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The review provides a detailed analysis of main trends in Russia's economy in 2006. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political background; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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## Introduction

### Key directions of economic policy

Russia's finances are stable. The budget is drawn up with a surplus. The State has cut its expenditures on the servicing of external debt. In terms of its gold and foreign currency reserves, the country has become the third in the world, being behind only China and Japan. One might think that Russia can no more be faced with financial disasters similar to those that occurred in the late 1980s – early 1990s, that this nightmare is a thing of the past. The estimates made by the IET in cooperation with the CSR<sup>1</sup> have demonstrated that the accumulated reserve of stability will enable this country to live through the period of 2007 – 2009 without any economic difficulties comparable in scope to the 1998 crisis, even given an unfavorable scenario of the global economy's development. But life will not end in 2009. The budget horizon of 3 years is not sufficient to adequately assess the strategic problems associated with national finances.

### *Lessons provided by historic hindsight*

In 2000 Russia was recovering from the crisis caused by the bankruptcy of the Soviet Union and by the post-socialist transition, this crisis having been further aggravated by the default in 1998. It was obvious that financial resources were limited, and the budget depended on foreign credits. Nowadays it has been already forgotten by many, but during that period the looming problem to be faced in the year 2003 was being widely discussed. The peak of payments against external debt scheduled for that year was viewed as a strategic challenge faced by this country.

The main theme of the politico – economic discussion going on in early 2000 was the choice to be made between cutting the share of public expenditures in GDP and improving the quality of economic institutions. These were two alternatives, but by no means two opposite directions: the improvement of economic institutions may create appropriate conditions for cutting public expenditures, while cuts in public expenditures require that the quality of institutions should be improved. However, the discussion was very acute. Neither of the parties involved in it became the winner. But the orientation toward diminishing the share of public expenditures in GDP became one of the important components of economic policy.

During President V. Putin's first period of office, the growing public revenue was boosting up the budget surplus and the foreign currency reserves. The growth rate of budget expenditure was, as a rule, no higher than that of the growth of GDP. The budgeting policy was based on the standards of conservatism, reminiscent of the realities of the 19<sup>th</sup> century. Why do we resort to such an analogy? Because, when discussing long-term financial problems, it always helps to think in terms of a longer historic perspective.

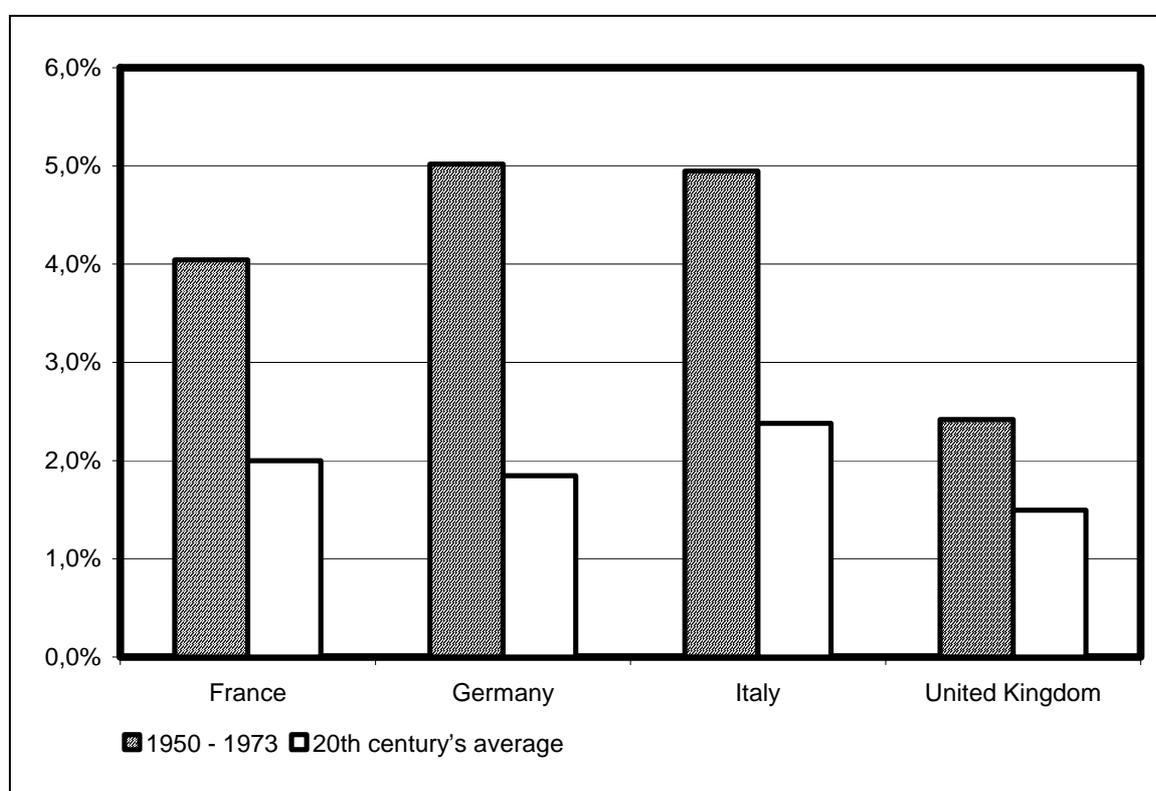
In Great Britain – the world's most developed country of the 19<sup>th</sup> century, which was the leader in everything that had to do with finances, - prevalent was the

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<sup>1</sup> CSR – Center for Strategic Research.

opinion that private persons could better manage their incomes than state officials could manage public revenue. Very weighty arguments had to be put forth, if the necessity of increasing public expenditure was to be properly substantiated. One of the principles of budgeting policy was that, in peace time, the government should not take upon itself any financial obligations for which its successors would have to be responsible.

In the 20<sup>th</sup> century, the situation changed. Now, the governments would often make decisions that did not incur too high a cost in a short-term perspective, but were fraught with serious future problems. The period of growing public revenue provided a favorable background for increasing budget liabilities. One vivid example is the Western Europe of the 1950s – early 1970s. The rates of economic growth during that time were, when measured against historic benchmarks, abnormally high (*Fig. 1*).



*Note.* The calculations are based on the data on GDP per capita in 1990 international dollars.  
*Source:* Estimations based on: Maddison A. *The World Economy. Historical Statistics*, Paris, OECD, 2003.

*Fig. 1. The rates of economic growth in 1950 – 1973 and the 20th century's average indices in some Western European countries*

The introduction of new taxes (VAT, the taxes on wages and salaries providing the sources of financing for social insurance systems) resulted in high growth rates of budget revenue. In France, on which the tax policies throughout the whole

Europe were modeled, public revenue grew in 1950 – 1973, in real terms, by 8.4 % per annum (*Table 1*).

*Table 1*

**The growth rates of public revenue in France in 1950 – 1980  
(average indices, by decade)**

Years	Growth rates, %
1950 – 1960	7.2
1960 – 1970	5.7
1970 – 1980	10.1

*Source:* International Financial Statistics, IMF 2006.121

In such a situation, the assumed social obligations seem to be realistic. The politicians who put forth such programs of public expenditure do not give a thought to the financial capacity of the future generations of taxpayers to meet such costs.

When it so happened that the taxpayers were not prepared to pay the growing taxes, certain reforms had to be carried out, with cuts in budget liabilities. This posed a challenge to the political elites of developed countries. A succession of defeats of the ruling parties of Western Europe was a logical outcome of the situation when the dismantling of the social welfare systems, created at a time when the State's potential to mobilize resources had seemed to be unlimited, was inevitable in terms of economics but fraught with political conflicts.

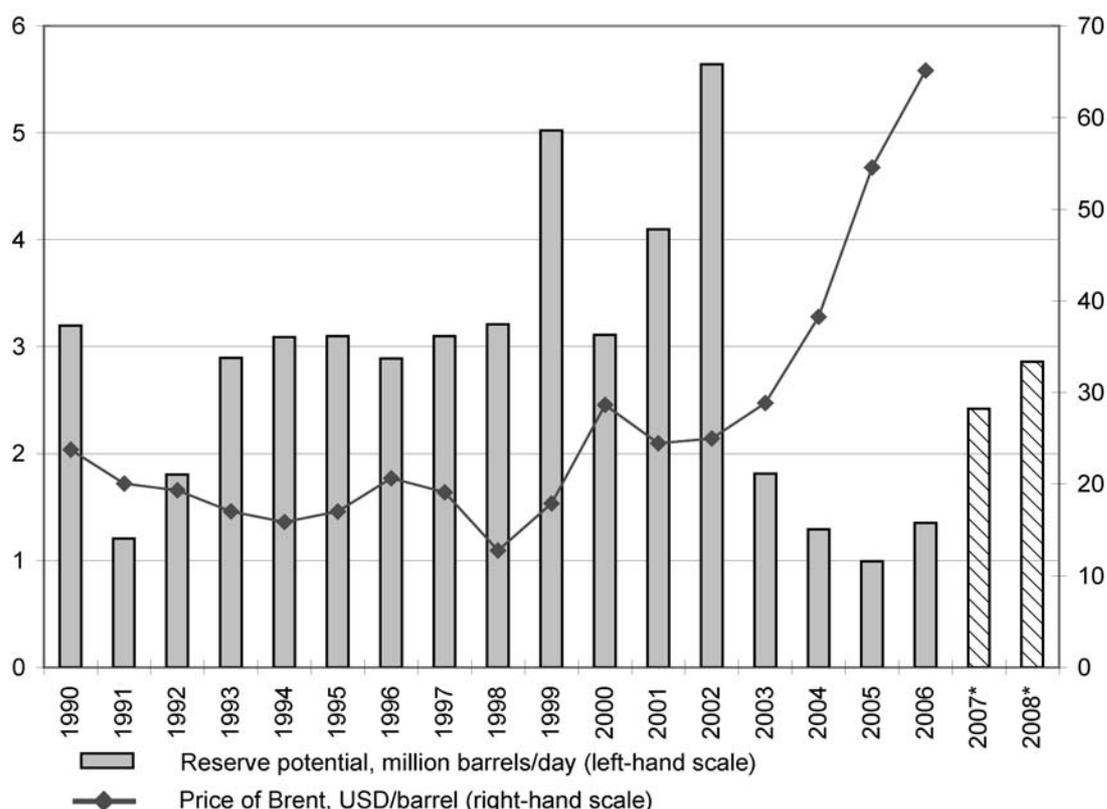
The Russia of the 2000s faced a similar challenge, which was reminiscent of the problems experienced by Western Europe in 1950 – 1973. Renewed economic growth, coupled with the successful tax reform of 2000 – 2002, ensured high growth rate of budget revenue. From 2004 onwards, a decisive influence on the development of the financial situation has been produced by the situation on the oil market. The prices of hydrocarbons approached the abnormally high levels of the 1970s – early 1980s. The public revenue's rate of growth (on the average in 2000 – 2006 - 13% per annum in real terms) became abnormally high by any historical standards.

*The oil challenge*

Russia is not the only country whose leadership has been able to acknowledge, on the basis of its own experience, that the unpredictability of oil prices is an objective factor that has to be reckoned with, and to learn from its experiences of the 1980s. Oil, if judged from the point of view of market mechanisms, is a specific type of commodity. Many of the indices of the global economy can be forecasted on the basis of inertia models, which essentially represent extrapolation of past events, with due regard to the set of factors capable of making events depart from a habitual trajectory. This method yields good results. In an event of errors in excess of 1 % in the forecasts of economic growth in the world's most potent countries for a next year, the authors of such forecasts can be accused of professional incompetence.

However, nobody was surprised when one of the authoritative international financial organizations – the IMF – made a radical revision of its forecasts of oil prices for the year 2007. No dismissal of its CEOs followed. Specialists have become used to the fact that no one actually knows how to reliably predict oil prices. These prices represent one factor which is significant for the analysis of economic dynamic and to which, at the same time, no general rule can be applied.

An important parameter of the oil market is its dependence on the availability of free potential, capable of changing the volumes of supplies. The upsurge in prices in 2003 – 2005 was less pronounced than the one in 1973 – 1974 and 1979 – 1980 (by 113 %, 250 % and 180 %, respectively)<sup>2</sup>, but still comparable in its scope. The factor that promoted the growth in oil prices during those years to an abnormal historic high was the assurance of the market participants that no free potential was available (Fig. 2).



\* Forecast.

Source: US Energy Information Administration, Short-Term Energy Outlook, January 2007, <http://www.eia.doe.gov/emeu/steo/pub/contents.html>

Fig. 2. Reserve potential of oil extraction and oil prices, 1990 – 2008

From the second half of 2006, the situation began to change. Having been faced with the downward trend in the level of oil prices, which became visible in the summer of 2006, the OPEC made the decision that the production quotas should

<sup>2</sup> IMF's estimates.

be reduced from 1 November 2006 by 1.2 million barrels per day, and then from 1 February 2007 – by another 0.5 million barrels. This was a clear sign that some free potential had emerged. But it is easier to negotiate the lowering of quotas than to actually implement it. The members of the organization are faced with acute budget-related problems, and not all of them are prepared to agree to reduce their revenues from exports.

The estimates as to what degree the decision concerning the lowered production from 1 November 2006 is based upon actual practice are not quite reliable. The majority of observers believe that the production level is by 0.4 – 0.7 million barrels higher than the negotiated level<sup>3</sup>.

Russia is less vulnerable to the fluctuations of oil prices than the Soviet Union of the mid-1980s. This country now does possess appropriate mechanisms for adjusting to the changeable situation. The response to falling prices, instead of the State's bankruptcy, can now take the shape of the rouble's depreciation, resulting in a higher competitive capacity of the processing industries. In fact, this is what happened in 1998 – 1999. In contrast to the USSR, Russia is not faced with the problem of unmanageable government debt. Currency reserves provide a "safety net" that can help to avoid, in an event of falling oil prices, a catastrophic situation similar to that in which the Soviet Union found itself in the late 1980s – early 1990s. However, even in the presence of these factors, the dependence of Russia's balance of payments on the prices of hydrocarbons is associated with risks, which must be assessed realistically.

Previous experiences have urged many oil-producing countries to pursue a careful budgeting policy<sup>4</sup>. For a few years, we have also succeeded in this. However the key words here are "a few years". The longer the period of high oil revenues lasts, the more difficult it becomes to follow such a policy.

In a situation when the State's financial potential is growing, it is difficult not to yield to the temptation of participating in a contest, the essence of which is the competition of the most popular spending programs. It takes just a few seconds to say everything about how the Stabilization Fund can be spent. But it takes more time – and an audience prepared to understand well-substantiated and complex arguments – to explain why this can be dangerous for the national economy.

The assumed budget obligations and the trends of demographic development urge the State to increase the share of its spending in GDP. Russia is by no means

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<sup>3</sup> OPEC to keep growth plan as prices fall: Saudi says group expects a rise in global demand // Associated Press. January 18. 2007.

<sup>4</sup> In Algeria, Azerbaijan, Bahrain, Iran, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates the governments in 2003 – 2005 spent on the growth of public revenue, in the medium term, 30 % of the surplus revenues from the rising oil prices. The average surplus of public finances in those countries, in per cent of GDP, increased from 2 % in 2002 to 15.5 % in 2005 (See: Regional Economic Outlook, September 2005: Middle East and Central Asia Department. IMF, 2005.) As a rule, the oil-producing countries in the 2003 – 2005, having learned from their experiences of the 1970s – early 1980s, based their projected budget indices on very cautious forecasts of the level of the prices of hydrocarbon raw materials. In many of them, special funds for leveling-out the consequences of fluctuations in oil prices for their budget revenues were created.

unique in this respect. This country is specific in another respect – the dependence of budget revenues on the oil and gas sector. Even when prices are not changing, these revenues have a downward trend. There are several responsible factors here. The growth rate of the production of oil and gas is lower than economic growth. There are no reasons to believe that this trend may change. As GDP per capita increases, the level of prices in the national economy becomes closer to that characteristic of more developed countries. The volume of GDP, estimated at the exchange rates of the world's reserve currencies, approximates its volume estimated by the parity of purchasing powers. This produces a downward trajectory of the share of revenues from oil and gas in GDP.

An important component of the budget revenues from the gas and oil sector is the export duties on energy carriers. In 2006, these amounted to 7 % of GDP. The accelerated growth of the national economy, as compared to the production of energy carriers, results in growing domestic demand for oil and gas. Thus, the resources of exportable hydrocarbons become lower.

The estimates of the reserves of oil and gas are nearly as unreliable as the forecasted prices of hydrocarbon raw materials. In the 1960s it was estimated that by the present time these reserves would be exhausted. Such forecasts have proved to be untrue. But the exhaustible nature of hydrocarbon resources is a reality that cannot be overlooked. Some tell-tale examples have been provided by the experiences of countries faced with the consequences of falling hydrocarbon production. According to the official forecasts, the growth potential of oil production in this country will be exhausted by the early 2020s<sup>5</sup>. This has to do with the perceptions of the Russian authorities concerning the future of the extracting industries in this country. When discussing the long-term prospects of the Russian budget, this perception can by no means be ignored.

The influence of the revenues from the oil and gas sector on Russian finances was estimated by the RF Ministry of Finance, the IMF, and the IET. The obtained results are similar. These revenues constitute more than one-third of Russia's federal budget revenue. The declining share in GDP of the revenues from the extraction of hydrocarbons and the increasing social burden on the national economy are two factors that will determine the shape of the financial problems to be faced by this country in the next decades.

### *The fate of the Stabilization Fund*

In Russia, the discussion of the issues relating to the feasibility of the creation of the Stabilization Fund, designed to level the influence of oil prices on the state budget, began in 2001 – 2002<sup>6</sup>. At that time, there existed no indications that these

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<sup>5</sup> The Ministry of natural resources forecasts a decline in oil extraction by 1 % per annum from 2021, and a stabilization of gas extraction from the early 2030s.

<sup>6</sup> Drobyshevsky S., Zolotariova A., Kadochnikov P., Sinelnikov S. Perspektivy sozdaniia Stabilizatsionnogo fonda v RF [The prospects for the creation of the Stabilization Fund in the RF]. Nauchnye trudy No 27R [Scientific Works No 27R] . M.: IET, 2001.

prices might once again, as it had happened in the late 1970s – early 1980s, rise to an abnormally high level.

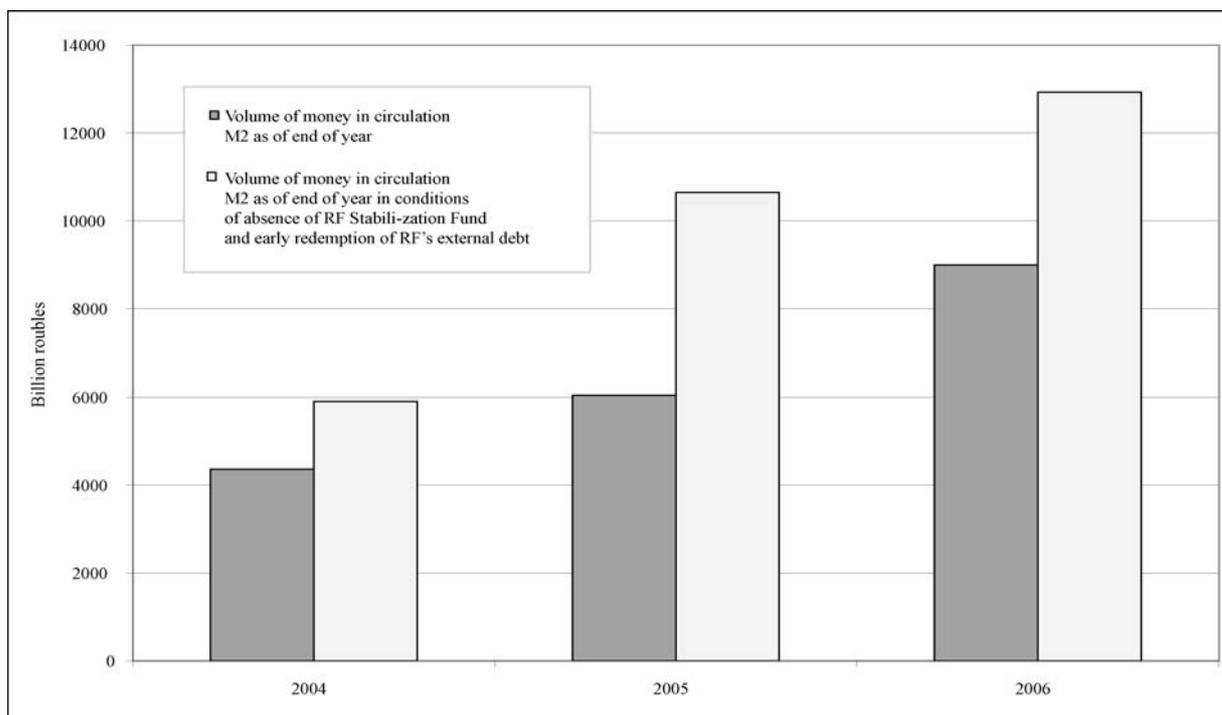
This is the case when the instrument necessary for implementing a responsible financial policy was created at a time when the demand for such an instrument was highest. The resources accumulated in the Fund, alongside the possibility to repay the external debt, have also made it possible to restrict the growth of money in circulation resulting from the monetization of the assets in the balance of trade. However, even when this instrument was applied, the rate of growth in money supply in 2004 – 2006 remained high ( *Table 2*).

*Table 2*

**Growth rate of money in circulation (M2)**

Year	Growth rate of M2, in %
2000	61.5
2001	39.7
2002	32.4
2003	50.5
2004	35.8
2005	38.6
2006	48.8

Source: the RF CB.



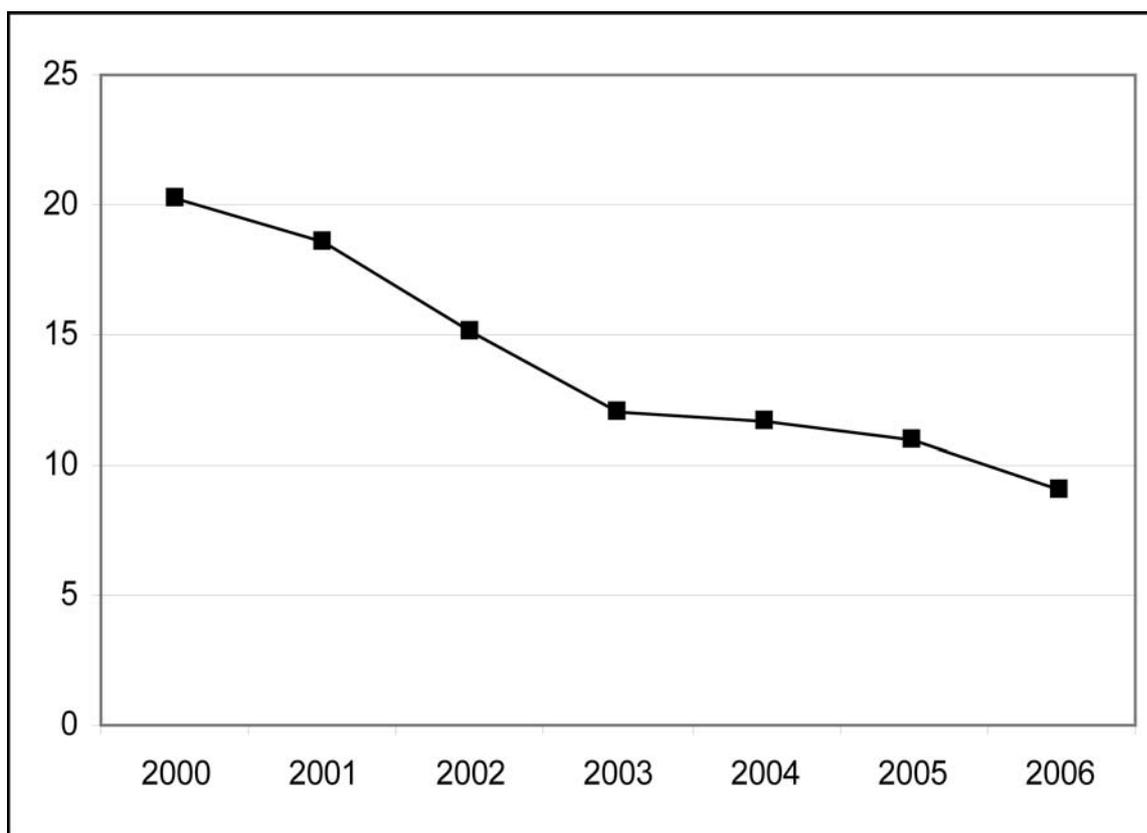
Note. The rate of potential growth of money in circulation (M2) in conditions when there exists no Stabilization Fund and no early redemption of the external debt takes place has been calculated on the assumption that the money multiplier's value is constant.

Source: the IET's estimates.

*Fig. 3. Volumes of money in circulation M2*

Without these instrument, the growth in money supply would have become dangerously high (*Fig. 3*)<sup>7</sup>. According to the estimates of the RF Ministry of Finance, if the revenues of the Stabilization Fund were used to finance the state budget, the rate of inflation in 2004 would have become 16 %, and in 2005 – 20 %<sup>8</sup>.

However, even the Stabilization Fund failed to sustain, in a situation of the upsurge of oil prices in 2004, the emerging downward trend of the inflation rate that was characteristic of the period of 2000 – 2003 (*Fig. 4*). This decline in the inflation rate became slower. The rouble's strengthening against the basket of currencies of Russia's principal partners in trade became more rapid (*Fig. 5*).



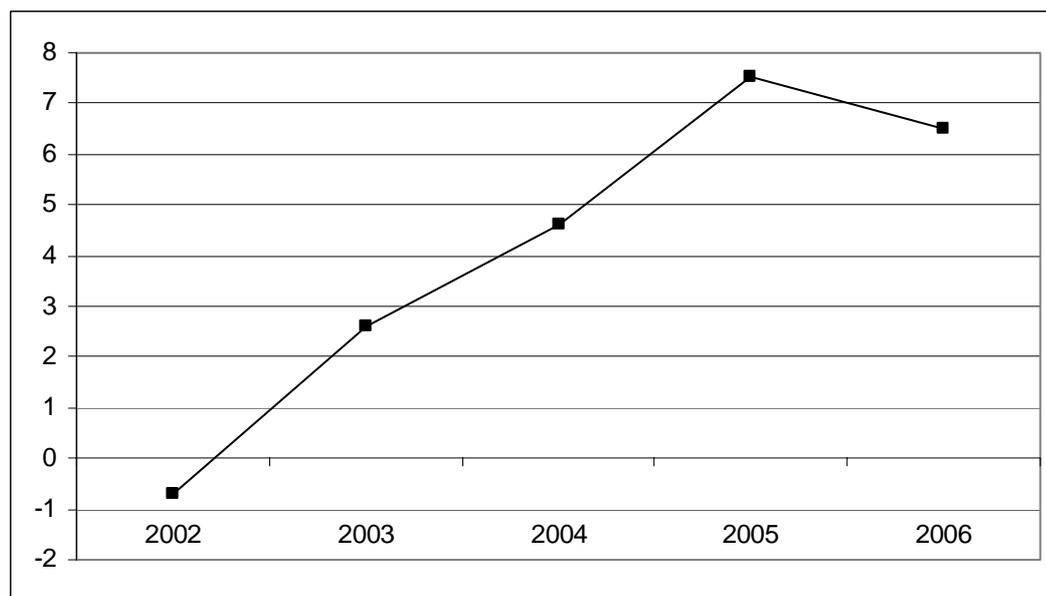
Source: the Rosstat.

*Fig. 4.* Rate of growth of consumer prices in 2000 – 2006, in %

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<sup>7</sup> From this point of view, Russia shares the destiny of the oil-producing countries in a situation when the prices of this natural resource are high. The rate of growth of the broad money supply in the oil-producing countries of the Middle East and Central Asia in 2003 was, on the average, 56.5 %, in 2004 – 57.9 %, in 2005 – 56.7 %. See: Regional Economic Outlook, September 2005: Middle East and Central Asia Department. IMF, 2005.

<sup>8</sup> Newspaper "Gazeta" ["Gazette"] of 11 December 2006.



Source: the RF CB.

*Fig. 5.* The dynamics of the real effective exchange rate of the rouble against the currency basket in 2002 – 2006, in % (positive values represent the rouble's strengthening, negative value – its weakening )

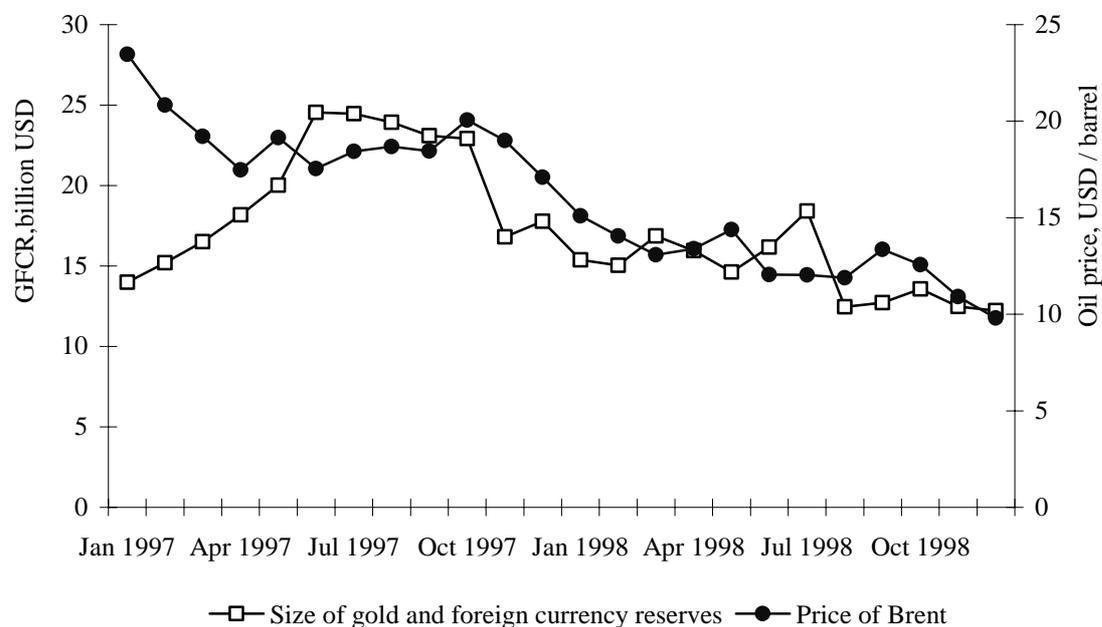
Neither the Russian political elite nor society have been used to the situation when the country possesses substantial financial reserves. Moreover, they did not see any need for such reserves. The Soviet Union, having spent in the 1960s the main bulk of its gold reserve on grain purchases, did not create any big gold and foreign currency reserves even during the period of abnormally high oil prices in the 1970s and the first half of the 1980s. This is one of the factors that made inevitable the collapse of the Soviet economy after the fall of oil prices in 1985 – 1986.

Even in 1997, when the onset of economic growth became a reality, the size of gold and foreign currency reserves remained modest. Coupled with the budget problems associated with the management of domestic debt, this made it impossible for the country to adapt to the fall in prices and to avoid its disastrous consequences (*Fig. 6*).

It seems that the financial disaster of the late 1980s - early 1990s, as well as the lesser in scope but more recent problems of 1998 could, indeed, teach us the simple notion, well understood by Joseph, son of Jacob: years of plenty may be followed by years of dearth. It is a dangerous policy – to spend everything today, without giving any thought to the risks of tomorrow.

Meanwhile, the issue of selecting the most attractive areas for spending the resources of the Stabilization Fund represents one of the most popular themes in the economic and political discussions presently going on in Russia. We are by no means unique in this respect. Politics in conditions of universal suffrage is largely a

competition among those who are striving to put forth the most popular programs for spending taxpayers' money<sup>9</sup>.



Source: the RF CB, IMF IFS.

Fig. 6. Russia's gold and foreign currency reserves against oil prices in 1997 – 1998

When a country has at its disposal a Stabilization Fund, there can be no issue as to where the money needed for finding appropriate solutions to various existing problems should be taken. A Minister of Finance – even if he is the person notoriously nicknamed “Mister No”, cannot always respond to the requests with the traditional answer: “Your proposal is excellent, but the government has no money for implementing it!” His opponents can then use the well-substantiated argument that the resources accumulated in the Stabilization Funds are enormous, and there is no sense in increasing them further in face of the existing acute socio-economic problems.

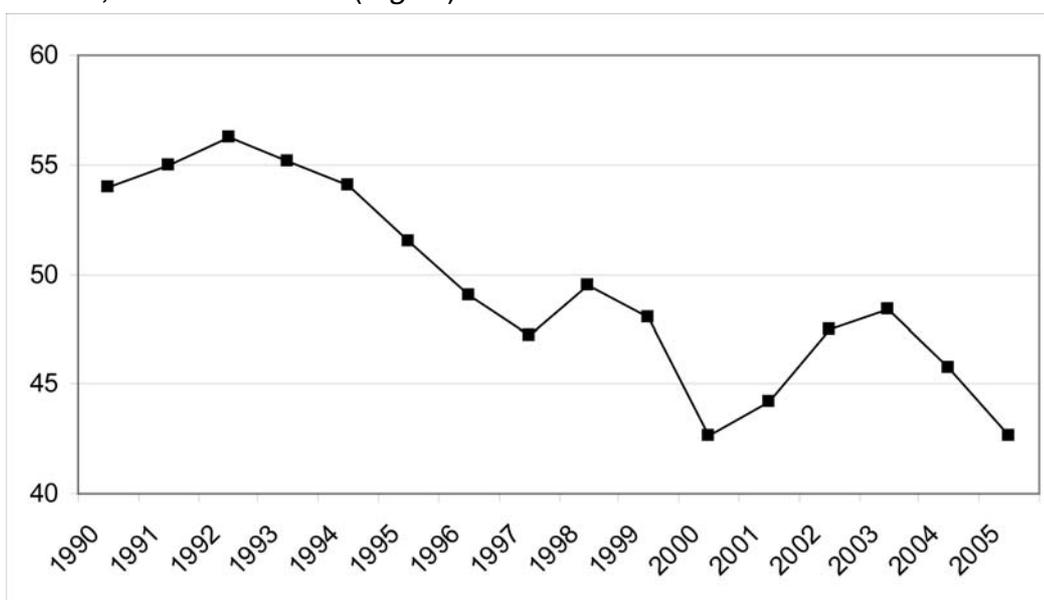
As of 1 February 2007, the money accumulated in the Stabilization Fund of Russia amounts to 2.6 trillion roubles, or 9.9 % of GDP in 2006. This is a handsome sum. But the picture looks optimistic only if one forgets the extent to which the prices of oil, oil products and natural gas are influencing the Russian budget. The estimates prepared jointly by the IET and CSR show that if the price of oil goes

<sup>9</sup> The Founding Fathers of the United States, indeed, suspected that this would be so. J. Adams wrote that, if universal suffrage is introduced in the country, the first thing to be done would be the abolition of all debt obligations, then high taxes would be levied on the rich, while the rest would become tax-exempt, and finally the majority of voters would cast their votes for universal division of property. See: *Adams J. Defense of the Constitutions of the United States. Vol. 1.* London: Minted For C. Dilly, in the Poultry, 1787–1788.

down from \$ 50 to \$ 25 per barrel, that is, to a level higher than that which not so long ago, in 2000 – 2002, was assumed to be a natural benchmark for financial planning, the revenue of the general government will fall by more than 8 % of GDP. If this happens, the resources accumulated in the Stabilization Fund will be spent in 3 years.

The previous period of low oil prices began in 1985 – 1986 and lasted for 15 years. For 3 years, the Soviet Union was able to properly regulate the problems associated with its balance of payments by attracting private credits. When this resource was exhausted, the collapse of the Soviet economy became inevitable. This should be borne in mind while discussing the sufficiency of the present “margin of safety”, guaranteed by the Stabilization Funds, for ensuring the reliable functioning of the Russian economy.

It is not advisable to blindly extrapolate somebody else’s experience. But it is useful to remember it while making key economic and political decisions. By the index of life quality (the human development index) Norway is the world’s leader<sup>10</sup>. This is one of the countries where the national economy, just like Russia’s, depends on the situation on the hydrocarbon market. It is not easy to believe that such results have been achieved by a state pursuing an irresponsible policy, which is contrary to its own national interests. Since the time when the oil fund was created, that country managed not only to curb the trend of a growing share of public expenditure in GDP, but to reverse it (*Fig. 7*).



Source: BD OECD, <http://stats.oecd.org/wbos>

*Fig. 7.* The share of expenditures of the Norwegian general government, in % of GDP, 1990 – 2005

<sup>10</sup> Human development index is calculated by the UNO; it is determined by a set of parameters characterizing the expected lifespan, education level and GDP per capita. By this index, in 2005 Norway was the first, followed by Iceland and Australia. Russia was in the 65th place.

The problems faced by the pension system, as well as the prospect of a diminishing share in GDP of revenues from the oil and gas sector, urged the government of that country to transform the Oil Fund, whose purpose had been to level out the fluctuations of budget revenue, into accumulations designed to ensure stable functioning of the national system of social insurance. Between 60 % and 100 % of the government revenue from the extraction of oil and natural gas is earmarked as the fund's revenue. Its size as of 1 February 2007 amounted to \$ 280.9 billion, and the forecast for 1 January 2008 is \$ 299.5 billion. In 2005, Norway's GDP was \$ 283.9 billion.<sup>11</sup> The incomes from the placement of the fund's assets (as estimated by the Norwegian authorities – approximately 4 % of GDP) create a base which is necessary and sufficient for the pension system's stability.

### *Oil revenues and pension endowment*

It is easy to assume budget obligations. They can not, however, be shed off with the same ease. The political problems emerging as a result of such a reasonable but inefficiently implemented measure as the monetization of social privileges represent one vivid example of this principle. Lately, Russian authorities have begun to display "quite an extraordinary light-mindedness" towards their own obligations<sup>12</sup>. But even the Soviet leadership, while being in full control of the mass media and relying on efficient secret police, well understood that the system would be stable until they breached the terms of their quite simple agreement with society, namely that "we'll not ask you why you are ruling the country, while you guarantee us the habitual conditions of existence and do not undertake any experiments that may radically change our lifestyle". This compromise remained valid until the late 1980s, when the fall of oil prices made it no longer possible to keep the terms of the contract between authority and society.

For the majority of the Soviet Union's population in the early 1950s the very idea that people had a right to pension endowment was something quite exotic. Collective farmers at that time had no annuity rights. Since then, the institutions of social protection created in Russia and involving tens of millions of people have become an element of everyday life. Today it would be impossible to abolish them without giving rise to a serious socio – political upheaval.

The decisions made during 2005 – 2006 (national projects, parent capital, investment programs), the dynamic of demographic development, and the growing number of pensioners per one worker can all make an increase, in the nearest decades, of the share in GDP of the general government's expenditures at least probable, if not inevitable. In an event of a reasonable economic policy and the implementation of reforms aimed at promoting the spending of private funds on annuity provision, public health care, public education, and on improving the efficiency of public expenditures earmarked for state defense and security, this trend can be

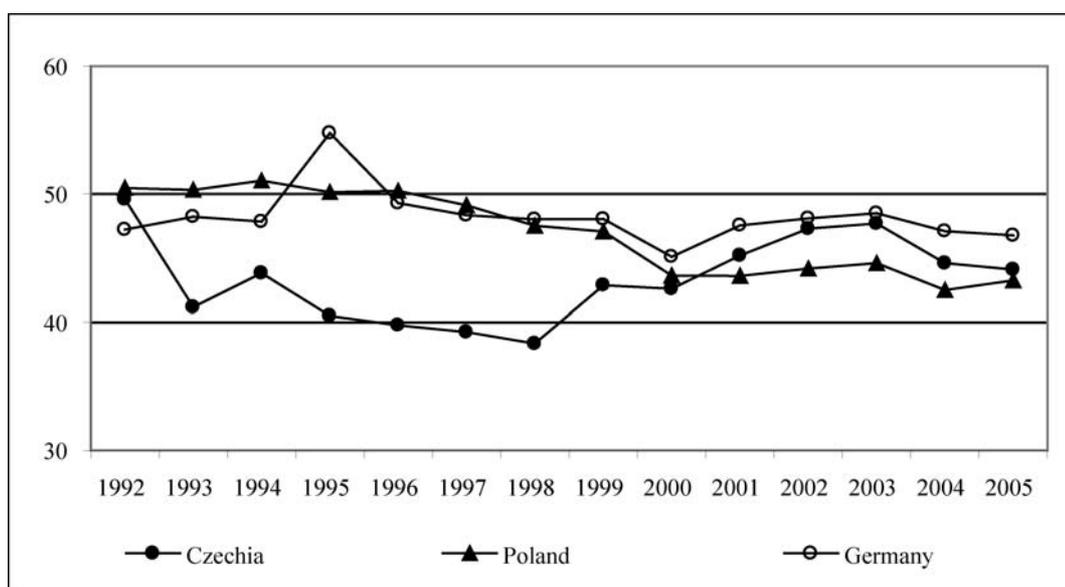
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<sup>11</sup> The data published by the Pension Fund of Norway and the World Bank.

<sup>12</sup> One example is the proposal of the Ministry of Health Care and Social Development that pension savings should be withdrawn from the Vneshekonombank (they amount, as of 1 January 2007, to 267 billion roubles).

come less pronounced, but its total disappearance is highly unlikely. Against this background, the lagging of the growth rates of oil and gas extraction behind the growth of GDP, the strengthening of the rouble's exchange rate, and the growing cost of oil and gas extraction have launched the trajectory of declining revenues from the extraction of hydrocarbons.

The level of the general government's expenditures in those post-socialist countries that are more developed than Russia and began their transition to the market economy at an earlier stage has now become comparable to that characteristic of the majority of the OECD members (*Fig. 8*).



Source: the data concerning Poland and Czechia are taken from *EBRD Transition Reports*; the data on Germany: OECD, <http://stats.oecd.org/wbos>

*Fig. 8.* Budget expenditure of the general government in 1992 – 2005, in % of GDP

In Russia the level of public load on the national economy is lower, but the demographic dynamic has shown that the approximation of this country's corresponding indices with the indices of the better developed East European countries is just a matter of time.

The popularity of distributive annuity systems in the first years of their existence was associated with the fact that those who were then retiring did not have to pay for their annuity. The system was financed from the taxes paid by the next generations of workers. During the transition from a distributive to an accumulative annuity system there emerges a situation when those who work must not only pay for those who have retired, but also to accumulate the resources necessary for financing their own annuities. The earmarking of the revenues from the oil and gas sector for the capitalization of the funded component of annuity makes it possible to find a solution to the "double payment" problem. And here the experience of Norway may prove useful.

Norway and Russia are faced with rather similar sets of long-term financial problems. In Norway, life expectancy is higher, but the retirement age is higher, too<sup>13</sup>. The specificity of demographic transition in Russia (a rapid reduction, during industrialization, of the number of births per female) created the trajectory of the population's early ageing and rapid growth of the number of post-retirement age groups against the number of actively employed. Those problems of the pension system that Russia should have experienced several decades later are already existing.

The replacement coefficient<sup>14</sup> in Russia in 2005 was 27.6 %. When the inertia-based scenario is realized, when no changes are made to pension legislation, the value of this coefficient will go down by 2015 to 20.2 %, by the early 2020s – to 16.4 %<sup>15</sup>. For this index to remain at a habitual level, the country will need resources in the amount of approximately 4 % of GDP, that is, comparable to the revenues of the Global Pension Fund of Norway.

The Norwegian Pension Fund sets the standards of financial responsibility to be achieved by a country dependent on the situation on the hydrocarbon market<sup>16</sup>. The estimations of the scope of the problems associated with ensuring the stability of the Russian pension system yield similar figures. The mobilization of resources necessary for ensuring comparable and stable incomes is the key issue of Russia's financial strategy.

#### *The reserves of privatization and the incomes of pensioners*

Nobody knows how long the period of a favorable situation on the oil and gas market will last. Its price is represented by the difference between the 10 % of GDP accumulated in the Stabilization Funds and no less than 50 % of GDP needed for ensuring the stability of the national pension system.

The source of the funding to compensate for the deficit of pension savings is state property. Privatization in Russia took place against the background of the Soviet Union's bankruptcy, lack of foreign currency reserves, and political instability. Big enterprises, chosen as the objects for privatization, were debtors both of the budget and of their own employees. Arrears of wages for many months on end were a habitual element of everyday life. The hopes of mobilizing big financial resources through the sale of such state-owned assets had little to do with reality. The main goal then was to ensure the control of private owners with an interest in the efficient performance of such enterprises over their economic activity.

At the meeting on 18 April 1996 at the Ministry of Fuel and Power Engineering of Russia, the probability of a decline in oil production in this country by 2000 to the

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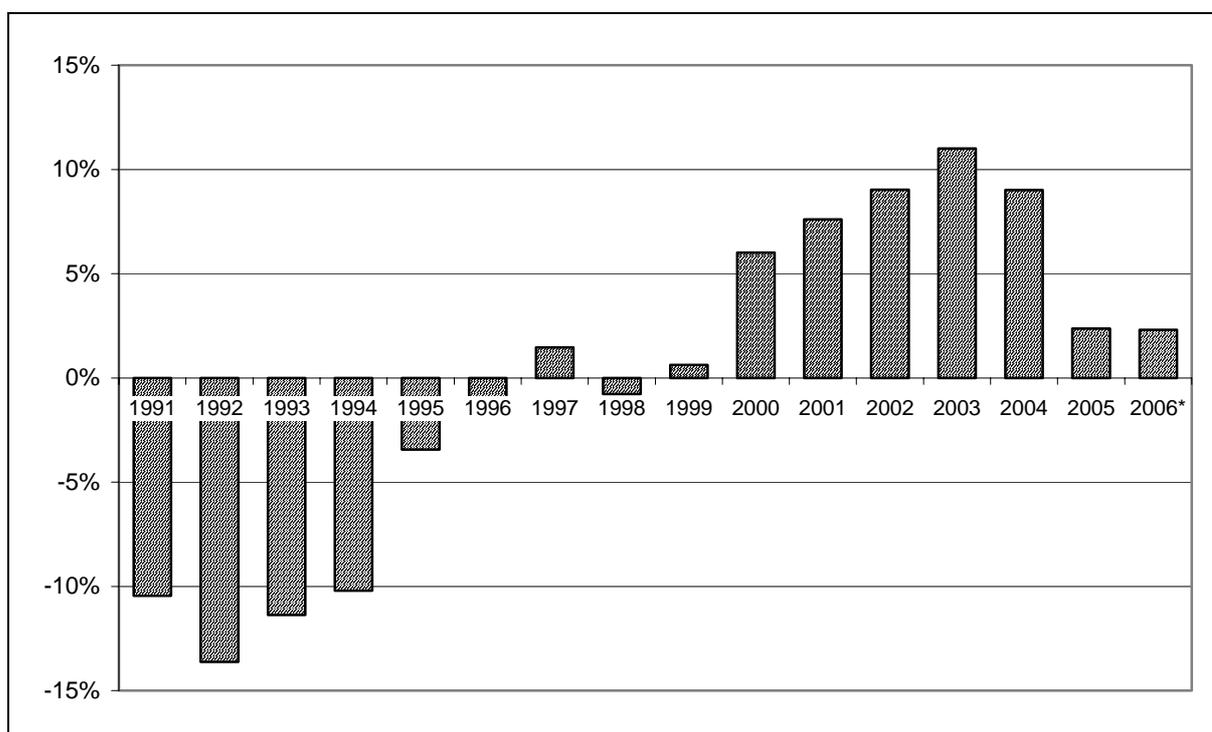
<sup>13</sup> Mean life expectancy in Norway is 79.3 years, in Russia – 65.4 years, the retirement age in Norway is 67 years.

<sup>14</sup> The ratio of average annuity to average wage.

<sup>15</sup> CSR's estimates.

<sup>16</sup> The growth in average annual revenues of the Oil Fund of Norway, from the moment when the government's funds were transferred to it (1997), was 6.3 % when estimated in the international reserve currencies, and 4.5 % per annum when adjusted by the level of inflation and less administrative costs.

level of 150 – 190 million tons per annum and its transformation into a net importer of oil was discussed<sup>17</sup>. Approximately at the same time there was a discussion as to what should be done when, by 2000, the oil output of the amalgamation “Nizhnevartovskneftegas”, which was exploiting Russia’s largest oil deposit in Samotlor, would fall to zero, and the 200-thousand population of Nizhnevartovsk would have to be moved elsewhere<sup>18</sup>. However, this problem did not need to be solved. After the privatization of “TNK”, whose main asset was “Nizhnevartovskneftegas”, 50 % of its property, at the price of \$ 6.75 billion<sup>19</sup>, was purchased by the company “British Petroleum”. In *Fig. 9* the changes in the dynamic of oil extraction in Russia after privatization are shown.



\* In the first half-year, against the first half-year of 2005.  
Source: the RF Federal Statistics Service (<http://gks.ru>)

*Fig. 9.* Growth rates of oil extraction in Russia in 1991 – 2006, in % per annum

The growth of the national economy’s factor productivity, which gave rise to a trend of GDP’s long-term growth, began when a predominating part of the Russian economy became private<sup>20</sup>. Economic growth, financial stability producing a lowering government debt / GDP ratio, and higher credit rating of the country and its

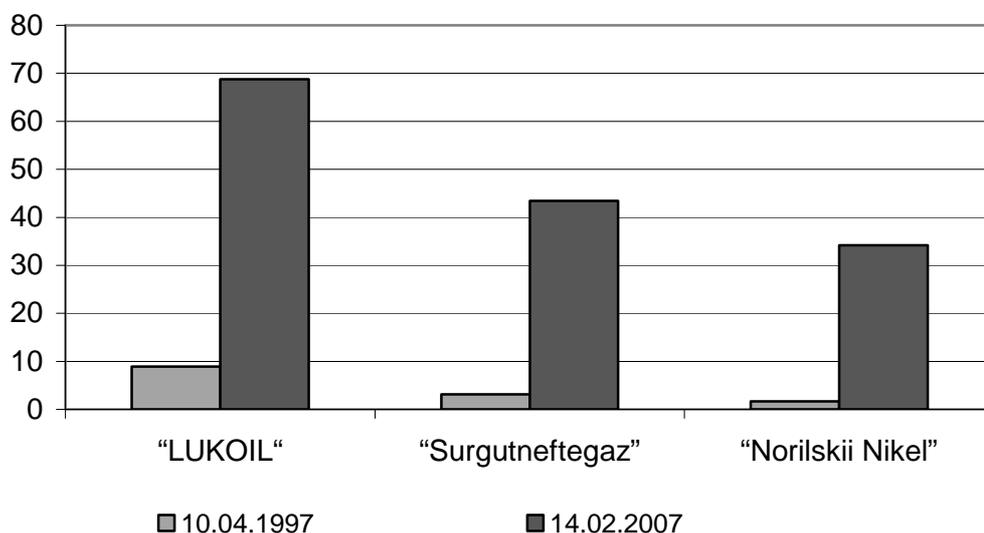
<sup>17</sup> Kommersant. 18 April 1996.

<sup>18</sup> Kommersant. 17 July 1996.

<sup>19</sup> From the “TNK VR”’s website.

<sup>20</sup> Entov R. M., Lugovoi O. V. et al. Faktory ekonomicheskogo rosta rossiiskoi ekonomiki [Factors of economic growth of the Russian economy]. Nauchnye trudy [Scientific Works] No 70R. M.: IET, 2003.

biggest companies all produced a revision of the notion as to how much the price of property in Russia might be (*Fig. 10*).

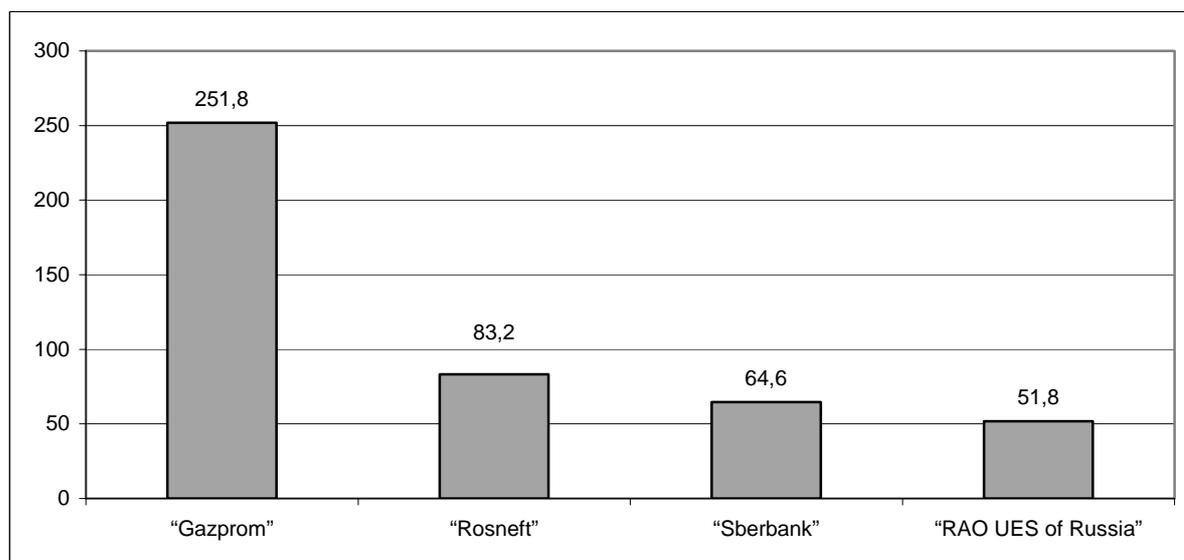


Note: First data on capitalization of "Norilskiy Nickel" as of 30 May 2001 г.  
Source: RTS.

*Fig. 10.* Capitalization of "LUKOIL", "Surgutneftegaz" and "Norilskii Nickel" in 1997 and 2007, \$ billion

From the year 2003 onward, the Russian authorities took a course toward re-nationalization. One example is the destiny of "Yukos" - one of the biggest companies. There are no facts, however, that could demonstrate any improvement in the quality of management in the oil sector.

The financial results achieved by the companies operating in the Russian oil and gas sector can hardly be regarded as a reliable argument in favor of the advantages of state ownership. The arrears accumulated by state-owned enterprises in 2006 were approximately 20 times higher than those of private ones. Russia's example is yet another proof that the State is not an efficient manager, while a corrupt State – even more so. However, the assets concentrated in the hands of the State are comparable to the funds necessary for ensuring the stability of the pension system (*Fig. 11*).



Source: RTS.

Fig. 11. Capitalization of "Gazprom", "Rosneft", "Sberbank", and "RAO UES of Russia" (data as of 14 February 2007), \$ billion

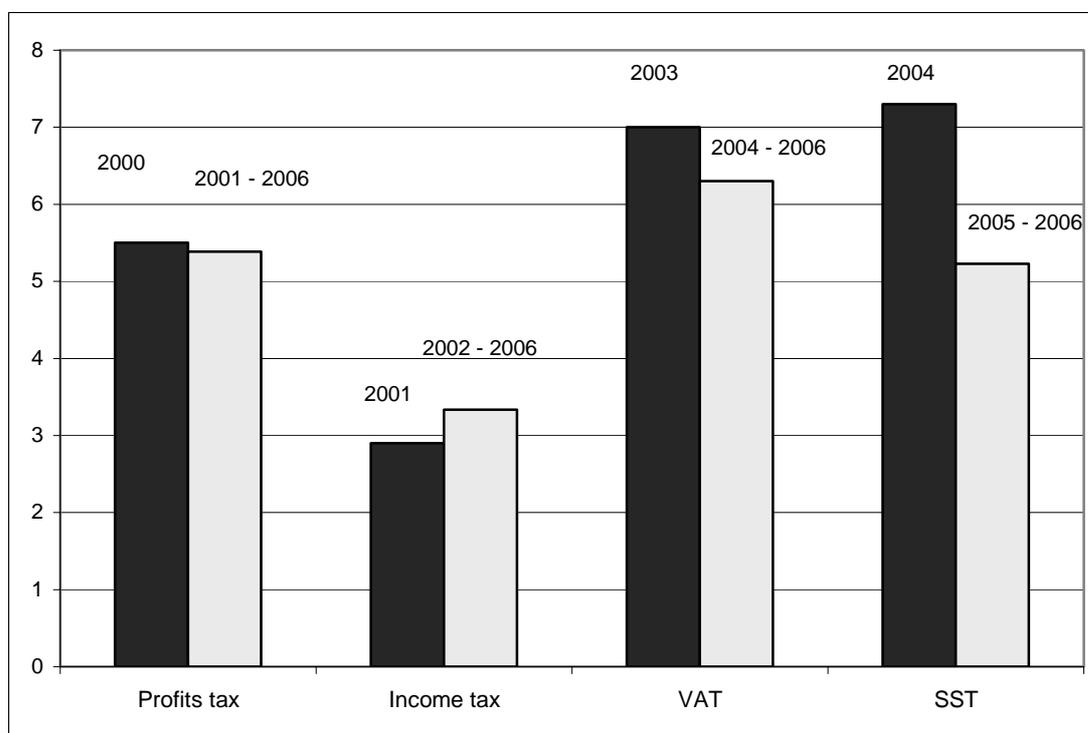
According to Alfa-Bank's estimates, the price of the shares in Russian state-owned enterprises quotable on financial markets by early 2007 amounted to \$ 369 billion (approximately 35 % of Russia's GDP in 2006)<sup>21</sup>. It is not easy to find arguments in favor of the assumption that keeping these companies in state ownership is compatible with national interests. The pension system's stability, which can be ensured by an unhurried privatization of the assets of state-owned companies, timed with a favorable situation on the market, represents a goal that cannot be disregarded. The choice of this particular direction of the economic policy will make it possible to mobilize adequate resources for the financing of this country's pension system in the 21<sup>st</sup> century.

#### *The price of the State's generosity*

Economic growth, whose stability by 2003 – 2004 had become obvious, in a situation of rising oil prices was changing the background for financial policy. In 2003 – 2004 the government of Russia, believing that the lowering of tax rates could pave the path toward the legalization of business activity and increased tax collection, lowered the rates of two major sources of budget revenue: the value added tax (from 20 % to 18 %) and the single social tax (SST) (the base rate was decreased from 35.6 % to 26 %). The income legalization effect was close to zero. The budget lost more than 2% of GDP - approximately the same amount as that yielded by the income tax prior to the introduction of its flat rate. The differences between the consequences of reforming the income tax and the profits tax, on the

<sup>21</sup> Monitoring of investor activity in Russia. Alfa-Bank. 12 February 2007.

one hand, and the lowering of the rates of SST and VAT, on the other, are illustrated by *Fig. 12*.



Note: The data of 2006 are for the period of January through October.

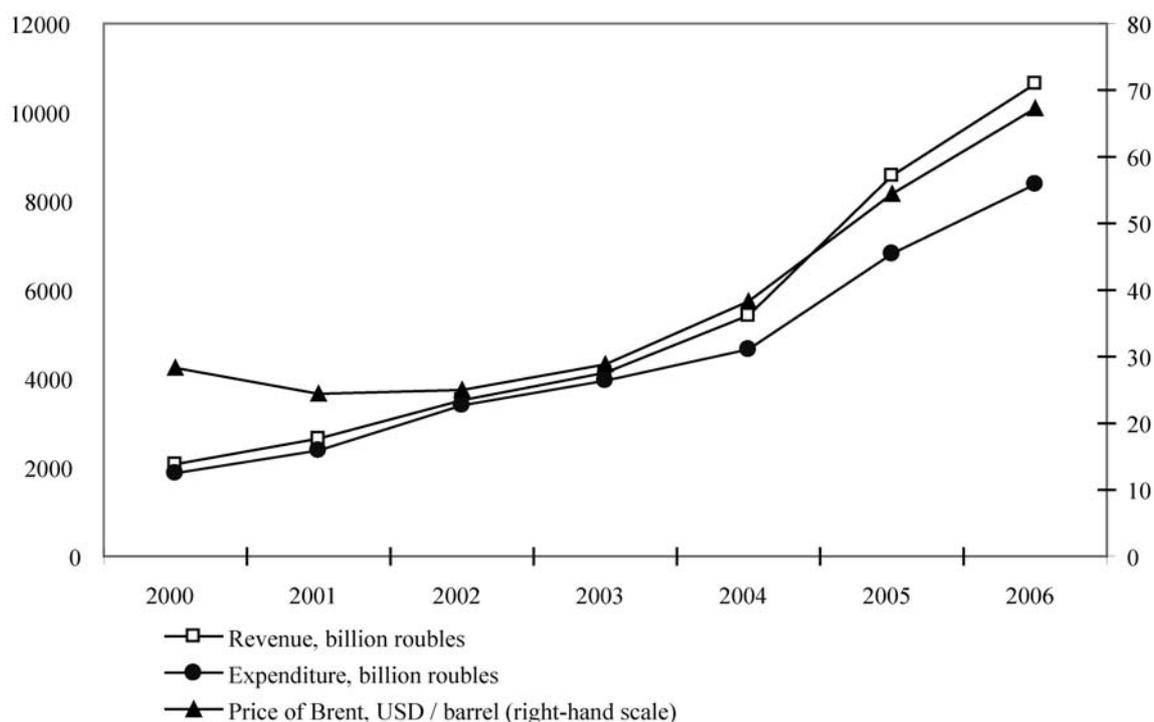
Source: the RF Ministry of Finance.

*Fig. 12.* Russia's general government budget receipts from some taxes, in % of GDP

The structural component of the federal budget's tax revenues, which is not dependent on the level of oil prices, reached its historic high in 2002 (18.9 %). Later it declined (to 15.2 % of GDP in 2006)<sup>22</sup>. The situational component, which is dependent on high oil prices, has been growing since 2003. In 2006 it amounted to approximately 7 % of GDP.

In 2005 – 2007, the already habitually high prices of oil and natural gas, coupled with economic growth, inevitably resulted in the expansion of the State's financial liabilities. Hence the new national projects, the investment fund, and measures designed to finance the demographic policy. The RF Ministry of Finance has succeeded in maintaining the growth rate of budget expenditure within the limits imposed by the growth rate of GDP, and moreover, it managed to lower the share of the general government's expenditures in GDP (see *Fig. 13, Table 3*).

<sup>22</sup> The IET's estimates. The structural component of budget revenue is estimated on the basis of the average oil price in 1990 – 2006.



Source: IMF IFS, the RF Ministry of Finance.

Fig. 13. The revenue of the general government's budget and oil prices in nominal terms, 2000 – 2006

Table 3

**The execution of the general government's budget, in % of GDP, in 1999 – 2006**

	1999	2000	2001	2002	2003	2004	2005	2006
Revenue	33.8	38.3	38.4	37.8	37.1	37.5	39.7	40.0
Expenditure	35.3	34.3	35.2	36.3	36.0	32.9	31.5	31.5
Surplus	-1.5	4.0	3.2	1.5	1.1	4.6	8.1	8.5

Source: the IET's estimates based on the data provided by the RF Ministry of Finance.

This has nothing to do with the volume of budget liabilities. National projects have been planned for a period of 2 – 3 years. However, they create long-term budget obligations. One hardly object to secondary schools being equipped with electronic devices and provided with an access to the Internet. But while making such a decision, it would be quite reasonable to remember that these are not going to be one-time investments. The electronic equipment will need to be upgraded, and the access to the Internet – to be paid for.

The resources of the investment fund are being spent on the financing of the development of infrastructure, which is considered to be a priority, and can hardly be objected to, either. But it is not enough just to build a new infrastructure – it will have to be exploited. The upkeep of the high-speed highway between Moscow and

St. Petersburg is expensive. And there exist no estimates of the long-term consequences of the budgeting decisions that have been made so far.

The investments in public health care projects will involve the allotment of substantial resources to the purchases of high-tech equipment. Once installed, this equipment will require more expenditures on purchases of spare parts and technological materials. No funding is earmarked for such purposes in the project. The available information provides no grounds for an assumption that someone has, indeed, calculated the financial outcome of the parent capital project in terms of Russia's budget at least for the next 10 years. It is planned that credits will be granted for 8 years, to be spent on the construction of state-of-the-art livestock-breeding complexes, and the State is going to subsidize the interest rate (2/3 of the rate of refinancing established by the RF Central Bank). The project is for the period of 3 years. The credit facilities are for 8 years. It seems that no long-term budgeting consequences have been calculated, either.

Such decisions determine the prospects of budgeting policy for many years to come. Regretfully, some people do not understand this.

The signal to the economy is clear. The orientation to restricting the share of public expenditure in GDP is a thing of the past. Today's agenda is to develop new programs of budget allocations. To resist the trend of growing public expenditure as a percentage of GDP, it will take a political will and consistent efforts. In 2005 – 2007 the authorities demonstrated that their reserves had been exhausted. Hence the consequences for tax policy.

#### *More on the issue of budget conservatism*

In the 19<sup>th</sup> century it was an axiom that increasing budget expenditure must be backed by increased taxes. To the British financial authorities of that time it could never have occurred that a law on budget liabilities might be voted for without specifying exactly which taxes would have to be increased in order to provide the necessary funding.

Two fundamental innovations were introduced in the 20<sup>th</sup> century: the idea of a budget that must be balanced with due regard for the cyclic fluctuations on the market and for the current economic situation, and the idea that the decisions concerning new expenditures, to be borne by those who would form a future government, could be an element of an efficient economic and political tactics. These represented a departure from the rigid logic of the 19<sup>th</sup> century's financial conservatism. However, the general rules of the game have remained unchanged. Just like a family budget, the state budget in a long-term perspective must be drawn so as to match expenditure and revenue. Even in the 1950s and 1960s, in a situation of expanding public financial, it was an axiom that the government leaders, when intending to increase expenditure, had first to think which taxes would have to be raised in order to back such a decision.

The crisis of public finances, which was felt more and more strongly since the 1970s, changed the situation. The political problems caused by cuts in public expenditure, in face of the unpopularity of growing tax rates, made fashionable the

idea that budget revenue could be boosted by lowering taxes, instead of increasing them. It has been known at least since the publication of the classical work by Adam Smith, *Wealth of Nations*, that high rates of taxes may result in declining budget revenues. For its author, the issue of tax burden was equivalent to that of state expenditure.

Since 1970s – 1980s, there appeared another version of the interpretation of the relation between the rates of taxation and public revenue. The thesis that it was possible, by lowering tax rates, to compensate for the budget's potential losses through discouraging tax evasion, became quite widespread. This, indeed, seems to appeal to common sense. The State, when it tries to extract too much from the economy, may diminish the scope of legal economic activity. However, no one has ever succeeded in reliably tracing the connection between the levels of taxation and the levels of revenues from specific taxes in countries where such studies were undertaken.

The experience of tax reforms accumulated during the past decades has made it possible at least to imagine, if not to exactly forecast, the succession of resulting events in the sphere of public finances. When reform results in decreased tax rates and in the elimination of their progression, and the tax system becomes simpler, with fewer tax exemptions, then the outcome may be an increased tax collection, with a high degree of probability. But this is a hypothesis that each time has to be tested by practical experience.

In 2000 – 2002, such reform took place in Russia. Its elements were the introduction of a flat income tax rate, a regressive social tax, the abolition of turnover taxes and the sales tax, a lower rate of the profits tax, and reduction in the scope of tax exemptions. Resulting was increased budget revenue. A by-region analysis of the revenues from the income tax confirmed that the reform became a factor of growing budget revenue<sup>23</sup>. But it would be a gross mistake to draw on this basis the conclusion that the lowering of tax rates is a guarantee of tax collection growth.

In the history of finance, reforms resulting in a combination of lowered rates of taxes and growth of public revenue represent rather an exception from the general rule than the general rule itself. It is far from evident that Russia, after the reform of 2000 – 2002, still has some potential left for further growth of revenue through implementing such a strategy. For any hope for the success of tax innovations aimed at lowering the rates to be realized, the determination will be needed to make some serious steps in the direction of tax regime unification and the elimination of its specific exemption elements, such as the taxation regimes in free economic zones or simplified systems of small business taxation. These measures are fraught with conflict. There is no convincing evidence that the Russian authorities are indeed prepared to follow this line. This means that it is time for resorting once again to common sense in the financial policy.

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<sup>23</sup> Sinelnikov – Murylev S., Batkibekov S., Kadochnikov P., Hekipelov D. Otsenka resul'tatov reformy podokhodnogo naloga v Rossiiskoi Federatsii [An estimation of the results of reform of the income tax in the Russian Federation]. Nauchnye trudy [Scientific Works] No 52R. M.: IET, 2003.

Once a country's leadership has chosen a course towards increasing the share of public revenue in gross domestic product, there is little sense in continuing the talk of the lowering of the rates of the basic taxes, or in the discussion as to the rate of which tax it would be better to decrease – VAT or SST, or if it would be worthwhile to abolish VAT altogether and to replace it by the sales tax. It is far better to discuss the source of financing for the programs aimed at increasing public expenditure – namely, the rates of the specific taxes to be raised, which must be the one least dependent on the situation on the oil market.

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Now let us draw some conclusions. The dynamic economic growth, which occurred after the post-socialist recession, the success of the tax reform of 2000 – 2002, the changes on the oil and gas market, and the increased revenue of the Russian budget have created appropriate conditions for a rapid (by the standards of financial history) rise in public revenue. The growth of the State's potential resulted in the expansion of its liabilities. This has long-term consequences. The problems created by the decisions once made will be determining the alternative to be faced by the Russian financial policy for decades to come.

The key problem of the Russian finances is the need to ensure the stability of the national pension system, to preserve the habitual ratio of the average annuity to the average salary in a situation of ageing society, when one worker has to support a growing number of pensioners. Coupled with the liabilities assumed in other spheres, this has given rise to the trend of a growing share of public expenditure in GDP. Russia's specificity is that these problems emerge in face of the trend of a declining share in GDP of the revenues from the oil and gas sector. This is the main challenge to this country's financial stability.

This problem is better to be solved today, and not to be left for a time when the situation may get out of control. We suggest here the following strategic solutions:

1. To spend the revenues generated by high hydrocarbon prices on the strengthening of the financial base of the funded component of the pension system. This implies that the system should also encompass those Russian citizens who presently have no right to a funded annuity.
2. To implement the program of privatization of state property, and to earmark the resulting revenues for the financing of the funded pension system.
3. To stabilize those tax revenues which are the least dependent on the revenues from the oil and gas sector, to abstain from lowering the rates of those taxes which are the least dependent on the situation on the hydrocarbon market, when it is not backed by the decisions to restrict the budget's spending obligations.

It might be feasible to follow the example of Norway and to transform the Stabilization Funds into a pension fund for future generations of pensioners, thereby guaranteeing the fulfillment of the State's principal social obligations independently

from the market's fluctuations for many years to come. Of course, a certain reserve for dealing with emergency situations must also be created within its framework.

While enjoying high oil incomes, it is easy to disregard the existence of long-term financial problems. The Soviet Union's experience has clearly demonstrated that such a policy can be very costly.

## **Section 1. The Socio-Political Background**

### **1.1. State policy and state institutions in 2006<sup>1</sup>**

#### *1.1.1. The main trends of economic and political development*

The past year was not marked by any outstanding events in terms of either economics or politics. The authorities continued their course outlined in the previous years. There were no remarkable external challenges which could exert significant influence on the economic life of the country and necessitate some special responses.

This observation is confirmed by macroeconomic indicators (Table 1). The economy was growing at a steady if not spectacular rate, sufficiently high to exceed both the world's and European average but still too modest to secure the achievement of the recently so cherished goal of "doubling the GDP". And this idea has somehow slipped off into the background. Practically none of the important indicators exhibited any changes either to the better or to the worse.

In terms of economic growth, Russia continued to considerably outpace the most developed countries of the world, but slightly lagged behind the majority of post – Soviet countries (Table 2). By comparison with the countries of Central and Eastern Europe, Russian growth rate appears, on the whole, to be satisfactory (with the exception of the Baltic states), thus confirming the regularity that has revealed itself after the completion of the period of transition - that "the further from Brussels the higher is economic growth"<sup>2</sup>.

The investments, especially foreign ones, are exhibiting a positive dynamic. And it is noteworthy that it is taking place in a situation when the State is clearly boosting up its role in economic life by increasing the assets of the state – owned enterprises operating in the sectors which are the most attractive ones under the existing conditions (the branches of the fuel and power – engineering complex).

The government continued to pursue a cautious financial policy. The resources of the Stabilization Fund and gold and foreign currency reserves were growing. Although the budgeting policy has become weaker (the federal budget's expenditure rose in nominal terms by more than 20 % on the previous year), and therefore the dependence of the state sector on the situation on the market has increased, it is still too early to affirm that the conservative budgeting policy has been abandoned, and budgeting populism has come in its stead. It has now become very clear that it is a rather difficult task - to avoid populism in a situation when money is in abundance, and throughout the past year the authorities were continuing their quest for arguments and solutions designed to control the torrent of populist demands and calls. This was especially important from a political point of view, because the year was pre-electoral.

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<sup>1</sup> The author expresses his gratitude to V. Novikov and O. Kochetkova for their help in preparing this section of the review.

<sup>2</sup> For more details, see Oslund, A. 'Paradoks evraziiskogo rosta (The paradox of Eurasian growth) // Rossiia v global'noi politike (Russia in global politics). 2006. Vol. 4. № 6.

The first year of realization of the “national projects” came to an end. Having been formulated by V. Putin in autumn 2005, these projects became the core of the country’s social and budgeting policy, because they provided a means for significantly accumulating budget expenditures and endowing the government’s economic policy with a social accent. To the initially suggested projects (public health care, education, agriculture, and housing), one more issue was now added – the need to overcome the demographic crisis.

The national projects have become a reflection of the general tendency of transition toward medium and long – term politics. There emerged a strong demand for programs aimed at the development of the whole country and also of its individual regions and sectors of the economy. The development of a ten-year socio – economic strategy of the country was started. A Summary Report on the results and main areas of activity, containing three – year benchmarks for the government’s activity, was prepared, and similar reports were prepared by ministries and agencies. For the first time in Russia’s economic history, a switchover to three – year budget planning took place: even in conditions of the Soviet planned economy, the feat of extending budget planning beyond the limits of one year had never been achieved. The Federation’s subjects started mapping long – term (for 3 – 5 years) strategies and medium – term (for 3 – 5 years) programs of their socio – economic development. The Government periodically considers strategies for the development of some individual manufacturing and infrastructural sectors.

In the course of the year 2006, the Government continued to actively design and materialize the “institutions of development”. Special economic zones, concession agreements, and the Investment Fund became the reality of economic life. Simultaneously, a lot of intensive effort was devoted to creating the legal and organizational foundations of the State Development Corporation (or the Bank of Development), which should become the source of investments for large projects supported by the State. Apparently, this work will be finished in 2007, and Russia will then possess an integral system of the so – called “institutions of development”.

The process of the consolidation of the most important (strategic) sectors of the economy in the hands of the State or under its control was continued. Recent years have demonstrated that there exist two fundamental models for restoring state control over the key assets – through court proceedings (the “Yukos model”) and through buying – out<sup>3</sup>. The Yukos precedent performed its demonstrative function, and last year the second model was the absolute leader. The most vivid example of this is the penetration of “Gazprom” into the project “Sakhalin-2”, which was accomplished through buying – out a controlling block of shares from western corporations. The same trend can be traced in the formation of the “United Aircraft Building Corporation”. Finally, there emerged an idea that a draft law designed to

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<sup>3</sup> See: Ekonomicheskaja politika 2005 g.: opredelenie prioritetov (The economic policy of the year 2005: the determination of priorities) / Rossiiskaia ekonomika v 2005 g.: Tendentsii i perspektivy (The Russian economy in 2005: Trends and prospects). Vyp. 27. Moscow: IEPP (IET). 2006.

regulate the access of foreign capital to the Russian production assets should be put forth.

In the year 2006, there were some significant changes in how Russia positioned itself on the international arena. Two opposite tendencies could be observed in this regard. On the one hand, the process of Russia's entry into the structures of the contemporary world was going on. On the other hand, it became obvious that Russia's relations with the western world – or, to put it differently, with the developed market democracies - were worsening.

The first tendency was related to the continuation and completion of the processes which began rather long ago. It was manifested by the negotiations concerning Russia's joining the WTO and by her chairmanship in the G8, which passed more or less successfully (or, in any case, without any excesses). One should also note the liberalization of the exchange regulation in the part relating to capital movement, which formally made the rouble a fully convertible currency (in contrast to the convertibility of the rouble for current transactions (or current account convertibility)), introduced as early as 1992). However, these developments and tendencies have not become, so far, a factor of Russia's integration in the communities of developed market democracies.

The second tendency, unfortunately, is a reflection of the existing problems – the cooling off (and even the deterioration) of the relations with the EU, and the criticism of the latest political tendencies of Russia's development as being contrary to the principles of democracy. Additional difficulties are being created by Russia's intention to rearrange its tariff policy in respect of the pricing of energy carriers, which became obvious last year. An attempt at switching over to international prices in Russia's relations with her CIS partners causes not only the resentment of the latter (which is quite understandable), but also criticism on the part of other European countries who consider this attempt both as the blackmailing of the former Soviet republics and as the source of risks for the security of their own energy supplies (because the oil and gas pipelines pass through the territory of the countries for whom the tariffs are being raised). Also, the situation is becoming especially difficult for Russia because, within the framework of her chairmanship in the G8, the slogan of energy security was put forth as one of the key issues on the agenda. And, according to Russia's western partners, it is precisely this demand that is being undermined by the revision of tariffs for gas supplies to the “near abroad”.

*Table 1*

**Major economic indicators of the post – crisis period (1999 – 2006)**

	1999	2000	2001	2002	2003	2004	2005	2006*
1	2	3	4	5	6	7	8	9
<b>GDP</b> (as percentage of previous year))	106.4	110.0	105.1	104.7	107.3	107.2	106.4	106.7
<b>Index of industrial growth</b> (as percentage of previous year)	111.0	108.7	102.9	103.1	108.9	108.3	104.0	103.9
<b>Agricultural products of farms of all categories</b> (as percentage of previous year)	104.1	107.7	107.5	101.5	101.3	103.0	102.4	102.8
<b>Investments in fixed capital</b>								

1	2	3	4	5	6	7	8	9
<i>Billion roubles</i>	670.4	1165.2	1504.7	1762.4	2186.4	2804.8	3534.0	4482.7
<i>as percentage of previous year</i>	105.3	117.4	110.0	102.6	112.5	110.9	110.5	113.5
<b>Foreign investments** (billion USD.)</b>	9.6	11.0	14.3	19.8	29.7	40.5	53.7	55.1
including:								
<b>Direct investments</b>	4.3	4.4	4.0	4.0	6.8	9.4	13.1	13.7
<b>Portfolio investments</b>	0.031	0.145	0.451	0.472	0.401	0.333	0.453	3.182
<b>Other investments</b>	5.3	6.4	9.8	15.3	22.5	30.8	40.1	38.2
<b>Foreign trade turnover</b>								
<i>in billion USD</i>	115.1	149.9	155.6	168.3	212.0	280.6	368.9	468.4
<i>as percentage of previous year</i>	86.9	130.2	103.8	108.1	126.0	132.4	131.5	127.0
<b>export of commodities</b>								
<i>in billion USD</i>	75.6	105.0	101.9	107.3	135.9	183.2	245.3	304.5
<i>as percentage of previous year</i>	101.5	139.0	97.0	105.3	126.7	134.8	132.9	125.0
<b>import of commodities</b>								
<i>in billion USD</i>	39.5	44.9	53.8	61.0	76.1	97.4	125.3	163.8
<i>as percentage of previous year</i>	68.1	113.5	119.8	113.4	124.8	128.0	128.7	129.3
<b>Budget revenue (as percentage of GDP)</b>								
<b>consolidated budget</b>	25.2	28.5	29.3	32.1	31.1	32.3	36.1	35.5
<b>federal budget</b>	12.7	15.5	17.8	20.3	19.5	20.1	23.7	23.6
<b>Budget expenditure (as percentage of GDP)</b>								
<b>consolidated budget</b>	26.3	25.6	26.4	31.1	29.7	27.8	27.5	27.5
<b>federal budget</b>	14.0	13.1	14.8	18.9	17.8	15.8	16.3	16.1
<b>Budget surplus / deficit (-) (as percentage of GDP)</b>								
<b>consolidated budget</b>	-1.1	2.8	2.9	1.0	1.4	4.5	7.7	8.0
federal budget	-1.1	2.4	3.0	1.4	1.7	4.3	7.4	7.5
<b>Retail trade turnover (as percentage of previous year)</b>	94.2	109.0	111.0	109.3	108.8	113.3	112.8	113.0
<b>Consumer price index (as percentage of December of previous year)</b>	136.5	120.2	118.6	115.1	112.0	111.7	110.9	109.0
<b>Industrial producers' price index (as percentage of December of previous year)</b>	170.7	131.9	108.3	117.7	112.5	128.8	113.4	1110.4
<b>Total number of unemployed, by end of period, million persons</b>	9.4	7.6	6.4	5.8	6.2	6.0	5.7	5.1
<b>Average money income per capita , per month (in roubles.)</b>	1658.9	2281.1	3062.0	3947.2	5170.4	6410.4	8023.2	9911
<b>Real available money incomes (as percentage of corresponding period of previous year)</b>	87.7	112.0	108.7	111.1	115.0	110.4	111.1	110.0
<b>International reserve assets (by end of period, billion USD)</b>	12.5	28.0	36.6	47.8	76.9	124.5	182.2	303.7
<b>Aggregate volume of resources in Stabilization Fund of Russian Federation</b>								
<i>billion roubles</i>						522.3	1 237.0	2346.9
<i>billion USD</i>						18.8	42.3	89.1

\*preliminary estimate

Source: Rosstat, RF Central Bank.

