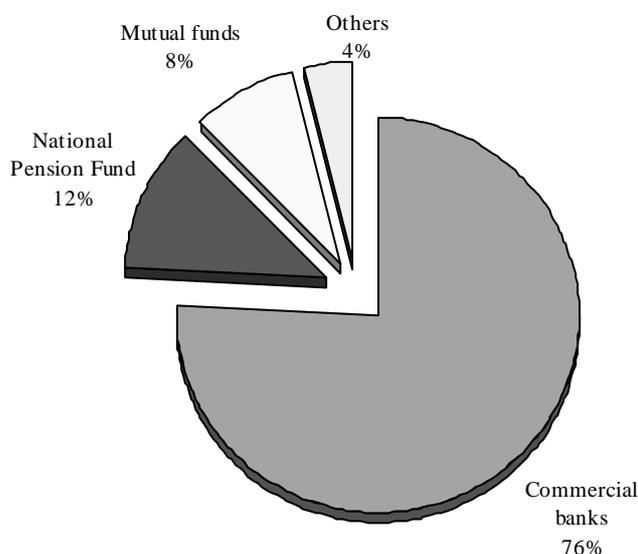
Fig. 15. Volumes of secondary trade with bonds on MICEX

The maximum volume of secondary trade with GKO-OFZ on MICEX had been fixed in 1997 and reached Rb 876.1 bn denominated rubles. In 2004, the total volume of secondary trade with ruble bonds amounted to Rb 1169.8 bn, of which Rb 408.6 bn is accounted for OFZ market, Rb 338.0 bn – for regional bonds, and Rb 423.2 bn – the corporate bond market.

Despite rapid growth of volumes of the market of ruble bonds, the situation on this segment of the market still differs from that taking place on GKO-OFZ market the day before default. The main differences are in that the present issuers are making borrowings at reasonable rates, which are often lower than the level of inflation. Increase in the volumes of corporate and regional bond redemption is so far behind the volumes of bond placements. Moreover, supervising the market of ruble bonds is carried out by FSFM (Federal Service on Financial Markets), i.e. the body that is independent of issuers and market participants.

Though, such a rapid growth of ruble borrowings causes a number of problems. The main problem is in that demand is formed at the bond market from the short-term resources, basically excessive bank liquidity, as balances of correspondent bank accounts and on their deposits in the Bank of Russia. Extra amount of such resources allows to finance the public debt, corporate and regional issuers at a negative real interest rate. This, in turn, repels from the ruble bond market non-governmental pension funds, unit investment funds and citizens who, in contrast to banks, do not possess excess money supplies and cannot afford investments at interest rates lower than the level of inflation.

The structure of investors on the market of corporate and regional bonds is shown in *Fig. 16 and 17*.



Source: Calculations according to the data of the Bank of Russia, FSFM and.

Fig. 16. Structure of regional bond investors in Russia in the mid-2004 (estimate)

On the regional bond market 76% of securities belong to commercial banks, the share of banks on the corporate bond market accounts for about 50%. Considering that part of the banks make bond investments through subsidiary non-bank agencies, the actual share of banking groups on the market of corporate and regional bonds still higher.

In conditions of low-liquidity market of the government securities and absence of bank refinancing system on the part of the Bank of Russia, the corporate and regional bonds began to act an unusual (for them) part of regulating the volume of money in circulation and servicing the interbank crediting market. However, involvement in the market of companies' long-term debts and banks' excessive liquidity substantially raised the risks of this market segment in the eyes of investors¹⁰³. Falls of bank liquidity because of changes in the economic situation, bank crisis or emergence of a new financial instrument, which is better adapted to regulation of banks' excessive liquidity (for example, the Bank of Russia bonds or liquid GKO), may restrict new bond placements and considerably decrease liquidity of the secondary market. Impossibility of refinancing the domestic debts will make problems of creditworthiness of individual issuers, and in unfavorable scenario will provoke a wave of defaults on the bonds of companies and regions.

Therefore, despite differences in the structure of investors on domestic bond and stock markets, both markets incur a deficit in domestic investors ready to invest in the long-term bonds of Russian issuers. Major obstacle for the emergence of such investors on the domestic debt market is negative effective yield of the greater part of ruble issuers.

¹⁰³ In the opinion of MDM-bank analysts, "just the use of short cheap liabilities for purchase of long... bonds generates the investors' profits on the market"; however, this is an extremely risky model, which is not for the first time in Russia, in 2004 again "punished" many of investors (bank crisis), as in conditions of "credibility crisis" on the interbank market many investors could not finance their positions in ruble bonds and had to sell them at the bottom of the market. (See: MDM-bank Investment Banking. Debt market. Results of 2004. Strategy of 2005. January 2005. p. 31. www.invest.mdmbank.ru.)

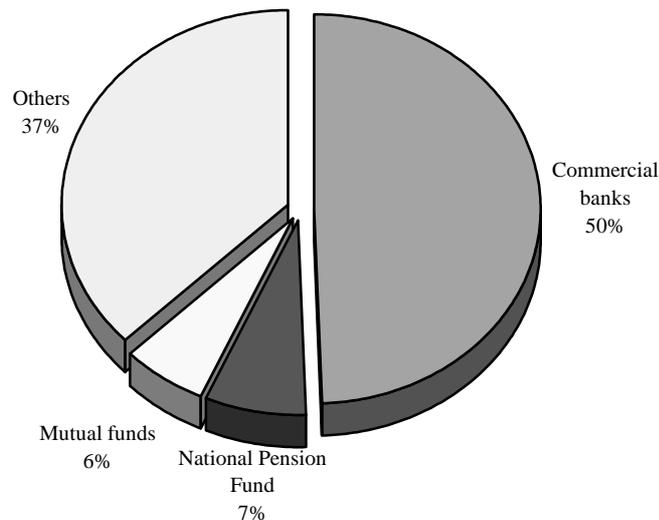


Fig. 17. Structure of the investors on the corporate bond market in Russia in the mid-2004 (estimate)

The domestic bond market begins suffering considerable competitive pressure on the part of global markets, where not only more reputable creditors are available, but, in conditions of falling the real dollar rate credits also become much less expensive than ruble borrowings. Even now the volumes of external borrowings, made by Russian companies, substantially exceed the volume of means attracted by them on the ruble bond market.

In conditions of acute competition with global capital markets the Russian stock market needs finding new niches that will allow it to survive and exercise its practicality for various groups of investors.

4.4.3. New niches for the Russian stock market

For the Russian stock market the most actual problem is attraction of mass domestic investor to the market. Despite curtailing the central social programs and failure of pension reform, the most part of Russian population does not take interest, so far, in saving up for the future. According to our calculations, it's many years already that the population's savings in financial assets are decreasing – from 16,1% in 1997 to 8,7% in 2004.

The reasons why population does not invest their means in financial assets in Russia are - low profitability and increased risks. The main body of bank deposits and ruble bonds may gain negative effective yield. Even if investments in the stock of Russian companies gain positive effective yield, they are often unacceptable for conservative investors because of increased risks of considerable volatility of their prices. The services of Russian financial intermediaries are often inaccessible for population because of remoteness of people's place of residence and high cost of such services.

A serious problem for the growth of schemes of collective investment in Russia is excessive cash resources concentrated in the banks, foreign exchange reserves of the Bank of Russia, and in the Stabilization Fund. Investing such resources in financial instruments of the Russian issuers is impossible without increased risks and negative effective yield. In such an environment cannot successfully develop the schemes of collective investments that accumulate the resources of private investors.

Shortage of qualitative financial instruments on the domestic stock exchange market is necessary for the formation of diversified portfolios, it may be added by an access of Russian investment funds and other portfolio investors to acquisition of securities of foreign issuers. Calculations show that an increase of the proportion of securities of issuers from the developed financial markets in portfolios of Russian investment funds to 80%, allows to considerably reduce the risks with minor lessening of investment yield. Such approach requires taking competitive decisions in the sphere of currency regulation, in particular, authorization for the Russian portfolio investors unhampered purchase and sale and keeping foreign assets under the supervision of banks as currency control agents. Such deals must be out of requirements on the resource reservation in making transactions in foreign currency.

The advantage of such an approach is in that it provides conditions for competitive ability of Russian financial intermediaries through enhancement of their capability to invest in assets on global markets. The financial intermediaries in Europe or USA are not confined in possibility of purchasing reliable financial assets abroad, so, to restrict the rights of Russian investment or pension funds in acquisition of foreign assets is unwise.

Another field in development of investment funds and other forms of collective investing, where a breakthrough may be achieved, is creation of modern centralized systems of financial product distribution, for example, the investment shares of unit investment funds. The above can be achieved by orientation of clearing infrastructure of the Russian stock market (depositories, registrars, clearing organizations and clearing houses) to receiving requests for purchase and repayment of investment shares of the unit investment funds and settlements on deals with shares on DAP terms.

The perspective direction of growth of the exchange market in Russia may become the secondary market of investment shares of the exchange index funds, closed end and interval unit investment funds. On the MidAmerica Stock Exchange in the USA the volume of transactions with securities of investment funds reaches 85% of the total volume of trade. On the Tokyo and Osaka exchanges in Japan, Hong Kong exchange, All-European Trading System Euronext, German stock exchanges, and on other largest foreign trading floors, deals with the papers of investment funds are a significant segment of the markets served by them. The growth rates of the securities market of the exchange index funds and the stock of closed end investment funds on the New-York Stock Exchange and in NASDAQ multiply surpass the growth rates of turnovers on deals with other securities.

In Russia, on MICEX the volume of deals with shares of unit investment funds make up only 0,003% of the total volume of trade with securities. At the same time, revival of domestic investor with the use of efficient collective investments, oriented to the potential of exchange infrastructure, would lead to forming additional demand of the domestic investors for securities circulated on exchanges.

Therefore, the future of the Russian stock exchange is concerned with its integration into global capital markets. To retain the domestic securities market as an independent competitive institution, it should be reoriented to needs of the country's population and other Russian investors. It is possible to attract such categories of investors to the market, only if every possible effort is made by Russian financial intermediaries in usage of the advantage of international diversification of portfolio investments and forming the organized market of papers of investment funds.

4.5. Functioning of the pension system's saving component

In March 2004, the Pension Fund of the Russian Federation for the first time delivered the monies of the pension savings to the managing companies for the purpose of their respective asset management. These were the insurance payments for the saving part of the labor pensions according to the results of the year of 2004 as well as returns from their investing. In 2002, according to the data of the RF Pension Fund, about 38 bln roubles were paid to the saving system as insurance premiums for the saving part of the labor pensions, in the year of 2003 – 50 bln roubles¹⁰⁴. In the end of the first quarter of 2004, the Pension Fund of the Russian Federation transferred to the said managing companies 47.2 bln roubles¹⁰⁵ consisting of the premiums made in the year of 2002, and 13.5 bln roubles of the investment returns from the respective investing.

If we proceed from the data on the returns received from the temporary placement of insurance premiums in the saving part of the labor pension in 2002 which comprised 1.5 bln roubles, as stated in the Federal law “On Performing the Budget of the Pension Fund of the Russian Federation for the Year of 2002”, then most of the returns from investing the said premiums collected in 2002, come on the year of 2003 and the beginning of the year of 2004. However, it does not seem possible to make definite conclusions about it with a sufficiently high degree of assurance because of the absence of respective information on the methods of accounting used by the RF Pension Fund. In particular, it is not quite clear whether due account was taken of the unrealized exchange rate growth of securities in the year of 2002 or if all these returns were shown only by the results of the securities sales but the account was being performed at prices of the acquisition while the respective incomes from the said temporary placement in the year of 2002 were not reflected in full.

Returns from investing the premiums collected in 2003 by the results of the year, were estimated by the Pension Fund of the Russian Federation to comprise 2.015 bln roubles¹⁰⁶ although, like in the case with the insurance premiums for the year of 2002, it can be asserted that the resulting profitability from their investing will be significantly different from the respective intermediate data.

A rather significant part of the premiums collected which the Pension Fund of the Russian Federation received in 2002 but was unable to duly distribute to the respective bank accounts of insured persons and, accordingly, referred them to the category of “unidentified” (of the total sum of 37.85 bln roubles, 33.68 bln roubles¹⁰⁷ were distributed to respective personal bank accounts of the insured persons).

Profitability of investing insurance premiums for the saving part of the labor pension, collected by the Pension Fund of the Russian Federation in the year of 2002, comprised 40%. This high indicator is easily explainable taking into consideration the dynamics of prices on the euro bonds of the Russian Federation in which a significant part of the collected premiums was invested. During the year of 2003 alone, prices on the issues which are in the portfolio of the RF Pension Fund, grew:

- for the RF 10 issue – 5.7%;
- for the RF 28 issue – 20.3%;
- for the RF 30 issue – 21.2.

¹⁰⁴ Data for the year of 2003 are preliminary.

¹⁰⁵ 1.66 bln US dollars as recounted at the rate for the end of March 2004.

¹⁰⁶ “Commerzant”, 16. 04. 2004.

¹⁰⁷ “Rossiyskaya Gazeta”, 31. 03. 2004.

The period both for the acquisition and for selling the euro bonds turned out to be very successful. The Pension Fund of the Russian Federation became able to start investing its monies in the summer – autumn of 2002 when prices on the most liquid RF30 issue were at the level of the face-value, and it sold them at a price close to the face-value, that is the profitability, due to the growth rate for the RF30 issue during this period alone, comprised about 43% in the US dollars.

Information on investing pension savings by the said management companies after they have received the respective monies from the Pension Fund of the Russian Federation is also of a rather episodic character. In 2003, such managing companies selected 704 thousand people. Accordingly, they received 1.6 bln roubles from more than 47 bln roubles of the total sum of the respective payments. The rest went to Vnesheconombank legally appointed as the State Managing Company (SMC).

If distribution of funds is considered among private managing companies alone, then it is to be noted that 37% of the monies given for the asset management of the pension savings, account for only two managing companies – “Capital” and the “Rosbank” managing company.

Choice of instruments for investing monies of pension savings

In April 2004, the managing companies, which had successfully passed the competitive testing for the right to conclude agreements on the asset management of the pension savings, started investing the monies transferred to them by the Pension Fund of the Russian Federation, according to respective applications of duly insured persons.

The aggregated structure of the investment portfolios of the non-governmental managing companies, as of the end of May, same year, is represented in Fig. 18.

According to the data on the 25th of May, the said managing companies invested in the state securities 78.3% of all the savings of those who entrusted to them for duly asset management. 0.53% of the monies were invested in the shares of the Russian companies, 0.5% - in the bonds of the RF subjects, 0.57% - in the corporate bonds. The respective monies and deposits account for 12.9% of the pension savings volume including 9.67% invested in roubles and 3.01% in foreign currency. Another 7.14% went to other assets.