Table 2

**GDP dynamics in individual countries, in % by year**

<b>Countries</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
1	2	3	4	5	6	7	8	9
Austria	3.3	3.4	0.8	0.9	1.1	2.4	2	2.8
Azerbaijan	11.4	6.2	6.5	8.1	10.4	10.2	24.3	25.6
Armenia	3.3	6	9.6	13.2	13.9	10.1	13.9	7.5
Belarus	3.4	5.8	4.7	5	7	11.4	9.3	7
Belgium	3.1	3.7	1.2	1.5	0.9	2.4	1.5	2.7
Bulgaria	2.3	5.4	4.1	4.9	4.5	5.7	5.5	5.6
Bosnia and Herzegovina	9.5	5.4	4.3	5.3	4.4	6.2	5	5.5
Great Britain	3	3.8	2.4	2.1	2.7	3.3	1.9	2.7
Hungary	4.2	6	4.3	3.8	3.4	5.2	4.1	4.5
Germany	1.9	3.1	1.2	0	-0.2	1.2	0.9	2
Greece	3.4	4.5	5.1	3.8	4.8	4.7	3.7	3.7
Georgia	3	1.9	4.7	5.5	11.1	5.9	9.3	7.5
Denmark	2.6	3.5	0.7	0.5	0.7	1.9	3.2	2.7
Israel	2.9	8.7	-0.6	-0.9	1.5	4.8	5.2	4.1
India	6.9	5.3	4.1	4.3	7.2	8	8.5	8.3
Ireland	10.7	9.2	5.7	6	4.3	4.3	5.5	5.8
Island	4.3	4.1	3.8	-1	3	8.2	5.5	4
Spain	4.7	5	3.5	2.7	3	3.1	3.4	3.4
Italy	1.9	3.6	1.8	0.3	0	1.1	0	1.5
Kazakhstan	2.7	9.8	13.5	9.8	9.3	9.6	9.4	8.3
Canada	5.5	5.2	1.8	2.9	1.8	3.3	2.9	3.1
Cyprus	4.8	5	4.1	2.1	1.9	3.9	3.7	3.5
Kyrgyz Republic	3.7	5.4	5.3	0	7	7	-0.6	5
China	7.1	8.4	8.3	9.1	10	10.1	10.2	10
Korea	9.5	8.5	3.8	7	3.1	4.7	4	5
Latvia	4.7	6.9	8	6.5	7.2	8.6	10.2	11
Lithuania	-1.7	4.7	6.4	6.8	10.5	7	7.5	6.8
Luxemburg	8.4	8.4	2.5	3.6	2	4.2	4	4
Moldova	-3.4	2.1	6.1	7.8	6.6	7.4	7.1	3
Norway	2.1	2.8	2.7	1.1	1.1	3.1	2.3	2.4
Poland	4.5	4.2	1.1	1.4	3.8	5.3	3.4	5
Portugal	3.9	3.9	2	0.8	-1.1	1.2	0.4	1.2
Russia	6.4	10	5.1	4.7	7.3	7.2	6.4	6.7
Romania	-1.2	2.1	5.7	5.1	5.2	8.4	4.1	5.5
Swaziland	3.5	2.6	1.6	2.9	2.4	2.1	1.9	1.2
Serbia	-18	5.2	5.1	4.5	2.4	9.3	6.3	5.5
Slovakia	1.5	2	3.2	4.1	4.2	5.4	6.1	6.5
Slovenia	5.4	4.1	2.7	3.5	2.7	4.2	3.9	4.2
USA	4.4	3.7	0.8	1.6	2.5	3.9	3.2	3.4
Tajikistan	3.7	8.3	10.2	9.1	10.2	10.6	6.7	8
Turkmenistan	16.5	18.6	20.4	15.8	17.1	14.7	9.6	9
Turkey	-4.7	7.4	-7.5	7.9	5.8	8.9	7.4	5
Uzbekistan	4.3	3.8	4.2	4	4.2	7.7	7	7.2
Ukraine	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	5
Finland	3.9	5	2.6	1.6	1.8	3.5	2.9	3.5

	1	2	3	4	5	6	7	8	9
France		3	4	1.8	1.1	1.1	2	1.2	2.4
Croatia		-0.9	2.9	4.4	5.6	5.3	3.8	4.3	4.6
Czech Republic		1.3	3.6	2.5	1.9	3.6	4.2	6.1	6
Chile		-0.8	4.5	3.4	2.2	3.9	6.2	6.3	5.2
Switzerland		1.3	3.6	1	0.3	-0.3	2.1	1.9	3
Sweden		4.5	4.3	1.1	2	1.7	3.7	2.7	4
Estonia		0.3	7.9	6.5	7.2	6.7	7.8	9.8	9.5
Japan		-0.2	2.9	0.4	0.1	1.8	2.3	2.6	2.7

*Source:* International Monetary Fund, World Economic Outlook Database.

### 1.1.2. Problems of economic growth

The issues of economic growth remained among the leading ones in the economic – political discussions of 2006. However, the debates on these issues have undergone a certain transformation.

What we see now is an apparent de-politicization of the issue: owing to the fact that none of the principal (or alternative) models has been chosen by the top officials to be the universal one for public use, the adoption of decisions on concrete measures within the framework of these models and the discussion of their justifiability have shifted to individual interested agencies and their branches. At the same time, the issue of “doubling the GDP” is slipping off to the periphery of the discussion, and although it has not been discarded officially, the political elite is certainly becoming disinterested in the matter. This development can only be welcomed, because any fetishism with regard to quantitative indices can only de-stimulate real growth accompanied by structural reforms.

#### The models of growth and the attitude to industrial policy

In recent years, there emerged four major approaches to economic growth consolidation – the dirigiste (on the basis of state investments), the “chibanistic” (through the active development of financial and industrial groups), the consistently liberal (advocating a dramatic diminishment in the burden imposed on the economy by budget and regulation), and the institutional (through the formation of a modern institutional environment, approximated to its western analogues)<sup>4</sup>.

The obvious completion, in 2006, of the active discussion between the proponents of each of these models resulted in no approach gaining the upper hand became. The economic policy being pursued in Russia contains elements of all four approaches toward the consolidation of economic growth. The regulatory and investment activity of the State is on the rise. Financial and industrial groups, especially those under state control, are becoming stronger, and the typically Russian feature is their being controlled by the State not only de facto (as in the case of South – Korean *chibans*), but also formally, because the controlling blocks of

<sup>4</sup> See Mau, V. *Ekonomiko – politicheskie itogi 2002 g. i osobennosti ekonomicheskoi politiki v preddverii vyborov* (The economic and political results of the year 2002 and the peculiarities of economic policy on the eve of the election) / Rossiiskaia ekonomika v 2002 g.: Tendentsii i perspektivy (The Russian economy in the year 2002: Trends and prospects). Vyp. 24. Moscow: IEPP. 2003.

shares in the leading financial and industrial groups are either already owned by the State or moving in this direction. At the same time, the task of reducing the budget's share in GDP remains a part of the official policy. Although in the past two years this indicator has been growing, the three-year budget planning is oriented to reducing it in the medium term. And finally, the core of the Government's policy is undoubtedly the formation and strengthening of the institutions typical of modern market democracies.

In other words, at the present time the cornerstones of state policy are as follows:

- macroeconomic and political stability;
- the development of modern market institutions;
- an active participation of the State in the organization of economic life.

However, the question of just how stable such an economic and political configuration can be, remains open. Naturally, it will be stable as long as the external economic situation is making it possible to combine macroeconomic stability with state interference. This situation can last for a long time, but not forever. And the choice will finally have to be made of the sequence in the preferential treatment of each or some of the models of growth.

In 2006, the stimulation of industrial growth was one of the most crucial issues in government discussions. Prime Minister M. Fradkov even put forth a proposal that a special government commission for dealing with the issues of industrial policy should be created. The characteristic feature of this discussion was that it was related not to the decline in the rate of growth but to the dissatisfaction with the growth being produced primarily by the sectors of trade and services, and not by the operation of high – tech companies.

However, the accelerated development of the services sector is a justified response to the structural heritage of the Soviet economy; moreover, it can be conjoined with the development of high technologies. Thus, the purchases of information technologies (IT) by big Russian trading organizations are comparable to the expenses on IT in the oil and gas sector<sup>5</sup>. It should also be borne in mind that in the USA the retail trade leaders have accounted for approximately 50 % of the US advantage over Europe in the rise in productivity over the past 10 years (another 25 % is accounted for by a similar progress achieved by wholesale chains of supply)<sup>6</sup>.

The issue of industrial policy has been periodically arising in political discussion throughout the fifteen years of post – communist development. Whenever the case in point was industrial policy, it was understood, as a rule, as the determination of priority sectors and industries by the State, and the various form of support to them, mainly through financial injections from the budget. Such an industrial policy has featured in a number of developed countries, so Russia is not unique in this respect. It has its roots in the industrial past, in the epoch when large industrial firms were the leaders, and when it was possible to define, with a sufficient degree of precision, the most promising sectors and industries. In the industrial epoch it

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<sup>5</sup> See *CNews Analytics*, 2006.

<sup>6</sup> K. Rogoff, Wall-to-Wall Wal-Mart? ( <http://www.project-syndicate.org/commentary/rogoff15> )

was possible to define the long – term prospects of growth in each industry, to concentrate financial (budget) resources thereon, and to achieve some specified goals. That was precisely how the Soviet Union pursued its industrialization, but similar (although not so ruthless) instruments were applied in the western world as well.

In the 1990s, the majority of recommendations concerned with industrial policy were based on precisely such logic. And it is this logic that was causing the aversion of liberal critics, who insisted on the impossibility and inadmissibility of the logic of industrialization being used in the contemporary epoch. The high rate of the transformation of needs and the potential for their satisfaction, coupled with the rapid pace of technological innovation, have sharply reduced the predictability of industrial production. It is now becoming impossible – and irresponsible – to determine the long – term priorities as a basis for taking large – scale budgeting decisions. This impossibility is further emphasized by the problems faced by the post – communist Russia, where the weakness of political institutions could well conduce to “political entrepreneurship” rather than to the advent of State – guided innovation.

However, in recent years the perception of industrial policy issues has, apparently, entered a new phase, which testifies to a certain growth in the maturity of the Russian political elite.

*Firstly*, the President has formulated the national priorities, and labeling as such human development, and not certain branches of industry. The emphasis placed on education, public health care, living conditions, and human reproduction as such (the falling birthrate problem) has been manifest of a step of fundamental importance in overcoming the logic of industrialism and the Soviet understanding of economic problems in general, and in recognizing the realities of the post – industrial epoch.

*Secondly*, the quantitative benchmarks of growth (the demand to “double the GDP”) have been steadily losing ground to the realization of the importance to ensure the quality of growth, and especially that of its innovative base – the theme of innovation is becoming one of the central issues, when the tasks and mechanisms of economic policy are being discussed. In 2006, the dissatisfaction with the slow pace of proliferation of high technologies was expressed in the already mentioned discussions.

The latter criticism was aimed both at the structure of industrial and individual consumption, and at the structure of production, and in particular, that of exports. Thus, the share of high – tech exports in the total volume of exports does not exceed 4 %, which is far below the same index of developed countries, and even of China (by more than 25 %).<sup>7</sup>

In other words, last year has provided sufficient examples of the growing awareness that modern industrial policy, in order to be authentically modern and

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<sup>7</sup> See *Tsentr razvitiia. Obozrenie rossiiskoi ekonomiki (za period s 12 po 25 dekabria 2006 g.)* (The center of development. A review of the Russian economy (for the period from 12 to 25 December 2006)).

effective, should become considerably different from what was understood as such throughout the major part of the 20<sup>th</sup> century. Nowadays it has to do, for the most part, with the formation of a system of incentives for the development of different industrial sectors, without any rigid establishment of their priorities.

The key industrial policy instruments used by the Russian Government are as follows: private – public partnership, the exchange rate policy (aimed at restraining the rouble's strengthening), the regulation of customs tariffs, technical regulation, support for the export of processed products export, and some other forms.

### Institutions of development

An important role in stimulating economic growth should be played by the special economic zones, the Investment Fund, the Russian Investment Fund for Information and Communication Technologies, the Venture Fund (the Russian Venture Company), the Agency for Mortgage Crediting of Housing Construction (AMCHC), and the Corporation (or Bank) for Development. Last year saw the beginning of the practical realization of the first three instruments. The AMCHC has already been in existence for a number of years. The authorities have initiated an active scrutiny of the problems of venture financing and the Bank for Development.

A number of *special economic zones* (SEZ) - two industrial production zones (in Lipetsk Oblast and Tatarstan) and four technical - development zones (in Dubna, Zelenograd, St Petersburg and Tomsk) were created in 2006. It is yet too early to offer any comments as to their practical effectiveness. At the present time, the process of developing the zones' infrastructure is under way, and negotiations are being held with potential candidates for obtaining the status of residents. Although there are plenty of applicants eager to launch their production in the SEZs, no "break – through" projects backed by strong investment or involving unique technologies have surfaced so far. And it is not surprising: on the one hand, the Russian SEZs do not offer any significant tax preferences, and on the other it will take some time to develop the infrastructure. Also, there has emerged a problem that should have been taken into consideration when developing this mechanism for stimulating investment – it is advisable that the producers of exports should be attracted into the SEZs, with no distortions of the conditions for domestic competition being permitted. But so far, under the influence of the inertia produced by a decade of crisis, most of the zones are oriented to manufacturing import – substituting products.

In 2006, the amendments to the existing law introducing special economic zones of the tourist and recreational type (SEZ – TRT) were adopted. It is significant that these zones offer practically no tax benefits, while the incentives aimed at increasing its attractiveness have been changed so as to promote state investments in the infrastructure (industrial, communal, and transport); at the same time, federal investments must be combined with those funded from regional and municipal budgets. In fact, the choice made by the Federal Government in favor of SEZ – TRT is akin to the selection of projects financed from the Investment Fund: the State adopts the responsibility to finance the infrastructural costs which conduce not

only to the development of this type of business but also create additional incentives in order to boost the economy of a corresponding region. This makes the SEZ – TRT regime more attractive to the Federation's subjects who thus acquire an additional resource for developing the areas with potential advantages for developing tourism. The winners in the recent contest were Irkutsk Oblast and Buriatia, Altai Krai and the Republic of Altai, Krasnodar Krai, Stavropol Krai, and Kaliningrad Oblast.

It is worth mentioning that, at present, Kaliningrad Oblast has two SEZ regimes operating in its territory: in 2006, the general Law "On the Special Economic Zone in Kaliningrad Oblast" entered into force, and at the same time it became possible for the Oblast to develop some sections of the Baltic coast under the SEZ – TRT regime. The above-mentioned general law has resulted from the year-long discussion concerning the advisability of introducing a special economic regime in this oblast. The new law has replaced the special regime introduced in 1996, which was based on customs privileges being granted to the import of consumer and capital goods into the region. Undoubtedly, the old mechanism, though mainly successful in stimulating the import of goods and the assembly of imported goods from parts for their subsequent realization in the main territory of Russia, did manage to play a certain positive role in the adaptation of the formerly closed militarized region to market conditions. The new Federal Law, which entered into force from 1 April 2006, mainly stimulates investment activity by granting considerable privileges to those entrepreneurs who are willing to establish new enterprises in the region. The adoption of the Law has already resulted in an upsurge of investment activity in Kaliningrad Oblast.

In 2006, the *Investment Fund* also began functioning. From the very beginning, it was planned that it should be formed within the framework of the federal budget in a situation when the prices of fuel and energy resources were high. In essence, it is the money which otherwise would have been transferred into the Stabilization Fund. Given the enormous pressure being applied to the financial bodies so as to force them to spend the petrodollars on the development of the "national economy", the Government has agreed to a compromise solution by allocating a part of the funds to state investments. Naturally, this decision has somewhat increased the vulnerability of the Russian economy should the oil prices change unfavorably, but would not be fatal if two conditions are observed. Firstly, the size of the Investment Fund should remain moderate in relation to that of the Stabilization Fund, and secondly, the resources of the Stabilization Fund should be spent really efficiently, that is, the spending should result in a rise in labor productivity and in positive structural changes (a diminished dependence on raw materials) in the Russian economy. Nevertheless, it should be taken into account that if the oil prices plummet, the resources of the Stabilization Fund should be primarily allocated to the fulfillment of the obligations assumed within the framework of investment projects, and only after this has been done – to the compensating for the reduction in other budget expenditures.

It is planned that the afore – said state support should be used when implementing the projects aimed at developing the infrastructure of national importance, and also in order to create and develop certain elements of the Russian innovation system, as well as to ensure the realization of institutional reforms. Under present conditions, the latter component ( institutional innovation) is especially important, for this innovation is a key factor of the dynamic development of both the infrastructure and the innovations.

In 2006, the selection of projects to be financed from the *Investment Fund* was started. The actual decisions were to be made by the Government Commission for Investment Project of National Importance having the final say. The majority of applications submitted in 2006 were concerned with the transport sector. Preference was given to those objects of infrastructure that were of crucial importance for the development of regions or to the major production clusters associated with this infrastructure. The objects of the federal infrastructure that are being created at the expense of the Investment Fund stimulate large – scale investments on the part of the private sector. In 2006, the volume of the Investment Fund amounted to approximately 70 billion roubles, while the long – term financial plan envisages its increase to 378 billion roubles in the years 2007 – 09.

On the whole, the selected projects can be subdivided into two categories: first, the transport projects designed to eliminate the infrastructural limitations that impede the development of the economy and to increase the mobility of the population; and second, the projects aimed at the industrial development of the country's territories and of new mineral deposits. Among the selected projects the following ones are especially worth mentioning: the construction of the “Western High – Speed Diameter” and of a tunnel under the River Neva in St. Petersburg, and a section of the speedway from Moscow to St Petersburg; the largest project in the sphere of infrastructure - the complex development of the Lower Angara region in Krasnoïarsk Krai, related to the formation of the biggest production cluster in Eastern Siberia; the creation of a transport infrastructure in Chita Oblast and Krasnodar Krai; and a number of other objects. The share of federal co–financing in such projects varies between 13 % and 60 %, and, as a rule, the larger the project, the smaller is the share of public finances.

The already supported projects have by no means exhausted the resources consolidated to the Investment Fund by the 2006 budget. The emerging situation inspires certain optimism because it is indicative of a cautious approach being taken toward spending budget resources on investment projects, and of the growing understanding of the extreme vulnerability of state investments to inefficient and even corrupt decisions<sup>8</sup>.

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<sup>8</sup> The problem of the inefficiency and vulnerability of state investment projects to corruption is not limited to Russia alone, or to developing economies. For the problems faced in this sphere, see Flyvbjerg, B. *Strategicheskaiia otsenka planirovaniia krupnykh infrastrukturykh proektov (Strategic valuation of policy and planning for large infrastructure projects)* // Ekonomicheskaiia politika (Economic policy). 2006. № 1.

In 2006, it was also decided to form the *Venture Investment Fund*. It is planned that this instrument would play a key role in stimulating innovation activity and in promoting high – tech manufacturing in industry. In order to increase the investors' interest in the innovation sector, it is planned to decrease their risks and increase the profitability of venture investments by means of some state participation in private venture funds.

In 2006 – 07, the authorized capital of the Venture Fund should be financed by the Investment Fund in the amount of approximately 15 billion roubles. It is suggested that the resources of the Venture Fund, among other things (and first of all), should be spent on the development of nanotechnologies, on increasing the capital of the financial institutions specializing in leasing, and on crediting and insuring contracts for the acquisition of state-of-the art technologies.

Finally, in late 2006, the issue of the *RF Bank (or Corporation) for Development*, which should start functioning by the end of 2007, was submitted to the Government for consideration. According to G. Gref, the formation of the institutions of development in Russia should be completed with the creation of this establishment. In the opinion of many participants in the discussion, such an institution, provided that it is completely materialized, would essentially substitute the government, and could begin playing the role of a parallel budget. This development would be rather dangerous, because the State must spend its resources in accordance with a uniform and transparent procedure. The emergence of alternative budgets, though capable of performing the short – term tasks of spurring up investment, practically always results in diminishing its efficiency and, ultimately, in stagnation (or even a crisis).

The administrative and political (and not commercial) nature of this institution originates from the fact that the Bank for Development, by its organizational and legal form, is deemed to be a not – for – profit organization, which is not oriented to the extraction of profit. Thus, it is suggested that this ‘bank’ should subsidize individual projects (or even sectors). However, the possibility of making productive and responsible decisions is therefore open to question. This institution should orientate itself, instead of profitless projects (or instead of being literally subsidized), to the projects with a long payback period, which are not attractive to ordinary banks. Even if the abovesaid criterion is adopted, the selection of projects, as well as the very prospects of such an institution, would give rise to many questions.

Apart from creating special institutions of development, the Government was actively engaged in studying the prospects for the development of individual branches of industry, believed to be of priority importance for the development of national economy. The debate was concentrated on the issues of development of the motor and aviation industries, new technologies, etc. The Government has approved the program for the development of nanotechnologies, the program “National Technological Base” for the years 2007 -11, and other similar programs. Thus, the tendency toward using the traditional dirigiste approaches to economic policy was manifesting itself more and more openly. However, it should be admitted that this tendency has so far been limited to the political and organizational –

and – administrative (the consolidation of assets) spheres without significantly influencing the realm of budgeting.

The formation of the institutions of development is a policy which can be quite understandable in a State with high revenues. However, this policy has two very significant limitations.

First, financial decisions, being the simplest and most apparent ones, can deflect attention from the necessity to solve other (and, perhaps, deeper rooted) problems of consolidating economic growth. In recent time, such limitations of modern growth as the lack of high – performance equipment, the rising competition with imports, the backward structure of exports and, most importantly, the deficit of skilled labor force, have become increasingly apparent. These issues are much more important than the support for individual sectors and enterprises, and they require foremost attention on the part of the authorities.

Secondly, there exists the issue of whether it can be in principle possible to solve the problems of post – industrial growth by bearing on the institutions which, for the most part, have been devised at the previous stage of the socio – economic development of both this country and the world. Are the institutions of development authentically modern, that is, do they adequately match the challenges of the post – industrial epoch? Only time will give answer. So far, we can only note that under certain circumstances, the use of traditional institutions for performing the new tasks of modernization is possible in principle. However, this can always be achieved at a price which can be too high in a medium – term perspective. To bear upon the old institutions means promoting the rigidity of the social system and decreasing its adaptability necessary for adequately responding to the new rapidly changing challenges. All the history of Russia in the 20<sup>th</sup> century, be it the crisis of capitalist modernization at the beginning of the century or the crisis of the Soviet system, bears witness to this.

#### Some issues of investment activity

Under conditions of transition to the investment growth model it is crucial to demonstrate the State's attitude to private investors, including foreign ones. Any assessments with regard to this issue cannot be unequivocal and straightforward. It by no means always happens so that everything which seems advisable or, on the contrary, undesirable in accordance with the logic of developed market democracies should inevitably produce an unambiguously positive or negative result. To a certain extent, the high profitability of investments compensates for the “unconventionality” of the attitude toward the investors, and therefore the activity of foreign business could be relatively energetic in situations which can be characterized as unfavorable when judged by the standards of developed democracies. This is especially true with respect of foreign capital which feels itself relatively more politically protected than domestic business.

Usually, the presence of attractive assets, combined with the predictability of the actions of the authorities, creates sufficiently favorable conditions for the investment activity of businesses, including foreign ones. This effect is becoming

especially pronounced against the background of the continuing decline of Russia's ratings in terms of state administration efficiency, corruption, compatibility, etc - and the simultaneous improvement of its international credit ratings.

Last year, one of the major indicators of the relations between the Russian authorities and foreign investors was the course of events regarding the project "Sakhalin - 2", which was being developed under a production sharing agreement (PSA). From the point of view of the events of the past three years, nothing new has happened: the State in the person of "Gazprom" has taken the development of a promising oil deposit under its control by buying out the controlling block of shares from private investors. In other words, the "Sibneft" model, rather than the "Yukos" one, was used, which was positive from the point of view of internal - policy logic and even was not harmful to the investors. However, this model is favorable only by the logic of relations between the State and domestic businesses. But whether this model can satisfy foreign investors will be seen only in the year 2007.

For now, it is possible to make a preliminary assumption that the situation with "Sakhalin - 2" is unlikely to produce any significant negative impact on the activity of foreign business in the part of direct investment. Firstly, the actions of the authorities in this case were quite predictable and relatively restrained (the foreigners were granted their compensation). Secondly, the activity of foreign capital is gradually shifting from the fuel and energy sector to the sectors which the Government is not planning to place under its control; this trend clearly answers the interests of the national economy's development. Thirdly, the questionable efficiency of the production sharing agreements concluded in the mid - 1990s was always sufficiently clear.

At one time, the PSAs were seen as a mechanism for attracting foreign capital into those sectors which, in a country with an unfavorable investment climate (both politically and economically), required considerable investments. The inefficiency of the tax system required that the tax regimes granted to the projects urgently in need of large investments should be individualized, while the serious political risks necessitated the withdrawal of these investments from national jurisdiction. That was how the PSA projects of the mid - 1990s came into being: special tax regimes were established for them and the resolution of disputes concerning these projects was placed under the jurisdiction of the Stockholm Court.

After the achievement of political stabilization and a considerable improvement of the tax system, the production sharing agreements, in fact, became senseless. At the same time, the serious systemic problems of the PSA regime had fully revealed themselves.

Firstly, in conditions of weak state authority the PSA regime, with its implications of haggling for an individual tax treatment, gives rise to corruption. Secondly, the regime provokes a conflict of interests between the tiers of state power - in the adopted PSA model, what is profitable for subjects of the Federation turns out to be detrimental to the federal budget. Thirdly, the adopted model stimulates the investor to blow up the costs, because they are subtracted before the production is shared (moreover, the agreements initially did not even set the upper margin of

costs to be subtracted). As a result, the PSA regime of the mid – 1990s type could only make the authorities, whose position had become much stronger, feel serious doubts as to its feasibility.

However, the comprehension of the dubious nature of the PSA regime only adds to the basic impossibility of practicing this model even in conditions of an underdeveloped democracy. The regime can actually become possible only in two cases: either when state authority is extremely feeble, and a special treatment could be “bought”, or in conditions of an authoritarian rule, when it is sufficient to obtain (or buy) patronage of the highest – ranking person. Under conditions of any relatively mature democratic system such a situation would be practically impossible.

When summarizing the results of the discussion on the issues of the stimulation of economic growth, it is necessary to make one general note. Despite all the importance of the specific issues of ensuring economic growth which were on the agenda of last year’s discussion, institutional and structural reforms will remain of principal importance in the foreseeable future. They, actually, should top the list of the first – priority measures designed to consolidate economic growth and to endow it with a stable and authentic dynamic. At present, this would be especially important because the readily accessible factors of growth are nearly exhausted (the idle facilities, the unused labor resources), and in the medium – term perspective it is the new investments that will become the main source of growth.

The areas where efforts must be intensified are as follows: the protection of property rights (which is the aim of administrative and judicial reforms), reform of natural monopolies, reform of the public health care service, the transformation of the pension system, and reform of the housing and utilities sector. The development and implementation of reform in these areas of socio – economic policy is a much more difficult intellectual task than the creation of the “institutions of development”. The institutional reforms of the institutions of power (related to state administration and the judicial system), and of the institutions of development of human capital (education, public health care, the pension system) are concerned with the realities of the post – industrial epoch. Their state-of-the-art high-performance models are to be devised anew because they cannot bear upon the accumulated experience of functioning under conditions of industrial systems. But no institutions of development would be capable of producing a stable long – term effect, unless a thorough institutional renovation of these sectors is carried out.

### *1.1.3. Financial stability and the Stabilization Fund*

In 2006, the financial stability of the country, on the one hand, was formally strengthening: there was a significant growth of resources accumulated in the Stabilization Fund, and of the gold and foreign currency reserves of the Central Bank. On the other hand, the level of budget expenditure, in real terms, was also rising, which increased the vulnerability of the Russian economy to the market fluctuation of oil prices. Last year, the oil – and – gas deficit of the federal budget (calculated as a difference between the revenues not depending on oil and gas and the expen-

ditures) amounted to more than 5 % of GDP. This resulted from the decrease of taxes and the growth of budget expenditures. In fact, the financing of this deficit is carried out at the expense of the revenues depending on the export of fuel and energy resources and also on borrowing and the proceeds from privatization.

Any further weakening of budgeting policy in favor of growth in wages, current expenditures and tax reduction is unlikely to become a source of economic growth acceleration. These expenditures could result in a dangerous strengthening of the rouble exchange rate in real terms and could contribute to the worsening of the structure of the Russian economy, especially against the background of a slowdown in structural reforms. In fact, the case in point is the danger for the country to be caught once again in this structural trap, into which the USSR once had been led to by the thoughtless policy of boosting its budget expenditures in the 1970s, which resulted in the disintegration of the country when oil prices collapsed.

The necessity to be cautious in budgeting policy becomes especially urgent if one remembers that over the past 35 years the price of oil has been fluctuating in the range from 8 to 96 USD per barrel (in the 2003 dollars). Also, it should be taken into account that no responsible expert would be able to plot a more or less reliable trend, thus making it possible to forecast the dynamic of oil prices.

Political practice indicates that the Stabilization Fund is a factor of economic destabilization in its own right. The presence of considerable financial resources constantly urges the elite to search for the areas where these resources could be spent in order to achieve its own political aims. And it is very difficult, if not impossible, to resist this pressure<sup>9</sup>. The criticism aimed at the Stabilization Fund is two – fold. For one thing, it is affirmed that the resources of the Stabilization Fund are inefficiently managed, that is, they do not yield any considerable income, while in the political sense they are used in order to strengthen the economies of foreign states (in whose securities they are placed). For another, the ever increasing number of areas where this money could be spent is being suggested time and again – from social and infrastructure projects (the worst scenario) to the lowering of taxes (a softer variant).

The debate on this problem is very complicated because, within its framework, the Ministry of Finance has to present some weighty technical arguments in response to the political demands put forth by the opponents to the current course. But any dialogue between the parties that use arguments belonging to different systems of coordinates is impossible in principle. Moreover, for the problem of managing the resources of the Stabilization Fund is indeed a most difficult one. Profitability must be combined with high liquidity, which can be ensured only when absolutely reliable and low – yield financial instruments are used. But these instruments are the securities of the most developed western countries, which gives

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<sup>9</sup> It seems that the most radical approach to solving this problem in a similar situation was found in Ancient Athens. After the Peloponnesian War (431 – 404 B.C.), the Athenians formed a reserve fund and took a decision that “he who, except in an event of the state of emergency, proposes to tap the reserve of 5000 talents kept in the Temple of Athena should be sentenced to death” (Van Kreweld, *M. Rastsvet i upadok gosudarstva (The rise and decline of the State)*. Moscow: IRISEN. 2006. P. 50.

rise to a political counter – argument that such a policy is “not patriotic” (it would be “patriotic” to invest money in high – yield domestic securities and to lose it exactly at the time when a crisis situation develops and these resources are most urgently needed by the budget).

Initially, the resources of the Stabilization Fund were being spent on repaying external debts. As a result, in 2005 the debt to the International Monetary Fund was repaid in full and before schedule, and in June 2006 Russia completely repaid its debt to the Paris Club. Therefore, Russia’s external debt fell last year to 5 % of GDP - a figure unprecedented in modern developed countries. The policy of repaying this debt ahead of schedule has made it possible to slow down the nominal growth of the Stabilization Fund and to explain, to the opponents, the importance of a further accumulation of its resources. After having repaid the debts, it became necessary to find new arguments in favor of preventing the excessive funds to be injected into the economy because of the danger of serious negative macroeconomic and structural effects.

Last year, President V. Putin also joined the discussion concerning the Stabilization Fund. His arguments and proposals are to the effect that it would be inadmissible to spend the resources of the Fund on resolving any day – to – day problems. But it is likely that even the President cannot afford to impose a direct veto on the spending of these resources. His proposals are two – fold. On the one hand, it is suggested that “in 2007 and in the medium term the growth of the expenditures of the federal budget fixed as a percentage of GDP ... should be effectuated at a rate which would be adequate to the rate of growth of the economy”<sup>10</sup>. It is clear that this would mean abstaining from such a use of the Stabilization Fund’s resources that could imply a higher rate of growth on the expenditure side.

On the other hand, the President has proposed “to draw a clear distinction between the means being reserved in the Stabilization Fund, in order to minimize the negative consequences of a decline in oil prices (the reserve part) and the resources being formed in excess of this volume (“the future generations’ fund”). It is advisable that the volume of the reserve part should be set as a percentage of GDP”<sup>11</sup>. This proposal makes it possible to distract the attention of political and other lobbyists from the ongoing sharing out of petrodollars and to reorient the discussion toward long – term issues.

While elaborating these issues throughout the past year, the RF Ministry of Finance persistently emphasized the necessity to continue the policy of accumulating in the Stabilization Fund the market – dependent revenues of the budget. In this connection it is planned to subdivide the Stabilization Fund into two parts, the reserve fund and the future generations’ fund<sup>12</sup>. It is planned to increase the receipts

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<sup>10</sup> Putin, V. *Biudzhethnoe poslanie Federal’nomu Sobraniuu “O biudzhethnoi politike v 2007 godu”* (The budget message to the Federal Assembly “On budgeting policy in the year 2007”).

<sup>11</sup> Ibid.

<sup>12</sup> Osnovnye rezul’taty i napravleniia biudzhethnoi politiki v 2007 godu i srednesrochnoi perspective. (The major results and directions of budgeting policy in the year 2007 and in the medium – term perspective). Moscow: Minfin Rossii (the Ministry of Finance of Russia). 2006. Pp. 5, 42.

of the Stabilization Fund not only by the proceeds from oil export, but also by those from the export of other raw materials (that is, also market-related) – first of all, from the export of natural gas (and, possibly, metals). Such an approach can be characterized as justified because it clearly demonstrates the state of the budget, the degree of efficiency of the economy and its capability to generate real and not only market – dependent revenues.

The existence of a reserve part of the Stabilization Fund is an issue readily understandable from a practical point of view, but it is not the most important one. A fall in revenues from oil and gas cannot be continually compensated for by the reserve resources of the budget. In the event of any worsening of market situation, the Government should have at hand a sensible set of measures (in the sphere of budgeting, monetary, tax, etc. policy), aimed at adapting the economy to a new situation. The resources of the Stabilization Fund will be able to play a certain limited role in relatively softening the process of adaptation, and practically in nothing else. As far as the day – to – day budgeting issues are concerned, the issue of using the resources of the Stabilization Fund for covering current budget expenditures can emerge as soon as 2007 if the trend of oil prices falling below 60 USD per barrel, which emerged in late 2006 – early 2007, should persist.

By contrast, the issue of “the future generations’ fund” will certainly become the subject of a most serious discussion. This fund should not be considered as some untouchable and continually growing stock, which our clever descendants will put to a better use than that which our contemporaries can think of. The waiting for the “clever descendants” to come usually finishes with all the funds being spent (or stolen) during the lifespan of a current generation. And it is equally pointless to expect the exhaustion of natural resources because the exhaustion is not so much a physical phenomenon as an economic one (the irrationality of developing natural resources at a given price level) and a technological one (the emergence of alternative resources and a fall in demand for traditional resources).

Possibly, the most efficient way of using some of the resources of the Stabilization Fund as a future generations’ fund is to spend it on the refinancing of the pension system in the future, that is, to compensate for the lack of resources in the future system of pensioning. A decision of this kind would considerably hamper these resources being spent on populist goals at the present time and would confer political concreteness (and sensibility) to the withdrawal of market – dependent superprofits from current circulation.

#### *1.1.4. State institutions and socio – economic development*

The *speed* of socio – economic development is predominantly determined by the possibility to keep the political “window of opportunity” open in the long run<sup>13</sup>, in order to be able to introduce necessary adjustments into state policy, while the *results* of this development are determined by the possibility to guarantee the quality of state policy and by the long – term applicability of regulatory decisions, or, in

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<sup>13</sup> See *John W. Kingdon, Agendas, Alternatives, and Public Policies* (NY: Longman, 2002).

other words, by the rejection of populism. Apparently, all this depends on the degree of development of state and social institutions.

The openness of the political “window of opportunity” implies the strengthening of the institutions which could make it possible to ensure the correspondence between the problems appreciated by society, the political agenda of the dominant political forces, and the existence of alternatives put forth by the community of experts. The lack of anything from this list would result in political stagnation and in the aggravation of the problems either unattended to or ignored by experts and politicians. At present, the major instrument which could be used in this sphere by the State is administrative reform as the method for improving the quality of state administration, including such components as transparency<sup>14</sup>, accountability, and the participation of citizens in decision - making<sup>15</sup>.

The year 2006 was not marked by any significant progress in these areas. Thus, the Draft Federal Law “On Ensuring the Access of Citizens and Organizations to the Information on the Activity of State Agencies and Bodies of Local Self – Government”, prepared by the Ministry of Economic Development and Trade as early as 2004, was submitted to the Government only in December 2006. The delay was caused by the long wait for the Federal Law “On Information, Informatization, and the Protection of Information” to be adopted. Another draft federal law, “On Ensuring the Right of Citizens and Organizations to Obtain Information on the Judicial Activity of the Courts of General Jurisdiction in the Russian Federation” is waiting to be submitted to the State Duma.

This situation was not changed by the contest involving the federal agencies of executive authority and the supreme executive agencies of state authority of the subjects of the Russian Federation, which was held in 2006 for the purpose of providing support for the implementation of administrative reform in the year 2006: most of the funds were allocated not to the rationalization of administrative processes but to the sprucing – up of the various offices and bureaus. Although it was done for the undisputed benefit of the citizens, the whole initiative could be seen not as an example of an administrative reform being implemented but rather as an example of state purchases for logistic needs.

The continuous openness of the “window of opportunity” can be guaranteed only by the possibility to continuously adjust economic policy, but not by the quality thereof. It depends, first of all, on the role and position of the community of experts. However, the rendering of an authentic expert opinion suggests that the experts are sufficiently independent of the State, whereas this independence is still being undermined by the high budget expenditures on scientific research in the sphere of state policy (in 2006, 48.9 billion roubles was earmarked for research in the sphere of national economy and issues of national importance alone), which, in Russia, have approached the level of expenditures on one of the branches of power, the judiciary (59.9 billion roubles). It is apparent that in such a situation the “expert”

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<sup>14</sup> In 2004, the 40<sup>th</sup> place out of 48 in the non – transparency index of the Kutzman Group.

<sup>15</sup> According to the World Bank, only 25 % of countries had worse results by this indicator in the year 2005.

capabilities of political parties are incomparable to the capabilities of the executive authorities which the parties and Parliament are expected to control.

#### *1.1.5. Political processes and the economy*

Last year, the ongoing political processes were demonstrating a degree of stability quite natural in a situation characterized by the presence of a popular president and a stable party majority in Parliament. Draft laws were passed quickly and with no difficulties, and the effect of the failures suffered in the course of the monetization of benefits was gradually weakening.

The pre – electoral character of the year 2006, by definition, suggested a certain turn to populism. However, in the concrete situation of contemporary Russia it is unlikely that the scope of such developments will be large. The stability of the political system and the fact that political processes are effectively controlled by the ruling elite make populism practically unnecessary. Moreover, in order to limit the influence of electoral campaigning on the budgetary process, V. Putin has proposed that the Government and the Federal Assembly should adopt the Law on the 2008 Budget as early as the first half – year of 2007.

Of course, in the years 2006 and 2007 there was a certain boosting of the budget expenditures not fixed as a percentage of GDP (by almost 25 % per annum in nominal terms). However, it can be expected that the authorities would somewhat reduce their budgeting activity and return, unless something unexpected happens, to the conservative course after the elections are over. Fluctuations of this kind are well known to researchers of the political business – cycle as comprising the “non – party” or “opportunistic” model (the strengthening of budgetary populism before the elections and the conservative consolidation in the post – electoral period – whatever the ideological orientation characterizes the party at power might be)<sup>16</sup>.

Quite another matter is the populism related to the deceleration of the reform process. It will greatly reduce the opportunities for implementing institutional reforms, but the objective need for them will not become any less. Thus, the institutional problems will continue to accumulate, and it will still be necessary to resolve them in the future – but at a greater cost, especially if the external market situation worsens by that time.

A new turn in party building was the formation of the center – left party “Fair Russia”, aspiring to play the role of the leading parliamentary party similar to that played by the center – right party “United Russia”. After its creation was announced, “Fair Russia”’s leaders would repeatedly arrange meetings with V. Putin, which confirmed that the new party had been granted an “official blessing”. Its political credo differs little from that of “United Russia” and consists in unreserved support for V. Putin’s policy.

However, the existence of two brands competing for the role of the “leading and guiding force” could confer a certain dynamism to the forthcoming election

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<sup>16</sup> See *Alesina A., Roubini N. with G.D.Cohen. Political Cycles and the Macroeconomy. Cambridge, Mass and London: The MIT Press, 1997. P. 1–3.*

campaign, which would positively distinguish it from the classical “one – and – a – half - party” model. The capability of these forces to actually polemicize with each other, to mutually expose the existing drawbacks and to criticize them, will become an important issue when assessing the role and prospects of these forces. The case in point is, first of all, the criticism of real actions, because any polemics on the program issues would be senseless in the existing situation and is of a very limited interest.

Mutual supervision and mutual criticism could become an important factor of overcoming the traditional shortcomings of the “one – and – a – half- party” model – political stagnation and corruption. However, it will be unwise to expect any real criticism and polemics, because both parties associate themselves with the personality of the present President. To expose the shortcomings of any of them would mean, in fact, criticism of V. Putin. Also, the existing electoral legislation extremely restricts the possibility to criticize an opponent in the course of an election campaign. At the same time, there is little doubt that the emergence of the two-party model can result in some additional budgetary populism.

In absence of any significant alternatives, the ruling party was prone to discuss some highly peculiar matters. Each Duma is doomed to have its own “Law on Bee Keeping”, which has once become the synonym for pointless legislative activity<sup>17</sup>. A similar role was played in the year 2006 by the draft law on restricting the mentioning of foreign currencies which was designed to prohibit the officials to use the words “dollar” and “euro” in those instances when their use was not sufficiently justified (although it remained unclear who was to judge whether this justification was sufficient or not). Also, this tendency is rooted in the regrettably widespread phenomenon when people try to combat not the cause but the consequence. Thus, struggle against inflation is frequently substituted for by a price freeze. Another example is the hope that the mistrust of foreign currency can be overcome by banning the circulation of foreign currency<sup>18</sup>. ( However, it should be acknowledged, for the sake of justice, that over the past fifteen years, the Russian authorities have repeatedly demonstrated that they are aware of the difference between the cause and the consequence. The economic history of post – Soviet Russia offers practically no examples of senseless bans, introduced contrary to economic logic).

The year 2006 has provided a new theme in the quest for a political model and ideology appropriate for contemporary Russia. The demands to furnish the country with a “national idea” have been voiced for approximately the same time as the demands to work out the “sector priorities”. Nowadays, the concept of “sovereign democracy” is being advertised as the one best fitted to play the role of a “national

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<sup>17</sup>There was such a draft law in the mid – 1990s, and the MPs were elaborating it at a time when the country which had just abandoned “socialist law” was literally suffocated in absence of the most important laws.

<sup>18</sup> The banning of on the use of foreign words is frequently explained as a concession to patriotism. In reality, such actions are totally unpatriotic. These bans are rooted in their authors’ deep conviction that Russia is incapable of pursuing a policy which could guarantee that its currency is respected. The attitude is all wrong – it is necessary that the rouble gain sincere respect instead of being respected in words only out of fear of paying a fine.

idea”, and its discussion has become a rather noticeable phenomenon of the socio – political life of the country. It was adopted by “United Russia”, which had been chronically suffering from the absence of ‘ideomotor image badges’, and after a short discussion this term has become one of the focal points in the program of this party holding a parliamentary majority.

The emergence of the new term was met with visible misgivings. This attitude is quite understandable: it is in our country’s traditions to furnish certain concepts popular in the developed world with some adjectives totally emasculating the essence of the terms they are added to. That was the meaning of “socialist democracy” and “people’s democracy”, the terms denoting a regime opposite to a democratic one. It is natural that the emergence of the new term caused a suspicion that the whole initiative was just an attempt to camouflage a rejection of the democratic principles of society organization and a toughening of the political regime. In other words, there exist strong misgivings that “social democracy” can in fact be synonymous to “untrue democracy”.

These doubts and suspicions have the right to exist, especially in the context of centuries – old Russian history. However, this aspect of the issue rather reflects the present – day situation. But there also exists a deeper rooted problem as to which institutions of modern democracy are of primary importance for a stable and onward economic development. The term “sovereign democracy” must be synonymous to the term “competitive economy”. Only a competitive economy is capable of creating a basis for both the sovereignty of a country and for the stability of its economic regime.

In real life, the whole set of democratic institutions cannot emerge simultaneously. It will take a long time for them to be introduced in daily practice. It is possible to single out the institutions (or the rules of the game or laws) which are of principal importance for stable economic growth, while the rest of them are of secondary importance by comparison with the former. The primary political conditions necessary for growth are the guarantees of the inviolability of the person, his or her life and freedom. This also suggests the existence of an independent judicial system and of a certain level of independence of the mass media, as well as their capability to ensure some public control over the situation. The protection of life and property from arbitrariness constitutes an absolutely indispensable foundation of modern economic growth: before starting to accumulate and to invest, to organize and to product, and even before starting to keep property and to spend money, a person must be sure that his or her life and freedom are safe from any arbitrariness of the authorities.

The IET conducted a statistical research<sup>19</sup> aimed at measuring the influence of various political institutions on economic growth in more than fifty countries that had undergone radical transformation in the second half of the 20<sup>th</sup> century. The analysis has confirmed that the constitutional system (presidential or parliamentary

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<sup>19</sup> See *Mau, V., Yanovskij, K., Zhavoronkov, S., Maslov, D.* *Institutsional’nye predposylki sovremen-nogo ekonomicheskogo rosta* (The institutional prerequisites for modern economic growth). Moscow: IEPP. 2007.

republic), the territorial structure (federation or unitary state), the tax regime, the administrative barriers and a lot of other things do play a much lesser role than the above – listed factors. The experience of England, the first country of modern economic growth, unambiguously confirms this conclusion<sup>20</sup>.

Thus, the level of economic development determines, to a great extent, the political institutions preferable for a given country. Therefore, the political regime optimal for a stable economic growth depends on the level of this country's economic development. Countries with a high level of development are capable of resolving the problems of adaptation to post – industrial challenges only if they possess sufficiently developed institutions of modern democratic society. Countries with a low level of development (like China) are successfully resolving the problems of modernization under conditions of authoritarian political systems. It is evident that Russia, by the level of the development of human capital, can be classed with the first category of states, despite it relatively lagging behind them by formal economic indicators.

The essence of the debate on “sovereign democracy”, whatever the ideas of its initiators might be, consists in defining the long – term trends of Russia's development. At present, three scenarios of this development can be discerned in a long – term perspective.

Firstly, the preservation of the current trends characterized by an approximately 50 – year - long lagging behind the most developed western countries. It is a rather stable (inertia) model. This gap was observed for about three hundred years, and was noted in absolutely different epochs by absolutely different observers - from Stendhal to Gaidar<sup>21</sup>.

Secondly, the actual acceleration of socio – economic development, capable of ensuring Russia's convergence with the most developed countries of the world. It is very difficult to achieve these ends, and only a handful of nations did, indeed, manage to accomplish this aim in the 20<sup>th</sup> century.

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<sup>20</sup> Modern economic growth began in England after the political and financial settlements had been achieved there as a result of the Glorious Revolution of 1689. The Habeas Corpus Act stipulated that none of the citizens could be arrested or deprived of his life and property unless a decision was taken to this effect by an open and independent court of justice. The King acknowledged the exclusive right of Parliament to establish taxes and levies, thus putting an end to arbitrary decision making with regard to the organization of state finances. The financial settlement was a logical continuation of the political one, because it had already been widely understood that arbitrarily imposed taxation and shaky finances (inevitably resulting in inflation) meant unlawful (extrajudicial) deprivation of property similar to extrajudicial confiscation. The necessity for the Crown to abide by these settlements was emphasized by memories of the year 1649, when King Charles I was executed for having misused the royal prerogative in his attempts to introduce extra – parliamentary rule, to arbitrarily impose taxes, and to subject the judiciary to his will.

<sup>21</sup> Stendhal wrote about this in the early 19<sup>th</sup> century, N. Bunge – in the mid 19<sup>th</sup> century, while Ye. Gaidar convincingly expounds this phenomenon nowadays. (See *Travin, D., Marganiia, O. Evropeiskaia modernizatsiia (European modernization)*. Moscow: AST. 2004. Kn. 1. P. 18; *Vlast' i reformy (Power and reforms)*. Moscow: Olma – Press – Ekslibris. 2006. P. 349; *Gaidar, Ye., Dolgoe vremia (A long time)*. Moscow: “Delo”. 2005. P. 235.).

Thirdly, a gradual degradation of the system with its possible disintegration, because the weakening state authority would no longer have any strength or resources to preserve the territorial (political) integrity of the country in conditions of economic interests being localized. Under these conditions it would no longer be sensible to discuss the issues of sovereignty.

By its own nature, the inertia scenario seems the most likely one. The scenario is relatively simple and self – sustaining; it suggests a gradual (as the average per capita GDP increases) development of democratic institutions, and most likely, the preservation of the existing level of independence in political decision-making.

However, the specific feature of the current political situation consists in a possibility, which is now stronger than usually, that the second scenario would be chosen. There is a certain chance to achieve a breakthrough. But to attain these ends, it is necessary to clearly comprehend the task and to substantially consolidate the elites so as to accomplish it.

Russia will have to make much effort as yet in order to ensure the efficiency of its democracy and the reality of its sovereignty. With this aim in mind, it should, firstly, strengthen its democratic institutions without making too many excuses regarding the immaturity and the young age of Russian democracy. Secondly, Russia should effectively increase its competitive capacity. The latter thesis must become the centerpiece of Russian economic and political doctrine. The experience accumulated during the past fifteen years indicates that we are able to resolve the problems facing the country if the political elite treats them seriously. One of the convincing examples of this is the successful experience of overcoming the consequences of the recent macroeconomic crisis.

Now the country should overcome the institutional crisis, whose existence is demonstrated by the results of the ratings reflecting the quality of state institutions.

The task of forming adequate state institutions is much more difficult than that of financial stabilization. However, some countries did manage to solve it in the course of the 20<sup>th</sup> century. In order to achieve this, it is necessary to consolidate political forces and to pursue a responsible economic policy, devoid of populism. The solution of this task will ensure Russia's transformation into a true and entirely sovereign democracy.

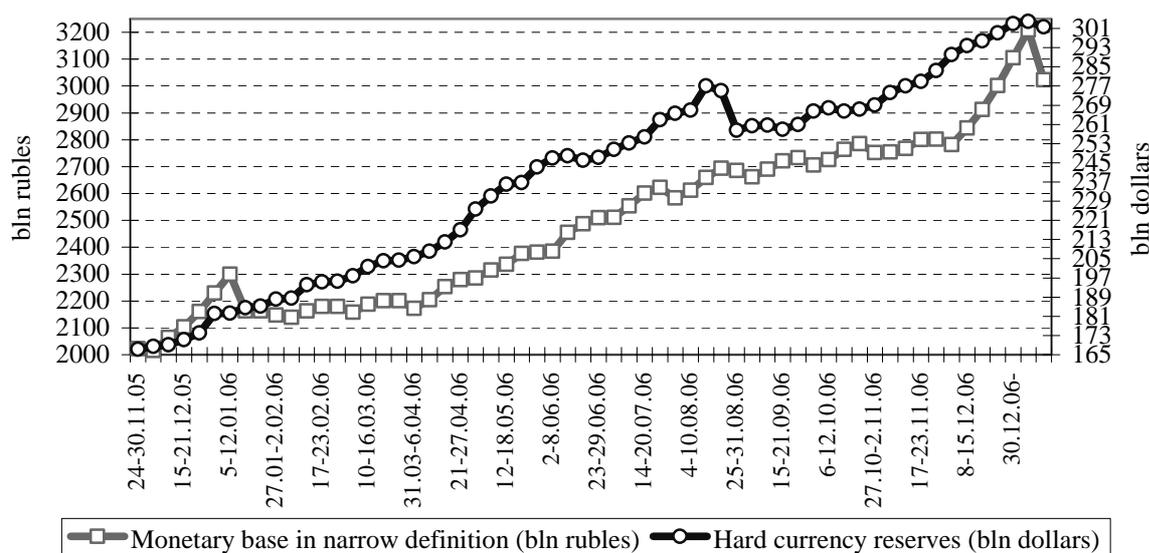
## Section 2. Monetary and Budgetary Spheres

### 2.1. Monetary and Credit Policy

The major development in the Russian monetary and credit policy in the year of 2006 was an explicit inflation slowdown, which has reached its historical peak; for the first time in the RF history consumer price index did not exceed 10 per cent. Though that indicator is conventional, a decrease of that indicator to the level lower than 10 per cent is considered worldwide as a major event and an explicit factor of successful monetary and credit policy of the government. One should note, that at the beginning of the year nobody could forecast such a result, only at the second half of the year the inflation has slowed down and made 9 per cent as of December-January results. Herewith, we'll try to analyze the grounds of those developments, review the trends and interrelations in the national monetary market, the inflation processes in general and outline major developments in the RF monetary and credit sphere in the year of 2006.

#### 2.1.1. Monetary Market

In 2006 a considerable growth of gold and foreign currency reserves was observed in the RF (See Fig. 1). The basic factors of growth were the peak prices for the major Russian export commodities, primarily oil prices. Reduction of reserves (as per results of the month) was noticed only in August and was caused by pre-scheduled repayment of the external government debt to the Paris Club of creditors in the amount exceeding USD 23 bln. By the end of the year the volume of gold and foreign currency reserves has reached an absolute record in the history of Russia, USD 303.7 bln (+66.7 per cent within 2006).



Source: RF Central Bank

Fig. 1. Changes in Monetary Base and Gold and Foreign Currency Reserves in Years 2005–2006

However, in order to restrain the accelerated stabilization of exchange rate of the national currency, the Bank of Russia was compelled to buy the foreign currency flowing into the country, thereby increasing money supply. Let us take a closer look at the money supply dynamics.

In 2006 the monetary base (in a broad sense<sup>1</sup>) increased by RUR 1.2 bln and reached RUR 4.1 bln (+41.4 per cent). It should be reminded, that as of results of the year of 2005, that indicator has grown only by 22.4 per cent. The monetary base volume in broad definition as of 1 January 2006 was RUR 2.9 trillion (See *Table 1*). The cash in circulation volume, including the cash balances of credit institutions, as of January 1, 2007 was RUR 3.06 trillion (+39.5 per cent as compared with January 1, 2006), the correspondent accounts of credit institutions with the Bank of Russia made RUR 638.1 bln (+25.5 per cent), mandatory reserves – RUR 221.1 bln (+ 37 per cent), credit organizations' deposits with the Bank of Russia – RUR 98.1 bln (times 12.6), the value of the Bank of Russia's bonds held by credit institutions – RUR 102.2 bln (growth 2.1-fold), the reserve funds under foreign currency operations, deposited with the RF Central Bank made RUR 0 bln<sup>2</sup> (reduced for RUR 8.8 bln). In 2006 the growth of cash in circulation (by 39.5 per cent at the background of increased mandatory reserves (by 37 per cent) have resulted in extension of the monetary base in narrow definition (cash + mandatory reserves)<sup>3</sup> by 38.9 per cent (See *Fig. 1*). At the same time, the gold and foreign currency reserves of the RF Central Bank also grew within a year by 66.7 per cent and amounted, as of January 1, 2007 to USD 303.7 bln. A greater portion of the national liquidity inflow was accumulated in the RF Stabilization Fund, which volume as of January 1, 2007 amounted to RUR 1,237 bln. (USD 42.3 bln, 5.7 per cent of GDP).

Monetary supply  $M_2$  in national terms has grown in 2006 by 48.8 per cent and made as of January 1, 2007 RUR 8,995.8 bln, or 33.8 per cent of GDP (as of January 1, 2006 the monetary indicator  $M_2$  was equal to RUR 6,045.6 bln (28 per cent of GDP).

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<sup>1</sup> Monetary base in broad definition reflects the Bank of Russia monetary and credit liabilities in national currency, which serve as a basis of money supply growth. The RF monetary base in a broad definition, in addition to the cash in circulation issued by the Bank of Russia, and the residuals on the accounts of mandatory reserves of the funds in the national currency attracted by credit institutions and deposited with the Bank of Russia, includes the funds in corresponding accounts with credit institutions and bank deposits, placed with the Bank of Russia, reserve funds for foreign currency operations, as well as other liabilities of the Bank of Russia under operations with credit organizations in national currency of the Russian Federation.

<sup>2</sup> Starting as of July 1, 2006, the requirements for mandatory reserves and usage of special accounts for transactions with foreign currency were abolished.

<sup>3</sup> Monetary base in a narrow definition is a monetary instrument (an indicator of monetary supply volume), which is fully controlled by the RF Central Bank. The Monetary base in narrow definition includes the cash in circulation, issued by the Bank of Russia (and the balance on the accounts of credit organizations), balances on the accounts of mandatory reserves of the funds in the national currency attracted by credit institutions in national currency, deposited with the Bank of Russia.

Table 1

**Changes in Monetary Base in Broad Definition in 2006 (RUR bln)**

	01.01.2006	01.04.2006	01.07.2006	01.10.2006	01.01.2007
<i>Monetary base (in broad definition)</i>	2 914,10	2 721,00	3 285,90	3 484,20	4 121,60
including:					
Cash in circulation with regard to balances in credit organizations	2 195,40	2 061,20	2 386,60	2 565,40	3 062,10
Correspondence accounts of credit organizations of the Bank of Russia	508,6	320	430,9	443,7	638,1
Mandatory reserves	161,4	172,1	190,2	205,8	221,1
Deposits of credit organizations in the Bank of Russia	7,2	44,2	108	109,6	98,1
Securities of the Bank of Russia in credit organizations	32,8	115,2	164,2	159,6	102,2
Reserve funds in foreign currency, deposited with the Bank of Russia	8,8	8,3	6,1	0,1	0

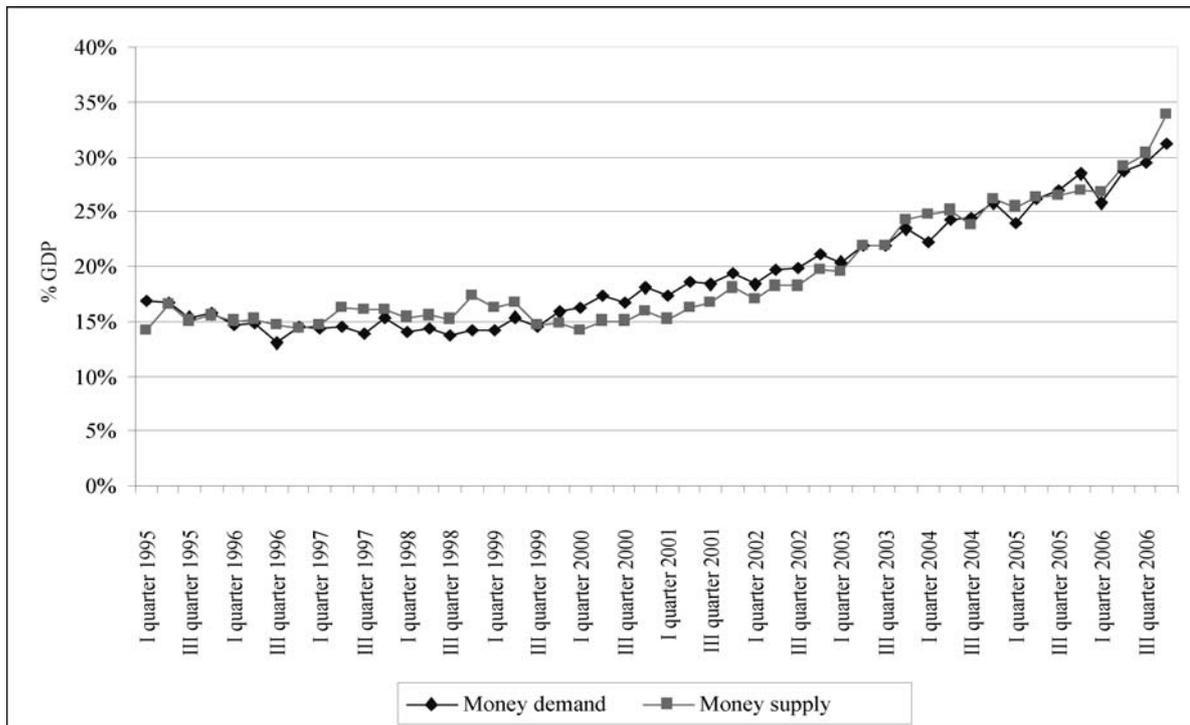
Source: RF Central Bank

Therefore, as of results of the year of 2006, a more expressed growth of monetary supply was observed as compared with 2005. At the same time, in the year of 2006 active liquidity sterilization was occurring in regard to foreign currency in Stabilization Fund, which volume as of the end of the year has exceeded the amount of USD 89 bln. It should be noted, that there were some changes in the structure of monetary base growth in broad definition within the year of 2006. Thus, as of the year results, the rate of growth of cash in circulation was lower than the growth rates of monetary base in general, whereas in 2005 the rate of growth of cash in circulation was higher by 40 per cent than the growth rate of monetary base. Therefore, the above-mentioned positive trend reflected a lower role of cash in the national economy. Moreover, the amount of deposits in the RF Central Bank has been considerably increased due to the raised interest rates on the Bank of Russia deposit operations. In the preceding year the RF Central Bank has been raising the interest rate four times (with the aim to increase the role of deposit operations in monetary and credit policy). At the same time, to increase liquidity sterilization, the Bank of Russia was actively offering its securities for sale.

To assess the success of efforts taken by monetary and financial institutions with the aim to increase liquidity sterilization, an analysis is made of correlation between money demand and supply<sup>4</sup>. The dynamics of demand for money demand and supply is shown in *Fig.2*.

<sup>4</sup> We assess the demand for money equation of the type  $\frac{M_t}{GDP_t} = a_0 + a_1 Y_t + a_2 \Delta p_t + a_3 t + \varepsilon_t$ ,

where  $M_t$  – money supply M2,  $GDP_t$  – nominal GDP, value,  $t$  – GDP volume in prices of 1995,  $\Delta p_t$  – consumer price index,  $t$  – time. The assessment was based on the quarterly data of the years 1999–2006 with no regard to seasonal data. The resulting residual values can be interpreted as excess of money supply, as the left part of equation shows the actual money supply and with the help of indicators of the right part the demand for money can be estimated.



Source: RF Central Bank, IET estimates

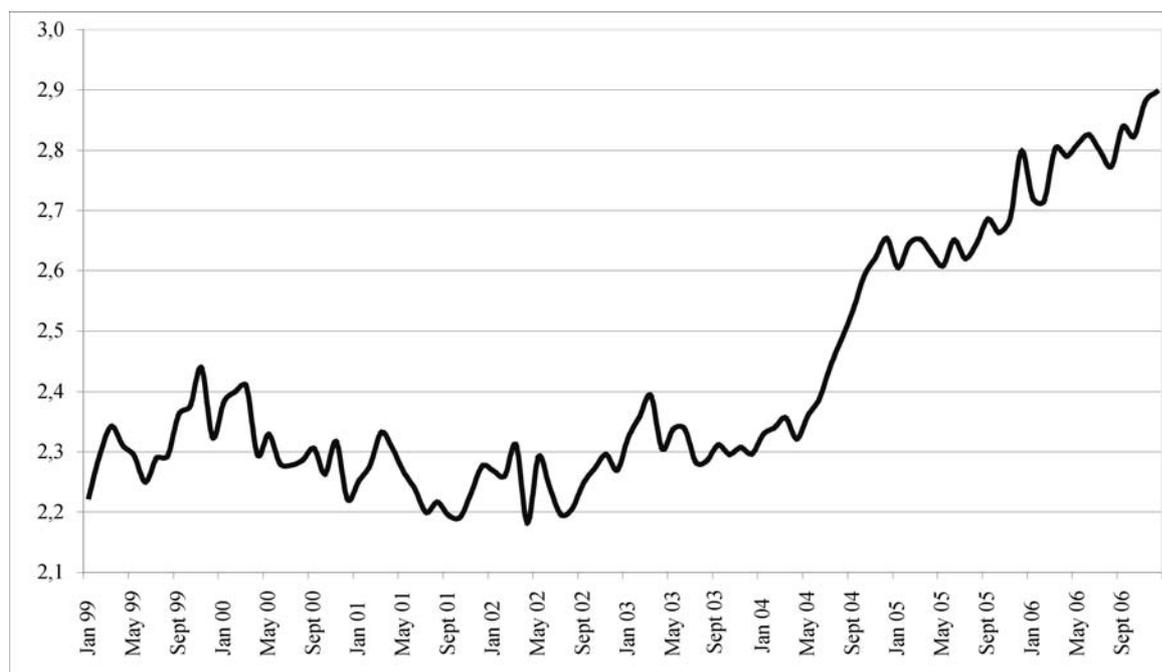
Fig. 2. Dynamics of Demand for Money and Money Supply (Money Aggregate M<sub>2</sub>) in Q III 2006

One can note, that within 2006 money supply was exceeding the demand for money, which can cause excessive inflation pressure in 2007, caused by a delayed impact of changes in the money supply over the inflation processes. In our estimates, the lag of the monetary supply changes impact over consumer price index is one-two calendar quarters<sup>5</sup>.

It should be also noted, that despite the increased monetary supply, the money multiplier in the RF remains at a low level as compared with the countries of Eastern Europe, where, as a rule, its index value considerably exceeds 3. Against this background, the index value of 2.9, achieved by late 2006, appears very insignificant (See Fig. 3). Since mid-2002, the multiplier is characterized by an upgrading trend, reflecting the gradual development of the RF banking sphere. Till mid-2004 the multiplier' value was varying within the range of 2.15 – 2.45.

Therefore, basing on the obtained results of the estimates, the increased money supply, caused by the extensive purchases of foreign currency by the RF Central Bank, was exceeding the demand for money in 2006. Under those conditions, there is a high probability, that further slow-down of the inflation rate will be rather difficult. Let us review the inflation processes in more detail and try to detect non-monetary inflation factors in the RF.

<sup>5</sup> Ref: "Some Approaches to Economic Indicators' Estimates", published by IET, the CPI N 89P, M.: IET, 2005.



Source: RF Central Bank, IET estimates.

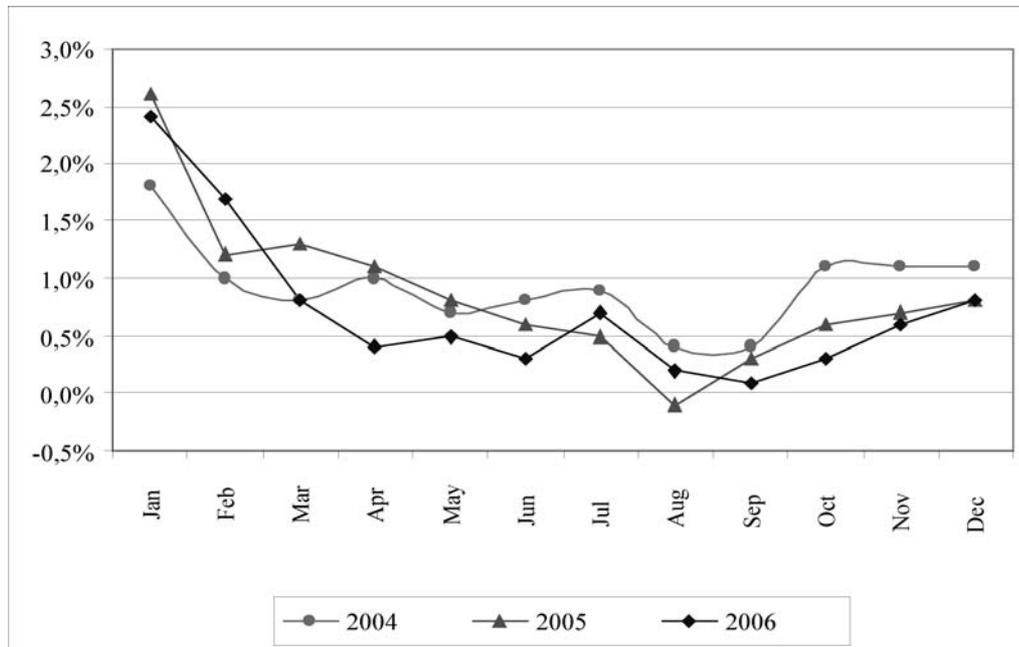
Fig. 3. Money Multiplier in the RF in 1999–2006

### 2.1.2. Inflation Processes

Early 2006 saw dramatic acceleration in the rate of inflation (*Fig. 4*). As a result, there were serious doubts that by the results of the year the consumer price index in 2006 will not exceed the target value of 8.5 per cent. However, later a slowdown of inflation took place and the target value was upgraded to 9 per cent. As of the year results, CPI made 9 per cent. It should be noted that for the first time in the RF newest history the rates of consumer prices growth was restrained at the level less than 10 per cent. We are going to take a closer look at the dynamics of inflation rates throughout the year.

In the category of foodstuff prices have grown by 8.7 per cent (as compared with 9.6 per cent in 2005) (*See Table 2*). Throughout the year, from January to December, the upward trend in the foodstuff price growth was caused by increased prices for granulated sugar (+14.9 per cent), grits and beans (+12.1 per cent), bread and bakery products (+ 11.1 per cent), vegetables and fruit (+10.3 per cent) and alcohol (+10.1 per cent). Within twelve months of 2006 the highest growth was traditionally observed in the category of commercial services (by 13.9 per cent, versus 21 per cent in 2005); thus, in pre-school education (+28.5 per cent), as well as by housing utilities (+17.9 per cent). As concerns non-food products, their prices went up within twelve months by 6 per cent on average (versus 4 per cent within twelve months of 2005). Within January-December the utmost growth of prices took place in construction materials (+11.5 per cent) and motor petrol (+10.9 per cent). The basic CPI growth for consumer goods in general made in 2006 7.8 per cent (as compared with 8.3 per cent in the relevant period of preced-

ing year). Therefore, as of 2006 year results, the basic reasons of the expressed inflation were the accelerated growth of prices for commercial public services, construction materials, motor petrol and a number of foodstuffs.



Source: Rosstat.

Fig.4. Dynamics of CPI in RF in 2004–2006

The data of *Table 2* shows, that one of basic factors of inflation throughout 2003–2006 was the growth of housing utilities tariffs, which have grown practically 1.5-fold within January 2003 – December 2006. Pre-school education takes the second place in terms of input in the accelerated inflation, the cost of their services went up by 137.6 per cent; they are followed by culture services (+98.7 per cent) and public transportation (+77.4 per cent). An accelerated upward trend was observed in the prices for motor petrol (+96.9 per cent), meat and poultry (+63.6 per cent), bread and bakery products (+74.1 per cent).

An analysis and dynamics of prices and tariffs for services of natural resources monopolies (electricity, gas, cargo transportation) in 2002–2006 demonstrates that within the period under review the highest growth rates were noticed in prices for gas and cargo transportation. As opposed to that, electricity tariffs have only slightly exceeded the growth rate of CPI.

It should be reminded, that in 2007 the RF Central Bank is planning to reduce the inflation to the level of 8 per cent. This target looks quite realistic, what is confirmed by the results of IET model forecast for 2007, where the CPI index is assessed at 8–8.5 per cent.

Table 2

**Yearly Price Growth Rates as per Types of Goods and Services  
in 2003–2006 (% per year)**

	2003	2004	2005	2006	2003–2006
<b>CPI</b>	12,0	11,7	10,9	9,0	51,2
Foodstuffs	10,2	12,3	9,6	8,7	47,4
<i>Bread and bakery products</i>	30,4	16,7	3,0	11,1	74,1
<i>Grits and beans</i>	17,0	11,6	0,2	12,1	46,7
<i>Pasta products</i>	14,0	14,6	1,9	4,7	39,4
<i>Milk and dairy products</i>	13,1	12,8	10,5	8,7	53,2
<i>Meat and poultry</i>	8,9	19,6	18,6	5,9	63,6
<i>Fish and sea food</i>	9,9	11,5	12,7	7,8	48,9
Non-food products	9,2	7,4	6,4	6,0	32,3
<i>Motor petrol</i>	16,8	31,3	15,8	10,9	96,9
Commercial services to population	22,3	17,7	21,0	13,9	98,4
<i>Housing utilities</i>	28,7	23,5	32,7	17,9	148,7
<i>Public transportation</i>	13,7	18,0	15,8	14,2	77,4
<i>Culture organizations services</i>	21,8	19,9	17,7	15,6	98,7
<i>Pre-school education</i>	15,1	21,6	32,1	28,5	137,6

Source: Rosstat.

In the recent years RF Central Bank in “Basic trends of Monetary and Credit Policy” pays more and more attention to the importance of inflation targeting, rather than rouble exchange rate. In other words, the Bank of Russia is making a gradual transfer to the regime of inflation targeting. This regime is getting rather popular worldwide; many industrialized and developing countries reject alternative policies in favor of inflation targeting regime. (See Table 3).

Table 3

**Countries, applying Inflation Targeting Regime**

Country	Date of regime introduction	Inflation as of regime introduction (% per year)	Inflation targeting indicator at present (% per year)
1	2	3	4
<i>Developing countries, economies in transition</i>			
Israel	Q II, 1997	8,5	1 3
Check Republic	Q I, 1998	13,1	3 (+/ 1)
Poland	Q IV, 1998	9,9	2,5 (+/ 1)
Brasilia	Q II, 1999	3,3	4,5 (+/- 2)
Chili	Q III, 1999	2,9	2 4
Columbia	Q III, 1999	9,3	5 (+/- 0,5)
Republic of South Africa	Q I, 2000	2,3	3 6
Thailand	Q II, 2000	1,7	0 3,5
South Korea	Q I, 2001	3,2	2,5 3,5
Mexico	Q I, 2001	8,1	3 (+/- 1)
Hungary	Q II, 2001	10,5	3,5 (+/- 1)
Peru	Q I, 2002	0,8	2,5 (+/- 1)
Philippines	Q I, 2002	3,8	5 6
Slovakia	Q I, 2005	3,2	3,5 (+/- 1)
Indonesia	Q III, 2005	7,8	5,5 (+/- 1)
Romania	Q III, 2005	8,8	7,5 (+/- 1)

1	2	3	4
<b>Industrialized Countries</b>			
New Zealand	Q I, 1990	7	1 3
Canada	Q I, 1991	6,2	1 3
Great Britain	Q IV, 1992	3,6	2
Switzerland	Q I, 1993	4,8	2 (+/- 1)
Australia	Q II, 1993	1,9	2 3
Iceland	Q I, 2001	3,9	2,5
Norway	Q I, 2001	3,7	2,5

Source: Inflation Targeting and the IMF (2006).

*Table 4*

### RF Compliance with Advisable Requirements of Introduction of Inflation Targeting Regime

Requirement	RF compliance	Comments
Institutional independence of monetary and credit control authorities	Partially compliant	RF Central Bank is an autonomous structure, but it is often under pressure of both, executive and legislative power authorities
Highly professional analytics, reliable statistics	Partially compliant	Qualification of Experts Квалификация экспертов the Bank of Russia is sufficient for efficient inflation estimates, but currently there is a lack of adequate statistics, required for reliable forecasts.
Diversified market economy	Incompliant	Economic situation in the RF highly depends on natural resources' prices, some of prices are actually dependent of certain factors, and dollar equivalent in the economy is still high, though somewhat reduced.
Highly developed financial system	Partially compliant	The rates of the national financial system are rather high, but in comparison with other countries with transition economy, our economy is still insufficiently developed and exposed to high risks

According to the point of view, dominating worldwide till recent time, the inflation targeting is far more sensitive to institutional and macroeconomic environment factors than other regimes. Rather tough requirements to the situation, when an affective transfer to inflation targeting can be performed, made developing countries and economies in transition very prudent in terms of the new regime of monetary and credit policy. However, later on it became clear that the majority of those requirements relates as much to the regime of inflation targeting, as to any other regime of monetary and credit policy. Moreover, it is confirmed by practice, that compliance with the tough technical requirements is as important in the period of regime introduction, as in further improvement of the situation during the transfer to the inflation targeting regime<sup>6</sup>. One can see from *Table 4*, to what extent the Russian Federation is compliant with those requirements.

However, in our estimates, the RF is compliant with the majority of requirements, set forth to the successful transfer to the inflation targeting (*See Table 5*).

Therefore, one can only welcome a gradual transfer of the Bank of Russia to the inflation targeting regime, especially basing on the results of numerous surveys, demonstrating<sup>7</sup> positive macroeconomic dynamics in the countries, where the inflation targeting was applied, as compared with the periods, when alternative

<sup>6</sup>Ref.: Survey of IMF country desk officers, 2005.

<sup>7</sup> Ref. «Inflation Targeting and The IMF», Prepared by Monetary and Financial Systems Department, Policy and Development Review Department and Research Department, March 2006.

regimes of monetary and credit policy were in effect, as well as with the countries, applying alternative regimes. Moreover, a significant result of inflation targeting regime is a higher credibility to the monetary and credit policy of central banks on the part of economic agents and reduction of volatility of the basic macro economic indicators, which lowers the risk of financial crisis<sup>8</sup>. At the same time, a transfer to inflation targeting regime should be supported by dismissal of the guided flexible rouble exchange rate, what can be achieved in present circumstances through a strong political decision.

Table 5

**RF Compliance with Necessary Requirements of Introduction of Inflation Targeting Regime**

Requirement	RF compliance	Comments
Relatively large-scale economy	Compliant	RF economy is under sustained development. GDP is relatively high
Prices are established on the national level	Compliant	Though the RF economy is highly dependent on external markets, basically the dynamics of prices in the national market is determined by domestic factors
Inflation rate is less than 10%	Compliant	As of 2006 results, the CPI made 9%
Support to the transfer of inflation targeting on the part of government authorities	Compliant	Currently the task of inflation reduction is a priority to the government of the country, and the inflation targeting regime is the best instrument for achievement of that target
Monetary and credit control bodies firmly adhere to the declared targets	Partially compliant	RF CB representatives repeatedly make statements on sustainability of their objectives, but they are far from reaching all the those target objectives

At the end of this section, let us compare the growth rates of consumer prices in the RF and other CIS countries (See Table 6).