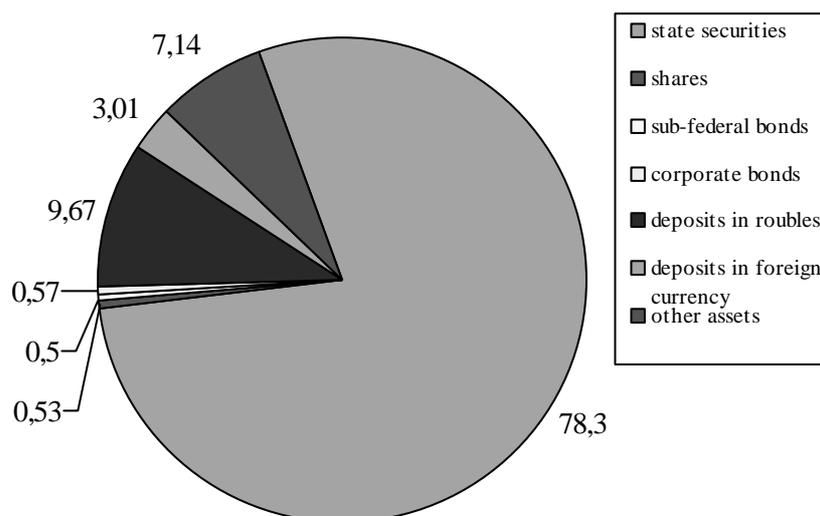
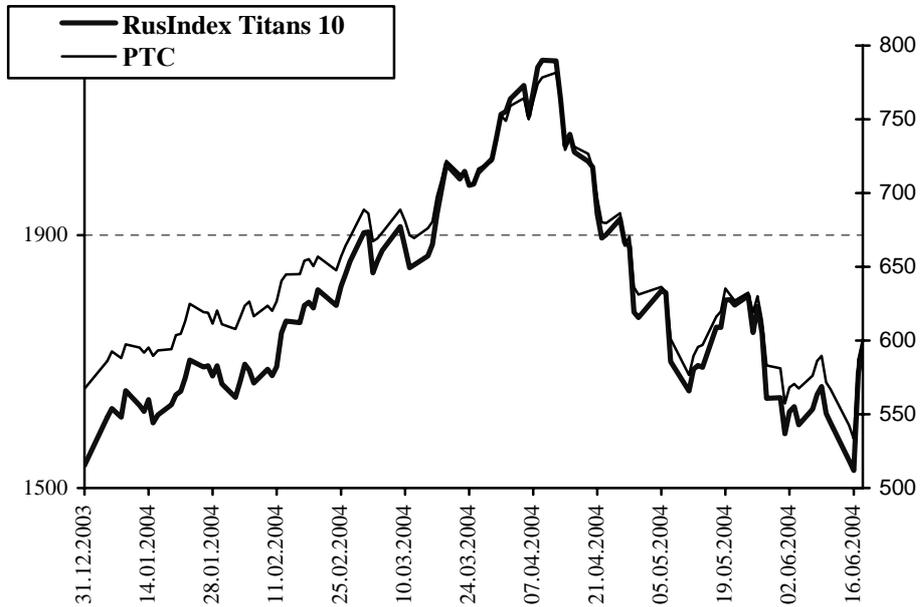


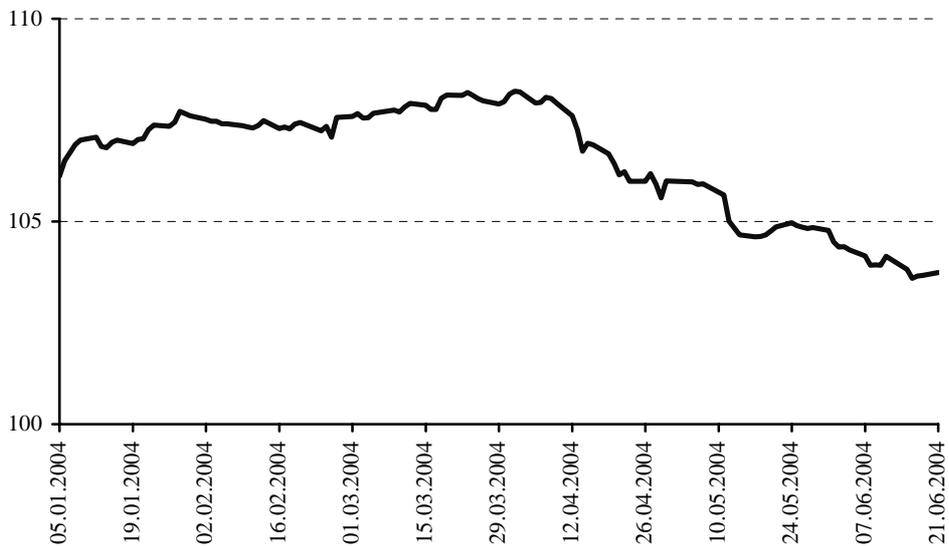
Fig. 18. Investing monies of the pension savings by the respective managing companies as of May 25, 2004

Thus, the part of shares and corporate bonds turns out to be much less than the maximal permitted values.



1 – RusIndex 10 [USD] (left axis)
2 – RTS index [USD] (right axis)
Sources: www.rts.ru, www.djindexes.com

Fig. 19. Dynamics of the RTS and RusIndex Titan 10 index values (in the US dollars)

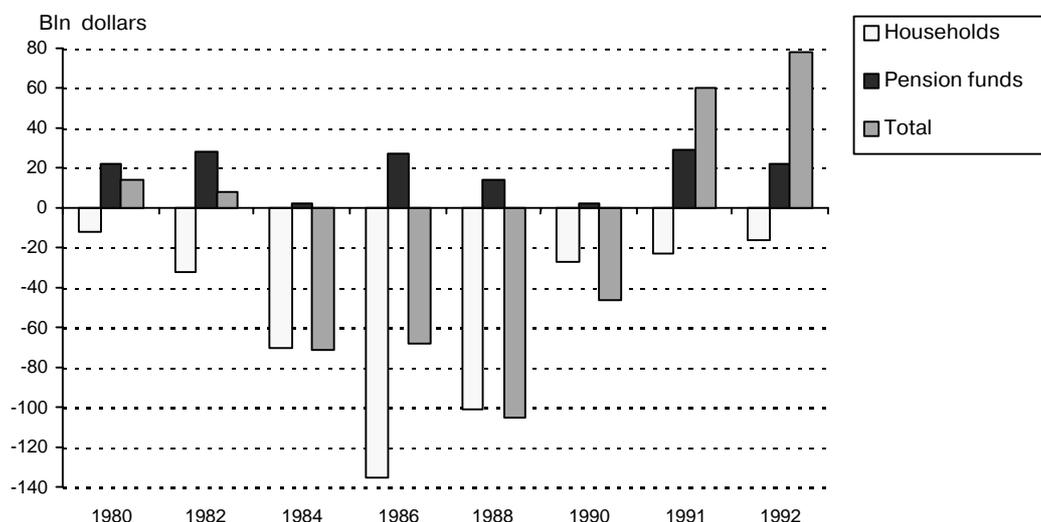


Source: www.micex.ru

Fig. 20. Dynamics of the MICS (Moscow International Currency Stock Exchange) index of corporate bonds

The decisive influence on carefulness of the managing companies with regard to such instruments was indeed exerted by the negative situation on the stock -exchange market (see Fig. 19 and 20). In April, the said market seemed to be a sort of “overheated” but then recession began which continued in May as well. The greatest decrease fell on the “blue chips” and the most liquid issues of the corporate and sub-federal bonds. Negative impacts on the price dynamics on the stock -exchange market were exerted by both the lower level of the rouble liquidity in the banking system caused by the reduction of residuals on the corresponding accounts of respective banks, and high rates of the inter-bank credits.

In countries with long traditions of collective investing, both the pension and investment funds play a stabilizing role in such situations since their investment horizons are typically oriented towards the long-term perspective. In the USA of the 80s – early 90s, for example, when private persons were intensively selling shares while net purchases of households were of negative value, net purchases of the pension funds were, on the contrary, of positive value during the whole period thus exerting smoothing influence on the general dynamics of the stock exchange market (see Fig. 21).



Source: Federal Reserve Bulletin, November 1993.

Fig. 21. Net purchase of shares in the USA in 1980–1992

The Russian asset managers are so far more disposed to behave more in line with the situation which is, to a certain extent, provoked by the very model of the saving pensions system where a person, insured once a year, enjoys the right to transfer his/her savings to any other managing company or a non government pension fund as well as the uncertainty in the future fate of these very monies in the light of the Government declared measures aimed at financing the forecasted deficit of the Pension Fund of Russia’ budget. Besides, the total volume of the monies transferred to various private managing companies, obviously could not exert any significant influence on the dynamics of the respective market indicators. The aggregate volume of trading in shares on the RTS and MICS stock exchanges in April comprised 353.4 bln roubles, in May it comprised but 211.5 bln roubles (in accordance with the official data published by the RTS and MICS). Thus, even if the sum of the pension savings in the amount of 1.6 bln roubles transferred to the respective

managing companies, were fully and completely invested in the respective shares in April, would have comprised no more than 0.4% of the turnover. In May, this indicator would have comprised 0.7% of the total volume of sales. Since it was established by the Decision of the RF Government No. 379, dated 30.06.2003¹⁰⁸, that no more than 40% of the pension savings can be invested in shares then the respective indicators undergo more than a double reduction, accordingly. A similar situation was developing with bonds as well. In April 2004, the summary volume of trading in the bonds segment at the MICS and RTS cites comprised 15.4 bln roubles of which 6.2 bln roubles were directed to corporate bonds, 9.1 bln roubles – to the sub-federal and 0.1 bln roubles to the municipal ones. In May, the summary volume of trading in bonds at the MICS and RTS cites comprised 8.2 bln roubles of which 2.3 bln roubles were directed to corporate bonds, 5.8 bln roubles to the sub-federal and 0.1 bln roubles to the municipal ones. Thus, if we proceed from an assumption that the respective private managing companies could invest in bonds maximally permitted volumes of the pension savings (50%) then these would comprise 5.2% in April 2004 and 9.8% in May 2004. Since the probability of investing monies of the pension savings in the maximal permitted volumes is rather miserable, then the respective shares of pension savings in the trading volumes of bonds and shares should indeed be less and they are not very likely to exert any significant influence on the respective markets of shares and corporate bonds.

At the same time, as clearly shown by analysis of the publications devoted to the initial investing stage of pension savings carried out by respective non Government managing companies, not all them proved to be ready for work in this new segment of the market. Thus, a certain part of the managing companies faced a problem of selecting the investing instruments on their own, not transgressing at that certain limitations set up by the Federal Law “On Investing Monies for Financing the Saving Part of the Labor Pension in the Russian Federation”, the Investment Declaration and other complementary quantitative limitations for issuers of securities as established by the said Decision of the RF Government, No. 379. This, first of all concerns questions of the necessary informational support for investing in securities of various non Government issuers.

The form in which some of the requirements to securities for investing pension savings were formulated in the said Decision of the RF Government No. 379, really turned out to be far from being the best. As noted by the managing companies, the selection process of securities is extremely labor intensive and, accordingly, is very time taking.

In accordance with the said Decision of the RF Government No. 379, investing the monies of the pension savings which the respective management companies have in their asset management, in shares is limited by such issuers whose shares are included in the stock exchange quotation lists. The market cost of such shares must comprise no less than 300 mln roubles, the cost of net assets of the securities issuer must comprise for shares no less than 500 mln roubles, the average monthly sum of market deals with the shares of Open Joint Stock Societies (OJSS), as calculated according to the results of the last six (6) months, must comprise no less than 2 mln roubles. Besides, such issuer must have no less than 1000 shareholders and work without any losses the last two years as minimum.

Nevertheless, some questions inevitably arise to which the said Decision of the RF Government No. 379 does not give any sufficiently clear answer. For example: with what

¹⁰⁸ Besides, the RF Ministry of Finance issued Order No. 27H, dated March 5, 2004, “On establishing the criteria of placing monies of the pension savings in the assets as stated in sub-points 2–4 and 6, point 1, p. 26 of the Federal Law No. 111 – F3, dated July 24, 2002 “On Investing monies to finance the saving part of the labor pension in the Russian Federation”, but it does not contain any amendments to the demands as stated in the said Decision of the RF Government No.379.

periodicity must the managing companies check the correspondence degree of those issuers whose shares they bought for their portfolios, to the established requirements? Besides, information with regard to the cost of net assets is not freely available so its estimation is quite hard for managers to make. Also, it is extremely difficult to collect such necessary information on issuers in whose securities private managing companies invest pension savings, as quantity of the share holders, periodicity of the publications and the composition of accounting.

On the whole, the requirements, as officially stated in the said Decision of the RF Government No. 379, are quite close to those established for including securities in the respective quotation list "A" of the first level¹⁰⁹. Thus, according to Decision of the Federal Commission for Securities (FCS), dated January 4, 2002, "On Approving the Regulations on the Requirements to Organizers of Trading on the Securities Market"¹¹⁰, the market cost of shares must comprise no less than 300 mln roubles, the cost of net assets of the securities issuer must comprise for shares no less than 500 mln roubles, the average amount of monthly deals with securities calculated on the basis of the results for the last six (6) months, must be for shares no less than 2 mln roubles. The list of shares which the respective pension monies are allowed to be invested in, can indeed be made wider than the quotation list "A" of the first level since the issuer, on the one hand, can fully correspond to the requirements established for the quotation list "A" of the first level but on the other

hand, for such or other reasons, has not yet become its part. Among the shares entered in this category, judging by the lists which were compiled by the respective managing companies on the basis of their own analytical investigations, are shares of such largest companies as "Aeroflot", "Norilsk Nickel", "Severstal", "Sibirtelecom" and "Surgutneftegas". Their total capitalization amount on the date of March 31 comprised approximately 53 bln US dollars. On the other hand, however, the common shares of the Stoylensk OMPE (Ore mining and processing enterprise) are included in the MICS quotation list "A" of the first category but the volume of trading in them is less than the average monthly amount of market deals with shares of JSS as established by the known Decision of the RF Government No. 379. Yet, they remain to be in the listing.

According to our estimations, capitalization of issuers in whose shares the pension savings were permitted to be invested, comprised, as of March 31, 2004, 208 bln US dollars or something about 83% of the summary capitalization volume (according to the data of the Red – Stars/Financial Informational Agency, capitalization amount of the Russian issuers comprised, as of March 30, 250.2 bln US dollars). The summary volume of trading in respective shares which are included in the "A" list of the first level, comprised, for the five years of 2004, 85% of the total volume of the MICS trading in shares for the same period.

As established in the said Decision of the RF Government No. 379, requirements to bonds quite coincide with such for requirements to include bonds in the quotation list "A" of the first level in accordance with the FCS Decision No. 1- pc. Thus, the market cost of bonds in which the respective pension savings are permitted to be invested, must comprise no less than 30 mln roubles. The average monthly amount of market deals with the state securities of a RF subject, municipal bonds as well as with bonds of the Russian economic societies as calculated according to the results of the last six (6) months, must comprise no less than 400 thousand roubles.

¹⁰⁹ Later, certain changes were introduced in the said Decision which directly pointed at the necessity to include securities in the quotation lists "A" of the first level so that they could be acquired with the monies of the pension savings.

¹¹⁰ The Decision of the FCS, dated December 26, 2003, entered into force beginning from July 1, 2004.

As of early April, the MICS quotation list “A” of the first level included bonds of nine (9) issuers. Yet, the volume of trading in the “MMK” JSS bonds which are included in the top listing category, does not fully comply with the limitations as established by the Decision of the RF Government No. 379 for the average amount of deals with bonds of the Russian economic societies. The summary volume in the circulation of the corporate bonds issues in which the non state managing companies may invest part of the respective pension savings, comprised, according to the estimations as of the end of the first quarter 2004, comprised approximately 14% of the total volume in the corporate bonds circulation at face value. According to the data on issues at the MICS, the volume of the respective trading in January – May comprised about 30% of the aggregate secondary trading volume in the MICS corporate bonds segment¹¹¹.

The sub-federal and municipal bonds are basically traded in two respective stock exchanges – the MICS and the SPCS (St Petersburg Currency Stock Exchange). The said MICS quotation list “A” of the first level includes bonds from all RF subjects whose total issue volume comprises 88.7 bln roubles, and the respective municipal bonds of one issuer (the issue volume comprises 0.7 bln roubles). The dominant position here belongs to bonds issued by the Government of Moscow. The respective SPCS quotation list of the first level includes only those bonds issued by the Finance Committee under the Saint – Petersburg’s Administration (a number of issues in circulation the total volume of which comprised, as of March 1, 2004, 10.6 bln roubles) but the managing companies which took an active part in the discussion of the investment matters in the press, simply ignored them.

Among the sub-federal bonds which were taken by the respective managing companies as fully corresponding to the criteria set up in the said Decision of the RF Government No. 397, but which are not included in the quotation list “A” of the first level, presented are bonds of the Irkutsk, Kostroma, Tomsk, Yaroslavl regions and the Chuvash Republic. The respective managing companies also paid attention to the municipal bonds of the city of Novosibirsk as permitted for respective investing. The total issue volume of these bonds comprises 41.1 bln roubles and they satisfy the necessary requirements both to the issue volume and to the turnover of the respective trading for investing pension savings in them but they are nevertheless included in the MICS quotation list “B”.

On the whole, even if the additional requirements have been taken into due consideration, the list of permitted instruments for investing provides the managing companies with quite a sufficient choice of instruments necessary for investing such amounts of the pension savings which they were able to obtain for the respective asset management. Besides, the prospect of significantly increasing this amount in the feasible future seems to be rather vague, particularly so if we proceed from the amendments to the Federal Law “On Compulsory Pension Insurance in the Russian Federation”, approved by the State Duma, in accordance with which, citizens who had been born before the year of 1967, are excluded from the saving pension system which is inevitably leading to the reduction of the respective premiums to the saving pension system approximately by 23% in the year of 2005.

* * *

In the autumn of 2004, 376 thous. people more of the 42 mln insured persons decided to transfer their pension savings to the respective private managing companies and

¹¹¹ The list of corporate bonds issuers which are not included in the top level quotation list but the acquisition of which does not exclude non state managing companies, includes “Bashkirenergo”, “Bashinformsviaz” “Mechel” and “Centrtelecom”. The total volume of bonds issue by these issuers comprises 2.25 bln roubles.

non state pension funds. Most of the applications – 256 thous. – were made by the citizens in favour of the non state pension funds (NPF). The leading position in the quantity of clients – more than 60 thous. - belongs to the “Lookoil - Garant”, 38 funds were unable to conclude at least one respective agreement, 22 funds – less than 1 thous.¹¹² clients (81 funds enjoy the right to draw pension savings according to the official data of the Pension Fund of the Russian Federation). The real quantity of citizens who made their choice in favour of the non state form of managing their pension savings, for the period of two years, is less than the amount of applications which came to the Pension Fund of the Russian Federation. According to the information which appeared in the mass media means, part of the clients who last year elected private managing companies, this year changed their minds and turned to the said Non State Pension Fund.

4.6. Realty market in the Moscow Region: some results and forecast

Results of the year of 2004; the turning point in the trend

In the year of 2004, quite significant impacts on the Russian realty market were exerted by the processes undergoing in the Russian economy as a whole¹¹³.

Actually, the early part of the year of 2004 was not fraught with any threatening changes on the Moscow realty market: quite preserved remained the record price growth rates on realty which fully corresponded to the earlier obtained regression dependence of these rates on the level of the world oil prices¹¹⁴. It should probably be reminded in this respect that in the period of 2002 – 2003, with the oil prices comprising 18 to 20 USD per barrel, the growth rates of realty prices were rather insignificant, with the oil prices comprising 25 –26 USD per barrel, they grew up to 2% a month, with such prices comprising 29 to 30 USD per barrel, these already reached 3.5 – 4.0%. Averagely, 1 USD per barrel growth of oil prices accounted for 0.35 % growth of the monthly price rates on realty. During the year of 2003, this corresponded to half the total increment in the respective prices which comprised then 45 %. Similar regularities were also observed on the realty market of Moscow, the Moscow Region (*Fig. 22*) and St. Petersburg. By the Autumn of 2003, such growth of prices went outside the confines of the Russia’s European part having thus acquired a somewhat universal character.

In connection with this, growth of realty prices in Moscow for the year of 2004 was forecasted¹¹⁵ at the 2003 level, i.e. 35 to 40 % (from 1594 to 2100 – 2300 USD per sq. m). Two possible scenarios were considered then. According to the first and most probable of these, expected was a rather gradual asymptotic transition to the price stabilization at the level of 2100 – 2200 USD per barrel accompanied with the further 5 to 10 per cent “*inflationary*” increase during the next two – three years. In accordance with the second scenario, the price level could comprise then 2100 to 2200 USD per barrel in the year of 2004 followed then by a 20 to 25 per cent “*roll back*” of the realty prices and a fluctuating stabilization (the “*price bubble*” scenario).

¹¹² Finance. 08. 11. 2004.

¹¹³ This section contains the monitoring data on the Moscow realty market carried out by the *MIEL-Realty* company (Sternik, G.M., Lutzkov, V.M. *Certified Analyst of the Realty Market* [CARM]), RMLC (Sapozhnikov, A.Yu. CARM), “IK «DM Fund»” (Kolokolnikov, D.A. CARM), independent analyst Beketov, A.G. (CARM).

¹¹⁴ Sternik, G.M., *Forecast of the Moscow Realty Market Development till the Year of 2005*. The AEKSIP Report. April 2003. www.realtymarket.org.

¹¹⁵ Sternik, G.M. *Realty Market in Moscow: results of the year*. - www.realtymarket.org. January 2004; *Russian Economy in 2003. Trends and Perspectives*. Issue 25. M.: IET. February 2004, pp. 383 – 393.

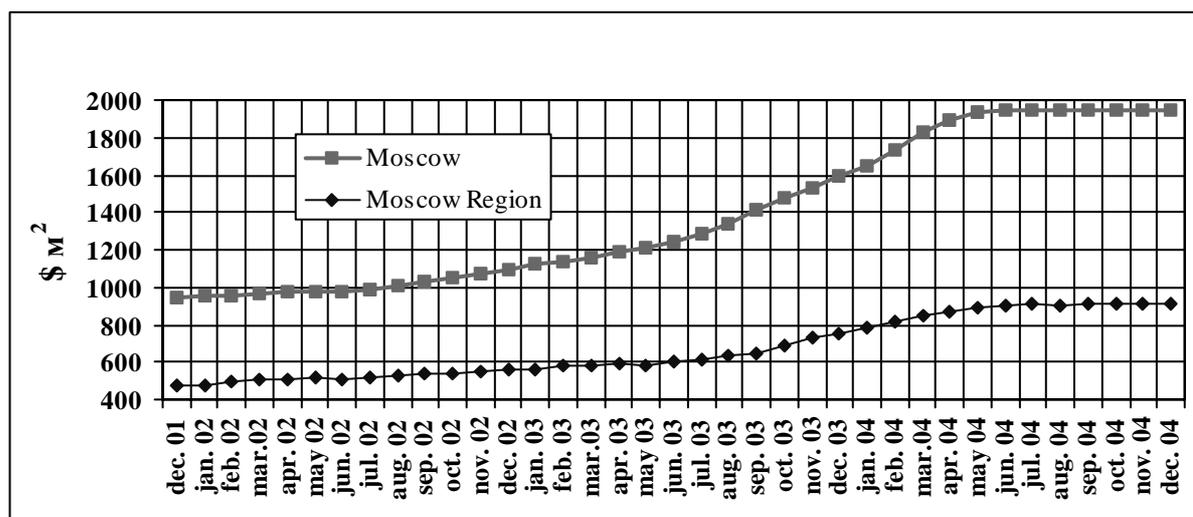


Fig. 22. Dynamics of the average specific prices for supply of living apartments in Moscow and the Moscow Region in the years of 2002 – 2004

Practically, the *de facto* dynamics of prices in Moscow on the whole did correspond to the second forecast scenario during the first five (5) months of the year of 2004 but already in June - July there followed a sudden change in the said trend, that is transition from growth of the respective turnovers and prices (which lasted during more than three years) to stabilization. At that, the realty market during the first half year was characterized with lower sales of the living apartments and continued price growth (the average specific price of realty supply at the secondary market in Moscow grew from 1594 to 1950 USD per sq. m or by 22.3 % in the period from December 2003 to June 2004) while the second half was characterized with slow restoring rates of the sales volumes and the stable supply prices which were fluctuating within the 1944 – 1953 USD per sq. m range. As to the Moscow Region, the average specific realty prices there grew from 748 to 908 USD per sq. m (by 21.3 %) during the first seven months and then stayed rather stable at the level of 903 – 915 USD per sq. m (see: Table 8, Fig. 22).

Table 8

Dynamics of the growth and price index rates on realty in Moscow in 2002 – 2004 (December 2001 is the datum period)

Month, year	Moscow			Moscow Region		
	Average specific price of realty USD/sq. m	Index of growth by datum period (nominal)	Growth rates (to preceding period), %	Average specific price of realty USD/sq. m	Index of growth by datum period (nominal)	Growth rates (to preceding period), %
12.01	940	1,00	–	471	1,00	–
12.02	1096	1,166	16,6	559	1,187	18,7
12.03	1594	1,696	45,4	748	1,588	33,8
06.04	1950	2,074	22,3	898	1,906	20,1
12.04	1953	2,078	0,15	908	1,928	1,1
12.04*	1953	2,078	22,5*	908	1,928	21,4*

* Values characterizing respective growth in December 2004 as compared against December 2003.

On the whole, the nominal USD prices grew during the year of 2004, as compared against such during the December of 2003, by 22.5% (by 17% in 2002, by 45% in 2003), in the Moscow Region - by 21.4% (by 18.7% in 2002, by 33.8% in 2003). As compared against December 2001, such growth comprised 2.07 times in Moscow and 1.93 times in the Moscow Region.

Influences exerted by the macroeconomic parameters on the realty market as well as prerequisites for respective changes in the price trend in-between the two halves of the year

The dynamics of the respective macroeconomic parameters in the year of 2004 can be characterized by the following indicators. The January "burst" of inflation (1.8 %) which took place on the eve of the presidential elections, was suppressed down to 1 % a month accompanied with simultaneous bringing to a stop of the rouble strengthening with regard to the US dollar which had earlier caused devaluation of the population's savings. However, already by November, this support of the dollar resulted in a new speed up of inflation (1.3 %) so the financial authorities let its rate float free. Nevertheless, the annual growth of inflation comprised 11.57 % (having exceeded the predicted value of the RF Government more than by 1.5 %).

The average nominal dollar rate comprised 27.92 roubles in December 2004 whereas it was 29.44 roubles only a year before. Hence, the inflation rate index of the rouble to the dollar comprised 0.948 roubles in 2004. Thus, the dollar in Russia kept its creeping devaluation in the course of the past year, like that in the year of 2003, and its purchasing power during one year went down by 15.1 %.

For purposes of evaluating the index of the real (both the rouble and the dollar inflation rectified) realty prices (the IGS index)¹¹⁶, below are the macroeconomic dynamics indicators in Russia for the recent three years (2002 – 2004) relative to the December of 2001 as well as for certain periods (*Table 9*).

Table 9

**Dynamics of the macroeconomic parameters in 2002 – 2004:
(December 2001 – the datum period)**

Month, Year	Index of consumer prices (relative to the datum period)	Rate of inflation (relative to preceding period) %	Average monthly exchange rate rouble/dollar	Index of devaluation (rouble to dollar)	Index of inflation of dollar in Russia	Index of dollar purchasing power relative to the consumer basket
12.2001	1,0	18,6	30,09	1,000	1,000	1,0
2002	1,151	15,1		1,058	1,088	0,919
12.2002	1,151	15,1	31,84	1,058	1,088	0,919
2003*	1,120	12,0		0,925	1,211	0,826
12.2003	1,289	12,0	29,44	0,978	1,318	0,759
1 st half year 2004*	1,061	6,1		0,986	1,076	0,929
06.2004	1,368	6,1	29,03	0,965	1,418	0,705
2004*	1,117	11,7		0,948	1,178	0,849
12.2004	1,44	11,7	27,92	0,928	1,552	0,644

* Indicators for the period (year, half year).

¹¹⁶ The IGS index was calculated according to the following formula:

$$IGS = HIPR/CPI = HPID/IID,$$

where HIPR – housing price index, as Rb.; CPI – Consumer Price Index, I HPID – housing price index, as USD.; IID = CPI/DIIR – index of USD inflation in Russia (vs. the dynamics of consumer price); DIIR – index of Rb. depreciation vis-avis USD.

Calculations with regard to the data given in *Tables 8* and *9*, clearly show that growth of the IGS index in Moscow, which went 14 points up during the first half year, comprised in 2004 on the whole no more than 4.0 % (due to the respective lowering during the following months). However, as compared against the said datum period (December of the year of 2001), the growth in question comprised 34 %. In the Moscow Region, the index of real prices during the year of 2004 went 3 % up while that for the three years (2002 – 2004) – 24 % (*Table 10*).

Table 10

**Dynamics of the average level of realty supply
in the Moscow Region in 2002 – 2004**

Period	Indexes of realty nominal values		Indexes of realty real value (IGS)	
	Moscow	Moscow Region	Moscow	Moscow Region
12.2001	1,0	1,0	1,0	1,0
12.2002/2001	1,166	1,187	1,07	1,09
12.2003/2002	1,454	1,338	1,20	1,10
12.2003/2001	1,696	1,588	1,29	1,20
1	2	3	4	5
06.2004/ 12.2003	1,223	1,201	1,14	1,12
06.2004/ 12.2001	2,074	1,906	1,46	1,34
12.2004/2003	1,225	1,214	1,04	1,03
12.2004/2001	2,078	1,928	1,34	1,24

It obviously follows from the above said that the true realty value was growing faster in the capital of Russia than in the Moscow Region. However, such an impressive result was achieved much due to the previous 2003 results when the annual IGS index in Moscow was twice the similar indicator for the Moscow Region. Nevertheless, in the years of 2001 and 2003 the growth rates of the true realty value in both subjects of the Russian Federation were approximately the same.

On the whole, volatility of the said macroeconomic parameters did not exert any significant influence on the dollar realty market in the Moscow Region although should this trend continue there is always a possibility for the “*running of the population away from the dollar to realty*” scenario to come to life again.

The sequence of events which led to the change of trends on the realty market in Moscow was as follows.

The first alarming signs appeared already in February – March of 2004 during the preparation period for the presidential elections as well as right after such. In March, for instance, many Heads of the respective sales departments in a number of developer and broker companies noted lessening of their customer flows while in April even large companies recorded some 20 to 40 % lower sales in newly-erected living constructions and 10 to 20 % more in May and June. Moreover, under conditions of high and steadily growing oil prices on the world markets, possible causes of such events on the realty market in Moscow (similarly – in the Moscow Region and St. Petersburg as well) remained rather unclear. The banking crisis which started in June – July, 2004, seemed to the respective analysts both quite unexpected and rather hard to explain.

Early in July, the RF Central Bank made an official statement about the outflow of foreign currency from the RF to other countries (5.5 bln US dollars during the half year), starting from February, as caused by the worsening investment climate which was traditionally attributed to the well-known events developing around the “*Yukos*” oil company as well as

to the efforts of the state to cut the inflation rates down. A direct consequence of this was the attendant liquidity crisis both in the banking system and as regards individual enterprises. It was from this particular moment that it was quite clear that nothing else but this very fact became the fundamental cause for the said negative processes in the banking sector and on the real estate markets¹¹⁷.