Table 6

**Indices of Consumer Price Growth in CIS in 2000 2006, as %**

	2000	2001	2002	2003	2004	2005	2006 <sup>9</sup>
Azerbaijan	2	2	3	2	7	10	8,9
Armenia	1	3	1	5	7	1	3,7
Belarus	169	61	43	28	18	10	5,6
Georgia	4	5	6	5	6	8	7,9
Kazakhstan	13	8	6	6	7	8	7,4
Kyrgyzstan	19	7	2	3	4	4	3,6
Moldova	31	10	5	12	12	12	12,7
Russia	20	19	15	12	12	11	9
Tajikistan	24	37	10	17	7	8	11,1
Ukraine	28	12	1	5	9	14	10,6

Source: CIS Interstate Statistical Committee. (<http://www.cisstat.com/>).

One can notice that the inflation rates in Russia are still high in comparison with other CIS countries. As mentioned above, the reasons for sustained high rates of consumer prices in RF might be both, high growth rates of money supply (See Fig. 2), caused by a tendency to maintain a stable rouble rate, and non-monetary

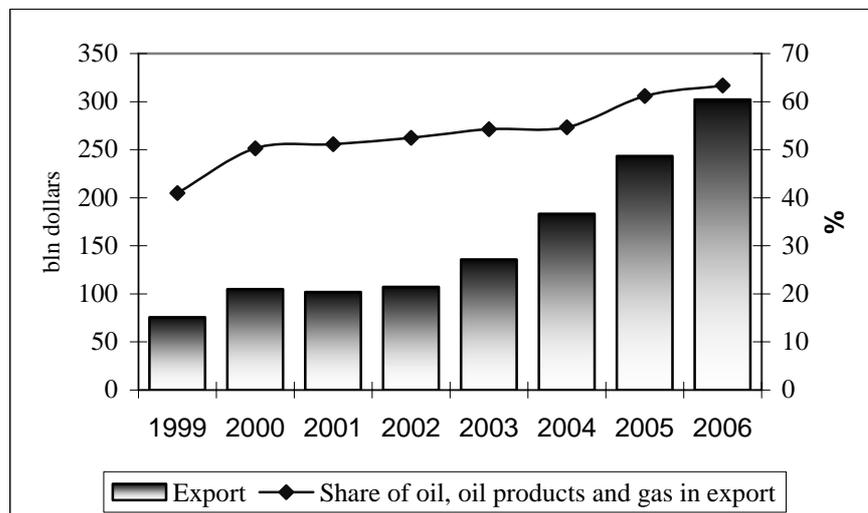
<sup>8</sup> Ref. Masson P., M. Savastano and S. Sharma, «The Scope for Inflation Targeting in Developing Countries», IMF Working Paper 97/130, Washington, IMF, 1997.

<sup>9</sup> The basic information on the RF is provided as of 2006, on other countries – as of January-November.

factors, like high market monopolization, accelerated growth of commercial services (See Table 2), as well as other reasons, not quite clear at this point.

### 2.1.3. State of Balance of Payments<sup>10</sup>

The RF stable situation with the balance of payments in 2006 as in years before was due largely to the peak volumes of the Russian main exports, first and foremost its energy sector. At the background of raising oil prices, the value of Russian exports has grown by 24 per cent. However, the rates of export sales growth have been reduced times 1.5 versus the preceding year of 2005, which resulted in some decline of oil prices in 2006. At the same time, the RF Central Bank has been accumulating gold and foreign currency reserves. Moreover, 2006 was also remarkable in terms of large amount of net capital inflow, which increased 13-fold as compared with the relevant indicator of preceding year, when the inflow capital to the RF has exceeded the outflow for the first time.



Source: RF Central Bank

**Fig. 5. Dynamics of Export Sales and Share of Energy Sector in Exports in 1999-2006**

According to the tentative estimates of the RF balance of payments in 2006, published by the Bank of Russia, the surplus balance of current account surplus stood at USD 95.6 bln, i.e., has grown by 14.7 per cent versus the level of 2005 (See Table 7). Trading surplus in particular rose by 18 per cent (from USD 118.3 bln to USD 139.6 bln), with growth in exports at 24.1 per cent (from 243.6 bln to USD 302.3 bln) and imports also grew by 29.8 per cent (from USD 125.3 bln to USD 162.7 bln). The share of products from the oil and gas segment of the economy made 63.4 per cent of total exports (versus 54.7 per cent in 2004, 61.1 per cent in 2005) (See Fig. 5). Therefore, as in the years before, status of Russia's cur-

<sup>10</sup> The analysis of the state of balance is made on tentative data of the RF Central Bank.

rent account depends largely on its trade component, which in its turn is mostly determined by changes in prices for energy products and other major Russian export commodities, brought out to the world market. The data presented in Fig. 6 demonstrates that the correlation between the Russian trade account balance and the world market energy prices observed within 2002-2005, continued in 2006 as well.

Deficit in services account made USD 15.8 bln and has grown by 7.3 per cent as compared with 2005. Russian exported services amounted to USD 30.1 bln, USD 5.5 bln (or 22.2 per cent) more than the level of preceding year. At the same time, value of imported services also grew by 16.6 per cent in 2006 versus the level of 2005 and reached USD 46 bln.

Labor costs in 2006 continued to decline and made USD 4.3 bln. (In 2005 that figure was USD 1.2 bln).

Deficit of the RF investment income in the balance of payments in 2006 as compared to its 2005 level rose by 27 per cent (to USD 22.7 bln). The investment income increased from USD 15.7 bln to USD 25.4 bln due to considerable growth of the indicators of monetary and credit supervision authorities (from USD 4 bln to USD 10.7 bln.<sup>11</sup>) and non-financial organizations (from USD 8.4 bln to USD 10.3 bln). Similar growth of investment income payments at the non-financial sector (from USD 25.9 bln to USD 39.5 bln) has contributed to larger overall income payments (from USD 33.5 bln to USD 48.1 bln).

The balance of current transfers in 2006 changed insignificantly as compared with 2005; that value was estimated at USD 1.2 bln.

Table 7

**Major Components of the RF Balance of Payments and Dynamics  
of External Debt in 2004–2006 (USD bln)**

Balance items	2004					2005					2006				
	I Q	II Q	III Q	IV Q	Year	I Q	II Q	III Q	IV Q	Year	I Q	II Q	III Q	IV Q <sup>12</sup>	Year*
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Current Account Transactions	12,7	13,5	15	17,9	59,1	20	22,1	19,7	21,7	83,5	29,5	24,9	23,6	17,6	95,6
Capital Account Transactions <sup>13</sup>	-3,1	-8	-8,1	11,9	-7,3	-1,4	-1,8	-10,6	3,4	-10,4	-6,3	17,4	-12,9	16,4	14,6
Changes in Gold and Foreign Currency Reserves ( «+» - a decrease, «-» -growth of reserves)	-6,8	-5	-6,5	-26,9	-45,2	-14,4	-18	-8,1	-21	-61,5	-21,4	-40,9	-13,8	-31,3	-107,4

<sup>11</sup> The high level of income of monetary and credit control authorities is based on the beginning of investments to the RF Stabilization Fund.

<sup>12</sup> Tentative estimates.

<sup>13</sup> Minus changes in foreign currency reserves.

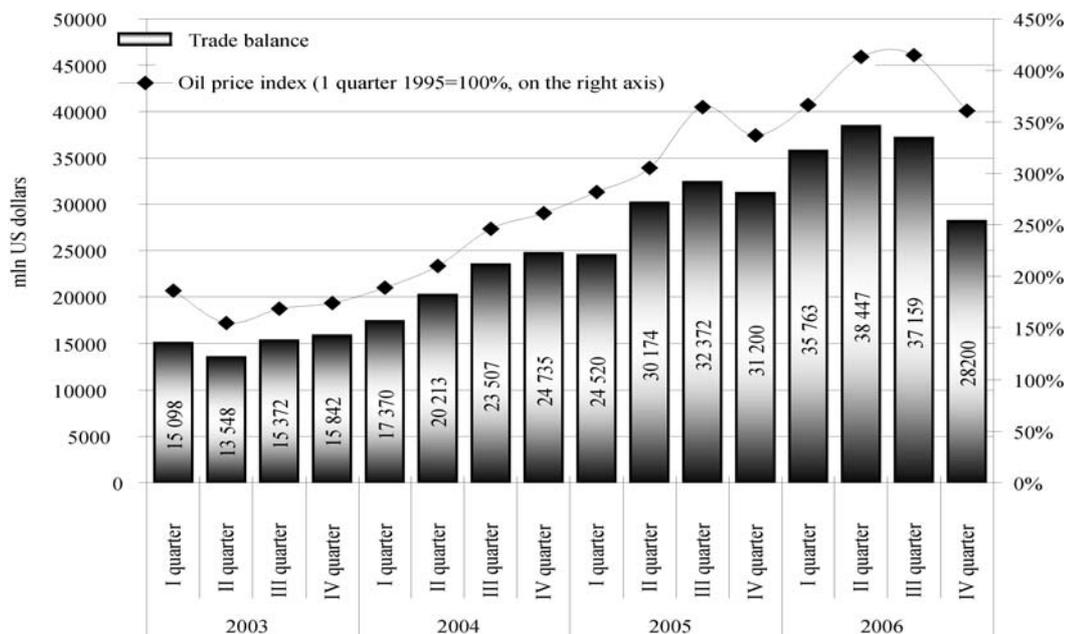
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Net Errors & Omissions		-2,8	-0,5	-0,3	-2,9	-6,5	-4,1	-2,2	-1	-4,1	-11,4	-1,7	-1,4	3,2	-2,7	-2,6
Changes in the RF external debt («+» - growth, «-» - decrease of external debt)		-	-	-	-	27,5	6,0	8,4	-1,1	30,6	43,9	16,1	14,9	-19,8	-	-
Changes in the RF external government debt		-	-	-	-	-0,6	-4,8	-0,6	-18,9	1,2	-23,1	4	-7,1	-24,5	-	-
Changes in the external debt of the RF private sector		-	-	-	-	28,0	10,8	9,1	17,8	29,4	67,1	12,1	22,0	4,8	-	-

\* - Estimates.

Source: Bank of Russia.

For the first time since 1998, a surplus was achieved in 2006 in terms of capital accounts transactions and financial instruments, which has reached USD 14.5 bln. Herewith, if the basic input in the above surplus in 1998 was made through increased loans of government sector, in 2006 the surplus of capital account transactions was formed primarily due to increased inflow of investments in private sector.

The balance of capital transfers was insignificant in 2006 and made USD 0.5 bln. Therefore, regardless capital transfers, made in 2006, the surplus of capital account was noted in the amount of USD 14 bln.



Source: RF Central bank, IET assessments.

Fig. 6. RF Balance of Trade and Index of World Oil Prices for 2003–2006

Growth of the RF external liabilities in 2006 stood at USD 69.8 bln, i.e., 26.3 per cent higher than in preceding year (USD 55.3 bln).

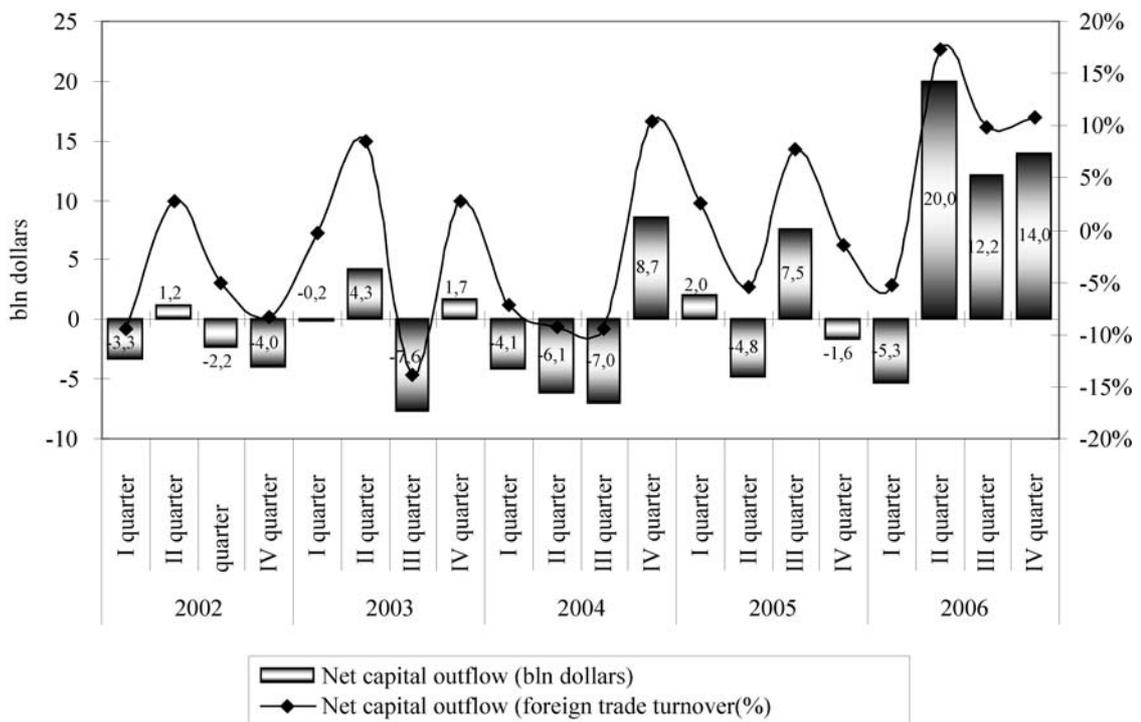
As a year ago, federal government was still a net borrower to non-residents. Its external liabilities have been declined by USD 28.9 bln, basically due to pre-scheduled repayment of the RF external debt to Paris Club creditors. The external liabilities of the RF Subjects made USD 0.2 bln. Reduction of liabilities of monetary and credit control organizations has reached USD 7.1 bln. The expansion of activities of banking sector in terms of foreign capital involvement has resulted in the growth of liabilities of this sector (+ USD 48.5 bln). That indicator has been raised times 2.5 as compared with the relevant indicator of 2005. As per methodology of balance of payments, non-residents' investments in the real sector made USD 57.1 bln (USD 54.4 bln in 2004 r.). It should be noted, that despite an insignificant growth of investments in the real sector, their structure in 2006 has greatly changed: if in 2005 more than 75 per cent of investments were made in the form of loans and credits, in 2006 about 54 per cent of assets, involved by non-financial organizations, were made in the form of direct investments.

Foreign assets held by Russian residents have been increased in 2006 for USD 55.8 bln (in 2005 that indicator was USD 53 bln.). Practically all surplus is derived from the operations in private sector.

Foreign assets held by the RF federal government increased by USD 1.4 bln. Foreign assets held by the regulators of the national monetary base decreased by USD 7.6 bln. For the private banks the increase was by USD 23.4 bln.

Assets taken out of country in 2005 by non-financial sector and households were estimated at USD 38.6 bln, with a 15.6 per cent decrease versus the preceding year. At the background of growth in "direct and portfolio investments" (USD 20 bln), as well as in "trade credits and advance payments" (USD 0.9 bln), a significant decline was observed in the amount of cash held in foreign currency (USD 10.6 bln). In other words, in the continued strengthening of RUR in nominal terms in 2006, both, physical persons and non-financial sector actively disposed foreign currency. Value of export earnings not received timely, imported goods paid for under import contracts but not delivered and asset transfers under non-existing contracts has decreased since 2005 to the level of USD 17.7 bln.

Therefore, in our opinion, the major trend in dynamics of the balance of payments indicators in 2006 was a considerable inflow of net capital in non-financial sector in the amount of USD 40.9 bln (as opposed to outflow of capital from non-financial sector in 2004 at the level of USD 8.5 bln and inflow in 2005 in the amount of USD 3 bln) (See Fig. 7).



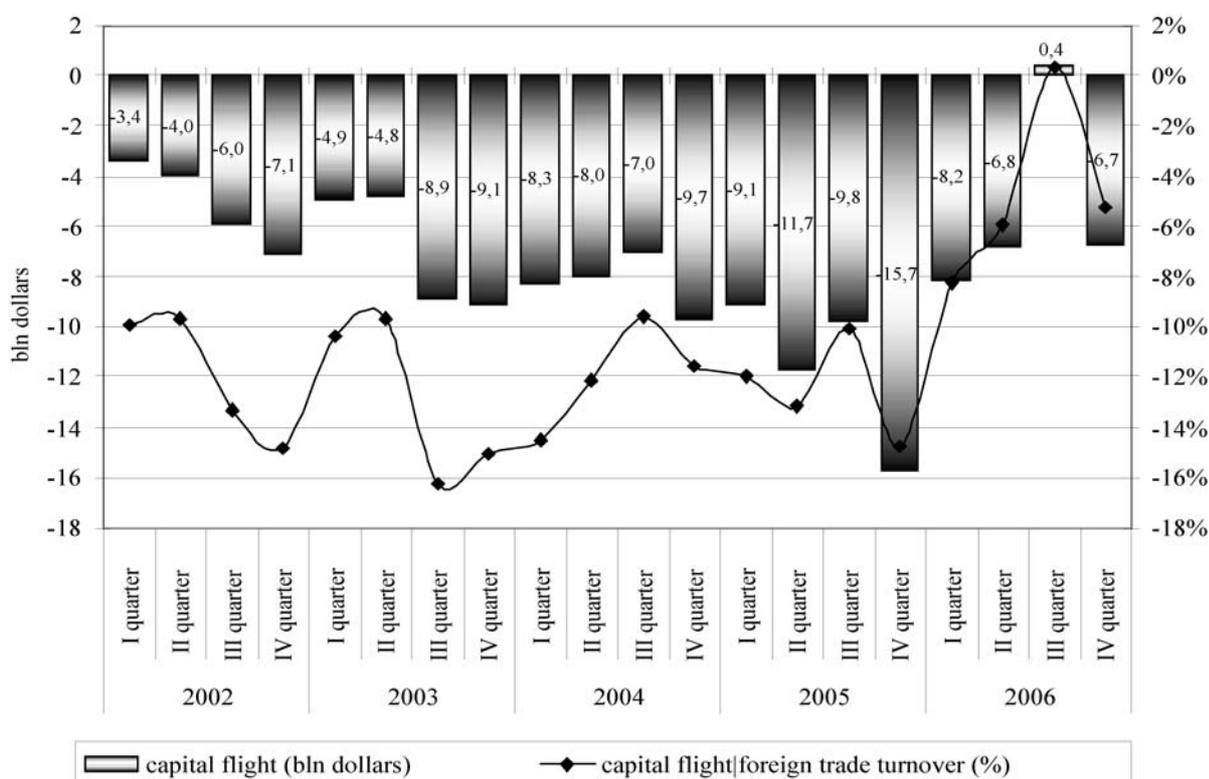
Source: RF Central Bank, IET assessments

Fig. 7. Net Capital Outflow Dynamics within 2002–2006

It has to be noted that as per results of the 1st quarter, there was observed an outflow of capital in the amount of USD 5.3 bln. Total capital inflow within the year was ensured during the II-IV quarters, when the net inflow of capital to non-financial sector made USD 46.1 bln and determined the outcome of the year. These capital inflows resulted mainly from national companies and banks' active involvement in attraction of foreign credits, as well as foreigners' enthusiasm in lending money to Russian companies in the face of the country sound macroeconomic dynamics. We'd like to mention once again, that the bulk of the assets, attracted by non-financial organizations, were made in the form of direct investments, rather than loans and credits, made a year earlier.

Moreover, in 2006 there was observed a restructuring in the trend of non-official capital outflow ("capital flight") (See Fig. 8), which made as per the year results, according to our estimates<sup>14</sup>, USD 21.2 bln, i.e., USD 25.1 bln less than in 2005. A relevant decrease was observed in regard to "capital flight" in external trade (from 12.6 per cent in 2005 to 4.6 per cent in 2006).

<sup>14</sup> "Capital flight" is assessed in accordance with IMF methodology as a grand total of "trade credits and advance payments", "export earnings not received timely, imported goods paid for under import contracts but not delivered", and "net errors and omissions".



Source: RF Central Bank, IET assessments

Fig. 8. Capital Flight Dynamics within 2002–2006

Among other specifics of balance of payments of 2006, one should note high, as before, and still growing share of income from energy sources and export sales, once again demonstrating high level of dependence of Russian economy on natural resources export and market prices. On the other hand, there are high expectations for stabilization of prices in 2007, what can decrease the share of energy sources in the total export sales. Therefore, as was expected in the preceding year, in the background of further growth of net capital inflow to the RF and reduced capital outflow, the stability of balance of payments will be maintained both, by the surplus balance of current account (which might be reduced under conditions of lower prices for energy resources and growing imports), and by the account of operations with capital and non-financial instruments (accompanied by accumulation of gold and foreign currency resources).

#### 2.1.4. Basic Measures to be Implemented in the Sphere of Monetary and Credit Policy

In January 2006 Rosstat has published basic structure of consumer expenditure weights of population, used for assessment of consumer price index for 2006. We should mention, that that structure was published for the first time, which was a serious move towards higher transparency in the IET estimation methodology.

Within 2006 the RF Central Bank has been raising four times the interest rates on financial instruments on deposit operations in national currency for credit or-

ganizations, made under “Tom-next”, “spot-next”, “on demand” standard terms to 2.25 per cent per annum; on the operations made under “one week” and “spot-week” terms - to the level of 2.75 per cent per annum. The interest rate increase was effected for the purpose of excessive money supply sterilization and came into effect due to some changes in national and external economic conditions, namely to the refund rate policy, pursued by Federal Reserve System of the USA and European Central Bank. It should be noted, that the raised refund rates on the RF Central Bank deposits have, in fact, increased their attraction. As per results of the year, credit organizations' deposits with the Bank of Russia have grown practically 13-fold. With the help of this measure the Bank of Russia was pursuing the policy of raising the significance of the interest rate as an instrument of the general monetary and credit policy.

In 2006 the RF Central Bank has decreased the refund rate twice, on June 26 it was reduced from 12 per cent to 11.5 per cent, and since October 23 it was established at the rate of 11 per cent. It should be noted, that the decrease of the refund rate was implemented at the background of growing interest rates on deposits of credit organizations with the RF Central Bank. The decline of refund rates was aimed at raising the significance of interest rates in monetary and credit policy. As a matter of fact, the effective refund rate is much higher than the standard rate of a bank credit, and therefore, changes in refund rate provide minimum effect in terms of monetary and credit policy. However, the raised rates on deposits has led to their increased attractiveness to the banks and made a positive impact over liquidity sterilization in the Bank of Russia.

Due to abolishment of restrictions in foreign currency operations as of January 1 2007, to achieve the aim of unrestricted convertibility of the Russian rouble, the Bank of Russia has reduced twice the reserve limit of funds for foreign currency operations and cut down to zero the quota for mandatory sale of foreign currency receipts. Soon after that, on May 29, the RF Central Bank issued a resolution on abolishment of requirements on reservation of funds on certain transactions with foreign currency. Moreover, on July 1, 2006 a demand to open special accounts for certain types of operations with foreign currency was also dismissed (i.e., special bank accounts, special deposit accounts, accounts of non-residents in the register of securities holders). Those measures were aimed at annihilation of restrictions in regard to operations with capital and at free rouble convertibility.

In May the RF State Duma has adopted in final reading the law on the RUR graphic symbol, with relevant amendments to the Law “On the RF Central Bank (Bank of Russia).” According to the new law, Russian rouble will have an appropriate visual symbol, which is subject for approval by the Bank of Russia in compliance with appropriate legislative procedure.

In June the Paris Club of Creditors has accepted the prescheduled recovery of the long-term Russian debt, which exceeded the amount of USD 20 bln. It was planned to repay 51.4 per cent of that amount at face value, whereas the balance of total debt should be recovered with an interest of about USD 1 bln. It should be reminded, that in 2005 Russia has made early repayment of its debt to IMF (in the

amount of USD 3.3 bln) and partially recovered the debt to Paris Club (in the amount of USD 15 bln). In our opinion, prescheduled recovery of external debts is a positive way of accumulated national funds expenditure, as on the one side, that measure does not bring inflation pressure in the national economy, and on the other side, reduces the liabilities to external creditors.

In August the bank of Russia has submitted to the RF State Duma a document on "Major Trends of Consolidated Monetary and Credit Policy in 2007", where, for the first time in recent years, the Bank of Russia has outlined its primary task for the year of 2007, namely – combating of inflation and bringing it to the level of 6.5-8 per cent as of the year results. As concerns the index of inflation targeting for the rouble rate in real terms, it should be held within the range of 0 per cent to 10 per cent. In our point of view, those measures will help the Bank of Russia to pursue effective monetary and credit policy, avoiding attempts to achieve several conflicting targets. Moreover, according to the Central Bank estimates, the surplus of monetary base in narrow definition will make 14–22 per cent in 2007. Gold and foreign currency reserves by the end of 2007 should reach about USD 316 bln- USD 390 bln. We consider that both estimates are somewhat lower than they should be. According to the model of approximation of short-term estimates of the RF socio-economic indicators, in the first half-year of 2007 the growth rate of the monetary base should reach 18.1 per cent, and gold and foreign currency reserves will exceed USD 384 bln.

Since October 1 of the preceding year, the Bank of Russia has increased the rate of deductions to Mandatory Reserve Fund and under the debts of Russian banks to external credit organizations from 2 per cent to 3.5 per cent. By this means, Central Bank was making an attempt to reduce the attraction of foreign credits to the Russian banks and to protect national currency from excessive pressure. However, that measure has not bring any problems with liquidity to the banks, as the Bank, having increased the rate of deductions to Mandatory Reserve Fund, has also raised the average index from 0.2 to 0.3. Therefore, now the banks are able to withdraw at the beginning of the month and repay at the end of month up to 30 per cent of their deductions to Mandatory Reserve Fund. As a whole, those two counteracting measures, taken by the Central Bank, lead to a neutral result, but their introduction might point to the beginning of a tougher monetary and credit policy.

## **2.2. The state budget**

### *2.2.1. A general overview of the budgetary system*

When analyzing the main parameters characteristic of the RF budgetary system in 2006, it should be noted that last year's level of revenue and expenditure by comparison with that of 2005 changed only slightly (see *Table 1*): in the federal budget, the share of tax revenues in GDP decreased by 0.1 p. p. and amounted to 22.2 % of GDP, while in the budgets of RF subjects the amount of tax revenue as a percentage of GDP was the same as in the previous year (10.3 % of GDP). As a result, the share of taxes and payments in the revenues of the RF consolidated budget in 2006 amounted to 32.5 % of GDP, against 32.6 % of GDP in 2006.

According to the data on the actual execution of the RF federal budget in 2006, its revenue was 23.6 % of GDP, which is by 0.1 p. p. lower than the corresponding index of 2005. The revenue of the RF consolidated budget in 2006 amounted to 35.5 % of GDP, which is by 0.3 p. p. higher than the previous year's index. As for the expenditure indices of the RF budgetary system in 2006, they demonstrated a certain decline against the sum of expenditure in the 2005 federal budget (16.1 % against 16.3 % of GDP), but did not change in terms of the RF consolidated budget and amounted to 27.5 % of GDP.

The revenue of the RF territorial budgets in 2006 constituted 14.3 % of GDP against 13.9 % of GDP one year earlier. The expenditure of the budgets of RF subjects also demonstrated a slight growth on the year 2005 (13.6 % of GDP) and amounted to 13.7 % GDP. Due to the decreased revenue and expenditure in the federal budget, and the increased revenue and unchanged expenditure in the RF territorial budgets, the surplus in the consolidated budget, as shown by the results of the year 2006, rose on the previous year and amounted to 8.0 % of GDP (against 7.7 % of GDP in 2005), having reached its historic high of the whole post-Soviet period.

The single social tax (SST), a part of which is transferred to the federal budget, deserves a separate comment. Thus, throughout the period of 2002 – 2004, the revenues generated by this tax were declining at a stable rate, having demonstrated a noticeable fall in 2005 to the level of 1.24 % of GDP against 2.6 % of GDP in 2004. By the results of 2006, the share of revenues from this tax in GDP decreased even further – to approximately 1,19 % of GDP. The main cause of this sharp decline is the lowering of the rate of SST in 2005 - from 35.6 % to 26 %. It should be noted that, for example, in 2001, assuming the tax base was 100,000 roubles, the proportional shares of the SST rate divided between the budget and off-budget funds would be as follows: 28 % – to the federal budget, 4.0 % – to the Social Insurance Fund, 0.2 % – to the Federal Compulsory Medical Insurance Fund, and 3.4 % – to the territorial funds. In 2005 the law was amended, whereby the proportional distribution of the SST rate, at a tax base of up to 280,000 roubles, became as follows: 20 % – to the federal budget, 3.2 % – to the Social Insurance Fund, 0.8 % – to the Federal Compulsory Medical Insurance Fund, and 2.0 % – to the territorial compulsory medical insurance funds. Thus, the diminished share of transfers to the federal budget in 2005 was the direct consequence of the sharply decreased standard deduction rate established for the aggregate revenue from this tax.

The budget of the RF general government, by the results of 2006, was executed in respect of revenue at the level of 40 % of GDP against 39.7 % of GDP in 2005. Expenditure amounted to 31.5 % of GDP against 31.6 % of GDP in 2005. The growing revenue of the general government's budget alongside the reduction in its expenditure as a share of GDP was conducive to an increased budget surplus - from 8.1 % of GDP in 2005 to 8.5 % of GDP in 2006.

Table 8

**The execution of the revenue and expenditure of the consolidated budget, the federal budget and territorial budgets (in % of GDP)**

	1999	2000	2001	2002	2003	2004	2005	2006
<b>Federal budget</b>								
Tax revenues	11.7	14.5	16.3	18.9	18.2	18.6	22.3	22.2
Including from SST <sup>15</sup>	–	–	–	3.13	2.75	2.60	1.24	1.19
Revenue	12.7	15.5	17.8	20.3	19.5	20.1	23.7	23.6
Expenditure	14.0	14.2	14.8	18.9	17.8	15.8	16.3	16.1
Deficit (-)/Surplus (+)	-1.1	1.4	3.0	1.4	1.7	4.3	7.4	7.5
<b>Territorial budgets</b>								
Tax revenue	11.1	11.8	11.0	11.5	10.8	11.4	10.3	10.3
Revenue	13.4	14.1	14.5	15.1	14.6	14.1	13.9	14.3
Expenditure	13.3	13.4	14.5	15.5	14.9	13.9	13.6	13.7
Deficit (-)/Surplus (+)	0.1	0.7	0.0	-0.4	-0.3	0.2	0.3	0.6
<b>Consolidated budget</b>								
Tax revenue	22.8	26.3	27.3	30.4	29.0	30.0	32.6	32.5
Revenue	25.2	28.5	29.3	32.1	31.1	32.3	35.2	35.5
Expenditure	26.3	25.6	26.4	31.1	29.7	27.8	27.5	27.5
Deficit (-)/Surplus (+)	-1.1	2.8	2.9	1.0	1.4	4.5	7.7	8.0
<b>General government's budget</b>								
Tax revenue	31.4	35.7	35.7	35.6	34.6	35.3	36.9	36.9
Revenue	33.8	38.3	38.4	37.8	37.1	37.5	39.7	40.0
Expenditure	35.3	34.3	35.2	36.3	36.0	32.9	31.6	31.5
Deficit (-)/Surplus (+)	-1.5	4.0	3.2	1.5	1.1	4.6	8.1	8.5

Source: the RF Ministry of Finance; the IET's estimations.

Against the background of a sufficiently favorable situation on the international market for oil and metals (the average per annum price of Urals was \$ 60.97 per barrel against \$ 50.2 per barrel<sup>16</sup> in 2005), the stabilization of budget revenue occurred due to the changed amounts of revenues from individual taxes, which will be discussed in more detail later.

The actual indices of oil prices being in excess of the target ones set in the 2006 budget resulted, just as in the previous year, in a surplus over the planned revenues of the budgetary system, and therefore on 1 December 2006 a law was passed, in accordance with which the revenue of the RF federal budget was increased to 6,170.48 billion roubles (in the initial draft – to 5,046.14 billion roubles), the expenditure – to 4,431.08 billion roubles (in the initial draft – to 4,270.11 billion roubles).

<sup>15</sup> From 2001, SST replaced the previously existing contributions to the state off-budget social funds. From 2002, a part of the aggregate SST rate has been transferred to the federal budget.

<sup>16</sup> The data published by the Energy Information Administration of the US Department of Energy [www.eia.doe.gov](http://www.eia.doe.gov). For a more detailed discussion of the situation on the oil market, see the corresponding section of this report.

### 2.2.2. An analysis of revenues from the main taxes in the RF budgetary system

The data concerning the amounts of revenues from the main taxes received in the RF budgetary system in 2006 are shown in *Table 9*.

*Table 9*

#### **Revenues from the main taxes in the budget of the general government of the Russian Federation in 1998 – 2006 (in real terms, in % of GDP)**

	1998	1999	2000	2001	2002	2003	2004	2005	2006
1	2	3	4	5	6	7	8	9	10
<b>Tax revenues in real terms (trillion roubles)</b>									
<b>Tax revenue*</b>	0.84	0.88	1.10	1.15	1.20	1.26	1.38	1.53	1.63
Profits tax	0.10	0.13	0.17	0.19	0.14	0.14	0.20	0.26	0.28
Personal income tax	0.07	0.07	0.07	0.09	0.11	0.13	0.13	0.14	0.15
VAT <sup>17</sup>	0.16	0.17	0.19	0.23	0.24	0.24	0.24	0.28	0.25
Excises <sup>18</sup>	0.07	0.06	0.07	0.09	0.08	0.09	0.06	0.05	0.04
Revenues from foreign economic activity <sup>19</sup>	0.04	0.05	0.10	0.12	0.10	0.12	0.20	0.32	0.38
Payments for use of mineral resources	0.02	0.03	0.03	0.05	0.10	0.11	0.13	0.18	0.20
Sales tax	0.00	0.01	0.01	0.02	0.02	0.02	0.00	–	–
Allotments to off-budget funds <sup>20</sup> , including SST to RF Social Insurance Fund	0.21	0.20	0.22	0.23	0.13	0.14	0.14	0.17	0.19
SST to Federal Compulsory Medical Insurance Fund	–	–	–	0.01	0.01	0.01	0.01	0.01	0.01
SST to territorial compulsory medical insurance funds	–	–	–	0.02	0.02	0.02	0.02	0.02	0.02
Insurance contributions to mandatory pension insurance in RF	–	–	–	–	0.09	0.11	0.11	0.12	0.16
<b>Tax revenues in % of GDP</b>									
<b>Tax revenue*</b>	31.9	31.4	35.7	35.7	35.6	34.6	35.3	36.9	36.9
Profits tax	3.7	4.6	5.4	5.7	4.3	4.0	5.1	6.2	6.3
Personal income tax	2.7	2.4	2.4	2.9	3.3	3.4	3.4	3.3	3.5
VAT	6.0	5.9	6.2	7.2	7.0	6.7	6.3	6.8	5.7
Excises	2.6	2.2	2.3	2.7	2.4	2.6	1.4	1.2	1.0
Revenues from foreign economic activity	1.4	1.8	3.1	3.7	3.0	3.4	5.0	7.8	8.7
Payments for use of mineral resources	0.8	0.9	1.1	1.4	3.1	3.0	3.4	4.3	4.5
Sales tax	0.03	0.40	0.47	0.50	0.46	0.43	0.04	0.00	0.00

<sup>17</sup> The value added tax on the commodities produced in the territory of the Russian Federation and imported into its territory.

<sup>18</sup> The excises on excisable goods produced in the territory of the Russian Federation and imported into its territory, without the oil excises.

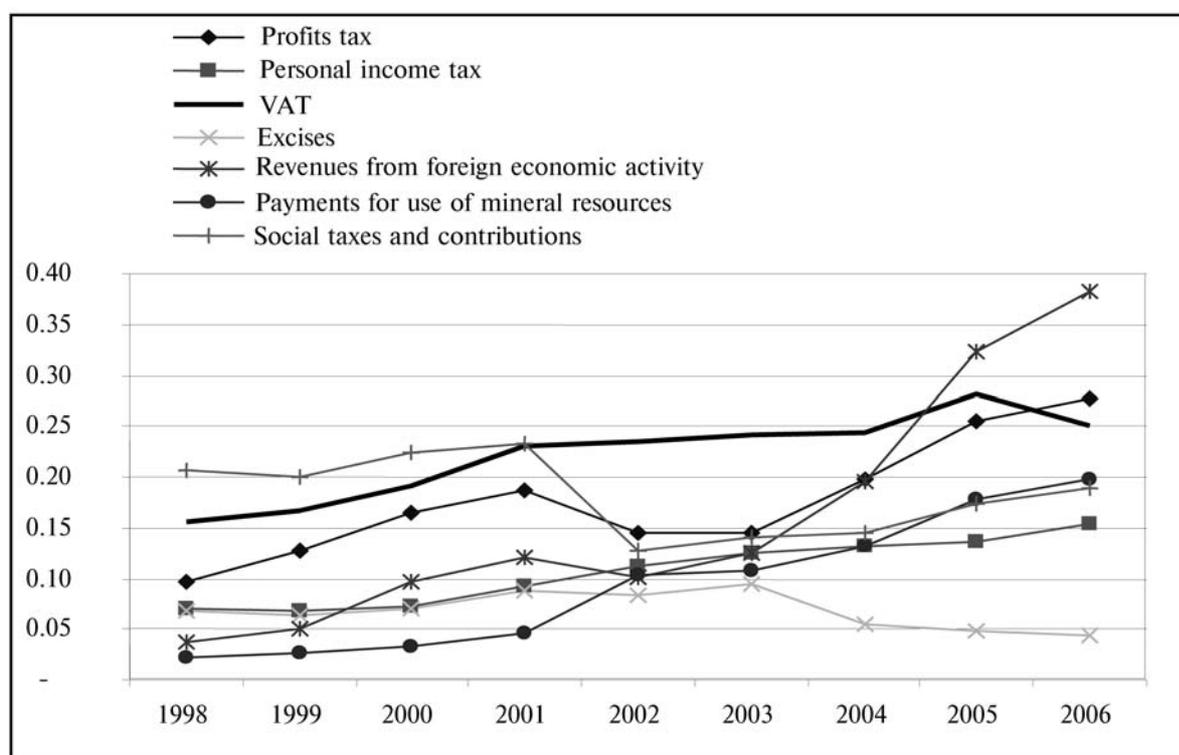
<sup>19</sup> Customs duties, customs levies and other revenues from foreign economic activity.

<sup>20</sup> Prior to 2002 - the aggregate allotments to the off-budget social funds. From 2002 – taxes and contributions to social needs, without the deductions of SST being transferred to the federal budget.

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	1	2	3	4	5	6	7	8	9	10
Allotments to off-budget funds, including		7.9	7.1	7.3	7.2	3.8	3.9	3.7	4.2	4.3
SST to RF Federal Social Insurance Fund					0.24	0.23	0.22	0.25	0.22	0.21
SST Federal Compulsory Medical Insurance Fund					0.04	0.05	0.04	0.04	0.14	0.21
SST to territorial compulsory medical insurance funds					0.59	0.71	0.66	0.62	0.38	0.37
Insurance contribution to mandatory pension insurance in RF						2.76	2.94	2.80	2.88	3.51

\* – the data prior to 2005 incorporate the revenues of target budget funds.



Source: the RF Ministry of Finance.

Fig. 9. Dynamic of revenues from main taxes in real terms in 1998 – 2006 (trillion roubles)

As seen from the data presented here, the whole period from 1998 to 2006 is characterized by growing tax revenues in the budget of the general government of the Russian Federation Russian in real terms (see Fig. 9): the per annum growth rate of this index was fluctuating between 4.3 % (in 2003) and 25.1 % (by the results of 2000), which was mainly due to the substantial growth in the revenues from the profits tax, VAT and export customs duties. However, if we look at the period after the introduction of basic changes to tax legislation, the maximum growth of tax revenues in real terms was demonstrated by the results of 2005 – 11.1 %. Similar changes were observed in the indices of tax revenues as a percentage of GDP, which by 2005 had reached its historic high of the whole period under considera-

tion (36.9 % of GDP). In 2006 the share of tax revenues remained at a constant level – 36.9 % of GDP.

Among the main factors responsible for the growing tax revenues within the budgetary system we can point to the favorable situation existing for Russian export commodities, primarily oil, natural gas and metals; the expansion of the tax bases for many taxes due to Russia's economic growth; improved tax administration; and a partial reduction in the arrears of taxes. In the period prior to 2004 a number of taxes and levies were abolished, which had an additional impact on the behavior of tax revenues. In particular, this abolition involved the sales tax, the tax for the upkeep of the housing fund and the objects in the cultural sphere (prior to 2001 the tax was levied at the rate of 1.5 % of turnover), the tax on purchase of motor cars, the tax on the sale of fuels and lubricants; besides, the rates of the motor road tax and the tax on the owners of motor cars were lowered, and later these two taxes were completely abolished altogether.

The behaviors of revenues from individual taxes differed greatly. Thus, the highest volatility both in real terms and in % of GDP was displayed by the revenues from the tax on profit of organizations. From *Table 9* it can be seen that before 2001 the revenues from this tax had been growing due to the increasing balances of enterprises' financial results, improving payment and settlement procedures in the national economy, as well as the introduction, in 2001, of the municipal profits tax at the rate of profit by way of compensation for the abolished tax for the upkeep of the housing and utilities sector. However, the results of 2002 demonstrated a substantial fall in the revenues from the tax on profit of organizations, which constituted approximately 26 % in real terms and 1.4 p. p. in % of GDP. In 2003 the revenues from this tax in real terms slightly grew, while as a percentage of GDP they became even lower, having decreased from 4.3 % to 4.0 % of GDP.

The principal factors responsible for the fall in the revenues from the profits tax in 2002 and 2003 were as follows: the enactment of the new provisions of the Tax Code concerning this tax, in particular changes (upward) in the structure and volume of costs to be deducted when determining the tax base; the lowered tax rate - from 35 % to 24 %; the application of a "transitory provision" concerning the estimation of tax base on the accrual basis; altered depreciation deductions; and the general reduction in the net financial results of enterprises' activity. As estimated by the RF Ministry of Finance, in 2003 approximately 0.12 % of the aggregate reduction in the revenue share in GDP resulted from the changes in the part concerning the determination of tax base for the profits tax. Only in 2004 the trend of declining tax revenues became reversed, and revenues increased by 48 % in real terms, or by 1.1 p.p. in % of GDP, and this growth continued in 2005 and 2006.

The main factors responsible for the increased revenues from the profits tax in 2004 were economic growth and the favorable economic situation in respect of international prices of energy carriers, and in particular, the growing oil prices. Against this background, a considerable expansion of the taxation base was observed: while in 2003 the net balance of the financial activity of enterprises and organizations decreased by 12 %, in 2004 it rose by 50 %, and in 2005 – by 35 %.

Besides, the growth of revenues in 2004 can be to a certain extent explained by the termination of a number of exemptions from the profits tax granted prior to the 2002 tax reform. The growth of revenues in 2005 is partly a consequence of the transfer to the budget, in Q I 2005, of the payment against the tax arrears of "Yukos".

As seen by the results of 2006, the revenues from the profits tax somewhat increased on the previous year and amounted to 6.3 % of GDP. This increased revenues can be explained by an expanded tax base (in the first ten months of 2006 the net balance of the financial activity of enterprises in the RF rose by 26 %). Besides, production growth in industry (3.9 % per annum) and in other types of economic activity, coupled with growing producer prices (in industry – 10.5 %) could also be conducive to increased tax revenues.

The revenues from the personal income tax in real terms remained at a sufficiently stable level until 2001. However, from 2002 the real revenues from this tax began to grow, and this growth continued throughout the following period. At the same time, growth in % of GDP could be observed only until 2004 inclusive, after which the share of revenues in GDP demonstrated a certain decline. Only in 2006 the revenues from this tax in % of GDP, as demonstrated by the year's results, once again grew and amounted to 3.5 %, whereas the revenues from SST remained at the same level as in 2005 (2 % of GDP). At the same time, according to the RF Rosstat, in 2006 the population's incomes in real terms increased by 10 %, while the growth of an average monthly salary in real terms was 13.5 %. During the same period, the growth of GDP in real terms amounted to 6.7 %. Thus, in 2006 the value of the effective rate of SST and the personal income tax in real terms turned out to be lower than in 2005.

The behavior of the revenues from the personal income tax should be viewed with due regard for the fact that in 2001, as a result of reform, a flat rate of 13 % was introduced for this tax. Thus, it can be noticed that as early as 2001 the annual results demonstrated a certain growth of tax revenues. One of the growth factors was that prior to reform the lower margin of the tax rate had been 12 %, and therefore its increase by 1 %, given the assumption that the tax base remained unchanged or expanded, resulted in a noticeable growth in revenues (according to different estimations, by approximately 0.1 % of GDP), even though the marginal rate established for that part of the population that had been paying the tax at a higher rate had become lower (a fall in revenues by approximately 0.05 % of GDP). Besides, according to estimates, approximately 0.2 % of the growth in revenues from the personal income tax in % of GDP was generated by the expanded tax base. The subsequent growth was largely due to the overall rise in the population's incomes produced by economic growth, as well as to the partial legalization of incomes.

Prior to and through the year 2003, the revenues from excises both in real terms and in % of GDP varied to a noticeable degree. However, overall revenues were growing, having reached in 2001 their historic high of the entire post-crisis period. Later on, from the year 2004 onward, a rather significant decline followed.

The initial growth of revenues in 2001 – 2003 was produced by the introduction of the excises on diesel fuel and engine oils, the increased rates of the excises on alcoholic beverages and on petrol (more than threefold)<sup>21</sup>, as well as of the excises on natural gas in response to its growing international prices. The reversal of the upward trend in the growth of excises, registered in 2004 and resulting in the onset of the aforesaid decline in their sum in real terms and in % of GDP, was largely due the abolition, from 1 January 2004, the excise on the natural gas, the revenues from which in 2003 amounted to approximately 45 % the total revenue from excises received by the budgetary system.

A substantial portion of the tax revenues in the budget of the general government is represented by the revenues from the value added tax. While their amount in real terms until 2005 was mainly growing, in % of GDP it grew only until 2001, which was followed by a three-year decline in revenues. A noticeable improvement was seen only by the results of 2005, and then in 2006 these revenues once again demonstrated a marked drop. The growth of 2000 – 2001 was largely due to the switchover to the payment of VAT “by the country of destination” in the trade relations with the CIS member states, as well as to the abolition of some exemptions. However, as early as 2001 a noticeable growth in the volume of VAT refunds was seen, which had a negative impact on the level of revenues from this tax in 2001. This phenomenon also to a certain extent accounted for a decline in the revenues from VAT in 2002 – 2004. At the same time, in 2004 the additional decline in the volume of revenues from VAT was produced by the lowering of the tax rate from 20 % to 18 %. At the same time, the decrease in the total share of revenues in GDP amounted to only 0.4 p. p. against the expected figure of approximately 0.6 % of GDP, which can be in part explained by a noticeable reduction in the volume of VAT refunds in respect of exports transactions.

In 2006 the share of revenues from the value added tax fell significantly – to 5.7 % of GDP from 6.8 % of GDP in 2005. Among the main factors responsible for the declining revenues from VAT, we should point to the increased tax deductions and the shrinkage of the tax base, associated with the changes in legislation that entered into force in 2006.

Besides, an important item of revenue in the budgetary system of the Russian Federation are the payments for the use of natural resources, a considerable part of these being constituted by the revenues from the tax on the extraction of mineral resources (TEMR). While prior to 2001 such revenues remained relatively insignificant, from 2002 onward they began to display a stable growth due to the growth of the international prices of energy carriers. Since the rate of TEMR was directly linked to the level of international oil prices, the improved situation on the global market of energy carriers was automatically producing changes in the level of revenues from this tax, and consequently in the amount of aggregate revenues generated by the payments for the use of natural resources.

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<sup>21</sup> Such a substantial increase in the rate of the excises on petrol was designed to compensate for the abolition of the tax on the sales of fuels and lubricants and for the lowered rate of the tax on users of motor roads.

Rather similar behaviors were demonstrated by the revenues from foreign economic activity, which during the greater part of the period under consideration were growing as a result of the growth of both the Russian economy and the foreign trade turnover, and of the changes in the export duties on oil, which from the year 2002 onward were calculated on the basis of the international oil price.

As for the tax revenues in 2006, the share of payments for the use of natural resources in GDP rose from 4.5 % of GDP (against 4.3 % of GDP in 2005), while the growth of revenues from foreign economic activity amounted to 0.9 p. p. of GDP (a rise from 7.8 % to 8.7 % of GDP). The main source of the growing revenues was the improving situation on the international oil market, as well as on the metals market (during that year, the prices of nickel and other metals reached their absolute historic highs). As for foreign trade, by the results of 2006 its volume was approximately \$ 470 billion (exports – \$ 304.5 billion, imports – \$ 163.9 billion), having increased by 27 % (growth in exports by 25 %, in imports – by 30.8 %).

The level of allotments to social off-budget funds in 1998 – 2001 remained rather stable, but noticeable changes occurred from the year 2001 onward, which can be explained mainly by the amendments to legislations, which entered into force in 2001. When discussing the period of 2002 – 2006, it should be noted that in 2003 (less the amount of SST transferred to the federal budget) there occurred an increase in the amount of allotments in % of GDP, followed in 2004 and 2005 by a decline. In 2006 the revenues transferred to the off-budget funds markedly grew also as a percentage of GDP and amounted to 4.3 %. At the same time, from 2002 an overall decline in the social allotments was observed.

If we look at the structure of allotments to off-budget funds, it will be noticed that in 2001 – 2004 their share in GDP was remaining at a sufficiently stable level, whereas by the results of 2005 and 2006 a noticeable fall in the revenues transferred to the social insurance fund and the territorial compulsory medical insurance funds was observed. The main reason for this substantial decline was the changed proportional distribution of the revenues from SST. Thus, for example, if in 2001 4.0 % of the rate of SST was transferred to the social insurance fund (the tax being under 100,000), in 2005 its size was revised and decreased to 3.2 %. The corresponding indices of 2001 and 2005 for the allotments to the territorial compulsory medical insurance funds were 3.4 % and 2 %, respectively. On the contrary, the growth in the share of allotments to the Federal Compulsory Medical Insurance Fund in 2005 from 0.2 % to 0.8 % was conducive to the growth of revenues transferred to the Fund in 2005 and 2006. And finally, the revenues from the insurance contributions to mandatory pension insurance throughout the period of 2002 – 2005 remained at a rather stable level of approximately 2.7 % – 2.9 % of GDP, and only by the results of 2006 increased to 3.51 % of GDP.

The structure of tax revenues in the budget of the general government is shown in *Table. 10*.

*Table 10*

**The share of tax revenues in the aggregate revenues of the general government's budget in 2000 – 2006, in %**

	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Tax revenues</b>	89.9	93.0	93.3	92.8	94.2	93.2	94.3	92.9	92.2
Profits tax	10.3	13.5	14.1	15.0	11.3	10.7	13.6	15.5	15.7
Personal income tax	7.6	7.2	6.2	7.4	8.8	9.3	9.0	8.2	8.7
VAT	16.8	17.6	16.2	18.6	18.4	17.9	16.7	17.2	14.2
Excises	7.3	6.7	5.9	7.1	6.5	7.0	3.8	3.0	2.5
Revenues from foreign economic activity	3.9	5.3	8.2	9.6	7.9	9.2	13.5	19.6	21.7
Payments for use of mineral resources	2.4	2.7	2.8	3.8	8.1	8.0	9.1	10.8	11.2
Sales tax	0.08	1.18	1.23	1.31	1.22	1.15	0.10	0.00	0.00
SST*				15.1	10.9	9.9	9.3	5.0	4.9
<b>TOTAL REVENUE</b>	<b>100</b>								

\* – aggregate revenues from SST.

While discussing the structure of tax revenues in the general government's budget, it should be noted that in some of the years within the period under (1998 – 2006) the ratio between the main taxes as percentages of the aggregate revenue of the consolidated budget was changing. Thus, until 2004 the highest shares in the aggregate budget revenue were constituted by the profits tax, by VAT and - from 2001 – by the single social tax. Their aggregate share in 2002 – 2004 amounted to approximately 58 % of the aggregate revenue of the general government's budget. Later on, rather noticeable growth was demonstrated by the share of revenue from foreign economic activity, which in 2005 and 2006 became the biggest component of the tax revenues in the general government's budget. On the contrary, the share of tax revenues from SST during the last two years showed a marked decline of the indices registered at the beginning of the period under consideration. In addition, some attention should be paid to the rather high volatility of the share in the aggregate revenues of the general government's budget constituted by the tax on profit of organizations. Thus, throughout the whole period it fluctuated between 10.3 % of GDP 1998 and 15.7 % of GDP in 2006.

### *2.2.3. The expenditures of the budgetary system*

From 1 January 2005, the budgetary classification has been changed, and so it is impossible to adequately compare the main items of expenditure in the budgetary system for the years 2005 – 2006 and earlier. In this connection, below we are going to analyze separately the data prior to 2004 and the actual execution of the budgets of all levels in 2005 – 2006. The main characteristics of the expenditures of the RF budgets of all levels in 2002 – 2004 are shown in *Table. 11*.

Table 11

**The expenditures of the federal, territorial and consolidated budgets in 2002 – 2004 (in % of GDP)**

	2002			2003			2004		
	Federal budget	Territorial budgets	Consolidated budget	Federal budget	Territorial budgets	Consolidated budget	Federal budget	Territorial budgets	Consolidated budget
1	2	3	4	5	6	7	8	9	10
State administration and local self-government	0.5	0.8	1.4	0.5	0.9	1.4	0.5	0.8	1.3
Judicial authority	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 activity and state security	1.7	0.5	2.2	1.9	0.4	2.3	1.9	0.4	2.3
Fundamental research and promotion of scientific and technological progress	0.3	0	0.3	0.3	0	0.3	0.3	0.0	0.3
Industry, power engineering 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, motor road system, communications and informatics	0.1	0.4	0.5	0	0.3	0.3	0.0	0.2	0.3
Housing and utilities sector	0	2.3	2.3	0	1.9	1.9	0.0	1.7	1.7
Public education	0.7	3	3.8	0.8	2.8	3.6	0.7	2.8	3.5
Culture, art 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
Public health care and physical culture	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
Government debt servicing	2	0.1	2.2	1.7	0.1	1.8	1.2	0.2	1.4
Financial support to budgets of 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
Motor road system	0.4	0.4	0.7	0.3	0.5	0.8	0.3	0.2	0.5
Target budget funds	0.1	1.4	1.6	0.1	1.1	1.2	0.1	1.0	1.1
<b>Total expenditure</b>	<b>18.7</b>	<b>15.3</b>	<b>31.1</b>	<b>17.7</b>	<b>14.9</b>	<b>29.7</b>	<b>16.1</b>	<b>14.1</b>	<b>27.8</b>

Source: the RF Ministry of Finance.

\* In 2001 – including the expenditures on the road system upkeep.

\*\* Including transfers to the RF PF for the financing of the basic component of pension at the expense from the part of SST centralized in the federal budget.

\*\*\* From 2003 this section reflects the transfers to the state off-budget funds.

*Table 12*

**Expenditure of the federal, consolidated and territorial budgets in 2005 and 2006 (in % of GDP)**

	2005			2006		
	Consolidated budget	Federal budget	Territorial budgets	Consolidated budget	Federal budget	Territorial budgets
General state issues	3.5	2.3	1.2	3.1	2.0	1.1
<i>of these</i> , servicing of state and municipal debts	1.1	1.0	0.1	0.7	0.6	0.1
National defense	2.7	2.7	0.0	2.6	2.6	0.0
National security and law-enforcement activity	2.7	2.1	0.6	2.7	2.1	0.6
National economy	3.5	1.2	2.4	3.6	1.3	2.3
Housing and utilities system	2.2	0.0	2.1	2.4	0.2	2.2
Environment protection	0.1	0.02	0.08	0.1	0.02	0.06
Education	3.7	0.8	2.9	3.8	0.8	3.0
Culture, cinematography and mass media	0.7	0.2	0.5	0.7	0.2	0.5
Public health care and sports	2.6	0.4	2.1	2.8	0.6	2.3
Social policy	2.4	0.8	1.6	2.4	0.8	1.6
Interbudgetary transfers	3.5	5.8	0.1	3.4	5.6	0.1
<b>Total expenditures</b>	<b>27.5</b>	<b>16.3</b>	<b>13.6</b>	<b>27.5</b>	<b>16.1</b>	<b>13.7</b>

*Source:* the RF Ministry of Finance.

The main items of expenditure of the federal, consolidated and territorial budgets of the RF in 2005 and 2006 are shown in *Table 12*.

The structure of the RF budgetary system's expenditure in 2006 did not demonstrate any significant changes by comparison with the previous year. Just as one year earlier, a substantial volume of financing was allocated to the items "General state issues", "National defense", "National security and law-enforcement activity", "Education", "Public health care and sports", and "Social policy". At the same time, certain changes occurred in some of the sections of the functional classification of the consolidated budget's expenditures, which should be pointed out. Thus, the majority of sections demonstrated either a marked decline or the same figures as in the previous year. The most noticeable decline was seen in the item "General state issues", where the amount of expenditures decreased from 3.5 % to 3.1 % of GDP. This happened due to the diminished volume of costs relating to the servicing of government and municipal debt. The greatest upward shifts occurred in "Housing and utilities system" (growth from 2.2 % to 2.4 % of GDP), "Education" (from 3.7 % to 3.8 % of GDP), and "Public health care and sports" (from 2.6 % to 2.8 % of GDP), which can be explained by the onset of the implementation of national projects, that is, projects in the socially important spheres of the national economy.

No marked changes were observed on the expenditure side of the federal and the territorial budgets of RF subjects, either: the share of the corresponding items in GDP either somewhat decreased against the index of the previous year, or remained unchanged. It is noteworthy that, despite the stability of expenditure in respect to GDP, its further growth at the rate higher than that of economic growth in a situation of an excessive inflation pressure creates additional problems, which di-

minish the effect of the anti-inflation measures being implemented by the government. Despite the fact that, according to the results of 2006, the government has succeeded in keeping inflation at a predetermined level, any further growth in non-interest expenditures may cast doubts as to the efficiency of the government's actions aimed at further reduction of the growth rate of consumer prices in the short and medium term.

#### *2.2.4. The estimation of budget parameters cleared of the share of the oil and gas sector and the impact of international oil prices*

The rather strong dependence of the Russian budgetary system on the export of energy carriers, and consequently, on the situation on the international markets, is fraught with serious risks of a potential destabilization of the balance of the budgetary system. It was, to some extent, to neutralize the impact of this factor that in 2004 the RF Stabilization Fund was created, whose purpose is to accumulate the "situational" revenue in order to sterilize the excessive money supply and to cover the loss of revenues in the future, when the international prices of energy carriers will fall. Besides, the RF Ministry of Finance suggests that the concept of a budget not including the revenues (or expenditures) of the national economy's oil and gas sector should be introduced in legislation. It is suggested that the resources generated by the export of raw materials and accumulated in the so-called oil and gas fund should be used to cover fully or in part the budget deficit not associated with the oil and gas sector. The estimates of the RF federal budget's oil-and-gas balance made by the Ministry of Finance and by the International Monetary Fund (IMF), as well as the IET's estimations, are shown in *Table 13*.

From this Table it follows that the balance of the budgetary system of the Russian Federation cleared of the oil-and-gas balance is negative. Besides, as estimated by the IMF, prior to 2004 the deficit was gradually declining in relation to GDP (from - 5.2 % to - 4.3 % of GDP), whereas from the year 2005 onward it began to grow, and consequently by the the results of 2006 it may amount to approximately - 7.4 % of GDP. If we look at the IET's estimations, for the year 2005 they will be rather close to those of the IMF, while for 2006 the discrepancy between the two is much higher. Moreover, the IET's estimations for 2006 are compatible with the estimations of the RF Ministry of Finance, judging by which the year 2006 saw a certain improvement of the federal budget's balance cleared of the oil-and-gas balance (in % of GDP).

*Table 13*

#### **The value of the oil-and-gas balance of the RF federal budget cleared of the oil-and-gas balance (in % of GDP)**

	2002	2003	2004	2005	2006
Balance of RF consolidated budget, in % of GDP	1.0	1.4	4.5	7.7	8.0
Balance of RF federal budget, in % of GDP	1.4	1.7	4.3	7.4	7.5
Balance of RF federal budget less oil and gas balance, in % of GDP (IMF's estimation)	-5.2	-4.6	-4.3	-5.9	-7.4
Balance of RF federal budget less oil and gas balance, in % of GDP (IET's estimation)	-	-	-	-5.5%	-5.1

The estimations cited here demonstrate that when the situational component of the budgetary system's revenue is eliminated it can be seen that in the last 5 years expenditure has been markedly higher than revenue. It is obvious that the revenue from the oil and gas sector in the state budget cannot be disregarded entirely, because the raw materials sector plays a very important role in the national economy; however, these estimations do confirm the timeliness of the proposals as to the necessity for these revenues to become structured and subsequently used in accordance with legislatively established mechanisms.

In addition to the estimation of the consolidated and federal budgets' balance cleared of the oil-and-gas balance, it is necessary to analyze the influence of the international prices on individual budget indices. In particular, the situational (determined by the behavior of international oil prices) and the structural (independent of their behavior) components of tax revenues should be separated. For this purpose, the IET has applied regression-based estimations of the dependence of the main budget items on the oil prices. According to the obtained results, the elasticity of the tax revenues in the federal budget (in % of GDP) relating to the prices of Urals amounted to approximately 0.28, that is, the growth of the international oil price by \$ 1 increases the tax revenues by 0.28 % of GDP. In this connection, the value of the situational component of the tax revenues was determined on the basis of the estimated elasticity and the difference between the actually registered price of Urals and its long-term average price (for the period between 1990 and 2006). The structural component, on the contrary, represents the difference between the actual share in GDP of the tax revenues in the federal budget and the value of the situational component. The estimated values of the structural and situational components of the tax revenues in the federal budget in % of GDP, as well as the actual share of the tax revenue in GDP, are shown in *Table 14*.

As seen from the Table, throughout the period of 1996 – 1999 the situational component of the tax revenues in the federal budget in % of GDP remained negative. Later on, in 2000, there occurred a marked growth of this index from –2.1 % of GDP to 0.5 % of GDP, after which in 2001 and 2002 it once again remained negative due to the fall in oil prices during that period. Since 2002, the improving situation on the international oil market was conducive to a noticeable growth of the situational component which, by the results of 2006, has reached its historic high of the whole period under consideration and amounted to approximately 7.0 % of GDP.

*Table 14*

**The estimated structural and situational components of tax revenues  
in the RF federal budget (in % of GDP)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Actual tax revenues	11.0	10.9	8.8	10.7	13.2	16.2	18.6	18.0	18.8	22.3	22.2
Structural component of tax revenues	12.3	12.7	12.5	12.8	12.7	16.7	18.9	17.4	16.1	15.8	15.2
Situational component of tax revenues	-1.3	-1.8	-3.7	-2.1	0.5	-0.5	-0.3	0.6	2.7	6.5	7.0

### *2.2.5. The main developments in the budget sphere and the changes introduced in tax legislation*

The RF Government in 2006 was paying much attention to the issues of improving tax legislation and tax administration, managing the resources accumulated in the Stabilization Fund and the RF's debt policy, as well as to the forecasting of the parameters of budgeting policy in the short- and medium-term perspective.

First of all, throughout the year 2006 representatives of the Ministry of Finance were voicing proposals concerning the improvement of existing tax legislation, as well as offering comments in respect of the proposals put forth by some members of the government for certain changes to be made to tax legislation. Thus, according to the estimations of the Ministry of Finance, if tax legislation is amended as proposed, in 2007 – 2009 the tax load on the national economy may be decreased to the level of less than 27 % of GDP. In particular, in 2005 the tax load cleared of the influence of oil prices amounted to 27.4 % against 33.6 % in 2001. One group of new provisions concerning taxes came into force during 2006, whereas the rest is to become effective from 1 January 2007. Among the latter is the shortened and simplified procedure for VAT refunds to exporters, the abolition of the restriction of the carry-forward of the tax losses of the past years within the tax base for the profits tax, and the abolition of the provision concerning the determination of the efficiency of results and expenditures relating to research and development. It is also planned that, from 2008 onward, solutions should be provided to a number of problems associated with the taxation levied on the use of objects of aquatic and biological resources.

While discussing some of the proposals concerning the changes in the parameters relating to individual taxes and levies in Russia, the issue of lowering the rate of the single social tax should not be overlooked. Thus, during the year, some proposals were put forth that the rate of SST should be lowered to 13 – 14 %. However, as estimated by the Ministry of Finance, in this case, in order to compensate for the unreceived revenues, the level of wages and salaries in the private sector of the national economy should be increased and become, on the average, in the region of \$ 2,000 – 2,500. Otherwise it would be necessary to look for supplementary sources, by way of compensation for the unreceived revenues. The arguments put forth by the Ministry of Finance are based on the statistics of the revenues received by the budget and off-budget funds and generated by taxes and levies after the rate of SST had been decreased to 26 %, with the expected resulting growth in the volume of legal wages and salaries. However, as seen by the results of 2005, the budget and the Pension Fund incurred losses in the sum of approximately 295 billion roubles as compared to the results that would have been achieved should the rate remain unchanged. According to RF Minister of Finance S. Shatalov, the taxable base increased only slightly. No additional legalization of incomes has been observed so far as a result of a lowered SST rate: on the whole, the volume of shadow remuneration and the use of various tax evasion schemes remained at the same level as before. According to a variety of estimations, approximately 30 –

35 % of the remuneration money in Russia is still changing hands “below the counter”.

During last year, the issue of reforming the value added tax was also the subject of an active discussion. Thus, toward the year’s end, the Ministry of Finance had planned to complete the work relating to the establishment of a special column for the entry of VAT in the order for payment form. Besides, in 2007 a law may be adopted concerning the introduction of a system for registration of VAT payers from the year 2008 onward. The main purpose of such registration will be to relieve many companies – at least small-sized ones – of the responsibility to pay VAT and to register for this purpose. Also, the registration will make it possible to significantly reduce the number of companies with the right to tax deductions. At present, in the RF there exist more than 2 million registered juridical persons, many of whom are formally VAT payers but do not submit any tax reports.

According to the Ministry of Finance, the federal budget’s revenues generated by the value added tax (VAT) will grow, and by 2009 their sum will be equal to approximately 7.8 % of GDP. Thus, the revenues from VAT in 2006 amounted to 5.7 % of GDP, the forecast for 2007 is in the region of 6.6 % of GDP, and that for 2008 is 6.7 % of GDP. The very low rate of growth in the revenues from VAT in 2008 is associated with the fact that the refunds of VAT to exporters will be granted not in the permitting procedure (as it is done now), but in the advising procedure. Besides, in legislation it is envisaged that the tax should be paid on a quarterly basis, instead of the current monthly basis.

At the same time, RF Minister of Finance A. Kudrin said that it was not at all impossible that, from 2009 onward, the rate of VAT might be lowered to 15 % – 16 %, if the federal budget expenditure continued to grow. In other words, it would be possible to take advantage of the potential offered by the reduction in this tax only if the budget expenditure remained relatively stable. Thus, for example, in 2006 the level of the budget’s non-interest expenditures was approximately 15.4 % of GDP, in 2007 it may become 15.5 % of GDP, and in 2008 – 16 %. At the same time, the average level of such expenditures between 2000 and 2005 amounted to approximately 14.7 % of GDP. The Ministry of Finance’s standpoint is that the government must maintain this level and avoid any further increase of expenditures.

By 1 January 2007, the arrears of VAT refunds had been estimated as equal to approximately 140 billion roubles. The goal of the tax agencies is not only to refund the currently paid VAT, but also to provide some additional settlements so that, during 2007, “it (the arrears) could be brought to minimum values”. By comparison, as of 1 January 2006, the volume of arrears against VAT refunds was approximately 197 billion roubles. And this outstanding debt continued to grow, because the prices of commodities and trade turnover were also increasing. On the whole, for the next three years the Ministry of Finance is planning no changes in the rate of VAT, the personal income tax and the profits tax, nor is it planning to bring down the rate of SST, because the budget is bearing a substantial burden of supporting the budgets of off-budget funds.

As for the other taxes, in 2006 the law on the introduction of a reduced rate of the tax on the extraction of mineral resources for nearly exhausted deposits was adopted, the criterion being the exhaustion level of 85 % of reserves. The law also envisages the granting of tax holidays in respect to the tax on the extraction of mineral resources to the newly developed deposits in Eastern Siberia and the continental shelf. At the same time, in the event of prospecting of such deposits, the tax holiday may be extended with due regard for the period of prospecting. Besides, in 2007 no indexation of the excises on oil products is envisaged. However, in 2007 it is planned to levy excises on oil refineries. Previously, excises were levied on sellers and resellers, and not on producers, which resulted in a distorted distribution of revenues between regions. Now the regions receive 10 %, while another 50 % of the collected excises is redistributed through the federal treasuries.

From 1 January 2007, for purposes of excise taxation, the upper margin of the price of tobacco products has been set, on the basis of which the excises are to be calculated. The information concerning this upper margin should be printed on the package of a tobacco product. This has to do primarily with the ad valorem component of the excise on cigarettes. In this connection, according to the estimations made by the Ministry of Finance, it is expected that the average price growth should be no more than 1 rouble in all categories of tobacco products. Moreover, from 2007 onward the rate of excise on tobacco products will be raised by 30 %, and later on, in 2008 – 2009, will be increasing at a rate approximately twice as high as the rate of.

The sufficiently high oil prices throughout 2006 were conducive to further growth in the volume of resources accumulated in the RF Stabilization Fund. In particular, as of 1 January 2007 its size was approximately 2,346.9 billion roubles. A part of the resources of the Stabilization Fund in 2006 was spent on the redemption of the RF government debt. Thus, in early April the RF Government considered the issue of an early repayment of a part of the RF's debt to the Paris Club and put forth its proposals to the Club's representatives. During the negotiations it was decided that the residual debt should be repaid before the end of August. In August the Russian Federation effectuated the relating transfers, which settled the whole sum of debt due to the Paris Club. Therefore, the total savings of the interest payments in the federal budget for the period until 2020 will amount to \$ 12.0 billion.

Besides, in 2006 a number of decisions were made concerning the rules for managing the resources of the RF Stabilization Fund. Thus, in November the Ministry of Finance announced that before 1 December it planned to present the concept of a future generations fund. This will be done within the framework of the Ministry's modeling of Russia's strategy for the use of oil and gas resources and the preparation of the concept of a future generations fund. It is intended that the Stabilization Fund should be divided into two parts, to be invested in securities in accordance with two different strategies. It is these strategies that are going to determine the specific distinctive features of the two parts of the Fund, one earmarked for spending in the event of declining oil prices, while the other is to remain invested in a sufficiently diversified portfolio of securities. As for the list of assets

available for investing in, the RF Ministry of Finance is planning to expand it and to place the Fund's resources accumulated in excess of the reserve part into the less conservative assets. It should be reminded that presently it is allowed for the Fund's resources to be placed only in the securities issued by a number of developed countries with the highest credit ratings as established by the leading rating agencies. At present the Stabilization Fund's resources are deposited with the RF CB: 45 % in USD, 45 % – in euro, and the other 10 % – in UK pounds.

The volume of the investment fund in 2007 may exceed 160 billion roubles, whereas its size for the year 2007 is planned at the level of 95.8 billion roubles, including the saved interest payments resulting from the redemption of the remaining part of the RF's debt to the Paris Club ahead of schedule, the final settlement against which took place in July - August 2006, as well as the the investment fund's resources unspent in 2006 (approximately 59 billion roubles), which will be carried forward to the 2007 investment fund, its total amount being potentially in excess of 160 billion roubles.

During the year, the indexation of salaries in the budget-funded sphere was carried out. Thus, according to the information released by the Ministry of Finance, the indexation of the salaries of the budget-funded employees in 2005 – 2007 will result in their remuneration in real being increased by 1.5 times. In 2007 the salaries of this category of employees will be raised by 15 % from 1 September. The total amount of allocations to this indexation will be approximately 127.8 billion roubles.

Also in 2007, much attention was paid to the issues of social support to the population. In particular, in March the Ministry of Finance responded to the proposals put forth by the RF President in his presidential message to the RF Federal Assembly and aimed at supporting maternity and childhood. As a result, in 2006 a corresponding law was adopted, which came into force from 1 January 2007. According to Minister of Finance A. Kudrin, a total of 30–40 billion roubles per annum will be required for these measures to be sustained. In this connection, for the implementation of all the measures designed to provide additional social support, a certain adjustments will have to be introduced in the three-year financial plan.

And finally, during last year the forecasts of the basic parameters of the RF's debt policy in the period until 2009 were published. According to these data, the total RF government debt from 2007 will begin to grow in nominal terms, while continuing to decline in respect to GDP. As stated by Minister of Finance A. Kudrin, the government commission for budget projecting on the whole has approved the RF's debt policy for the years 2007 – 2009. Thus, the government debt in 2007 will become as high as 2 trillion and 878.9 billion roubles, in 2008 – 3 trillion and 30.1 billion roubles, in 2009 – 3 trillion and 246.4 billion roubles. On the whole, in 2007–2009 the government debt's volume will be increased by 145.1 billion roubles. The forecasted volume of the RF's domestic debt invested in government securities as of the end of 2007 will amount to 1 trillion and 238.7 billion roubles, as of the end of 2008 – to 1 trillion and 445.6 billion roubles, and as of the end of 2009 – to 1 trillion

and 644.2 billion roubles. The total RF government debt in 2007 will be 9.78 % of GDP, in 2008 – 9.16 % of GDP, in 2009 – 8.71 % of GDP.

#### *2.2.6. The 2007 federal budget*

The Law on the 2007 federal budget was developed on the basis of the forecast of the RF's socio-economic development in 2007 prepared by the RF MEDT (see *Table 15*). Within this forecast's framework, two alternative scenarios of the RF national economy's development were considered. The first is inertia-based and reflects the Russian economy's development in a situation of stabilized volumes of hydrocarbon exports, being characterized by a diminishing competitive capacity of domestic product and its substitution with imports, alongside a continuing deterioration of domestic product's competitive capacity in terms of pricing. The forecasted preconditions in this scenario imply a relatively unchangeable situation on the international markets of energy resources – the fall in the price of Urals from \$ 63 per barrel in 2006 to \$ 61 per barrel in 2007. In this case, the growth of exports in terms of value is forecasted to be at the rate of 0.4 %, while oil production growth will be by 1.2 %. Under this scenario, the growth rate of GDP by 2007 should decline to 5.0 %.

The second scenario is oriented to a relative improvement of the competitive capacity of Russian businesses and to the intensification of structural shifts due to the implementation of a set of measures designed to enhance economic growth. Within the framework of the forecast in accordance with this scenario, the behavior of oil prices will be similar to that in the first one, whereas the growth of exports is forecasted to be at the rate of 1.4 %, and GDP growth – at the level of 6.0 %. This scenario is the basic one for the development of the federal budget for 2007 and the prospective financial plan for the period until 2009.

At the same time, for purposes of assessing the realistic value of the main macroeconomic indices for the year 2007, the IET calculated several scenarios of the development of the RF's economy in 2007 on the basis of a structural econometric model of the Russian economy. The exogenous parameters applied in that model were the prices of Brent, the index of investments in fixed assets, the growth rate of the population's incomes in real terms, and the growth rate of money supply  $M_2$ .

Within the framework of the model, three scenarios of the RF economy's development in 2007 were considered. Under the first scenario, the average per annum USD / euro exchange rate was 1.30, the price of Urals – \$ 40 per barrel, the growth rate of money aggregate  $M_2$  – 25 %, the growth rate of investments in fixed assets by the year's results – 10 %. The second scenario is more optimistic and implies a slight decline of oil prices (\$ 50 per barrel). Besides, in accordance with the second scenario, the growth rate of investments in fixed assets is plotted at the level of 12 %, the USD / euro exchange rate by the end of 2007 is to remain at the level of 1.30, and the growth rate of money supply – 30 %. Scenario 3 is the most optimistic of all and implies the preservation of high prices of Urals at the level of \$ 60 per barrel in 2007. Also, in accordance with the third scenario, the growth rate of

investments in fixed assets will be at the level of 13 %, the USD / euro exchange rate by the end of 2007 will remain at the level of 1.30, while the growth rate of money supply will be 35 %

*Table 15*

**Main forecasted indices of the RF's socio – economic development in 2006 and 2007**

	RF MEDT			IET		
	2006	2007		2007		
		Variant I	Variant II	Scenario 1	Scenario 2	Scenario 3
<b>Exogenous factors</b>						
Price of Urals, \$ per barrel	63	61		40	50	60
Oil extraction, million tons	482*	488	492	–	–	–
Gas extraction, million tons	648*	652	654	–	–	–
Oil exports, million tons	255*	261	264	–	–	–
Gas exports, billion m <sup>3</sup>	200*		193	–	–	–
USD / euro exchange rate	1.26		1.29	1.3	1.3	1.3
Growth rate of investments in fixed assets, in %	13.5	7.6**	10.4**	10.0	12.0	13.0
<b>Forecasted values</b>						
GDP growth in real terms, in %	6.7	5.0	6.0	4.5	5.2	5.6
GDP, trillion roubles	26 621.3			29 857	30 388	30 842
Growth rate of CPI, in %	9.0		6.5–8.0	8.2	8.4	8.7
RRb / USD exchange rate, in real terms	27.1		26.5	27.3	27.1	26.8
Exports, \$ billion	304.5	305.7	308.8	284	299	309
Imports, \$ billion	163.9	193.8	199.3	186	190	193
Growth rate of retail turnover, in %	13.0	9.3	10.5	5.1	7.2	9.9
Growth rate of IPI, in %	3.9	2.8	4.2	2.5	3.2	3.8
Growth rate of population money incomes in real terms, in %	10.0	8.2	10.2	5.8	7.1	8.2
Tax revenue of RF consolidated budget, in % of GDP	32.5	–	–	32.4	32.7	32.9

– estimation.

\*\* – in the RF MEDT's forecast this index is not exogenous.

It can be seen that in the IET's model the values of exogenous parameters under Scenario 3 are more compatible with the parameters forecasted by the RF MEDT. At the same time, it is in Scenario 3 that the IET's model yields the forecasted values of socio-economic indices which are close to the parameters taken as the basic ones in developing the budget for the year 2007. The differences under the other two scenarios are more dramatic. The realistic value of the preconditions assumed within the model's framework is confirmed by the forecasted data on the sum of taxes in the RF consolidated budget. Thus, within the framework of the three scenarios, they amount to between 32,4 % and 32.9 % of GDP, against 32.5 % of GDP in the results of 2006. In view of the slowdown in the growth rate of tax revenues against the backdrop of the high growth rate of the national economy as seen by the results of 2006, these differences can be explained quite easily.

In our opinion, the most important shortcoming of the macroeconomic forecast on which the 2007 federal budget is based, especially considering the forecast's time horizon (2007 – 2009), is that the two scenarios differ only slightly. In the final analysis, the slight variations in the forecast's resulting figures display no

qualitatively different features. At the same time, one qualitatively different scenario (crisis-based) is not considered at all. Our estimations have made it possible to obtain sufficiently cautious values relating to the behavior of the RF economy's basic macroeconomic indices both when oil prices are high and when they are low. Thus, in our scenarios a fall in oil prices, in fact, implies that events will be developing according to the worst variant, and the authorities must be prepared to resort to measures designed at least to somewhat softened the negative consequences noted by us. As for the situation of high oil prices, all the scenarios appear rather conservative, indicating the lower margin of the possible variants of the national economy's development.

Now we are going to analyze directly the parameters established by the law on the 2007 federal budget. The sums of revenue of the RF federal budget in 2006 and 2007 are shown in *Table 16*.

*Table 16*

**The basic characteristics of the RF federal budget's revenues  
in 2006 and 2007**

	2006 – approved <sup>22</sup>		2006 – fact		2007 – law	
	million roubles	% of GDP	million roubles	% of GDP	million roubles	% of GDP
<b>Revenue</b>	<b>6 146 277.6</b>	<b>22.6</b>	<b>6 276 298.6</b>	<b>23,6</b>	<b>6 953 317,2</b>	<b>22,3</b>
<i>including:</i>						
tax revenues <sup>23</sup>	5 873 279.5	21.6	5 901 974.6	22.2	6 698 042.8	21.5
non-tax revenues	272 998.1	1.0	374 323.6	1.4	255 274.4	0.8
<b>GDP</b>	<b>27 220 000</b>		<b>26 621 300</b>		<b>31 220 000</b>	

\* – in the 2006 prices.

On the basis of the data presented in *Table 16* it can be concluded that in 2007 the forecasted revenue of the federal budget in absolute terms may be markedly higher than both the indices initially stated in the budget for 2006 and the actually registered values. At the same time, if we take the relative indices (in % of GDP), the revenue of the 2007 budget would become somewhat lower than both the indices approved by the law on the 2006 budget and the values demonstrative of the budget's actual execution (23.6 % of GDP). The decline of the share of revenues in the 2007 budget in % of GDP against the actual budget execution in 2006 can be explained by the changes introduced in the RF tax and budget legislation. However, the resulting decline was partially compensated for by the revision of the basic macroeconomic indices of the RF, as well as by the influence of some other factors.

While taking a look at the main growth factors influencing the forecasted macroeconomic indices of the RF, we should point to the growth of GDP; the changing volumes of imports and exports; the increasing profits of enterprises, the volumes

<sup>22</sup> By Law "On the 2006 Federal Budget" as of 01 December 2006.

<sup>23</sup> Including: (1) the profits and income taxes; (2) the social taxes and contributions; (3) VAT and excises on the commodities sold in the territory of the RF and imported into the territory of the RF; (4) the taxes on aggregate income; (5) property taxes; (6) taxes, levies and regular fees for the use of natural resources; (7) State duty; (8) arrears and settlements in respect of abolished taxes, levies and other mandatory payments; (9) revenues from foreign economic activity.

of production and sale of excisable commodities, the volumes of the extraction of mineral resources and other quantitative parameters; the changing prices of Urals and the export prices of natural gas.

The main innovations in the taxation sphere that influenced the decline in revenues in % of GDP by comparison with the indices of the 2006 budget execution were the switchover from the permitting to the advising procedure for the refunds of VAT being paid to exporters in compensation for their payment of VAT on stock supplies; the diminishment, by taxpayers, of their tax base for the tax on profit of organizations by the amount of losses incurred by them in the previous years; the shortened periods for writing off the costs of research and development against the tax on profit of organizations; and the establishment of a downward coefficient for the rate of the tax on extraction of mineral resources, designed to promote further development of oil deposits at the final stage of exploitation, and the introduction of a zero rate of the tax on extraction of mineral resources for new oil deposits. The partial decline in revenue resulting from changed introduced in tax legislation was compensated for by the changed rates of excises in the RF Tax Code. As for changes in budget legislation, we should note the transfer, to the budgets of RF subjects, of the federal part of the tax on extraction of mineral resources levied on extracted diamonds, and of lumpsum payments for the use of subsoil resources in instances specified in licenses for the use of revenue resources in the RF territory, relating to deposits of natural diamonds.

If we consider the enlarged structure of the 2007 federal budget revenue, we can notice the substantial growth of the budget's tax revenues in absolute terms as compared to the indices established by the Law on the 2007 budget and the indices of its actual execution in 2006. At the same time, it is forecasted that in nominal terms in 2007 the non-tax budget revenues will be somewhat decreased against the 2006 indices. In relative terms (in % of GDP) their behavior was slightly different. Thus, while the share of tax revenues in the 2007 budget must be approximately 21.5 % of GDP against 21.6 % and 22.2 % of GDP, as established by the Law on the 2006 budget and the actual budget execution in 2006, respectively, the share of non-tax budget revenues in the 2007 budget is noticeably lower than the indices established by the Law on the 2006 budget (1.0 % of GDP) and the indices of the actual budget execution (1.4 % of GDP).

The structure of tax revenue in the 2007 federal budget, by main taxed, is shown in *Table 17*.

Judging from the data presented in *Table 17*, it can be concluded that the revenues from all the main taxes, except the tax on the extraction of mineral resources, in 2007, according to the forecast, will grow in nominal terms. However, if we take the relative indices (in % of GDP), their values in respect to many taxes did not changed, or slightly rose by comparison with the values of 2006. This, the highest growth is forecasted for the value added tax (from 5.7 % (by the results of 2006) to 6.6 % GDP). On the contrary, the revenues of the federal budget from foreign economic activity may decline from 8.7 % to 7.9 % of GDP, whereas the revenues from the tax on the extraction of mineral resources – from 4.1 % to 3.3 % of

GDP. The main downward factors may become the lower rate of oil production, as well as the stabilization of oil prices on the international market, which directly determine the rate of the tax on extraction of mineral resources and the exports duty levied on oil.

Table 17

**The structure of tax revenues in the federal budget  
in 2006 and 2007 (in % of GDP)**

Tax	2006 Law		Actual budget execution in 2006		2007 Law	
	million roubles	% of GDP	million roubles	% of GDP	million roubles	% of GDP
Tax on profit of organizations	485 681.7	1.8	509 914.6	1.9	580 408.8	1.9
SST, transferred to federal budget	310 412.1	1.1	315 839.8	1.2	368 773.9	1.2
VAT	1 534 485.3	5.6	1 510 903.4	5.7	2 071 792.3	6.6
Excises	107 560.9	0.4	110 487.9	0.4	126 683.4	0.4
Revenues from foreign economic activity	2 301 236.5	8.5	2 306 318.7	8.7	2 455 079.8	7.9
Tax on extraction of mineral resources	1 083 188.2	4.0	1 094 319.3	4.1	1 037 739.6	3.3

\* – in the 2006 prices.

Below, see the comparison between the volumes of expenditure in the RF federal budget in 2006 and 2007, presented in *Table 18*.

Table 18

**Basic expenditure parameters of the RF federal budget in 2006 and 2007**

	2006 – law <sup>24</sup>		2006 – fact		2007 – law	
	million roubles	% of GDP	million roubles	% of GDP	million roubles	% of GDP
<b>Expenditure</b>	4 431 076.8	16.3	4 281 329.2	16.1	5 463 479.9	17.5
<i>including:</i>						
fixed as %	171 466.5	0.6	169 058.7	0.6	156 845.3	0.5
not fixed as %	4 259 610.3	15.6	4 112 270.5	15.5	5 306 634.6	17.0

\* – in the 2006 prices.

When comparing the values shown in the table, it can be concluded that the 2007 budget is oriented to a marked increase in the volume of federal budget expenditure in absolute terms both as compared to the 2006 budget law and to the actual budget execution. In respect to GDP the 2007 budget expenditure was also noticeably higher than that established by the 2006 law (16.3 % of GDP) and the indices of budget execution in 2006 (16.1 % of GDP). At the same time, as can be seen from *Table 17*, the aggregate growth of budget expenditure was due exclusively to the increased non-interest expenditures, which rose up to 17.0 % of GDP against the 15.6 % of GDP established by the 2006 budget law, and the 15.5 % of GDP as seen by its actual execution in 2006. One of the main reasons for this noticeable growth in 2007 of the federal budget non-interest expenditures was the response to the Presidential Message to the RF Federal Assembly, where a number of priority directions of state policy in 2007 were determined. In particular, among

<sup>24</sup> By Law "On the 2006 Federal Budget" as of 01 December 2006.

these priorities was the finding of solutions to a whole set of problems in the sphere of social policy, the national economy and interbudgetary relations. Besides, in the 2007 budget expenditure a certain sum was earmarked to the implementation of the Message's provisions aimed at improving Russia's demographic situation.

Now let us look at the structure of expenditure in the 2007 RF federal budget and compare it to the structure of expenditure in 2006 – both as stated in the law on the 2006 budget and with the changes that occurred later (*Table 19*).

*Table 19*

### The structure of federal budget expenditure in 2006 and 2007

	2006		2007			
	law <sup>25</sup> (million roubles)	% of GDP	fact (million roubles)	% of GDP	law (million roubles)	% of GDP
General state issues <i>of these, servicing of state and municipal debts</i>	623 208.39	2.3	529 666.7	2.0	808 196.48	2.6
National defense	686 148.28	2.5	681 802.9	2.6	822 035.93	2.6
National security and law- enforcement activity	556 337.12	2.0	550 232.5	2.1	662 867.23	2.1
National economy	358 628.27	1.3	345 015.0	1.3	497 229.53	1.6
Housing and utilities system	54 336.28	0.2	52 697.3	0.2	53 024.46	0.2
Environment protection	6 816.09	0.0	6 642.0	0.02	8 096.53	0.0
Education	211 976.79	0.8	212 371.3	0.8	277 939.33	0.9
Culture, cinematography and mass media	55 834.65	0.2	55 219.7	0.2	67 804.67	0.2
Public health care and sports	160 347.54	0.6	147 525.0	0.6	206 373.53	0.7
Social policy	216 506.39	0.8	201 243.3	0.8	215 565.76	0.7
Interbudgetary transfers	1 500 937.01	5.5	1 498 913	5.6	1 844 346.45	5.9
<b>Total expenditures</b>	<b>4 431 076.81</b>	<b>16.3</b>	<b>4 281 329.2</b>	<b>16.1</b>	<b>5 463 479.90</b>	<b>17.5</b>

\* – in the 2006 prices.

If budget expenditure is analyzed by item of the functional classification, on the whole the structure of expenditure in the 2007 budget is comparable both with the structure established by the law on the 2006 budget and with the actual execution of that budget as shown by the results of 2006. The most noticeable changes in the volume of expenditure occurred in the following items and subitems of the budgetary classification: "General state issues" (growth from 2 % to 2.6 % of GDP), "National economy" (growth from 1.3 % to 1.6 % of GDP), "Interbudgetary transfers" (growth from 5.6 % to 5.9 % of GDP). As for the other items and subitems, the differences displayed by the relative indices (in % of GDP) were found to be less pronounced. The main items of expenditure in the 2007 budget, as before, are interbudgetary transfers, general state issues, national defense, national security and law-enforcement activity, and national economy. The aggregate share of these items of expenditure is 14.8 % of GDP against the 13.6 % as demonstrated by the results of budget execution in 2006. Thus, the aggregate value of the main items

<sup>25</sup> By Law "On the 2006 Federal Budget" as of 1 December 2006.

and subitems of budget expenditure as a percentage of GDP in 2007 markedly rose on the previous year.

Table 20

**Federal budget surplus and the sources of financing for ederal budget deficit in 2006 and 2007**

	2006 – law <sup>26</sup>		2006 – fact		2007 – law	
	million roubles	% of GDP	million roubles	% of GDP	million roubles	% of GDP
Deficit (-) / surplus (+) of federal budget	1 739 407.8	6.4	1 825 910.3	7.5	1 501 837.3	4.8

\* – in the 2006 prices.

The decline of revenue in the 2007 federal budget, coupled with a market growth of expenditure, resulted in a significant fall in federal budget surplus (*Table 20*). Thus, while the law on the 2006 budget stated that it was 6.4 % of GDP, and by the year's end it went up to 7.5 % of GDP, in accordance with the law on the 2007 budget it may amount to approximately 4.8 % of GDP.

As for the structure of the sources for domestic financing of federal budget deficit, in 2007 it planned than, through the placement of government securities, the sum of 293,633.3 million roubles should be attracted, while the redemption of government securities will amount to 80,109.7 million roubles. Thus, the net balance of resources attracted on the domestic market will amount in 2007 to approximately 213,523.6 million roubles. The 2007 budget contains revenues from the sale of state-owned and municipal property in the amount of 49,000 million roubles, as well as resources specially earmarked to a potential fulfillment of RF government guarantees in the amount of 3,649.4 million roubles.

If the structure of the sources for external financing is analyzed, it can be seen that in 2007 no placement of government securities denominated in foreign currencies is planned. Besides, among the external financing sources in 2007, no tied loans granted by foreign governments or international financial organizations are listed. At the same time, the planned volume of attracted tied loans from foreign governments and international financial organizations 2007 is at the level of \$ 763.6 million (20,251.6 million roubles), which is by \$ 349.2 million (or by 11,576.6 million roubles) less than that of 2006. The planning of the use of tied loans was compatible with the main directions of the RF's debt policy established for the current and the next years, which envisaged that no credits from foreign states should be attracted in the future, as well as with the prospective financial plan for the years 2007 – 2009. The current policy will make it possible to round up the use of tied loans as early as 2007 (that is, two years earlier than the initially established timeline).

Also in 2007 it is expected that the volumes of repayments against external debt will be decreased, which has become possible due to the large-scale redemption of Russia's government debt, at the expense of the RF Stabilization Fund, in the amount of \$ 44 billion during the period of 2005 – 2006. In 2007 it is planned to

<sup>26</sup> By Law "On the 2006 Federal Budget" as of 01 December 2006.

earmark to the redemption of the RF's foreign debt the sum of approximately \$ 6,850.3 million (or 181,670.6 million roubles). In this connection, more than 47 % of this sum will be spent on the payments against old government securities denominated in foreign currencies. It is also planned that in 2007 a eurobond loan in the amount of \$ 2.4 billion (or 63,648.0 million roubles) will be redeemed, along with an increased volume of redemption against RF eurobonds with maturities in 2010 and 2030. Besides, certain resources are earmarked in the budget to the potential fulfillment of guarantees in support of the export of industrial products from the RF in the amount of \$ 158.3 million (or 4,198.1 million roubles). Thus, the government continues its course toward the expansion of its domestic debt and reduction of its foreign debt in circulation.

On the whole, the law on the 2007 federal budget can be characterized as being rather conservative, because no significant changes in its structure of revenue and expenditure are planned. At the same time, by comparison with the 2006 budget, one can observe the stabilization of revenue, coupled with a marked growth of non-interest expenditures. Any further pursuance of the policy aimed at increasing such expenditures at a rate higher than that of GDP growth may result in an additional inflation pressure, which will make even more difficult the implementation, by the RF Central Bank, of measures designed to maintain the rate of price growth within the planned margins. Besides, the stabilization of the situation on the international raw materials markets, alongside with the changes introduced in the tax and budgetary sphere, may play down the risks associated with the reduction in the amount of the situational share of revenue and losses of tax revenues in the budget. It also should be noted that the volume of federal budget revenue as stated in the budget (both in % of GDP and in nominal terms) is close to the estimated values yielded by the medium-term macroeconomic structural model of the Russian economy developed at the IET.

### **2.3. Forecast Models of the RF Economic Development and Restrictions in Economic Policy over a Medium-Term Prospective**

If one compares the situation, when for several years the international markets have been demonstrating high prices for oil and other energy carriers as opposed to the situation, when the oil prices are low, it will be noted that one of the main distinctive features characterizing the external conditions for implementing monetary, credit and exchange rate policies will be characterized by differences in the balances of payments and the equilibrium values of real exchange rate (that is, equilibrium from the point of view of balance of payments).

During the period of high prices for energy sources, an extensive capital inflow, based on high export revenues, results in strengthening of nominal exchange rate, growth of import and reduction of export. In other words, oil prices growth and surplus of trade balance contribute to strengthening of the real exchange rate, contributing to equilibrium of trade balance. Dynamics of capital flow balance also supports the above statements, and as a result, the real exchange rate is strength-

ened either due to domestic prices growth (under stable exchange rate), or stabilization of exchange rate. Herewith, in case of an upward breakthrough of external market, a higher value of equilibrium of real exchange rate versus the current rate is established and vice versa, a lower equilibrium value occurs under the external market downfall<sup>27</sup>.

In our opinion, despite a seeming symmetry of situations, characterized by a decline or growth of oil prices, with regard to inflation and exchange rate fluctuations for population and their impact over economic growth, monetary and credit policy trends should be significantly different in the above situations.

Basing on certain assumptions<sup>28</sup>, one can demonstrate that in the situation, when the energy sources prices in the external market are high, the most effective policy for Russia would be moderate (restrained) rates of rouble exchange policy in real terms with rather low inflation. In fact, this is a policy of one-way inflation targeting (with regard to restricted volume of foreign currency inflow and growing reserves with nominal exchange rate kept up at the same level), i.e., maintaining the upper limit of yearly growth rates of prices preferably decreasing from year to year). The RF Central Bank policy in the external market depends on its capacity for sterilization of emission, resulting from maintaining the stable nominal exchange rate to ensure required real rouble rate growth in the situation of effective inflation. In the situation of downgrading energy sources prices, the effective measure of monetary and credit policy would be gradual, but rather fast decrease of nominal rouble rate to the values, ensuring the equilibrium balance of current account operations.

The situations with both, high and low prices for energy sources were observed within the past decades in the world market. High prices, noted in the late 1970-s and the beginning of 1980-s served for the stabilization of socialist regime, while an explicit downfall of the world prices in 1985–1988-s was a major factor of budget crisis, which has caused the breakdown of the Soviet Union<sup>29</sup>. A similar downfall of the world prices for energy sources played a significant role in development of financial crisis of 1998 in Russia.

A case study of the 1998 financial crisis can be reviewed as an example of unfavorable prices for energy sources in the external market.

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<sup>27</sup> Basing on zero volatility of capital flows balance and exports from Russia at the real exchange rate and imports volatility with the real exchange rate accounting to 0.8–0.9, one can assess the rate, at which import will reach the volume, enough to cover the excessive foreign currency supply in the market (matching accumulated external reserves). Those simple assumptions help to define, that the nominal exchange rate to maintain the equilibrium trade balance (in case of a single rouble revaluation) made RUR 16–18 for USD 1 as of the end of 2006.

<sup>28</sup> See for ref.: Clark P.B., Logue D.E., Sweeney R.J. (1977). *The Effects of Exchange Rate Adjustments*. Washington, D.C.: U.S.; Morley S.A. (1992). *On the Effect of Devaluation During Stabilization Programs in LDCs // The Review of Economics and Statistics*. Vol. 74. Issue 1 (Feb., 1992). P. 21–27 etc.

<sup>29</sup> For detail of the financial and budget crisis mechanism in the USSR at the end of 1980s, see “The Empire Breakdown. Lessons for Modern Russia”, E.T. Gaydar. – M.: ROSSPEN, 2006.

The basic grounds for financial crisis, happened in summer 1998, can be categorized as fundamental factors and external shocks<sup>30</sup>. The fundamental factors that caused the crisis were created by the national policy of financial stabilization, pursued by the country, characterized by rigid monetary and soft budgetary measures. Quasi-fixed exchange rate of foreign currency under conditions of high inflation brought up the growth of real rouble rate, extended imports and deterioration of balance of payments. High level of budget deficit (5–8 per cent of GDP in 1995–1998) caused the high rates of government debt growth. By the year of 1998 the total debt burden accounted to nearly 50 per cent of GDP. That indicator is not so high as it is, but the domestic debt was made in the form of short-term “GKO” (state treasury bills), and the amount required monthly only for redemption of the issued GKO, have reached 10–15 per cent of monthly GDP by the first half-year of 1998.

The situation was aggravated by the external shocks: downgrading of the world market prices for energy sources, outflow of short-term capital investments from the financial markets of developing countries and transition economies, which made the financial crisis inevitable<sup>31</sup>. The crisis, which has reached its peak in August 1998, was characterized by the stock market downfall, banks’ collapse and deficiency of external resources. Measures were taken on introduction of a flexible rouble exchange rate, three-month moratorium on redemption of the Russian banks’ external debts and mandatory restructuring of GKO-OFZ liabilities. Three-fold rouble devaluation took place, and inflation rate jumped up to nearly 40 per cent in September 1998.

The government, headed by the Prime Minister Mr. E. Primakov, despite populist approaches, was pursuing a restrained monetary and credit policy, which allowed to stabilize the situation by the end of the year. A vast-scale rouble devaluation, which brought up the national currency exchange rate to the level of 1994, has ensured equilibrium of external trade balance and served as a basic factor of economic growth, started at the end of 1998. Nevertheless, reviewing the background of transfer to the economic growth in Russia, one should not forget the successful developments, achieved by 1997 in the sphere of financial institutions: liberalization of economy, privatization, monetary and budget stabilization and finalization of economic stagnation of transitional decay<sup>32</sup>. An important role played also the commenced growth of oil prices in the world market.

Rouble devaluation acted as a measure of social support to the domestic producers, which has reduced the competition of the imported goods and stimulated

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<sup>30</sup> Economy of Transitional Period. Outline of Economic Policy in Post-Communist Russia. 1998–2002. – M.: Delo, 2003, PP. 29–86.

<sup>31</sup> Materials of Scientific Conference “Financial Crisis: Background and Consequences”. – Series “Research Works”, No. 18P. – M.: IET, 2000.

<sup>32</sup> Economy of Transitional Period. Outline of Economic Policy in Post-Communist Russia 1998–2002. – M.: Delo, 2003, PP. 114–128; R. Entov, O. Lugovoy, E. Astafyeva, V. Bessonov, I. Vosko-boynikov, M. Turuntseva, D. Nekipelov “Factors of Economic Growth of the Russian Economy” – Series “Research Works”, No. 70P, M.: IET, 2004.

national production<sup>33</sup>. All other conditions being equal, devaluation has increased relative price of imported goods, shifting the economy to the equilibrium balance, characterized by lower welfare level with a reduced share of imported goods in the total consumption volume. The aggregate effect of lower consumption level for domestic and imported goods in the background of relative prices dynamics was formed under the influence of import restructuring and income factors (together with income dynamics, based on the changes in the structure of relative prices, a noticeable impact on the demand was provided by reduction of income, caused by the crisis).

The effect of restructuring significantly differed as per economic sectors, depending on volatility of consumption, preference in favor of imported goods, capacity for prompt regulation of import volume and extension of domestic production. One can assume that rouble devaluation in 1998 caused a transfer to consumption of competitive domestic goods (with no return to preference of imported commodities), which was kept up in the consequent years in the background of rouble strengthening in real terms. Russian economy, with its technologies and labor sources, was capable to produce a wide assortment of goods, the demand for which was almost totally covered by import. One should note, that against a considerable share of natural resources in the total export volume and favorable situation in the external market, the real exchange rate provides an insignificant impact on the exports, and restructuring is observed primarily in the domestic market. The experience of the 1998<sup>th</sup> has demonstrated that an intensive import consumption restructuring was taking place in the background of a sharp downfall of real exchange rate.

Therefore, basing on the Russian experience of economic development after the financial crisis of 1998, we come to conclusion, that in the conditions of aggravated external market situation, the reaction of financial authorities should be different from the policy, pursued in favorable market conditions. Herewith we will demonstrate, that under favorable trading conditions there is no reason to use the nominal exchange rate for trading balance compensation., firstly, due to desirability to maintain a decreased real exchange rate, and secondly, to avoid excessive reaction of the nominal exchange rate to the external shocks.

In line with the analysis of the effect of import restructuring, the assessment of exchange rate upward/downward trends should take into account, that those trends have other consequences, including import restructuring due to the changes in relative prices and real income of consumers, variable rates of external debt services, different export revenues, changes in the bank interest rates, depending on the currency of deposits, etc. Among basic negative impacts of national currency devaluation one should mention accelerated inflation, caused by higher prices for imported goods, lower level of welfare of the individuals, who

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<sup>33</sup> O. Dynnikova. "Macroeconomic Perspective of Rouble Strengthening and Foreign Currency Policy // Instruments of Macroeconomic Policy for Russia" – M, 2000; O. Dynnikova "Is a Weak Ruble a Key Factor of Economic Growth? // Banking Business. – 2002. No. 1. P. Kadochnikov, S. Sinelnikov-Murylev, S. Chetverikov "Imports Restructuring in the Russian Federation in 1998–2002", M., 2003.

keep their savings in national currency; pessimistic expectations of further rouble exchange rate downgrading on the part of both, domestic and external investors, which might provoke extended demand for foreign currency and capital outflow from the country.

Moreover, one should take into regard that devaluation could be blocked by political measures, taken by high-rank officials, whose career is brought up at risk in that situation. Whereas in the period of financial crisis the state of external reserves could not restrain a transfer to the floating currency rate, in the situation of considerable currency reserves, accumulated during favorable external market conditions, financial authorities can for some time maintain (or prevent from downfall) the nominal exchange rate of national currency. Nevertheless, it should be pointed out, that vast-scale sales of foreign currency, arranged by the Central Bank (for the purpose of gradual devaluation or maintenance of stable rate of national currency, rather than an abrupt downfall), leads to reduction of the monetary base, followed by relevant depression tendencies in the economy, caused by the monetary supply deficiency, and to the crisis of financial system in general.

In view of the above considerations, one can come to conclusion that in unfavorable conditions of external trade a reasonable policy would be an accelerated downgrading of rouble nominal exchange rate (with due regard to political restrictions and a "margin", serving as a reserve for its growth under the conditions of further cyclic growth of prices for energy carriers. Political feasibility of such model can be ensured by gradual and predictable rate of devaluation (in case that rate is denounced in advance) with the help of foreign currency interventions, made by the Central Bank to support the rouble rate, gradually decreased in the course of time.

The situation with high energy sources prices is observed currently in the Russian market, where there is a tendency to rouble strengthening, which can be beneficial to equilibrium of payment balance. However, the Central Bank is restraining this process with the help of foreign currency interventions, increasing foreign currency reserves and money supply as a result. Whereas there are no effective mechanisms of sterilization of interventions, implemented by the Central Bank, the inflation is restraining the process of rouble strengthening in real terms.

Equilibrium of current account operations could have been reached by strengthening of nominal rouble rate in case the Central Bank would have canceled or reduced the interventions to the amount, insufficient for maintenance of a stable nominal exchange rate. The above options of the simple model of equilibrium of current account operations provide similar results in the background of dynamics of exchange rate in real terms, though detailed analysis reveals a noticeable difference between those options.

In case the nominal exchange rate is used as an instrument of adaptation to the new economic situation, is hindered by the excessive reaction of exchange rate to external changes, as well as potential negative pressure on rouble rate on the

part of external participants of foreign currency market<sup>34</sup>. As a result, in the background of floating RUR exchange rate dynamics of the external trade markets can lead to immediate drastic changes in relative prices and competitive capacity of domestic producers, exceeding the values, required for equilibrium.

If the Central Bank restrains the nominal exchange rate volatility with the help of foreign currency interventions, the trend of real exchange rate to shift to equilibrium can be implemented gradually. In this case high competitive potential of economy involves high growth rates in the periods, when the real exchange rate is getting close to equilibrium. As a result, one can expect that when the real exchange rate comes up to equilibrium value, the economy will reach the peak level (in terms of GDP share per capita). In its turn, it will form an additional demand for transactions with real cash balances, resulting in the background of low inflation to the reduced equilibrium of real exchange rate, than in case of immediate nominal devaluation.

Considering the option of restraining the nominal exchange rate and strengthening of real exchange rate (with regard to inflation) as the most reasonable one, we proceed from the assumption that currently the reduced RUR real exchange rate makes for sustainable economic growth, as compared with the value, ensuring the trade balance equilibrium. Under conditions of pronounced strengthening and maintenance of national currency rate, the majority of businesses, not involved in highly-effective resource exports (under current business indicators), might become uncompetitive. As a result, the economy will be specialized in mineral resources extraction and primary processing (similar processes were observed in Netherlands upon discovery of Slokhteren natural gas deposits in 1960s). The policy, which does not provide countermeasures against displacement of domestic production, processing industries, agriculture and other sectors, when rapid price growth in the sector of non-trading production is happening, can not be regarded as reasonable on in the conditions of high volatility of the world markets of natural resources and limited economic resources thereof.

The necessity to pursue a restrained budget policy in the background of favorable external market situation is commonly recognized in both, highly industrialized and developing countries. Thus, within 2002–2005, in such countries as Algeria, Azerbaijan, Bahrein, Iran, Kazakstan, Kuwait, Libya, Oman, Catarrh, Saudi Arabia, United Arab Emirates the share of government oil revenues in the total to non-oil GDP has grown from 41 per cent to 81 per cent by average. At the same time, government expenditures have been raised from 56 per cent of non-oil GDP

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<sup>34</sup> The “marginal” effect in R. Dornbusch’s basic model (under conditions of open economy, in the absence of necessary flexibility of prices in the short-term prospect) is associated with the established equilibrium in the monetary market, while the interest rate is being changed, due to the inflow/outflow of capital, which affects the nominal rate, results in the external equilibrium in the changed competitiveness of economy. Herewith, the rate has an excessive trend at the beginning of the process, but in view of further income changes the exchange rate rolls back. As a result, a new equilibrium value is established, equal to the previous one in real terms. Ref.: Dornbusch, R., Expectations and Exchange Rate Dynamics, *The Journal of Political Economy*, Vol. 84, No. 6. (Dec., 1976), pp. 1161–1176.

to 63 per cent. On average, only 26 per cent of surplus revenues were addressed to the current needs, 74 per cent were reserved (45 per cent were spent for acquisition of financial assets, 29 per cent – for recovery of external debts). As a result, the budget surplus has grown in those countries from 2 per cent of GDP in 2002 to nearly 15.5 per cent in 2005 on average<sup>35</sup>.

The growth of non-interest budget expenditures in the conditions of extremely favorable external market situation for the Russian export creates a threat of serious socio-political disturbances in case of oil prices decline. Understanding of this threat has brought Russia to creation of Stabilization Fund (starting from the budget year of 2004), serving as a mechanism of restriction of budget expenditures excessive growth in the periods of high world prices for energy sources. The assessment of budget expenditure portion was made on the assumption that the budget revenues will be equal to the level of an average long-term level of oil prices (USD 18–20 per barrel for URALS). In this case LUKOIL surplus budget expenditures are regarded as temporary ones, caused by favorable external market situation, and are addressed to the Stabilization Fund. The assets of the Fund can be used for compensation of reduced tax proceeds of the federal budget under conditions of downfall of oil prices and for financing of non-interest expenditures and external debt redemption in the periods of peak pressure of the debt burden on the budget.

Until current time the Russian government was pursuing the policy of strengthening the stabilization of the budget system and would not accept the offers for expansion of non-interest expenditures in the situation of revenues growth. However, it looks that extremely favorable external market situation is maintained for a too long period, creating an illusion of further maintenance of high oil prices and high budget revenues in the long-term prospective.

However, an analysis of oil prices within the preceding 20 years shows that those prices are rather unstable, and there is no expressed trend of one-way dynamics. The statistical analysis of oil prices within a certain period of time demonstrates their instability, and mathematical estimates (average values) and dispersion (deviation from average values) of oil prices are being changed with time. Sustained oil prices at the level exceeding an average long-term values for quite a long time (about four years) is supporting the theory of strengthening the volatility of prices from year to year. As one can see from the experience, the prices for energy sources tend to decrease, whereas the financial agents come to understanding that the high level of prices is set up for a long term, and basing on that idea, they review their investment plans, addressing extra resources to extended extraction of energy sources and energy saving policy.

In such situation one can expect in future a dramatic and long-term downgrading of oil prices (at least USD 15 per barrel in stable dollars). Lower prices are hardly reachable in the nearest 5–10 years due to the growing demand for oil and oil products on the part of China and India). Apparently, the federal budget revenues will be reduced in the background of oil prices downgrading, Russian oil

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<sup>35</sup> Regional economic outlook. September 2005, IMF, pp. 19–20.

fields exhaustion and higher costs for oil extraction from the new and hardly accessible oil wells.

Despite the forecasts of international centers for oil market investigations, which do not expect a drastic downfall of oil prices, one can not completely ignore such a possibility. An extra threat to the stability in the budget sphere and in socio-economic situation in general is added by an opportunity of price downfall at the end of 2007–2008, coinciding in time with the new political and economic development cycle in the RF. It is evident, that in the pre-election period the Russian government will not be able to cut down the non-interest expenditures, increased in the period of high oil prices. Under those circumstances Russia can again find itself in the situation of an acute budget crisis (which might be delayed due to quickly growing government debt)<sup>36</sup>.

Besides a retreat from the principle of “average long-term price” in formation of federal budget expenditure part, i.e., a violation of one of the conditions of the federal budget stability in the situation, when the budget revenues are highly dependant on oil prices volatility, the negative impact of expansion of non-interest budget expenditures is an accelerated inflation and growth of RUR exchange rate in the background of low sterilization. The second basic task of Stabilization Fund is to prevent those processes. IET assessments confirm that return of the assets, deposited at the Bank of Russia on government accounts, to the economy, will lead to excessive growth of monetary base and later on – to multiplier growth and inflation acceleration due to enlarged volume of uncommitted funds at the banks. Apart from evident social consequences, expansion of inflation will negatively affect the rates of economic growth in general through the accelerated process of RUR exchange rate strengthening in real terms and tougher competition with imports.

Therefore, basing on the assumption of necessity to maintain the low RUR rate in real terms in the conditions of surplus balance of external trade, the policy, pursued by the RF Central Bank and the Ministry of Finance, is basically rather sound. Nevertheless, due to the extremely high prices for energy sources, sustained within the past two years, financial authorities experience the lack of instruments for sterilization of excessive money supply, resulting from Central Bank interventions of foreign currency<sup>37</sup>. As a result, the inflation, which has not come down lower than 9–10 per cent within recent years, brings forward accelerated RUR strengthening by 8–10 per cent per year.

Coping the inertial inflation and formation of counter-inflation expectations are the key measures for inflation reduction. The international experience shows that reduction of inflation expectations is a slow process. The actions of monetary

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<sup>36</sup> As per IET assessments, downgrading of the world oil prices to the level of an average long-term level of USD 20 per barrel will result in the budget deficit in the amount of 4.5–5.0 per cent of GDP. Stabilization Fund of the Russian Federation will be completely expired within 3–4 years (in case of expenditures maintained at the level of 2006).

<sup>37</sup> Ref. P. Kadochnikov “External Factors of Monetary and Credit policy in the RF” – “Research Works” Series, No. 49P. – M.: IET, 2002; S. Drobyshevsky, P. Trunin. Correlation of Capital Flows and Basic Macroeconomic Indicators in the Russian Federation. – IET Research Works, No. 94P. – M.: IET, 2006.

and credit authorities provide an impact over the financial agents' behavior only after a long-term lag (up to 1 year).

The absence of negative reaction on the part of the RF government and Central Bank (adherence to moderately strict monetary and credit policy, avoidance of extra budget expenditures, maintenance of stability in foreign currency market and banking sector, restricted growth rates in regard to prices and tariffs) can ensure inflation reduction by 1 p.p. per year.

The growth of monetary supply ensures a comparable share of total price growth in line with the inertial inflation. Despite active sterilization measures, taken by the RF government and Central Bank, within the past two years the average yearly growth rates of money supply  $M_2$  made 35–40 per cent, GDP in monetary terms has grown from 15.8 per cent (as of end of 2000) to 28.0 per cent (as of end of 2005).

Reduction of price growth flexibility in regard to money supply growth restricts attainable level of inflation downgrading with the help of tightening of monetary and credit policy. However, extended monetary supply can provoke an outburst of consumer prices, i.e., in the background of inflation upswing its flexibility versus money supply growth will be considerably higher.

As per our estimates, under conditions of yearly monetary supply growth decrease at the rate of 20–25 per cent, which will maintain and strengthen the trend to GDP monetization, required to support high economic growth rates, the current inflation level can be reduced by 1.5–2 p.p. per year within 2–3 years.

Sterilization of excessive monetary supply in Russia is achieved by several instruments: surplus of the extended government budget (accumulated assets at the accounts of government bodies and Stabilization Fund), accumulated reserve fund of commercial banks with Central Bank<sup>38</sup> and securities of the Bank of Russia.

In monetary policy one should take into account, that sterilized interventions, though have no immediate impact over the monetary base and inflation, do have an influence<sup>39</sup>, first of all, on a higher growth of RUR assets (versus foreign currency funds) and its impact on interest rates and capital inflow. Moreover, even sterilized interventions, means of their implementation, their time frames and volumes serve as indicators of current priorities of monetary and credit policy to the market participants, who can also affect the interest rates and market balance.

To cut down the growth of monetary supply under favorable external market situation and transparent Russian economy in general and in view of complete liberalization of financial operations, planned for 2007, in particular, the following measures can be proposed.

Firstly, preservation of Stabilization Fund functions as a basic instrument for sterilization. There should be considered an issue of allocation a section within the

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<sup>38</sup> IET estimates point out, that there is a coordination in dynamics of funds, accumulated at the accounts of government authorities and excessive reserves of commercial banks; i.e., accumulation of commercial banks' reserves is most likely implemented with due account to financial authorities' policy.

<sup>39</sup> Ref. the Survey (*Sarno, Taylor, 2001*).

Fund or formation of a special fund (based on similar principles) to be used for accumulative pension fund for the Russian citizens (in favorable market conditions). When the amount of deductions to Stabilization Fund is being determined, the cut-off price should not be increased, it should be rather decreased to an average yearly value (USD 20 per barrel), as the upgrading of the cut-off price reduces the budget system sustainability and pretty soon will lead to the federal budget deficit, even in case the oil prices are higher than long-term average values.

Secondly, upgrading of interest rates and transfer to the policy of "tight money" are necessary, namely, expansion of variety of instruments for commercial banks' assets involvement with the help of the Bank of Russia securities or increase of interest rates on commercial banks' deposits with the Bank of Russia.

Naturally, in view of additional sterilization of potential capital inflow and monetary supply adjustment for the amount of interest rates to be paid to commercial banks, those measures will complicate the implementation of monetary and credit policy. The correlation between the amount of funds involved and interest rates upgrading can be assessed by analysis of input/output effects of such policy and its benefits in terms of inflation reduction and a slow-down of the process of RUR real exchange rate strengthening<sup>40</sup>.

However, such policy might have a negative impact over credit processes in the real sector, but in favorable external market situation the majority of businesses are capable to finance the investments at their own expense.

Thirdly, some limitations could be introduced in regard to external loans for government companies. That measure looks effective as a supplementary instrument for cutting down an excessive foreign currency supply in the domestic market. Moreover, the growth of those loans might result in an upswing of the future government budget expenditures, if the debts of government companies will have to be recovered from the federal budget.

There are restrictions in the effective sterilization of foreign currency interventions with the help of shares of the Bank of Russia and increased interest rates on the deposits of commercial banks with the Central Bank in the form of practical difficulties of control over the investments made by non-residents, enlarging the volume of foreign currency inflow to the national economy, which is reflected in capital account balance of payments. If non-residents' assets are admitted only through certain banks, placements of the Bank of Russia securities will result in reduction of monetary supply and depend on the volume of excessive capital inflow, which will raise the demand for interventions, made by Central Bank in foreign currency, and hence, the need for sterilization.

Various measures of limitation of foreign capital inflow, transferred to the RF

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<sup>40</sup> The analysis of monetary and credit policy, pursued in USA in 1980s shows, that the high interest rates make for sterilization of excessive money supply, resulting from budget deficit monetization and external credits' involvement, with the help of substantial reserve funds of the banks. Moreover, high interest rate allows to increase the volume of assets in national economy, which firstly, reduces the necessity of emission for recovery of budget deficit, and secondly, raises the demand for money in view of transactions, necessary for the accumulated assets transfer to investments or agents' current expenses.

in view of the interest rate growth (such as supervision of banks activities in involvement of external loans, limited share of external obligations for the banks, a demand for reserve guarantees on short-term foreign investments in the national economy, etc.), get in conflict with the effective policy of financial operations liberalization. Therefore, the above measures are rather restricted.

Apparently, the requirement for higher volumes of guaranteed reserve can not be regarded as an effective instrument of control over monetary supply growth in the nearest future. This is explained by essential differentiation of the Russian banks' financial position in the background of underdeveloped market of inter-bank credits and poor mechanisms of refinancing for commercial banks, implemented by the Central Bank. In such a situation tightening of FMR requirements (Fund of Mandatory Reserves) aggravates the risk of liquidity crisis. Therefore, before wide implementation of FMR standards as instruments of monetary management, measures should be taken for improvement of credit mechanisms for the banks, which are in need for liquidity assets.

Abolishment of a requirement for obligatory repatriation of a part of foreign currency revenue can be considered as an instrument that reduced the demand for sterilization of the Central Bank operations in the foreign currency market. However, the application of that measure depends on the effectiveness of the system of tax control over operations of the national companies, made through their foreign accounts, which is currently far from being perfect.

In general, the common trend of monetary and credit policy in medium-term prospective should apparently become a more distinctive differentiation between the instruments of monetary and credit and fiscal policies. Currently the basic tasks of monetary and credit policy in management of monetary assets are resolved through budget instruments. In the recent years those instruments include as accumulation of surplus in the budgetary sphere and Stabilization Fund, as well as budget expenditures, for instance, expenses for the support (crediting) of various economic sectors.

To estimate quantitative and qualitative results of the above instruments of monetary and credit policy in the situations with high and low oil prices, IET has reviewed seven optional models of the RF economic development in the medium-term prospective (5 years, up to 2011).

The first four models are based on the situation the situation, when oil prices are rather high in the international market within the period under review (no less than USD 45 per barrel<sup>41</sup> for Brent oil).

Model I describes, in fact, an inertial option of economic development in the RF. It is assumed, that upon President's election in 2008 the government will keep the growth of federal budget expenditures within the level of 18.5 per cent of GDP (growth of budget expenses within pre-election period will not exceed 2 p.p. of 2006 GDP). The existing tax system will be sustained, the guidelines of Stabilization Fund accumulation will not be reviewed and the yearly growth rates of prices and tariffs for goods and services, provided by big natural monopolies, will exceed the inflation rate maximum by 2–2.5 p.p. The RF Central Bank will maintain the policy of

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<sup>41</sup> As USD in 2006.

accumulating gold and foreign currency reserves, making for relevant growth of monetary supply, including the funds for the support of high GDP growth rates, as well as restraining the RUR real exchange rate. Therefore, in that model there are no provisions for the trend to nominal RUR strengthening at the expense of gold and foreign currency reserves. We presume, that favorable external market situation and macroeconomic indicators will make for both, direct investments inflow and financial capital to the country. To facilitate estimations, exchange rate for the entire period under review is understood as EURO 1 to USD 1.2–1.30.

The other three models, where high oil prices are regarded, are based on dynamics of certain indicators of Model I, whereas other parameters stay unchanged.

Model II differs from Model I in terms of expanded budget expenditures at the background of sustained high oil prices and budget revenues. For instance, we assume some extension of federal budget expenditures (by 2–2.5 p.p. of GDP i.e., up to 21.0 per cent of GDP by 2009). Therefore, the trend to extended federal budget expenditures under high oil prices is maintained.

Model III presumes achievement of yearly inflation in the amount of 4 per cent by 2011, which allows to estimate the level of required extra volume of sterilization of foreign currency interventions, effected by the bank of Russia.

In 2006 the Central Bank has implemented nominal RUR strengthening versus USD by 8.5 per cent. Model IV regards the version of policy changes on the part of the RF Central Bank, when financial authorities abandon the policy of accumulation of gold and foreign currency reserves and allow nominal RUR strengthening in regard to foreign currencies, resulting in the zero balance of the RF current account.

Models V–VII are based on the situation, when oil prices in the international market get down to the average long-term level (USD 25 per barrel of Brent).

In Model V such a decrease is happening gradually (by 2009), whereas in Model VI and VII an aggressive downfall takes place already in 2007. The basic approaches of economic policy are the same, that are taking place under high oil prices, and the Stabilization Fund is used for replenishment of federal budget deficit. Nevertheless, we presume that a noticeable capital outflow will take place in the course of oil prices downgrading.

Model VI, together with a presumption of oil prices downfall from USD 65 to USD 25 per barrel already in 2007, reviews the policy of the RF Central Bank, which releases the RUR exchange rate, preserving the volume of gold and foreign currency reserves, resulting in the brief RUR denomination.

Model VII presumes an opposite policy: RUR nominal rate maintenance (versus USD for simple computation) and interventions, until gold and foreign currency reserves are totally expired.

It should be noted, that we are using formal mathematic computation for quantitative analysis of economic models, basing on the assumption of reliable and conservative behavior of economic agents to get equilibrium values of variables under given conditions for each model, which is unattainable in practice. This assumption is especially true for the models, applicable under decreasing oil prices.

IET estimates provide rather prudent valuations of basic macroeconomic indicators' dynamics for both situations, under high and low oil prices. In case of low oil prices the situation will be developing in a negative direction, so the financial authorities should be ready to take measures for affordable mitigation the negative consequences, detected in the estimates. Potential models, developed for the situations of high oil prices, are conservative and provide a lower margin of economic development.

Modeling of the RF basic economic indicators dynamics in general, and monetary sphere in particular, was performed on the basis of IET approximation of medium-term socio-economic indicators modeling<sup>42</sup>. The basic parameters were taken from initial estimates of the year 2006 results. Dynamics of macroeconomic indicators by models are given in *Table 21*.

*Table 21*

**Dynamics of Macroeconomic Indicators by Models  
of Economic Development in the RF in 2007–2011**

Optional Model	GDP in real terms % (growth within the period)	Inflation % (2011)	Share of population with the income below minimum living level % (15.8 % in 2006)	Share of monetary income of the first 20%-group of population, % (5.4 % in 2006)	Nominal exchange rate RUR/USD (2011)	Real effective exchange rate, % (growth within the period)	Gold and foreign currency reserves (2011), USD bln	RF Stabilization Fund (% in GDP, 2011)
I	+25–26	6.0	12.1	4.9	29.5–30.5	+34–35	405–415	26
II	+21–21.5	7.0	17.0	5.7	29–30	+39–40	310–320	17
III	+26–27	4.0	11.0	4.8	28.5–29.5	+29–30	440–450	27
IV	+11–12	4.0	15.0	5.2	22–23	+44–45	300	25
V	+5.5–6.5	6.0	16.3	5.4	40–42	–8–9	90–100	0 (2010)
VI	–0.5–1	4.5	16.7	5.4	37–38	–6–7	300	0 (2009)
VII	–3–4	3.0 (2009)	18.3	5.7	27.0	+19–20	0 (2009)	0 (2009)

According to the estimates, under inertial model of the RF economy development (Model I) the aggregate growth of GDP in real terms within 5 years (2007–2011) will make about 25 per cent, with regard to the decrease of yearly GDP in real terms by 3.5 per cent by the end of the period. The reduction is explained by downgrading of cost-effectiveness of oil and gas sector and stabilization of export volumes in the conditions of sustainable structure of natural resource industry. With

<sup>42</sup> Model description in detail is published in the works by M. Turuntseva, A. Yudin, S. Drobyshevsky, P. Kadochnikov, S. Ponomarenko, P. Trunin “Some approaches to economic indicators modeling”, “Research Works”, No.89P, M.: IET, 2005, and some model elements are provided also in the works by S. Drobyshevsky, V. Nosko, R. Entov, A. Yudin “Economic Analysis of Basic Macroeconomic Indicators Dynamic Series” “Research Works” No. 34P, M.: IET, 2001; R. Entov, V. Nosko, A. Yudin, A. Kadochnikov, S. Ponomarenko “Some Macroeconomic Indicators Approximation”, “Research Works” № 46P, M.: IET, 2002.; G. Karasev, S. Chetverikov “Structural Models of RUR Exchange Rates”, No. 88P, M.: IET, 2005.

regard to RUR growth rate in real terms, by 2001 Russia will reach the GDP volume of USD 1.5 trillion (as per current exchange rate).

Despite some decrease of national revenues (approximately to 22.5–23 per cent of GDP) due to a decline of tax rates for the oil sector and general decrease of cost-efficiency level in the economy, there is still a surplus in the federal budget balance (at least 4 per cent). As a result, by the end of 2011 the Stabilization Fund will reach 25–26 per cent of GDP (USD 380–390 bln).

The Central Bank policy in terms of accumulation of gold and foreign currency reserves accumulation and in view of restriction of RUR yearly rates of strengthening with the help of sterilization of foreign currency interventions will result in achievement of the level of gold and foreign currency reserves in the amount of USD 405–415 bln. Within five years the total effective growth of RUR in real terms will make about 35 per cent (+48 per cent versus the pre-crisis period of 1998). Herewith, the nominal RUR rate will make by the end of 2011 about 29.5–30.5 for USD 1.

As a result of that policy, the trading account balance will reach a zero value by 2009–2010, i.e., the growth of gold and foreign currency reserves will be made purely due to capital inflow. Starting from 2010, the growth rates of money supply, though somewhat decreased (to 9–10 per cent in 2010–2011), will stay higher than inflation rates. Monetization will be sustained at the level of 34–35 per cent of GDP. According to our estimates, the inflation can not be reduced in such a situation lower than 6.0 per cent. The aggregate growth of prices within five years will make at least 40 per cent.

Sustained high oil prices, revenue growth in economy in general and real wages in particular, at the background of rather high inflation, as well as RUR strengthening will keep up a trend to stronger differentiation between incomes of population and higher living standards. We presume, that within five years, by 2011, the share of income of the first group of population (20 per cent with the lowest level of income) will be decreased from 5.4 per cent to 4.9 per cent, while the share of population, whose income is beyond the minimum living standard, will be cut down from 15.8 per cent to 12.1 per cent<sup>43</sup>.

Extra budget expenditures (expected in the amount of two per cent points of GDP according to Model II) will negatively affect a number of indicators. Thus, an aggregate GDP growth will not exceed 21.5 per cent, and inflation will be not less than 7.0 per cent within the period under review.

Accordingly, differentiation of income as per population groups will be reduced: the share of income of the first group of population (20 per cent of population with the lowest income) will grow from 5.4 per cent to 5.7 per cent. However, despite the increased budget expenditures, the share of population with the in-

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<sup>43</sup> It is assumed in the framework of the Model, that the minimum living standard is varied in proportion to GDP per capita, though it is generally incorrect. Under conditions of high oil prices and excessive regulated tariffs GDP deflator should be higher than the minimum living standard growth rates. Therefore, our estimates of reduced share of population with minimum income level are rather pessimistic.

come lower than the minimum living standard will be also increased from 15.8 per cent to 17.0 per cent.

Federal budget surplus will be relevantly reduced by 2011 to 1.0 per cent of GDP, the aggregate RUR growth in real terms will reach 39 per cent (+52 per cent versus the pre-crisis period of 1998), the amount of Stabilization Fund will not go beyond 17 per cent of GDP.

Compared with the inertia model, achievement of lower inflation rates by 2011, (up to 4 per cent as per Model III) without budget expansion will require surplus sterilization of monetary supply in the amount of RUR 200 bln per year. That level of sterilization can be reached with the help of Stabilization Fund assets and additional monetary instruments of the Central Bank policy, described above. The aggregate CPI within the five years will not exceed 35 per cent. Herewith, due to slower growth RUR rate in real terms (not over 30 per cent), the aggregate growth of GDP within the five years will be not higher than under Model I.

Like in the first Model, the trend is kept up to stronger differentiation of income by population groups and higher living standard, which will result in increased share of income of the first group population (20 per cent with the lowest income) from 5.4 per cent to 4.8 per cent by 2011 and the share of population with the income lower than the minimum living standard will be increased from 15.8 per cent to 11.0 per cent.

In Model IV, where the nominal RUR strengthening is foreseen, changes in the dynamics of macroeconomic indicators are more expressed. Thus, at the sustained volume of Central Bank reserves at the level of the end of 2006 (approximately USD 300 bln), the nominal RUR rate by the end of 2007 will be strengthened to RUR 18 for USD 1 (by 30–35 per cent within a year), which will result in trading account balance deficit at the turn of 2007–2008. The growth of RUR in real terms within 2007–2011 will make up to 45 per cent (55–60 per cent versus July 1998).

Accordingly, the aggregate growth of the RF GDP in real terms will not exceed 11.5 per cent within five years, and the trading account balance deficit can reach USD 35–40 bln by 2011 (about 15 per cent of exports). At the same time, in view of moderate scale of foreign currency acquisition and monetary emission, the yearly rate of money supply growth will be reduced to 4.5–5 per cent, which will result in reduction of inflation yearly growth rate to nearly 4 per cent per year (not over 35 per cent within five years).

Thereafter, differentiation of income as per population groups will be slowed down: the share of income of the first group of population (20 per cent of population with the lowest income) will get down from 5.4 per cent to 5.2 per cent. However, the share of population with the income lower than the minimum living standard will be stay rather high, not lower than 15.0 per cent.

According to Model IV, the volume of the Stabilization Fund will reach 20–25 per cent of GDP by 2011.

Therefore, the analysis of four Models in the situation with high oil prices brings us to the following conclusions in terms of consequences of alternative measures of economic policy.

Under the terms of inertia Model rather high economic indicators are demonstrated. The rates of real GDP growth are the highest among other models, and in our opinion, the inflation is within reasonable limits. RUR growth rate in real terms results in decreased balance of trading account, but in the background of sustained average growth of GDP there created favorable conditions for external capital inflow and expansion of natural resource sector of the economy.

The Model, where extended budget expenditures are foreseen, demonstrates, in fact, according to the estimates, insignificant differences in macroeconomic indicators from those ones of the basic model. It can be explained by relatively moderate scale of extra expenditures and suspended budget expansion under stabilized oil prices at the level of USD 45 per barrel.. Nevertheless, the estimates evidently demonstrate, that with such scale of downgrading of rigid budget policy the government actions provide negative impact over the economy in general.

Comparative analysis of the two versions of economic policy under high oil prices (which differ by extra sterilization and admitted increase of RUR exchange rate in nominal terms) shows, that the first version is preferable. The level of additional sterilization is not excessive as compared with the inertia model, and in view of additional measures, mentioned above, the sterilization volume could have been even higher. In other words, under this model lower inflation level could be achieved, comparable with the level of the model, where strengthening of RUR exchange rate in nominal terms is foreseen. However, in the fourth model such low inflation level is achieved through downgrading of economic growth rates.

Model V (where gradual decrease of oil prices is considered) outwardly demonstrates the dependence of the RF economy on oil prices. In fact, there is a threat of a crisis, even regardless the drastic qualitative changes in expectations and behavior of economic agents in case of oil prices downfall.

According to the estimates, under such model, when oil prices are getting down, the aggregate growth of real GDP within five years (2007–2011) will make no more than 6 per cent, whereas in 2010–2011 the yearly rates of real GDP growth will be in deficit (up to – 2.0 per cent). In 2011 GDP will not exceed USD 900 bln (as per currently effective exchange rate), i.e., nearly 40 per cent less than in the first model.

Federal budget revenues will be decreased lower than by 14.5 per cent, so that the deficit of the federal budget is expected already by 2008 (under oil prices at the level of USD 30 per barrel). In such a case Stabilization Fund assets will be totally expired by 2010 at the background of federal budget deficit in the amount of at least 4.5 per cent of GDP in 2010–2011.

In the framework of that model we assumed, that the RF Central Bank policy will be restricted to gradual RUR devaluation through foreign currency interventions. It is evident, that such policy is hard to be implemented due to potential attacks at rouble. However, regardless expectations of economic agents, according to the estimates, by the end of 2011 RUR will be devaluated 1.5-fold as compared with 2005 and reach more than RUR 40 per USD 1, which will run the Central Bank

“in the expense” of USD 200 bln of gold and foreign currency reserves (with the balance of gold and foreign currency reserves by the end of 2011, not exceeding USD 110 bln).

Within five years the effective RUR exchange rate in real terms will get down by approximately 8–9 per cent, but due to oil prices decline there will occur a deficit in the trading account balance.

As far as an option of surplus recovery of budget deficit and monetary emission in the economy in the critical situation are not considered in the framework of the model, the growth rates of money supply will practically reach zero, GDP monetization will drop down to 30–31 per cent. Nevertheless, in the background of exchange rate impact on prices, there will be no adequate reduction of inflation rates. The accumulated index of consumer prices within five years will reach nearly 40 per cent, and in 2011 the trend to lower inflation rate will be broken, prices will grow faster than in 2010.

As mentioned before, Model six, where the Central Bank restrains from the control over the exchange rate in the background of oil prices downfall, is rather conventional. Practically, in view of qualitative changes in behavior of market participants and clear political prospects of such events to financial authorities, such situation is hardly possible.

According to our estimates, in the situation of stable position of other market participants, in the background of preset downgrading of prices for energy sources, the yearly decrease of nominal RUR exchange rate versus USD will exceed 25 per cent, within total period under review RUR will be devaluated approximately by 40 per cent, i.e., less than in the model, where gradual oil prices decline is foreseen.

Under the negative impact of the collapse, the rates of GDP growth in real terms will come to negative value already by 2008 and remain at that level within the total period (aggregate GDP decrease will not exceed one per cent within five years), but already in 2011, due to imports restructuring and adaptation of the economy to low oil prices, there will be observed a trend to rehabilitation of GDP growth rates. Remarkably, export surplus balance will be sustained within all those years.

The worst impact of oil prices downfall will be provided on budgetary sphere: Stabilization Fund assets will be expired already by the end of the third year upon prices landslide (in 2009), while the budget deficit will be within 5.0–5.5 per cent of GDP (with no regard to prepositions of reduced expenditures of federal budget, required in that situation).

In that model we do not make assumptions of surplus emission addressed at recovery of the federal budget deficit, and relatively, the rates of money supply growth are lower than in Model five. Rigid monetary and credit policy allows to reduce the impact of the declined exchange rate on the prices, and in 2011 the inflation get down to 4.5 per cent.

In terms of living standard of population, according to our estimates, that model makes for maintenance of the situation to a large extent. Thus, the share of

population of the first group (20 per cent of population with lower income) will stay practically at the same level (about 5.4 per cent) and the share of those, whose income is below the living standard, will be increased up to 16.7 per cent.

An alternative to the policy of nominal devaluation is the policy of keeping up the RUR exchange rate at a fixed level (Model VII). According to the estimates within the framework of that model, gold and foreign currency reserves will be sufficient to keep up the exchange rate for four years, in case the RUR rate is maintained at the level of RUR 27 for USD 1, and by the beginning of 2011 those reserves will be expired. Nevertheless, as mentioned above, quantitative results, obtained for that model, are rather conventional, as in practice the policy of keeping up the fixed RUR rate in the situation of oil prices downfall means, that RUR will be inevitably attacked within the first year, and gold and foreign currency reserves will be expired faster, than is forecasted by the model estimates.

Moreover, the level of living standard decline is also underestimated within the model. According to the model estimates, the share of monetary income of the first group (20 per cent of population with the lowest income) will be somewhat increased from c 5.4 per cent to 5.7 per cent, while the share of those whose income is below the living standard, will grow from 15.8 per cent to 18.3 per cent.

Comparative analysis of the results of three crisis models brings us to the following conclusions in terms of their consequences.

In the situation, when oil prices are getting down, there is no chance to avoid a severe decline of growth rates and stagnation in economy. However, there is a chance for Russia to avoid the crisis, comparable with the situation of the second part of 1998.

The minimum losses for economy will take place, if in case of oil prices downfall the choice is made in favor of policy of nominal RUR devaluation, though political limitations should be taken into regard in implementation of such policy option. Moreover, in this case one can expect a trend to economic growth due to the effect of import restructuring in the background of national currency downgrading, like in the IV quarter of 1998–1999.

Alongside with that, it should be noted that preset conditions for critical situations were rather rigid in terms of time frames. Thus, we were considering the case of low oil prices within three-four years in a row.

There is a low probability for a steep (two-fold) downfall of oil prices within one year. Therefore, the fifth model is most likely in terms of oil prices dynamics, and apparently, economic policy measures will be applied within the framework of that model. Accordingly, releasing of RUR rate by the Bank of Russia under the higher, though declining, oil prices, when the economy is rather sound, reduces impartial difficulties of practical implementation of such policy.

It should be also noted, that the model might overestimate the dependence of Russia on oil prices, as for a number of preceding years an important factor of economic growth were investments, and in the first turn, the model reflects interrelations between the dynamics of natural resources prices and the economic growth of Russia.

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Analysis of various optional models of economic development in Russia in the situations with high and low energy sources prices allows to choose those policy measures, which will ensure the best results in economic development in both situations.

The best policy in the situation with high oil prices is the highest sterilization of Central Bank interventions in foreign currency markets in line with accumulation of gold and foreign currency reserves. The basic disadvantage of such policy is that positive results of its implementation are observed in a long- and medium-term perspective, whereas all difficulties of rigid monetary policy, implemented by financial authorities, are experienced immediately.

The best policy measure in the situation with lower oil prices is RUR devaluation. It is very important to declare at the initial stage of energy sources price decline, before they reach the lowest point, that financial authorities will make no efforts to support the RUR rate at a certain level with the help of gold and foreign currency reserves, regardless any political consequences. This measure will bring potential attacks to RUR to minimum and reduce the crisis impact in the economy.

#### **2.4. Interbudgetary Relations and Subnational Finance**

Last year saw no drastic changes in the system of interbudgetary relations. The structure of tax revenues and tax powers exercised by different tiers of government has remained basically unchanged. At the federal level, there continued to exist channels of financial support to regional budgets, which have been stable over recent years<sup>44</sup>. Against the background of the increasing revenues to the federal budget in real terms, the financial situation of subnational budgets, with account of the federal financial aid, can be characterized as relatively stable.

But the complex of decisions made and/or promulgated in 2005-2006 allows conclusion that Russia continues to progress along the path of formation of the corporate federalism. In the previous review, we have already highlighted peculiarities of such a model: at the federal level, a uniform legislation on all the critical matters is complemented by the administrative and political control over regional administrations, with the federal authorities viewing regions as branches of a single corporation. This is proved by such decisions as considered in the last year's review actual cancellation of elections of regions' heads, the federal center's unilateral decisions on the "monetization of benefits", division of powers and implementation of the so-called "national projects". These tendencies have further intensified in 2006, which can be evidenced by the already passed Act on the 2007 federal budget, which provides for a considerable increase in the proportion of subsidies and subventions in interbudgetary transfers. This proves that the subnational authorities are increasingly assigned the role of "executive executors" of certain measures planned, funded and controlled by the federal center.

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<sup>44</sup> See: Russian Economy. Trends and Outlooks. M., IET (issues 21–27)

### *2.4.1. Evolution of Budgetary Federalism in Russia*

The Russian federalism has advanced in a “pendulum” mode, when the centralized structure of the USSR was substituted by a serious decentralization of the 1990s. However, the latter was in turn again replaced by the prevailing tendency to centralization. Underlying the tendencies to centralism in Russia were several causes:

- 1) First, the institutional environment of the Russian federalism was extremely flexible, or, more precisely, nascent – the Constitution has failed to set a closed list of rights and obligations of the Subjects of the Federation, with a considerable part of critical for the society governmental powers falling under the “joint jurisdiction”. The balance of division of government powers could be easily broken either in favor of a further decentralization (up to the country’s break-up), or towards centralization (up to a de-facto unitary state). The selection of either option was dependent on who, regions or the federal center, would be able to concentrate in his hands financial and state power resources. Other causes for the centralization explain why the shaky equilibrium of the 1990s has been replaced by the current centralization.
- 2) In the conditions of economic crises (those of the early 1990s and in 1998) and an uneven dispersion of production, numerous regions had no sufficient financial resources in hand to exercise the powers granted by the federal center. As a result, the latter acquired additional powers associated with redistribution of resources between regions, most of whom were keen to participate in such a redistribution.
- 3) Many regions pursued incompatible interests; regional authorities have failed to form a joint front with respect to the division of powers and advocacy of their stand before the federal center.
- 4) The need for promoting nationwide reforms and solving nationwide challenges (for instance, repayment of a huge external debt or the need to consolidate the society in the light of the terrorist threat) has helped form the value of the integrity of the political and economic space in the eyes of the society.
- 5) The correlation between the today’s level of decentralization and the state of the respective institutions in the past<sup>45</sup>. In retrospective, all Russia’s institutions and the society on the whole was closely associated with the planned economy and the hypercentralized administrative-and-command decision-making system, which to a significant extent has affected redistribution of the power and financial resources in favor of the federal center.

Thus, Russia has witnessed a gradual rise of a country-specific model of federalism. It displays a unique combination of fundamentals of cooperation and competition with the federal center’s administrative control. On the one hand, regions compete with each other for placement in their territories of the most profitable enterprises, as well as for financial aid from the center and public investment resources. But, on the other hand, the federal center has concentrated in its hands

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<sup>45</sup> Path dependence – Arzaghi M., Henderson J. Why countries are fiscally decentralizing// Journal of Public Economics. Vol. 89, No. 7, 2005 – P. 1186–1188.

key powers and financial resources, and it sets a uniform legislation on all the critical matters and enforces the uniformity of the tax system across the Federation. These are characteristic features of the cooperative federalism of the German type. However, in Germany, subnational governments can maintain a significant influence on the federal center's policies by means of the party system and the *Bundesrath*. In Russia, the nascent party system challenged the federal center with a complex mission of ensuring efficacy of the regional governance by means of administrative methods. Hence, as noted above, the federal center is compelled to regard regions as branches of a single corporation, to formulate strategic objectives for them and evaluate the regional authorities' performance.

#### 2.4.2. Main Trends of Development of Relationships between Budgets of Different Levels

To analyze main trends of 2006 in the area of relationship between budgets of different tiers, let us consider the revenue and expenditure structure of the RF consolidated budget and its evolution over several recent years. *Table 22* below contains data that characterize the proportion of tax revenues and expenditures of budgets of the RF Subjects in the nation's consolidated budget.

*Table 22*

#### **The Proportion of Some Indicators of Budgets of Subjects of the Federation in the Respective Indices of the Consolidated Budget of the Russian Federation in 1992–2006 (as %)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
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	30.9	31.8
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	49.5	43.4

*Source:* the RF Ministry of Finance, the authors' calculation.

The data in the *Table 22* evidence that the trend to centralization of taxes in the federal budget, which had started in 1999, has been somewhat modified in 2006. While between 1999 and 2005 the share of tax revenues to budgets of the RF Subjects in Russia's consolidated budget revenues slid from 56.6% in 1998 to 30.9% in 2005, a year later, in 2006, it posted a 31.8% growth. Meanwhile, the proportion of expenditures of budgets of the RF Subjects in expenditures of the nation's consolidated budget plunged from 49.5% to 43.4%. Such a decline was caused by a faster increase in the federal budget expenditures. Whilst considering the state of tax revenues to consolidated regional budgets in 2005, one can note that, as before, it is revenues from two taxes, that is, personal income tax and corporate profit tax, that account for over a half of the tax revenues (34% and 42% of tax revenues to regional budgets, respectively). In 2006, the share of revenues from these two taxes in tax revenues to regional budgets slightly slid vis-à-vis 2005 – from 80% to 77%, which can be attributed to a slight decline in the share of corporate profit tax. It should be noted that revenues from personal income tax to consolidated budgets of the RF Subjects rose up to 3.5% of GDP (in 2005 – 3.3.%

of GDP), while revenues from corporate profit tax slid to 4.35% of GDP (4.41% in 2005). Excise taxes continued their decline to 0.6% of GDP (vs. 0.7% in 2005), while revenues from payments for the use of natural resources remained on the same level (0.26% of GDP). Small businesses have now found themselves taxed at a greater level (0.36% of GDP vs. 0.33% reported last year), while revenues from property taxes in the shares-of-GDP equivalent remained stable and accounted for 1.17% of GDP.

Given the above, an analysis of the indicator of tax revenues to consolidated budgets of the RF Subjects in per capita terms shows that in 2006 the cross-regional unevenness of this indicator continued to decline. Thus, the respective value of Jini coefficient fell over the year and accounted for 0.48 (vs. 0.57 in 2004 and 0.51 in 2005). The last year's decline in the cross-regional unevenness of per capita tax revenues to consolidated budgets of the RF Subjects occurred mostly because of the fall in the proportion of an unevenly distributed corporate profit tax in the said budgets. Yet another reason behind the fall in the unevenness of this indicator became integration of the data on execution of budgets of Krasnoyarsk krai, Taymyr and Evenk autonomous okrugs. It is also possible to suggest a hypothesis, according to which in the aftermath of an economic crisis the renewal of economic activity starts in a small number of regions (in Russia, those are oil-producing regions and the largest economic centers). As a result, regions began to diverge from each other in terms of various indicators and those of tax revenues in particular. Such a trend was noted in Russia between 1999 and 2004. Expanding across new regions, economic growth leads to a lower unevenness in distribution of tax revenues. Time will show whether the hypothesis is accurate. Presently, it seems too premature to judge its accuracy basing solely on the tax revenue data, as the 2005 reduction in the cross-regional differentiation of per capita tax revenues to consolidated budgets of the RF Subjects was caused mostly by the centralization in the federal budget of unevenly distributed taxes, namely, the mineral tax (9.4% of it in the part of oil and gas condensate) and corporate profit tax (1.5%).

Revenues to the consolidated budgets of the RF Subjects grew by 18% in real terms, with just 7 Subjects reporting their decline in real terms<sup>46</sup>. It should be noted that Novgorod oblast and the Republic of Sakha (Yakutia) have experienced just an insignificant fall in their budget revenues – at 0.66 and 0.67%, accordingly. In most cases, underlying a decline in regional budget revenues is the “abandonment” of a large corporate taxpayer, followed by a fall in revenues from corporate profit tax. Thus, the 2006 revenues from this particular tax slid in real terms vs. the respective indices of 2005 in the following regions: Chukotka AO – at 86%, Republic of Mordovia – 68%, Khanty-Mansy AO – 62%, Omsk oblast – 51%. Interestingly, in 2005 the proportion of corporate profit tax in the budgets of these regions was consid-

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<sup>46</sup> Novgorod oblast, Republic of Mordovia, Republic of Tatarstan, Khanty-Mansy AO, Omsk oblast, the Republic of Sakha (Yakutia), Chukotka AO.

erably greater than the respective average indices reported across the country. As these regions appear so dependent on revenues from corporate profit tax, an “abandonment” of a large taxpayer obviously could not help but trigger a fall in their budgetary revenues.

The maximum increments in tax revenues in absolute terms were reported by the city of Moscow, Saint Petersburg and Krasnoyarsk krai. These regions have displayed a great level of budget sufficiency and reported a great share of corporate profit tax in their 2006 tax revenues structure. For reference, the respective index has slid nationwide from the average 32% in 2005 to 31% in 2006, while the said regions, on the contrary, reported a growth of this index: the city of Moscow: from 44 to 47%, Krasnoyarsk krai – from 35 to 43%, and Saint Petersburg – from 22 to 32% (1.4 times!). However, it was Aginsky Buryatsky AO that posted a record-breaking increment in budgetary receipts per capita in real terms (7.48 times vs. the 2005 level). Such a breathtaking rise in budgetary revenues was caused by the registration in the region of a large corporate taxpayer (in 2006, the local budgetary revenues from corporate profit tax were reported to soar 17.8 times).

As regional budgets appear greatly dependent on corporate profit tax revenues, the situation result in an intensification of the race between regional authorities for getting large corporate taxpayers registered in the respective regions. In this competition regions are not anxious to improve a local investment climate. Rather, they are keen to attract a taxpayer by means of administrative resource or “bribing” him with budgetary subsidies on projects whose implementation is profitable for specific companies.

The problem can be remedied in two ways: first, by curbing the “mobility” of corporate profit tax; second, by getting the budgetary system adapted to prompt and sizeable “migrations” of tax bases.

The former option seems to be the most attractive one, but hard to implement. While Art. 288 of the Tax Code of RF (below referred to as TC of RF) reads that “the organization is bound to deduct a part of its profit to regions where it carries out its operations according to the formula  $0.5(a+b)$ , where  $a$  is the proportion of the residual value of the organization’s capital assets in a given region, while  $b$  is the proportion of salaries and wages or the number of its employees in the region”, because of drawbacks of Art. 40 and 20 of TC of RF, “formally independent corporations” not only can conceal a part of corporate profit tax, but even easily “move” their profit from one region to another. But today, from the perspective of tax administration, it appears impossible to solve the problem of transfer pricing.

It is therefore appropriate to once again consider the problem of introduction to the RF tax law of the concepts of consolidated taxpayer and corporate profit tax, which suggests identification of the tax base of this particular tax on the whole by all the taxpayers that form a holding, with a consequent redistribution of tax revenues between budgets of the RF Subjects in the territories wherein the said taxpayers operate. But in all likelihood such a consolidation of legal entities for the sake of payment of corporate profit tax will be voluntary. Hence, the institution of “consoli-

dated taxpayer” will unlikely to fully solve the problem of “migration” of the tax in question.

The other option is to abolish the 4% regional benefit by corporate profit tax. This would bridle the businesses’ eagerness to declare profit in certain regions, thus affecting the other ones. But as noted above, today regions mostly “entice” large taxpayers employing administrative means, rather than tax benefits.

Numerous corporations (such as, for instance, Gasprom and Transneft) account a great deal of their assets (pipelines) in the balance sheet of their head companies headquartered in the capital cities. Accordingly, once their corporate profit tax payments are distributed, the regions wherein the said assets are actually located, loose considerable revenues. Thus, it seems fair to distribute corporate profit tax not only between regions where just separate divisions of such organizations reside, but to include regions where their assets are located. This should help make the tax in question less mobile, especially in such sectors as oil and gas transportation. However, again, from the perspective of tax administration, this option also appears hard to implement.

Thus, in the short run it appears unlikely that one would be able to modify the tax law in such a manner, so that to radically “lower” the mobility of corporate profit tax. Hence, it is imperative to have the budgetary system adapted to prompt and considerable migrations of the tax bases. The only rational way to damp sharp fluctuations in regional budgetary revenues is to create regional stabilization funds, as most instruments the federal center so far has employed to this effect have been less efficient<sup>47</sup>.

The year of 2006 has become the third straight year of an aggregate surplus of consolidated budgets of the Federation’s Subjects. In 2006, the surplus accounted for 0.52% of GDP, while the rise in the surplus of consolidated budgets of the RF Subjects accounted for 0.26 p.p. of GDP vs. the 2005 index.

The analysis of quantitative characteristics of the financial aid from the federal budget to the RF Subjects’ ones (*Table 23*) evidences that the volume of the federal financial resources transferred *gratis* in favor of the subnational budgets dropped insignificantly (at 0.08 p.p, or 3.6% of GDP, vis-avis 2005).

Once compared with the recent situation, the 2006 federal budgetary expenditures on provision of financial aid to the RF Subjects and municipalities have undergone certain modifications. Thus, the tendency towards cuts in funding from the Fund for Financial Support of Regions, which had started in 2003, was reversed – the subsidies earmarked from FFSR grew from 0.88% of GDP in 2005 up to 0.94% of GDP in 2006. But, because of the procedure of the annual adjustment of FFSR with account of CPI, it can be forecasted that in the future the tendency should be renewed. Under the same share of public expenditures in GDP, economic growth in real terms should result in a rise of public expenditures at a pace greater than that

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<sup>47</sup> Nazarov V.S. Nuzhny li regionalnye stabilizatsionnye fondy. – M.: Bankovskoye delo. No. 26, 2007. – P. 40–45

of CPI. Furthermore, one can project a rise in public expenditures at a pace advancing that of the economy's growth. It is also possible to suggest that interbudgetary transfers would grow, at least, at a pace equal to that of the federal budget expenditures. Accordingly, the FFSR growth rates should be lagging far behind the growth rates of other interbudgetary transfers. The 2007 federal budget law, which will be considered in a greater detail below, proves the accuracy of the above assumptions: it is envisaged that the overall volume of interbudgetary transfers should grow from 2.17% of GDP in 2006 up to 2.51% of GDP in 2007, while the volume of FFSR should slid from 0.94% of GDP to 0.83% of GDP.

In conjunction with the division of powers between the levels of the budgetary system and the federal center's eagerness to fund its mandates in full, the volume of funds allocated from the Compensations Fund has grown dramatically – from 0.17% of GDP in 2005 up to 0.3% of GDP in 2006. After a rapid growth of the Fund for Co-Financing of Social Expenditures (from 0.04% of GDP in 2004 up to 0.12% of GDP in 2005), which is explained by the monetization of benefits (with subsidies for a partial compensation for the costs of implementation of measures of social support to veterans and other individual categories of citizens), in 2006, the volume of subsidies from the Fund declined insignificantly, to the level of 0.11% of GDP. Plus, subsidies on ensuring measures on maintenance of balanced regional budgets likewise slid only slightly- from 0.24% of GDP in 2005 to 0.16% of GDP in 2006. As a year before, a vigorous employment of this mechanism of financing has aggravated the problem of soft budgetary constraints. The volume of financing from the Fund for Development of Regions and the Fund for the Regional Finance Reform have remained unchanged, each accounting roughly for as much as 0.01% of GDP. Among negative results of the 2006 development of interbudgetary relations one should note a considerable rise in mutual settlements, which forms one of the most non-transparent instruments of interbudgetary relations: they grew from 0.01% of GDP in 2005 up to 0.05% of GDP in 2006.

The period between 2004 and 2005 saw some attempts to ensure a greater transparency in the interbudgetary relations area. Thus, it was 2005 when for the first time ever the FFSR and FC resources were distributed according to the methodology approved by the RF Government's Resolution. The formation and use of the Fund for Co-Financing of Social Expenditures, the Fund for the Regional Finance Reform and a part of subsidies on support of measures on ensuring balanced budgets of the RF Subjects were exercised on a formalized basis. Despite the reform attempts, distinguishing features of this particular kind of the federal budget expenditures still remain considerable amounts of funds distributed according to interbudgetary regulation procedures, without any methodological and financial, and economic justification. The proportion of the 2006 financial aid assigned on a formalized basis in the total volume of transferred resources accounted for less than 60%.

A characteristic feature of the period between 2003 and 2006 became the revision of the budget law and an increase of the originally allocated amounts of fi-

financial aid to regions (in 2006 alone, at RUR 32 bn.). Notwithstanding that the volume of the additional, i.e. not provided for at the beginning of the financial year, aid to regions was reduced more than twice vis-avis its 2005 volume, the mere fact of the existence of a significant source of soft budget constraints compels one to question the efficiency of the completed reform of distribution of financial aid between regions.

To exemplify the current procedures and fundamentals of distribution of additional financial aid, suffice it to note that:

- subsidies to ensure balanced regional budgets were increased from RUR 25 bn to 40 bn, or at 62% over 2006;
- subsidies to budgets of the RF Subjects on diesel fuel consumed to complete seasonal agricultural works were increased from RUR 5 bn up to 12.5 bn (2.5 times);
- subsidies to budgets of the RF Subjects on compensation for teachers' out-of-class activities in the designated by the RF Government types of public and municipal educational institutions were raised from RUR 7.7 bn up to 11.7 bn (1.5 times);
- subsidies to budgets of the RF Subjects on monetary compensations to medical staff at local medical attendant's and obstetric offices, doctors, medical attendants and nurses employed in the ambulance service were raised from RUR 4.7 bn up to 5.1 bn (at 10%).

The above witnesses that launched in 1997–98 process of the interbudgetary relations reform, has recently displayed clear signs of deceleration. As the most recent practices show, the reform of fundamentals of distribution of the federal financial aid is still remains in the government's *ordre de jour*, as the current system remains insufficiently transparent. It does not therefore allows any conclusions on its efficiency and suggests it may contribute to the rise of negative incentives for regional, as well as local, administrations' budgetary policies. Below we are going to consider changes in characteristics of interbudgetary relations triggered by the 2006 decisions in the fiscal federalism and subnational finance areas.