Both these processes were chain-like strengthening each other. The lower inflow of investments from private buyers of realty in newly-erected buildings obstructed financing of the housing construction, servicing the bank credits and redemption of the earlier issued promissory notes. This, along with the general liquidity crisis in the country, made it much more difficult for the banks to issue new credits to developers thus only further aggravating their respective (already existing) problems. There followed lesser profitability levels of the housing construction (according to the available official data, the net profits in the housing construction industry went 20 % down during the said half year), the construction rates slowed (in some cases even up to “freezing” of certain objects), some larger developers became unable to fulfill their obligations to their contractors, creditors and, what’s more important, to their respective private investors. Hence, lower attractiveness of living apartments in the buildings still under construction and even the money withdrawn from the problematic banks (about 2 bln US dollars overall), did not at all “hurry” to start overflowing into the realty market. Plus – careless (or, may be, quite purposefully targeted) statements made by certain functionaries (who obviously were in a rush to report to the RF President on fulfilling the task set up by him) about 10 – 15 % decreases of realty prices in Moscow as well as about availability of lists containing the so called “unfair developers, problematic banks, etc”.

Thus, the above chain of negative events started not at all with the falling prices on energy - carriers, as had been assumed in the 2004 forecast, but rather with pure foreign currency outflow from the country due to reasons within the Russian economy itself. Further on, lower activity of the realty market accompanied with the crisis in the banking sector started both to strengthen and to support each other in a sort of mutual way.

Accordingly, growth of realty prices in Moscow in June was sort of minimum and quite indicative of the turning point in the three year long price trend. It became finally clear in July that the said turning point in the realty market trend had been caused by respective events in the macroeconomic sphere. It took place simultaneously in different industries of economy and was supported by efforts of the authorities in sterilizing the money mass (in order to decrease the ensuing inflation).

At first, the full of confidence declaration by Sergei Ignatiev, Chairman of the RF Central Bank (made on July 3), that the foreign currency outflow and the liquidity crisis had already been overcome, gave certain hopes for quick enough restoring growth of demand and prices on the realty market in Moscow. However, later on, as clearly shown by concrete results in July, such foreign currency outflow reached the record mark (up to 1.1 bln US dollars), nor did it any slow down in August. Taking capitals out of the country became the business of not only our own countrymen but that of foreign investors as well – finding themselves under conditions of pressing political instability, they, after all, were not yet quite ready to invest money in the Russian economy.

However, there are, indeed, some other factors to hinder the price growth process. Primarily so with regard to lowering the accessibility factor for the average income group buyers. In 2002 – 2003, significant price growth was ensured mainly by exceeding the

¹¹⁷ Sternik, G.M. Influence of the banking crisis on the realty market (report at the conference). – www.realtymarket.org.

purchasing capacity over the supply price level which resulted in a record growth of the respective sales. The sales volume sharply fell down in early 2004 and such cut down in the demand involved not only high-income population groups (as a direct/indirect result of the foreign currency outflow) but much less well-to-do citizens as well. Which, in its turn, demonstrated that the realty price growth started to outstrip real possibilities of the population on the whole. Quite a large number of buyers just *couldn't keep up on the par with the price race and...* and simply had to leave the market. Developing of the respective mortgage crediting system is normally happening somewhat late with regard to these very processes. The realty renting rates, at that, were growing much slower than those of the sales with the resulting lower investment attractiveness of such living apartments buying.

Because of these reasons, prices on the realty market just stopped growing. Even though during five months running, the said events were developing rather according to the "*prick-the-bubble*" scenario, this June saw the practical implementation of the gradual stabilization scenario. Moreover, this stabilization had started about half a year before and at the level of something like 90 % of the earlier forecasted level. As of the present day, the realty market is being so far kept from a serious "*avalanche*" mainly due to high world oil prices accompanied at that with the record volumes of exports.

Fully in connection with this, the earlier growth of prices forecast in the second half of the year of 2004, was then duly corrected (see *Fig. 25*). Which can be described as moderately optimistic: *slowly increasing business volumes under stabilized prices...* On the whole, some fluctuating stability was expected to be preserved for the year of 2005 (average price level fluctuations within the 1900 to 2000 US dollars per sq. m range). In certain realty segments (elite dwelling, cottages, land) however, a possibility still remained for continuing the price growth accompanied with the respective transition to stabilization just within a half-year period. While, at the same time, as regards other objects (low quality housing facilities, newly-constructed housing buildings in certain areas of Moscow, cottages in some so called "*unfavourable*" cottage settlements), lower prices were forecasted but not of the "*landslide*" nature at all. Because the *de facto* price dynamics in the 2-nd half year quite corresponded to the above forecast.

Trends of the second half-year

As was shown above (see *Table 8*), the realty prices in both Moscow and the Moscow Region were rather stable during the second half of the year with only certain segments of the primary and secondary markets demonstrating some insignificant increase or decrease of such prices. As to their respective turnovers and activities, then, according to the data on the profile units of the "*MIEL-Realty*" company, the quantity dynamics of the deals registered by them, was as follows (see *Fig. 23*).

According to the management data of this company, the sales volume in this segment of the Moscow realty market (which reached its minimum in June) kept increasing till the end of the year and finally returned to the level of April – 2.92, relative to the December 2002. The sales volume of the living apartments on the secondary market of Moscow (according to the data of the respective department of the "*MIEL-Realty*" company) were first slightly decreasing after April but then they got sort of stabilized at the 1.25 level and, already by the end of the year, grew up to 2.0, relative to the same datum period. According to the same source, the sales volumes of cottages were steadily going down from April till August (from 1.43 to 0.45 by the December 2002) but during the last months they grew up to the June 1.10 level. As to the rent segment, its activity was much higher than such in the preceding year; the maximum turnover level (as compared against the December 2002)

was achieved in November 2004 – 3.10, but then it went down to 2.3 in December, although comprising only 1.5 in December 2003.

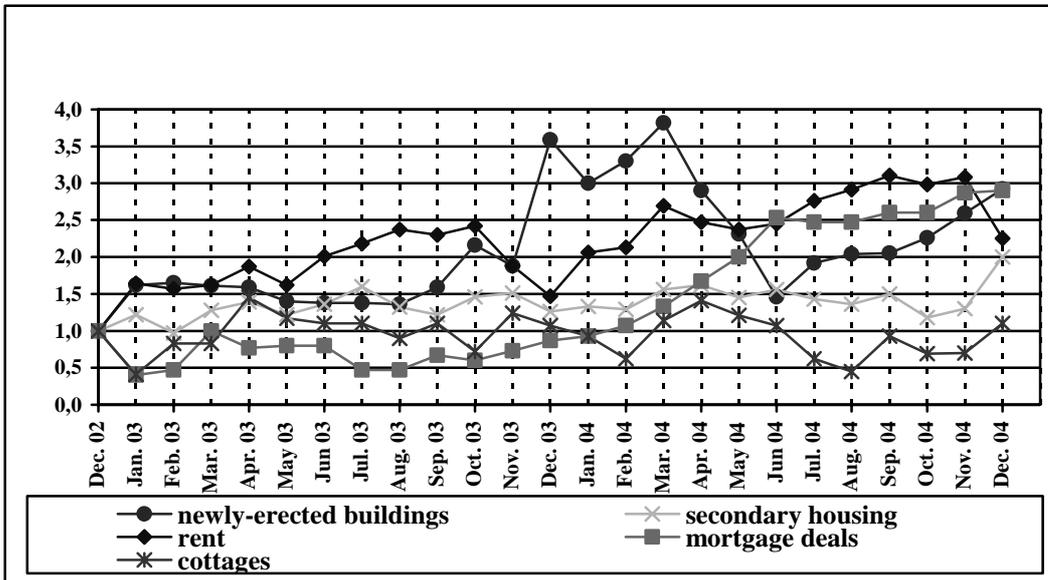


Fig. 23. Dynamics of the number of deals on the Moscow realty market and on the cottages market in the Moscow Region (according to the data of the “MIEL-Realty” company)

According to the data, as provided by the respective mortgage department, volumes of the mortgage deals on the primary and secondary realty markets of Moscow grew up drastically in the first half year (2.5 times relative to the December 2002), kept slightly increasing in the second half year and in December this index of the respective turnover already reached 2.9. The total share of such mortgage deals (for both the primary and the secondary markets of the living apartments) grew from 2 % in 2003 up to 8 % in the end of 2004 (Fig. 24).

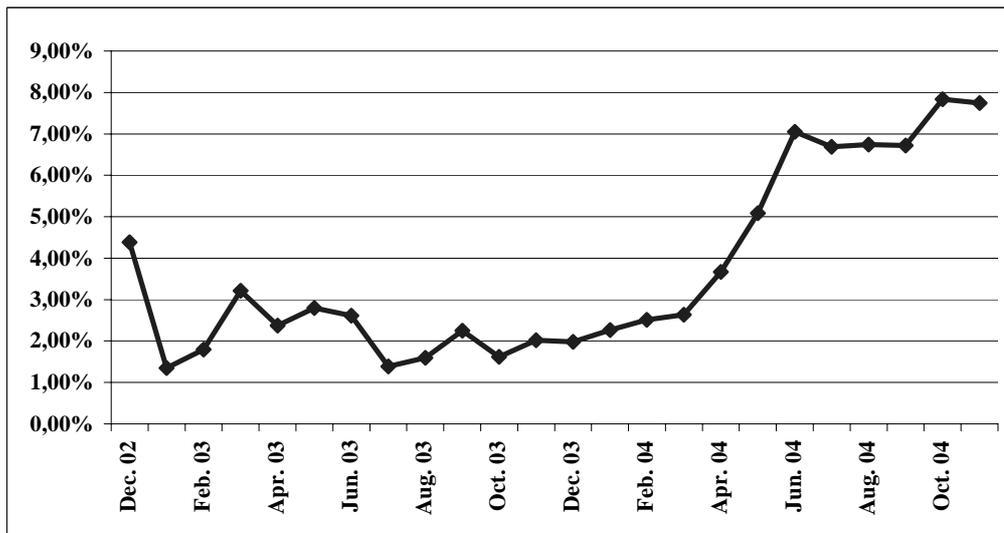


Fig. 24. Dynamics of the mortgage deals on the realty market of Moscow in 2003 – 2004 (%)

Thus, both positive and negative trends were present on the realty market of Moscow in the second six months of the year.

Certain impacts were indeed exerted by the consequences of the negative developments in the finance sphere which took place during the respective spring – and – summer periods. As a consequence of the recent liquidity crisis (possibly, almost overcome already) we now have slower growth rates of the industrial production. Not all banks have yet fully recovered their ability (particularly so taking into account higher norms for reserving the respective funds in the RF Central Bank) and wish to give crediting to developers (especially those having problems with servicing the credits received earlier). Quite a number of them, particularly bigger ones, who have entered the market of borrowing (obviously for purposes of preparing their further expansion into certain RF regions), turn out to be unable to settle accounts with their respective creditors and/or contractors even though they are doing their best to hide their insolvency under a thick smokescreen of noisy and aggressive advertising. While the middle-size developers, as well as some big ones, have sufficient working capital even under conditions of slower rates in attracting private investors which quite significantly helps them to successfully develop their respective business projects. Although, on the whole, the building industry has not yet fully overcome the falling profitability factor certain improvements are already visibly - the share of unprofitable enterprises still remains rather high but is nevertheless somewhat going down.

All the external factors which exerted certain impacts on the realty market in the second half year also had both positive and negative variables. The respective trends were (as before) determined mainly by unstable balances of foreign currency flows, i.e. the correlation between the level of the world oil prices and that of the foreign currency outflow from the country. Oil prices on the world markets remained sufficiently high. The outflow of capital abroad (net export of capital from the private sector in accordance with the data on the RF payment balance as estimated by the RF Central Bank) caused by the worsening investment climate in Russia as well as by the notorious capital – power confrontation, increased in the year of 2004 about four times over as compared against 2003, having thus actually returned to the 2002 level even though there was some net inflow in the last quarter.

Forecasting the trends on the realty market

The following factors capable of exerting stimulating influences on the realty market were primarily taken into consideration when forecasting the level of realty prices in Moscow for the new year of 2005 (*Fig. 25*): confidence of analysts in maintaining sufficiently high oil prices and amounts of energy carriers exported from Russia, potential attractiveness of the country for returning the national capital and inflow of foreign investments, development of the market legislation in the housing sphere which creates conditions necessary for further development of the mortgage crediting.

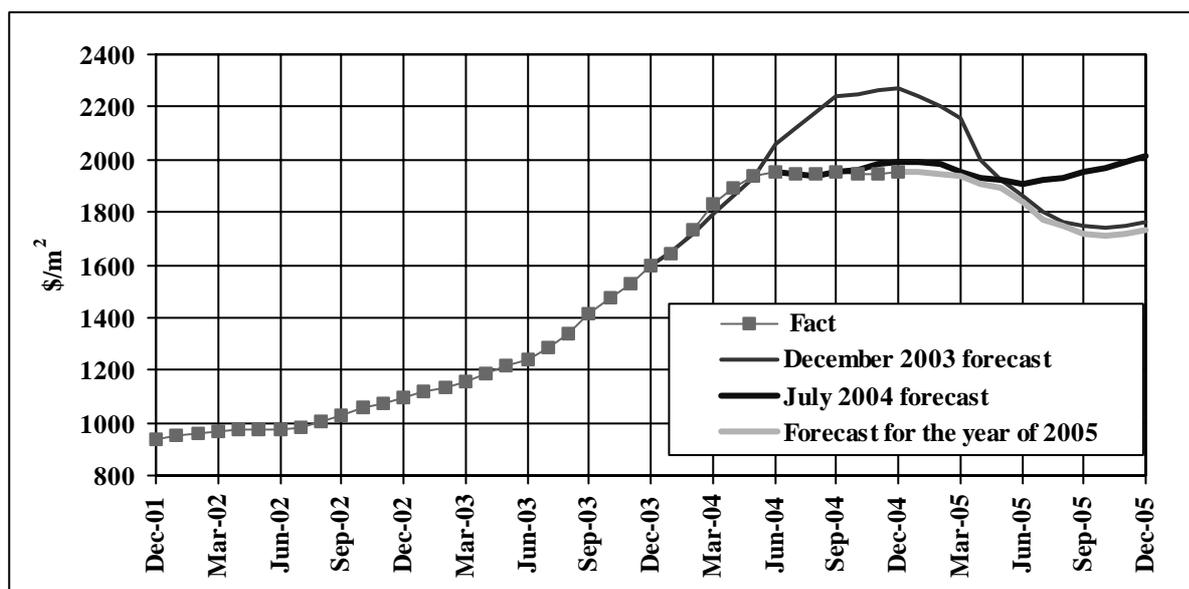


Fig. 25. Forecasting the dynamics of realty prices in Moscow

However, the macroeconomic situation in the country gives little grounds for making undoubtedly positive forecasts. In 2005, the realty market may have to face serious upheavals. Conditions for normal business activities are becoming neither better nor any more definite. The package of laws (adopted at the end of 2004) which is expected (at least from the respective official point of view) to stimulate more efficient development of the accessible housing markets, will be practically capable of exerting any positive influences after three to four years at best. Accordingly, the nearest feasible time promises but only quite painful consequences for all players of the realty sphere because of uncompleted transition of financing the housing and communal services (HCS) to the non-subsidy system and quite unclear perspectives for full monetization of privileges with regard to the HCS, the precocity and unjustified toughness of a number of norms in the new Housing and Town Planning codes from the viewpoints of expected social consequences, hardness of struggling against monopolistic structures and practices in the housing business (as demonstrated by the process of restructuring the natural monopolies and the present situation on the Russian fuel market, achievement of the real competition is not evident even several years after the respective normative and legislative basis has been enacted). Rather improper beginning of the practical implementation of the law on monetization of privileges has caused social tension in the country while measures being undertaken to overcome it will undoubtedly lead to unforeseen growth of inflation.