Table 23

**Financial Aid out of the Federal Budget to Consolidated Budgets  
of the Subjects of the Federation  
in 1992–2006 (as % of GDP)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007*	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1. Financial aid to budget of other tiers				1.8	2.3	2.5	1.6	1.18	1.43	1.79	2.2	1.94	1.7	1.65	1.52	1.64	

Section 2  
Monetary and budgetary spheres

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.1. Federal targeted programs, as well as subsidies to the RF Subjects on support of agriculture, water economy measures, support of small businesses, and measures on children's recovery														0.05	0.15	0.27
1.2. Fund for co-financing of social expenditures											0.15	0.11	0.04	0.12	0.11	0.11
1.3. Fund for financial support of regions, including: Subsidies on equalization of budget sufficiency State support of the "Northern Supply" Transfers at the expense of VAT	0	0	0.36	1.17	1.04	1.22	1.12	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.83
1.4. Subsidies and subventions, including: Subsidies to budgets on support of measures on securing balanced budgets	0	0	0.36	0.86	0.68	0.86	1	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.83
1.5. Resources of the Fund for reforming regional finance									0.06	0.08	0.08	0.07	-	-	-	0.00
1.6. Other gratis and irrevocable transfers (subsidies and subventions)	0	0	0	0.31	0.36	0.36	0.12	-	-	-	-	-	-	-	-	0.00
	0	0.02	0.09	0.06	0.09	0.13	0.1	0.06	0.15	0.54	0.28	0.29	0.27	0.36	0.21	0.25
													0.11	0.24	0.16	0.16
									0	0.01	0.01	0.01	0.01	0	0.01	0.01
											0.01	0.01	0.01	0.01	0.08	0.13

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	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.7. Fund for financing regional development										0.03	0.05	0.1	0.1	0.15	0.01**	0.01	0.02
1.8. Funds transferred under mutual settlements	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.28	0.05	0.2	0.14	0.12	0.01	0.05	0.00	
1.9. Loans and budgetary credits, less loan repayments to other levels of government**	0.09	0.03	0.02	0.04	0.23	0.64	-0.03	-0.1	-0.08	0.02	0.09	-0.01	-0.02	-0.03	-0.04	0.00	
2. Fund for compensations											0.37	0.38	0.36	0.34	0.17	0.30	0.49
3. Other inter-budgetary transfers									0.18	0.11	0.4	0.45	0.54	0.35	0.33	0.34	0.38
Funds earmarked to budgets of other levels of government	1.49	2.7	3.4	1.8	2.3	2.5	1.6	1.36	1.54	2.56	3.03	2.84	2.39	2.25	2.17	2.51	

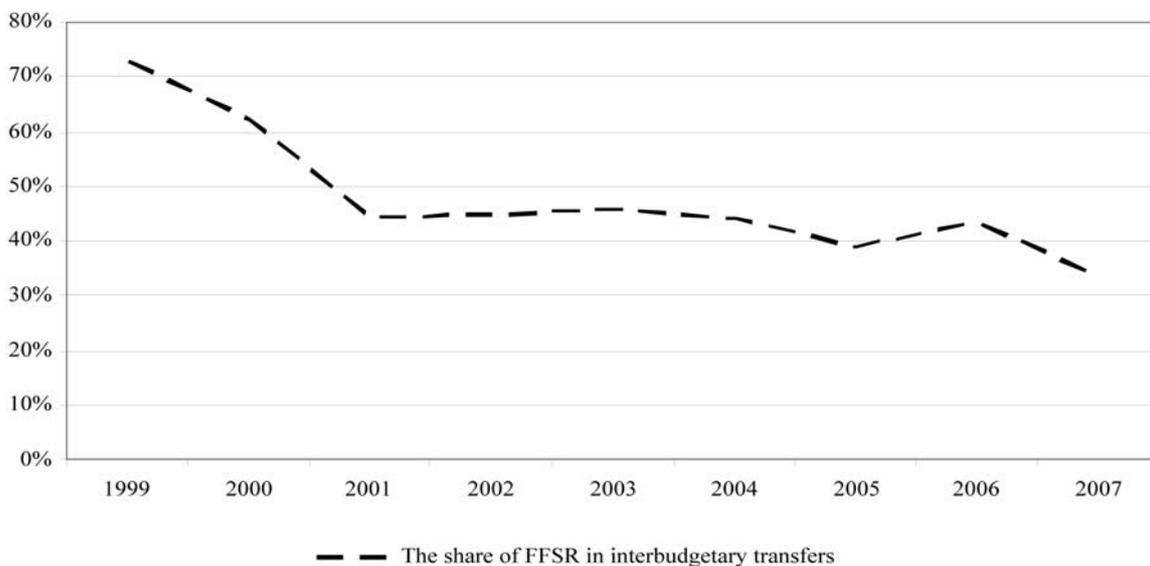
\* By the 2007 budget act.

\*\* Since 2005 – budgetary loans only.

### 2.4.3. The 2007 Federal Budget in the Part of Allocation of Interbudgetary Transfers to Other Levels of the Budgetary System

The overall amount of funds planned for allocation in favor of regional and local budgets in 2007 accounts for some RUR 784 bn, or 1.3 times more than the respective index of the prior year. It is particularly notable, as the general federal budget expenditures are going to rise 1.23 times. Accordingly, because of a faster rise in interbudgetary transfers to other levels of the budgetary system, their proportion in the federal budget expenditures should grow from 13.5% reported in 2006 up to 14.2%.

The main channel of financial aid to regional authorities is subsidies on equalization of budget sufficiency from the **Fund for Financial Support of Regions**. Their volume should grow at 14.1% and reach RUR 260.4 bn. It should be noted that 2007 should see the renewal of the tendency to contraction in the proportion of the Fund in interbudgetary transfers to 33.2% (vs. 43.1% in early-2006 as per the 2006 federal budget law and 38.2%, as per the same law as of late-2006).



*Fig. 10.* The share of subsidies from FFSR in the overall volume of interbudgetary transfers to other levels of the budgetary system in 1999–2007

As evidenced by the data presented in *Fig. 10*, the share of subsidies from FFSR in interbudgetary transfers plunged from 73% in 1999 to 34% in 2007. Given that the methodology of formation of the Fund is among the most non-transparent ones, this tendency is unlikely to be positive. Another associated with the Fund negative novelty of 2007 should become a modification of the methodology of its distribution. While the 2007 Methodology of distribution of subsidies from FFSR displays certain progress vis-à-vis the current one, it should be remembered that the core feature of provision of interbudgetary transfers is predictability and stability over time. If modified once in a year or two, the respective methodology does not contribute much to the stability of the budgetary system. In our view, it is appropriate to revise the existing methodology in the medium term, but its modification, even providing insignificant alterations, should take place, at least, once in 3–5 years. In the longer run it would be appropriate to raise the proportion of FFSR in the overall volume of interbudgetary transfers, mostly by concentrating in it subsidies to the lower-tier budgets, which are allocated to support measures on ensuring their balances, as well as other transfers whose distribution is conducted without following strict and formalized methodologies.

Since 2005 the Fund for Compensations (below referred to as FC) has been integrating resources allocated for financing all the federal expenditure mandates stipulated in the federal law. The 2007 federal budget law provides for a considerable increase in the volume of FC from RUR 73.9 bn in 2006 up to 153.1 bn (2.08 times). The Federation’s interests in regions begin gradually prevailing over the regions’ ones, for, as noted above, the principal mission of FC is to finance federal mandates. The main explanation to this is the reform process of the system of so-

cial support and assignment to the regional level of significant expenditure obligations. In 2007, subventions from the Fund for Compensations will be spent mostly on the following:

- a) subventions to regional budgets on payments for housing and public utilities services delivered to certain categories of citizens totaling RUR 81.7 bn, or 53% of the volume of the Fund (1.39 times more than in 2006);
- b) subventions to regional budgets on exercising powers with regard to pursuance of the state population employment policy, including the costs of their administering: RUR 33 bn, or 21% of the FC's pool;
- c) subventions to regional budgets on increases of money allowances and wages rises to the personnel of subdivisions of the territorial police, as well that of fire brigades, whose operations are covered from budgets of the RF Subjects and local budgets: RUR 15 bn, or 9.8% of FC.

On the one hand, the federal center's eagerness to finance expenditure mandates is a positive factor for the budgetary system as a whole. On the other hand, given a significant vertical budgetary imbalances and differences in regions' needs, it is equally imperative to boost at the same rate the non-targeted funding provided to regional authorities. Besides, in addition to the aforementioned huge subventions, which are significant to budgets of the RF Subjects, the last federal budget provides for a great number of "small-scale subventions", with the overall volume of financing by eight avenues accounting for less than RUR 1 bn. It should be noted that individual Subjects of the Federation often receive under one of these avenues less than RUR 1 m<sup>48</sup>. To cite a particular example, in 2007, the Altay Republic should receive RUR 176,000 to back-up powers on compiling (modifying, amending) lists of candidates for juries under the federal courts of law of general jurisdiction delegated to the executive and administrative bodies of municipal entities. The administrative costs associated with the subventions in question (planning and supervision of the respective spending) may exceed the volume of these subventions. We believe it is imperative to revise in the medium term principles of delegation of the

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<sup>48</sup> 1) Subventions to budgets to ensure funding of delegated to the executive and administrative bodies of municipal entities powers on compiling (modifying, amending) lists of candidates for juries under the federal courts of law of general jurisdiction in the Russian Federation (RUR 144 mln); 2) subventions to budgets on exercise of powers in the area of organization, regulation and protection of water biological resources (RUR 46 mln); 3) subventions to budgets on exercise of powers in the area of protection and use of the objects of fauna related to the category of hunting (RUR 31 mln); 4) subventions to budgets on payment of public one-time allowances under any form of placing children deprived of parental care to a family (RUR 677 mln); 5) subventions to budgets on exercise of powers on payment public one-time allowances and monthly compensations to citizens in the event of the rise of post- vaccinal complications (RUR 5 mln); 6) subventions to budgets on exercise of powers on payment to disabled insurance premiums under contracts of compulsory insurance of civil liability of vehicles owners (RUR 34 mln); 7) subventions to budgets on exercise measures associated with transportation between the RF Subjects and within territories of states that hold membership in CIS of minors that without permission have left families, orphanages, boarding schools, special education and rehabilitation centers and other institutions (RUR 34 mln); 8) subventions to the budget of the city of Saint Petersburg on exercise of the supreme executive body of state power in Saint Petersburg of the federal property management powers (RUR 19 mln).

powers, for the current procedures of their funding does not ensure a full coverage of regional expenditures on their exercise (for example, the costs incurred by regions on their administration are not taken into account). As well, there is no strict economic justification for efficiency of the delegation of powers, hence, the efficiency of standardization of the process of their delegation can be questioned, as in some regions it can be efficient, but fruitless in others. It is appropriate to examine the efficiency of the current division of powers and, if necessary:

- a) to drop the practice of delegating to regions a series of federal powers and to switch to their funding directly from the federal budget;
- b) to assign a number of federal mandates to the Federation's Subjects in a full volume, along with the respective increase in the volume of non-targeted transfers and those implying flexible conditions of consumption of thus received funds and/or expansion of the regional budgets' own receipts;
- c) to consider a possibility for delegation/centralization of some powers on the contractual basis, with strict and legally stipulated conditions of such contracts. It must be noted that Russia has accumulated a significant negative experience of the contract-based division of powers, while foreign experiences often witness efficiency of this particular mechanism. That is why it would be appropriate to resume consideration of this problem in the long run, which requires an in-depth legal and economic examination.

The 2007 volume of the **Fund for Co-Financing of Social Expenditures** should grow at a more moderate (1.36 times) pace than that of FC, and it should ultimately account for RUR 35.4 bn. This modification was mostly caused by an increase in subsidies to budgets on children's aliment in a trustee's family, as well as on wages payable to adoptive parents.

Besides, it should be noted that in 2007 there should happen drastic cuts in costs of the federal targeted programs on development of the Republic of Tatarstan and the Republic of Bashkortostan. The costs in question have been fairly huge, as they had been approved to compensate for the termination of the effect of special tax and budgetary arrangements under agreements on division of powers between these regions and the federal center. Recently as much as RUR 20 bn.- plus has been allocated for this purpose, while in 2005–2006 the volume of the respective funding was some RUR 11 bn. In 2007, there exists the only program, that is the federal targeted program "Socio-Economic Development of the Republic of Bashkortostan", which is worth a total of a. RUR 3 bn.

However, the 2007 budget law contains decisions that are aimed at a considerable increase in discretionary interbudgetary transfers. The volume and procedures of such transfers may vary substantially, due to the federal center's discretion. In 2007, there should occur a drastic rise in sectoral subsidies, as well as in the federal targeted programs on support to individual regions:

- subsidies to regional budgets on support to the agricultural sector – RUR 27.6 bn ( 1.6 times more than in 2006);
- subsidies to regional budgets on construction and modernization of territorial and municipal roads, including those in settlements, and road construction in

new areas of mass low-rise and apartments blocs construction, which will be worth a total of USD 35 bn (no such subsidies existed in 2006);

- subsidies on the monthly cash compensations for out-of-class activities at public and municipal schools of general education, worth a total of RUR 11.7 bn (1.5 times more than the respective amount provided for the start of the 2006 financial year);
- the federal targeted program “The social development of the rural areas through 2010”, worth a total of RUR 5.5 bn;
- RUR 2 bn to fund establishment of technoparks operating in the high-tech areas;
- the federal targeted program “Restoration of the economy and social sphere in the Chechen Republic (in 2002 and subsequent years)” – RUR 11.9 bn (a 17-fold increase vs. the respective volume of 2006);
- RUR 4.9 bn to fund the federal targeted program “The South of Russia” (a 2-fold increase vs. 2006);
- RUR 4.5 bn to fund the federal targeted program “The economic and social development of the Far East and Transbaikalia in 1996–2005 and through 2010” (1.6 times more than the 2006 level).

The subsidies allocated to the RF Subjects on support of measures on securing their budget balances should grow 1.24 times vs. 2006<sup>49</sup>.

A drastic increase of discretionary transfers that displays no strict binding with the regions’ budget sufficiency or funding of federal mandates can introduce distortions to the subnational authorities’ fiscal behavior. For instance, a region that enjoys a greater level of budget sufficiency prior to the receipt of interbudgetary transfers may lose its advantages upon receiving financial resources from the federal center. That will diminish its appetite for an independent embarkation on measures aimed at boosting its fiscal capacity, i.e. economic growth rates.

#### *2.4.4. Concept and Methodology of Advancement of Interbudgetary Relations in the Russian Federation and its Subjects in 2006 and in the Medium Run*

With its Resolution of April 3, 2006, No. 467-p, the RF Government approved the Concept of increasing efficiency of interbudgetary relations and quality of supervision of public and municipal finance in RF in 2006–08 (below referred to as Concept) and an action plan on its implementation.

The Concept addresses the following challenges:

1. Solidification of financial independence of the RF Subjects;
2. Creation of incentives for boosting revenues to budgets of the RF Subjects and local budgets;
3. Creation of incentives for improvement of the quality of control over public and municipal finance;
4. Enhancement of transparency of regional and municipal finance;

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<sup>49</sup> On negative influence of this kind of interbudgetary transfers on the subnational authorities’ fiscal behavior see the IET 2004 and 2005 annual issues “Russian Economy: Trends and Outlooks”.

5. Provision of methodological and consultancy assistance to the RF Subjects for the purpose of enhancement of efficiency and quality of control over public and municipal finance, as well as for the purpose of implementation of the local self-governance reform.

Below, we will consider in a greater detail main measures suggested by the Concept and their possible impact on the state of interbudgetary relations in Russia.

### **Solidifying financial independence of the Subjects of Russian Federation**

To tackle this task, the Concept suggests provision of stability of the tax law and interbudgetary relations in Russia for the sake of trustworthy and objective budget planning in the medium term. It is suggested to exclude a possibility of introduction of modifications on the federal level to the budget and tax legislation in the part of taxes and levies collected to budgets of the RF Subjects and local budgets that may result in a contraction of the tax base, as well as modifications of expenditure obligations of the regional budgets without adequate compensation from the federal budget. It should be noted that with all the indisputable accuracy of such a decision, the bulk of amendments to the budget and tax legislation in the part of taxes and levies collected to the noted budgets that result in the contraction of the tax base has been already passed (abolition of turnover taxes, sales tax, centralization of the mineral tax, and abolition of a number of minor regional taxes and charges, etc.). With that completed, the approach suggested by the Concept (that is, a full compensation payable from the federal budget to regions for their losses resulting from implementation of such measures) recently has not always prevailed. But with account of the imperfection of the national tax system, the priority of the tax reform relative to the need for securing the stability of interbudgetary relations has not been questioned.

Plus, most tax bases appear overlapped, and a change of procedures of calculation of a given tax may entail changes in other tax bases. The federal center can amend the tax law in the part of taxes and levies collectable to the federal budget, which may result in a contraction of the tax base in the part of taxes and levies subject to collection to regional and local budgets. For example, an increase of import duties that are collected exclusively to the federal budget may result in a contraction of the corporate profit tax base, a considerable proportion of which is collected to budgets of the Federation's Subjects. According to the Concept, such a contraction of the tax base does not require any compensation from the federal budget, albeit its effects on the consolidated budget of a given Subject of the Federation to a significant extent appear analogous to the direct centralization of corporate profit tax in the federal budget. Thus, the suggested by the Concept way of securing stability of the tax law and interbudgetary relations in RF appears formally correct, however, in reality it faces fairly rigid constraints. This calls for calculation in the medium run of the vertical budgetary imbalance with account of revenue sources, their instability, and expenditure obligations of all the levels of government. With account of thus calculated value of the vertical budgetary imbalance,

that should ensure a match between revenue sources and expenditure obligations of all the tiers of government.

To enable regions to efficiently exercise the medium-term budget planning, the Concept provides for timelines with regard to enactment of federal acts on introducing amendments to the RF law on taxes and charges effective since the start of next financial year. Such federal acts should be promulgated no later than in a month prior to the date of submission to the State Duma of the Federal Assembly of RF of the bill on the federal budget for next financial year.

To the same effect, the Concept suggests to specify the composition of the budget classification by completing the transition to the legislative approval of uniform (to all the budgets of the national budgetary system) groups and subgroups of the classification of expenditures, groups and items of operations of the public administration sector, as well as to introduce an ultimate timeline for introduction of amendments to the budget classification.

An important novelty suggested by the Concept became new procedures of the annual indexation of the volume of resources of the Federal Fund for Financial Support – in the event the actual level of inflation (CPI) in the reported year has proved to be greater than the projected one, it is necessary to increase the volume of resources of the Federal Fund for Financial Support of the RF Subjects by the difference between a volume of FFSR resources approved for the reported financial year and an estimated volume of its resources, proceeding from the actual inflation rate multiplied by inflation rates projected for the current and next financial years. These procedures of indexing the FFSR volume compensate for a greater inflation rate vis-a-vis the projected one, but with a one-year lag. If, for instance, in 2007 inflation is higher than planned, the 2007 FFSR volume should remain unchanged, while that for 2008 should be increased. It has to be noted that such a lag is likely to form a permanent defect, the significance of which would be reduced to minimum under a far lower inflation rate and/or a better quality of projecting of the consumer prices dynamic. Thus, these particular procedures of indexing the FFSR volume can be indisputably perceived as positive ones.

The Concept also specifies another critical avenue of addressing the objective of solidification of the RF Subjects' financial independence, namely, improvement of the structure of interbudgetary transfers allocated from the federal budget. In addition to main forms of provision of interbudgetary transfers (FFSR, FC, the Fund for Reforming Regional and Municipal Finance, the Federal Fund for Co-Financing of Social Expenditures, the Federal Fund for Regional Development, and budgetary loans), whose formation and distribution has been mostly formalized, under the evolving tax system and assignment of expenditure obligations from one level of the budgetary system to another, there occurred a rise in the employment of other interbudgetary transfers in the form of subsidies and subventions. They are allocated beyond the formalized system framework, without linking them to the current financial aid delivered in the frame of the main forms of interbudgetary transfers and without account of the regions' level of budget sufficiency. That substantially diminishes effects from provision of interbudgetary transfers on the whole. The Concept declares the necessity of systematization of the allocated interbudgetary

transfers, including a strict observance with the principle, according to which the financial aid should be allocated with account of the level of budget sufficiency of a given Subject of the Federation.

The Concept pays a particular attention to improvement of mechanisms of distribution of investment financial aid the federal budget allocates to the Subjects of RF. Given the promulgation of the federal acts on division of powers between the federal bodies of the state power, government bodies of the RF Subjects and local self-governance bodies, it is proposed to distinguish the financing of investment measures that result in the growth of the federal property from those which entail the rise in the regional property.

The Concept also suggests to design and introduce mechanisms of monitoring and evaluation by the federal bodies of executive power of efficiency of exercise of powers the federal center assigns to the government bodies of the RF Subjects and local self-governance bodies, and to increase responsibility for exercise of the delegated powers. Basing on the 2005 data on consumption of subventions from the Federal Fund for Compensations, it is proposed to introduce modifications to the procedures of submission by the RF Subjects of reports on execution of the assigned powers, to introduce to the practice of the federal bodies of executive power a preparation of annual reports, which will evaluate the efficiency with which the RF Subjects exercise the delegated powers. The monitoring system in question is likely to induce two different effects, that is, on the one hand, such a system may help promptly identify defects of the delivery of public goods and improve its quality. On the other hand, provided a great deal of public goods delivered by regional administrations falls on “the federal mandates”, it will help the federal center to tighten its control over regional authorities. That would lead to a degradation of competitive features of the Russian federalism in favor of corporative ones. The federal center would be increasingly perceiving its regional counterparts as branches of the same corporation, which will inevitably result in a serious unification of most expenditure programs and, consequently, in an equally inevitable fall in their utility function for many Russian regions.

#### **Creating incentives to boosting revenues to budgets of the RF Subjects and local budgets**

The Concept suggests a dual policy in the area of creation of incentives that should help boost revenues to budgets of the RF Subjects. On the one hand, the policy implied a tighter control over the so-called “subsidized regions”, while offering incentives to regions that have managed to expand their tax bases on their own, on the other.

Overall, the approach appears rational, however, specific ways of its implementation can be questioned.

First, in order to create incentives to the RF Subjects and local authorities to boost revenues to their respective budgets, the Concept proposes to legally introduce conditions of execution of budgeting for the RF Subjects depending on the extent to which they are subsidized. On the basis of proportions of interbudgetary transfers allocated from the federal budget over the past 2 of 3 reported years (except for funds assigned for the sake of exercising the delegated powers) in the vol-

ume of their own budget revenues, the RF Subjects are split into three groups, each being subject to different requirements.

So far as the RF Subjects in whose budgets the share of financial aid from the federal budget does not exceed 20% of the volume of their own revenues, are concerned, the Concept suggests application of general measures set by RF the budget law in the part of compliance with caps on the ultimate size of an RF Subject's public debt and budget deficit.

As concerns the RF Subjects in whose budgets the proportion of financial aid from the federal budget accounts for between 20 and 60% of their own revenue volume, the Concept suggests introducing additional caps on expenditures on maintenance of government agencies and labor compensations to public servants of an RF Subject, as well as introducing observance with ultimate sizes of wage rises payable to budget employees.

In addition, the Concept suggests introducing for such RF Subjects a provision regarding compulsory compliance with the RF Ministry of Finance's regulations with regard to budgetary matters, which are primarily aimed at elimination of problems in the part of accounts payable that arise in the course of the budget execution.

For the RF Subjects, in whose budgets the proportion of financial aid from the federal budget accounts for over 60% of their own revenues, it is imperative to set the following requirements with regard to control over efficiency of their consumption of budgetary funds:

- introduction of additional caps on the volume of their public debt and budget deficit;
- compulsory conclusion of agreements with the RF Ministry of Finance on measures on increasing efficiency of consumption of budgetary funds and tax and non-tax revenues to the budget of a RF Subject;
- imposition of a ban on financing out of budgets of the RF Subjects of measures that, according the RF Constitution and law, do not fall under jurisdiction of government bodies of the RF Subjects;
- conduct of an annual examination of the execution of the budget of a RF Subject by the Accounting Chamber of RF or the Federal Service for the Financial and Budget Supervision.

It is proposed to introduce similar requirements to relationship between the RF Subjects and municipal entities.

Such an approach appears methodologically incorrect.

First, the Concept and the Budget Code contain rather vague formulations of some requirements to the "subsidized regions" in. The Budget Code presently sets a number of restrictions with regard to the RF Subjects' budgetary policies, however, the failure to formally comply with restrictions approved by the Budget Code often appears related to imperfection in the formulations of the requirements in question. Thus, in compliance with the Budget Code, one of the conditions of eligibility for subsidies from FFSR is observance with the correlation between the size of labor compensations due to civil servants of the RF Subjects and the respective categories of the federal civil servants. The realization of this condition as a direct-

acting provision entails contradictions, as the mission of the territorial bodies of the federal government differs from that exercised by bodies of regional administrations. Their functions, an organizational structure and competence likewise differ from each other. Government bodies of the RF Subjects can practice their own approaches to improvement efficiency of the government and municipal service in a region, which can suggest greater labor compensations vis-avis those due to the staff of the territorial subdivisions of the federal bodies of the executive power. A correct comparison between the respective levels of labor compensations is inhibited by the lack of a formalized methodology of the comparison between sizes of labor compensations between the two groups concerned (which would otherwise take into account the above factors).

At the same time, in compliance with the budget law, in a municipal entity, to which subsidies are granted from the budget of the RF Subject, the sizes of labor compensations to local legislature, members of the elected local self-governance administration who exercise their powers on the permanent basis, and municipal staff are set at a level not greater than capped values set by the Subject's local law, which suggests setting amounts of labor compensations by each position and kinds of additional compensations. This suggests not only a detailed regulation of operations of local self-governance bodies in the part of the staff policy and list of members of staff, but requires considerable time and efforts on the part of the staff of the RF Subject. As well, it conflicts with provisions of Federal Act of Oct. 6, 2003, No. 131-FZ "On general fundamentals of organization of local self-governance in the Russian Federation".

The above necessitates respective amendments to the RF law, which should specify both requirements themselves and measures on enforcement of compliance with them, designing detailed procedures, which should introduce a methodology of evaluation of compliance with the requirements of the budget law and regulations of sanctions against those RF Subjects that breach the law, including economic and administrative mechanisms.

Secondly, so far as solidification of the regional authorities' financial independence is concerned, it appears inappropriate to give preference to the measures that per se imply introduction of various sanctions against the regions that receive great volumes of financial aid from the federal budget. There are, at least, two reasons for such an assertion.

First, a possibility for imposition of restrictions for the regions due to reasons not associated with a violation of the budget law or an inefficient spending of budgetary funds, may give a rise to incentives to distort the respective statistical data and a lower transparency of the budgeting, rather than a boost to the taxbase, which clearly conflicts with other provisions of the draft Concept.

Secondly, it is appropriate to introduce restrictions to the budgetary policy, as well as the external financial management, in the event of exposure of facts of an inefficient public finance management, which entailed the rise of excessive obligations of the public sector and outstanding debts. But such measures exercised by superior authorities, as a rule, are coupled with a provision of additional financial resources.

Meanwhile, given Russia's federative structure, a great proportion of financial aid in the conditions of existence of an interbudgetary equalization program (which in Russia is *de facto* represented by subsidies on equalization of the RF Subjects' budget sufficiency) does not *a priori* mean inefficiency in the public finance management area, as well as the situation of financial crisis in a given Subject of the Federation. Given that, such an indicator as the proportion of funds received from the federal budget in the form of interbudgetary transfers in the regional budget revenues can be determined by various factors, of which worth noting are the structure of the methodology of distribution of interbudgetary transfers, an overall amount of funds the federal authorities allocate for the sake of interbudgetary equalization, as well as other factors that do not depend on the regional authorities' decisions. In other words, a great proportion of financial aid in the regions' own budgetary revenues does not mean inefficiency in the public finance management area, but this phenomenon can be spotted even in those Subjects of the Federation that pursue a sound budgetary policy.

At the same time it should be noted that the bulk of financial aid from the federal budget is formed by non-targeted transfers, i.e. administrations of the RF Subjects are not bound with any conditions that would otherwise dictate areas, on which the federal resources should be spent (accordingly, even a greater volume of financial resources granted to them from the federal budget in the form of subsidies on equalization of their minimum budget sufficiency does not mean the necessity to control the targeted consumption of the funds in question).

As a result, the suggested remedy to the problem of creation of incentives to regional budgets to boost up their revenues may lead to punitive measures against the RF Subjects to whom such penalties do not pose a real threat. Meanwhile, it is equally undesirable to create a situation in which in the short run all the federal and regional authorities' attention and efforts would be centered on introduction of the aforementioned capping into highly subsidized regions and municipal entities, as problems of rehabilitation of regional and municipal budgets, creation of incentives for development of their tax bases, increase in the efficiency of financial management and, in particular, introduction to the national practice of the institution of external financial management, will *per se* be left beyond the framework of the discussion.

Thus, it is appropriate to introduce caps and restrictions into the budgetary policy, as well as the external financial management, upon exposing facts of an inefficient public finance management that has entailed a rise in excessive obligations of the public sector and outstanding indebtedness.

To ensure rehabilitation of regional finance, it is appropriate to apply certain measures to regions in a crisis situation, which differ from measures applied to regions that meet insolvency criteria. While contributing to the World Bank project entitled "Improvement of legislation on interbudgetary relations and subnational finance", the IET experts have already suggested a series of measures to prevent financial crises in Russian regions and create incentives for a sound public finance management on the regional level. In the most general form, they are as follows:

1. Regions in the situation of the financial crisis.

We propose to formulate the concept of a region (municipality) in the state of financial crisis as follows:

“A Subject of RF (municipal entity) in the state of financial crisis is the Subject of the Federation (municipal entity) whose volume of payments on servicing and repayment of its public (municipal) debt due in the current or regular financial year is in excess of 20% (or, optional, 30%) of the total volume of its revenues projected for the respective year, with account of non-targeted financial aid from the higher-tier budgets”.

Once given this status, the region has a chance to receive an additional financial aid in the form of a long-term budgetary loan from the federal budget, providing it fulfills a regional finance rehabilitation program approved by the federal Ministry of Finance and legitimized by an agreement with the RF Government.

The main characteristics of the region in the state of financial crisis are:

- voluntary (by application) nature of granting the status;
- position of the region that has applied for such a status matches certain criteria;
- possibility to receive additional financial aid from the federal budget upon receiving the status in question;
- entering in the respective agreement with the RF Government, which should contain, as its inseparable part, a regional finance rehabilitation program and obligations assumed by the RF Subject with respect to observance with the program.

It is also necessary to consider a possibility for adjusting the respective provisions of the Budget Code of RF associated with the introduction of the new status, as follows:

1) to consider the possibility for provision to the RF Subjects, which have been granted the status of the region in the state of financial crisis, of long-term budgetary loans for the purpose of implementation of a regional finance rehabilitation program. That said, it appears appropriate to split the amount of the loan into several parts and introduce conditions of transferring each of them against completion by the region of the respective part of the program or its demonstration of some progress in implementation of individual measures. This should form a key precondition that would help enforce implementation of such an agreement;

2) to modify requirements of the Budget Code with regard to caps on the volume of the public debt of an RF Subject, costs of its servicing and an ultimate size of the budget deficit, so that the federal center could be able to disburse a budgetary loan to the region in the state of crisis.

2. Regions that meet the insolvency criteria.

By contrast to the “crisis” regions, where the failure to fulfill public obligations appears possible, the regions that meet the insolvency criteria are those wherein the failure has already occurred. The federal center, therefore, has to impose direct enforcement measures on such regions to ensure improvement of their finance.

The main instrument with which the federal center can exercise influence on regional authorities’ budgetary policies is interbudgetary transfers. Should the regional legislature refuse to include in the local budget law measures provided for by

a given rehabilitation program, the upright effect of such a move shall be deprivation of the region of some kinds of interbudgetary transfers. This is where the difference between the status of the region (municipality) that meets insolvency criteria from the status of the region in crisis lies.

But, whereas a discontinuation of provision of the federal financial aid and collection to regional budgets of revenues from the federal taxes form very strong enforcement instruments, which practically excludes the possibility to oppose to the Federation's requirements, their application should imply certain legal constraints.

A bill on measures on regulation of debts accumulated by the RF Subjects and municipalities that meet the insolvency criteria should enumerate a closed list of measures that can be included in a budget rehabilitation program. The set of the measures should vary, depending on a concrete volume of the debt due to the restructuring, the extent to which a given region is subsidized, the structure and volume of its minimum budget expenditures, and other significant factors. Such a bill should specify bounds for differentiation of measures on rehabilitation of an insolvent regional (municipal) budget.

The Concept also offers stimulatory measures to regions that have increased their tax base on their own: it is envisaged to introduce amendments to the methodology of allocations of subsidies from FFSR, which will ensure creation of a mechanism of encouragement of government bodies of the RF Subjects to develop their own tax bases. The stimulatory effect will be ensured by specifying procedures of calculation of the said subsidies, which should not provide for their contraction, once an RF Subject displays socio-economic development indices greater than the average nationwide ones.

From the economic perspective, this measure raises questions, but it appears justified from the political perspective. Theoretically, in the frame of the 2006 methodology of allocation of subsidies from FFSR there existed an inverse relation between the volume of subsidies from FFSR and GDP growth rates, i.e. from the perspective of the formal cause-and-effect relation, there was no direct stimulation to GDP growth with the use of the FFSR subsidies. Regional authorities often criticized this particular aspect of allocation of subsidies from FFSR, but it is worthwhile noting that to a significant extent their criticism was steered by political reasons. First, it will be only a few years later when an accelerated growth in GDP could have a negative effect on the volume of the FFSR subsidies. Secondly, the regional authorities practically could not foretell a decline in GRP and growth in subsidies from FFSR, nor they could benefit from the phenomena, i.e. the 2006 methodology did not create negative fiscal incentives for them. Thirdly, there is no country in the world where subsidies on equalization of the level of budget sufficiency are aimed at stimulation of economic growth. Rather, they are aimed at ensuring a country's balanced budgetary system. Despite lax economic arguments against the 2006 methodology of distribution of FFSR and particularly its negative effect on the regions' fondness of economic growth, the RF Ministry of Finance has preferred to opt for an insignificant modification of the subsidies distribution formula, so that to ensure a positive political effect. The modification appeared absolutely justified from the perspective of the real economic policy, for upon an insignificant modifi-

cation of the methodology of distribution of the FFSR subsidies, which is one of the most transparent and economically rational methodologies of allocation of inter-budgetary transfers in Russia, the ranks of its critics should thin out. Time will show whether, from the perspective of a real stimulation of economic growth and budgetary and tax discipline in the regions, such a modification of the FFSR methodology is efficient. Meanwhile, the modification in question appears fairly disputable from the methodological perspective. Every single government regulation instrument must first of all address a certain challenge, without affecting remedies to other problems. Thus, subsidies on equalization of the level of budget sufficiency must first of all secure the possibility of provision of an equal level under equal tax efforts in all the regions, but without disincentives to regions keen to boost their budget sufficiency on their own. But an efficient encouragement of regions to do so is most likely to happen once other government regulation instruments are applied.

### **Creating incentives to improvement of the quality of public and municipal finance management**

The reform of division of powers has legitimized a considerable part of powers with regard to subjects of joint jurisdiction of the Federation and its Subjects by assigning such powers to the latter. Accordingly, the level of efficiency of the use of regional finance will have quite a strong cumulative impact on efficiency of the public sector on the whole.

To intensify incentives for improvement of the quality of public and municipal finance management, the Concept provides for the following:

- increase in the number of the RF Subjects and municipal entities selected to grant them subsidies according to results of the evaluation of regional and municipal finance reform programs;
- improvement of the current selection mechanisms by assigning a greater part to indices that determine the quality of the regional and municipal finance management;
- introduction of a system of the annual rating-based evaluation of performance by government bodies of the RF Subjects with regard to finance management, primarily their use of new fundamentals of result-oriented budgeting and medium-term budget planning. Creation of a system of financial rewards available to Subjects of the Federation that have been earned greater scores;
- revision of principles of provision of financial aid granted on terms of co-financing, to secure implementation of powers of government bodies of the RF Subjects that form priority powers for the Russian Federation. It is suggested to concentrate funds for provision of the said aid in a specially created Federal Fund for Co-financing of Expenditures. While identifying the level of co-financing from the federal budget of certain powers funded from budgets of the RF Subjects and/or local budgets, it is suggested to employ a mechanism of differentiated identification of volumes of the provision of subsidies, with account of the finance management quality indices. For example, should an RF Subject fail to fulfill set by its law obligations by accumulating a growing volume of the respective accounts payable, it is envisaged to reduce the amount of federal subsidies due to the region. Quite logically, should there be no debt or its amount is on the decline, the

region should be awarded with a greater volume of financial aid. That should allow development of incentives for the RF Subjects to enhance the quality of implementation of their own powers and avoid the rise of debts.

The measures on creation of incentives for improvement of the quality of the public and municipal finance management, especially in the part of intensification of the co-financing of the priority social expenditures from the federal budget, appear fairly justified. The urgency of intensification of the role played by the co-financing of the social expenditures is caused by a considerable vertical imbalance in favor of the federal budget, on the one hand, and the federal center's opting for its own expenditure obligations as a means of the vertical equalization. A notable increase in the federal budget expenditures and the national projects in progress prove the assumption. But with all its administrative and political attractiveness, this option suffers a number of defects. First, it took much time and a lot of efforts to complete the division of expenditure powers – with the promulgation of federal acts No. 122-FZ and 199-FZ, the health care, education and the housing and public utilities sectors now mostly falls under the regional authorities' jurisdiction<sup>50</sup>. Today, the national projects have de-facto revised the division in question. Secondly, one of the major pluses of federalism is delegation of expenditure powers to subnational authorities, *aka* the regional expenditure autonomy. It is possible to single out two major advantages of the assignment of implementation of social programs to the regional level:

- it is much easier to local authorities to take into consideration the local residents' preferences (as the federal center cannot fully account them – while one region displays the necessity of a wage rise for physicians, another one may be in a greater need for specialist doctors or medical centers);
- there exists room for innovations in the course of implementation of government programs by different regions (the federal center will always favor unification – a perfect illustration is payment by the federal center of an equal rise in wages to all the physicians nationwide, without regard to regional peculiarities).

The only advantage of a federal expenditure program is that it guarantees an equal accessibility to public goods to all the citizens of a country.

Thus, the best way to regulate the vertical budgetary imbalance in Russia is to employ the mechanism of co-financing of the priority social expenditures (to create

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<sup>50</sup> See 1) Art. 11.1 of Federal Act of Aug. 22, 2004, No. 122-FZ “On introducing amendments to legal acts of the Russian Federation and recognition invalidity of some legislative acts of the Russian Federation due to the enactment of the federal acts “On introducing amendments to the Federal Act “On fundamentals of organization of legislative (representative) and executive bodies of state power of Subjects of the Russian Federation” and “On fundamentals of organization of local self-governance in Russian Federation”.

2) Chapter 3 of Federal Act of Oct 6, 2003, No. 131-FZ “On fundamentals of organization of local self-governance in Russian Federation”.

3) Art. 26.3 pp. 13 and 21 of Federal Act of Oct. 6, 1999, No. 184-FZ “On fundamentals of organization of legislative (representative) and executive bodies of the state power of Subjects of the Russian Federation”.

4) Federal Act of Dec. 31, 2005, No. 199-FZ “On introducing amendments to individual legislative acts of the Russian Federation due to the improvement of division of powers”.

5) Art. 29 of Federal Act of July 10, 1992, No. 12-FZ “On education”.

a national analogue to CHST<sup>51</sup>), that is, a block transfer to the regions, which is aimed at the financing of the national priorities. It is the Federation that sets the volume of such a transfer and secures an equal access to the public goods for all the citizens. The volume of the transfer should be comparable with volumes of financing provided by the national projects program. The block transfer should grow in the course of completion of the national projects – after 2008 it is desirable to accomplish the transition towards financing the national priorities in the health care, education and housing areas (including the housing and public utilities sector) by means of the transfer. Meanwhile, the federal budget will have to allocate funds solely on interregional projects of national significance. Notwithstanding that proposed in the Concept measures on the co-financing of the priority social expenditures from the federal budget so far have not implied creation of such a block transfer, it can be asserted they form steps in the right direction.

#### **Enhancing transparency of the regional and municipal finance**

The Concept pays a particular attention to the fact that presently there is no complete picture of *modus operandi* of the public finance sectors at the regional and municipal levels, nor there is a uniform methodological basis for collection, processing and provision of such information. The problem appears particularly pressing at the municipal level, with data on municipal entities both of settlement and district types being fairly poor.

To have municipal entities efficiently exercise their powers on formation and distribution of interbudgetary transfers, the Concept suggests expanding possibilities for the use of tax reports and enhancing their quality and comprehensiveness by forming them by each municipal entity. Proceeding from that, the RF Ministry of Finance is going to design procedures of formation, running and dissemination of a single data base, which would characterize the state and quality of management of budgets of the RF Subjects and local budgets, and to ensure a free access to the base on the Internet. In addition, it is planned to develop uniform principles of compilation of statistical data on all the levels of government to compile the regional and municipal socio-economic performance indicators using a uniform methodology and to ensure their harmony with the respective federal-level indices.

The Concept emphasizes the need for introduction into practice of public annual accounts of government bodies of the RF Subjects and local self-governance bodies and for development of recommendations on their drafting and performance indicators in particular. Such public accounts should include reports on the government bodies' performance over the past period and plans to improve efficiency of the regional and municipal finance management in the forthcoming period.

The Concept assigns a special role in implementation of the budgetary reform and shift of focus in budgeting from “budgetary resources (costs) management” to “results management” to a non-partisan evaluation of government bodies of the RF

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<sup>51</sup> CHST (Canadian Health and Social Transfer) is the Canadian transfer on medical services and social insurance formed by subventions calculated proceeding from needs of a given province. Despite thus allocated funds are targeted, the Federation does not produce detailed conditions of their spending, which results in a great diversity of medical programs across Canadian provinces. – see Harvey Lazar. Money, politics and health care. The Institute for Research on Public Policy, 2004 .

Subjects and local self-governance bodies' performance. It is proposed to exercise the function not only with the help of accounting and control chambers, but by hiring independent audit companies, which is fully consistent with the best international practices.

**Providing methodological and consulting assistance to the RF Subjects for the purpose of increase of the efficiency and quality of public municipal finance management and implementation of the local self-governance reform**

The Concept suggests the following solutions to the problem:

- to continue developing model legal acts of the regional and municipal levels, and methodological recommendations;
- to improve the system of regional and municipal statistics that provide the necessary informational base of socio-economic performance indicators of different territories;
- to carry out training and retraining of the respective specialists on the level of the RF Subjects and municipal entities, publication of textbooks and methodological manuals, and creation of a single data base on the progress with the municipal reform, which will integrate and make available to the public at large necessary auxiliary materials and the best public and municipal finance management practices.

To implement the last of the aforementioned avenues, it is planned in the upcoming three years to complete training programs of the municipal staff, primarily the federal cadres, which will be done particularly in the framework of the federal targeted program of state support of development of municipal entities and creation of conditions of implementation of the constitutional powers of local self-governance.

In the transitional period of the reform implementation the RF Ministry of Finance will organize the work on sharing experiences between the RF Subjects in order to select an optimal way of the reform implementation.

To deliver the methodological assistance to the RF Subjects on increasing the manageability of the public and municipal finance, the RF Ministry of Finance will develop recommendations to the RF Subjects and municipal entities on the following guidelines of the budgeting reform:

- increase of effectiveness of budgetary expenditures;
- improvement of the medium-term financial planning;
- improvement of the system of the regional and municipal debt management;
- implementation of measures on preclusion from the rise of facts of the RF Subjects' insolvency.

*2.4.5. New Methodology of Allocation of Subsidies on Equalization of Budget sufficiency of Subjects of the Federation*

With its Resolution of September 18, 2006, No. 580 the RF Government introduced substantial modifications to the methodology of distribution of the FFSR subsidies. Accordingly, the 2007 subsidies from FFSR have been computed using

the new methodology. One can single out the following novelties in the 2007 procedures vis-à-vis the earlier ones:

1. While identifying a region's tax capacity, the procedures of calculation of value-added have been modified. If the growth rate of the value of value-added across the region is superior to the respective index averaged nationwide, the value of the value-added by the given Subject of RF is calculated proceeding from the average nationwide level. This provision allows additional benefits for the most vigorously advancing regions, as the initially designed level of their tax capacity proves to be lower than the actual one.

Two modifications below mirror a gradual transition to 100% payment by the population for housing and public utilities services in the frame of the respective reform currently in progress in the country. As well, they reflect the eagerness of the RF Ministry of Finance to encourage regions to pursue the reform.

2. Specific weights employed to identify the budgetary expenditures index (BEI) have been modified. The proportion of expenditures on labor compensations (including charges on labor compensations and other expenditures influenced by the level of labor compensations) in BEI remained unchanged and accounts for 0.55, while the specific weight of other expenditures has grown from 0.2 to 0.35, because of a fall in the proportion of expenditures on the housing and public utilities (and other costs whose formation is influenced by costs of the housing and public utilities services) from 0.25 to 0.10.

3. While calculating the coefficient of costs of the housing and public utilities services (which forms a part of the budgetary expenditures index) the marginal costs of the services in questions (including capital refurbishment costs) are substituted by costs computed on the basis of economically justified tariffs (still with account of the capital refurbishment costs). At this point, it should be noted that in the event the Federal Service for Tariffs introduces marginal indices of a maximum possible modification of the HPU tariffs, it is the very indices that should be used for computations.

4. Because of the aforementioned modifications in the methodology and in order to compensate for the regions' respective losses, since 2007 there has been established the second, additional part of FFSR. The Fund now includes resources needed to bring the 2007 volume of subsidies from the Fund to its 2006 level. This particular part of FFSR is also allocated in two stages. At the first stage, one calculates the volume of subsidies due to the regions whose designed volume of subsidies from the Fund for 2007 is lower than the 2006 volume of subsidies. At the second stage, the rest of the funds available after calculating additional subsidies is distributed between those Subjects of RF whose growth rates in subsidies from FFSR for 2007 are greater than in 2006, but lower than the average nationwide level computed without regard to the additional subsidy (of the first stage). It should be noted that, while computing additional subsidies from the second part of FFSR, one employs an adjusting index of fulfillment of measures on lowering accounts payable and boosting revenues to the RF Subject's budget. This index comprises three components that take into consideration the dynamic of the change in the following parameters: the proportional weight of accounts payable in the Subject's budget

revenues; the overall volume of accounts payable in the regional budget; and the total volume of budget revenues. The new methodology also contains the following provision: the overall volume of the 2007 subsidy to an RF Subject, with account of the additional subsidy earmarked at the first stage, may not exceed the volume of subsidies from the Fund provided for by the Federal Act "On the 2006 federal budget". Given that, with account of an additional subsidy assigned at the second stage, the overall volume of the subsidy may not exceed the volume of the subsidy from the Fund provided for by the Federal Act "On the 2006 federal budget" increased by the average nationwide level of growth of FFSR (without regard to the additional subsidy).

The regulations of distribution of the second part of FFSR entail breaching the "principle of monotonousness", i.e. an RF Subject that enjoyed a greater level of budget sufficiency prior to the equalization does not retain its rank afterwards<sup>52</sup>. The group of losers has been formed by 31 regions<sup>53</sup>, while the one of victors – by 16 ones<sup>54</sup>. The breach of the principle in question forms a substantial drawback of the new methodology, but one should bear in mind that observance with the principle poses a problem even in the frame of the existing budgetary system, while it becomes hardly doable in the event of the transition to a three-year budgeting.

Overall, one should note the ambiguity of the 2007 novelties in the methodology of allocation of the FFSR resources: on the one hand, most of them pursue the goal of creation of incentives to improve efficiency of the regional finance management, with a parallel compensation for whatever probable losses that may arise due to changes in the methodology, while, on the other hand, subsidies from the second part of the Fund break the principle of monotonousness in their allocation. Plus, as already noted above, subsidies on equalization of the budget sufficiency level should first of all ensure the possibility for the provision of an equal level of budgetary services vis-à-vis equal tax efforts by all the regions, providing there is no discouragement of regions' attempt to boost the level of their budget sufficiency on their own. But an efficient stimulation of regions to boost their tax capacity is most likely to become possible under employment of other government regulation mechanisms.

There also are other novelties associated with FFSR in 2007. More specifically, there will be 68 regions that will receive subsidies from FFSR, or at 3 regions more than in 2006. Underlying this change are the following causes:

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<sup>52</sup> The IET computations on the basis of the data of the RF Ministry of Finance.

<sup>53</sup> Volgograd oblast, Arkhangel oblast, Tula oblast, Krasnodar krai, Republic of Karelia, Orel oblast, Kursk oblast, Khabarovsk krai, Kaluga oblast, Tver oblast, Vladimir oblast, Voronezh oblast, Kostroma oblast, Amur oblast, Stavropol krai, Kirov oblast, Magadan oblast, Pskov oblast, Chita oblast, Republic of Chuvashia, Republic of Mordovia, Kurgan oblast, Altay krai, Bryansk oblast, Republic of Buryatia, Chukotka AO, Republic of Kalmykia, Kabardino-Balkar Republic, Republic of Dagestan, Taymyr (Dolgano-Nenetsky) AO, Republic of Tyva.

<sup>54</sup> Novosibirsk oblast, Novgorod oblast, Saratov oblast, Primorsky krai, Ulyanovsk oblast, Republic of Yakutia, Tambov oblast, Penza oblast, Republic of Mary-El, Ivanovo oblast, Koryaksky AO, Jewish AO, Republic of North Ossetia-Alania, Karachaevo-Cherkess Republic, Evenk AO, Republic of Altay.

1. The Republic of Bashkortostan has begun receiving the subsidies, as its budget sufficiency level had plunged below the average nationwide one;
2. Ust-Ordynsky and Koryaksky AOs once again became eligible for the subsidies separately from the respective oblasts.

In 2007, the volume of FFSR in real terms (with account of CPI) posted a 6.1% growth vs. the respective index of 2006. Meanwhile, this year 26 regions should receive lesser volumes of subsidies from FFSR in real terms than in 2006 (when this group comprised 16 regions)<sup>55</sup>. As well, there also exists some correlation between the change in the volume of subsidies from FFSR in real terms and the level of budget sufficiency of the RF Subjects (*Table 24*).

*Table 24*

**Correlation between Changes in the Volume of Subsidies from FFSR in Real Terms in 2007 vs. 2006 from the Level of Budget Sufficiency of the Region**

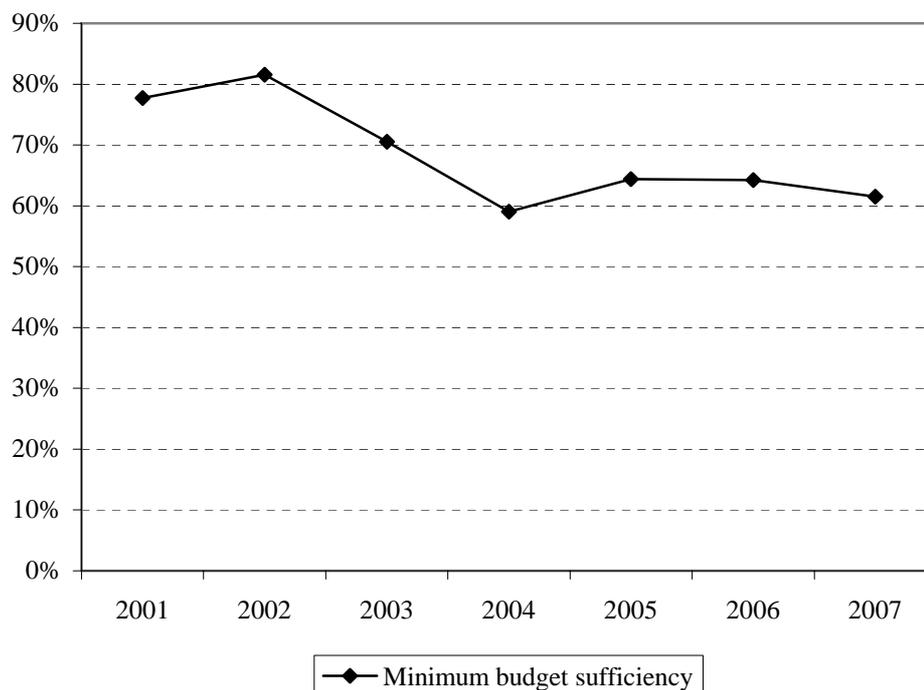
Budget sufficiency level	The number of regions that received subsidies from FFSR in real terms in 2007	
	Lesser amount than in 2006	Greater amount than in 2006
Under 60%	10	34
60–80%	12	5
Over 80%	4	3

The data of the *Table 24* evidence that some 77% of regions with the level of budget sufficiency below 60% will receive greater amounts of subsidies (in real terms), while the respective rate for regions with the budget sufficiency rate between 60 and 80% is just 29%. Last year, the respective proportions were 86% and 55%, accordingly. The situation in the group of regions with the budget sufficiency rate over 80% has not undergone any drastic changes. It should be noted that the above data may witness some rise in progressiveness of allocation of subsidies from FFSR.

It should also be noted that the minimum budget sufficiency of an RF Subject (after equalization) still remains very low, and in 2007 it accounts just for 62% of the average nationwide one. The respective index tends to fall vs. the period between 2005 and 2006 (at the time, it was 64%). It can be argued that, according to Rawls<sup>56</sup>, the allocation of the FFSR subsidies is still unjust. The dynamic of the change in the regions' minimum budget sufficiency rate after equalization is presented in *Fig. 11*.

<sup>55</sup> Belgorod oblast, Kursk oblast, Moscow oblast, Ryazan oblast, Smolensk oblast, Arkhangel oblast, Murmansk oblast, Novgorod oblast, Karachaevo-Cherkess Republic, Volgograd oblast, Republic of Mary-El, Saratov oblast, Ulyanovsk oblast, Republic of Khakassia, Irkutsk oblast, Kemerovo oblast, Novosibirsk oblast, Omsk oblast, Taymyr (Dolgano-Nenetsky) AO, Evenk AO, Republic of Sakha (Yakutia), Primorsky krai, Amur oblast, Kamchatka oblast, Sakhalin oblast, Jewish autonomous oblast.

<sup>56</sup> See Rawls, John. *A Theory of Justice*. Harvard University Press. 1999 [originally published 1971].



*Fig. 11. Dynamic of Minimum Budget Sufficiency of the RF Subjects between 2001 and 2007*

The analysis of the structure of FFSR allows the following observations: its newly established second part accounts for a meager 3.5% of its 2007 overall volume. The first part of FFSR is broken by stages as follows: 50% (of the total volume of FFSR) falls on the first stage, while 46.5 – on the second one. In 2006, the situation was opposite (44.3% – on the first stage and 55.7% – on the second). The change in the proportions has resulted in the following situation: the resources of the first part of the Fund remained after the allocation of subsidies at the first stage allowed allocation in 2007 of just 18.2% of the volume of budgetary subsidies needed to get the level of budget sufficiency of the regions of the second group to the average nationwide one (in 2006, this index made up 24.2%). As a result, the RF Subjects with a greater level of budget sufficiency (over 60% of the average nationwide one) ended up losing, as they became eligible to a smaller fraction of FFSR.

In conclusion, it is worthwhile noting that the insufficient volume of FFSR and a low level of equalization of the budget sufficiency level indirectly entail the necessity of employment of subsidies on support of measures on getting the RF Subjects' budgets balanced, soft budget constraints, and the whole complex of associated with these phenomena effects on the subnational authorities' fiscal behavior.

## 2.5. Russian Financial Markets

### 2.5.1. Internal Debt Market

In 2006, the internal debt of the Russian Federation in securities grew in volume by nearly 20.8 per cent, from RUR 851.15 bln to 1,028.04 bln (in terms of GDP, the national debt has somewhat reduced from 3.94 per cent to 3.86 per cent of GDP).

Table 25

#### The RF Internal Debt Structure (RUR, billion)

Type of securities	As of 01.01.2006	As of 01.01.2007
GKO	0,02	0,00
OFZ-PK	0,001	0,00
OFZ-PD	123,64	205,62
OFZ-FK	131,13	94,83
OFZ-AD	596,33	675,16
GSP-PPS	0,00	0,42
GSO-FPS	0,00	52,00
Total	851,15	1028,04

Source : the RF Ministry of Finance

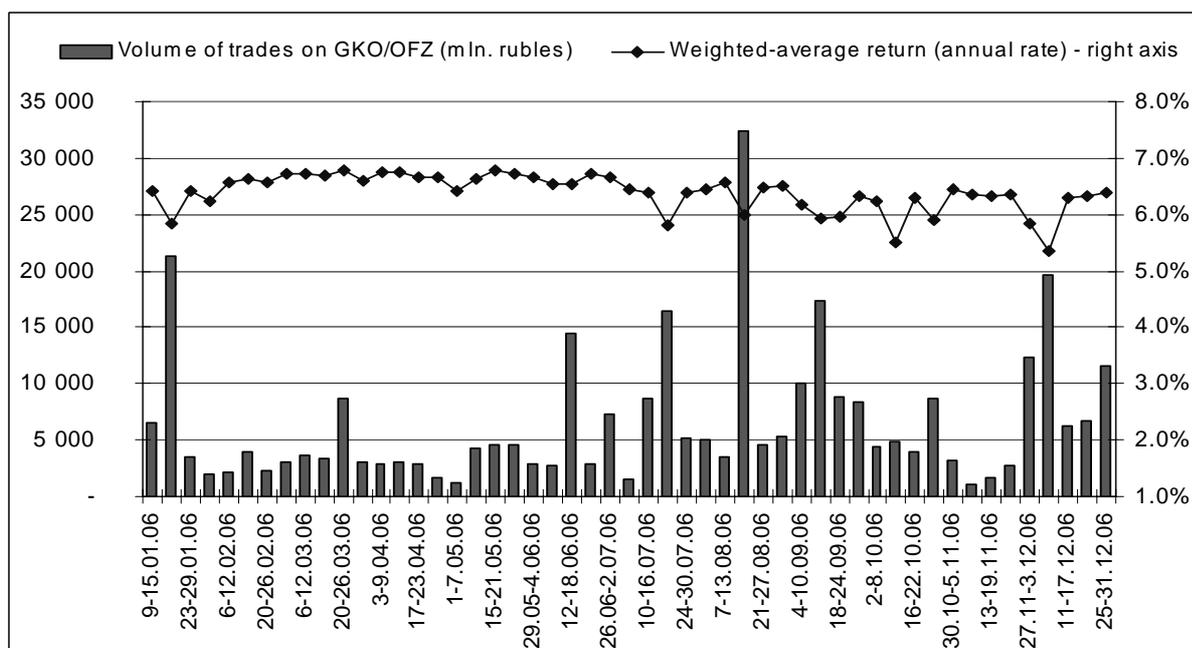
Over the period of the first three quarters of 2006, the external debt of the Russian Federation (government authorities and monetary-credit control bodies) reduced from USD 82.3 до 54.7 bln (according to the data of the Central Bank of Russia). Thus, the absolute value of external debt of the Russian Federation reduced by 33.5 per cent. At the same time, the private sector (banks and other institutions) increased its debt to non-residents from USD 175.1 billion to USD 214.0 billion ( +22.2 per cent ) over the same period. Thus, the external debt of the Russian Federation grew from USD 257.4 to 268.6 billion in total within nine months of 2006.

#### Domestic Debt

In 2006, there was no such a substantial reduction in average weighted yield of the traded issues, that was noted in the ruble government debt market year ago. Thus, according to the data at closing on December 29, 2006, the average weighted yield has been reduced to 6.39 per cent per annum as opposed to 6.42 per cent p.a. at the beginning of 2006 .(See Fig. 12). Herewith, up to July the situation in the market remained quite stable, but in the second half of the year volatility was growing to a certain extent. Before July average weighted yield was kept up within the range of 6.24 per cent to 6.79 per cent per annum, while it changed to 5.36 per cent–6.57 per cent per annum in the second half of the year. A special emphasis should be placed on the fact that in 2006 the parameters of investment activity has somewhat decreased as compared with the data of preceding year of 2005. The total trading volume of GKO/ OFZ bonds in 2006 made RUR 333.04 bln against RUR 355.07 bln in 2005.

Herewith, at the background of some decrease in the total trading volume in 2006, the average weekly parameters were also getting down and made RUR 6.5 bln as opposed to RUR 6.9 bln in 2005. The maximum weekly trading volume in

2006 reached nearly RUR 32.36 billion in 2005 ( as opposed to nearly RUR 24.2 bln in 2005), while the minimum was nearly RUR 993.8 bln (about RUR 993.8 bln in 2005). Thus, in the year of 2006, the maximum trading volume parameter has somewhat decreased as compared with the minimal weekly trading volume parameter in the market of government bonds denominated in rubles, despite the growth of maximum trading volume.



Source : Finmarket Asset Management Company, estimates made by the authors.

Fig. 12. Market Dynamics for GKO/ OFZ bonds in 2006

In analyzing the annual market dynamics, it should be noted that market quotations periodically moved up and down throughout the year. Thus, upon a short period of decrease to 6 per cent per annum at the beginning of the year, the average weighted yield of GKO-OFZ was gradually growing up to July and then got stabilized at the level of 6.5 – 7 per cent per annum. The process was continued till mid-July, when a moderately negative trend in the dynamics of short-term up and down fluctuations was formed at the market. Let us consider in detail the monthly dynamics in liquidity in the market of government bonds, denominated in rubles.

Thus, within the first month of 2006, there were observed periods, when quotations would go up or down, which resulted in insignificant average weighted monthly indicators. Liquidity situation was quite favorable, and only one auction was held at the primary market. Also in January the government has approved the Program of National Debt for the year of 2006, according to which the total OFZ volume was planned in the amount of RUR 186 bln, whereas in 2005 the total amount of domestic debt was planned within RUR 258.9 bln, and actually bonds were placed for RUR 182.3 bln. A session of market participants, arranged by the RF Ministry of Finance, MICEX and National Fund Association, involved in the above situation, where the Ministry of Finance has confirmed the sustainability of the pol-

icy domestic debt with OFZ issues 3, 5, 10 and 15. It was also declared that Ministry of Finance is prepared to stop the extra liquidity on placed securities, which might become even lower than planned in the federal budget. The need of the Ministry of Finance in internal debt is decreased, and there is no necessity in extra yield of placed securities.

A month later the major part of investors' activities was moved to the primary market, where the demand was several times higher than securities offer. Inconsistency of the demand and offer in terms of price was noted in a number of issues, and hence, placement of some securities was incomplete. At the same time, insignificant volatility of quotations was observed in the secondary market, prices varied within a narrow range. In general, the market was supported by the stable RUR rate with some trend to its strengthening against USD, as well as sufficient liquidity level in the bank sector. As opposed to that, prices were affected by inflation expectations, since within the first two months consumer prices have grown by 4.1 per cent, much higher than the level of official estimates. Economic situation in general has been aggravated, what was confirmed by lower indicators of GDP, industrial production, investment and trading activities within the first month of preceding year as compared with December 2005..

In March inflation estimates made a stronger negative impact on the market, as the inflation within the first three months of the year reached about 5 per cent, whereas according to the estimates, that level should have been in the limits of 7-8.5 per cent by the end of the year. In this context, the Ministry of Economy and Trade has to make adjustments to the target estimates up to 8-9 per cent, while the Ministry of Finance admits that consumer prices can be increased by 10 per cent as of 2006 results. Apparently, all the above was taken into regard in the bonds yield estimates and resulted in the market quotations. Liquidity problems in the bank sector made an additional pressure on prices. Alongside with that, one of counter-inflation measures, taken by the RF Central Bank, is effective strengthening of RUR in nominal terms. However, that factor provides an adverse effect, supporting RUR liquidity, and the gross yield of securities has somewhat grown as compared with February indicators.

Further aggravation of the situation with monetary liquidity and high inflation expectations have made a stronger effect over the government bonds denominated in rubles, than strengthening of RUR against USD. The government proposed a series of counter-inflation measures to be taken in the economy to restrain the greater prices growth rates, than planned ones. Some downward trend in yield was observed in May. The dominating factors were monetary liquidity, which has considerably raised as compared with other periods; stronger RUR against USD, as well as lower inflation expectations due to slower rates of consumer prices growth (in May it made only 0.5 per cent against 1.4 per cent in May 2005). The situation in the primary market was also rather favorable and the auctions on government bonds placements were successful.

In June there were no expressed changes in prices of traded securities. While there was observed a negative trend in quotations in the market at the beginning of

the month, prices have been adjusted by the end of June. The market was supported by the information on complete recovery of the RF debt to Paris Club of Creditors, what allowed to save about USD 7.7 of interest payments. Inflation was getting down; consumer prices went up by 0.3 per cent against 0.5 per cent in May. One more stabilizing factor in the market of government bonds denominated in rubles was liberalization of the RF foreign currency legislation, planned for July 1, 2006, which could be taken into regard by the investors in their considerations on the structure of investment portfolios.

Quotations were growing till the end of July, and at that background the average weighted yield of GKO-OFZ has decreased below 6 per cent for the first time since January and made 5.8 per cent per annum. Herewith, as can be observed in *Fig. 12*, the yield decrease was accompanied by the growth of trades. The basic factors of favorable dynamics were stabilization of external debt market, high liquidity, RUR strengthening, liberalization of the RF foreign currency legislation. Rather favorable situation was also observed in August-September, despite the fact that the yield came back to the level of 6 per cent per annum. Meanwhile, the volume of secondary trades has reached its peak as compared with preceding months of 2006. Among other standard factors of yield growth, the RF raised rating played an important role as well.

Some yield growth of the most liquid bonds was observed in October, though there were no vast-scale trades. Comments of some authorized officials on excessive RUR strengthening negative impact on the RF economy made some effect over the demand-offer balance. For instance, the RF Minister of Finance has mentioned, that further RUR strengthening will provide negative effect on the Russian economy and can result in RUR devaluation after 2009. Lower liquidity in the bank sector has added to the yield growth. Only noticeable RUR strengthening against USD contributed to the situation of the end of November, when the yield of the government bonds denominated in rubles has considerably grown, regardless some liquidity problems. That growth was continued till the end of the year, and has resulted in decrease of the most liquid ruble bonds. The basic supporting economic factors were the expected in 2006 high rates of economic growth and lower inflation. However, rather high volume of primary offer in the market of corporate bonds, characterized by high yield, and some aggravation of the situation in the sector of the Russian government foreign currency debt, prevented the bonds from reaching the level of potential, formed by the end of the year.

In 2006 the RF Ministry of Finance has successfully held 34 auctions on placement of GKO-OFZ for the total amount of about RUR 208.1 bln (against 20 auctions for the amount of RUR 165.7 bln in 2005). The actual placement volume amounted to RUR 188.6 bln. The yield at the average weighted price varied from 6.08 per cent to 7.06 per cent per annum (in 2005 the range of average weighted price varied from 6.22 per cent to 8.85 per cent per annum). Therefore, an expressed growth of government debt was observed in domestic market, accompanied by significant yield reduction, as compared with the preceding year. As of December 28, 2006, the volume of GKO/ OFZ bonds market amounted to RUR 875.6

bln billion at par value and RUR 879.3 bln at market value. Duration of the GKO/OFZ market portfolio was 5.46 years.

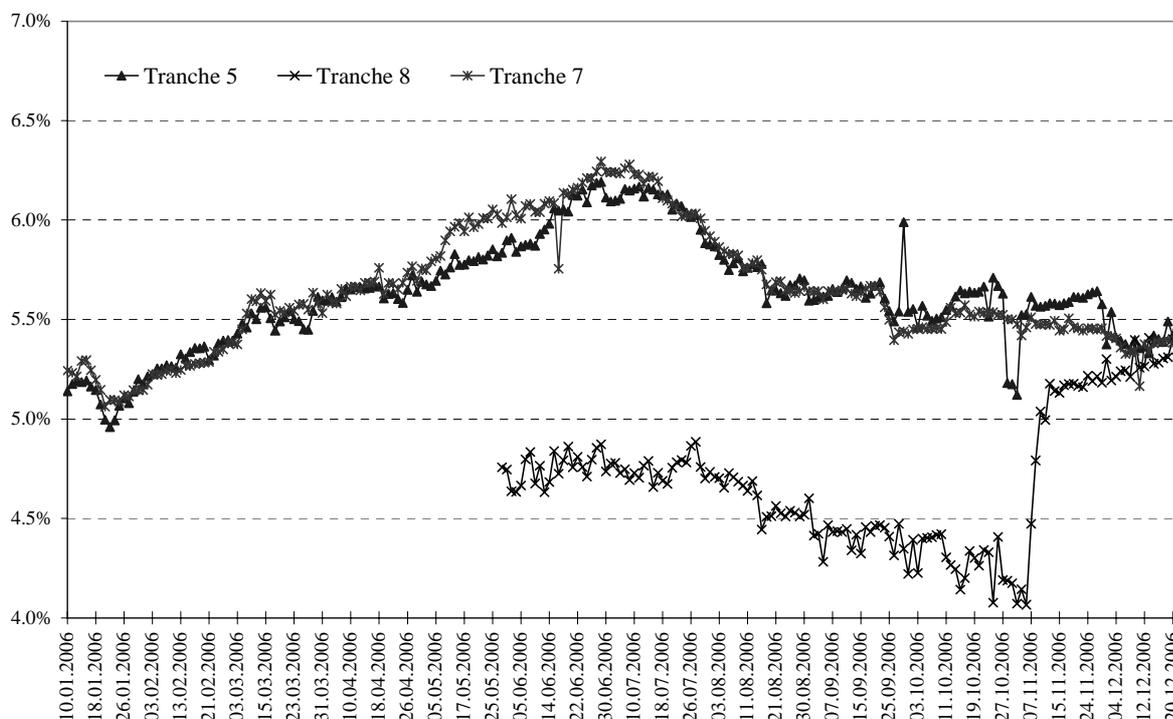
### External Debt

As of 2006 results, there was an upward trend for some bonds denominated in foreign currency (Figs 2 and 3). Thus, as of the end of December, 2006, the yield of the fifth tranche of MinFin Bonds amounted to 5.47 per cent per annum (as opposed to 5.14 per cent early in the year), the seventh tranche of MinFin Bonds – 5.48 per cent per annum (as opposed to 5.24 per cent) eighth tranche of MinFin Bonds – 5.57 per cent per annum (against 4.76 per cent at the beginning of trades as of May 2006). The yield of RUS-30 varied within the year from 5.42 per cent to 5.5 per cent and RUS-28 bonds stayed at the level of the beginning of the year, 5.96 per cent; the yield to maturity of RU-07 varied insignificantly and was established at the level of 5.05 per cent versus 5.03 per cent early in the year, and RUS-18 bonds were traded at prices corresponding to the yield of 5.64 per cent per annum (as opposed to 5.5 per cent early in the year).

Several most significant factors regarding the movement in the Eurobonds market can be highlighted. The first one is extremely favorable conditions in the world oil and metal markets, as well as stable macroeconomic situation in the country. The second factor is the early repayment of a share of the RF sovereign debt to the Paris Club of Creditors. The third factor: it is essential that Standard & Poor's upgraded the Russia's credit rating in foreign currency from BBB up to BBB+, and rating in national currency from A- to BBB, as well as Fitch upgraded the RF sovereign credit from BBB to BBB+. The key adverse factor for the market throughout the year was the movement of the yield of the US Treasury Bonds, which was influenced by periodical increases of the discount rate by the US Federal Reserve System, as well as the growth in inflationary processes in the US economy.

In the analysis of Russian bonds quotations dynamics several periods should be highlighted, when the market situation was variable. Thus, quotations were steadily growing up to mid July with occasional corrections. During the second period, from mid July to early October quotations were decreasing, partially winning back the growth of the beginning of the year. Throughout the third period, in October-December the yield was variable within a certain range. Let us consider the basic factors, which have influenced the dynamics of prices in the market of Russian Eurobonds. In January-February favorable information on the US economy were published in the USA, what has reduced the expectations of the slow-down in the economic growth rates, but supported inflation growth, especially in view of the forthcoming meeting of Committee on open markets of USA FRS. As a result, investors were selling US government bonds, what provoked trades in the Russian market as well, which nevertheless did not reach a vast scale, since the Russian bonds were substantially supported by high oil prices, demonstrated an expressed growth within January. In late January investors' expectations came true, the basic rate in US was raised by 0.25 p.a. and reached 4.5 per cent per annum. The investors were also influenced by several developments, in particular, by the statement

of B. Bernake, the new head of the US Federal Reserve System, though there was no new information in his words. He has mentioned, that the mechanism of the basic interest rate adjustment will be further applied as a balance instrument against inflation pressure. As a result of the month, quotations of the Russian bonds, denominated in foreign currency, have been decreased.



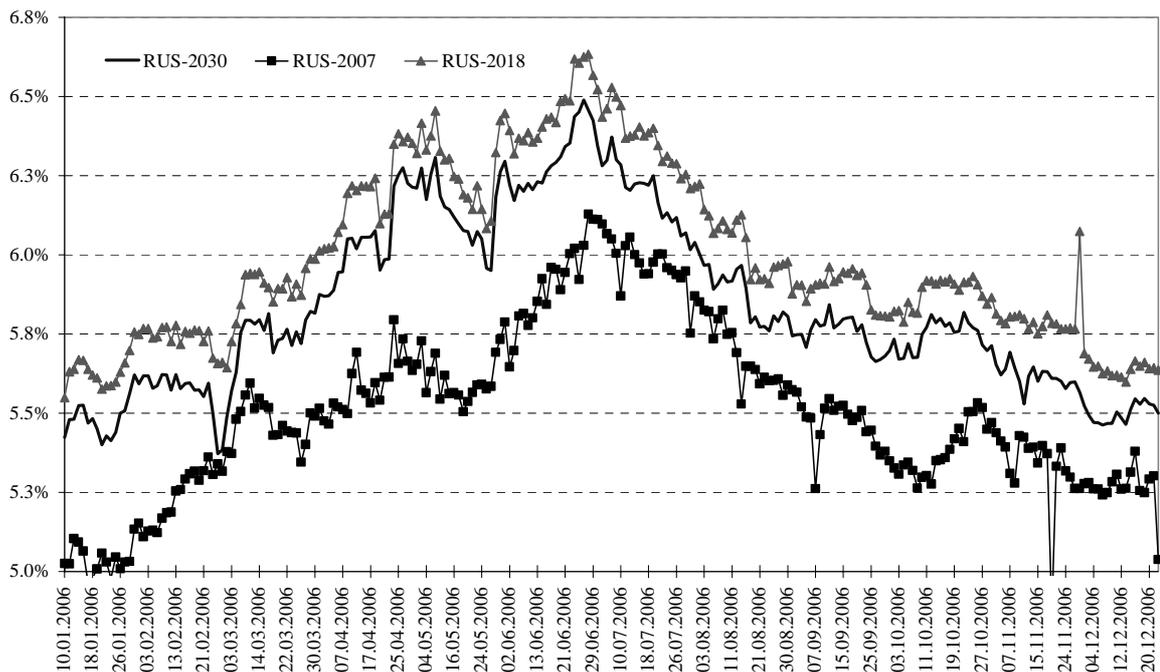
Source : Finmarket Asset Management Company.

Fig. 13. MinFin Bonds Yield to Maturity in 2006

Similar trends were prevailing in the market up to July. The interest rate in USA went up several times (up to 4.75 per cent per annum in March, to 5 per cent per annum in May). A greater portion of US economic statistics stated a steady economic growth rate, whereas the upsurge of the world prices for energy sources created additional grounds for stronger inflation development and as a result, for further growth of interest rates. Comments of financial authorities in Europe also pointed to their intentions to raise the interest rates. In this situation one could most likely expect a downward trend in the sector of the Russian Eurobonds, what has actually happened in the market.

In July the upward trend of the Russian Eurobonds yield was replaced by an adverse tendency. The basic factor in the dynamics of the market situation was a reduced probability of further tightening of US Federal Reserve System monetary and credit policy, which effected both, the markets of the US government bonds and consequently, Eurobond markets of other countries. Moreover, statistical data, published in USA, reflected some slow-down in economy and inflation stabilization. In that situation investors were planning a decrease of interest rates in their forecasts, what also inspired price upswing. Their forecasts came true in October, when FRS made a pause in the series upgrades of interest rates. To the contrary,

the Central bank of Europe has increased the interest rate by 0.25 p.p. up to 3.25 per cent per annum, but commented on low likelihood of further growth. In November and December there was no expressed dynamics in the market of Russian Eurobonds as well. Herewith, while in the US market the bonds were downgrading in December due to contradictory publications on macroeconomic data, provoked one more review of expectations in regard to the US Federal Reserve System policy, the Russian debt market demonstrated high resistance to that factor, though there was observed some yield upgrading in some bonds.



Source : Finmarket Asset Management Company.

Fig. 14. Russian Eurobonds Yield to Maturity due 2030, 2018 and 2007, in 2006

### 2.5.2. The market for Municipal and Subfederal Borrowings

#### The dynamic of market development

By the results of the year 2006, the consolidated regional budget was drawn with a surplus of 139.8 bn roubles (0.53 % of GDP). The budgets of subjects of the Federation were drawn with a surplus of nearly 133.8 bn roubles, the budgets of city okrugs and the intracity municipal formations of the cities of Moscow and St. Petersburg – with a surplus of 0.3 bn roubles, the budgets of municipal raions – with a surplus of 9.8 bn roubles, the budgets of urban and rural settlements – with a surplus of 2.2 bn roubles<sup>57</sup>.

<sup>57</sup> For five subjects of the Russian Federation (Moscow Oblast, the Republic of Ingushetia, the Chechen Republic, Koriak AO, and Chulotka AO), the budget statistics on municipal formations is cited without

In 2005, the consolidated regional budget was drawn with a surplus of 57.1 bn roubles, or 0.26% of GDP. The budgets of subjects of the Federation were drawn with a surplus of nearly 53.8 bn roubles, the budgets of municipal formations – with a deficit of 9.4 bn roubles (*Tables 26 and 27*).

Thus, in one year the surplus of the consolidated regional budget against GDP increased more than twofold – by 0.27 p.p. of GDP.

Table 26

**Ratio of the surplus (or deficit) of territorial budgets to budget expenditure (in %)**

	Consolidated regional budget	Regional budgets	Municipal budgets <sup>1</sup>
2002	-2.7	-3.0	-2.8
2003	-2.6	-2.3	-3.2
2004	1.1	1.6	0.2
2005	1.6	2.3	-0.8
2006	3.7	4.4	

Source: the IET's estimates, based on the data of the Federal Treasury.

Table 27

**Ratio of the surplus (or deficit) of territorial budgets to budget expenditure in 2006 (in %)**

The budgets of city okrugs and intracity municipal formations of Moscow and St. Petersburg	Budgets of municipal raions	Budgets of urban and rural settlements	Local budgets of five subjects of Russian Federation (Moscow Oblast, Republic of Ingushetia, Chechen Republic, Koriak AO, Chukotka AO) <sup>1</sup>
0.04	1.63	2.52	-2.07

As of 1 January 2007, the consolidated budget was drawn with a surplus in 54 subjects of the Federation (as compared to 33 in 2005). The aggregate volume of budget surplus in those regions amounted to 190.6 bn roubles, or 6.9% of the total revenue of their budgets (in 2005 – 5.4%). The average budget surplus amounted to 2.5% of budget revenue budget.

The highest surplus to revenue ratio in the consolidated budget was achieved in Agin-Buriat AO – 22.9%, in St. Petersburg and Nenets AO – 14.7% each, in Chechen Republic – 13.4%, Koriak AO – 12.0%, in Cheliabinsk Oblast – 11.7%, in the republic of Bashkortostan – 10.3%, in Krasnoyarsk Krai – 10.2%, in Pskov Oblast – 9.3%, in the city of Moscow – 8.8%, in Tumen Oblast – 8.5%. Nearly 2/3 (or 64.2%) of the aggregate surplus of the consolidated regional budget was achieved by four subjects of the Federation: the city of Moscow – 35.0%, or 66.6 bn roubles, the city of St. Petersburg – 16.8%, or 32.0 bn roubles, Tumen Oblast – 7.1%, or 13.5 bn roubles, and Krasnoyarsk Krai – 5.4%, or 10.2 bn roubles.

The substantial budget surplus in two autonomous okrugs was produced by additional budget funding in connection with the approaching merging of Agin-Buriat AO and Chita Oblast, as well as Koriak AO and Kamchatka Oblast. The high surplus in

breaking it into the categories of “city okrugs”, “municipal raions”, and “urban and rural settlements”. The budgets of the municipal formations in these regions were drawn with the deficit of 2.2 bn roubles.

the budgets of Moscow, St. Petersburg, Tumen Oblast and Bashkortostan is associated primarily with the high growth of export prices of energy carriers.

In 2006, the consolidated budget was drawn with a deficit in 33 RF subjects (in 2005 – in 54 regions)<sup>58</sup>, its aggregate volume amounting to 50.7 bn roubles, or 4.9 % of their budget revenue (in 2005 – 48.0 bn roubles).

The average level of budget deficit amounted to 2.7% of budget revenue. The highest deficit to budget revenue ratio was observed in the Republic of Mordovia – 13.1%, in Magadan Oblast – 9.9%, and in the Republic of Sakha (Yakutia) and Khanty-Mansi AO – 8.4% both.

More than a half, or 54.4%, of the aggregate deficit was produced by 5 subjects of the Federation: the Khanty-Mansi AO had an aggregate deficit of 20.0 %, or 10.1 bn roubles, Moscow Oblast – 12.4%, or 6.3 bn roubles, the Republic of Sakha (Yakutia) – 9.3%, or 4.7 bn roubles, Omsk Oblast – 6.6%, or 3.3 bn roubles, Samara Oblast – 6.2%, or 3.1 bn roubles (*Table 30*).

#### Changes in the structure of accumulated debt

The amount of accumulated debt in the consolidated regional budget increased in 2006 to 54,777.75 mln roubles, or 0.21 % of GDP. The increased debt resulted from the growth of domestic debt (that is, rouble-denominated debt). The external debt in the regional consolidated budgets decreased by 496.2 mln roubles, while domestic debt grew by 54,981.5 mln roubles (*Table 28*). As in the previous years, the combination of the surplus of the consolidated regional budget and the growing volume of accumulated debt can be explained by the general increase of the amount of residuals on the budget accounts and the growth of the other assets owned by the territorial authorities.

*Table 28*

#### Net borrowings regional and local budgets (in % of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006
Borrowings of subfederal and local authorities	0.15	-0.29	-0.04	0.47	0.37	0.26	0.09	0.21
Including:								
Reimbursable loans from budgets of other levels	-0.11	-0.03	0.04	0.12	-0.1	-0.02	-0.03	-0.04
Subfederal (municipal) bonds	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14
Other borrowings	0.31	0.01	-0.02	0.19	0.6	...	0.03	0.11
Decreasing residuals on budget accounts	-0.19	-0.30	-0.05	-0.04	-0.18	-0.62	-0.48	
Financing of deficit from borrowings and decreasing residuals on budget accounts	-0.04	-0.59	-0.09	0.38	0.19	-0.36	-0.38	

*Source:* the IET's estimates, based on the data of the RF Ministry of Finance and the Federal Treasury.

<sup>58</sup> In the reports published by the RF Ministry of Finance (or the Federal Treasury) on the execution of the budgets of subjects of the Russian Federation in 2005 and 2006, the data on Evenk AO and Taymyr (Dolgano-Nenets) AO are not shown separately.

### The structure of borrowings

The total volume of borrowings in the regional consolidated budget in 2006 amounted to 264,166.1 mln roubles, of which external borrowings constituted 14,964.1 mln roubles. As in 2005, the sole recipients of external loans were Moscow city (13.7 bn roubles) and the Republic of Bashkortostan ( 1.2 bn roubles), which were refinancing the previously received external loans.

The aggregate volume of internal borrowings received by regions and municipalities amounted to 249,202.0 mln roubles. The biggest borrowers on the domestic market were as follows: Moscow Oblast – 48.1 bn roubles, Moscow city – 17.9 bn roubles, Omsk Oblast – 14.7 bn roubles, and Novosibirsk Oblast – 11.7 bn roubles. By comparison with 2005, the volume of domestic borrowings in nominal terms increased by 23.5 bn roubles, or by 10.6%, which is nearly equal to the rate of inflation.

Within the total volume of domestic borrowings of the consolidated regional budget, the issue of securities amounted to 29.4%, the loans from the federal budget – to 4.4%, and other types of borrowings (primarily bank loans) – to 66.2%.

In a situation of an absolute reduction in the volume of the issue of securities, the level of securitization of borrowings made by regions and municipalities went down from 36.0 % in 2005 to 29.4% in 2006 (*Table. 29*).

*Table 29*

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

	2006			2005			2004		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Issue of securities	29.4	37.1	9.7	36.0	45.5	10.2	32.5	41.0	4.0
Budget loans	4.4	6.0	0.3	1.2	1.6	0.03	3.0	4.0	46.4
Other types of borrowings	66.2	56.9	90.1	62.9	52.9	89.8	64.5	55.1	49.6

*Source:* the IET's estimates, based on the data of the RF Ministry of Finance and the Federal Treasury.

The highest ratio of net borrowings to budget revenue was demonstrated by Moscow Oblast – 16.5%, Astrakhan Oblast – 12.8%, Kostroma Oblast – 9.4%, Kaluga Oblast – 8.8%, Yaroslavl Oblast – 7.9% (*Table 30*).

The biggest net borrowers were as follows: Moscow Oblast – 28.9 bn roubles, Moscow – 8.9 bn roubles, Samara Oblast – 3.6 bn roubles, Irkutsk Oblast – 2.6 bn roubles, Yaroslavl Oblast – 2.1 bn roubles, Astrakhan Oblast and Saratov Oblast – 2.0 bn roubles each.

The greatest reduction in the amount of accumulated debt was observed in Krasnoyarsk Krai – by 4.9 bn roubles, in Nizhnii Novgorod Oblast – by 2.1 bn roubles, in St. Petersburg – by 1.6 bn roubles, in Leningrad Oblast – by 1.5 bn roubles.

*Table 30*

**The execution of the consolidated budgets of subjects  
of the Russian Federation in 2006**

	Budget revenue, thousand roubles.	Budget surplus (deficit), thousand roubles.	Ratio of surplus (deficit) to revenue, in %	Attracted borrowed resources to revenue, in %	Net borrowings to revenue, in %	Cost of debt redemption, in %	Net borrowings to budget surplus (deficit), in %
1	2	3	4	5	6	7	8
<b>Central Federal Okrug</b>							
Belgorod Oblast	29 484 991.76	-1 615 443.06	-5.48	3.84	3.05	0.80	-55.59
Briansk Oblast	17 602 562.54	-195 708.94	-1.11	14.08	1.81	12.27	-162.74
Vladimir Oblast	21 514 145.62	491 021.71	2.28	0.05	-0.79	0.84	-34.41
Voronezh Oblast	30 435 574.02	453 109.44	1.49	7.50	1.44	6.06	96.51
Ivanovo Oblast	17 598 473.14	130 194.82	0.74	1.71	0.30	1.40	41.14
Tver Oblast	24 276 982.69	162 631.36	0.67	4.28	-3.28	7.55	-489.11
Kaluga Oblast	17 428 075.24	-1 402 107.61	-8.05	14.00	8.79	5.21	-109.24
Kostroma Oblast	10 239 314.04	-679 101.85	-6.63	22.62	9.37	13.26	-141.22
Kursk Oblast	16 707 865.59	301 239.29	1.80	0.66	-0.34	1.00	-18.85
Lipetsk Oblast	27 935 248.32	646 410.12	2.31	6.44	6.26	0.18	270.73
Moscow Oblast	175 166 922.03	-6 299 496.49	-3.60	27.49	16.48	11.01	-458.24
Orel Oblast	11 181 582.93	251 151.27	2.25	1.43	0.89	0.53	39.65
Riazan Oblast	17 727 957.73	-323 485.86	-1.82	8.22	2.37	5.85	-129.75
Smolensk Oblast	13 619 936.64	327 285.37	2.40	3.42	-1.71	5.12	-71.08
Tambov Oblast	15 203 434.33	294 919.40	1.94	3.42	1.32	2.10	67.83
Tula Oblast	23 789 184.02	-1 401 707.76	-5.89	34.53	6.36	28.17	-107.91
Yaroslavl Oblast	26 447 297.54	-1 890 399.90	-7.15	16.37	7.94	8.43	-111.05
Moscow city	757 936 696.98	66 606 909.18	8.79	4.18	1.18	3.01	13.45
<b>Total</b>	<b>1 254 296 245.15</b>	<b>55 857 420.50</b>	<b>4.45</b>	<b>8.68</b>	<b>3.74</b>	<b>4.96</b>	<b>83.88</b>
<b>North-Western Federal Okrug</b>							
Republic of Karelia	15 158 667.26	-1 057 344.49	-6.98	13.69	6.13	7.56	-87.88
Republic of Komi	30 071 168.79	670 319.23	2.23	1.12	0.03	1.09	1.37
Arkhangelsk Oblast	27 470 667.82	337 842.82	1.23	4.45	0.28	4.17	22.41
Vologda Oblast	32 684 358.61	506 973.59	1.55	1.67	-0.63	2.29	-40.33
Kaliningrad Oblast	20 782 886.55	-156 177.57	-0.75	8.62	1.02	7.60	-135.20
Leningrad Oblast	37 096 265.98	2 488 579.26	6.71	1.69	-4.10	5.79	-61.05
Murmansk Oblast	29 151 834.53	141 683.50	0.49	6.88	0.87	6.01	178.47
Novgorod Oblast	12 054 297.59	-286 838.19	-2.38	0.12	-0.97	1.10	40.82
Pskov Oblast	11 107 536.40	1 035 094.49	9.32	1.09	-6.31	7.40	-67.69
St. Petersburg city	218 096 278.88	31 961 300.62	14.65	1.86	-0.74	2.60	-5.06
Nenets AO	7 650 921.80	1 126 908.51	14.73	0.00	0.00	0.00	0.00
<b>Total</b>	<b>441 324 884.22</b>	<b>36 768 341.77</b>	<b>8.33</b>	<b>2.90</b>	<b>-0.61</b>	<b>3.51</b>	<b>-7.29</b>
<b>Southern Federal Okrug</b>							
Republic of Dagestan	27 095 641.55	545 436.04	2.01	0.00	0.00	0.00	0.00
Republic of Kabardino-Balkaria	11 079 032.31	526 164.44	4.75	8.67	-2.27	10.94	-47.85
Republic of Kalmykia	4 665 809.76	-68 007.66	-1.46	7.72	1.30	6.42	-89.52
Republic of North Osetia - Alania	11 418 024.51	104 126.89	0.91	9.63	1.89	7.75	206.74

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1	2	3	4	5	6	7	8
Republic of Ingushetia	6 438 992.64	-16 956.75	-0.26	0.00	0.00	0.00	0.00
Krasnodar Krai	81 032 699.06	5 133 373.90	6.33	1.00	0.51	0.49	8.12
Stavropol Krai	35 720 169.22	1 237 746.31	3.47	3.90	0.88	3.02	25.34
Astrakhan Oblast	15 644 980.75	-1 222 172.57	-7.81	49.83	12.84	36.99	-164.36
Volgograd Oblast	39 839 761.98	-690 523.52	-1.73	10.52	2.37	8.15	-136.72
Rostov Oblast	59 641 367.30	1 510 089.89	2.53	0.18	0.00	0.18	0.15
Republic of Adygeya	5 708 000.36	162 094.83	2.84	0.35	-2.75	3.10	-96.71
Republic of Karachaevo - Cherkessia	6 248 318.64	-77 117.17	-1.23	26.32	3.48	22.84	-282.16
Chechen Republic	31 624 049.42	4 247 709.56	13.43	0.00	0.00	0.00	0.00
<b>Total</b>	<b>336 156 847.50</b>	<b>11 391 964.21</b>	<b>3.39</b>	<b>5.47</b>	<b>1.12</b>	<b>4.35</b>	<b>33.10</b>
<b>Volga Federal Okrug</b>							
Republic of Bashkortostan	83 565 631.02	8 635 577.68	10.33	3.28	1.57	1.90	15.21
Republic of Marii El	10 464 294.32	-143 259.12	-1.37	7.16	2.06	5.10	-150.37
Republic of Mordovia	14 356 730.25	-1 885 905.16	-13.14	0.00	-0.74	0.74	5.66
Republic of Tatarstan	88 326 860.15	2 064 567.36	2.34	8.73	-0.11	8.85	-4.88
Republic of Udmurtia	25 339 742.02	-1 102 825.24	-4.35	4.07	0.05	4.02	-1.22
Republic of Chuvashia	19 171 874.22	-499 010.92	-2.60	6.21	4.84	1.38	-185.76
Nizhnii - Novgorod Oblast	59 242 672.46	4 295 302.71	7.25	7.52	-3.54	11.06	-48.83
Kirov Oblast	21 649 798.63	-336 218.93	-1.55	8.67	4.62	4.06	-297.40
Samara Oblast	67 696 875.17	-3 142 590.83	-4.64	8.39	5.35	3.04	-115.21
Orenburg Oblast	35 793 475.32	193 883.83	0.54	0.39	-1.03	1.42	-190.76
Penza Oblast	19 743 330.90	55 462.64	0.28	10.58	0.91	9.68	322.76
Perm Oblast	56 572 339.83	2 334 274.74	4.13	1.13	0.56	0.57	13.59
Saratov Oblast	32 904 692.51	-823 946.95	-2.50	13.82	5.98	7.84	-238.93
Ulianovsk Oblast	20 419 309.01	1 212 795.80	5.94	0.11	-4.28	4.39	-72.02
Komi-Permiak AO	3 393 009.86	21 986.75	0.65	0.07	-0.71	0.78	-109.46
<b>Total</b>	<b>558 640 635.67</b>	<b>10 880 094.37</b>	<b>1.95</b>	<b>5.89</b>	<b>1.07</b>	<b>4.84</b>	<b>54.98</b>
<b>Ural Federal Okrug</b>							
Kurgan Oblast	13 448 299.19	-256 332.85	-1.91	5.41	2.56	2.84	-134.36
Sverdlovsk Oblast	97 882 319.84	6 771 737.58	6.92	0.41	-0.18	0.59	-2.62
Tumen Oblast	159 368 409.34	13 509 541.07	8.48	0.01	-0.23	0.24	-2.74
Cheliabinsk Oblast	66 866 623.62	7 792 056.19	11.65	0.86	-0.45	1.31	-3.90
Khanty-Mansi AO	121 064 671.80	-10 119 699.34	-8.36	0.65	0.18	0.47	-2.12
Yamal-Nenets AO	64 621 447.15	347 585.97	0.54	3.17	0.74	2.43	137.43
<b>Total</b>	<b>523 251 770.94</b>	<b>18 044 888.63</b>	<b>3.45</b>	<b>0.87</b>	<b>0.04</b>	<b>0.84</b>	<b>1.03</b>
<b>Siberian Federal Okrug</b>							
Republic of Buriatia	21 361 222.34	191 613.66	0.90	9.03	0.95	8.08	105.82
Republic of Tyva	7 540 373.50	-42 924.79	-0.57	0.00	-0.48	0.48	84.24
Altay Krai	35 892 424.96	900 063.30	2.51	4.55	-3.64	8.19	-145.02
Krasnoyarsk Krai	99 687 940.60	10 201 968.87	10.23	6.43	-4.99	11.42	-48.75
Irkutsk Oblast	50 372 002.51	-1 854 726.60	-3.68	17.04	5.19	11.85	-141.09
Kemerovo Oblast	63 420 573.99	-2 604 559.91	-4.11	2.55	0.92	1.63	-22.47
Novosibirsk Oblast	51 633 127.34	1 580 010.03	3.06	22.66	-1.81	24.47	-59.26
Omsk Oblast	41 626 420.45	-3 340 427.34	-8.02	35.33	3.00	32.33	-37.39
Tomsk Oblast	25 897 683.36	373 069.88	1.44	26.73	0.63	26.10	43.81
Chita Oblast	22 299 648.60	512 741.13	2.30	2.38	-1.04	3.42	-45.22

1	2	3	4	5	6	7	8
Republic of Altay	7 343 323.21	87 769.43	1.20	4.00	-0.39	4.39	-32.73
Republic of Khakassia	8 906 297.63	43 408.69	0.49	0.42	-0.32	0.74	-66.04
Agin-Buriat AO	17 391 010.92	3 988 694.54	22.94	0.04	0.04	0.00	0.19
Ust-Ordyn Buriat AO	2 886 066.00	88 044.54	3.05	-1.88	-1.88	0.00	-61.63
<b>Total</b>	<b>456 258 115.42</b>	<b>10 124 745.42</b>	<b>2.22</b>	<b>11.91</b>	-0.61	12.51	-27.36
<b>Far Eastern Federal Okrug</b>							
Republic of Sakha (Yakutia)	56 028 624.58	-4 713 991.13	-8.41	14.02	3.29	10.73	-39.10
Primorskii Krai	42 170 346.62	1 155 056.55	2.74	1.59	-0.59	2.17	-21.49
Khabarovsk Krai	38 940 124.46	1 401 150.66	3.60	20.26	-0.06	20.32	-1.64
Amur Oblast	20 781 029.01	-490 177.97	-2.36	10.43	4.55	5.88	-192.69
Kamchatka Oblast	15 810 492.39	-958 415.24	-6.06	33.16	5.87	27.29	-96.77
Magadan Oblast	10 294 903.30	-1 021 789.99	-9.93	8.95	6.98	1.97	-70.37
Sakhalin Oblast	24 269 286.14	393 427.53	1.62	9.47	-0.52	9.98	-31.98
Jewish AO	4 646 637.75	182 989.03	3.94	0.54	-0.51	1.04	-12.87
Koriak AO	5 864 167.60	703 846.64	12.00	33.42	-6.28	39.70	-52.30
Chukotka AO	9 590 995.91	138 037.89	1.44	34.62	-2.15	36.77	-149.39
<b>Total</b>	<b>228 396 607.75</b>	<b>-3 209 866.04</b>	<b>-1.41</b>	<b>14.16</b>	<b>1.51</b>	<b>12.66</b>	<b>-107.14</b>
<b>Total, federal okrugs</b>	<b>3 800 391 881.18</b>	<b>139 793 189.73</b>	<b>3.68</b>	<b>6.95</b>	<b>1.44</b>	<b>5.52</b>	<b>39.18</b>

Source: the IET's estimates, based on the data of the Federal Treasury.

### Domestic bond loans

In 2006, the prospectuses of bond loans issued by 27 subjects of the Federation and 16 municipal formations were registered (as compared to 25 regional and 13 municipal loans in 2005). The total volume of bonds to be placed in 2006 amounted to 73.3 bn roubles, against 81.2 bn roubles in 2005 (decrease in nominal terms by 7.9 bn roubles), having gone down in one year from 0.37% to 0.28% of GDP (*Table 31*).

Although the volume of debt securities issued by regions and municipalities decreased by comparison with the previous year, in 2006 the volume of the market for subfederal bonds increased, in real terms, by 8.1% – from 161.1 bn roubles in 2005 to 189.8 bn roubles. This was explained by the increasing duration of debt securities: the issue volume, as before, remained higher than that of the bonds redeemable during the year.

*Table 31*  
**Volume of issue of subfederal and municipal securities (in % of GDP)**

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47	0.37	0.28
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19	0.28	0.14
Net financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14

Source: the IET's estimates, based on the data of the RF Ministry of Finance and the Federal Treasury.

The following entities registered their issue prospectuses at the RF Ministry of Finance in 2006: the Republic of Chuvashia, the Republic of Komi, the Republic of Sakha (Yakutia), the Republic of Bashkortostan, the Republic of Karelia, the Re-

public of Marii El, Krasnoyarsk Krai, Volgograd Oblast, Tomsk Oblast, Irkutsk Oblast, Moscow Oblast, Yaroslavl Oblast, Lipetsk Oblast, Nizhnii Novgorod Oblast, Voronezh Oblast, Belgorod Oblast, Tver Oblast, Samara Oblast, Kirov Oblast, Kaluga Oblast, Tambov Oblast, Irkutsk Oblast, Kurgan Oblast, Penza Oblast and Tula Oblast, the cities of Moscow, St. Petersburg, Ekaterinburg, Novosibirsk, Volgograd, Kazan, Tomsk, Astrakhan, Blagoveshchensk, Bryansk, Voronezh, Lipetsk, Magadan, Yaroslavl and Orekhovo-Zuevo, as well as Klin raion, Odintsovo raion, and Noginsk raion of Moscow Oblast.

The biggest issuers of debt securities were as follows: Moscow Oblast, whose aggregate issue amounted to 18.7 bn roubles, or to 25.6% of the aggregate volume of territorial issues; Moscow city – 17.4 bn roubles, or 23.8%; Samara Oblast – 4.5 bn roubles, or 6.1%; Irkutsk Oblast – 4.2 bn roubles, or 5.7%, and St. Petersburg – 4.1 bn roubles, or 5.5%. Thus, the five biggest issuers produced 61.2% of the total volume of placed regional and municipal bonds.

Besides, big issues were placed by the following entities: the Republic of Sakha (Yakutia) – 2.5 bn roubles, Yaroslavl Oblast – 2.4 bn roubles, the Republic of Tatarstan – 2.3 bn roubles, Nizhnii Novgorod Oblast – 2.0 bn roubles, and the Republic of Bashkortostan – 1.5 bn roubles (*Table 32*).

*Table 32*

**Placement of subfederal and municipal securities  
in 2006**

Federation's subject	Issue volume, thousand roubles	Issuer's share in total issue volume, in %	Ratio of issue volume to domestic borrowings, in %
1	2	3	4
<b>Central Federal Okrug</b>			
Belgorod Oblast	1 020 000.0	1.4	90.0
Bryansk Oblast	300 000.0	0.4	12.1
Voronezh Oblast	500 000.0	0.7	21.9
Kaluga Oblast	1 300 000.0	1.8	53.3
Lipetsk Oblast	1 800 000.0	2.5	100.0
Moscow Oblast	18 740 516.5	25.6	38.9
Tambov Oblast	100 000.0	0.1	19.2
Tula Oblast	1 500 000.0	2.0	18.3
Yaroslavl Oblast	2 411 027.5	3.3	55.7
Moscow	17 433 218.9	23.8	97.3
<b>North-Western Federal Okrug</b>			
The Republic of Karelia	500 000.0	0.7	24.1
St. Petersburg	4 058 466.3	5.5	100.0
<b>Southern Federal Okrug</b>			
Astrakhan Oblast	500 000.0	0.7	6.4
Volgograd Oblast	1 236 454.8	1.7	29.5
<b>Volga Federal Okrug</b>			
Republic of Bashkortostan	1 519 600.0	2.1	100.0
Republic of Marii El	499 136.2	0.7	66.6
Republic of Tatarstan	2 300 000.0	3.1	29.8

1	2	3	4
Republic of Chuvashia	1 000 000.0	1.4	83.9
Nizhnii - Novgorod Oblast	2 000 000.0	2.7	44.9
Kirov Oblast	600 000.0	0.8	32.0
Samara Oblast	4 500 000.0	6.1	79.2
Penza Oblast	800 000.0	1.1	38.3
<b>Ural Federal Okrug</b>			
Kurgan Oblast	500 000.0	0.7	68.8
Sverdlovsk Oblast	172 800.4	0.2	43.0
Khanty – Mansi AO	507 000.0	0.7	64.5
<b>Siberian Federal Okrug</b>			
Irkutsk Oblast	4 150 230.0	5.7	48.4
Novosibirsk Oblast	300 000.0	0.4	2.6
Tomsk Oblast	68 962.1	0.1	1.0
<b>Far Eastern Federal Okrug</b>			
Republic of Sakha (Yakutia)	2 500 000.0	3.4	31.8
Amur Oblast	75 500.0	0.1	3.5
Magadan Oblast	450 000.0	0.6	48.8

*Source:* the IET's estimates, based on the data of the Federal Treasury.

So far, a high level of securitization has been observed predominantly in respect of biggest issuers: Moscow – 99.2% and St. Petersburg – 100%. Borrowings exclusively in the form of issue of securities were made by Lipetsk Oblast. The level of securitization of borrowings in Belgorod Oblast amounted to 92.4%, in the republic of Komi – to 87.7%.

The aggregate volume of net borrowings on the market of subfederal and municipal securities, earmarked to cover the deficit budget, and the refinancing of debt against bank credits amounted in 2006 to 36.5 bn roubles, having increased on 2005 (20.9 bn roubles) by more than 1.5 times (*Table 33*).

*Table 33*

**Volume of net borrowings on the market of domestic subfederal and municipal securities, thousand roubles**

	Consolidated regional budget	Regional budgets	Municipal budgets
1	2	3	4
<b>2006</b>			
Net borrowings	36 489 742	35 161 627	1 328 115
Attraction of resources	73 288 653	66 524 832	6 763 820
Redemption of debt proper	36 798 911	31 363 205	5 435 706
<b>2005</b>			
Net borrowings	20 887 596	16 939 894	3 947 703
Attraction of resources	81 220 540	75 016 756	6 203 783
Redemption of debt proper	60 332 944	58 076 863	2 256 081
<b>2004</b>			
Net borrowings	47 880 300	44 470 128	3 410 172
Attraction of resources	79 436 708	74 995 965	4 440 743
Redemption of debt proper	31 556 408	30 525 837	1 030 571
<b>2003</b>			
Net borrowings	41 908 199	40 043 511	1 864 688
Attraction of resources	61 712 635	59 012 901	2 699 734
Redemption of debt proper	19 804 436	18 969 390	835 046
<b>2002</b>			
Net borrowings	17 696 530	17 153 760	542 770

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1	2	3	4
Attraction of resources	29 141 777	28 169 158	972 619
Redemption of debt proper	11 445 247	11 015 398	429 849
<b>2001</b>			
Net borrowings	6 601 447	6 667 592	-66 145
Attraction of resources	15 123 785	14 226 931	896 854
Redemption of debt proper	8 522 338	7 559 339	962 999
<b>2000</b>			
Net borrowings	-1 877 328	-2 286 175	408 847
Attraction of resources	13 042 220	10 090 208	2 952 012
Redemption of debt proper	14 919 548	12 376 383	2 543 165

Source: the RF Ministry of Finance and the Federal Treasury.

The majority of the regions regularly issuing debt securities were continuing this activity in 2006. Since 1999, bonds have been issued every year by Moscow, St. Petersburg, the Republic of Chuvashia, and Volgograd Oblast. Since 2000 – by Tomsk Oblast, the Republic of Komi, and Ekaterinburg. Since 2001 – by Irkutsk Oblast (*Table 34*).

Table 34

**Registration of prospectuses for the issue of subfederal and municipal securities in 1999–2006**

Issuer	1999	2000	2001	2002	2003	2004	2005	2006
1	2	3	4	5	6	7	8	9
Moscow	*	*	*	*	*	*	*	*
St. Petersburg	*	*	*	*	*	*	*	*
Republic of Chuvashia	*	*	*	*	*	*	*	*
Volgograd Oblast	*	*	*	*	*	*	*	*
Tomsk Oblast		*	*	*	*	*	*	*
Republic of Komi		*	*	*	*	*	*	*
Irkutsk Oblast			*	*	*	*	*	*
Moscow Oblast				*	*	*	*	*
Republic of Sakha (Yakutia)				*	*	*	*	*
Yaroslavl Oblast					*	*	*	*
Krasnoyarsk Krai					*	*	*	*
Republic of Bashkortostan			*	*		*	*	*
Republic of Karelia						*	*	*
Lipetsk Oblast						*	*	*
Nizhnii Novgorod Oblast						*	*	*
Voronezh Oblast							*	*
Belgorod Oblast				*	*		*	*
Tver Oblast				*	*		*	*
Samara Oblast					*		*	*
Kirov Oblast							*	*
Republic of Marii El		*			*	*		*
Kaluga Oblast						*		*
Tambov Oblast					*			*
Irkutsk Oblast								*
Kurgan Oblast								*
Penza Oblast								*
Tula Oblast								*
Khabarovsk Krai				*	*	*	*	
Novosibirsk Oblast	*				*	*	*	
Kostroma Oblast				*	*		*	
Republic of Kabardino-Balkaria		*					*	
Republic of Udmurtia							*	
Leningrad Oblast			*	*	*	*		
Yamal - Nenets AO					*		*	
Krasnodar Krai						*		
Briansk Oblast						*		
Khanty-Mansi AO				*	*			
Murmansk Oblast				*	*			
Republic of Mordovia				*				

1	2	3	4	5	6	7	8	9
Sakhalin Oblast				*				
Kursk Oblast				*				
Stavropol Krai			*					
Primorskii Krai		*						
<b>Municipalities</b>								
Ekaterinburg		*	*	*	*	*	*	*
Novosibirsk					*	*	*	*
Volgograd	*	*	*	*	*		*	*
Kazan							*	*
Klin raion, Moscow Oblast							*	*
Odintsovo raion, Moscow Oblast							*	*
Tomsk					*	*		*
Noginsk raion, Moscow Oblast						*		*
Astrakhan								*
Blagoveshchensk								*
Briansk								*
Voronezh								*
Lipetsk								*
Magadan								*
Orekhovo-Zuevo, Moscow Oblast								*
Tomsk								*
Yaroslavl								*
Yuzhno-Sakhalinsk					*	*	*	
Krasnoyarsk					*	*	*	
Novocheboksarsk	*		*			*	*	
Cheboksary	*						*	
Angarsk							*	
Vurnarsk raion, Republic of Chuvashia							*	
Shumerlia, Republic of Chuvashia							*	
Ufa				*	*	*		
Barnaul						*		
Perm						*		
Nizhnii Novgorod				*				
Kostroma	*	*						
Arkhangelsk	*							
Dzerzhinskii	*							

*Source:* the RF Ministry of Finance.

## The credit potential of territorial authorities

### Credit rating

The substantial fall in the ratio of accumulated sovereign debt to GDP (associated with high rate of economic growth in Russia, early redemption of foreign debts by the federal government, and the strengthening, in real terms, of the rouble's exchange rate), as well as the growing volume of the Stabilization Fund and the gold and foreign currency reserves in recent years, have all accounted for Russia's growing credit rating among other countries. At the same time, the credit rating of territorial authorities has also been growing. In 2006, Moscow's international credit rating went up, alongside the sovereign rating of the Russian Federation, to the level "BBB+", as estimated by Standard&Poor's and Fitch, and since November of last year has stayed at the level "Baa2", as estimated by Moody's.

Besides, Moody's estimated as being at the level of sovereign credit rating the credit rating of the city of St. Petersburg. Standard&Poor's and Fitch estimated the rating of St. Petersburg as being two grades below the sovereign level, or "BBB-", which, however, also placed it in the category of "investment level". The other Russian regions and municipal formations did not manage to meet the investment-level credit rating of either of the rating agencies (*Table 35*).

*Table 35*

**Standard&Poor's international credit rating as of early 2007**

Issuer	In foreign currency / Forecast	In national currency / Forecast
<b>Sovereign Ratings</b>		
Russian Federation	"BBB+"/Stable	"BBB+"/Stable
<b>Ratings of regional and local authorities</b>		
Balashikha raion	"B"/Stable	"B"/Stable
Bashkortostan	"BB"/Stable	"BB"/Stable
Bratsk	"B"/Stable	--/--/--
Volgograd Oblast	"B+"/Stable	"B+"/Stable
Vologda Oblast	"B+"/Stable	--/--/--
Irkutsk Oblast	"B+"/Stable	--/--/--
Klin raion	"B-»/Positive	"B-"/Positive
Krasnodar Krai	"BB-"/Stable	"BB-"/Stable
Leningrad Oblast	"B+"/Positive	--/--/--
Moscow	"BBB+"/Stable	--/--/--
Moscow Oblast	"BB"/Positive	"BB"/Positive
Nizhnii Novgorod	"BB-"/Stable	"BB-"/Stable
Novosibirsk	"B"/Positive	--/--/--
Omsk	"B"/Stable	--/--/--
Samara Oblast	"BB-"/Positive	--/--/--
St. Petersburg	"BBB-"/Stable	"BBB-"/Stable
Sverdlovsk Oblast	"BB"/Stable	"BB"/Stable
Stavropol Krai	"B"/Positive	"B"/Positive
Surgut	"BB-"/Stable	--/--/--
Tatarstan	"BB-"/Stable	"BB-"/Stable
Ufa	"B+"/Stable	"B+"/Stable
Khanty-Mansi AO autonomous Okrug	"BB+"/Positive	--/--/--
Yamal-Nenets Autonomous Okrug	"BB+"/Stable/	--/--/--

Source: Standard&Poor's.

**The regulation of state debt in regional budgets**

Against the backdrop of an improving budgeting situation in the majority of subjects of the Russian Federation, the process of state debt regulation became more intensive. According to the data published by the RF Ministry of Finance, the volume of stale (non-regulated) debt against the liabilities of regions as of October 2006 had gone down, by comparison with October 2005, more than twice – by 7.2 bn roubles in nominal terms, or from 14.2 to 7.0 bn roubles. By comparison with

October 2004 (29.0 bn roubles), stale debt decreased by more than four times, amounting to only 0.22% of the budget revenue of the Federation's subjects, or less than 0.03% of GDP.

The most serious situation in respect of non-regulated debt against debt liabilities was observed in the following regions: in Tumen Oblast – 2.6 bn roubles, or 1.8% of budget revenue, in Samara Oblast – 1.3 bn roubles, or 2.5% of budget revenue, in Irkutsk Oblast – 1.1 bn roubles, or 2.9% of budget revenue.

Besides, the arrears of receivables in regional budgets continued to decrease at a high rate, having been reduced in 2006 by 23.1 bn roubles, and amounted, as of the year's end, to 57.9 bn roubles. One in one-tenth of all the regions the volume of debt increased – by the aggregate value of 2.2 bn roubles.

*Table 36*

**Stale (non-regulated) debt against liabilities of subjects of the Federation**

	Volume of stale (non-regulated debt)*	Ratio of stale (non-regulated) debt to budget revenue, %**
<b>Central Federal Okrug</b>		
Belgorod Oblast	137 867	0.59
Briansk Oblast	39	...
Kostroma Oblast	105 322	1.32
Kursk Oblast	77 982	0.57
Moscow Oblast	9 280	0.01
Tver Oblast	151.4	0.00
Yaroslavl Oblast	709 612	3.91
<b>North-Western Federal Okrug</b>		
Kaliningrad Oblast	7 187	0.05
Novgorod Oblast	33 549	0.35
Pskov Oblast	414	...
<b>Southern Federal Okrug</b>		
The Republic of Adygeya	35 700	0.75
Volgograd Oblast	36 154	0.13
<b>Volga Federal Okrug</b>		
The Republic of Bashkortostan	31 311	0.04
The Republic of Chuvashia	14 450	0.09
Nizhnii Novgorod Oblast	2 190	0.01
Orenburg Oblast	367 528	1.32
Samara Oblast	1 341 794	2.52
Saratov Oblast	1 170	...
<b>Ural Federal Okrug</b>		
Kurgan Oblast	84 781	0.77
Tumen Oblast	2 571 397	1.82
<b>Siberian Federal Okrug</b>		
Irkutsk Oblast	1 050 000	2.89
Novosibirsk Oblast	3 120	0.01
<b>Far Eastern Federal Okrug</b>		
Primorskii Krai	377 750	1.17

\* Data as of 1 October 2006.

\*\* The relation of stale (unregulated) debt as of 1 October 2006 to a regional (non-consolidated) budget's revenue of the year 2006.

*Source:* the IET's estimates, based on the data of the RF Ministry of Finance.

### 2.5.3. Stock Market

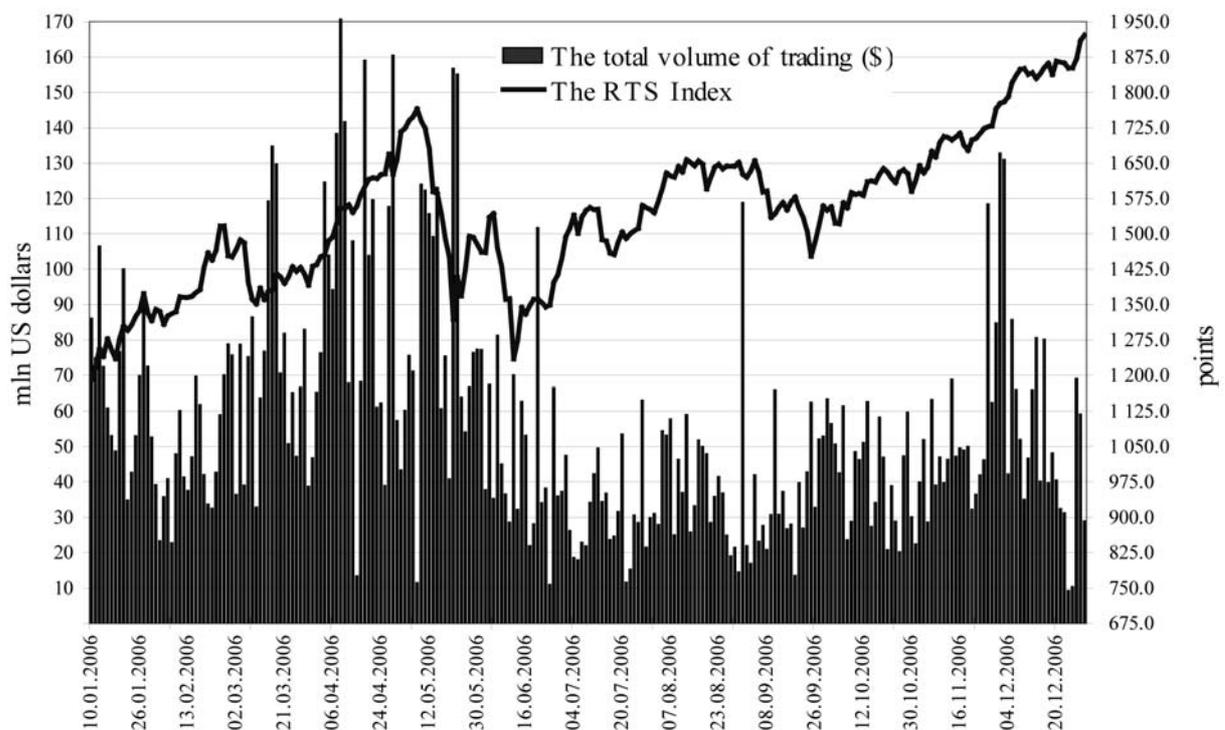
According to the results of the year, the Russian Stock Market in 2006 grew significantly, like in preceding year. Such a rapid growth of the Russian Stock Market was caused by several key factors, namely fairly favorable conditions in the world markets of oil and metals, which allowed the revenues of the budget system of the Russian Federation to significantly exceed the estimates, the same is true with regard to the Stabilization Fund of the Russian Federation. Moreover, in summer of 2006 the RF has completely recovered its debt to the Paris Club of Creditors. All those factors contributed to upgrading of the sovereign rating of Russia with the leading rating agencies; thus, Standard & Poor's and Fitch have upgraded its rating by one point to the level of BBB+ within the year. The macroeconomic situation was also favorable, combating with the inflation was successful and consumer prices did not go beyond the forecasted range. In July 2006, the Russian government has taken actions on further liberalization of foreign currency legislation, what has also contributed to the market dynamics, since the last barriers for capital movement were removed.

Internal corporate news played a significant role as well. According to the outcomes of the first two-three quarters of 2006, financial performance results of most companies involved in the raw materials, telecommunication and some other sectors were considerably beyond the indicators of 2005, which made such companies more attractive in terms of investment. In addition, developments in electric power and telecommunication sectors (like "Svyazinvest" privatization) contributed to the upward movement of that sector securities. Liberalization of Gazprom and IPO Rosneft shares, actively traded for population, became a significant factor for the market.

In the past 2006, the Russian RTS Stock Market grew by 731.58 points from 1190.34 to 1921.92 points, which accounts for 61.46 per cent of the index value at closing on January 10, 2006 (against 85.26 per cent in 2005). Thus, in 2006, the stock market again demonstrated a fairly impressive growth as opposed to the preceding year. The minimum growth of RTS index in 2006 – 1190.34 – was recorded in the first trading session of the last year, while the historical maximum – 1921.92 points – was attained on December 29. Regarding investment activity in 2006, it grew as opposed to the previous year of 2005. In particular, the trading turnover in the classic stock market in the RTS amounted in 2006 to nearly USD 16.5 bln with an average daily turnover of USD 65 mln, which was far beyond the corresponding figure of 2005 (nearly USD 7.65 bln with an average daily turnover at the level of USD 30.86 mln). Hence, the trading volume has been nearly doubled in 2006 as opposed to the corresponding indicator of 2005.

Several distinctive periods can be highlighted in the market movement. In the period between January -February the market grew from 1190.34 до 1516.99

points under the RTS index, which was followed by a short-term correction in the mid March, when the RTS index rolled back to reach 135126 points. As illustrated in *Fig. 15*, despite the short period of correction, the movement of the RTS index was accompanied by rather high trading volume during that period. The next period was accompanied by a steady growth of RTX index growth, which reached its historical peak on May 6 (1765.35 points). Herewith, before early May, the market was growing at the background of higher trading volumes than in the second half year, when the market was recovering from deep correction. Thus, in the period between January-May the average monthly turnover in the classic stock market in the RTS amounted to nearly USD 1469.5 bln, while throughout the rest of the year it remained at the level of USD 875 bln. That period was followed by a deep correction, continued till mid June and accompanied by downgrading of RTS index to the minimum level in the year (1234.82 points).



Source : the RTS Stock Exchange.

*Fig. 15.* The RTS Stock Exchange and Trading Volume in 2006

Then, the rest of the year of 2006 can be split in two sub-periods. The first one includes the market recovery up to the level of 1650 points of RTS index, followed by a decrease and then – by further growth till the end of the year, when RTS index has again reached its historical peak of the level of May 2006 (1853.24 points).

Making an analysis of monthly dynamics of the Russian stock market, one should note that despite long vacations in January, the investors' activity in the stock market was rather high, which allowed the basic stock indicators to reach historical peak values. Sberbank of Russia, LUKOIL, and RAO UES of Russia with their

prominent stock indices were in high demand. An extremely important event for the Russian stock market in terms of its liquidity, attractiveness to investors and further growth prospects became Gazprom open trades of its shares in MISEX, which became the leaders in trade volume since the first days of trades without any restrictions. External macroeconomic factors were also favorable: US index ratings, world oil prices and ADR prices for Russian bonds were growing by steady high rates.

In February the impact of those factors, accompanied by increased liquidity in the bank sector, contributed to high rates of Russian securities prices growth. A significant effect on the market dynamics in general was provided by the RAO UES of Russian shares, the upward movement of which took place due to positive news on reforms in energy sector. Thus, in his comments on the reform, the President of Russia has supported the idea to attract investments in the sector, both, domestic and external ones. Rostelecom shares have also demonstrated an expressed growth upon M. Fradkov's signature of Regulations on utilization of the RF consolidated telecommunication network resources to support the functioning of special nets as a necessary provision for privatization of Svyazinvest. Among external conditions, further growth of oil prices should be highlighted as a primary factor.

The first correction in the stock market happened in early March. Reduction of oil prices in the international market, strengthened expectations of interest rates in USA, as well as a number of technical factors (relative overestimation of some Russian companies) provoked a decline in the domestic stock market. However, the period of decline did not last long and from the middle of the month the quotations started to move upwards under the impact of positive news in the RF (LUKOIL statement on acquisition of a part of its own shares, a discussion, held in Moscow by "Big Eight" country-members on the issues of global telecom safety, a notification on a tentative date for Rosneft IPO), as well as external market news (expansion of basic stock markets).

Steady market growth was continued in April, when the market has reached its historical peak. An outstanding impact on the stock market was provided by Gazprom, which has made an application to the US Committee on Securities to get a registration in ADR program of the first level, as well as Nordnickel shares, which positive dynamics was supported by analytics' recommendations, based on the upward trend of nickel prices in the international market. Moreover, Gazprom got an upgraded rating in MSCI index, which is used by a lot of prominent foreign market participants as a reference point for formation of their portfolios in developing markets. The stock market was also extremely sensitive to external macroeconomic factors. Thus, in the tensed situation, created by Iran nuclear program, the world oil prices have come up close to the level of USD 70 per barrel, and the Russian Urals brand – to USD 65 per barrel. In that background, the markets of highly industrialized countries demonstrated variable dynamics, contributing to minimization of unfavorable factors effect in the domestic market.

After May 6, when RTS index has reached its peak of 1765.35 points throughout the period under review, the upward trend has been replaced with a decline, followed by a large-scale correction. Within nine trading sessions RTS index has got down from the maximum peak level of 1318.5 points, what makes about 33.9

per cent in relative terms. Basically it was caused by the outflow of assets of external investors from all «emerging» markets, including Russia, due to upgrading of the US interest rate up to 5 per cent per annum and statements on the prospect of tightening of FRS policy. Moreover, the growth of quotations of the majority of Russian securities, observed for quite a long period, could not last forever. The decline in the world oil market (“black gold” price in New York has decreased from USD 75 to USD 70 per barrel) and non-ferrous metals can be also considered as the grounds for vast-scale sales of shares. By late May prices have won back some of the downfall in the background of improved situation in the world markets and information on prospective merging of Severstal and Arcelor companies.

Further market dynamics was characterized by high volatility. While in the first half of June correction was continued and the market moved close to the minimum level during the year, in the second part of June quotations started to move upwards again. The downfall of early June was caused by rather high interest rate risks, coming from USA, due to which the net capital outflow from emerging markets within mid May to mid June accounted to USD 13.4 bln, or 5.1 per cent of total amount. Recovery of the market at the end of the month was based on extremely high oil prices, raised to the level of USD 74 per barrel and favorable macroeconomic indicators of the RF.

In July there were no expressed dynamics in the stock market. Quotations of the most liquid securities were variable, but throughout July some growth was observed. Lower market volatility was caused by reduced negative expectations of investors in regard to further US FRS policy, based on the published report, informing on completion of the period of increased interest rates, expected shortly due to some slow-down of economic growth in USA in the background of stable prices. In line with that, some strengthening of geopolitical factor was observed in the world stock market dynamics: expanding military conflict in Middle East discouraged the growth of quotations of industrial countries. On the other hand, that factor has boosted up oil prices, bringing them up to the historical peak again, which is traditionally favorable to the Russian market. Among the significant internal factors there should be highlighted Fitch’s upgrading of the Russia’s sovereign rating and IPO of Rosneft, which became the largest primary placement among the Russian companies, and the gains accounted to USD 10.4 bln. It should be noted that the company was the first in Russia to give an access to its shares for the population.

In August trading activity in the Russian stock market was restored after the summer stagnation. However, the greatest demand was focused on blue chips of (Gazpom and Sberbank of Russia). In one of scheduled meetings of FRS the interest rate was maintained at the level of 5.25 per cent per annum, which has positively effected both, the US and RF stock markets. Nevertheless, a noticeable downgrading of world oil prices started in August and continued in September (Brent price has declined from USD 75 to USD 60 per barrel, Urals – from USD 70 to USD 55 per barrel), which negatively effected quotations of oil companies. In September the market was supported by positive dynamics in US and other stock markets and a number of positive corporate news on electric power industry re-

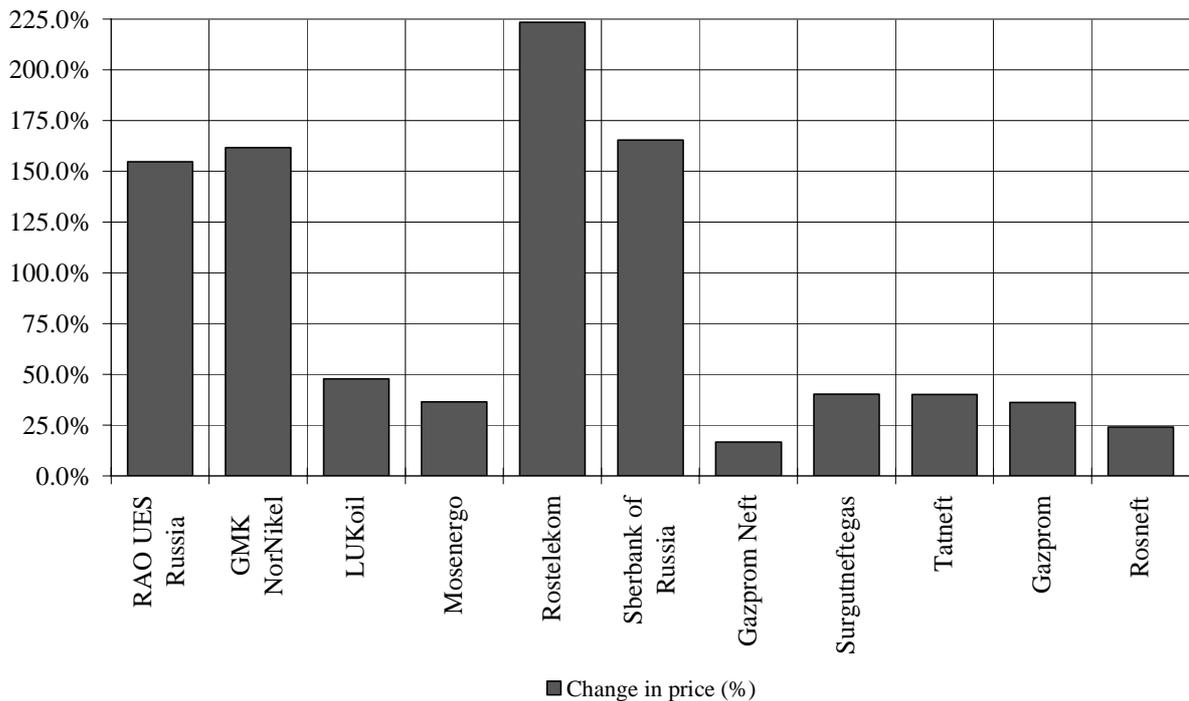
form, upgrading of several Russian companies' international ratings, including telecom companies. As a result, in late September the market decline has stopped and gradual growth of prices has begun.

On the one hand, declined oil prices were still providing some pressure on the prices. On the other hand, in the background of a number of positive factors, such as stable interest rate in USA and its expected decrease, upgrading of the world stock indices, the market became more resistant to the "oil factor" than it was in August-September. Among domestic factors, that made an impact on the market, there should be noted IPO of some Russian companies (TMK, OGK-5), where the demand for securities was much higher than the offer, demonstrating a high attractiveness of Russian companies to the investors.

In November the growth was continued and its rates have increased. Due to that fact, RTS index has again reached historical maximum of 1853.24 on December 15 (same level as in May). The grounds for such expressed growth were prepared by improved situation in the international oil market, where the "black gold" prices has growth again to the level of USD 63-65 per barrel in view of OPEC decision to reduce oil extraction volume and increased demand for fuel in cold season in USA. Securities of telecommunication and electric power companies were in high demand of the investors due to positive results of discussions of energy sector reform in President's Administration.

December of preceding year was not an exception; there was a traditional "pre-New Year rally" in the stock market. Bonds were growing due to improved situation in the oil market, in the international stock markets, as well as positive news background. Herewith, securities of companies that do not belong to primary commodity market were in high demand among investors: Sberbank of Russia, RAO UES of Russia, Rostelecom.

In 2006, like a year before, most liquid Russian shares grew significantly in value (*Fig. 16*). Last year, for example, returns on investments in OAO Rostelecom were most favorable, with the yield being 223.47 per cent (as opposed to 28.18 per cent in 2005).. Such high growth rates were caused mainly by expectations of investors for Svyazinvest prospective privatization. Some lower profitability was demonstrated by shares of OAO Sberbank of Russia, which gained 165.38 per cent (against 156.92 per cent in 2005). Next to OAO Sberbank were shares of GMK Norilsk Nickel, which gained in value 161.7 per cent (versus 12.36 per cent in 2005). Rather high returns on investments were demonstrated by RAO UES of Russia, which gained 154.72 per cent (against 53.07 per cent in 2005). As concerns other leading companies, their shares gained less: OAO LUKOIL– 47.82 per cent (100.34 per cent in 2005), Surgutneftegaz – 40.37 per cent (49.23 per cent in 2005), Tatneft – 40.06 per cent (127.87 per cent in 2005), Mosenergo – 36.43 per cent (–4.76per cent in 2005), Gazprom – 36.26 per cent and Rosneft – 23.98 per cent. The lowest growth rates among the "blue chips" were noted on shares of Gazprom Neft (former Sibneft), the value of which has grown in 2006 only by 16.69 per cent.



Data source : the RTS Stock Exchange .

Fig. 16. Blue Chips Price Dynamics in 2006

In 2006, among the “second echelon” companies whose shares gained maximum values, were OAO Chelyabinsk (447.95 per cent), OAO TKZ “Krasny Kotelschik (439.1 per cent), OAO Pskovenergo (423.53 per cent) respectively. However, trading activity of the above listed companies remained low. For example, 22 transactions were made on the shares of OAO Chelyabinsk, 26 transactions on the shares of OAO TKZ “Krasny Kotelschik, and 34 transactions on the shares of Pskovenergo

RAO Gazprom was the leader by trading turnover to account for 39.8 per cent of the total trading volume in the RTS in 2006. Apparently, such an upswing can be explained by open trading of Gazprom shares. The leader is followed by RAO UES of Russia, accounting for 16.7 per cent against 25.86 per cent in 2005. The next company is OAO LUKOIL , to account for 13.9 per cent (29.55 per cent in 2005). The shares of Norilsk Nickel and Sberbank were ranked accordingly as number three and four to account for 5.9 per cent (9.7 per cent in 2005) and 4.8 per cent (5.6 per cent in 2005) of the total trading volume in the RTS in 2006. Hence, in 2006, transactions on the shares of the five abovementioned issuers accounted to nearly 80.8 per cent of the total trading volume in the RTS, which significantly exceeded the relevant indicator of 2005 (71.28 per cent).

According to the data as of December 29, 2006, the top five list of companies by capitalization was as follows: Gazprom - USD 272.25 bln, Rosneft – SD 83.19 bln, LUKOIL – USD 74.18 bln (against USD 50,5 bln in 2005), Sberbank of Russia – USD 65.6 bln (USD 24.89 bln in 2005), Surgutneftegaz – USD 54.7 bln (USD 38.5

bln in 2005). There were no expressed changes in the companies' rating in terms of capitalization as compared with 2005. It should be noted that the four most capitalized companies of Russia belonged to the oil and gas sector against three companies in the previous year, which is explained by extremely favorable conditions in the primary commodity markets in 2006. Sberbank of Russia had the highest capitalization among the companies that do not belong to the primary commodity market, like in the previous year.

### Futures Contracts Market

Every year FORTS market (Futures and Options on the RTS) is steadily growing, and celebrated, and the year of 2006 was not an exception. For example, the turnover of futures and options contracts in the futures market totaled nearly RUR 2 708.5 bln in the previous year, as opposed to RUR 711.54 bln in 2005. In other words, the turnover of the futures contracts (FORTS) market in 2006 has grown nearly three-fold as compared with the corresponding figures of the previous year. Participants of the market entered into nearly 5 million transactions to amount to 89.6 million contracts (nearly 1.96 million transactions and 54.87 million contracts in 2005). The average daily volume of open positions on standard contracts was RUR 64.6 bln, 2.24 million contracts, to grow 2.6 times in rubles and by 37.2 per cent in contracts as compared with 2005. During 2006 the volume of open positions reached maximum level to the amount of RUR 147.8 billion (on December 12) and 4.19 million contracts (as of the same date). A share of futures transactions was the largest in the segment of futures contracts in 2006 to account to nearly 88 per cent of the total trading volume or RUR 2 397 bln (RUR 630.53 bln in 2005), while the value of option transactions amounted to only RUR 311.4 billion (as opposed to RUR 81.01 billion in 2005). Hence, a share of options transactions by trading volume remained in the last year at the same level as compared with 2005.

Some dynamics was observed in the ratings of trading volumes of a number of contracts. Thus, upon placement in the market of RTS index futures in 2005, it became most attractive for investors in 2006. Its share in the total trading volume made 27.7 per cent. It was followed by futures contracts on market value of the shares of Gazprom and RAO UES of Russia, whose shares in the total trading volume made 27.74 per cent and 20.79 per cent accordingly (21.62 per cent and 27.37 per cent in 2005). The next in the list is LUKOIL (significantly lagging behind the leaders), with the share in the total trading volume of 7.77 per cent (against 17.59 per cent in 2005). Among the options, those ones for futures of Gazprom shares were in highest demand (3.95 per cent in the total trading volume of the market of futures).

In 2006, some new instruments emerged in the market. On February 14 futures contract on Moscow ten-year bonds was launched, which is currently the sole long-term interest rate derivative. On February 20 futures contract for the RF Eurobonds with maturity term in 2030 was launched. Hence, there emerged a new market instrument for risk hedging and the investors have an opportunity for arbitration between Eurobonds 30 and US Treasuries at minimum expense. Futures contract for Moscow Inter - Bank Offered Rate was launched on May 30, which became the

first market instrument for risk hedging of short-term rates. Futures contracts for Urals oil and gold were launched on June 8, opening a new stage in FORTS market development. Further expansion of the number of commodities contracts can continue with oil and gold options, as well as futures for oil. Finally, futures contract for common shares of OAO Rosneft and options for futures contract for common shares of OAO GMK Norilsk Nickel were launched on October 16. With appearance of the new instruments, a full set of derivatives was formed for all blue chips of the Russian stock market. Hence, for the time being, FORTS participants can enter into transactions on 16 futures and 7 option contracts.

### Corporate Bonds Market

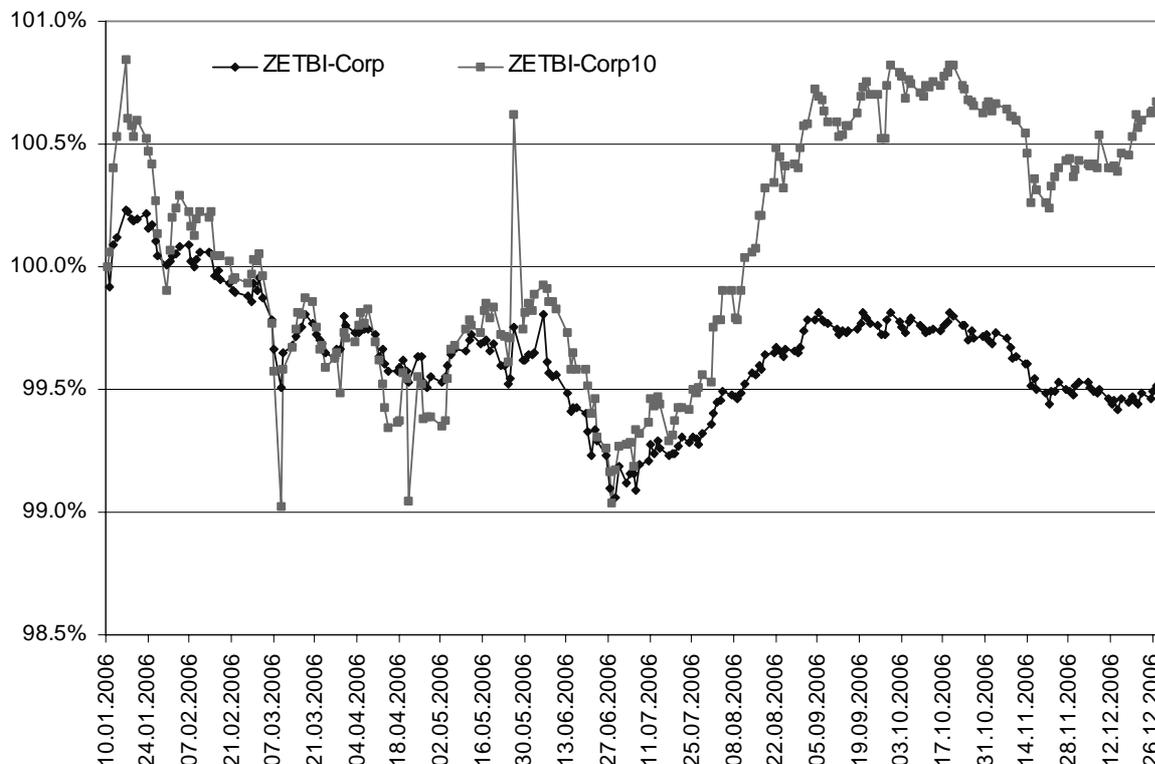
In 2006, the market of corporate and regional bonds was stable in general. However, the corporate bonds market did not demonstrate any expressed dynamics in 2006 as compared with the stock market. This is evidenced by the movement of corporate bonds indices assessed by Zenit Bank on the basis of market prices of bonds traded in the MICEX41 (Moscow Interbank Currency Exchange). In 2006, the ZETBI-Corp index grew by 0.43 points (-0.39 per cent) from 111.52 to 111.09 points. However, the ZETBI-Corp10 index, which is assessed on the basis of quotations of most liquid corporate bonds, grew from 118.2 to 119.11 points in 2006.

As compared with the market of government bonds, corporate bonds market quotations demonstrated higher volatility throughout 2006. Three periods can be highlighted within the year, when the dynamics of prices were different. (*Fig. 17*). The first one lasted from January to June, when a downward trend was prevailing in the market. The second period – from July to September, when the market was growing in general, while the most liquid bonds have stopped at the maximum levels of 2006. Finally, during the third period the market indicators remained at the level of late October, despite significant downgrading in November and upgrading in December.

Making an analysis of monthly dynamics of quotations, we should mention, that long January vacations have provided a negative impact over investors' activity in the market of corporate and regional bonds. Nevertheless, in early January quotations of the most liquid bonds have somewhat grown. Making an analysis of external factors, we should note, that the dynamics of US bonds and Russian Eurobonds made for the decline of corporate bonds prices. As opposed to that, domestic economic factors supported the stock market: RUR was strengthening against USD, liquidity was maintained at a reasonable level. The situation in the primary market was rather quiet, whereas the volume of trade was quite low.

In February-March relatively positive dynamics was observed in the market. The impact of primary market factors grew stronger: a considerable volume of primary offer made for the outflow of assets from the secondary market. Moreover, foreign currency market, where some decline of RUR versus USD was observed, made an additional pressure on prices. Apparently, the market dynamics was dependant on expectations for further growth of interest rates in developed markets, whereas other factors did not contribute to the market downfall (Russian Euro-

bonds quotations remained stable, and by the end of the month RUR has restored its position against USD). One more reason for the market downgrading was an upgrading of interest rates by industrialized countries (USA, European countries, Japan), which demonstrated a lower attraction to investment value.



Source : Zenit Bank.

Fig. 17. Corporate Bonds Price Index Dynamics in 2006  
( January 10, 2005 = 100per cent )

Within the next month investment activity in the market of corporate bonds has considerably grown, what however did not bring up a noticeable positive trend; quotations of the most liquid bonds were variable. The basic external factor that effected the situation, was uncertainty in regard to further priorities in the US FRS credit and monetary policy, which provided an immediate impact on activities of investors in emerging markets. Another upswing of oil prices in the international market and confrontation between Western countries and Iran also did not add to attraction of investors. An excessive pressure over the prices was made by interest rates growth in the inter-banking market. Even an expressed upgrading of RUR against USD could not contribute to the demand for securities.

May was characterized by moderate growth of quotations of the most liquid issues of corporate bonds against the background of relatively high activity in the market. The market was resistant to negative external factors. Apparently, it can be explained by the background of massive release of assets in the stock market and general aggravation of the situation in the international markets, when corporate bonds were regarded by investors as relatively attractive opportunity for invest-

ments. Moreover, the initial the structure of investments in the market of securities and corporate bonds was variable: investments in securities are made as a rule for a short-term for speculative purposes, while investments in corporate bonds are more conservative, and the investors, involved in such operations, are governed by the basic market indicators and are less affected by short-term trends. One should not ignore also the factor of liquidity, which is traditionally one of the most effective one for the RF debt market, as well as continued strengthening of national currency.

However, May growth did not last long and since June the market started to get down, which has affected a wide range of securities. Investment activity was still high, what confirmed both, technical and fundamental character of the decline. Uncertainty in the US FRS policy remained one of the basic fundamental factors, effecting financial markets in the majority of countries. Comments of the US financial authorities, that inflation is getting beyond a “comfortable margin”, have confirmed a high probability of further upgrading of interest rates. Hence, in May that factor has mainly effected the bonds market, whereas in June it has naturally made an impact on the debt market. Like some months before, the major factors, supporting the market, were rather high liquidity level in the banking sector and RUR strengthening against USD.

July was a turning point in the trend of corporate debt market, as well as in other sectors of the Russian financial market. In many ways it happened due to general improvement of the situation in the world debt market in general and in the Russian Eurobond market in particular. High liquidity and lowered inflation in the RF contributed to additional support to quotations. Rather large volume of securities was traded in primary market and restrained quotations in a way. The growth of corporate bond price continued in August due to high liquidity (international stock market quotations made about 2–3 per cent per annum), upgraded RF rating a month ago, favorable situation in the external debt market and lower inflation expectations.

The growth, observed within two months, in August and September, was replaced by variable price dynamics, and as of monthly results, quotations were changed insignificantly. External factors had a negative effect. Thus, a probability of increased interest rate in the EU and stability of that factor in the US were restraining the growth of quotations of the bonds, denominated in foreign currency and in RUR. In line with that, one could note the upsurge of volatility of USD nominal exchange rate as opposed to its relatively stable rate against RUR. In the background of expressed decline in the world oil prices, the investors realized, that one could not expect any support from that factor, which has been observed for the greater part of 2006. External factors also restrained the growth: liquidity decline, large volumes of primary placements. Regardless the fact, that by late September the yield of the most liquid issues got down to the minimum level, expressed changes in the structure of basic factors provided a growing pressure on prices. Information on upgrading of the RF long-term credit ratings by S&P credit agencies made a positive impact on the market.

In late October there started a smooth decline in the market. In general, external background remained neutral. On the one hand, interest rates in US and Europe remained unchanged, what contributed to stabilization of quotations. On the other hand, a noticeable aggravation in natural resource markets provided an adverse effect on prices of corporate bonds. Reduction of prices (for Brent) beyond USD 60 per barrel fostered downgrading of Russian securities, and then - corporate bonds' prices. Domestic factors also made a negative effect: the volume of offer in primary market was large, the situation with liquidity was deteriorated at the end of the month (the yields reached 7-10 per cent per annum).

In November the market trends were variable, but as of results of the month, the majority of the issues demonstrated some growth. The basic factors, that hindered the upward trend, were aggravated situation with liquidity in the bank sector and large volume of primary placements. On the other side, significant RUR strengthening against USD highly contributed to attractiveness of the securities, denominated in RUR. In December the market situation has improved due to positive macroeconomic factors, as well as upgraded financial indicators of business companies and ratings of some of them. The most negative factor was massive placements in the primary market, distracting the assets form secondary market.

Total volume of placements of corporate and regional bonds in the primary market was RUR 515.4 bln (investments of banks and companies made RUR 464.4 bln), as compared with approximately RUR 311 bln in 2005. Hence, one may see a substantial increase in primary offering in the market of corporate and regional debt. In the background of general growth of issuers' activity in 2006, auctions were arranged more regularly throughout the year. For example, the maximum volume of placements of corporate and regional bonds in primary market was recorded in December (like a year ago) to amount to nearly RUR 85.8 bln (as opposed to nearly RUR bln in December of 2005), while the minimum one amounted to RUR 13.9 bln in May (as opposed to RUR 9.05 bln in May of 2005). Therefore, the maximum and minimum volumes of placements of corporate and regional bonds in primary market were recorded in 2005 in December and May accordingly.

#### Factors that Have an Effect on the Russian Stock Market Dynamics

In 2006, the Russian Stock Market was governed by a series of factors, which conventionally can be broken down into the groups as follows :

- Internal political situation;
- Relations with international financial institutions and organizations;
- Situation in the international financial markets;
- Situation in the world raw material markets (especially oil);
- Corporate news.

Each of the above groups of factors had a different effect on developments in different segments of the Russian financial market during the year of 2006. In spite of the fact that most of these factors have already been mentioned in the analysis of different segments of the Russian financial market, it is appropriate to focus on

them in detail, and the situation in the world market of raw materials was considered in Section.

**Internal political situation.** Throughout 2006 internal political situation in Russia remained quite favorable for financial markets. First of all, it should be noted that published statistical data indicated the growth of Russian economy. Certain problems were observed in the first half of the year, caused by accelerated inflation, exceeding estimated parameters. It effected inflation expectations, and as a result, made an impact on the yield of stock market instruments. However, in the second half of the year the inflation was taken under control and some officials of the government and Central Bank expressed a hope to restrain the inflation within the estimated limits.

Another significant factor of financial market dynamics was the growth of the world market oil prices. Like a year ago, that factor promoted not only further upgrading of the RF budget indicators, but higher deductions to Stabilization Fund as well, which were partially addressed to final redemption of the Russian debt to Paris Club of Creditors.

Moreover, during the year there was no news on tax claims to large Russian companies, like it happened in 2004–2005. Any claims of tax authorities to individual taxpayers were settled without conflicts. The government maintained its policy of control over some sectors of economy. Thus, at the end of the year audits were performed in TNK-BP company, participating in PSA projects. According to official information, the basic reason for close attention to that company was violation of ecological legislation. However, one can presume, that PSA projects are rather attractive assets, but initial provisions of those agreements, could be unacceptable to the present government of the country.

Finally, one should not ignore a number of decisions, adopted on structural reforms, implemented in the country. Thus, the President has informed on the need to create conditions for involvement of domestic and international investments in the national electric power section. In autumn a successful discussion of the reform implementation took place, which can also be regarded as one of the support factors to the domestic market. Moreover, some comments were occasionally made on the need for Svyazinvest privatization, which is expected by the market participants for a long while and is considered as a factor of growth of the shares of telecom companies.

**Relations with international financial organizations.** Relations between Russia and international financial organizations developed successfully enough throughout the entire year, which depended largely upon favorable macroeconomic situation in the country available over the last two years, and effective management of the Russian external debt.

For example, in July Fitch rating agency has upgraded the Russia's sovereign credit rating denominated in foreign currency from BBB to BBB+ , Outlook Stable. The Agency representatives have explained the upgrading by several reasons, one of them is prompt strengthening of Russia's macroeconomic and financial positions due to high prices in the markets of raw materials, as well as decreased risks

in government debt service. According to the Agency forecast, by the end of the year Russia will be an external net-creditor for government debt in the amount of USD 200 bln, what will ensure considerable reserve for cases of negative market dynamics. In September another rating agency, Standard&Poor's has upgraded the Russia's long-term credit rating, denominated in foreign currency, from BBB to BBB+, and that one in national currency from BBB+ to A-. The Outlook Stable. According to the Agency press release, that decision was based on the enlarged gold and foreign currency reserves of the RF, improved budget indicators of the enlarged government, as well as reasonable approach of the government to the problems of macroeconomic stability.

Another factor, confirming strengthening of the Russian companies' positions is inclusion of their shares in the global stock indices. Thus, in 2006 Morgan Stanley Capital International agency has not only included Gazprom securities into the listing of bonds traded under index MSCI Russia, but was also upgrading its rating in the index.

Upgrading of Russia's sovereign credit rating in 2006 was based to a great extent on successful policy in external debt management. Thus, in June the RF has completed negotiations on early redemption of the debt balance to Paris Club of Creditors in the amount of USD 22 bln. The transaction has been completed in August.

**Situation in the international financial markets.** The year of 2006 was characterized by a substantial improvement of the situation in the world stock markets. (See *Table 37*).

*Table 37*

**Dynamics of International Stock Indices in 2006**

<b>Data on 29.12.2006</b>	<b>Value</b>	<b>Variance, %</b>
RTS (Russia)	1921,92	61,45%
Dow Jones Industrial Average (USA)	12463,15	14,90%
NASDAQ Composite (USA)	2415,29	7,65%
S&P 500 (USA)	1418,30	11,78%
FTSE 100 (Great Britain)	6220,80	9,50%
DAX-30 (Germany)	6596,92	21,04%
CAC-40 (France)	5541,76	16,55%
Swiss Market (Switzerland)	8785,70	15,17%
Nikkei-225 (Japan)	17225,83	5,28%
Bovespa (Brazil)	44474,00	32,73%
IPC (Mexico)	26448,32	47,54%
IPSA (Chili)	2693,22	38,85%
Straits Times (Singapore)	2985,83	26,01%
Seoul Composite (South Korea)	1434,46	3,25%
ISE National-100 (Turkey)	39117,46	-1,69%
Morgan Stanley Emerging Markets Free Index	912,66	29,09%

In particular, the US stock market indices demonstrated a significant growth in 2006. For example, while the Dow Jones has grown by 12.87 points (14.90 per cent), the Nasdaq Composite gained 168,87 points (7.65 per cent) as of the year results. Two periods with different trends can be highlighted in the dynamics of US stock indicators (*Fig. 18*). Thus, while in the first half of the year there were variable trends in the market, in the second half a steady growth was observed.

Making an analysis of the basic factors of dynamics, we should note, that the major ones were tightening of the US FRS monetary and credit policy, macroeconomic news, dynamics of the world oil prices, corporate news, as well as geopolitical tension in the Middle East.

It should be mentioned, that the significance of the first factor has grown up in 2006. Within the first half of the year FRS has repeatedly raised the interest rate, which effected the quotations of the US securities. The decision on upgrading the interest rate was adopted on the basis of macroeconomic statistics, which reflected a stable economic growth, accompanied by accelerated inflation. An additional factor, provoking inflation, was a considerable increase of the world energy sources' prices, whereas the US economy is dependant on oil and its products supplies. At the beginning of the year a group of corporations has published negative estimates of their productive and financial indicators, what has affected the stock market quotations. Moreover, certain negative impact was provided by Iran nuclear program. Inability of USA and Iran governments to find a compromise increased the risk of economic sanctions on the part of US and other industrialized countries and even a probability of a military conflict. All those factors also affected the investors' behavior.

As opposed to that, starting from July, macroeconomic statistics reflected some decline in economy and hence, reduction of inflation risks. With regard to that information, FRS has decided to sustain the interest rate. In view of that decision, many investors have reviewed their estimates of the interest rate and moreover, expected some decrease in case the trends of the end of the year stay in effect.

As concerns the stock markets of other countries, they have also grown as of 2006 results. Thus, the European stock indices grew some more than the US rates. German aggregate stock market index DAX-30 gained 21.04 per cent within the year, French CAC-40 –16.55 per cent. Upgrading of EU CB interest rate was one more factor, effecting the dynamics of the stock market. The situation in developing countries was even better, here the stock markets' growth measured more than a dozen of per cent per annum in 2006. As a result, the Morgan Stanley's aggregate stock market index in developing countries grew by nearly 29.09 per cent.

In general, the markets of industrialized countries had a greater effect on the Russian stock market, when there was no essential domestic news or oil prices were stable. On the contrary, when there were some domestic news on both, business or public sectors, they had a greater effect than external markets' fluctuations. It is the policy of the US Federal Reserve System that was the sole factor considered by investors from any country, which could have a medium-term effect

on market liquidity in the markets due to an outflow of major US funds and other institutional investors.

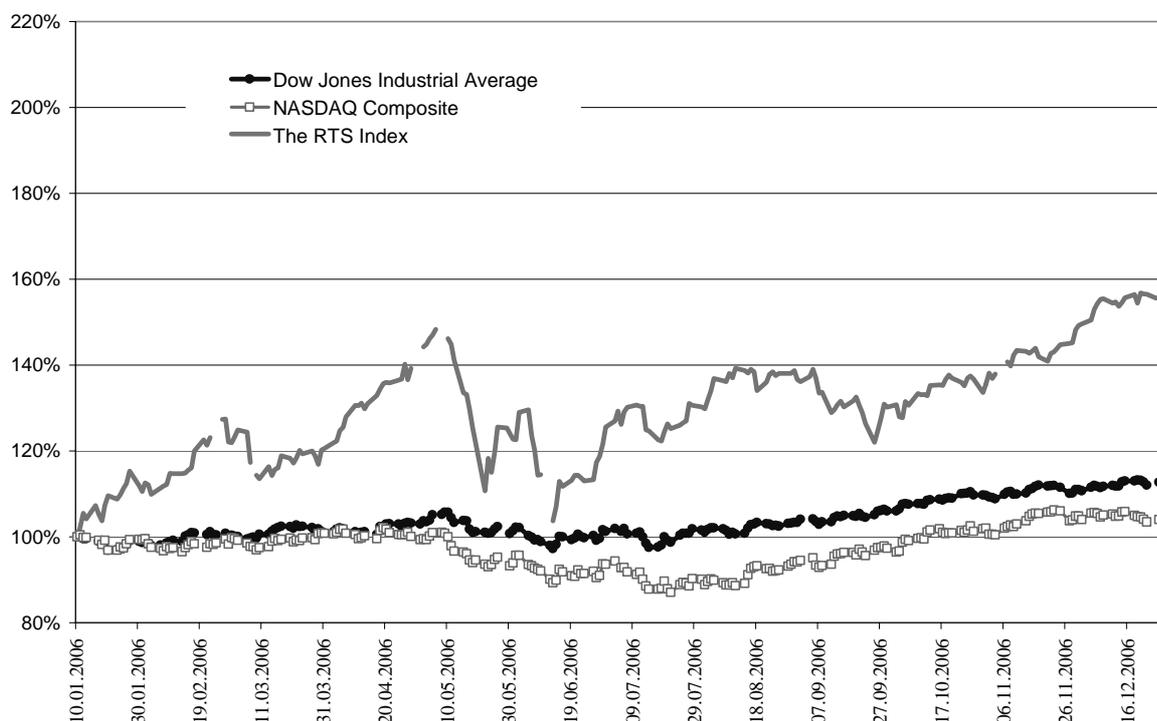


Fig. 18. Dynamics of US aggregate stock market indices Dow Jones и NASDAQ in 2006 (January 10, 2006 = 100 %)

### Corporate News

Upgraded credit ratings. Enhancement of some of Russian corporations' performance have been reflected in assigning long-term credit ratings or upgrading of existing ratings.

For example, late in March, Standard & Poor's, the international credit rating agency, decided to upgrade its long-term credit rating of OAO Rostelecom from B+ to BB-, Outlook Stable. Standard & Poor's reported that the upgrade reflected strengthened financial positions of the company, based on high performance and low arrears. Standard & Poor's has assessed OAO Rostelecom stable performance results, as well as efficient measures taken by its management in order to reduce company's costs and retain leading market positions. Further reduction of debt load, as well as increase of disposable cash flow contributed to high liquidity of the company. Moreover, in May the company has announced that Standard&Poor's has upgraded corporate management rating according to the national scale up to the level of RCM-6.2 and as per international scale to RCM-6. Total company rating is formed from the points, gained by separate components under 10-point scale. Thus, according to the year results, the points, gained on "property structure and shareholders' authority", have been slightly lower, from 5/5.3 to 5/5.2 (where the first figure reflects the points under international scale, the second one – according to the national scale), as well as the points, gained under "Authority of financially

involved entities and cooperation with them” from 7+/7.5 to 7/7.3 points. The points, gained for “Financial transparency and information disclosure” were confirmed at the level of 6+/6.9. However, due to upgrading of Rostelecom rating under component “Members and performance of the Board of Directors”, S&P raised the company rating from 5+/5.7 to 5+/5.9. Standard & Poor’s agency has positively evaluated the level of information transparency of the company, introduction of a new position of Corporate Secretary of the company, activities of Committees under the Board of Directors, in particular Audit Committee, implementation of fair bonus system for the company management. S&P has highly estimated commitment of the company management to upgrade the standards of corporate management in compliance with international standards.

In 2006 OAO LUKOIL rating was revised twice. On April 13, the company was assigned by Fitch, the international credit rating agency, the rating of issuer of securities, denominated in foreign and in national currency of BBB- level and F3 short-term rating; Outlook Stable. At the same time, the Agency has assigned BBB-rating to the issue of OAO LUKOIL shares for the amount of USD 350 mln, issued by LUKinter Finance BV. The Agency stated, that Outlook Stable is based on high financial stability of the company in future, ensured by sustained level of oil extraction and production, keeping up favorable price policy in the international oil market and gaining positions in the new markets, especially in the North America. On the other hand, adverse tax legislation, high export taxes and transportation costs as well as increased competition in the Russian market of oil products is a threat to the ratings.