Under such conditions, disposition of the population to spending money, to crediting (mortgage included) will indeed be decreasing while that for saving will most definitely be on the rise. However, under conditions of stable and somewhat going down prices on realty the latter ceased being an attractive means for saving monies and investing. Having become convinced in insufficiency of the purchasing capacity for realty, developers will simply have to begin to cut down prices in order to improve the value of the liquidity factor. Nevertheless, we are still of the opinion that they are already somewhat late: the attendant combination of both macroeconomic and microeconomic factors is expected to lead not to greater market turnover and adequate support of the price levels but rather to comparatively prolonged falling of prices in the spring and summer periods – by 15 to 20 % before

the end of the year. Then the said realty market will return to the trajectory of the second scenario forecast which was calculated in December of 2003. By the end of the year, the average price level of realty supply in Moscow will comprise 1700 – 1750 US dollars/sq. m.

4.7. Issues of Practical Implementation of the Local Self-Governance Reform

4.7.1. Normative and Legal Regulation of Reforms

In October 2003 a new version of the Law "On General Principles of Organization of Local Self-Governance in the Russian Federation" (Law No. 131-FZ) was adopted. It is envisaged that the Law will fully enter into force on 01 January 2006.¹¹⁸ Chapter 12 "Transitional Provisions" of the Law describes peculiar properties of local self-governance in the period of transition and the actions of government agencies of various levels aimed at preparing full-scale implementation of the municipal reform. In particular, the following actions aimed at implementing the provisions of the new version of the Law were to be carried out.

It was intended to establish the boundaries of municipal formations before 01 January 2005 and to endow these entities with the status of an urban or rural settlement, a city region or municipal district. As it will be shown below, this process has been developing with many complications and not without contradictions (experts warned it would); this necessitated additional legislative control. In December 2004 Law No. 186-FZ "On Introducing Changes into the Federal Law "On General Principles of Organization of Local Self-governance in the Russian Federation" was adopted, in which the deadline for establishing the boundaries and endowing municipal formations with a status was shifted to 01 March 2005.

The necessity to solve a number of issues of redistributing powers, property etc. between the regional and municipal levels in 2004 was related to the provisions of Law No. 95-FZ "On Introducing Changes In and Additions To the Federal Law "On General Principles of Organization of Legislative (Representative) and Executive Government Agencies of Constituent Entities of the Russian Federation" that came into force on 01 January 2005 (one year earlier than the legislation on local self-governance).

It had been planned at the level of the Russian Federation government:

- Before 01 June 2004, to approve the list of territories with low and high population density;
- Before 01 June 2005, to approve the order of property redistribution between the Russian Federation, entities of the Russian Federation and municipal formations as well as the order of delimitation of property in municipal ownership between various types of municipal entities;
- Before 01 January 2005, to introduce in the State Duma draft federal laws on making changes in and additions to federal laws that regulate the order of lodging local self-governance agencies with individual government powers, the authorities of local self-governance agencies to solve local issues and the rights local self-governance agencies for legal defense.
- Before 01 January 2005, to approve the order and dates of preparation of the act of transfer (delimitation) determining the local self-governance agencies' obligations that appear as a result of legal succession.

¹¹⁸ In two entities of the Federation, Stavropol Krai and the Novosibirsk Oblast, the Law comes into force on 01 January 2005.

In its decree of 03 March 2004 the RF Government approved the plan of preparing legal acts necessary to implement the Federal Law "On General Principles of Self-Governance in the Russian Federation". This plan envisaged implementing nine items including development of two federal level draft legal acts (one, on making changes in federal laws due to the coming into force of new legislation on Federation entities and on local self-governance, and, two, on state registration of municipal entities' charters) and a number of RF Government's regulations on qualification requirements to the heads of municipalities' financial agencies, to the relationship between tax inspectorates and municipalities etc. It had been intended to prepare the regulation on delimitation of territories with high and low population density in April 2004, and the regulation on segregation of property and regulation of legal succession issues, in November 2004. It had been recommended on the level of constituent entities of the Federation to approve similar plans, and most of the regions followed this recommendation.

Although, by the end of 2004 most of the envisaged normative legal acts had been either adopted or prepared to a high degree, not all of the plan items had been implemented.

E.g., in August 2004 Federal Law "On Making Changes in Legal Acts of the Russian Federation and Acknowledging Some Legal Acts of the Russian Federation as Inoperative due to Adoption of Federal Laws "On Making Changes in and Additions to the Federal Law "On General Principles of Organization of Law-making (Representative) and Executive Bodies of State Power of Constituent Entities of the Russian Federation" and "On General Principles of Organization of Local Self-governance in the Russian Federation" No. 122-FZ was adopted that provided for introducing changes to more than 150 legal acts of the Russian Federation. At the same time, the procedure for regulation of a number of issues that is contained in this Law does not correspond to the provisions contained in laws No. 95-FZ and No. 131-FZ. E.g., this law stipulates for making changes in the Law "On Education", in accordance with which it is the competence of entities of the Russian Federation to provide state guarantees for citizens' rights to free-for-all and publicly accessible pre-school and general education as well as additional education by means of allocating to local authorities subventions in an amount necessary for the implementation of basic programs of general education. At the same time Law No. 131-FZ stipulates that organizing the process of granting additional education and free-for-all and publicly accessible pre-school education is a local level issue; moreover, as opposed to the case of primary, basic and secondary general education, in this case no reservation is made that the authority to fund education are excluded from local issues.

In addition, the RF Government issued four regulations in the course of the year: "On the Order of Interaction of Agencies of State Authority of a Constituent Entity of the Russian Federation and Local Self-Governance Agencies with Territorial Agencies of a Federal Agency of Executive Power Authorized in the Area of Taxes and Duties" (August 2004); "On Qualification Requirements to the Head of the Financial Agency of a Constituent Entity of the Russian Federation and the Head of the Financial Agency of a Local Administration" (November 2004); "On the Authorized Federal Agency for the Approval of Boundaries of Municipal Formations" (December 2004) and "On Approving the Rules for Delineation of Municipal Formations' Obligations and for Preparation of the Act of Transfer (Delineation)" (December 2004). The RF Government regulated the issues of determining territories with low and high population density in its decree of 25 May 2004, which approved the list of constituent entities of the Russian Federation and separate districts of entities (within the existing borders) belonging to the territories with low population density and the list of constituent entities of the Russian Federation and separate districts of entities (within the

existing borders) belonging to the territories with high population density. The draft law on state registration of municipal formations was prepared in 2004; however, it has not been introduced for approval in the State Duma.

Owing to the fact that property redistribution between the regional and municipal levels was quite actively carried out in 2004 in connection with preparation for the implementation of Law No. 95-FZ, lack of a normative legal act regulating the order of such redistribution affected the course of reforms especially negatively.

Adoption of amendments to the Tax Code and Budget Code has become a most important novation that has a considerable effect on preparation of a full-scale introduction of Law No. 131-FZ. These documents regulate such issues as assigning sources of income to various type municipal formations (including a list of local taxes), possible mechanisms of establishment of interbudgetary relations, introducing provisional financial administration etc. The notion of local budget undergoes a fundamental change: it is now defined as a form of amassing and spending funds for financial year, which are allocated for the execution of specific expenditure liabilities of the relevant municipal formation, and not for implementing tasks and functions reckoned among issues of local self-governance in general. Expenditure liabilities arise out of normative legal acts and agreements adopted at the municipal level. It is made obligatory for agencies of local self-government to keep a register of their expenditure liabilities.

At the same time, not all of financial issues provided for in Law No. 131-FZ were described in the new version of the Budget Code. E.g., the Budget Code has failed to provide for adequate forms of including the citizens' self-taxation in the local budget's income.

4.7.2. Determining the Boundaries and Status of Municipal Formations: Practice and Problems

In the course of determining the boundaries and status of municipal formations the regions encountered a number of problems arising both out of flawed regulation of these norms in Law No. 131-FZ and out of objective contradiction between various municipal formation types that started to appear as early as at the stage of organization of municipalities. Municipal districts were affected by such reforms least of all; the district structure has remained unchanged practically everywhere. Problems have been mainly connected with the establishment of two municipal formation types, namely rural settlements and urban districts. By the time the municipal reform began there were no full-fledged municipalities at the village level in an overwhelming majority of Russian regions. In most of Federation entities with a developed municipal formation structure there were sub-municipal entities at that level, namely settlements, village soviets, rural areas, volosts, etc. While the head of such an entity was appointed by the district management and its funding was carried out according to a cost estimate, the real status of these structures varied greatly from one region to another. In some Federation entities they took an intermediary position between the district administration's subdivisions and independent municipal formations because the heads of sub-municipal structures were appointed in consultation with the local population, their fairly broad authorities were confirmed in the charters of municipal formations, and they had a certain degree of freedom in disposing of the formation's finances, both in respect of a part of the cost estimate, when it included the reserve fund in one way or another, and the self-taxation funds, where these played a considerable role. In some of Federation entities municipal structures formally existed at the village level, but in most cases they had no independent budget and were funded according to a cost estimate.

In reorganizing the territorial structure of local self-governance, in particular in creating a system of rural settlements, the regions had to take account of the following conditions and restrictions that resulted from Law No. 131-FZ:

- The entire territory of the Federation entity, with the exception of the territories with low population density, must be delimited between settlements;
- The settlement's administrative center must be close enough to reach it on foot within one working day from any inhabited locality included in its structure;
- As a rule, the population of a settlement must be over 1000 inhabitants, and for territories with high population density, over 3000 inhabitants; however, this condition does not apply to independent municipal formations that existed as of the date the law was adopted;
- The list of local matters must be codified in the law.

As early as at initial stages of territorial structure reforms it turned out that the legally codified benchmarks were quite vague and did not match. E.g., it remained unclear how one should determine the proximity on foot and what population categories were taken into account in the process of such determination. This criterion per se was criticized as being archaic and not in line with the present posture of affairs. Moreover, the requirement of on-foot accessibility in many cases did not match the necessity to take into account criteria related to the number of inhabitants in rural settlements. The proposal made by a number of region to substitute transportation accessibility for on-foot accessibility was not adopted; however, in the amendments to Law No. 131-FZ that were made in December 2004 this requirement was somewhat softened.

Problems encountered in the course of establishing settlements also occurred because the right to determine the list of underpopulated territories, in which the principle of territory delimitation between settlements would not apply, had been legally overcentralized at the level of the RF Government. Moreover, such a list could include only either constituent entities of the Federation as a whole or districts within such Federation entities, while population density may differ considerably not only from one district to another but also within one district. In some districts there are territories with inhabited localities, in which there remain only few inhabitants. Further still, even in densely populated areas there are practically unpopulated spots (reserves, forestlands etc.). Under these conditions it is fairly difficult to ensure delimitation of the entire territory between settlements' municipalities; at the same time, such delimitation stops to make sense because the most part of the territory of some settlements turns out to be unpopulated. However, no steps had been made in 2004 to expand the regions' authority to determine underpopulated territories.

Along with the contradictions related to legal benchmarks for the formation of the territorial structure, this process also brought to light deeper problems. Assigning certain issues to settlements implied that municipal formations of that level were capable of implementing the functions assigned. However, the number of inhabitants or on-foot accessibility does not generate such capabilities. It is necessary to take into account other factors, namely availability of an adequate infrastructure, economic base etc., although the law does not say that these are necessary. The importance of such factors is further underscored by the fact that the experience and traditions of establishing co-operation between municipalities are lacking in Russia, and so municipal formations are quite wary of such an approach to local matters. All the attempts at establishing intermunicipal cooperation that the authors have considered in the course of researching this problem were either short-lived and ineffective or resulted in such tensions that the parties concerned made efforts to find other ways of providing the population with municipal services.

Under these conditions, the regions usually followed one of the three below-mentioned strategies in forming rural localities' territorial structure

Strategy No. 1 was to keep the district structure of municipal formations unchanged despite the novations introduced in the new law. The solution selected was to form urban regions that included the entire territory of a district even if the district in question was to a great extent rural. Without breaking the letter of the law, such an approach clearly contradicted the municipal reform concept. Therefore, the definition of the territory of an urban region was detailed in the amendments to Law No. 131-FZ so as to prevent broad interpretation. Under these amendments, the territory of an urban settlement (including an urban region) can incorporate territories, including rural territories, that, in accordance with the general layout, are designed for the development of its social, transportation and other infrastructures. In the event that the town (settlement) that is to receive the status of an urban settlement has no general layout or its existing territory exceeds the urban boundary and in the event that there are territorial disputes between the town (settlement) and other municipal formations that have not been determined in a judicial proceeding, the composition and boundaries of the urban settlement in question shall be fixed:

- On the basis of the town's (settlement's) historical territory and in accordance with the boundaries of plots of land allotted for urban development and of the territories designed for the development of the town's (settlement's) social, transportation and other infrastructures;
- In accordance with the boundaries of the territories and plots of land specified in the legal acts, which determine that the disputed territories and plots of land are part of the town's (settlement's) territory.

As of now, it is still unclear what will be the steps of the regions adhering to this strategy after the amendments to Law No. 131-FZ have been passed; they will have to change their approach to the formation of the territorial structure in a very short period of time, namely before 01 March 2005.

Strategy No. 2 was to form rural settlements on the basis of existing sub-municipal structures, namely village soviets. Under this strategy, there usually occurred no problems with on-foot accessibility, but the criteria relating to the number of inhabitants were sometimes not observed. Such an approach formally conforms to the legally fixed requirements and takes into account historical relations. However, in the event of a full-scale implementation of the law it can cause serious difficulties because it ignores both real capability of the created structures to solve local issues assigned to them and availability of the necessary personnel, infrastructure and economic potential. Furthermore, this approach *ceteris paribus* will cause the greatest increase in administrative expenses and expansion of the managerial staff machinery.

Strategy No. 3 proceeded from the necessity to take into account a bunch of factors that would ensure the most favorable starting conditions for the operation of rural settlements. It considered both formal criteria provided for in the law and transportation accessibility, available infrastructure and economic base. As a result, in the regions adhering to this strategy the number of rural settlements is appreciably, up to several times, lower than the number of sub-municipal structures existing in that territory. Under these conditions, a settlement's ability to solve local issues increases and administrative expenses grow to a lesser extent; however, this is achieved at the expense of on-foot accessibility. In this event the distance from some inhabited localities to the administrative center can exceed 30 km. Thus, as a result of applying this approach the administration may become estranged from the population instead of moving nearer to it as this was proclaimed when Law No. 131-FZ was adopted.

Under these conditions it becomes especially important to provide municipal services to the population of the territories where administrative structures (village soviets) had existed previously and were liquidated in the course of the reforms.

It is thus clear that each of the strategies used to form territorial structures in the rural area has internal contradictions that are bound to come to the fore in the course of a full-scale implementation of the municipal reform thus complicating management in new conditions.

The urban region issue was just as critical for many regions in the course of forming their territorial structure. Initially, the status of the towns that were not regional capitals or large science towns developed in different and fairly chaotic ways in different regions. In some constituent entities of the Russian Federation practically all of them were independent towns of the so-called oblast subordination, in other regions an overwhelming majority of them were part of districts. There were regions, in which towns with practically equal numbers of inhabitants and economic potential (including towns with population of 80 to 100 thousand) were independent municipal formations in some cases and were included in the district in other cases. At the same time, relatively small urban settlements with up to 20 thousand inhabitants could be made independent municipalities. In the event that a town was part of a district, usually no special sub-municipal structures were established in its territory; the district administration carried out the urban management functions directly.

Provisions regulating the formation of urban regions were one of the most actively disputed parts of the legislation on local self-governance and in the course of the legislation's development they were changed many times. As a result, any references to quantitative criteria of urban region formation that related to the number of inhabitants were eliminated from the wording of the law. At the same time, it was proclaimed that an urban settlement that is a full-fledged municipal formation must become an urban region unless the law of the constituent entity of the Federation stipulated otherwise before 01 February 2005 (according to the amendments, before 01 March 2005). In doing so, the entity in question was to be governed by two provisions: firstly, both the urban settlement and the territory of the adjacent district were to have a social, transportation and other infrastructure necessary for them to independently solve local matters and to carry out certain governmental authorities. Secondly, it is necessary to obtain the consent of the local population to assign or to withdraw the status of an urban settlement. The situation became even more complicated because the article prescribing to find out the population's opinion is to enter into force only from 01 January 2006.

At the same time, assigning the urban region status to urban settlements that were not a full-fledged municipal formation required that the above-mentioned infrastructure criteria must be taken into account and that the opinion of the population both of the urban settlement and the municipal district that has incorporated this settlement be found out.

As a result, the case of assigning the urban settlement status to urban regions has developed as follows. At this point in time the authors do not know of any case in which the urban settlement status has been assigned to an urban settlement that previously was not an independent municipal formation even if a developed infrastructure allowed both the town and surrounding district to solve local issues independently. The procedure related to such assigning turned out to be overly complicated and costly to apply in practice. The situation with independent municipal formations developed in different ways. In some regions they were assigned the urban settlement status automatically; in others they were incorporated in districts even in the event of fairly large towns with long-time traditions of self-regulation. In doing so, no attempts were made at finding out or taking into account the population's opinion about the status of such municipal entities.

It is clear, like in the first case, that both decisions are pregnant with future conflicts. Creating an urban region on the basis of an urban settlement that is a district center will in most cases strip the district of any considerable sources of income and is bound to create problems linked to joint use of objects of social infrastructure located in the town's territory. On the other hand, incorporating a town in a district as an urban settlement is not a problem-free solution either. E.g., in this event one can predict that there will be inevitable conflicts between the head of the district and the head of the district center, which may negatively affect the process of making and implementing decisions that require co-operation from both sides.

Different options of solution for the urban settlement problem can lead to controversial results for municipal formations' investment attraction. E.g., the necessity to get an approval at one more level, namely that of a district, can affect investor interest to urban objects negatively. At the same time, as a result of the lack of a tradition of intermunicipal cooperation, in some instances the town needs a territory for establishing new production and the district needs the infrastructure, but the two entities of municipal power cannot reach an agreement.

The idea that an urban center cannot be the center of the surrounding district, which does not follow from the wording of Law No. 131-FZ directly, has posed a special problem in assigning urban settlements with the urban region status. As a result, in some regions reorganization of the territorial structure of local self-governance provided for assigning the urban region status to all urban type independent municipal formations except for district centers, i.e. the largest formations that solid grounds to qualify for this status. A special clarification to this effect has been included in amendments to Law No. 131-FZ, which stated "a town (settlement), which has the status of an urban region and is located within the boundaries of a municipal district can be considered the municipal district's administrative center".

The mechanism used in forming the territorial structure of local self-governance is of considerable importance from the point of view of the consequences that the introduction of Law No. 131-FZ will have. In most regions district level municipalities that developed drafts of new territorial structures played the main role in this process. As a rule, the heads of sub-municipal structures were involved. Population was mainly gathered in the event of a conflict, however, in some districts gatherings were convoked everywhere. Then the prepared draft was presented to the oblast administration, where a special committee would consider and usually adopt it, although occasionally the draft was returned for rework. However, we have seen cases of a different approach to this issue, in which the draft of a new territorial structure was worked out at the oblast level together with district heads; sub-municipal structures were not involved and practically no gatherings were convoked.

Clearly, in the first case the process of territorial structure formation included co-operation and co-ordination of interests of various "players". In this event the heads of sub-municipal structures played the role they do play in most cases, namely that of an organizer of the local community, and not just a formal role of an employee of the district administration. Although the process of creating the structure of a municipal formation could include more difficulties and conflicts, social adaptation of this structure should *caeteris paribus* be less painful. Approach No. 2 wholly rests on the formal structure of power and in many respects transfers the procedure for the formation of a territorial structure to the area of administrative solutions. It is clearly not as time-consuming as the above-mentioned option. However, the advantage that this approach can offer at the stage of territorial structure formation can lead to additional difficulties and problems by the time it is necessary to solve local issues using such a structure. A new territorial structure that has

not undergone social adaptation with the local population and has been created without account for information available at the sub-municipal structure level can turn out to be socially and politically vulnerable.

4.7.3. Other Aspects of Municipal Reform Preparation.

It is obvious that preparing the municipal reform at the regional level included two main components, namely establishing the boundaries and determining the status of municipal formations. Other aspects of the reform played a far lesser role. Still, we should not pass over at least three groups of issues that are bound to exert fundamental influence on the creation of municipal formations after 01 January 2006. These groups are: redistribution of authorities and property between various levels of power, both between the regional and municipal levels and between districts and settlements, as well as creation of financial mechanisms that conform to the new versions of the Tax Code and Budget Code.

Redistribution of Power and Property

In 2004, due to the preparation for enactment of Law No. 95-FZ, authorities were quite actively redistributed between the regional and municipal levels. The most significant change in this respect is the centralization at the regional level of the functions relating to social protection of the population. Some regions transfer such functions to municipal formations in the form of official authorities; others fully centralize them at the regional level, creating subdivisions of regional structures in municipalities.

The management of many municipal structures is quite wary about transferring social functions to the region. It is believed that the real state of affairs and real needs of the people are better known at the local level, while granting social aid from the regional level would only result in bureaucratization of the process. At the same time, they are considering options aimed at keeping at the local level certain authorities in the field of social policy under the new legislation. E.g., a number of municipal programs in the field of social assistance may be changed into programs in the field of education or health care without any essential change in their content.

The transfer of social authorities to the regional level is accompanied by transfer of items of property necessary to implement such authorities. Conflicts arising in the process of property transfer are caused by two main reasons. Firstly, municipal formations have invested considerable amounts of money from local budgets (and, in some instances, money of the population) in a number of social facilities, and transferring them without any compensation is considered unfair. Secondly, difficulties arise when premises and a number of other items of property necessary for administering the social sphere are divided.

As far as distribution of power between districts and settlements is concerned, it should be borne in mind that, despite strict delineation of local issues between the district and the settlement levels, the law provides for a possibility to transfer power from settlements to the district and from the district to settlements. Such a transfer may be carried out on the basis of agreements concluded for a certain period of time. The authorities transferred must be funded out of subventions granted either from the budgets of settlements to the budgets of municipal districts or from the budgets of municipal districts to the budgets of settlements.

So far, in most regions this issue has not reached the practical stage. At this point in time only approaches to the delineation of powers between the two levels of municipal formations are being discussed. And since both the necessary human resources and organizational potential are lacking at the settlement level, it is now widely believed that the

functions must everywhere be transferred from settlements to districts together with the corresponding financial resources. This in fact means reproducing the previous, pre-reform model of organization of municipal formations.

But, even if we forget that such a system contradicts the spirit of the law, it should be taken into account that it is fraught with deep conflicts. The law stipulates for elected bodies at the settlement level, and such bodies will see their task in protecting the interests of the people that have elected them. If settlement level authorities are deprived of powers and means of solving their inhabitants' daily issues, new authorities will concentrate their main efforts on protecting the interests of their inhabitants at the district level, which will inevitably result in problems and conflicts. In a situation like this the proneness to conflict that is inherent in the two-level model (and that has been on many an occasion pointed out by foreign and Russian experts on municipal issues) can grow significantly.

In our opinion, the option providing a greater degree of selectivity in respect of distribution of powers between the district and settlement levels is more promising. From this point of view, four various settlement groups may be separated:

1. Settlements, to which additional powers are transferred, primarily in the field of education and health care. Such a transfer allows to ensure coordinated growth of the communal and social infrastructure in the settlement's territory and to optimize use of municipal immovable property. In respect of stations of first medical and obstetrical aid, such a transfer appears advisable practically everywhere. As far as other authorities in the sphere of health care and education are concerned, this is important for urban settlements in the first place.
2. Settlements that can solve local issues legally assigned to them without external assistance.
3. Settlements that transfer to the district level issues that are related to the organization of communal services to the population. It is this set of local issues, which causes the greatest problems, because, in many cases, economies of scale play an important role here. Given the lack of tradition of intermunicipal cooperation (which we have already mentioned above), losses at the level of a separate settlement connected with an insufficient scale of operations are highly possible; this can result in a higher price and lower quality of the services provided. It is advisable to pose the questions of maintaining the municipal housing stock at the settlement level. This will allow settlements to become gradually involved in the organization of granting housing and utility services, starting from the easiest (housing) services; at the same time this will help to delineate the granting of housing (potentially competitive) and utility (naturally monopolistic) services that, at present, in most cases is combined within multidisciplinary housing and utility companies operating at the district level. This results in insufficient transparency of financial flows in the housing and utility sector, lower manageability in the sector of services granted by natural monopolies and to artificial monopolization of potentially competitive services markets.
4. Settlements that transfer most of authorities relating to local issues to the district level. Clearly, in this case it is the smallest settlements that are really unable to implement even the easiest functions assigned to them.

In spite of the fact that, under the law, each settlement must have a local administration of its own, it could be more expedient to join the efforts of several settlements to implement some specialized functions. This could to a certain extent mitigate the problem of insufficient human and organizational resources as well as lower administrative expenses on municipal management without transferring the main settlement authorities to the dis-

trict level. Moreover, it is not necessary (and, probably, simply inexpedient) to organize such co-operation at the district level.

Formation of New Financial Mechanisms

The main elements of organization of municipal level funding have been provided for in the new version of the Tax Code and the Budget Code. It is stipulated that both local taxes (the land tax and the tax on property of individuals) and deductions from federal taxes or taxes introduced as part of a special tax regime (the tax on income of individuals, tax on imputed earnings and unified agricultural tax) shall be assigned to municipal formations.

A list of sources of income assigned by the federal law to each municipal formation type is presented in *Table 11*.

Table 11

Tax Incomes Assigned to Local Budgets (%)

Tax Incomes	Deductions to Budgets of		
	Urban Re- gions	Municipal Dis- tricts	Settle- ments
Local Taxes and Duties			
Land tax collected on the territories of settlements and urban re- gions	100	0	100
Land tax collected on territories between settlements	0	100	0
Tax on property of individuals collected on the territories of settle- ments and urban regions	100	0	100
Tax on property of individuals collected on territories between set- tlements (??)	0	100	0
Federal Taxes and Duties, Including Those Stipulated by Special Tax Regimes			
<i>Income tax</i>	30	20	10
Unified tax on imputed earnings	90	0	0
Single agricultural tax	60	30	30
State duty payable at the place of registration	100	100	0

Source: RF Budget Code, dated 31 July 1998. No.145-FZ (version of 20August 2004).

It is possible at the regional level to assign to the budgets of municipal districts or settlements single norms of deductions, established on a permanent basis, from regional taxes or federal taxes assigned to constituent entities of the Federation. In addition, the Federation entity should decide what instruments of interbudgetary relations from the 'menu' provided in the Budget Code will be used in the region.

In 2004, most regions began to work out approaches to the formation of a system of interbudgetary relations under new conditions and made preliminary calculations (in some of the regions these calculations included the level of the proposed settlements). Approaches to solving individual issues of a new mechanism to be applied for the funding of municipal formations are being discussed, in particular the following issues:

- On the possibility to assign single deduction norms at the regional level (some regions do not intend to assign additional norms, others contemplate, e.g., assigning part of the tax on corporate property to municipal districts);
- On organizing financial leveling of settlements (some regions propose to do it starting from the regional level, others intend to establish district funds of financial assistance to the population);

- On the necessity of applying negative transfer¹¹⁹.

However, in 2004 only few regions that set the target to speed up the implementation of the municipal reform or its individual elements did develop full-fledged methods of financial leveling on the basis of the new principles. It became clear in the process of this development that distributing financial means under the old and new financial assistance mechanisms differs significantly. Cities (in particular, regional capitals) gained most. In order to make the process of transition to the new financial leveling mechanism smoother, practically all of these regions decided to establish a fund that would in ever smaller portions partially compensate municipal formations' losses from the introduction of the new financial mechanism throughout the transition period. It is envisaged to compensate 90 percent of losses in 2005.

This measure could become even more efficient if it were accompanied by creation and implementation of special municipal formation level programs. Such programs should stipulate the directions of growth of budgetary income and provide for greater efficiency of budgetary spending. This would allow, by the end of the period of transition, to co-ordinate budgetary spending with sources of income under the conditions of leveling the fiscal capacity and to guarantee that local issues are solved at the level that corresponds the requirements of the local community.

4.8. Reform of the accounting system in Russia

The harmonization of national accounting standards in Russia with those accepted in the international practice has a long history behind it. The transition to the International Accounting Standards (IAS) – now International Financial Reporting Standards (IFRS)¹²⁰ – was set forth as the major avenue of the reforms in this sphere by Resolution of the RF Government No. 283 of March 6, 1998, “On the Approval of the Program for Reforming Accountancy in Accordance with the International Accounting Standards (IAS).”

The action plan aimed at the implementation of this program included the improvement the normative legal regulation; formation of a regulatory framework, formation of a methodological and personnel base; as well as measures of international cooperation in the sphere of development of accounting standards and regulation of accounting. It was planned to implement the whole package of these measures within two years¹²¹. Thus, the publication of the International Accounting Standards and the related glossary of terms in Russian translation was scheduled for March of 1998. The measures aimed at the final elaboration of the new standards, in particular, the development of instructions and methodological recommendations across individual rules (standards) of the accounting, as well as those relating to the training of respective experts and their attestation were delayed until year 2000.

According to the Program, the key element of the reform of the accounting and financial reporting in Russia should be the development of new and elaboration of the previ-

¹¹⁹ The law of a constituent entity of the RF can introduce the negative transfer (subvention transferred from municipal formations' budgets to the budgets, whose funds are used for the financial leveling of the corresponding type of municipalities) for settlements, whose estimated fiscal capacity level is at least the double of the average level for the settlements in such a region. The amount of a negative transfer cannot exceed 50-percent difference between the estimated fiscal capacity of this settlement and the double average fiscal capacity of the region's settlements in the past reporting year. At present discussions are under way whether it is expedient to introduce amendments to the Budget Code that would allow wider application of the negative transfer practice and increase the related revenues.

¹²⁰ On April, 1st, 2001 International Accounting Standards Board (IASB) has come in stead of former Board of the International Accounting Standards Committee (IASC). Eventually the International accounting standards will be improved by IASB and to be added to new International financial reporting standards (IFRS). IFRS includes earlier accepted standards (IAS).

¹²¹ See the Supplement to Resolution of the RF Government No. 283 of March 6, 1998, “On the Approval of the Program for Reforming Accountancy in Accordance with the International Accounting Standards (IAS).”

ously approved rules (standards) of accounting and introduction of these rules and standards to practice. It should be noted that such an approach to the harmonization of the national accounting standards to IFRS has not in fact required the Russian accountants' community to familiarize itself with the system of International Standards *per se*. It only required the implementation of the new Accounting Rules (AR) developed and approved by the RF Finance Ministry. This became one of the reasons, which generated the grave legislative and personnel problems relating to the switching of Russian enterprises to the presentation of their financial statements in accordance with IFRS they face at present¹²².

At the same time, the new Accounting Rules only in part correspond to IFRS. The fundamental principles of the International Financial Reporting Standards – the understandability, relevance, and reliability of the information contained in the reports have not been clearly set forth in the AR. The principles underlying the formation of reports – the completeness, prudence, and priority of economic substance over the legal form are set forth in item 7 of the AR 1/98 “Accounting policy of the organization.”¹²³ However, the accounting policies of organizations reflect the specifics of accounting at individual enterprises, what creates an ambiguous situation with respect to these fundamental principles.