On July 11 the rating agency Standard & Poor’s has upgraded the long-term credit ratings of OAO LUKOIL from “BB” to “BB +”. The outlook is Positive. At the same time, the rating according to national scale has been raised from “ruAA” to “ruAA +”. Upgrading of the ratings reflects the continued growth of cost efficiency of the company within the first quarter of 2006 (net profit per barrel was USD 9, what is by 29 per cent higher than the relevant indicator of the first quarter of 2005). Standard & Poor’s expects that in future the gains of LUKOIL Group and its resistance to oil prices decline will continue to grow due to rapidly increasing gas production.

Credit rating of GMK Norilsk Nickel in 2006 was also upgraded by two leading rating agencies. Thus, on August 8 the international rating agency Standard & Poor’s has upgraded the ratings of OAO GMK Norilsk Nickel from “BB+” to “BBB-”. This is the highest rating among private companies in Russia. The Outlook “Stable”. At the same time, the rating according to the Russian national scale was confirmed at the level of “ruAA +”. According to common ratings of other agencies (Fitch’s, “BBB-”, Moody’s “Ba1” and Standard & Poor’s - “BBB-”) Norilsk Nickel is keeping the leading position among the highest ranking private Russian companies. According to the rating agencies, the ratings are based on the unique resource base, sound financial position, successful performance of the company managers, as well as leading positions of GMK Norilsk Nickel in the world market of nickel, palladium, platinum, copper.

On October 9, the international rating agency Moody's Investors Service upgraded the corporate rating of OAO GMK Norilsk Nickel to "Baa2" "from" Ba1 ", i.e. by two points, bringing it to the investment level. Rating of unsecured bonds was upgraded by 3 points from "Ba2" to "Baa2" according to the national scale; as per Moody's Interfax – from "Aa1.ru". to "Aaa.ru" The Agency stated, that upgraded rating is based on strong basic performance indicators of the company. The Outlook is Stable. According to consolidated ratings (Fitch, "VVB-", Moody's, "Vaa2" and Standard & Poor's, "BBB"), Norilsk Nickel holds a leading position with the highest ranking private Russian companies. These ratings reflect the unique resource base and sound financial standing company, as well as leading positions of GMK Norilsk Nickel in the world market for nickel, palladium, platinum, copper.

Results of financial performance. In the period between August-December 2006, most companies published their financial performance statements for 2005. The following companies should be mentioned.

On December 5, 2006, RAO UES of Russia disclosed the results of its performance in the first half of 2006, prepared in accordance with international accounting standards (IAS). For example, its earnings from basic activity totaled RUR 453.3 bln in the first half of 2006, what is RUR 62.2 bln higher than in the relevant period of preceding year. Profit from basic activities of RAO UES of Russia for the first half-year of 2006 rose by RUR 6.6 bln (14 per cent) as compared with the first half of 2005 and amounted to RUR 53.4 bln. Profit before tax amounted to RUR 47.2 bln, having increased by RUR 8.5 bln. Net profit of RAO UES of Russia for January-June 2006 amounted to RUR 27.2 bln. As compared with the first half of 2005, there had been an increase in net income by RUR 5.3 billion (24 per cent), based on the increase in operating income by RUR 6.6 bln and cut down of expenses by RUR 1.6 bln.

On December 21 OAO Gazprom has disclosed unaudited consolidated interim financial statement for the first half of 2006, developed in accordance with International Accounting Standard 34 "Interim Financial Reporting" (IAS 34). Thus, within the six months of 2006 net proceeds from natural gas increased by RUR 225.929 bln, or 46 per cent, as compared to the corresponding period of 2005, and amounted to RUR 721.885 bln, what was mainly based on price growth for sales to Europe and former Soviet Union countries, as well as higher volumes of sales in natural terms. The profit of AOA Gazprom shareholders for the first half-year of 2006 amounted to RUR 321.491 bln, what is RUR 168.681 bln, or 110 per cent more than in the same period of 2005. Net debt was decreased by RUR 126.716 bln, or 16 per cent, from RUR 797.465 bln as of December 31, 2005 to RUR 670.749 bln as of June 30, 2006. The decrease was mainly explained by a net repayment of long-term debt due to an increase of monetary assets and raised proceeds from operational activities, as well as RUR exchange rate dynamics.

In early October, consolidated financial reporting for the first half of 2006 was disclosed by OAO Gazprom Neft, a daughter company of Gazprom. In accordance with the reporting, prepared in conformity of US GAAP, revenues for the first half of 2006, compared with the first half of 2005, increased by 77 per cent and amounted to USD 10.1 billion. Profit before tax, interest and depreciation (EBITDA) for the

first half of 2006 to compare with the same period the previous year increased by 35 per cent and amounted to USD 2.6 billion. Net profit of OAO Gazpromneft for the first half of 2006 amounted to USD 1.8 billion, which is 26 per cent more than in the same period of preceding year.

On October 18 LUKOIL has also issued consolidated financial statements for the first half of 2006, prepared in accordance with generally accepted accounting principles the United States (US GAAP). According to the information provided, the net profit for the first half of 2006 amounted to USD 4 010 billion, an increase of 54.8 per cent as compared with the same period of preceding year. The EBITDA parameter grew by 50.4 per cent to USD 6 464 million. Sales revenue rose to USD 33,210 billion, or by 38.1 per cent. The increase in net profit was based on favorable price environment, increased production, processing and effective control over expenditures, as well as higher oil refining margins. However, the increase in profit was constrained by RUR strengthening against USD, as well as increased tax burden.

On November 2 Rostelecom has published unaudited results for the first nine months of 2006 in compliance with the Russian accounting legislation (RAS). According to the reporting, revenues for the first nine months of 2006 increased as compared with the relevant period of the preceding year by 47. per cent and amounted to RUR 43,757.1.1 million. The EBITDA parameter decreased against the same period of 2005 by 21.9 per cent, to RUR 9,069.4 million due to significant increase in costs, caused by changes in mutual settlements with Russian companies. Cost efficiency as per EBITDA amounted to 20.7 per cent. Net profit of Rostelecom for the first nine months of 2006 amounted to RUR 5,004.6 million, as compared with RUR 7,843.8 million in the first nine months of the previous year.

Mergers and acquisitions. In 2006, several Russian companies continued to purchase new assets, including foreign ones, as well as establish long-term relations allowing them to expand and enhance efficiency of their businesses. In addition, some of these companies implemented business reorganization and restructuring.

For example, January, Norilsk Nickel has informed on creation of a joint venture with Rio Tinto, one of the world largest mining and metal companies, which will deal with exploration and development of mineral deposits in Russia. The companies signed an agreement on cooperation in the Ministry of Natural Resources of the Russian Federation. Based on the principles of the agreement, a contract will be signed, which will stipulate the provisions of the joint venture. The agreement implies establishment of a joint venture for exploration and development, 51 per cent of which would be owned by Norilsk Nickel and 49 per cent by Rio Tinto. Initially exploration works will be concentrated in the Siberian and Far Eastern Federal Regions of Russia.

LUKOIL Overseas, the operator of international upstream projects OAO LUKOIL, has signed an agreement on merging with the company Chaparral Resources, Inc., according to which LUKOIL Overseas acquires all Chaparral Resources shares, issued in circulation. The agreement was approved by a special

Committee of the Board of Directors of Chaparral Resources. Recommended purchase price is USD 5.80 per share, which includes a bonus of 12.3 per cent to an average price of the share over the past 30 days. The total cost of the package of shares of Chaparral Resources, not owned by LUKOIL, amounts to USD 88.6 million, what is equal to the value of acquired proven reserves of oil (USD 8.10 per barrel). Consolidation of Chaparral Resources assets is executed by LUKOIL for complete control over the company, as well as enhancement of management system.

Also in May LUKOIL, acting through its 100 per cent subsidiaries, and Marathon Oil Corporation reached an agreement, that LUKOIL will acquire extraction facilities of Marathon Oil Corporation in Khanty-Mansi Autonomous Region. Those assets include more than 95 per cent of OAO Hantymansiyskneftegazgeologiya, as well as 100 per cent of the shares of two other companies : OAO Paytyh Oil and OAO Nazymgeodobycha". The amount of the transaction is USD 787 million with regard to adjustment for circulating capital and other adjustments. Total oil productive capacity as of January 1, 2006 was 257 million tons of brand AVC1 + C2 (about 1.88 billion barrels).

On June 26 OAO Gazprom, represented by ZGG GmbH, signed with OOO LEVIT and SWGI GROWTN FUND (CYPRUS) LIMITED (main shareholders of OAO NOVATEK, a preliminary agreement on the acquisition (for market price) of their shares in the authorized capital of OAO NOVATEK in the amount of less than 20 per cent of outstanding stock of the company.

On November 20, 2006 GMK Norilsk Nickel has informed on the signature of a purchase agreement for nickel business of OM Group Inc. for USD 408 million for monetary assets, excluding financial indebtedness. The acquired Nickel business includes OMG nickel refinery, a unit OMG mining and refining of nickel ore, 20 per cent of the shares of MPI Nickel Pty. Ltd, a company that develops Black Swan nickel mines and Silver Swan, as well as up to 11.1 per cent in the form of ordinary shares and convertible debentures in Talvivaaran Kaivososakeyhtiö (project on concentrated bioleaching in the Kainuu Region in Finland). The transaction will allow GMK Norilsk Nickel to continue international expansion of its business activities, and to strengthen their position in the international mining and metal market.

Capital investment. In the preceding year the native companies have actively pursued the policy on investing additional volumes of assets, including those in foreign financial markets, as well as in the world stock markets.

On March 2 OAO Mosenergo has placed the bond loan amounted to RUR billion, at the rate of 7.65 per cent from 1 to 12 coupon. The mature term is 10 years. OAO Mosenergo has placed the bond loan to refinance debt liabilities and optimize financial activity of the company. Placement purpose of the loan is ZAO Stock Exchange MICEX. Agency Standard and Poor's has assigned ruBBB + rating to the loan. Furthermore, on September 19 there was placed a ruble bond loan of OAO Mosenergo, in which the output made RUR 5 billion, at the rate of 7.54 per cent from 1 to 6 coupons with the term of maturity of 5 years. The next day after posting the bond loan, the rating agency Standard & Poor's has increased the international credit rating of Mosenergo from B- to B , the national rating was upgraded from ruBBB + to ruA-.

On April 18, 2006 OAO Gazprom has announced the entry into force of the program of depository receipts (DR) of the Society of the First Level, as well as of the simultaneous amendments to correlation of a number of ordinary shares of OAO Gazprom per one DR, from ten shares for one DR to four shares per DR. Gazprom DRs, available in circulation so far, were automatically converted at the effective rate (on the basis of existing restrictions). Depository receipts, issued under Program ADR of the first level will be freely circulating in the USA stock market, as well as in European stock markets. The maximum amount of ordinary shares, which may be the base asset for all ADRs of OAO Gazprom, will not exceed 35 per cent of the authorized capital of OAO Gazprom.

On 20 October OAO Sberbank of Russia has signed an agreement on a syndicated loan in the amount of USD 1.5 billion between Sberbank of Russia and foreign banks, including bank founders of ABN AMRO Bank N.V., Barclays Capital, J.P. Morgan plc and Sumitomo Mitsui Banking Corporation Europe Limited. Thirty banks with the widest geographical representation participated in the syndicate. The average prices for Syndicate has been much higher than in earlier syndicated borrowings of Russian borrowers. Syndicated loans held for a period of 3 years with a single payment at maturity. The borrowing was announced at the level of USD 1 billion. However, the proposals on the part of banks to participate in the loan amounted to about USD 1.7 billion, and in this regard, Sberbank of Russia has decided to increase the loan amount up to USD 1.5 billion. The rate of borrowing was LIBOR+0.3 per cent per annum, while the margin is the lowest for a three-year syndicated loans to Russian borrowers. The loan will be used for general corporate purposes. The transaction is the largest unsecured syndicated loan, ever granted to the financial institutions of Russia and other CIS countries, as well as countries in Eastern Europe, Middle East and Africa. The syndicated loan of Sberbank of Russia in the amount of USD 1.5 billion is the third largest syndicated transaction, organized in 2006.

On October 27, the Board of Directors of RAO UES of Russia has approved the issuance of additional shares of OAO Mosenergo for a closed subscription in favor of the Gazprom Group. During the additional emission, OAO Mosenergo intends to attract at least USD 2.1 billion of investments. Monitoring of the implementation of investment projects will be implemented by a simple partnership, formed by RAO UES of Russia, Gazprom and OAO Mosenergo.

On November 2, OAO Gazprom posted ruble bonds, series A7 and A8, accounted to RUR 5 billion each, with a nominal value of RUR 1000 rubles, with the maturity term of 3 and 5 years respectively. The annual coupon rate bonds series A7 paid every 182 days, as per the auction results on the MICEX, was established in the amount of 6.79 per cent per annum. The investors have made applications amounting to RUR 9.6 billion. The annual coupon rate bonds series A8 paid every 182 days, to the auction on the MICEX, was determined at the rate of 7 per cent per annum. Investors have made applications amounting to RUR 7.4 billion. The loans were arranged by the investment group Renaissance Capital and Rosbank OAO

,with the Horizon investment company as a partner; the financial advisor was OAO Federal Stock Corporation.

On December 14, 2006 LUKOIL has placed two issues of non-documentary interest bonds of OAO LUKOIL payable to the bearer, when they keep Series 03 and 04, for the total amount of RUR 14 billion. The contest coupon rate bonds series 03 totals to the nominal value of RUR 8 billion for a period of 5 years, at the rate of 7,10 per cent per annum. The annual coupon rate on Series 04 bonds in the amount of 6 billion rubles and treatment for 7 years was 7.40 per cent per annum. Price placement of bonds Series 03 and Series 04 was set at 100 per cent of nominal value. Early repayment of bonds and preferred right for the bonds' acquisition is not provided. 152 applications were filed for acquisition of the bonds, worth over RUR 20 bln, which exceeds the emission nearly 2.5-fold. As a result, LULOIL has become the first Russian private company, which has successfully placed bonds with a continuous maturity of 7 years. The issuance was executed by ABN AMRO Bank, Dresdner Bank and IB Renaissance Capital.

On December 20 an extraordinary general meeting of shareholders of OAO Mosenergo has approved an increase in the authorized capital of the Company by issuing additional shares in favor of a strategic investor. Shareholders of Mosenergo have approved the limit of issued ordinary shares in the amount of 11 500 000 000 and relevant amendments to the Charter of the Company with respect to the number of declared shares and the deployment of issuance of additional shares in favor pf OAO Gazprom and/or other affiliated entities of OAO Gazprom. The price of shares will be determined as the weighted average value of RTS and MICEX trades within the six months, preceding the date of the meeting of shareholders of OAO Mosenergo, but not less than 5 rubles per share. OAO Mosenergo is intended to implement an investment program of the Company amounting at to USD 2,1 billion for the issuance of additional shares.

Dividend Policy. We know that one way of enhancing the attractiveness of the shares is efficient dividend policy.

In May, the Board of Directors of Sibneft decided to advise the annual general shareholders' meeting of the company to pay dividends as per results of 2005 fiscal year in the amount of RUR \$ 7.90 per ordinary share. The deadline for payment of dividends, according to the Articles of the company is May 31, 2007

On June 24 Rostelecom decided to pay dividends in the amount of RUR 3.72 per preferred share and RUR 1.56 per ordinary share. Total dividend payment as of results of 2005 amounts to RUR 2,040.8 billion.

Finally, on June 22, 2006 shareholders of OAO Gazprom Neft "at the annual meeting has approved payment of dividends as per results of 2005 in the amount of RUR 7.9 per ordinary share. Thus, payment of dividends will make RUR 37,456 billion. Dividends will be paid before May 31, 2007

#### *2.5.4. Investments of Pension Savings in the System of Mandatory Pension Insurance*

The main bulk of the funded component of the mandatory pension system, as before, is accumulated by a government asset manager, whose functions are performed by the USSR Bank for Foreign Trade (Vneshekonombank). As of the beginning of 2006, the value of the pension savings invested by the government asset manager amounted to 176.5 bn roubles, while the total volume of pension savings administered by private asset managers (PAM) was 5.6 bn roubles (3%). Another 2 bn roubles (1%) were transferred by citizens to the Non-Government Pension Fund (NGPF).

Simultaneously, yet another 91.7 bn roubles was constituted by the insurance contributions to the funded component of labor pension collected by the Pension Fund of the Russian Federation (PFR) but not yet transferred into the trusteeship management of asset managers or the PFR. Out of this sum, more than 80 bn roubles was invested by the PFR in government securities. During the first half of 2006, another 40.7 bn roubles was received by the PFR as part of the funded component of labor pension. The share of funds invested by the PFR in government securities did not undergo any important changes<sup>59</sup>.

By late 2006, the value of the pension savings invested by the government asset manager (Vneshekonombank) had exceeded 267 bn roubles, having increased during that year by 90.8 bn roubles (51%). Most of it was represented by the funds transferred during the year from the PFR (83.5 bn roubles). The rate of return on investments declared by Vneshekonombank amounted in 2006 to 6% (against 12% by the results of the year 2005)<sup>60</sup>.

The reports published in the autumn of 2006 by the Federal Service for Financial Markets (FSFM) concerning the investment of pension savings in 2005 made it possible, for the first time, to observe the directions along which pension savings were being invested by private asset managers and the NGPF, and not only by the government asset manager<sup>61</sup>. The structure of investments of the Vneshekonombank and the aggregate investment portfolio of all private asset managers<sup>62</sup> as of the end of 2004 and 2005, as well as of the end of Q III 2006, is shown in *Fig. 19-25*.

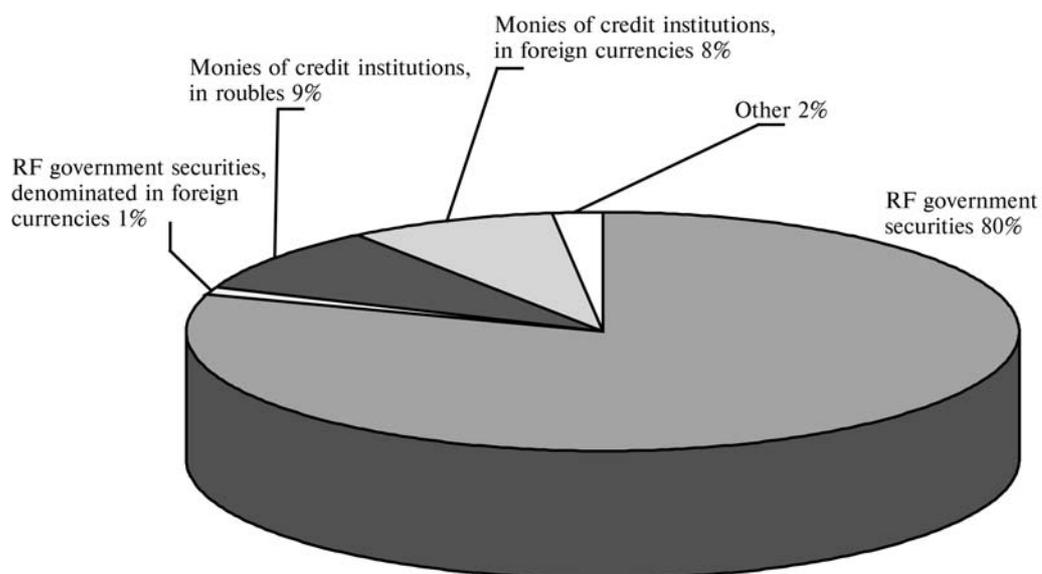
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<sup>59</sup> Federal Law "On the budget of the Pension Fund of the Russian Federation for the year 2007", *Vestnik [Herald] of the PFR* No 3 for 2006.

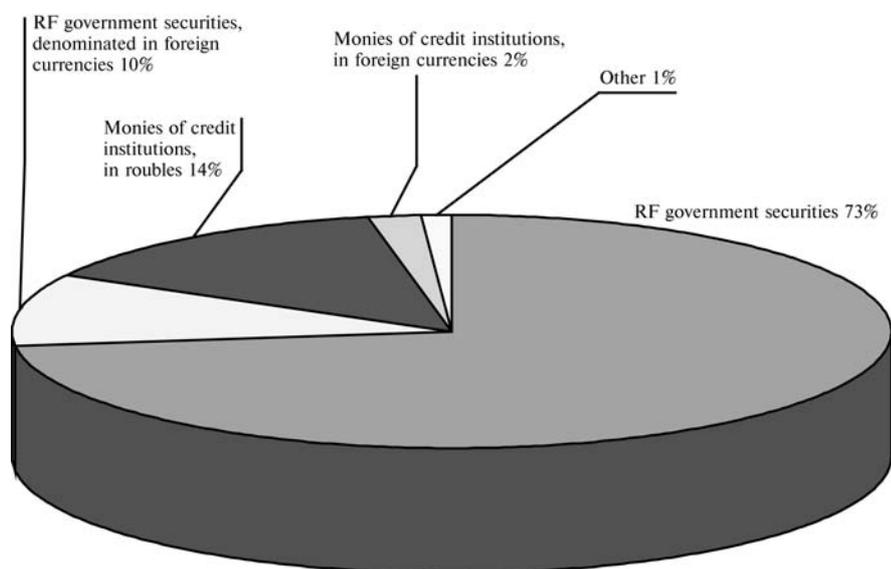
<sup>60</sup> The data concerning asset managers and the NGPF have not been published yet. In the Federal Law "On the budget of the Pension Fund of the Russian Federation for the year 2007", the PFR made a preliminary estimation of the amount of pension savings as of the end of 2006 as being equal to 345.3 bn roubles, which constitutes slightly more than 1% of GDP. As of 1 January 2006, the corresponding index was 255.9 bn roubles.

<sup>61</sup> For the data for the first three quarters of 2006, see the PFR's website: <http://pfrf.ru>.

<sup>62</sup> For purposes of analysis, the data published by the Federal Service for Financial Markets in respect of each of asset managers, in disputable cases were checked with other sources of information, and then aggregated. The source of data for 2006 is the PFR's website: <http://pfrf.ru>



*Fig. 19.* The structure of the investment portfolio of the government asset manager (*Vneshekonombank*), as of end of 2004



*Fig. 20.* The structure of the investment portfolio of the government asset manager (*Vneshekonombank*), as of end of 2005

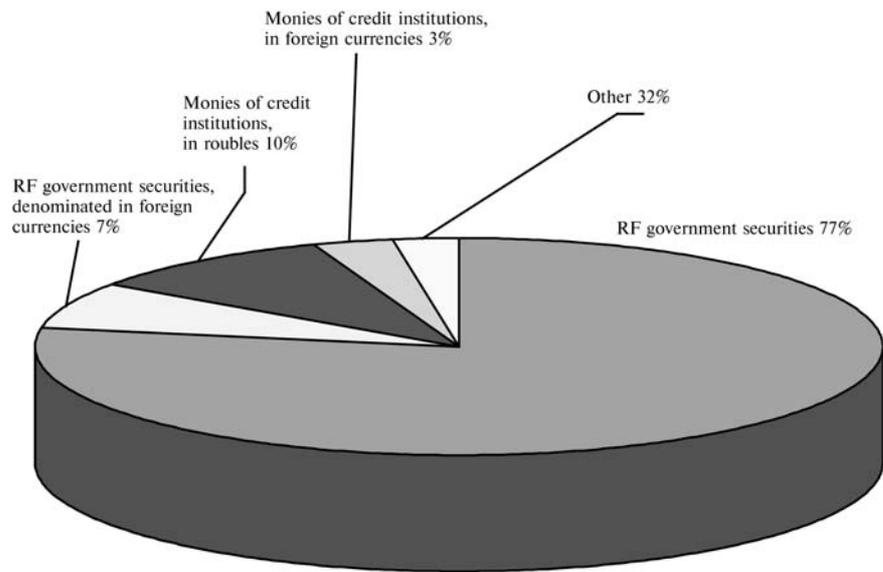


Fig. 21. The structure of the investment portfolio of the government asset manager (Vneshekonombank), as of end of Q III 2006

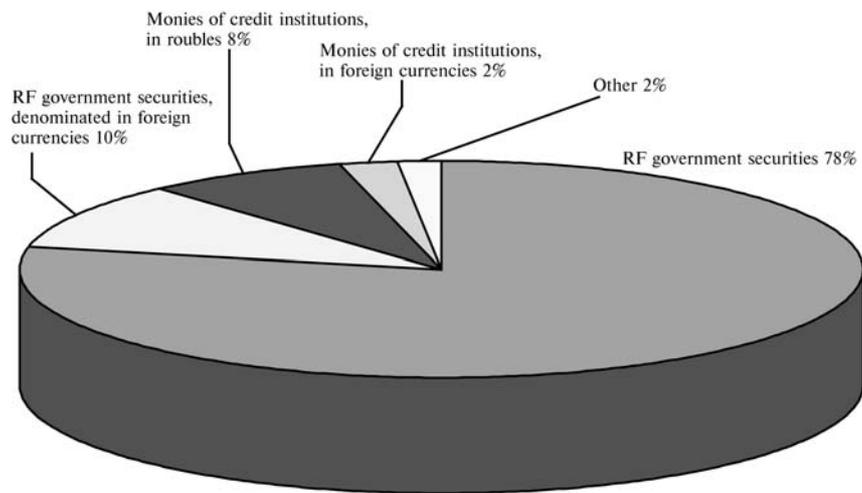
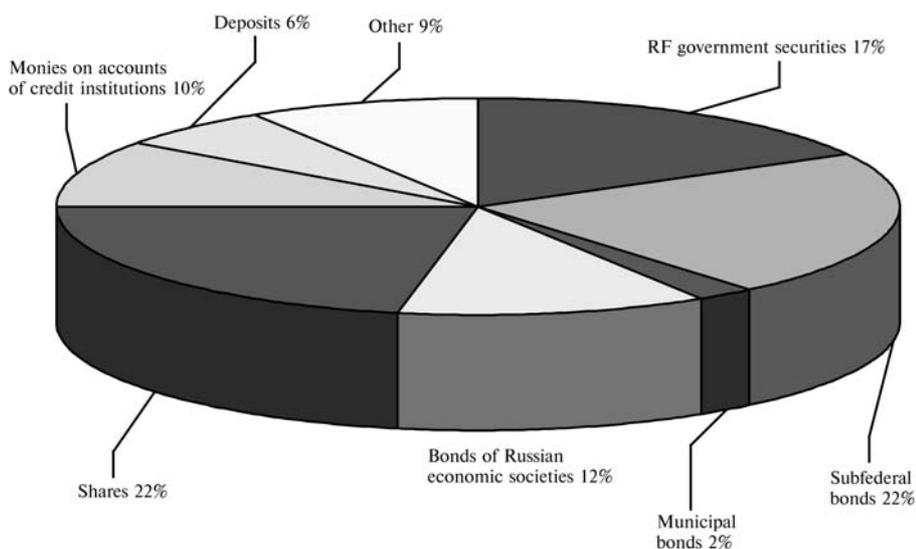
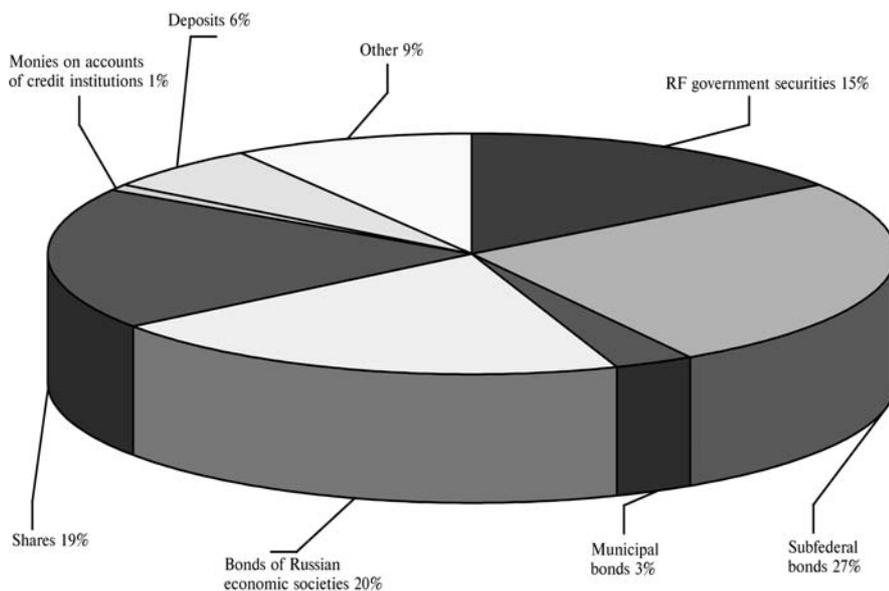


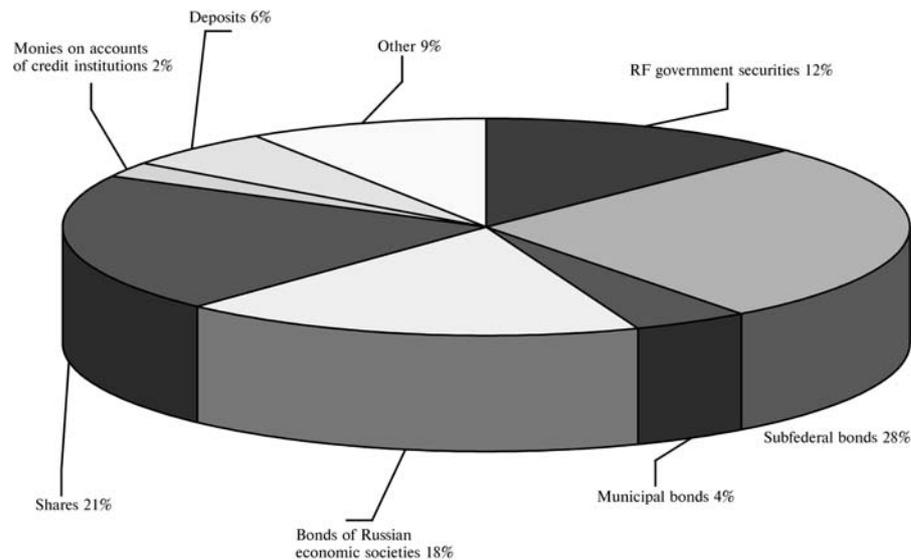
Fig. 22. The structure of the investment portfolio of the government asset manager (Vneshekonombank), as of end of 2006



*Fig. 23.* The structure of the aggregate investment portfolio of private asset managers as of end of 2004



*Fig. 24.* The structure of the aggregate investment portfolio of private asset managers as of end of 2005



Source: calculated on the basis of information published by the Federal Service for Financial markets, the Pension Fund of the Russian Federation, Vneshekonombank.

*Fig. 25.* The structure of the aggregate investment portfolio of private asset managers as of end of Q III 2006

As was found, the share of government securities of the Russian Federation in the investment portfolios of private asset managers varied between 0 and 96%, as of the end of 2004, and between 0 до 73% as of the end of 2005 constituting 17% in the aggregate portfolio in 2004, and 15% – in 2005. However, there were only two asset managers whose share of RF government securities as of the end of 2005 was more than 50% (“Dvortsovaia ploshchiad” and “KIT”), while 29 investment portfolios<sup>63</sup> contained no such securities. As of the end of Q III 2006, the highest share of RF government securities in the portfolios of PAMs decreased to 54%, while 28 investment portfolios contained no such securities, and their average share was 12.4%.

Thus, during one year and 9 months the share of federal government bonds decreased from 17% to 12%, which, no doubt, reflected the trend of diminishing rate of return on this instrument. At the same time, such an explanation can hardly be accepted as exhaustive, because the decrease of the rate of return was small, while the dynamics of the rate of return on subfederal and corporate bonds was displaying a similar trend. However, the share of these instruments in the aggregate investment portfolio of PAMs was growing, thus reflecting the diversification of the investments being made by asset managers, and in the case of corporate bonds – also the dynamic development of the market.

At the same time, in contrast to the government asset manager, private asset managers do not invest in RF government securities denominated in foreign currencies. As seen in *Fig. 19–22*, Vneshekonombank increased the share of Euro-

<sup>63</sup> The number of asset managers engaged in the trust management of pension savings is not compatible with the number of investment portfolios listed under their management, because several asset managers have formed more than one investment portfolio.

bonds in its portfolio to 10% by the end of 2005, and afterwards it was fluctuating within the range of 7–10 %.

On the whole, fixed-income securities (federal, subfederal, municipal, corporate bonds) amounted, in the aggregate investment portfolio of private asset managers, as of the end of 2004, to 54 %, as of the end of 2005 – to 64%, and as of the end of Q III 2006 – 62%.

The percentage of shares in the aggregate investment portfolio of PAMs was fluctuating around 20%, while at the same time 11 asset managers had no shares in their investment portfolios as of the end of 2005 (*Table 38*). In 2004, there were 10 such asset managers, and as of the end of Q III 2006 – only 5. The actual average percentage of shares in the aggregate investment portfolio of private asset managers is much lower than the maximum indices permissible for this type of assets in accordance with Decree of the RF Government No. 379<sup>64</sup>.

*Table 38*

**Private Asset Managers with no Shares in their Investment Portfolios  
as of the End of 2004 – Q III 2006**

Asset manager (investment portfolio)	End of 2004	End of 2005.	End of Q III 2006
1 VIKA	+	+	
2 Dvortsovaia ploshchiad	+	+	
3 Natsionalnaia upravliaushchiaia kompania [National Asset Manager]	+	+	
4 UNIVER Management	+	+	
5 TRINFIKO (for conservative preservation of capital)	+	+	+
6 PIOGLOBAL Asset Management		+	
7 PROMYSHLENNYE TRADITSII		+	
8 REGION Asset Management		+	
9 RN-trust		+	+
10 Rostov Trust Company		+	
11 YAMAL		+	
12 Alfa-Capital	+		+
13 Alians ROSNO (conservative)	+		
14 INTERFINANS	+		
15 Metropol	+		
16 Analytical Center	+		
17 FINAM MANAGEMENT			+
18 NVKUK			+

*Note:* + means absence of shares in investment portfolio as of corresponding date.

At the same time, it were shares that generated the highest rate of return during the period under study. In 2005–2006, the RTS index grew by 3.1 times (in USD denomination) and, no doubt, such a dynamics of the prices of shares was a factor of the high rate of return achieved by PAMs in 2005–2006. By the results of 2005, the highest rate of return on investments demonstrated by PAMs amounted to 52% (Troika-Dialog), in 2006 - to 39% (UNIVER Management).

<sup>64</sup> The margin for 2004 was 40%, for 2005 – 45 %, and for 2006 – 55 %.

In *Table 39*, the structure of the investment portfolio of asset managers with the highest rate of return by the results of the first three quarters of 2006 is shown. It appears that judging by that structure, one cannot come to the conclusion that it was the investments in shares, which provided the highest rates of return on investment portfolios. Only RTK-INVEST had an investment portfolio where shares constituted approximately one half of all assets. Three asset managers with the rate of return of 26–29% had a rather similar percentage of shares (25–26 %) and a high percentage of subfederal bonds (31–36 %). As for the leader of 2006 – UNIVER Management – its investment portfolio is negligible in absolute terms (its market value was only 2,3 mln roubles as of the end of Q III 2006), which, evidently, was the reason for the deformity of its structure (more than a half of assets was accumulated at credit institutions in the form of residuals on the asset manager's accounts or the monies transferred to the professional participants of the securities market, which has nothing to do with instruments with high rates of return).

*Table 39*

**Structure of the Investment Portfolio of Asset Managers with the Highest Rate of Return, by Results of the First Three Quarters of 2006**

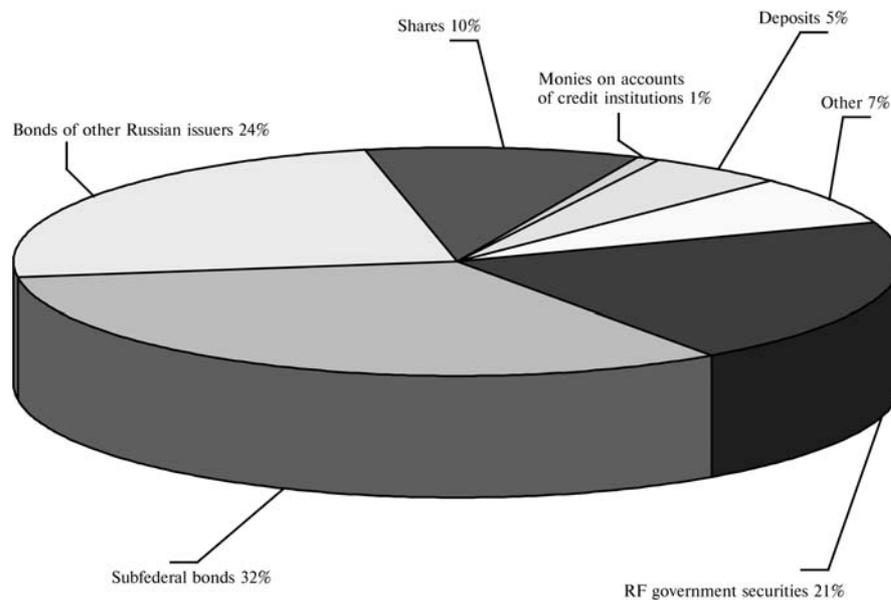
	UNIVER Manage- ment	RTK- INVEST	AKKORD As- set Manage- ment	URALSIB - ASSET MANAGEMENT	URALSIB
1	2	3	4	5	6
<b>Rate of return, % PER ANNUM</b>	44.4	29.8	29	28.5	25.7
<b>Market value of portfolio, mln roubles.</b>	2.3	20.1	34.1	15.9	533.7
<b>Share in investment portfolio, %</b>					
RF government securities	6.4	26.0	4.8	4.8	4.6
Including in foreign currencies	0.0	0.0	0.0	0.0	0.0
Government securities of RF subjects	21.1	21.5	36.7	33.6	31.3
Bonds of municipal formations	8.6	0.0	0.0	8.2	7.6
Bonds of Russian economic societies	5.2	0.0	14.5	10.4	11.4
Shares of Russian issuers	2.5	44.3	24.9	25.7	26.1
Monies on accounts at credit institutions	26.7	0.3	0.0	0.0	0.0
Rouble – denominated deposits at credit institutions	0.0	0.0	0.0	0.0	0.0
Receivables	29.5	7.9	19.0	17.4	19.0
including					
monies transferred to professional participants of the securities market	28.7	7.4	17.9	16.2	17.8
receivables against interest income on securities	0.8	0.5	1.2	1.2	1.1
other receivables	0.0	0.0	0.0	0.0	0.0

The data published by the FSFM offer no exhaustive information concerning the amounts of money being placed by asset managers at credit institutions. The corresponding tables, compiled by asset managers, contain no information on bank deposits, which is available only for the system as a whole. Thus, a rather substantial percentage of assets has remained hidden. For some asset managers, this index is higher than 15%, although the total number of asset managers (or investment portfolios) decreased in 2005 from 28 to 15.

The statistics published by the PFR makes it possible to obtain a more complete picture concerning the use of bank deposits by asset managers. As of the end of Q III 2006, this instrument was represented in only 10 investment portfolios, while their share in the aggregate investment portfolio of PAMs was less than 6%. At the same time, the percentage of the monies being transferred by asset managers to brokers and/or exchange settlement systems for purposes of purchasing securities is still high. For the aggregate investment portfolio of PAMs this index amounted to 8%, while the total percentage of monies placed within the banking system was thus equal to 16%.

As for the pension savings in the NGPF, the data published by the Federal Service for Financial Markets make it possible to estimate the structure of the investment portfolios only at one date – as of the end of 2005. The data are arranged by the list of those funds, which participated in the mandatory pension insurance system.

As compared to the aggregate investment portfolio of the private asset managers administering the monies of the Pension Fund of the Russian Federation, the percentage of shares in the aggregate portfolio of the NGPF earmarked for mandatory pension insurance is lower (10% against 19%). As of the end of 2005, the highest percentage of investments in shares was 31% (by the NGPF “Volga – Kapital”), while 10 of 43 NGPFs had no shares in their investment portfolios earmarked for mandatory pension insurance. The percentage of RF government securities in the investment portfolios of the NGPF earmarked for mandatory pension insurance varies between 0% and 99% (the NGPF “StalFond”), amounting to 21% in the aggregate portfolio, which is by 6 p. p. higher than the average index of private asset managers as of the same date. On the whole, the instruments with fixed rate of return (federal, subfederal, municipal, corporate bonds) constituted 77% in the investment portfolio, which was also higher than the same index of private asset managers. The most popular type of assets among both private asset managers and the NGPFs were subfederal bonds: as of the end of 2005, the average percentage of subfederal bonds in the aggregate investment portfolio of private asset managers was 26%, that of NGPF – 33 %.



*Note:* The bonds of other Russian issuers include corporate and municipal bonds.

*Source:* Calculated on the basis of the data published by the Federal Service for Financial Markets.

*Fig. 26.* The structure of the aggregate investment portfolio of non-government pension funds as of end of 2005

The sum of assets being administered by private asset managers under agreements with the Pension Fund of the Russian Federation amounted, as of the end of 2005, to 5.6 bn roubles, while the sum of assets of NGPFs earmarked for mandatory pension insurance, as of the same date, – to 2 bn roubles. In their aggregate investment portfolio the percentage of subfederal bonds was 28%. However, among the total volume of subfederal bonds being circulated on the market, pension savings constituted only 1.5%<sup>65</sup>. An even less percentage of pension savings (0.4%) was on the corporate bond market. So far, the only segment where the presence of pension savings represents a significant factor has remained the market for rouble-denominated federal bonds (OFZ). Even without the investments made by the Pension Fund of the Russian Federation itself<sup>66</sup>, their share was, as of the end of 2005, equal to 18.1%, where Vneshekonombank accounted for 17.9%. The share of pension savings invested in the foreign-currency-denominated bonds of the Russian Federation is much smaller – about 2% of the total volume of RF eurobonds in face value.

Since the data concerning the structure of the investments of pension savings, formed by NGPFs in 2006 was not yet available by the moment of publication, the role of the institutes participating in the mandatory pension system within the corresponding segments as of later dates can be assessed only by the data on the asset managers investing the PFR's monies. Thus, the percentage of pension sav-

<sup>65</sup> Estimation based on the date posted at [www.rusbonds.ru](http://www.rusbonds.ru) concerning the volume of subfederal and municipal bonds in circulation, in face value.

<sup>66</sup> If all the contributions to the funded component of labor pension invested by the PFR were placed in OFZ, then it accounted for another 11% of OFZ being circulated on the market.

ings invested by asset managers in rouble-denominated government securities increased, by the end of Q III 2006, to 22% of the total volume of marketed OFZ issues. At the same time, the share of pension savings on the corporate bonds markets and share markets remains negligible (0.2 and 0.01%, respectively). If one takes it into account that pension savings may be invested only in high-level listed securities the situation will change only slightly. The share of pension savings in the total volume of bonds listed as A1 at the Russian exchanges constituted only 2.2%, in the capitalization of shares included in those lists – 0.04%.

This situation provides grounds for placing the focus of attention once more on the urgent necessity to diversify the instruments and to liberalize the procedure for investing the pension savings formed for the benefit of those persons who have not made their investment choices<sup>67</sup>. The intention to this effect was declared by the RG Government as early as 2004, but so far it has not been practically implemented.

## **2.6. Municipal Reform: the First Year of Implementation**

The year 2006 stands apart within the overall process of the implementation of municipal reform. According to the reform's initial concept, it is in this year that the full-scale implementation of Federal Law of 6 October 2003, No. 131-FZ, "On the general principles of the organization of local self-government in the Russian Federation", was to begin all over the country's territory. That Law envisaged certain fundamental transformation in the system of local self-government in the Russian Federation. The key ideas of reform was to establish in legislation, clearly and with a single interpretation, the structure and functions of municipal formations of various types, and on that basis to determine their spending powers and to consolidate to them, on a permanent basis, appropriate sources of revenue. The main directions of transformations were to be as follows:

- on the greater part of the country's territory, it was intended to establish a two-tier model of local self-government, with municipal formations being formed both at the level of settlements and at the level of raions; one-tier municipal formations – city okrugs – could be created in urban territories by decision of regional authorities;
- rigid lists of issues of local importance were established for each type of municipal formations – settlements, municipal raions, city okrugs; on the whole, the competence of bodies of local self-government was noticeably reduced by comparison with the pre-reform situation;
- a more precise regulation was established for the transfer, to the local level, of certain state powers and for their financial backing from the budgets of superior levels;

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<sup>67</sup> For more details, see L. V. Mikhailov, L. I. Sycheva "Predlozheniia po izmeneniiu poriadka investirovaniia sredstv pensionnykh nakoplenii zastrakhovannykh lits, ne vospol'zovavshikhsia pravom vybora investitsionnogo portfel'ia" [Proposals concerning changes to the procedure for investing the pension savings of those insured persons who have not made use of their right to choose an investment portfolio] // Ekonomiko-politicheskaia situatsiia v Rossii [The economic and political situation in Russia]. M., IET, 2005 (11).

- the legislatively consolidated requirements to bodies of local self-government were made more strict; in particular, it was envisaged that each municipality was to have a representative body, a head official and a local administration; the number of deputies to that representative body was subject to special regulation, etc.; at the same time, the opportunities for regional authorities to influence the organization and composition of the bodies of local self-government were expanded;
- the list of property that could be placed in municipal ownership was limited; those objects that fell beyond the legislatively established restrictions were to be used for other purposes or alienated;
- sources of revenue were consolidated to municipal formations on a permanent basis; the principles and mechanisms for the granting of financial assistance to municipalities were rigidly consolidated in federal legislation (including the possibility of negative transfers for municipal formations with the most favorable financial situation).

During the preparation for the implementation of reform, it became obvious that the suggested model of the organization of the system of local self-government was too rigid and not totally adequate, while at the same time the necessary prerequisites for its practical implementation in many regions were lacking. The crisis in the implementation of municipal reform developed in mid-2005, when a group of deputies submitted to the State Duma a draft amendment whereby the timelines for the transformations as envisaged in legislation were to be extended. In a somewhat softened version this amendment was adopted on 21 September 2005. The changes introduced into Law No. 131-FZ envisaged that a transition period was to be established until 1 January 2009, within the framework of which, as far as the newly created municipal formations were concerned, the Federation's subjects could on their own distribute issues of local importance and sources of revenue between municipal raions and settlements, and thus largely determine the rate of implementation and directions of municipal reform.

That amendment marked just one important step in the sequence of changes being introduced into Law No. 131-FZ, influenced both by the lobbyism on the part of regional authorities and by the pressure of objective circumstances, which necessitated that the Law's excessively rigid structure was to be adjusted to the demands of practicality. One characteristic feature of all those changes was that the Law's intrinsic ideology, aimed at a strict division of the spheres of competence between the bodies of local self-government of different types of municipal formations and at the introduction of financial equalization mechanisms, designed to endow municipal formations with appropriate financial resources, was becoming more and more vague under the influence of currently arising problems and short-term demands. In this connection, no acknowledgement was made of the fact that the viability of the conceptual approaches that laid the foundation of municipal reform had never been tested, nor that the existing situation had to be rethought comprehensively from the point of view of the strategic prospects for the development of the entire system of local self-government in Russia. The necessary pre-

requisite for such rethinking was an analysis of the real situation surrounding the implementation of municipal reform in different regions. From this point of view, the monitoring of reform as it was developing in 2006 is of especial interest. In a situation when regional authorities were given ample opportunities for determining the rate and directions for implementing municipal reform until 2009, more than a half of the regions declared that they were going to initiate full-scale reform of local self-government from 1 January 2006. This means that we now can make assessments not only of the preparatory measures, but the of transformations proper as they were envisaged in legislation.

### *2.6.1. Normative-Legal Regulation of the Ongoing Transformations*

In contrast to the years 2004 and 2005, the changes introduced into legislation on local self-government in 2006 did not influence in any significant way the division of powers between municipal raions and settlements. Some serious amendments were made only to land legislation. By Federal Law of 17 April 2006, No. 53-FZ, "On making changes to the Land Code of the Russian Federation", Federal Law "On the enactment of the Land Code of the Russian Federation", Federal Law "On State registration of the rights to immovable property and the transactions therewith", and "On the recognition as null and void of some provisions of the legislative acts of the Russian Federation" it was determined that the disposal of the plots of land the State ownership of which has not been divided should be executed by the bodies of local self-government of municipal raions and city okrugs.

Such regulation cannot be recognized as logical, because the main powers in the sphere of the regulation of the use of land have been consolidated to the bodies of local self-government of settlements. Thereby, at the level of settlements, in respect of those lands the State ownership of which has not been divided, there should be established rules for the use of lands and their construction development, as well as construction permits should be issued, while the disposal of these lands (that is, the allocation of plots of land) is the prerogative of a municipal raion. Thus, there emerge additional grounds for conflict between two levels of authority within local self-government: the bodies of local self-government of settlements may refuse to issue construction permits in respect of a plot of land allotted by the raion, simple because they have taken no part in related decision-making. Besides, the costs being borne by the recipient of a plot of land become higher, because he has to effectuate coordination at two administrative levels instead of just one.

By the same normative act it was established that the plots of land in those settlements that are administrative centers or capitals of RF subjects should be disposed of by the bodies of local self-government of the said settlements, if by the laws of the corresponding RF subjects it is not established that the disposal of those plots of land should be carried out by the executive bodies of state authority of RF subjects. This provision appears to be rather bizarre, because the situation when a settlement and not a city okrug is the capital of a Federation's subject can be regarded as a rare exception. This can be observed only in a few autonomous city okrugs – in particular, Nenets AO, Agin Buriat AO, and Ust'-Ordynskii Buriatskii AO. In this connection it is unclear why it has become necessary to separately

regulate this specific instance. However, this is an illustration of the general trend that characterizes nearly every initiative aiming at introducing changes into the normative – legal regulation of local self-government in 2006 – namely, the intention to shift the balance of power between the bodies of local self-government located in regional capitals and the bodies of state authority of the Federation’s subjects in favor of the latter.

More obviously this trend has revealed itself in the draft Federal Law “On making amendments to Article 26i of the Federal Law ‘On the general principles of the organization of the legislative (representative) and executive bodies of state authority of subjects of the Russian Federation’ and to Article 75 of the Federal Law ‘On the general principles of the organization of local self-government in the Russian Federation’”, submitted to the State Duma in late April 2006 by deputies V. S. Mokryi, V. A. Zhidkikh, and A. V. Ogon’kov. Under this draft law, it was intended that subjects of the Federation should be granted the right to temporarily execute some of the powers of the bodies of local self-government of those settlements and city okrugs that are administrative centers of the Federation’s subjects, for purposes of ensuring the uniform functioning of their utilities and communications systems and other infrastructure. The draft contained no specific fundamental principles or conditions for temporary regulation of the “life support” systems in big cities at the level of the Federation’s subjects. Up to ten key issues of local importance could be potentially withdrawn from the jurisdiction of big municipal formations, including the organization of the supply of heating, gas, electric power and water; the organization of removal and utilization of domestic and industrial waste; the construction and maintenance of motor roads and bridges; the organization of transport services to the population; the establishment of rules for the use of land and its construction development, and the control over the use of lands. It was suggested that the timelines for the temporary withdrawal of powers and the specific grounds for such actions should be established by laws of the Federation’s subjects.

The draft law stirred strong public response, and opinions in society became divided. The draft law’s critics pointed to its lack of democracy and incompatibility with the RF Constitution and the European Charter of local self-government, and to local self-government becoming discredited in the eyes of the population as a result of its adoption. In this form, the draft law could not even find support among all the subjects of the Federation (thus, for example, the Legislative Assembly of Uliyanovsk Oblast, in its resolution, declared that “the amendments violate the essence of local self-government, the RF Constitution and the European Charter of local self-government”). Under the pressure from the public, the State Duma adjourned the consideration of this amendment.

In its stead, however, and under the same number, in October 2006 by a similar group of deputies from the faction “United Russia” a somewhat different amendment to Law No 131-FZ was suggested. The draft law put forth by the deputies envisaged that in administrative centers and capitals of subjects of the Russian Federation local self-government may be executed either within the borders of an administrative center or the capitals of a subject of the Russian Federation as a

whole, or in inner urban territories<sup>68</sup>. In this connection, in both instances to regional capitals, in fact, the regulation was extended which was envisaged for the inner urban municipal formations of the two cities of federal importance – Moscow and St. Petersburg. In particular, it was suggested that legislation of the Federation's subject should regulate the following issues:

- with due regard to the opinions of the population, to establish and change the borders of inner urban municipal formations, and to effectuate their transformations;
- to determine lists of issues of local importance, sources of revenue for local budgets;
- to establish the powers of the bodies of local self-government to make decisions concerning the issues of local importance from the list established by federal legislation;
- to establish the composition of municipal property on the basis of the federal composition of property and the regional list of issues of local importance, determined for the corresponding municipal formations by laws of the Federation's subjects.

Besides, it was suggested that amendments should be made to the RF Budget Code to the effect that to the Federation's subjects should be consolidated the right to determine the sources of revenue for the budgets of those city okrugs and settlements that have the status of administrative centers, capitals of subjects of the Russian Federation, as well as of the inner urban municipal formations located on their territories, and the list of spending powers and the procedure for their execution.

The emergence of such suggestions is quite logical in terms of the structure of the vertical of power. Since it became clear that within the existing RF Constitution it would be impossible to introduce the mechanism of actual appointment of mayors similar to that being executed in respect to governors, another pathway was chosen – that of limiting the independence of elective bodies of local self-government in biggest regional centers, which in most cases have the powers to dispose of vast resources, - namely, regional capitals<sup>69</sup>.

At the same time it is obvious that such an initiative, which, similar to the previous one, being designed to dramatically shift the balance of powers in favor of the Federation's subjects and to actually restrict the protection of the rights of local self-government (ensured by federal legislation) in regional capitals, was met with indignant response of the municipal community. Negative opinions were voiced not only domestically, but also by international organizations. As a result, the amendment was not considered by the State Dume, and the ultimate fate of this initiative is still unclear.

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<sup>68</sup> Accordingly, it was suggested that legislation should reflect the definition of such an inner urban territory as part of the territory of an administrative center or the capitals of a subject of the Russian Federation, within the borders of which local self-government is executed by the population directly and (or) through elective bodies of local self-government.

<sup>69</sup> Only in two regions – Vologda Oblast and Kemerovo Oblast – the regional capital is not the largest city in their respective territories.

The last among the significant legislative acts of 2006, which had to do with local self-government, was Federal Law of 29 December 2006, No. 258-FZ, "On making amendments to some legislative acts of the Russian Federation in connection with the improvement of the division of powers". The new law deals mainly with the division of powers between the Federation and subjects of the Federation, although it does, indeed, also touch upon the activity of bodies of local self-government. In respect to the latter, the changes introduced into legislation can be subdivided into two groups: some of them bring order and classification to the changes introduced earlier, while others actually touch upon the sphere of competence of bodies of local self-government.

These changes consolidate a rather complicated and controversial interpretation of the sphere of competence of bodies of local self-government, which incorporates the following:

- the settlement of issues of local importance;
- the execution of delegated state powers;
- the participation in the execution of other state powers, if this participation is envisaged by federal laws;
- the settlement of other issues, which are not placed within the sphere of competence of the bodies of local self-government of other municipal formations or bodies of state authority, or not withdrawn from the sphere of their competence by federal laws or laws of subjects of the Russian Federation.

At the same time, in respect to each type of municipal formations, a list of those issues is specified, which do not belong to the category of issues of local importance, but can be dealt with by bodies of local self-government. These issues are very versatile in their nature. Some of them can be treated as non-delegated state powers, in the execution of which bodies of local self-government may participate, which has become possible after the introduction of amendments into Law No. 131-FZ in late 2005. However, for example, the right to found local museums can hardly be fully compatible with this category, from the point of view of its essence. One gets the impression that, alongside the evolution of the division of powers, there also emerge the foundations for the subdivision of issues of local importance into compulsory and voluntary, which has already been practiced for a long time in foreign countries. However, the process itself is rather inconsistent and controversial.

It should be noted that the new classification of the spheres of competence of municipal formations is not quite compatible with their powers in the financial sphere (Article 86 of the RF Budget Code), because it is not defined precisely to which category of powers belong the rights of bodies of local self-government to deal with those issues that are not placed within the category of issues of local importance.

As for the specific set of issues of local importance, which are placed within the sphere of competence of bodies of local self-government but not on the established list, the recognition of the right of the bodies of local self-government of settlements to execute notarial actions in the event of absence of a notary in a settle-

ment is of utmost importance<sup>70</sup>, because otherwise in many instances the population's access this service would have become more difficult. In order to realize this right, in the Fundamental Legislation of the RF on the notariat some amendments were made, whereby the head of a local administration of a settlement and the specially empowered official of the local self-government of a settlement should have the right to execute the following notarial actions:

- to certify wills;
- to certify powers of attorney;
- to take appropriate measures for the protection of bequeathed property and, in an event of necessity, appropriate measures for its management;
- to attest to the correctness of copies and extracts from documents;
- to attest to the authenticity of a signature on a document.

By legislation of the Federation's subject, this list can be expanded.

At the same time, on accordance with the RF Budget Code, the State duty, as well as the fees for the execution of notarial actions by notaries working at state notary's offices and appropriately empowered by legislative acts of the Russian Federation and subjects of the Russian Federation, by government officials of bodies of executive authority, and by bodies of local self-government, are to be transferred to the budget of a municipal raion. Thus, there emerges a discrepancy between the execution of notarial actions at the level of settlements and the transfer of the corresponding revenues to the budgets of municipal raions

As for any changes to issues of local importance, the lawmakers have revived the trend of excluding social issues from the sphere of competence of bodies of local self-government<sup>71</sup>. From the list of issues of local importance of settlements such issues have been excluded as aid in establishing trusteeship and guardianship, as well as the computation of subsidies for the housing and utilities fees and the organization of the procedure for granting subsidies to those citizens who are entitled to them. This last issue was placed on the list of issues of local importance only a year ago. This inconsistency in the lawmakers' behavior does not make any easier the organization of the work of bodies of local self-government. As for municipal raions, the issue of trusteeship and guardianship has been withdrawn from the sphere of their competence. Accordingly, the whole bulk of these issues has also been withdrawn from the sphere of activity of city okrugs and placed within the sphere of competence of the Federation's subjects. In this connection, the participation in the activity relating to trusteeship and guardianship had been placed on the list of issues that are not classified as those issues of local importance that can be settled by the bodies of local self-government of all types of municipal formations<sup>72</sup>.

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<sup>70</sup> The provisions of Law No. 131-FZ concerning this right are to enter into force from 15 January 2008.

<sup>71</sup> The corresponding items of Articles 14, 15, 16 of Law No. 131-FZ will become null and void from 1 January 2008.

<sup>72</sup> The corresponding provisions of Law No. 131-Fz concerning this right will enter into force from 15 January 2008.

Such changes can hardly be regarded as positive. It is highly doubtful that the distancing, from the grassroots, of certain social issues, especially issues like as trusteeship and guardianship, which are so delicate and require an in-depth knowledge of the situation (including the specific family situations), could indeed result in improved performance. As for the issue of the computation and granting of subsidies, its successful settlement also depends on the knowledge of local specificities and the opportunities provided by the resources of local budgets, which has also become impossible in the situation of the new division of powers.

To the list of issues of local importance assigned to settlements and city okrugs, that of creating appropriate conditions for the activity of voluntary population units for the protection of public order was added<sup>73</sup>, while to the list of issues of local importance assigned to all types of municipal formations – not only that of the replenishment of library holdings, but also of the ensuring of their adequate protection.

It should be noted that this legislative is not free of the imprecision that was characteristic of the previously adopted documents of a similar type. The new powers of the bodies of local self-government, assigned by the amendments to branch legislation, have not been fully reflected in the amendments introduced to Law 131-FZ and are poorly compatible with the issues of local importance consolidated by this Law to municipal formations. The most vivid example of this incompatibility are the amendments made to the *Fundamental Principles of Legislation of the Russian Federation on the Protection of Citizens' Health*.

#### *2.6.2. The Implementation of Reform in Certain Regions: General Trends and Local Features*

The amendments to Law No. 131-FZ adopted in 2005 enabled the regions to determine on their own the volume of powers to be executed and the sources of revenue applicable to the newly created settlements. In this connection, different subjects of the Federation provided different solutions to that issue: some of them declared that they were going to implement municipal reform full-scale in 2006, while others took advantage of the right granted to them by the newly adopted amendments to legislation and resorted to the evolutionary variant of reform implementation. Thus, the first question to be answered by the monitoring of reform in 2006 is as follows: how great is the actual difference between the situation in those regions where municipal reform has been fully implemented and in those where the transformations planned at the municipal level were not in their entirety carried out in 2006.

The analysis of the situation as it exists in some regions<sup>74</sup> has demonstrated that nowhere do the newly created municipal formations of the settlement level deal with all the issues of local importance envisaged in Law No. 131-FZ. From this

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<sup>73</sup> This amendment to Articles 14 and 16 of Law No. 131-FZ will enter into force from 1 January 2008.

<sup>74</sup> In 2006, a detailed analysis of the situation with the implementation of municipal reform was conducted in Vologda Oblast, Cheliabinsk Oblast, Orenburg Oblast, Kaluga Oblast, Tver Oblast and the Republic of Chuvashia, while information on the other regions was sketchier.

point of view, those regions that have declared full-scale implementation of municipal reform do not in any significant way differ from those where the evolutionary variant has been chosen. In this connection, in those regions where full-scale implementation of reform has been declared, the instrument of agreements as to the transfer of powers between the bodies of local self-government of settlements and municipal raions is applied, in order to limit the competence of the bodies of local self-government of settlements. As for those regions where reform has not yet been fully implemented, there the powers of settlements are limited both by regional legislation and by agreements on the transfer of powers. Nevertheless, we may point out certain differences between the regions where reform has been implemented full-scale from the rest of the subjects of the Federation. Thus, the share of the budgets of settlements in the consolidated budgets of municipal raions, as can be derived from the information relating to the first-half year 2006, in the former category of regions amounts to 16.6%, while in the other regions it is only 6.2%.

Of some interest also the question as to the ratios of competence of the bodies of local self-government of newly created and previously existing settlements. In all probability, the situation varies greatly between regions. For example, in Orenburg Oblast, where prior to the onset of reform there existed only 4 municipal formations of the settlement type, the differences between the powers granted to newly created and previously existing settlements are rather substantial. Thus, the competence of the bodies of local self-government of newly created settlements in 2006 was restricted by both regional legislation and by agreements on the transfer of powers, while the previously existing municipal formation "Chernorechenskii sel'soviet" was not only dealing with all the issues of local importance envisaged in Law No. 131-FZ, but was also continuing to finance from the local budget the objects of public education and public healthy care located in its territory. Quite a different situation developed in Cheliabinsk Oblast, where prior to the onset of reform the two-tier model of territorial organization had already been implemented. Here, in order to restrict the competence not only of the newly created, but also of the previously existing settlements the mechanism of transfer of powers is applied. Simultaneously, there is an obvious intention to bring the powers granted to the bodies of local self-government of settlements to that level which emerged in the pre-reform period.

It is evident that the main instrument for restricting the competence of the bodies of local self-government of settlements, applied in the regions where municipal reform has been implemented full-scale, as well as in the regions where the process of transformation has not been completed yet, is the agreement on the transfer of powers. And this instrument may be widely applied not only within the framework of the transition period, but also after 1 January 2009. Therefore, the character and peculiarities of the application of this instrument need to be analyzed in more detail.

The possibility of and the conditions for the conclusion of an agreement on the transfer of powers are envisaged in Law No. 131-FZ, and not in its transitory provisions, but in its text body (Article 15). By legislation it is thus envisaged that:

- the transfer of powers may be effectuated both from the bodies of local self-government of settlements to the raion level, and from the bodies of local self-government of municipal raions - to settlements;
- the agreements must provide for the financial backing of the powers being thus transferred from the subventions granted from the local budgets of those municipal formations that have transferred their powers; the procedure for determining the annual volume of subventions must be determined by the agreement;
- the agreements must envisage the transfer not of an issue of local importance as such, but a part of the powers assigned to the bodies of local self-government for the decision-making in respect to a certain issue of local importance;
- the agreements must be concluded for a certain period of time;
- the agreements must contain provisions establishing the grounds and procedure for their termination, including early termination;
- the agreements must envisage financial sanctions for the non-execution of the agreements.

In actual practice, in a vast majority of cases, the agreements are concluded with violations of existing legislation. The most *typical violations* are as follows.

1. *The agreements are not voluntary in their essence* (being an obligation instead of a right). A model agreement is adopted at the level of either a whole region, or one municipal raion. Thus, for example, the Administration of the President of the Republic of Chuvashia developed a model agreement containing a list of powers assigned to settlements, which the Republic's bodies of state authority recommend to be transferred from settlements to the level of raions. The corresponding agreement in most cases is signed, without any changes, by the bodies of local self-government of municipal raions with all the settlements on a uniform basis. In this connection, no regard is given to the specific potential of each settlement for dealing with issues of local importance, and from the instrument designed to adjust to the shortage of material resources and personnel in certain settlements the agreement is turned into a universal instrument for restricting their powers.

In some cases the individualization of agreements is allowed to previously existing settlements. Thus, in Maloyaroslavets raion of Kaluga Oblast, individual agreements were signed by only two previously existing settlements with the status of municipal formations: "Posiolok Detchino" and the town of Maloyaroslavets (in this latter case the volume of powers actually being transferred was minimal). At the same time, all the newly created settlements signed agreements in a single format determined by the administration of the municipal raion, despite their organizational potentials being entirely different. An attempt made by the largest of the newly created settlements with the population of approximately 4,000 to limit the volume of powers being transferred to the raion level resulted in a serious personnel reshuffle at the settlement level.

However, in some other regions the situation is less oppressive: there are some "rebel" municipal formations who are defending their right to execute a wide

range of powers than that envisaged by the standard approached. Nevertheless, in none of the surveyed regions the number of such settlements, according to representatives of local administrations, is more than 10%. And in only some regions the oblast administration does not impose the unification of the mechanism of transfer of powers and truly wants to take into account the local peculiarities. One such example is Tver Oblast.

*2. Not the powers but the whole issues of local importance are transferred.* As a result, the bodies of local self-government of settlements actually lose control over a certain issue of local importance. The transfer of issues of local importance generally, without any specification of the powers being transferred, results in a situation when the actual activity of the bodies of local self-government of the municipal raion in their dealing with a given issue may substantially differ from the settlement's expectations. Thus, in one of the rural settlements in Nizhnii-Novgorod Oblast the bodies of local self-government, as admitted by their representatives, when transferring to the raion level the issue of providing appropriate conditions for the development of mass-scale physical culture and sport in the settlement's territory, believed that rural children would thus obtain the opportunity to regularly visit the raion center in order to train at a local sports school, while the hockey field in the village would be repaired, and the sports organizer would be receiving methodological assistance from the raion. At the same time, the bodies of local self-government of the municipal raion were planning to receive additional funding for the upkeep of the administrative apparatus, for the participation of athletes in inter-raion and regional competitions, as well as for the upkeep of the sports school, although it was not planned that rural children would be brought to train at that school.

The transfer of issues of local importance in their full volume implies that the bodies of local self-government of settlements, in fact, will lose control over the decision-making in respect of a given issue of local importance, while remaining formally accountable for that issue to the population. Accordingly, the agreements envisage neither monitoring nor any control by the bodies of local self-government of settlements over the execution of the powers transferred to the municipal raion, or any accountability of the raion bodies of local self-government to settlements, etc. Thus, the provision concerning financial sanctions for the non-execution of an agreement cannot be realized in actual practice, either. At the same time, it should be noted that in those cases when powers are transferred from a municipal raion to settlements (which actually happens sometimes), the situation may become entirely different. This asymmetry can be observed in the agreements being made in Cheliabinsk Oblast. Thus, in Troitsk raion, in the agreement on the transfer of powers from settlements to the municipal raion there is neither a special section concerning the rights of a settlement nor any sanctions for the non-execution of the obligations undertaken by the raion. At the same time, sanctions are envisaged for settlements if they do not transfer in due time the subventions to cover the execution of the transferred powers (as a rule, it is a penalty in the amount of 1/300 of the rate of interest established by the RF Central Bank for each day of delay). As for the agreements on the transfer of powers from the municipal raion to settlements

(this transfer of powers has taken place in the sphere of pre-school education), their structure is quite different. There exists a well-elaborated section in the agreement concerning the rights of the municipal raion in respect to the agreement's execution, including the conduct of checks and revisions, expert's assessment of pre-school educational establishments, the formation of an estimate of expenditure for each establishment, the establishment of the regime of operation for each establishment, the procedure for demanding explanations, the issue of instructions, etc.

*3. Subventions for the financing of the powers being transferred are either not established altogether, or are determined on a purely formal basis in an amount clearly insufficient for the backing of the relating activity.* The main bulk of expenditures to cover the transferred powers come from the budget of a municipal raion. It should be noted that no such participation in the financing of the powers transferred under an agreement is envisaged in legislation, in contrast to the transferred state powers that can be co-financed from local budgets. Thus, no references to the lack of financial resources in the budget of a settlement may be regarded as legitimate grounds for making an agreement. In actual practice, the bodies of local self-government are attempting to bypass these restrictions, entering into agreements of other types, instead of the agreements on the transfer of powers. For example, in Orenburg Oblast and in the Republic of Chuvashia they apply agreements on the interaction between the administration of a municipal raion and settlements in the decision-making with regard to issues of local importance. However, such approaches cannot be recognized as being fully compatible with the existing legal space.

*4. The bodies of local self-government of settlements transfer to a municipal raion such powers, which by their very nature cannot be treated as transferable.* Thus, for example, the powers for ownership, use and disposal of a settlement's property are transferred. In this connection it is not clear how, in absence of any opportunities for the execution of its property rights, a settlement can deal with issues of local importance. Evidently, the necessity of transferring appropriate powers in a certain specific sphere may follow from the transfer to the raion level of the powers to provide the population with some municipal services; however, no transfer of powers for the ownership, use and disposal of a settlement's property as a whole may be regarded as being lawful.

A similar situation arises when the transfer of powers may give rise to a conflict of interests. Thus, for example, it happens in a situation when to the bodies of local self-government of a municipal raion the right to represent the interests of a settlement in a court of justice is transferred. This right cannot be executed in an event of direct court proceeding between a municipal raion and a settlement and may give rise to a conflict of interests when, while representing the interests of a settlement, the municipal raion has its own related interest in a given case, which is different from the settlement's interests.

The procedure of the transfer of powers cannot always ensure the best possible division of rights and responsibilities between municipal raions and settlements,

either. For example, the surveying of this issue in one of the raions in Orenburg Oblast yielded the following picture. Although the oblast has declared that from 2007 it is implementing full-scale municipal reform, the actual volume of powers assigned to settlements has not increased by comparison with the year 2006. The text of the agreement elaborated by the raion administration for 2007 envisages the transfer to the raion level of 12 key issues of local importance, including in the sphere of utilities, construction and maintenance of motor roads, cultural services, physical culture and sport, library services, the formation of a settlement's archival funds, the use of lands and construction thereon, civil defense, mobilization readiness, promotion of agricultural production and small businesses, children's and youth activities, and the calculation of housing and utilities subsidies and the provision of these subsidies.

All the settlements in a raion make agreements in a single format, in conditions of rigid administrative pressure. The decision concerning the transfer of powers is made by the representative bodies of settlements "orally", no materials in writing being distributed. The whole list is being voted on, and not each power separately. The raion administration submits no report as to how it has been executing the powers transferred to it for the previous period, or which funds have been spent in this connection. The division of objects of property does not correlate in any way with the division of powers: for example, the powers for utilities services are transferred to the bodies of local self-government of a municipal raion, while boiler stations are transferred into municipal ownership.

As a result, one may come to the conclusion that, although the list of issues of local importance to be actually dealt with by newly created settlements, as it has emerged under the influence of both regional legislation and the agreements being concluded, does, indeed, differ from region to region, most often the bodies of local self-government of settlements realize their powers in the following spheres:

- creation of adequate public recreation conditions for the residents of a settlement and the organization of adequate equipment of popular public recreation sites;
- organization of the collection and removal of domestic waste and litter;
- organization of the provision of all amenities and the planting of urban greenery on the territories of settlements;
- organization of street lighting and the setting-up of signs with names of streets and numbers of buildings;
- organization of funeral services and the maintenance of cemeteries.

In some instances, these issues are supplemented by the maintenance of roads, children's and youth activities, and the provision of cultural services to the residents. In a great majority of cases, the issues of the disposal of land resources are concentrated at the raion level. The treasury execution of the budgets of settlements also takes place at the level of municipal raions.

Although the large-scale transfer of powers is directed from the bodies of local self-government of settlements to those of municipal raions, there are also some instances of a reverse process – the transfer of powers from municipal raions to settlements. Most often, the organization of pre-school education is transferred

to settlements (which is quite understandable, this service being of a local nature), and sometimes also such issues as the organization of supplementary training, current upkeep of educational establishments, current upkeep of medical institutions, primarily first-aid and tocolological stations (FATS). However, this process is better developed at previously existing settlements and reflects the aforesaid trend of bringing the competence of the bodies of local self-government of these settlements to its pre-reform level: while previously such issues were dealt with at the settlement level, now they are transferred to the same level by agreements.

Special problem is represented by the organization of financing procedures at the newly created municipal formations. Nearly all the regions have been faced with difficulties in that sphere. No adequate base has existed – either for forecasting the revenues of settlements, or for planning their budget expenditures.

Also, certain difficulties arose in connection with the land tax, for which the tax base from the year 2006 has been radically altered. According to the information from the regions, the forecasting of revenues from this tax has, nevertheless, been done “from the achieved level”, on the basis of the data of previous years. This has resulted in serious errors, because the volumes of revenues from the land tax have changed significantly, being different in different regions and municipal formations. Thus, in the municipalities of Kaluga Oblast the revenues from this tax declined nearly by one order, while in some regions of Orenburg Oblast the land tax payments increased six-fold.

Different regions are practicing entirely different approaches to the granting of financial assistance to settlements – from covering the difference between the actual or standard expenditures and the revenues, to applying complicated mechanisms of computations, with the determination of the tax potential index and the spending needs index. However, the application of the methodological recommendations originating from the provisions of the Budget Code cannot by itself ensure any real financial equalization of settlements. Thus, in Orenburg oblast, where financial equalization represents a regional power delegated to the raion level, and financial assistance is being distributed on the basis of the equalization of budget sufficiency with due regard for the indices of tax potential and spending needs (that is, the existing system is fully compatible in this respect with federal legislation), the actual differences in the budget sufficiency of settlements in different raions are greater than by 10 times. The practice of granting dotations to settlements has also become quite widespread, which completely distorts the nature of this instrument.

As for the treasury execution of the budgets of settlements, such powers, with a few exceptions, have been transferred to the raion level.

### *2.6.3. The price of municipal reform is the cost of administration*

While the preparations to the implementation of municipal reform were going on, there was no end to discussions as to what would be the result of transformations from the point of view of the efficiency of budget expenditure. This issue is of especial significance in terms of administrative costs. Here, two opposite standpoints have emerged. On the one hand, there existed the opinion that the approach

suggested in Law No. 131-FZ to the reforming of local self-government can substantially lower the level of performance in the administrative sphere and result in growing administrative costs. On the other, there were also some contrary arguments – since the total volume of powers assigned to the bodies of state authority and local self-government was not to be changed, and was only to be redistributed between different levels of authority, the associated administrative costs were not to become greater, either. Only an analysis of the actual administrative costs can provide an adequate answer to the question as to whether resulting from the creation of tens of thousands of new municipal formations at the settlement level there will be significant losses due to the insufficient scale of administrative activity, associated with increased costs.

Naturally, it is yet too early to draw any final conclusions. Nevertheless, the analysis of this issue on the basis the national budget statistics for the first half-year 2006, as well as surveys of the situations existing in some regions, has yielded the following results.

*Firstly*, the growth of administrative costs in municipal budgets in 2006, by comparison with 2005, was far ahead of the corresponding index of the previous years. This can be explained by different factors; at the same time, the conclusion that this has largely been produced by the implementation of municipal reform seems to be well-substantiated. Such a conclusion is confirmed by the fact that in those regions where full-scale implementation of reform from 2006 was declared, the corresponding growth was higher than in all other regions. At the same time, the highest growth was observed in those regions where municipal reform had been fully implemented, and the number of municipal formations had been accordingly greatly increased. While the costs of the upkeep of the bodies of local self-government grew in all regions, on the average, by 30.7% in real terms, in those regions where municipal reform had been fully implemented the growth was 32.8%, while in those where municipal reform had been fully implemented and the number of municipal formations increased more than twice – by 41.7%.

*Secondly*, during our study certain facts have been revealed, which are indicative of the existence of real losses due to the insufficient scale of activity at the level of settlements, this problem, not having been softened in the course of reform, has become even more acute. This conclusion can be substantiated by the following arguments:

- as shown by the results of the analysis of budgets in the first half-year 2006, the share of expenditures on the upkeep of the bodies of local self-government at the level of settlements amounts to more than 30%, while at the level of raions it is lower more than four-fold, and amounts to 7%; in some settlements, where the situation was analyzed during regional studies, – to more than 80%;
- the estimated numbers of residents of a settlement per one staff member of a local administration demonstrate a rather distinct inverse dependence on the number of residents in a settlement; in other words, the less residents there are in a settlement, the higher is the relative number of staff in the local administration;

- in some settlements, which existed prior to the onset of municipal reform, resulting from the reformed division of powers and the implementation of other provisions of Law No. 131-FZ, the share of administrative costs has become much higher; thus, for example, in Khomutinskii rural settlement in Cheliabinsk Oblast it has more than doubled.

*Thirdly*, the growth potential of administrative costs, associated with the implementation of municipal reform, have not yet been exhausted in either those regions where the evolutionary approach to municipal reform has been chosen, or in those where its full-scale implementation has been declared. The increased administrative costs will be determined by several factors:

- the inevitable growth in the number of the administrative staff of settlements in many regions, and, accordingly, the associated growing costs of their upkeep (at present, the growth in the number of administrative staff is being restricted by administrative measures, thus preventing them from any real decision-making in respect to issues of local importance);
- the necessity to provide the local administrations with additional technical resources: computers, office equipment, service motor transport;
- the acute need for better qualification of the personnel.

Thus, any full-scale reform of local self-government will entail additional budget expenditures, and, as estimated, the costs will be comparable to those associated with the insufficient scale of administrative activity at the level of a settlement. Thus, the issue of the need to optimize such costs through a rational division of issues of local importance between municipal raions and settlements, as well as the organization of adequate cooperation between municipalities, will become of utmost importance. At the same time, it has become obvious that this growth in administrative costs is largely inevitable in view of the specific model of municipal reform that has been selected, and the attempts to restrict it by administrative measures, which are being made by regions, may result only in disorganization of the smooth operation of the bodies of local self-government of settlements.

## **Annex 1. An Overview of Legislation in the Field of Tax Regulation and Civil Legislation Adopted in 2006<sup>1</sup>**

The year 2006 proved to be no exception for lawmakers in the sphere of tax legislation's reforming. A whole package of laws was adopted, which introduced some significant changes to the RF Tax Code (TC) and touched upon not only the general norms stipulated in Part I, but also upon nearly all the existing taxes – the value added tax (VAT), the profits tax, the single social tax (SST), excises, the tax on the extraction of mineral resources (TEMR), the single agricultural tax, as well as levies for the right of use of objects of fauna and for the right of use of objects of aquatic biological resources.

Below we are going to discuss the most important changes that occurred in the tax sphere, and also in the spheres of civil and labor legislation.