A certain exception is the principle of neutrality of information in the financial statements. This principle is set forth in item 7 of AR 4/99 “Financial reporting of the organization.”¹²⁴ According to this Rule, information is not neutral in the case it influences the decisions and estimates of users due to the selection or forms of presentation of such information aimed at the achievement of predetermined results or consequences. In spite of clear formulation, at present this principle is not completely complied with, since it does not contain the prohibition to use the financial statements of enterprises for the purposes of tax administration and control.

The reform of the Russian accounting carried out in accordance with the Program of 1998 did not bring the expected results. The system of accounting and reporting formed at present has failed to provide the users of financial statements with reliable and useful information necessary to take economic decisions. An evidence of this is the fact that the majority of large Russian enterprises having counterparts abroad draw up their reports not only in accordance with the national standards, but in accordance with the standards accepted in the international practice, like IFRS or US GAAP, as well. Therefore, the reform of the accounting system in Russia is still far from being completed.

In 2004, there was made a significant step towards the creation of a system of accounting disciplines in Russia meeting the modern requirements to the quality of financial information. As compared with the Program of 1998, there was taken another approach to the reform in this sphere – the harmonization of national accounting standards with international practice began to transform into the transition to the International Financial Reporting Standards. For instance, there was taken an attempt to grant IFRS a legal status in Russia.

The following documents indicate the origination of this new trend:

1. The “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook”;
2. Draft federal law “On Consolidated Financial Statements.”

¹²² For details, see: Russian economy in 2003. Trends and outlooks. M.: IET, 2004. Chapter 4.5 “Reform of the accounting system in Russia.”

¹²³ Approved by Order of the RF Finance Ministry No. 60 n of December 9, 1998.

¹²⁴ Approved by Order of the RF Finance Ministry No. 43 n of July 6, 1999.

At the same time, these documents contain a number of provisions, which may have a significant negative impact on the progress of the reform of the Russian system of accounting.

4.8.1. The Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook

The “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook” (2004–2010) was approved by Resolution of the RF Government No. 180 of July 1, 2004. The Concept stated that it was aimed at the improvement of the quality of information formed in accounting and reporting and at ensuring of guaranteed access to such information for interested users.

In order to achieve this aim, it was decided to develop accounting and reporting in Russia along the following key avenues:

- Improvement of the quality of information formed in accounting and reporting;
- Creation of the infrastructure of the use of IFRS;
- Changes in the system of regulation of accounting and reporting;
- Increase in control of the quality of financial statements;
- Training and improvement of skills of the personnel.

The Concept envisages that accounting and formation of non-consolidated financial statements of enterprises should correspond to the Russian accounting standards, consolidated financial statements of groups of enterprises should be formed in accordance with the International Financial Reporting Standards (IFRS), while tax reporting should be based on the information formed in accounting by the way of adjustment in accordance with the rules set forth by the tax legislation.

In 2004 through 2007, it is planned to mandatory switch consolidated financial statements presented by socially important economic entities, with the exception of enterprises having securities traded on stock markets of other countries and drawing up their reports in accordance with other standards accepted in the international practice, to IFRS. Economic entities are defined as socially important in the case their commercial activities involve the funds of unlimited circles of persons: open joint stock companies and other organizations issuing publicly placed and/ or publicly circulated securities; financial organizations working with the funds of individuals and legal entities; other organizations.

Besides, it is stated in the Concept that the major package of the Russian standards of accounting based on IFRS should be approved at the same time.

In 2008 through 2010, the enterprises, which in the previous years used other standards accepted in the international practice for the drawing up of their consolidated financial statements, should also switch to the mandatory presentation of their reports in accordance with IFRS.

The evaluation of the option permitting a certain circle of economic entities to carry out their accounting in accordance with IFRS in stead of the Russian standards was postponed until 2008.

It should be noted that the version of the “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook” approved by the RF Finance Ministry in July of 2004 is significantly different from the variant presented to the RF Finance Ministry by the Ministry of Economic Development and Trade of the Russian Federation in March of 2004¹²⁵. The draft presented by the RF Ministry of Economic Devel-

¹²⁵ “Minekonomrazvitiya RF napravilo v Minfin RF predlozheniya po kontseptsii ucheta i otchetnosti v Rossii na srednesrochnuyu perspektivu” (The RF Ministry of Economic Development and Trade forwarded to the RF Finance Ministry the pro-

opment and Trade was elaborated in cooperation with the National Organization for the Standards of Financial Accounting and Reporting (NSFO).

These proposals envisaged several stages of implementation of the development strategy with respect to the accounting and reporting, at each stage the circle of Russian organizations using International Financial Reporting Standards should gradually expand and the state regulation in the sphere of accounting should be consistently liberalized¹²⁶.

In 2004 through 2006, the enterprises, whose securities are admitted to the circulation via organizers of trade on the stock market, banks¹²⁷, as well as professional operators of the stock market, should switch to the mandatory presentation of their financial statements in accordance with IFRS. At the same time, these enterprises should be exempted from the accounting and reporting based on the Russian standards. Since 2006, the option not to draw up financial statements should be introduced for all enterprises not included in the list of socially important entities. These enterprises would have to present only tax and statistical reporting.

The regulatory and methodological functions performed by the state in the sphere of accounting and reporting should be gradually transferred to a non-state regulatory authority.

2007. Insurance companies and state unitary enterprises¹²⁸ should present their financial statements in accordance with IFRS. These entities should be also exempted from the accounting and reporting based on the Russian standards.

2010. All joint stock companies and enterprises, which in the previous years presented their financial statements based on other standards accepted in the international practice, should switch to the International Financial Reporting Standards. The Government will have the possibility to influence the formation of the standards of financial reporting only via its representation in the supervisory board of a non-state regulatory authority.

Therefore, it is clear that the version of the "Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook" has significantly tightened the procedures governing the reform in this sphere, which would hardly be favorable for the Russian system of accounting.

There may be indicated the following negative changes:

- The requirement that the enterprises drawing up their financial statements in accordance with IFRS should continue to carry out the mandatory accounting and reporting based on the Russian standards;
- The requirement that the enterprises, which in fact have no interested outside users of their financial statements, continue to carry out mandatory accounting and financial reporting;
- Sharing of rule making and regulatory functions in the sphere of accounting biased in favor of state bodies.

The requirement to present non-consolidated financial statements based on the Russian standards presupposes the necessity to either carry out two types of financial ac-

posals concerning the concept of accounting and reporting in Russia for a medium term outlook) – published at <http://www.gaap.ru> on March 25, 2004.

¹²⁶ See, for instance, the publication "Ot redaktsii gazety Vedomosti: MSFO ne strashny" (From the *Vedomosti* editorial board: IFRS are not frightful) at <http://www.gaap.ru> on March 25, 2004.

¹²⁷ According to Instruction of the Central Bank of the Russian Federation No. 1363 - U of December 25, 2003, Russian banks should prepare IFRS based financial statements for the period ending on September 30, 2004.

¹²⁸ As concerns the budgetary sphere, the respective guidelines of the development of accounting and reporting are set forth in the "Concept of the reform of the budgetary process in the Russian Federation in 2004 through 2006," which was approved by Resolution of the RF Government No. 249 of May 22, 2004). According to this document, the key tool of the reform of accounting and reporting in the budgetary sphere should be the International Public Sector Accounting Standards (IPSAS).

counting, or transform the accounts, among other things, for the purposes of consolidation. Therefore, enterprises lack the incentive to apply the best practices with respect to the organization of the system of their accounting. It should be recognized that the introduction of accounting based on the International Financial Reporting Standards will result in information of a better quality (i.e. that correspond to IFRS) than the transformation of accounts.

As concerns the enterprises without a large circle of interested external users of financial information (small and medium sized businesses), the requirement of mandatory accounting and financial reporting results in an increase in the expenditures borne by such enterprises and slow down their development. Besides, the fact that these enterprises have to carry out accounting prevents the final division of functions of financial and tax accounting.

At the same time, it should be noted that at present the financial statements is also used for statistical purposes. The option not to draw up financial reports granted to a certain circle of enterprises should be accompanied by the elaboration of forms and procedures of statistical reports in the cases, where the necessary data can not be obtained basing on tax reporting. Such a step requires a balanced approach.

The approved text of the Concept states that “Changes in accounting and reporting, in particular, the transition to IFRS, should occur gradually and take into account the capability, requirements, and preparedness of the professional community and other interested public, as well as the state authorities.” At present, the majority of Russian enterprises, which may be deemed to be socially important, already draw up their financial statements in accordance with the standards accepted in the international practice (IFRS or US GAAP). The users feel that the reports prepared in accordance with the Russian standards are unreliable. The professional community is involved in the respective decision making process. Therefore, as it has turned out, only the state authorities turn were not ready for a full scale reform and for incomprehensible reasons linger to take the urgent measures aimed at the liberalization of accounting.

However, the current version of the “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook” is a significant step forward as compared with the Program for Reforming Accountancy of 1998, primarily due to the fact that the Concept recognized the necessity to grant IFRS a legal status in Russia. Among other positive shifts there are the following:

- The recognition of serious problems encountered in the course of the reform of accounting and reporting in Russia on the part of the state authorities responsible for these activities;
- The division of regulatory functions in the sphere of accounting and reporting between the state authorities and the professional community.

The text of the Concept indicates the following problems:

1. The absence of a legal status of the financial statements drawn up in accordance with IFRS;
2. The formal attitude of the regulating authorities and enterprises to many categories, principles, and requirements of accounting and reporting answering the market economy environment;
3. Unjustifiably high expenditures borne by enterprises with respect to the preparation of consolidated financial statements in accordance with IFRS by the way of transformation of the reports drawn up on the basis of the Russian standards;
4. Enterprises have to present excessive reporting to the state authorities, while the simultaneously carried out financial and tax accounting result in excessive expenditures;

5. The faulty system of quality control with respect to financial reporting and low quality of the respective audit;
6. Insufficient participation of the professional community and users of financial statements in the regulation of this sphere;
7. Low level of professional skills of the majority of accountants and auditors and the lack of practice as concerns the use of information prepared in accordance with IFRS.

The measures aimed at the solving of these problems are apparent and are as follows:

1. Legislative recognition of IFRS in Russia;
- 2, 3, 5, 6, 7. Implementation of educational and professional certification programs based on the standards accepted by the international community (the International Federation of Accountants, the International Accounting Standards Committee Foundation);
- 3, 4. The option to present financial statements, included non-consolidated financial statements in the IFRS format in stead of Russian financial reporting;
4. Exemption of enterprises without a large circle of interested external users of financial information from the mandatory financial reporting;
5. Reasonable convergence of the rules of financial and tax accounting;
6. Gradual transfer of regulatory functions in the sphere of accounting and reporting to the level of independent nongovernmental organizations.

However, the version of the Concept approved by the RF Finance Ministry reflects only some of these measures. At the same time, it should be noted that the Concept contains a number of provisions indicating the same formal attitude of the regulatory authorities to the fundamental principles of the modern system of accounting and reporting, which is named among the serious problems preventing its further development. Among such provisions there are the following:

1. The Concept (item 2.1) states: "The key objective in the sphere of non-consolidated financial reporting is to ensure that the interested users had guaranteed access to high-quality, reliable, and comparable personified information about economic entities. In order to achieve this objective, non-consolidated financial statements should be drawn up in accordance with the Russian standards developed on the basis of IFRS." At the same time, it is noted that non-consolidated financial reporting performs two functions – informational and control functions. According to the authors of the Concept, the latter statement means that "non-consolidated financial statements should be used for: <...> presentation to the supervisory authorities; detection of the indications of bankruptcy of economic entities; formation of the common state database of statistical observation and macroeconomic indicators, as well as for management of the economic entity, legal proceedings, and for taxation purposes."

The following questions arise:

In the case financial statements should be used for all these purposes, what for is the managerial accounting, statistical, and tax reporting required then?

What IFRS based standards may be discussed, if the fundamental principles of division of accounting disciplines are not complied with?

The attempt to develop Russian standards of accounting and reporting "on the basis of IFRS" is the most striking example of formal attitude to the reform of the system of accounting. The essence of the Russian standards contradicts IFRS, since they are based

not on the substance of financial events and operations, but their forms, as well as control on the part of the state. In the international practice, the controlling functions concerning financial reporting are performed by the users of information via respective economic decisions and auditors via audit reports. For the purposes of tax control there is formed tax reporting, which exists separately from financial reporting.

2. Item 2.1 of the Concept states: "In certain cases, Russian standards may envisage several alternative approaches to the formation and presentation of financial statements. However, for the purposes of better comparability of financial statements presented by different economic entities the number of such cases should be limited and consistently reduced." Item 2.2 of the Concept also states: "The mechanism of generalization and dissimilation of the practices related to the application of IFRS is important for the consistent and uniform use of the standards by economic entities and, as a result, the comparability of financial information about such economic entities."

These provisions also indicate the lack of understanding of the essence of the International Financial Reporting Standards. The uniformity of the use of IFRS by Russian enterprises should not be an objective, IFRS are based on the economic substance of financial events and operations, on the evaluation of such operations. At the same time, the requirement of comparability of information is achieved not via the use of a chart of accounts and mandatory reporting forms, but via the presentation of information in comparable form broken down across periods supplemented by respective explanations in the explanatory notes attached to the financial statements. Indeed, the comparison of indicators across enterprises may be inconvenient, however, it would not present serious difficulties in the case the user of financial statements has adequate professional skills and has notion about the economic substance of the respective indicators.

3. Item 2.4 of the Concept states: "As the domestic and international practices demonstrate, the most important element as concerns the ensuring of quality of financial statements is an efficient quality control." Further, the Concept states: "The system of control of quality of financial statements should also include a package of measures of financial, administrative, and criminal responsibility of economic entities and their managers."

In this, the Concept fails to discern the concepts of the audit of financial statements and state control. At present, users consider the reporting drawn up in accordance with the Russian standards as unreliable even in the case there is an audit report. The quality of audit of IFRS based reporting also is not high. At the same time, this problem should not be approached by the way of toughening responsibility for the presentation of unreliable information in financial statements. This approach is inefficient and will result in misrepresentation of information in financial statements, since the principle of neutrality will be violated. The interested users of information or professional nongovernmental organizations can evaluate and indirectly control the work of auditors.

The role played by the state in the implementation of the reform of the accounting system in Russia is excessive. As concerns the sphere of accounting and reporting, item 2.3 of the Concept stipulates the division of the respective regulating functions between the state authorities and the professional community. However, the Concept suggests that professional organizations should play only an advisory role, besides, this division of functions seems to be artificial.

For instance, the Concept vests with the professional community the development of the draft national standards, while stipulating that exactly the state authorities should organize the development. Therefore, the work of the existing professional associations,

where representatives of the government are among the members¹²⁹, will be organized by the state. Moreover, the initiative of such organizations is limited by administrative barriers. In this situation, insufficient participation of professional nongovernmental organizations in the regulation of accounting and reporting will for a long time remain a serious problem on the way to the creation of a modern and efficient system of accounting disciplines in Russia.

Yet another point should be stressed. In item 2.2 of the Concept it is stated: "In Russian Federation, there should be used the official text of IFRS in Russian. In this connection, it is necessary to create a standing nongovernmental body, which should: prepare the official Russian text of IFRS; monitor changes in the English text and in good time introduce such changes in the official Russian text; maintain a glossary of IFRS terms in Russian." These measures are indeed necessary and useful; however, the fact that the Concept fails even once mention the cooperation with the International Accounting Standards Committee Foundation (IASCF), including the work related to the preparation of the authorized translation is perplexing. If the Russian authorities wish to influence the substance of the standards of accounting and reporting to be applied in the territory of the Russian Federation after the transition to IFRS, it is necessary to actively involve representatives of our country in the development of the standards in accordance with the procedure set forth by IASCF. The procedure proposed by the Concept for the approval of the International Financial Reporting Standards in our country is in this case not sufficiently efficient and may result in the legal vacuum in stead of granting the legal status to IFRS.

4.8.2. Draft federal law "On Consolidated Financial Statements"

The draft federal law "On Consolidated Financial Statements"¹³⁰ passed the second reading in the State Duma in December of 2004.

In the case this law is approved, it will set forth the general requirements with respect to the preparation, presentation, and publication of consolidated financial statements on the part of organizations - legal entities. Consolidated financial statements is drawn up by a group of enterprises, which are defined as a single economic entity in accordance with the International Financial Reporting Standards.

It is proposed to extend this law to crediting organizations, as well as the enterprises, whose securities are admitted to the circulation via trade at stock exchanges and other organizers of trade on the stock market.

Consolidated financial statements should be drawn up in accordance with IFRS similarly to the non-consolidated financial statements of the organization drawn up in accordance with federal law "On accounting" No. 129 FZ of November 21, 1996.

The annual consolidated financial statements should be presented to the members of the organization, including the shareholders, as well as to the authorized federal executive body by all organizations with the exception of crediting organizations, while crediting organizations should present the respective documents to the Central Bank of the Russian Federation.

Annual consolidated financial statements are subject to the mandatory annual audit. The audit reports should be published alongside the respective financial statements.

¹²⁹ For instance, representatives of the RF Ministry of Economic Development and Trade and the Federal Tax Service are members of the Board of Trustees of the National Organization for the Standards of Financial Accounting and Reporting (NSFO).

¹³⁰ Bill No. 55792-4.

Organizations should publish their consolidated financial statements not later than 30 days after the presentation of such statements to the users eligible according to the aforesaid law.

It is set forth that all organizations subject to the law “On Consolidated Financial Statements” should present and publish the respective statements starting with reports for year 2005.

The organizations, whose securities (including bonds) are admitted to the circulation on the stock market and which draw up their financial statements in accordance with other standards accepted in the international practice, should present their consolidated financial statements drawn up in accordance with IFRS starting with reports for year 2008.

Since the terms of formation of the reports depend, according to the aforesaid law, on the time IFRS are granted the legal status in the territory of the Russian Federation, which has not been set yet, the draft law includes the clause that in the case the International Financial Reporting Standards are granted such a status after September 1, 2005, organizations should begin to present and publish their consolidated financial statements starting with reports for year 2006.

On the whole, the draft federal law “On Consolidated Financial Statements” is in compliance with the “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook”; however, it represents its most elaborated part.

The International Financial Reporting Standards, and not the national rules developed on the basis of IFRS, should become the basis for the preparation of the consolidated financial statements of the groups of enterprises in Russia. The subject of the drawing up of the consolidated reporting should be also determined in accordance with IFRS (item 2 of article 1 of the draft law).

Consolidated financial statements is indeed designated for the members of the organization – subject of reporting (including the shareholders), potential investors, and other interested users, to whom the external general purpose financial statements is usually addressed in the international practice. In item 3 or article 2 of the draft law it is stipulated that the information contained in the consolidated financial statements can not be used for the purposes of tax administration and tax control¹³¹.

The draft federal law “On Consolidated Financial Statements” also stipulates that it is necessary that IFRS would be granted the legal status in Russia. Item 3 of article 3 of the draft law states: “In the territory of the Russian Federation, there should be applied IFRS and IFRS Interpretations approved by the International Accounting Standards Board and recognized under the due procedure established by the RF Government as adjusted to the requirements set forth by the legislation of the Russian Federation. The recognized IFRS and IFRS Interpretations should be officially published in Russian language.”

Therefore, in the case this draft law is approved, the RF Government should establish the procedures governing the legal recognition of IFRS in Russia and official publication of the standards thus settling one of the key problems encountered in the course of the reform of the domestic system of accounting caused by the fact that financial statements of enterprises prepared in accordance with IFRS has no legal status. It should be noted that officially published should be the Russian translation of IFRS authorized by the International Accounting Standards Board.

¹³¹ This provision of the law does not prevent a group of enterprises to pay taxes proceeding from the consolidated data in the case this option (consolidated tax reporting) is envisaged in the tax legislation. It is the matter of prohibition of the use of the information contained in financial statements for the purposes of tax control, i.e. of the division of the objectives of financial and tax accounting.

At the same time, the draft federal law "On Consolidated Financial Statements" as a part of the Concept contains some insufficiently clear provisions. Below, there will be discussed some of such provisions.

1. The "Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook" does not envisage that enterprises would have the option to present their consolidated financial statements based on IFRS in stead of financial statements prepared in accordance with the Russian standards in the nearest future, what is reflected in item 2 of article 3 of the draft law "On Consolidated Financial Statements." According to item 1 of article 3 of the draft law, consolidated financial statements of enterprises should be drawn up in accordance with IFRS. Therefore, enterprises would have to either carry out two types of financial accounting simultaneously, or transform the financial statements presented by all enterprises being the members of the group. Somehow or other, this stipulation makes enterprises to bear additional costs, which the Concept recognizes as a serious problem in the Russian system of accounting.

The larger will be the group of enterprises, the lower will be the quality of information (the less will be its correspondence to IFRS) in consolidated statements, since in the course of transformation of larger volumes of data there exists a higher probability of omissions and errors. Besides, the draft law does not mention the procedures governing the formation of consolidated financial statements in a situation, where the majority of Russian enterprises just see no benefit in carrying out accounting in accordance with the international standards.

2. The draft law vests the control over the quality of information contained in consolidated financial statements with auditors. At the same time, the supervision over the presentation and publication of such statements (with the exception of the reporting carried out by crediting organizations) should be vested with an authorized federal executive body determined by the RF Government (item 1, article 6 of the draft law).

These provisions have been somewhat altered in comparison with the text of the draft law "On Consolidated Financial Statements" prepared for the first reading. Initially, it was envisaged to include in the law the provision setting forth the necessity of annual mandatory audits of consolidated financial statements in accordance with the International Standards on Auditing. As concerns the provisions for the supervising agency, this body was more clearly defined in the original version of the draft law as the authorized federal executive body in the sphere of financial markets. This definition capacitated such control with respect to the reporting prepared in accordance with IFRS.

4.8.3. Banking sector

The survey describing the reform of the accounting system in Russia in 2004 should necessarily dwell on the reform of accounting in the banking sector.

In accordance with the requirements set forth by the RF Central Bank (CB RF Instruction No. 1363 - U of December 25, 2003), crediting organizations should be bound to prepare financial statements based on IFRS for the period ending on September 30, 2004, and annual financial statements for the period ending on December 31, 2004.

Both consolidated and non-consolidated annual financial statements of crediting organizations should be confirmed by audit certificates and be submitted to the territorial agencies of the Bank of Russia vested with supervision of the activities of such organizations prior to October 1, 2005.

In spite of the fact that the IFRS based statements for the period starting on January 1, 2004, and ending on September 30, 2004, should be presented by the crediting organi-

zations to the Bank of Russia by November 30, 2004, it is impossible to evaluate the real results of the switching of the banking sector to the formation of IFRS based statements, in particular, because the financial statements not certified by auditors can not be reviewed as reliable information suitable for analysis on the part of external users.

Unfortunately, in the situation presently existing in Russia financial statements prepared in accordance with international standards is presented relatively late, since the respective audit, as a rule, takes a rather long time¹³². Taking into account the deadlines set forth in the documents elaborated by the Central Bank, more or less suitable data pertaining to financial statements of crediting organizations based on IFRS certified by audit reports will be available only by the end of 2005.

At present, there may be discussed only the results of the transition of the Russian banking sector to the presentation of IFRS based statements recognized by the Central Bank.

On November 22, 2004, there was held the conference "Transition of the banking sector of the Russian Federation to the preparation of financial statements in accordance with IFRS – the way towards the rising of competitiveness of Russian banks." The participants discussed the problems existing in this sphere, the results of transition, as well as perspectives of improvement of accounting of crediting organizations and banking supervision. Judging by the practical materials of the conference published by the mass media¹³³, at present the Central Bank and other participants see the International Financial Reporting Standards in the Russian banking sector primarily as a tool of banking supervision.

For instance, the report on the TACIS project, where the RF Central Bank is a participant, "Banking supervision and reporting, Russian Federation" presented by a PricewaterhouseCoopers's consultant notes that the key principles of efficient banking supervision set forth that financial statements of banks should be formed on the basis of internationally accepted accounting principles. According to the presenter, from the viewpoint of the banking supervision requirements the standards of financial reporting should answer three general criteria: facilitate reliable practice of bank management and risks control; tighten market discipline via the transparency of financial reporting; facilitate efficient banking supervision. The statements prepared in accordance with IFRS answer the aforesaid criteria.

In her report "International Financial Reporting Standards – the most important tool of development of the banking sector," T. Paramonova, the first deputy Chairperson of the RF Central Bank, presented a complex approach to IFRS as a means of ensuring security, consistency, and integrity of the procedures governing the evaluation, control, and preparation of financial statements. At the same time, the report notes that the RF Central Bank views the financial reporting drawn up in accordance with IFRS as the basis for implementation of the "Basel II" agreement used for the purposes of regulation and supervision. The toolkit set forth in this agreement is used for the evaluation of future expected and unexpected losses and, therefore, is useful not only for supervising authorities, but also for banks.

Only time can tell if the financial reporting of crediting organizations drawn up in accordance with IFRS may become a tool facilitating a better transparency of the banking sector in the interests of consumers of banking services in spite of the fact that it should

¹³² A considerable part of audit certificates pertaining to the reporting for year 2002 was signed only in the 3rd quarter of 2003. (see: Matovnikov M. Rossiyskiye banki prisposobili Mezhdunarodnye standarty finotchetnosti k otechestvennym realiyam (Russian banks have adapted International Financial Reporting Standards to the domestic realities) // Kompaniya. 2004. No. 3 (64)).

¹³³ <http://www.gaap.ru>

play a controlling role, which is uncharacteristic for it in the international practice. In the process of evaluation of the future results it is necessary to bear in mind that the largest Russian banks carrying out up to 90 per cent of all banking operations in the country had prepared their financial statements in accordance with international standards even before the Central Bank made public its instruction. Besides, crediting organizations prepared their financial statements for year 2004 in the situation, where IFRS had no legal status and the official Russian translation of the IFRS text did not exist, proceeding from Methodological Recommendations of the Bank of Russia No. 181 - T of December 25, 2003, "On the procedure of formation and presentation of financial statements by crediting organizations." The RF Central Bank failed to outline the perspectives of the use of the official text of IFRS by banks in the case it is available in Russia.

At present, it may be reasonably presumed that financial statements of crediting organizations presented to the RF Central Bank drawn up in accordance with international standards will significantly differ from the reports they prepare for foreign investors. Here, the mandatory audit of financial statements would hardly be an obstacle. In the present situation, where there is felt a significant lack of personnel able to carry out accounting and prepare reporting in accordance with international standards with quality and responsibility, Russian enterprises, including banks, hire experts of international auditing companies for drawing up such reporting (or for consultations concerning the issue of formation of such reporting), who later certify the respective statements. At the same time, it should be taken into account that financial statements formed for presentation to supervising agencies is more prone to offences related to the neutrality of information.

According to the "Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook" until year 2010, the reforms in this sphere will be of transitional nature, i.e. the rule making and regulatory functions will be gradually transferred to the level of professional and public associations. It will depend on the further measures of the Government in the sphere of reform of accounting and reporting, what financial statements is in the end available to the Russian users – in the format accepted in the international practice, or in the format adapted for supervision authorities.

* * *

So, in 2004 there was taken a serious step forward in the sphere of the reform of the Russian accounting system: there was recognized the necessity and indicated the intent to grant the legal status to the International Financial Reporting Standards in Russia. Therefore, there appeared a prerequisite for the principal change in the approaches taken with respect to the reform in this sphere. At present, although only with caution, it may be stated that there takes place not the harmonization of domestic accounting practices with the international standards, but the proper switching to IFRS, i.e. the adoption of these standards as an integral system of accounting disciplines.

In order to achieve the objective of creation of the system of accounting and reporting answering the modern requirements to the quality of information in Russia it is necessary to consistently implement the new approach to the respective reforms. It is important that the "Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook" recognizes serious problems preventing the success of the reform. Among these problems there are the formal approach to and misunderstanding of the fundamental principles of the system of accounting and reporting answering the requirements set by the market economy on the part of the regulatory authorities. Unfortunately, the substance of the Concept does not permit to state that this problem will be solved in the nearest future.

The consistent implementation of the new approach implies a complex of measures aimed at the realization of fundamental principles of accounting and reporting answering international standards, including rationality, in Russia. These measures should include:

- Division of financial and tax accounting, legislative fixation of the prohibition to use financial statements for the purposes of tax administration and tax control;
- Enterprises should be granted the right to choose the format of presentation of their non-consolidated financial statements (either in accordance with the Russian standards, or IFRS in stead of the Russian standards);
- Enterprises without large circles of interested external users of financial information should be granted the right not to draw up financial statements; such enterprises should carry out only tax and statistical reporting.

The division of financial and tax accounting is necessary primarily because these disciplines are oriented towards different target users and perform different functions. The method of adjustment of accounting records in the course of drawing up tax reporting does not imply that enterprises are completely relieved of tax accounting. This may be avoided by the way of harmonization of accounting and tax legislation. However, such measures, first, will negatively affect the accounting *per se*, since they imply the rejection of the use of accounting methods and ways of reflection of events and operations, which are based on the system approach and the requirement of completeness of the reflection of events and operations, what in turn challenges the reliability of information presented in financial statements.

Second, the artificial convergence of the tax and financial accounting creates a prerequisite for the inclusion of the controlling function in the sphere of accounting information, what is inadmissible from the viewpoint of adherence to the neutrality principle. Therefore, the result of the convergence of the tax and financial accounting may be positive only as concerns the degree, to which the calculation of the profit tax is simplified, while the confusion of terms is inadmissible.

The problem of personnel still remains acute. The insufficient level of professional training of Russian accountants, auditors, users of financial statements, as well as the lack of experience with respect to the use of information prepared in accordance with IFRS creates many serious obstacles to the reform of the domestic system of accounting. In particular, these problems are as follows:

- Disproportions on the market of consultative and auditing services in the sphere of IFRS;
- High costs borne by enterprises in relation to the drawing up and audit of the reporting prepared in accordance with international standards;
- Insufficient participation of professional organizations and interested public in the regulation of the system of accounting and reporting;
- Slack system of control of the quality of financial statements on the part of auditing organizations and external users of general purpose financial reporting;
- Slowing down of the rates of development of the Russian accounting system, the formal attitude to the reform in this sphere.

The Government and the professional community should set the support of the educational programs and improvement of professional skills of experts in the sphere of the International Financial Reporting Standards as the priority of their activities. It is necessary to design a program of continuous education for accountants and auditors with respect to IFRS answering the requirements set forth by the International Federation of Accountants, as well as the system of attestation of accountants and auditors approved by the International Accounting Standards Committee Foundation.

The “Concept of Development of Accounting and Reporting in the Russian Federation in a Medium Term Outlook” failed to indicate the cooperation with the International Accounting Standards Committee Foundation as a priority measure; however, it is necessary to develop such cooperation in order to play an active role in the elaboration and implementation of best practices in the sphere of accounting and reporting accepted by the international professional community.

RUSSIAN ECONOMY IN 2004
TRENDS AND OUTLOOKS
(Issue 26)

Editors: Glavatskaya N., Mezentseva K., Moldavsky A.,
Serianova S.

Prof-reader: Andrianova N.

Computer design: Yudichev V.

Information support: Avralov V., Pashlova O.

5, Gazetny per., Moscow, 125993 Russia
Tel. (095) 229-6413, FAX (095) 203-8816
E-MAIL – info@iet.ru, WEB Site – <http://www.iet.ru>