### **The main changes introduced in Part I of the RF Tax Code**

The main changes concerning the improvement of tax administration are introduced by Federal Law of 27 July 2006, No 137-FZ, "On making changes to Part One and Part Two of the Tax Code of the Russian Federation and in some legislative acts of the Russian Federation in connection with the implementation of measures designed to improve tax administration", to come into force from 1 January 2007 (with the exception of a number of norms). The changes introduced in Part I of the RF TC are aimed at improving tax control, putting in order the procedures for tax audits and circulation of documentation in the tax sphere, providing better conditions for the independent and honest execution, by taxpayers, of their responsibilities in respect to lawful payment of the established taxes and levies, and expansion of guarantees for the observance of the rights and lawful interests of taxpayers.

In accordance with this Law, the majority of provisions stipulated in Part I of the RF TC are to be amended: the procedure for the payment of taxes is changed; the procedure for the recovery of taxes, fines and penalties is changed; changes are made to the procedure for the request for documentation; considerable alterations are made to the procedure for the conduct of in-house tax audits; the procedure for the conduct of on-site tax audits, including repeated on-site tax audits, is changed; the rule of mandatory pre-judicial appeal against decisions to a superior tax agency is established; tax agencies are granted powers to impose a ban on the alienation of property by a taxpayer; taxpayers are granted the right, in the presence of a bank guarantee, to suspend the actions relating to the recovery of a tax, a penalty or a fine; and a number of other amendments are also introduced.

A new wording is adopted for Article 6.1, which regulates the procedure for determining the timelines established by legislation on taxes and levies. State bodies of executive authority and the executive bodies of local self-government, or other agencies, officials and organizations, empowered by them and receiving from taxpayers (or payers of levies) monies in the established procedure for the payment of taxes (or levies) and their transfer (remittance) to budgets, as well as

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<sup>1</sup> The overview has been prepared with the aid of the legal system KonsultantPlus.

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the agencies of state off-budget funds, are excluded from the list of participants of tax legal relations.

By the changes introduced in Item 2 of Article 11, the notions of “personal account”, “account of the Federal Treasury”, and “accounting policy for purposes of taxation” are determined. It is established that the rules envisaged in Part I of the RF Tax Code for banks are to be extended to the RF Central Bank.

The Law has broadened the rights of taxpayers: by the changes introduced in Article 21, the right of taxpayers to participate in the process of considering the materials of a tax audit or other acts issued by tax agencies in instances envisaged by the Code is established.

A new wording is introduced for Article 23 “Duties of taxpayers (or payers of levies)”. It is determined that individual entrepreneurs, notaries with a private practice, and advocates who have established advocate’s offices are obliged at the place of their residence to submit, at the request of a tax agency, the ledger for recording incomes and expenditures and economic operations, as well as accounting reports. Notaries and advocates are also obliged to notify, in writing, the tax agency located at the place of their residence of the opening (or closing) of accounts intended for the execution of their professional activity by them.

The instances when tax agencies may bring suits to courts of general jurisdiction or arbitration courts are defined more precisely. Tax agencies have lost the right to create tax posts. Tax agencies are now obliged to be guided by written explanations of the RF Ministry of Finance concerning the issues of applying RF legislation on taxes and levies. It is established that the RF Ministry of Finance, financial agencies of RF subjects and municipal formations issue written explanations within the limits of their competence within two months from the day of submitting an appropriate request. This period can be extended by decision of the head of an appropriate financial agency, but no longer than by one month.

By the changes introduced into Article 45 “Performance of the duty with regard to the payment of a tax or a levy” it is established that the taxes due as a redemption of arrears accumulated for a period of more than three months by organizations which are dependent (affiliated) societies (enterprises), as well as by organization for which a personal account has been opened, must be recovered in a judicial proceeding. The instances are determined when the duty of paying a tax is not recognized as having been fulfilled, in particular in an event of a recall by a taxpayer or a return by a bank (or an agency of the RF Treasury) of a non-executed order, or insufficiency of funds on an account, or an incorrect entry of the number of the RF Treasury’s account and the name of a recipient bank in the payment documents.

A new wording is adopted for the norms establishing the procedure for recovering a tax or a levy, or penalties and fines, from the monies kept at the accounts of a taxpayer (or a payer of levies) – an organization, an individual entrepreneur or a tax agent – an organization or an individual entrepreneur at banks, as well as the norms establishing the procedure for recovering a tax, a levy, or penalties and fines at the expense of the property of a taxpayer (or a payer of levies) – a physical per-

son who is not an individual entrepreneur. Thus, earlier it was established that a petition to sue for the recovery of a tax at the expense of a taxpayer's property – a physical person who is not an individual entrepreneur, may be submitted to a court of general jurisdiction by a tax agency (or a customs agency) within six months after the expiry of the period for the execution of a demand for the payment of a tax. In the new wording it is stated that the period for submitting a petition, if lapsed for a justifiable reason, may be reinstated by a court of justice.

Certain changes have been introduced in the procedure for granting a deferral (or an installment system) with regard to the payment of taxes and levies (Chapter 9 of the RF TC). In particular, the condition concerning the limits for their granting within the limits established by the laws of the RF, the laws of the RF subjects on the corresponding budgets and the legal acts of the representative bodies of municipal formations is excluded. The maximum period for granting a deferral (or installment payment) is extended from six months to one year. In this connection, a deferral or installment payment of federal taxes in the part transferable to the federal budget for a period of more than one year but no more than three years may be granted by decision of the RF Government. The institution of tax credit is abolished. Now only the methods for changing the timeline for the payment of a tax will be a deferral, an installment plan or an investment tax credit, which is quite logical, because tax credit represents a certain replica of a tax deferral. Besides, the period is shortened during which a related person must submit a copy of an application for the granting of a deferral or an installment plan for the payment of a tax to the tax agency at the place of registration, – now it is five days.

A new wording is introduced for the norms concerning the timelines for sending a demand for the payment of a tax or a levy; the consequences of a change of the duty with regard to the payment of a tax or a levy; the suspension of bank account operations of organizations and individual entrepreneurs; carry forward or refund of excessive amounts of a tax, a levy, a penalty or a fine; tax declarations and changes thereof; and the provisions on tax control.

The norms concerning the registration of organizations and physical persons are changed. Thus, when operations are carried out in the Russian Federation through a solitary subdivision, the application concerning the registration of an organization at the location of its solitary subdivision is to be submitted within one month after the creation of the separate subdivision.

A physical person whose place of residence for purposes of taxation is determined by location has the right to apply to the tax agency at his or her location for a registration with tax agencies. In accordance with the changes introduced to Article 84 of Part I of the RF TC, a tax agency is obliged to register a physical person on the basis of an application within five days from the receipt of the said application by the tax agency, and within the same period to issue to him or her a certificate of registration at a tax agency.

The range of responsibilities of the Chambers of Advocates of subjects of the Russian Federation, of the agencies (or institutions) empowered to conclude notarial actions, of private notaries, of the bodies and organizations effectuating the ac-

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creditation of affiliations and representative offices of foreign juridical persons, as well as of banks, to submit to a tax agency the information needed for the execution of tax control.

The norms establishing the timelines and the procedure for conducting tax audits are changed, which will be discussed later.

The changes in the procedure for appealing against the decisions of tax agencies are associated with the establishment of the rule of mandatory pre-judicial appeals against such decisions to a superior tax agency. From the year 2008 onward an organization will not be able to file a petition to a court of justice before undergoing the stage of a pre-judicial appeal against a tax inspectorate's decision to a superior agency.

The RF Tax Code is augmented by Article 101.2 "Procedure for appealing against the decision of a tax agency concerning the bringing to responsibility for the commission of a tax violation or the decision concerning a refusal to bring to responsibility for the commission of a tax violation". Such decisions of a tax agency may be appealed against first to a superior tax agency, and only after that – to be petitioned to a court. In this connection, an appellation procedure is introduced for appealing to a superior tax agency against a decision of a tax agency that has not entered into force.

It is established that within the period of limitations for bringing to responsibility is to be suspended if the person being brought to responsibility for having committed a tax violation has been actively resisting the conduct of a tax audit. The violation of the procedure for registration of objects of gambling business is also placed within the category of tax violations.

Below we discuss in more detail some of the changes introduced in the Tax Code.

#### *The procedure for recovery of taxes and fines*

In accordance with the new wording of the first paragraph of Item 1 of Article 104 of the RF TC, after the rendering of a decision concerning the bringing to responsibility for the commission of a tax violation and in those instances when no extrajudicial procedure for imposing tax sanctions is allowed, a tax agency should submit a petition to sue to a court of justice to the effect that tax sanctions should be imposed on the person being brought to responsibility. It is intended that a tax agency should appeal to a court of justice for the recovery of a fine when there exists a ban on the recovery of a fine in an extrajudicial procedure. Now, an extrajudicial recovery of a fine is not allowed only in one instance – in accordance with Item 1 of Article 115 of the RF TC, tax agencies may file a petition with a court of justice to sue for the recovery of fines from an organization or an individual entrepreneur in the procedure and within the periods envisaged in Articles 46 and 47 of the RF TC.

In accordance with Article 46 of the RF TC, the decision concerning the recovery of a tax from an organization (or an individual entrepreneur) must be made by a tax agency within 60 days from the date of the expiry of the period of compliance with the demand that a tax should be paid. In an event of a lapse of this period, a tax

may be recovered only in a judicial proceeding. For an appeal to a court of justice, in accordance with the explanations issued by a Plenum of the RF Supreme Arbitrage Court, the maximum period of six months is established<sup>2</sup>. If a tax agency petitions to a court of justice after a lapse of this period, this entails a refusal by the court to satisfy the petition. The new wording of Article 46 of the RF TC grants to courts of justice an opportunity, on a request of a tax agency, to reinstate the period for petitioning for an enforced recovery of a tax in an event when this period has lapsed for a justifiable reason. It should be noted that no criteria for determining the justifiability of such reasons are offered. We believe that such amendments result in a worsened position of taxpayers.

It is also noteworthy that if a taxpayer has not voluntarily paid a tax, a tax agency within two months after the expiry of the period specified in a demand for payment should make the decision that the tax be recovered from the monies kept at bank accounts. After the rendering of such a decision, the tax agency has the right to make a decision that the taxpayer's account operations should be suspended. Thus, an organization may lose the capacity to dispose of its money until it settles its debt. Some important changes concerning such a suspension of operations have been introduced into Article 76 of the RF TC. The article's new wording envisages that operations should be suspended not in respect of all the monies kept at a bank account, as it was established previously, but only within the limits of the sum specified in the tax agency's decision. That is, from the year 2007 onward a tax agency may suspend operations only within the limits of a sum needed for the redemption of the debt, which can be recognized as a positive factor.

#### *Set-off and refund of excess paid (or recovered) amounts of tax*

The most significant changes appear to be those concerning the broadening of the sphere for applying the rules established by Articles 78 and 79 of the RF TC. Thus, the procedure for setting off (or refunding) from 2007 onward will be extended to advance payments and fines. And from 2008 it will be possible to carry forward the amounts paid not by budgets, but by the types of taxes: federal taxes will be set off against federal taxes, regional – against regional taxes, and local – against local taxes, respectively. Thus, for example, the excess of the profits tax can be carried forward as the payment of VAT.

The timelines for setting off the taxes paid have also been changed. A tax agency now has the right to make the decision concerning the carry-forward of a tax within 10 working days instead of 5 calendar days from the day of receiving the application of a taxpayer, or from the day of signing an act of reconciliation (if it has actually taken place), which means that the period has actually been made three times as long by the lawmakers. The same 10-day period has been established for making the decision concerning a refund or the sending of an order for a tax refund to a territorial agency of the Federal Treasury (no such period was established previously).

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<sup>2</sup> Decree of the RF Supreme Arbitrage Court's Plenum as of 28 February 2001, No 5, "On some issues concerning the application of Part I of the Tax Code of the Russian Federation".

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The period for the notification, by a taxes agency, about its decision concerning setting-off (or refunding) of excess tax paid, or about its refusal to carry forward (or refund) the excess has, on the contrary, been made shorter. Instead of 2 weeks, this period is now 5 working days from the day of the corresponding decision being made by a tax agency.

Besides, the period during which a tax agency is obliged to inform the taxpayer concerning any fact of an excess payment of tax that has become known to it and of the amount thus paid in excess has been shortened from 1 month to 10 days. An important detail is the precise definition of the procedure for calculating the interest charged on the delay in refunding the excess amounts of taxes. From the year 2007 onward a territorial agency of the Federal Treasury will have to notify a tax agency as to the exact date of refund and the amount refunded, with the interest charged. If the interest has not been paid to a taxpayer in full, then, after receiving such a notification, the tax agency will be obliged within 3 days to make a decision concerning the refund of the remaining amount of interest, depending on the actual date on which the excess amount of tax was refunded.

The same is true for setting off and refunding the amounts of excess tax recovered: the procedure for refunding the amounts of excess tax is extended to advance payments and fines; the period for a tax agency to make the decision concerning the refund of the amounts of excess tax recovered; and the period for a tax agency to issue a notification of the established fact of an excess amount of tax having been recovered will now be 10 days instead of 1 month; and the amount recovered in excess, with the interest charged to it, will have to be refunded to a taxpayer within one month from the day of receiving a written application (no such period for refund was established before the introduction of this amendment).

#### *The procedure for conducting on-site tax audits*

In accordance with Article 88 of the RF TC, in-house tax audits are to be conducted within three months from the day of the submission, by a taxpayer, of a tax declaration and the documents serving as a basis for calculating and paying a tax, as well as of other documents concerning the activity of the taxpayer available to the tax agency. In accordance with the new wording of this article, an in-house tax audita can be conducted within three months from the day of the submission by the taxpayer of a tax declaration and the documents which, according to the Tax Code, must be attached to a tax declaration. Thus, the timelines established for submitting any additional documents should not influence the length of in-house tax audits.

Article 89 establishes that in an event of the reorganization or liquidation of an organization (or in the procedure of a superior agency controlling a subordinate one) a tax agency may conduct a second audit of a taxpayer. This innovation is associated with the establishment of the only justification for the conduct of a second on-site tax audit: if an organization submits an adjusted declaration with an amount of tax lower than that declared earlier, the tax agency has the right to conduct a

second audit of the documentation relating to the period in respect of which the taxpayer has made adjustments.

Other amendments establish that tax agencies have no right to conduct more than two on-site tax audits of one and the same taxpayer during one calendar year, except in extraordinary cases by decision of the head of a federal body of executive authority. Tax agencies may not conduct two or more on-site tax audits of the same taxes during one and the same period. The duration of an on-site tax audit has also been changed – now it may not continue for more than two months. Its duration may be extended to four months, and in exceptional cases – for up to six months. Presently it is possible to extend the duration of an on-site tax audit to three months. It should also be noted that the recent changes have introduced a rule whereby within the framework of an on-site tax audit a period can be checked which is no longer than three calendar years preceding the year during which the decision concerning the conduct of a tax audit is made. This direct stipulation makes it possible for a tax agency to interpret the date of the beginning of a tax audit at its own convenience (either the date of making the decision or the data of the actual onset of a audit).

By the changes introduced in Article 93 of Part I of the RF TC “The demanding and obtaining of documents during a tax audit” it is forbidden to demand a notary’s certification of the copies of documents submitted to a tax agency (or to an official), if not envisaged otherwise by legislation of the Russian Federation. Besides, the RF TC was augmented by Article 93.1 “The demanding and obtaining of documents (or information) concerning a taxpayer, a payer of levies and a tax agent, or information on specific transactions”. The norm determining the procedure for formalizing the results of a tax audit has been made more precise (Articles 100 and 101). In particular, it is established that on the basis of the results of an in-house tax audit a reference concerning the tax audit should be drawn up within 10 working days after its completion. Prior to the introduction of these changes the RF TC contained no stipulations concerning the mandatory nature of drawing up such an act. An organization will have the right to present motivated objections to an act of tax audit, for which a period of 15 working days from the moment of the receipt of such an act is granted.

#### *Bringing to responsibility for the commission of a tax violation*

By Article 113 of the RF Tax Code in the wording as of the end of the year 2006 it is established that a person may not be brought to responsibility for having committed a tax violation, if three years have expired since the day of the commission thereof or since the next day after the end of the tax period during which this violation was committed.

From January 2007 onward it is established that the three-year period of limitations for tax violations must be calculated from the moment of a tax violation being committed (from the next day after the end of the tax period during which this violation was committed) and until the moment of rendering the decision concerning the bringing to responsibility for the commission thereof.

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At the same time, the RF TC is now amended so as to include the stipulation as to the possibility for suspending the period of limitations for tax violations. The suspension of the period of limitations will become possible if the person being brought to responsibility for having committed a tax violation has actively resisted the conduct of an on-site tax audit, thus creating an insurmountable impediment to its conduct and the determination, by tax agencies, of the amounts of taxes due to be transferred to the budgetary system of the Russian Federation. The period of limitations is suspended if the head of an audit group draws up a special act, which is envisaged in Item 3 of Article 91 of the RF TC for instances when the access by the officials of tax agencies conducting a tax audit to the territory or premises of a taxpayer is obstructed. The period of limitations is reinstated after the decision is made that the on-site tax audit should be continued. Tax agencies will be obliged to prove, in a judicial procedure, that a certain taxpayer has created obstructions to them. However, it is not explained how exactly the currently existing notion of “active resistance” should be understood.

The punishment for operating without having registered at a tax agency has been made more severe. The lower threshold for a fine for an organization’s or an individual entrepreneur’s operation without having registered at a tax agency within a period of more than 90 days has been established (Item 2 of Article 117 of the RF TC): from 1 January 2007 the amount of fine is to be no less than 40 thousand roubles. This is one of the highest fixed fines envisaged by Russian legislation.

A positive development is represented by the expansion of the list of circumstances excluding the guilt of a person in committing a tax violation: instead of a closed list the lawmakers have approved an open one. Item 1 of Article 111 of the RF TC is augmented by an additional subitem which adds to the circumstances excluding the guilt of a person in committing a tax violation some other circumstances, which may be recognized by a court of justice or the tax agency considering a case as excluding the guilt of a person in committing a tax violation.

## **The main changes introduced into Part II of the RF Tax Code**

### *The value added tax (VAT)*

Among important changes, the switchover from the monthly to quarterly schedule for the payment of VAT can be noted. Presently VAT can be paid on a quarterly basis by all taxpayers whose monthly sums of proceeds from sales of goods (or work, or services) during a given quarter before tax are below 2 million roubles. The norm coming into force from 1 January 2008 for all taxpayers, tax agents including, will make it possible to reduce the bulk of submitted documentation and enable taxpayers to use the amounts of the tax as their circulating assets.

From 1 January 2007 the special procedure for VAT refunds on export transactions is abolished: the deductions of VAT on internal and external operations must be reflected in one declaration (Item 6 of Article 164 of the RF TC, requiring that a separate tax declaration with a zero tax rate should be submitted, is abolished). That is, the sums of the tax to be refunded to exporters will be entered into a

general declaration and thus be accepted for deduction in a declarative procedure. The procedure for refunding is general, to be applied only if the amount of VAT paid on internal and export transactions is in excess of the total amount of tax as calculated by a taxpayer (Item 1 of Article 176 of the RF TC).

A new wording is introduced for Article 176 "Procedure for tax refund". After a taxpayer has submitted a tax declaration, the tax agency, during an in-house tax audit, verifies the justifiable character of the amount of tax declared as due to be refunded. The decision concerning the refunding (in full or in part) of the corresponding amounts must be made by the tax agency within 7 days after the completion of a tax audit, if no violations of legislation on taxes and levies have been found.

If a taxpayer has arrears of VAT or of other federal taxes, or arrears of the corresponding penalties and (or) fines, a tax agency independently sets off the amount of tax to be refunded against the aforesaid arrears. If there are no arrears, the amount of tax to be refunded by decision of a tax agency is returned, on the basis of the taxpayer's application, to the bank account specified in it. Also, on the basis of the taxpayer's written application, the amounts to be refunded may be set off against future payments of VAT and other federal taxes.

On the next day after the decision concerning a refund was made the tax agency must send to a territorial agency of the Federaloro Treasury an order for the refund of the amount of tax, and the territorial agency of the Federaloro Treasury, within 5 days from the day of receiving this order, must refund to the taxpayer the amount of tax, and within the same period to notify the tax agency as to the date of the refund and the amount refunded to the taxpayer. The tax agency must also notify the taxpayer in writing as to its decision concerning a refund, or a setoff of the amount of tax to be refunded, or a refusal to refund it, within 5 days from the day of making the corresponding decision.

The norm stipulated in Article 149 concerning the exemption from the value added tax established for religious organizations was made more precise. At present it is established that the value added tax in the territory of the Russian Federation is not to be levied on the realization (or transfer for their own needs) of items used for religious purposes and religious literature produced and realized by religious organizations. In this connection, in actual practice this exemption can be taken advantage of by those religious organizations that both produce and realize, on their own, items used for religious purposes and religious literature. From the year 2007 onward VAT will no more be levied not only on the commodities (or work, or services) produced and realized by a religious organization or by the economic societies owned by that religious organization, whose charter fund is constituted only by the contributions made by religious organizations, but also on any transfers of such commodities (or work, or services) between any religious organizations and (or) the economic societies created by them, whose sole founders (or participants) are religious organizations (or unions).

Because of the establishment of a new type of state and municipal institutions –autonomous institutions (which are not budget-funded), which enjoy greater freedom in respect of the property transferred to them, certain changes have been

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introduced into Subitems 5 of Item 2 of Article 146 of the RF TC: VAT will not be levied on the reimbursable transfer of fixed assets to any state and municipal institutions – either budget-funded or autonomous.

*The personal income tax (PIT)*

Certain changes have been introduced in Chapter 23 of the RF TC “Personal income tax”, which make more precise the notion of tax levied on a resident of the Russian Federation. For purposes of PIT payment, all physical persons are divided into the tax residents of the Russian Federation and those persons who are not such residents. Different tax rates are applied to the incomes of residents and non-residents – 13 % and 30 %, respectively (Items 1 and 3 of Article 224 of the RF TC).

In accordance with Item 2 of Article 11 of the RF TC, tax residents are understood as those physical persons who have actually spent no less than 183 days in one calendar year in the territory of the RF. Thus, the status of a tax resident is acquired by a physical person in respect of each calendar year, and until the expiry of the period of 183 days from the beginning of a calendar year a physical person (including Russian citizens permanently residing in the RF) is not a tax resident.

Now, from 1 January 2007 onward, a tax resident will be recognized as a physical person who has actually spent no less than 183 calendar days in the RF during 12 successive months. In this connection, the period of a physical person being in the RF is not disrupted by his or her exit from the RF territory for a short period (less than six months) for purposes of medical treatment or education. It is suggested that certain categories of persons, namely the Russian military serving abroad, as well as the employees of bodies of state authority and bodies of local self-government dispatched to work abroad, beyond the limits of RF territory, should be recognized as RF tax residents no matter what the actual length of time has been spent by them in the territory of the Russian Federation.

Some workers, instead of a standard tax deduction in the amount of 400 roubles (Subitem 3 of Item 1 of Article 218 of the RF TC), enjoy the right to a monthly PIC deduction in the amount of 500 roubles (Subitem 2 of Item 1 of Article 218 of the RF TC). These are, e. g., veterans of World War 2; persons disabled from childhood and disabled persons of Groups I and II; citizens demobilized from the armed forces, who have served in the Republic of Afghanistan. In contrast to the deduction of 400 roubles, granted only after the annual income is below 20,000 roubles, the deduction of 500 roubles is granted on a monthly basis independently of the size of a worker’s income. From 1 January 2007 the right to a standard tax deduction of 500 roubles will also be enjoyed by those citizens who have participated in combat actions in the territory of the Russian Federation.

From 1 January 2007 onward the maximum size of a social deduction from the tax, granted to a taxpayer in connection with his or her expenses on education or medical treatment, will be increased from 38,000 to 50,000 roubles (Subitems 2 and 3 of Item 1 of Article 219 of the RF TC)<sup>3</sup>. In accordance with Subitem 3 of Item 1

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<sup>3</sup> If an application for a deduction is filed in 2007 in respect of the year 2006 and earlier tax periods, the maximum amount of deduction will be 38,000 roubles.

of Articles 219 of the RF TC, the social tax deduction will also cover the sums of insurance premiums paid under the contracts of voluntary personal insurance envisaging the payment of insurance companies only for medical services.

It is established that from 1 January 2007 the property deduction from the tax, envisaged in Article 220 of Part II of the RF TC, will be granted to a taxpayer in an event of sale or purchase not only of an apartment or a house, but also a room.

From 1 January 2007 it is envisaged that PIC should not be levied on the sums of parent capital established in the amount of 250,000 roubles (Item 34 of Article 217 of the RF TC). In this connection no social or property deductions are granted when parent (or family) capital is spent on education and (or) construction (or acquisition) of a residential building, apartment or share (shares) therein.

### *Excises*

Traditionally, the rates of excises on the majority of excisable goods have been raised (Item 1 of Article 193 of the RF TC). Thus, from January 2007 the rate of excise on ethyl alcohol is increased from 21 roubles 50 kopecks to 23 roubles 50 kopecks, the rate of excise on beer with per cent volume of ethyl alcohol from 0.5 % to 8.6 % inclusive – from 1 roubles 91 kopecks to 2 roubles 07 kopecks per liter, and with per cent volume of ethyl alcohol over 8.6 % – from 6 roubles 85 kopecks to 7 roubles 45 kopecks per liter.

The rate of excise remained the same for champagnes and sparkling, carbonated and prickling wines; the rate for natural wines has not been changed, either; the same rate will be applied to natural beverages with per cent volume of ethyl alcohol not higher than 6 %, produced from wine materials without the addition of ethyl alcohol. For all the other types of spirituous liquors a general rate is established of 162 roubles per liter of absolute ethyl alcohol contained in excisable commodities. The rates of excises on oil products have also remained unchanged.

A zero excise tax rate will be applied, as before, to beer with per cent volume of ethyl alcohol of up to 0.5 % and on passenger cars with engine capacity of up to 90 hp.

Previously, alcohol-containing products with metal spray cans – perfumes, cosmetics and household chemicals – were not recognized as excisable goods (paragraphs 7 and 8 of Subitem 2 of Item 1 of Article 181 of the RF TC). From 1 January 2007 onward these products will become excisable, but the rate of excise will be zero (Item 1 of Article 193 of the RF TC).

The rate of excise on passenger cars with engine capacity of above 90 hp and below 150 hp has been raised from 16 roubles 50 kopecks to 18 roubles per hp, and on passenger cars and motorcycles with engine capacity of above 150 hp – from 167 to 181 roubles per hp.

The rates of excises on tobacco products have been also raised, but this deserves a special comment. The rates of excises on cigarettes have been raised on the average by 30 %: on filter-tipped cigarettes the fixed part of the rate is increased from 78 to 100 roubles per 1000 pieces, on cigarettes without filter and cigarettes with cardboard mouthpieces – from 35 to 45 roubles per 1000 pieces.

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The minimum general rate of excise on filter-tipped cigarettes is 115 roubles per 1000 pieces, on cigarettes without filter and cigarettes with cardboard mouthpieces – 60 roubles per 1000 pieces. The most significant change is that the ad valorem part of the rate on cigarettes and cigarettes with cardboard mouthpieces will not amount to 5 % of their estimated value. That is, now the ad valorem (per cent) part of the rate on cigarettes and cigarettes with cardboard mouthpieces is established on the basis of the estimated value of a commodity, calculated by the maximum retail price and not by the disbursing price, as it was done previously. In this connection, a taxpayer must notify the tax agency concerning the maximum retail prices of each item name of tobacco products. Presently two forms for such a notification are established - for the maximum retail prices of tobacco products manufactured in Russia and for the maximum retail prices of tobacco products imported into Russia.

The rules for determining the estimated value of cigarettes and cigarettes with cardboard mouthpieces are established by new Article 187.1 of the RF TC. A taxpayer must independently determine the maximum retail price of one package of cigarettes of each brand. Tobacco products cannot be sold to consumers at a price higher than the established maximum retail price. The notification should be submitted no later than 10 days prior to the beginning of the month during which the prices indicated in it are going to be applied. The maximum retail price declared in a notification must be applied for no less than one calendar month. After the expiry of one month a taxpayer can change the price by submitting a new notification.

The information concerning maximum retail prices, as well as the information on the month and year in which a product was manufactured, must be indicated on each package of tobacco products. The production and import of filter-tipped cigarettes without the provision of this information will be forbidden from 1 January 2007, and their retail sale – from 1 January 2008. For cigarettes without filter and cigarettes with cardboard mouthpieces, any production and import without the indication of information on a package will be forbidden from 1 July 2007, retail sale – from 1 July 2008. In the period between 1 January through 1 July 2007 the estimated value of cigarettes without filter and cigarettes with cardboard mouthpieces will be determined on the basis of the maximum retail price stated in a notification.

Noticeable changes have been made in the levying of excises on oil products. The payers of excises will now be recognized as persons carrying out the realization of oil products produced by them. The persons engaged in wholesale, wholesale and retail, or retail sale of oil products will no more be treated as payers of excises. Article 179.1 of the RF TC, where the issue of certificates for carrying out transactions in oil products was envisaged, had been abolished. Also abolished are Subitems 2-4 of Item 1 of Article 182 of the RF TC, establishing the instances of the payment of excises on oil products: at the moment of the entry in the books of oil products produced on their own by persons without a certificate; at the moment of the receipt in the territory of the RF of oil products by an organization or an individual entrepreneur holding a certificate.

Excises on oil products will be paid by their producer at the moment of realization of the oil products (Subitem 1 of Item 1 of Article 182 of the RF TC), as well as in other general cases listed in item 1 of Article 182 of the RF TC, which are as follows:

- the transfer of excisable goods for processing and the return of excisable goods manufactured from a customer's raw materials (Subitem 12 and Subitem 7 of Item 1 of Article 182 of the RF TC);
- the transfer, within the structure of one organization, of manufactured excisable goods for further production of non-excisable goods (with the exception of transfer of straight-run petrol for further manufacture of petrochemical products within the structure of an organization holding a certificate for carrying out transactions in straight-run petrol) (Subitem 8 of Item 1 of Article 182 of the RF TC);
- the transfer of manufactured excisable goods for an organization's own needs and as a contribution in charter capital, or a contribution under a simple partnership agreement (Subitem 9 and 10 of Item 1 of Article 182 of the RF TC);
- the transfer of manufactured excisable goods at the withdrawal of a participant from an organization;
- the separation of the share of a participant in a simple partnership agreement (Subitem 11 of Item 1 of Article 182 of the RF TC).

When concluding transactions with straight-run petrol, the payers of excises will be recognized as producers of straight-run petrol at the moment of its realization (in accordance with Subitem 1 of Item 1 of Article 182 of the RF TC) and as the persons carrying out the production of petrochemical products from straight-run petrol at the moment of its receipt (in accordance with newly introduced Subitem 21 of Item 1 of Article 182 of the RF TC). The newly adopted Article 179.3 of the RF TC envisages the issue of certificates for carrying out transactions with straight-run petrol to the following agents:

- a) to persons engaged in the production of straight-run petrol, including from customer's raw materials, – a certificates for the production of straight-run petrol;
- б) to persons engaged in the production of petrochemical products, when straight-run petrol serves as raw material, – a certificates for the processing of straight-run petrol.

Exports of oil products are exempt from excises (Subitem 4 of Item 1 of Article 183 of the RF TC).

Besides, among the changes introduced in Chapter 22 "Excises" of the RF TC the elimination of tax posts at the payers of excises carrying out transactions with oil products (from 1 January 2007 Article 197.1 of the RF TC is to be deemed null and void).

#### *Other taxation – related changes introduced to Part II of the RF TC*

Some changes were also made to Chapter 24 "The single social tax" in Part II of the RF TC. Special lowered rates of the tax single social tax (Article 241 of the RF TC) are established for taxpayers – organizations operating in the field of informa-

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tion technologies, with the exception of taxpayers with the status of a resident of a special zone for technical development. These are recognized as Russian organizations carrying out the development and sale of software and databases on material carriers or in electronic form through communications channels, and (or) rendering services (or performing works) relating to the development, adaptation and modification, as well as installment, testing and maintenance of software and databases. An organization operating in the field of information technologies will be able to apply lower rates when complying with certain terms established by Item 8 of Article 241 of the RF TC:

- an organization must have State accreditation issued by the RF Ministry of Information and Communications;
- the incomes from information activity in the field of information technologies for the first 9 months of the year preceding the transfer to lowered rates must constitute no less than 90 % of all the incomes of an organization, where 70 % must represent incomes from foreign persons operating outside the RF territory;
- the number of staff of an organization in the first 9 months of the year preceding the transfer to the payment of SST at the lowered rates must be no less than 50 persons.

By the changes introduced into Chapter 25 “The tax on profit of organizations” it is determined that the operating in the field of information technologies enjoy the right not to apply the established procedure for depreciation of electronic appliances.

The most serious changes made to Chapter 25 are relating to the abolition of restrictions on carrying forward the losses of past years (Article 283 of the RF TC). Thus, in 2005 an organization could carry forward the losses incurred during past periods only within the limits of 30 % of the tax base of a current year. From 2006 this limit was equal to 50 % of profit received in a year. However, from the year 2007 there will be no more such restrictions. At the same time, although the norm concerning the abolition of the maximum size of losses carried forward is to come into force from 1 January 2007, the 50 % limit will be applied to the profit of 2006 being formed early in the next year.

One more change relating to the profits tax involves a marked simplification, from the year 2007 onward, of the procedure for recognizing incomes from research and development (Article 262 of the RF TC). Thus, from 2006 the costs of research and development that have yielded positive results may be included in costs during 2 years (in 2005 this period was 3 years). Also from 2006 another restriction – that on the recognition of the costs of research and development that yielded no results – was abolished. In particular, prior to 2005 costs could be charged in the amount of no more than 70 % of the actual costs, and from the year 2006 onward they are to be charged in full. In this connection, the period during which the costs of research and development that yielded no results are to be evenly distributed in order to diminish the tax base should be 3 years. From 2007 it will become possible to evenly charge such expenditures to costs during one year, irrespective of whether any positive results have actually been obtained or not.

Autonomous institutions do not record as their income the property received by decision of bodies of executive authority (Subitem 8 of Item 1 of Article 251 of the RF TC) or funding allocated to them in the form of subsidies and subventions (Subitem 14 of Item 1 of Article 251 of the RF TC).

Some of the changes introduced in Chapter 26 "Tax on the extraction of mineral resources", alongside those that have already been discussed here, are to come into force from January 2007. Thus, the procedure for determining the tax base for the extraction of dehydrated, desalted and stabilized oil is established. The norm concerning the taxation of mineral resources at the rate of 0 % (0 roubles) in the part relating to standard losses is augmented. It is established that at the moment of the payment of a tax a taxpayer has no approved standard losses for the next calendar year, until the approval of the aforesaid standards the previously approved standards should be applied, and for newly developed deposits – the standard losses established by a technical project<sup>4</sup>.

Beside, changes were made to Chapters 26.1 "The system of taxation for producers of agricultural goods" (the single agricultural tax)" and 26.3 "The system of taxation in the form of a single tax on presumptive income for some types of activity" in Part II of the RF Tax Code. These are aimed at improving the application of the system of taxation in the form of a single agricultural tax (and are also with force from 1 January 2007).

Thus, the norm determining the range of the payers of the single agricultural tax is augmented by the information on the types of agricultural products for purposes of applying Chapter 26.1 of the RF TC. It is established that no right for a switchover to the payment of the single agricultural tax can be enjoyed by the organizations and individual entrepreneurs operating in the sphere of gambling business; those producing excisable goods; organizations with affiliations (or representative offices); and budget-funded institutions.

The norms determining the procedure for a switchover to the single agricultural tax of newly created organizations or newly registered individual entrepreneurs, as well as the provisions determining the procedure for the discontinuation of the right to apply the single agricultural tax have been made more precise.

Significant changes were made to the norms relating to the procedure for determining and recognizing the incomes and expenditures when the single agricultural tax is applied. In particular, the list of items of expenditure that can be taken into account when determining the object of taxation has been expanded. These changes also apply to the legal relations that have arisen since 1 January 2006. Besides, the provisions of Chapter 26.1 concerning the procedure for the calculation and payment of the single agricultural tax and on the submitting of a tax declaration have been made more precise. Now it is envisaged that both organizations and individual entrepreneurs will be submitting their declarations in respect to the payment of the single agricultural tax within the same timelines.

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<sup>4</sup> For more details concerning the changes introduced in the sphere of taxation of the extraction of mineral resources, see the section "The oil and gas sector in 2006".

It is not allowed to apply the taxation system in the form of the single tax on presumptive income to operations in retail trade and public catering, if these operations are carried out by those organizations and individual entrepreneurs who have switched over to the payment of the single agricultural tax, when these taxpayers sell through their retail and public catering outlets their own agricultural products.

Simultaneously, some changes were made to Federal Law of 11 November 2003, No 147-FZ, "On making changes to Chapter 26.1 of Part II of the Tax Code of the Russian Federation and some other legislative acts of the Russian Federation", which are also to come into force from 1 January 2007.

Federal Law of 6 August 2001, No 110-FZ, has also been changed, and these changes are to come into force after the expiry of one month from the day of the official publication of this document and should be applied to the legal relations that have arisen from 1 January 2006. The changes are concerned with the periods for applying the various rates of the tax on profit of organizations by those producers of agricultural goods who have not switched over to the system of taxation in the form of the single agricultural tax, in the part relating to the sale of the agricultural goods produced by them, as well as the sale of the agricultural goods produced and processed by these organizations.

The changes introduced into Chapter 30 of the RF TC envisage some additional conditions for applying the exemption from the tax on property of organizations to residents of a special economic zone (SEZ). From 1 January 2007, in order to become exempt from taxation, property must not only be kept in an account of an organization – resident of a SEZ, but also be acquired or created for purposes of operating in the territory of a SEZ and be located in its territory (Item 17 of Article 381 of the RF TC). Only on condition of complying with these requirements an organization – resident of a SEZ will enjoy the right to an exemption from the tax in respect of its property.

Concerning the land tax (Chapter 31 of the RF TC) it has been specified that the land tax should not be levied on all the plots of land placed at the disposal of a resident of a SEZ (as it previously followed from Item 9 of Article 395 of the RF TC), but only on those located within the territory of a special economic zone.

## **Changes in the sphere of civil and labor legislation**

### *Reform of state and municipal institutions. Autonomous institutions as a new type of not-for-profit organizations*

One of the most important areas of reforming not-for-profit organizations is the transition to the competition-based principles of allocating budget funding within those sectors of the budgetary sphere where it can be possible. This primarily applies to the implementation of different forms of competition-based (or performance-oriented) financing instead of financing by estimate, which is designed for the upkeep of a budget-funded institution.

In recent years the procedure for planning and spending the resources allocated to budget-funded institutions has already been toughened, and they were switched over to the cash services provided by the Federal Treasury, which has yielded certain results in terms of preventing non-targeted spending of budget funds, while at the same time has complicated the operation of many (and especially highly-performing) budget-funded organizations.

It appears that the issues relating to improving the efficiency of budget spending must be resolved (whenever possible, which is true for a rather wide range of sectors of the budget-funded sphere) through introducing competition for budget funding among budget-funded institutions, while truly public control over state institutions should be developed not through consolidating “the vertical of power”, but through developing civil society, and in particular through introducing the procedure of reporting by the directors of such institutions to the specially created public councils of these organizations.

Presently, the following most important goals of reforming budget-funded institutions can be pointed out:

- the switchover from by-estimate financing, which is characterized by low performance and high costs, to performance-oriented budgeting;
- the liquidation of subsidiary responsibility of the budgets for the activity of budget-funded institutions;
- the creation of a mechanism for the co-financing, by the population, of socially important services, in order to prevent shadowy transactions in the form of bribing of certain employees of budget-funded institutions;
- higher transparency of off-budget activity in order to prevent the financing of off-budget activity (the incomes from which are not fully controlled) at the expense of budget (by estimate) financing;
- ensuring efficient public control over the activity of budget-funded organizations.

The goal of reforming the taxation of budget-funded organizations may become the introduction of exemptions from the tax on profit of budget-funded organizations on condition of compliance with certain general requirements established both for budget-funded institutions and non-government not-for-profit organizations.

In an event of a switchover to new types of budget financing (state personal financial liabilities (GIFO) the system of “money following students”, insurance-based financing in the health care system, etc.), the latter actually becomes analogous to off-budget financing and requires the introduction of appropriate changes in legislation. For purposes of a switchover to new competition-based forms of financing, which for formal reasons will be difficult to implement within the framework of existing legislation, the following should be done:

- either to change the organizational - legal form of budget-funded institutions in order to provide opportunities for receiving budget financing not for the upkeep of an institution by an estimate of expenses, but for specific activities relating to the rendering of specific services;

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– either to change the procedure for developing an estimate of expenses, which must be transformed from an instrument for planning and controlling the expenditures on the upkeep of an institution into an instrument for activity planning, which records all types of revenues as incomes (including budget funding allocated by an estimate of expenses; budget funds allocated to the payment for services rendered by a given institution; off-budget resources). That is, the estimate of expenses designed for the upkeep of an institution must become part of an estimate of off-budget incomes and expenditures of an institution, based on the latter principle (an institution’s independence in planning, the possibility of making adjustments during the execution of an estimate of expenses, etc.).

These goals can also be achieved by introducing a new and special form of a not-for-profit organization.

Last autumn, the State Duma adopted Federal Law of 3 November 2006, No 174-FZ, “On autonomous institutions”, whereby a new type of a state (or municipal) institution was established – that of an *autonomous institution*. This Law is dispositive and thus is conducive to the preservation of the existing legal status of those not-for-profit institutions which need not be transformed into an autonomous institution.

An autonomous institution is to be recognized as a commercial organization created by the Russian Federation, or by its subject, or by a municipal formation<sup>5</sup> for purposes of carrying out work or rendering services in order to execute the powers granted to the bodies of state authority and local self-government in the spheres of science, education, public health care, culture, social security, employment, physical culture and sports. An autonomous institution is a juridical person and may, in its own name, acquire and execute ownership rights and personal non-ownership rights, bear responsibilities, and act as a plaintiff or a defendant in a court of justice.

Autonomous institutions may be founded both by way of being created anew or by the reorganization of a budget-funded institution, on condition that such reorganization will not entail any violation of the rights of citizens in the social and cultural spheres, including the right to receive medical care and education services free of charge, and the right to participate in the cultural life.

An autonomous institution is subject to State registration in the general procedure, as established by RF legislation in respect to State registration of juridical persons and individual entrepreneurs.

The founder should set tasks for an autonomous institution in compliance with its main type of activity as established by its charter. In accordance with the tasks set by its founder and the liabilities to an insurer in respect to mandatory social insurance, an autonomous institution is to perform its activity related to the works being carried out or to services rendered both free of charge or partly on a commercial basis. The financial backing for the main type of activity, as established by the charter of an autonomous institution, is to be provided in the form of subventions

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<sup>5</sup> No joint foundation of autonomous institutions (including by different bodies of authority or local self-government) is allowed.

and subsidies allocated from an appropriate budget within the RF budget system, or to be covered from other sources that are not forbidden. The terms and procedure for the tasks to be formulated by the founder and the procedure for the financial backing to be provided are to be established by the RF Government in respect to those autonomous institutions that have been created on the basis of federal property; or by the supreme executive body of state authority of a RF subject – in respect to those autonomous institutions that have been created on the basis of property owned by that RF subject; or by local administration - in respect to those autonomous institutions that have been created on the basis of municipal property, respectively. The services rendered to the population partly on a commercial basis must belong to the range of an autonomous institution's main type of activity. Other types of activity may be engaged in by an autonomous institution only to the extent that they serve the achievement of the goals, for the achievement of which the said autonomous institution had been created, and only on condition that such types of activity are specified in its charter.

The administrative bodies of an autonomous institution are to be represented by a Supervisory Board, by the director of an autonomous institution, and by other bodies envisaged in the federal law and in the charter of an autonomous institution (an academic council, an arts board, etc.).

The founder is to play a significant role in organizing the administrative procedures for an autonomous institution. The founder is obliged to approve the charter of an autonomous institution and the introduction thereto of any changes and amendments; to coordinate the decisions concerning the creation of affiliations and the opening of the representative offices of an autonomous institution; to resolve issues relating to the reorganization and liquidation of an autonomous institution; to approve the deed of transfer of property and the division balance sheet; to appoint a liquidation board and to approve the intermediate and final liquidation balance sheet; to appoint and to terminate the powers of the director of an autonomous institution, as well as to conclude and terminate the labor contract with him, if no other procedure for appointing and terminating the powers of the director and (or) for concluding and terminating the labor contract with him is established by the federal law in respect to a given sphere of activity; to consider and approve the proposals put forth by the director of an autonomous institution concerning the transactions in respect to the property of an autonomous institution in the event when, for such transactions to be concluded, the consent of the owner of an institution's property is required.

The distinctive feature of autonomous institutions, in which they differ from the budget-funded ones, is the presence of a Supervisory Board, to be formed by the founder, within the structure of their administrative bodies. Among the members of the Supervisory Board, alongside the representatives of an appropriate branch administrative body and the administrative body for the management of state or municipal property, there should also be representatives of the public. Besides, the Supervisory Board may incorporate representatives of the labor collective of an autonomous institution, whose number, however, may not be in excess of

one-third of the total number of the board's members. This will ensure that autonomous institutions have a relatively higher degree of autonomy (as compared to budget-funded ones) and are closer to non-commercial organizations controlled by the public (or public ones).

Of the greatest interest in this connection are the certain limitations that have been established by the law in those spheres. Thus, neither the director of an autonomous institution nor his deputies may be members of the Supervisory Board, while no such restrictions are imposed on any other members of the labor collective. However, no other members of the labor collective may occupy the post of the chairman of the Supervisory Board.

At the same time, the opinions of the Supervisory Board in respect to the majority of issued to be considered by it are to be only of a recommendatory character. The sphere of its competence includes only: the consideration of proposals concerning the introduction of changes and amendments to the charter of an autonomous institution; proposals concerning the creation of its affiliations and the opening of its representative offices; proposals concerning the reorganization and liquidation of an autonomous institution; proposals concerning the participation of an autonomous institution in other juridical persons, including those concerning the contribution of monies and other property to the charter (or joint-stock) capital of other juridical persons, or concerning their transfer, in some other manner, to other juridical persons in the capacity of a founder (or participant); the draft plan of the financial and economic activity of an autonomous institution and the reports on its having been carried out; the annual accounting balance; the proposals put forth by the director of an autonomous institution concerning the conclusion of transactions in respect to the disposal of its immovable and especially valuable movable property which, in accordance with Item 2 of Article 3 of the Federal Law "On autonomous institutions", cannot be disposed of by an autonomous institution on its own; the proposals put forth by the director of an autonomous institution concerning the conclusion of big transactions; and the proposals put forth by the director of an autonomous institution concerning the conclusion of transactions in respect to which it is a related party. In respect to some of the issues, the supervisory board may only offer recommendations to an autonomous institution, while in respect to other issues it may make decisions.

The Law determines the competence of the director of an autonomous institution only in most general terms.

Autonomous institutions are allowed to conclude transactions with the participation of related parties. Autonomous institution may indeed conclude transactions in which related parties are participants<sup>6</sup> but, irrespective of the amount of a transaction, it must be coordinated with the supervisory board. In an event when such a transaction results in a loss, the related parties are to be brought to responsibility on a substantial level.

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<sup>6</sup> The related party must be either a member of staff of an autonomous institution, or a member of one of the administrative bodies. Besides, this party should be related to the second party in a transaction.

Such peculiarities of the legal status of an autonomous institution make it a more suitable form of organization for rendering budget-funded services on the basis of targeted financing in accordance with the established norms by comparison with a budget-funded institution, because, due to the expansion of its economic independence (and primarily – the elimination of the necessity to approve an estimation of revenues and expenses), the State is no longer responsible for the liabilities of an autonomous institution. Besides, the right of the founder to differentiate the terms and procedure for formulating the tasks of an autonomous institution makes it possible to build the relations with such institutions on a contractual basis. In particular, in presence of alternative private suppliers on the market of certain services, the founder can minimize the scope of mandatory tasks by placing the order for appropriate services on the basis of a tender. For their part, autonomous institutions may participate in such tenders on equal terms with other suppliers. The Law “On autonomous institutions” will come into force in early 2007, thus providing an impetus to the reorganization of the budget-funded network at all the levels of the budget system.

#### *The Law on the target capital of not-for-profit organizations*

In the last days of the year 2006, Federal Law of 30 December 2006, No 275-FZ, “On the procedure for forming and using the target capital of not-for-profit organizations” was adopted. This Law has institutionalized a form of financing the activity of not-for-profit organizations which is new for this country but has been actively used in countries with market economies (endowment). Target capital is determined in the Law as part of property of a not-for-profit organization, formed by donations of money and transferred by the not-for-profit organization to trust management by an asset manager for purposes of generating income, to be used for the financing of the charter activity of that not-for-profit organization. In the Law the relations arising during the formation of the target capital of a not-for-profit organization, its trust management, the use of the resulting incomes, etc., are subject to detailed regulation.

The adoption of this Law may be regarded as a certain “compensation” offered by the authority for the introduction, from the year 2006 onward, of a new procedure for the registration and control of the activity of not-for-profit organizations operating in the territory of Russia. The changes in the conditions and procedure for registration, as well as in the reporting procedure had an obvious political goal – to impose limitations on the actual or hypothetical influence of foreign organizations on this country’s domestic political situation; however, at the same time they complicated the activity of many not-for-profit organizations in Russia, which has no relation to politics but is financially supported by foreign beneficiaries. This provoked sharp criticism on the part of civil society both in Russia and in the West.

The existing tax regime prior to the adoption of this Law did not favor the creation of stable sources of income for not-for-profit organizations in the form of incomes from investments of an organization’s own or received funds. Firstly, this had to do with the taxation levied on the funds proper being received by a not-for-

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profit organization for purposes of investing (that is, the formation of capital), and secondly, the incomes received by a not-for-profit organization from investing. The main innovation in the sphere of taxation introduced by the Law on target capital is that the not-for-profit organizations forming and using their target capital are exempt from the payment of the profits tax with regard to the incomes received from their target capital. Another important issue has also been resolved in favor of not-for-profit organizations – that of donations designed to form target capital, which are not to be levied by the profits tax, either.

It is established that target capital should be created for a period of no less than 10 years, and the funds constituting target capital must always be transferred to an asset manager for investing. During that period, the incomes from the investment of target capital may be used. Target capital is to be managed by a specially created collegial agency (a council for the use of target capital), where representatives of a not-for-profit organization itself constitute no more than one-third of members; two-thirds of the council must be independent, formed from representatives of the recipients of the income generated by target capital, donors (or their representatives), citizens and representatives of juridical persons, merited by society or having authority and (or) achievements in the spheres corresponding to the goals of a given not-for-profit organization. If a donor has contributed more than 10 % of capital (balance-sheet value of property constituting target capital), the donor or its representative have the right (but not the duty) to demand that the donor or the donor's its representative should be made member of the council for the use of target capital.

The new Law offers a form of supporting the activity of not-for-profit organizations, which is sufficiently transparent for both the State and civil society. In other words, it provides the private persons and corporations prepared to provide financial support to not-for-profit organizations mostly in the socio-cultural sphere with a transparent mechanism guaranteeing the use of such donations in accordance with their declared purpose. Thus not-for-profit organizations are granted with opportunities for creating a source of long-term and guaranteed incomes, enabling them to implement long-term programs. At the same time certain limitations are imposed on the range of not-for-profit organizations authorized to have their own target capital, as well as on the directions for applying the incomes generated by it. The owners of target capital may be only those not-for-profit organizations that have the organizational-legal form of a fund, an autonomous not-for-profit organization, a public organization, a public fund or a religious organization. State corporations, political parties and social movements cannot be recipients of incomes from target capital. Target capital may be formed for purposes of using the income generated by it in the spheres of education, science, health care, culture, physical culture and sports (with the exception of professional sport activity), art, archives, social aid (or support). The formation of target capital and the use of the income generated by it for other purposes is not recognized as the formation of target capital and the use of the income generated by it. That is, in addition to the traditional spheres of charity, this list does not include such activities as protection of

human rights and freedoms of a person and citizen, environment protection, protection of fauna, etc. The Law introduces a number of important requirements and limitations for not-for-profit organizations in the part relating to the formation of a target capital and its investment.

For example, the Law envisages the minimum size of target capital has being equal to 3 million roubles. This is associated with the fact that investing a lesser sum was viewed as not feasible due to rather high costs of such an investment. Thus, within the period of two months from the day on which the sum of money received by a not-for-profit organization for purposes of forming its target capital will become equal to 3 million roubles, the not-for-profit organization will be obliged to transfer the money to trust management by an asset manager. From the day of the transfer of funds to trust management the target capital is recognized as having been formed. If during one year from the day of the coming to the account of a not-for-profit organization of the first donation earmarked for the formation of target capital the total sum of received donations does not exceed 3 million roubles, or if during that period a council for the use of target capital is not created, the not-for-profit organization will not have the right to transfer the donations to trust management. In this case no target capital is formed, and the not-for-profit organization before the end of the financial year, during which the period established for the formation of target capital has expired, will be obliged to return the received money to the donor, if not otherwise provided for by the donation agreement, or if the money is received by the not-for-profit organization in the procedure of inheritance. Thus, the donations that have not been used to form target capital and have not been returned to donors may be spent on a not-for-profit organization's charter goals.

It is established that a not-for-profit organization has no right to allocate its own money to the formation of its target capital or to the replenishment of its already formed target capital. That is, target capital may be formed only from donations (in the form of money denominated in national or foreign currency).

The rules for determining the objects of investments, in order to minimize risks, have been introduced. The resources of target capital can be placed in Russian and foreign government securities, shares, bonds, Russian mortgage securities, stakes in pension investment funds, and deposits; besides, investments can be made in immovable assets, but no immovables may be accepted as a donation.

The possibility of receiving substantial incomes from target capital and the tax privileges granted to not-for-profit organizations require that they pursue a policy aimed at limiting the financing of administrative costs. In the Law it is envisaged that a not-for-profit organization (the owner of target capital) may use it, to cover its administrative and managerial costs associated with the formation of target capital and the activity funded by the income generated by target capital, in the amount equal to no more than 15 % of the income from the trust management of property constituting target capital, or no more than 10 % of the sum of income from target capital received during a reporting year. Such costs are recognized, in particular, as the lease of premises, buildings and structures, the cost of acquisition of fixed

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assets and expendable materials, the cost of audit, and the payment of salaries to the staff of a not-for-profit organization, the costs of management of a not-for-profit organization or its separate structural subdivisions, and the costs of the acquisition of administrative services for managing a not-for-profit organization or its separate structural subdivisions.

The new institution may undoubtedly have a positive influence on the development of the non-government not-for-profit sector of the national economy of this country, but because of its complexity and the overall very low level of development of the practices of trust management the scope of applying the new mechanism will, most probably, remain rather narrow in the foreseeable future.

#### *The adoption of Part IV of the RF Civil Code*

From 1 January 2008, Part IV of the RF Civil Code comes into force<sup>7</sup>, which regulates relations in the sphere of intellectual property. It is established that Part IV of the RF CC is to be applied to the legal relations that have arisen after its coming into force. In respect to the legal relations that arose prior to the coming into force of Part IV of the RF CC it is applied to those rights and responsibilities which will arise after its coming into force.

Part IV of the Civil Code combines all the norms<sup>8</sup> relating to objects of intellectual property – works of science, literature, the arts, software, databases, inventions, useful models, industrial models, achievements in selection, phonograms and other objects. This Part of the RF CC contains only one section – Section VII entitled “Rights to the results of intellectual activity and the means of individualization”. This Part of the RF CC incorporates not only the existing norms in the sphere of intellectual property, but also a number of new norms.

Thus, legislation is amended by the notion of “secret of production” (know-how). This is understood as information of any character (industrial, technical, economic, organizational and other), including on the results of intellectual activity in the sphere of science and technologies, as well as information concerning methods of professional performance that have real or potential commercial value due to their being unknown to third parties, to which third parties have no legal free access and in respect of which the holders of such information have established the regime of commercial secret. The keeper of a production secret enjoys an exclusive right to its use. The specific features of an agreement of an alienation of the right to a production secret and the corresponding license agreement are deter-

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<sup>7</sup> Federal laws: “Civil Code of the Russian Federation (Part IV)” of 18 December 2006, No 230-FZ and “On the entry into force of Part IV of the Civil Code of the Russian Federation” of 18 December 2006, No 231-FZ.

<sup>8</sup> From the moment of the enactment of the new part of the RF CC, a number of normative acts previously regulating the relations in this sphere are recognized to be null and void, namely: the Civil Code of the Russian Soviet Federative Socialist Republic, the RF Laws “On author’s right and related rights”, “On trademarks, service marks, and names of places of origin of goods”, “On legal protection of computer programs and databases”, “On legal protection of topologies of integral microcircuits”, “On achievements in selection”, the RF Patent Law; and some other normative acts.

mined. The relations between an employee and employer associated with the creation of a corporate production secret are regulated.

To all the rights to the results of intellectual activity and the means of individualization recognized as equal to such rights (e. g., a business name and a trademark) a generalized term is applied – that of “intellectual rights” (Article 1226 of the RF CC). The notion of intellectual rights incorporates the exclusive right (which is a property right), personal non-property rights (copyright, the right to a name), as well as other rights (e. g., the right of descent and the right of access).

In the RF CC some provisions have been included establishing the requirements to the content of a business name as an object of rights in the sphere of intellectual property. It is envisaged that an exclusive right to a business name arises from the day of State registration of a juridical person and is terminated at the moment of the exclusion of a business name from the Unified State Register of juridical persons as a result of the termination of a juridical person or the change of its business name. A direct ban is imposed on the disposal of the exclusive right to a business name, including by means of its alienation or by granting the right of its use to another person.

The legal regime for commercial designation, which is also used for purposes of an enterprise’s individualization, is subject to detailed regulation. This designation can be used not only by commercial juridical persons, but also by not-for-profit organizations engaged in entrepreneurial activity, as well as by individual entrepreneurs. It should be noted that a commercial designation does not require registration and must not be included in a mandatory procedure in the Unified State Register of juridical persons, in contrast to a business name. The exclusive right to a commercial designation may be transferred to another person only as part of the enterprise for the individualization of which this designation is applied.

The notion of a commercial designation is broader than that of a business name. A business name or its separate components can be used by a possessor of right as part of the commercial designation owned thereby (Article 1476 of the RF CC). The business name incorporated into commercial designation is protected independently of the protection of commercial designation.

The list of works which are not objects of copyright has been made more precise. These are news programs, TV feature programs, transport timetables, etc., official documents of international organizations, as well as their official translations (Article 1259 of the RF CC). It is established that copyright is extended to a part of a work, its title, as well as a character depicted in a work.

The RF CC introduces the notion of “the right to the inviolability of a work”, which is somewhat broader than the currently existing notion of “the right the protection of an author’s reputation” (Article 1255 of the RF CC). Thus, in accordance with Article 1266 of the RF CC, it is not allowed, without the author’s consent, to make changes, abridgements or additions to his or her work, the augmenting of a work by illustrations, a preface, an afterword, commentaries or explanations. Article 1267 of the RF CC speaks of the inviolability of a work which is protected indefinitely. The lawmakers have for the first time determined the procedure for the heirs

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or other legal successors of an author introducing changes, abridgements or additions into a work, as well as the procedure for the publication of the works of a deceased author. In this connection it is envisaged that such actions can be executed by the aforesaid persons only if this is not contrary to the author's desire, explicitly expressed in writing (e. g., in a will, letters, diary, etc.). (Article 1266 of the RF CC).

Prior to the introduction of these changes existing legislation envisaged the transfer of exclusive rights by means of concession of the exclusive rights to the use of a work (by the Law on copyright and related rights), concession of a patent to an invention, a useful model, or an industrial sample (Patent Law) and concession of a trademark (the Law on trademarks, service marks and names of the places of origin of goods). In accordance with the Law on copyright and related rights, property rights may be transferred only under an author's contract (Article 30 of the Law). In this connection, an author's contract must determine the methods of using a work, that is, the specific rights transferred under this contract (Article 31 of the Law).

For purposes of ensuring a more effective participation in the civil turnover of intangible assets, the newly introduced part of the RF CC determines the procedure for the disposal of property rights to the results of intellectual activity and the means of individualization. Much attention is given to the characteristic and regulation of the two main types of agreements – the agreement of the alienation of an exclusive right and the license agreement (Article 1233 of the RF CC).

Under the agreement of the alienation of an exclusive right, the exclusive right to the results of intellectual activity or a means of individualization is transferred in full (Article 1234 of the RF CC).

It should be emphasized that the RF CC establishes rather strict requirements to the content and formalization of an agreement. A non-compliance with its properly written form or with the requirement concerning State registration entails nullity of an agreement. In an event of absence, in an agreement of an alienation of an exclusive right for a compensation, of a clause concerning the size of compensation or the procedure for determining its size, the agreement is considered not to have been concluded. The general rules for determining a price envisaged in Article 424 of the RF CC are not applicable in this case.

The owners of exclusive rights, if not interested in their complete and final transfer to another person, may resort to a license agreement (Article 1235 of the RF CC). Under a license agreement, one party – the owner of the exclusive right to the product of intellectual activity or to a means of individualization – grants or assumes the responsibility to grant to the other party the right to the use of such a product or such means within the limits envisaged in the agreement.

The right to the use of the product of intellectual activity or a means of individualization, if not directly stipulated in a license agreement, is not considered to have been granted. The period for which a license agreement is concluded cannot be longer than the period of effect of the exclusive right to the product of intellectual activity or a means of individualization. If this period is not determined in a li-

license agreement, the agreement in accordance with the general rule is considered to be concluded for the period of 5 years.

The transfer of the exclusive right to the product of intellectual activity or a means of individualization to a new holder of the right cannot serve as the grounds for making changes to or cancellation of a license agreement concluded by the previous holder of the right.

In accordance with Article 1236 of the RF CC, a license agreement can envisage that a person issuing a license to the right of use of the product of intellectual activity or a means of individualization may still preserve the right to issue a license to other persons (simple license), or may not preserve such right (exclusive license). If not provided otherwise by a license agreement, a license is considered to be of the simple type.

A number of norms envisaging additional guarantees for the protection of the rights of authors are introduced. In particular, it is established that no sanction may be applied to the exclusive right belonging to the author of a work or to a performer (Articles 1284, 1319 of the RF CC). For a publishing license contract an imperative rule is consolidated, whereby a publisher is obliged to begin the use of a work no later than a certain timeline established in the contract. A noncompliance with this requirement entails the possibility of a unilateral dissolution of a contract on an author's initiative, without any compensation to the publisher of the losses resulting from it, as well as the possibility to recover from the publisher the full amount of remuneration envisaged in the contract (Article 1287 of the RF CC).

Besides, for the first time the norms are introduced envisaging the liquidation of a juridical person or an individual entrepreneur for repeated or flagrant violation of the exclusive rights to the product of intellectual activity and means of individualization (Article 1253 of the RF CC).

In connection with the adoption of a new part of the RF CC, some changes have also been introduced in Parts I, II and III of the RF CC and other normative acts.

In particular, the Chapter "Non-material benefits and their protection" in Part I of the RF CC is augmented by Article 152.1, whereby it is envisaged that the publication and any further use of an image of a citizen (including a photograph, as well as a videotape or a work of visual art wherein he or she is depicted) is allowed only with the consent of the aforesaid citizen. After a citizen's death, his or her image may be used only with the consent of the children or the surviving spouse, and in absence of the aforesaid persons – with the consent of his or her parents. The instances are listed when such consent is not necessary, in particular if the image is used for the sake of state, social or other public interests; if the image of a citizen was obtained during filming in places open for free public use or at public events (meetings, congresses, conferences, concerts, shows, athletic competitions and other similar events), except in instances when such an image represents the main object of use; or when a citizen has posed for a compensation.

Article 256 "Common ownership of spouses" in Part I of the RF CC is augmented by the provision whereby common ownership of spouses does not include

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an exclusive right to the product of intellectual activity owned by the author of such a product. However, the incomes received from the use of such a product represent joint ownership of spouses, if not otherwise provided by an agreement concluded between them. A similar provision concerning the ownership of each of the spouses is introduced in the RF Family Code.

### *The “New” RF Labor Code*

In late July 2006 a law was adopted whereby numerous changes were introduced to the RF Labor Code. Changes have been made to more than 300 articles of the Labor Code, many of which are fully reworded, and some new articles are added. The majority of amendments and changes are aimed at eliminating the existing contradictions and imprecision in the norms stipulated in the Code.

Now the Code contains more detailed regulation of the issues concerning the local normative acts issued by employers; of the representation of the interests of workers by primary trade union organizations; of employers – physical persons; of the annulment of a labor contract; of changes in the terms of a labor contract determined by the parties thereto; and some other issues.

New requirements have been established to the content of a labor contract. In particular, it must contain information concerning the documents confirming the identity of a worker and an employer - physical person, the employer’s taxpayer identification number (with the exception of employers – physical persons who are not individual entrepreneurs), the information concerning the employer’s representative who has signed the labor contract, and the substantiation of his endowment with appropriate powers. Among the mandatory terms of a labor contract, the specific type of work assigned to the worker should be indicated. The procedure for augmenting a labor contract with additional information and terms is stipulated. The absence in a contract of any mandatory information or term cannot serve as the grounds for recognizing a labor contract as null and void. The missing information is added directly to the text of a labor contract, while the missing terms are determined in an annex to the labor contract or in a separate agreement between the parties concluded in writing, which is considered to be an inalienable part of a labor contract.

The absence in a labor contract of a stipulation concerning a probation means that a worker is accepted without probation. In an event when a worker has actually been allowed to work without a formalized labor contract (Part 2 of Article 67), the stipulation concerning probation may be included in a labor contract only if the parties have formalized it as a separate agreement prior to the onset of work. In addition to the existing limitations, no probation term is allowed for women who have children aged under one and a half years, and persons concluding a labor contract for a period under two months.

Changes have been made to the procedure of concluding a fixed-term labor contract. In instances determined by the Code, it will be possible to conclude a fixed-term labor contract by agreement of the parties thereto without taking into account the character and conditions of the future employment (for example, with

retired persons or students). In accordance with the new changes, a fixed-term labor contract may be concluded with a retired person only when he or she takes up work. In the sphere of small-size business fixed-term labor contracts will be concluded if the number of workers is no more than 35, including in retail trade and domestic servicing – no more than 20 (in the previous wording - 40 and 25, respectively).

If a worker has not taken up work on the day when his employment begins in accordance with the Code, the employer has the right to annul the labor contract. In this connection, in accordance with the introduced changes, the annulment of a labor contract cannot deprive a worker of the right to receive provision under the mandatory social insurance program if an insured event has occurred during the period from the day of the conclusion of a labor contract to the day of its annulment.

The list of grounds for the termination of a labor contract with regard to circumstances beyond control of the parties thereto has been extended, these circumstances being as follows: disqualification or another administrative punishment, as well as the expiry, suspension or deprivation of a worker of a special right, if this entails the impossibility for the worker to fulfill his or her duties relating to employment; termination of an access to a state secret, if the performance of work requires such access; or vacating of a court ruling or the decision of a state labor inspectorate that a worker should be reinstated in work.

A new article is introduced, which regulates the general procedure formalizing the termination of a labor contract, whereby it is established that the familiarization of a worker with the order (or disposition) issued by the employer concerning the termination of a labor contract must require the former's signature.

The employers who are individual entrepreneurs are charged with an additional responsibility, whereby they, similarly to juridical persons, are obliged to keep the labor books of their employees. Individual entrepreneurs are equated to organizations also in respect of other rights and responsibilities (the conclusion of collective labor contracts, the dissolution of labor contracts, etc.).

The notion of transfer to other work has been changed. In the new wording, the transfer to other work is understood both as a permanent or temporary change in a worker's labor function. The notion of transfer also encompasses the change of a structural subdivision in which a worker works (if the structural subdivision has been designated in a labor contract), the continuation of work with the same employer, as well as the transfer to work in another locality together with the worker. In all these instances the employer will need a written consent of the employee. Exceptions are represented by extraordinary cases. The Code is augmented by the norm whereby on the basis of a written agreement between the parties a worker may be temporarily transferred to other work with the same employer for a period of up to one year, and in those cases when such a transfer is made in order to replace a temporarily absent worker, for whom in accordance with the law the place of work is retained, - until that worker resumes work. If after the expiry of the period of transfer the former is not made available to the employee, and he or she has not

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demanded that it should be made available and continued to work, the contract's term concerning the temporary character of transfer becomes null and void, and the transfer is considered to be permanent.

In the new wording shirking as the grounds for a dismissal is understood not only as the absence from job without justifiable reasons for more than four hours in succession during a work day (or a shift), but also the absence from job without justifiable reasons for the duration of a whole working day (or a whole shift), which apparently is due to the fact that the duration of a shift may be less than 4 hours.

The Code equalizes the disclosure of the personal data of a worker, which has become known to another worker as a result of execution of labor duties, with the disclosure of a secret protected by the law, which as a result may entail the dismissal of the worker.

The procedure for calculating the average daily earnings for payment of leaves and payment of contributory compensation for unused leaves has been changed: the average earnings will now be calculated for the last 12 calendar months by means of dividing the amount of a earnings added by 12 and by 29.4 (average monthly number of calendar days). The procedure for replacing the annual paid leave by a money compensation has been made more precise – such a replacement is allowed for only a part of each annual paid leave in excess of 28 calendar days, or any other number of days from that part.

It is established that additional compensation should be paid to workers (with the exception of worker receiving a salary) for labor on non-work holidays, the size of which is to be determined by a collective contract, or by agreements, or by a local normative act, or by a labor contract. In this connection, the amounts of expenditures on the payment of such a compensation are charged to the payroll in full. Also another stipulation is added whereby the Government's acts concerning the carrying over of holidays to other days in each calendar year must be officially published no later than one month before the beginning of a calendar year. In an event when such an act is nevertheless issued during a calendar year, it must be published no later than 2 months prior to the calendar date of the newly established non-work day.

A new article concerning the system of payment of labor of workers of state and municipal institutions is introduced. The RF Government may establish basic salaries and basic rates by the professional qualification groups of workers which represent the lower thresholds for the salaries of workers of state and municipal institutions.

The Code is also augmented by an article regulating the compensation of expenses connected with the employment business trips of workers whose permanent work involves long-distance and short-distance travel, field work, and expeditions.

The new wording contains a list of instances when a severance benefit is granted in the amount of two weeks' average earnings – a severance payment will now be paid also in an event of the dissolution of a labor contract on the grounds of

an employee's refusal to continue work because of changes in the terms of the labor contract initially determined by the parties thereto.

Specific details have been added to the grounds for the dissolution of an apprenticeship contract, which may be dissolved before the expiry of the period of apprenticeship or for reasons envisaged in that contract.

Numerous alterations and amendments have been introduced to the Code's Section "Protection of labor": a new article concerning the state expert's estimation of conditions of labor is added, and the procedure for investigating accidents is described in more detail.

The procedure for compensating for the costs incurred by an employer when training a worker, in an event of the latter's quitting the job without justifiable reasons before the expiry of the period determined by a labor contract or agreement concerning training at the expense of the employer is described with greater precision. The worker will be obliged to compensate for such costs in proportion to the duration of the period which has actually been missed.

An important stipulation has been added to Article 236 of the Code. It is established that in the event of a violation by an employer of the established period for payment of earnings, payment for leave, severance payment in the event of dismissal or other payments due to a worker, the duty to pay the established amount of compensation will arise independently of the presence of the employer's guilt.

In accordance with Article 284, the duration of work time established for persons working in a second job may not exceed 4 hours per day. At the same time it is added that in those days when a worker is not engaged in his or her basic labor duties, the duration of work at a second job may be equal to a full work day (or shift). During one month (or another accounting period) the duration of work at a second job may not be longer than a half of the monthly work time norm (or the work time norm for another accounting period) established for a given category of workers. These restrictions on the duration of work are not extended to those cases when a worker suspends his or her work because of a delay (for more than 15 days) in the payment of salary or is temporarily dismissed from work.

The Code has also been augmented by other changes and amendments. The normative legal acts of the USSR are recognized as being null and void in the territory of the Russian Federation. Besides, some legislative acts of the Russian Federation that have lost their validity due to the newly introduced alterations have also been abolished (the laws "On collective contracts and agreements", "On the procedure for settling collective labor disputes", and "On the fundamental principles of protection of labor in the Russian Federation").

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## **Annex 2. Some Aspects of Approaches to the Problem of Combating Harmful Tax Competition in Terms of Capital Outflow**

Redistribution of international financial flows, which is taking place in the recent decades, has involved many countries in competition for the attraction of capital. The governments are making attempts to keep the assets in their countries by introduction of amendments to their tax legislations. Manipulation with tax legislation allows the countries to create favorable tax environment and hence, influence economic decisions of corporations and individuals. There is a very subtle barrier between legal and justified capital allocation on a certain territory as an optimization measure, from capital outflow as a negative factor, which many countries are trying to take under control. It is quite natural for any investor to seek for the best way of capital placement in a real business activity in those markets, where there is a demand for his goods or services, where tax environment is favorable and the investment portfolio is reliable and brings maximum profit.

Capital outflow is a key problem, based on harmful tax competition. Here we will not consider cases, when citizens of one country transfer their assets abroad without any reasonable grounds, which could be regarded as a legal investment in external market; or when the information on the transferred assets is not provided in accordance with relevant legal regulations; as well as cases, when investors, in fear of inflation of national currency, prefer to keep their assets in foreign currency of more reliable reputation, but can not do it in their native country, if it is in contradiction with national legislation.

Despite optimistic declarations of the Russian government about a decrease of capital outflow to other countries, a number of analytical agencies confirm sustainability of this process. Thus, according to the information of RIA "Novosty", in the second quarter of 2005 the capital outflow from Russia has grown times 27.5 as compared with the first quarter. According to the information of the Bank of Russia, published on its official web-site, the net capital outflow from the Russian private business sector made (as per tentative estimates) in the Q II of 2005 USD 5.5 bn (versus USD 0.2 bln in the first quarter of 2004). Therefore, in comparison with the relevant period of 2004, in the second quarter of the current year the capital outflow has been reduced by 11.3 per cent, but as opposed to the preceding quarter it has grown times 27,5. This figure includes the net capital outflow from banks in the second quarter (USD 4 bn) and net outflow from non-financial institutions and households (USD 1.5 bn). A year ago, in the second quarter of 2004, the banks have taken outside the country USD 3.3 bn, non-financial institutions – USD 2.9 bn. In the first quarter of 2005 the banks have taken outside the country USD 2.6 bn, non-financial institutions and households – USD 2.5 bn net. In 2004 the net outflow of Russian private capital made USD 9.3 bn, whereas banks ensured an outflow in

the amount of USD 3.8 bn, and non-financial institutions and households have taken out from national economy USD 13.1 bn<sup>9</sup>.

Apart from other grounds of capital outflow, recently another reason has appeared which is also as serious and meaningful as others, known before. There are significant differences between various countries not only in terms of their political systems, financial and labor resources, but in competitive tax systems as well. Certainly, tax rates are as significant as other tax system elements and tax collection procedures. Moreover, countries actively join the intergovernmental agreements on various issues, from double taxation avoidance to information exchange between tax authorities.

Like other governments, the Russian government makes efforts to attract taxpayers. Thus, a draft law on taxation of dividends, widely discussed in autumn of 2006, can serve as an example of such activities. In 1999 governments of OECD country-members have notified about the problems of competitive tax policy of some countries, that gets in contradiction with common international standards and principles. A decision was made on necessity to develop evaluation criteria for harmful tax competition and to provide recommendations for prevention of its destructive impact on the economic systems of OECD country-members<sup>10</sup>.

Due to that initiative, nowadays OECD has a leading position in the international coordination of prevention measures against harmful tax competition.

In 1998 OECD has published a special report on the problems of tax competition<sup>11</sup>. Basing on the results of research the issue of tax competition, the report provided a number of definition criteria for the cases of harmful tax competition, as well as for favorable tax regimes<sup>12</sup>. Moreover, methods of combating negative phenomena were proposed in the report. The subject of the research were tax policies of OECD members and other countries. It should be mentioned that Switzerland and Luxemburg (both are OECD members) have not approved the report and restrained from implementation of its recommendations. OECD is not authorized to put any pressure on its country members; practical application of its recommendations can be only voluntary. Further activities in that direction were continued in the following reports of OECD, published in 2000, 2001 and 2004<sup>13</sup>. Since that time, there were disclosed 41 "tax havens" worldwide, the majority of them were the off-shore zones. Some of them expressed willingness to cooperate with OECD; others were enclosed in the list of «tax havens».

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<sup>9</sup><http://www.polit-nn.ru/?pt=news&view=single&id=2997>;

[http://opec.demo.metric.ru/library/article.asp?d\\_no=40&c\\_no=9&c1\\_no=](http://opec.demo.metric.ru/library/article.asp?d_no=40&c_no=9&c1_no=)

[http://www.finiz.ru/cfin/tmpl-art/id\\_art-872366](http://www.finiz.ru/cfin/tmpl-art/id_art-872366) <http://www.forextimes.ru/news/hnews21342.htm>.

<sup>10</sup> Currently there 30 country-members in OECD, including the majority of industrial countries of the world, Russia is not a member of OECD, like neither of "tax have" countries".

<sup>11</sup> "Harmful Tax Competition, An Emerging Global Issue", OECD report, 1998, <http://www.oecd.org/dataoecd/33/1/1904184.pdf>.

<sup>12</sup> The research was focused on financial capital issues.

<sup>13</sup> Paris: OECD, 2000, The OECD's Project on Harmful Tax Practices: The 2001 Progress Report. Paris: OECD, 2001, The OECD's Project on Harmful Tax Practices: The 2004 Progress Report. Paris: OECD, 2004. <http://www.oecd.org>.

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Alongside with OECD, measures of combating harmful tax competition are taken in the framework of European Union. Unlike provisional recommendations of OECD, recommendations of EU are mandatory for application by its member states.

In 1997, under an assignment of EU Commission, a report was issued on harmful tax competition in EU countries<sup>14</sup>. In the report there was developed a plan of combating this problem. In pursuance of the plan, the EU Commission has started in 2001 a special investigation against eight EU country-members, where, due to special provisions of tax and corporate laws, large international companies were applying special corporate tax schemes. The investigation was started on the grounds of suspected breach of the EU Treaty by those countries<sup>15</sup>.

Besides combating harmful tax competition between its member countries, EU is struggling with violations in other countries, not only offshore zones and preferential tax regimes<sup>16</sup>. In 1998 EU has initiated a survey of legitimacy and compliance with regulations of WTO in terms of FSC regime (Foreign Sales Corporation), introduced by USA for export sales promotion. Under that regime, a corporation, effecting sales operations outside the country, would enjoy tax benefits (partial tax exemption) on export sales, what, in EU consideration, gets in contradiction with WTO regulations. WTO has recognized the claim as justified, and in 2000 USA had to make amendments to its tax legislation. EU was not satisfied with the amendments; an appeal was submitted and again accepted by WTO (Decision of Appeals Council, January 2002)<sup>17</sup>.

The European Union is also making strong efforts to solve the problem of tax competition with the help of measures of tax harmonization<sup>18</sup>. However, some countries are not happy to accept this approach. Many EU countries consider that the EU Treaty admits national tax immunity as one of the basic principles of EU. Thus, France and Germany support tax harmonization<sup>19</sup>. Apparently, the rules of corporate tax and VAT play their role here. With new country-members, joining EU, for instance, Baltic countries, the discussions on tax harmonization has been renewed. The problem is that in the majority of Central and Eastern Europe, including Baltic countries, basic tax rates are much lower than in EU. One of proposed measures to eliminate this gap is an introduction of minimum rate for corporate tax<sup>20</sup>. Currently a minimum threshold for VAT (15 per cent) is applied in all EU country-members<sup>21</sup>.

Irrespective of tax incentives, there are other reasons for capital outflow, but there is no doubt that this is a serious problem for many countries. The major part

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<sup>14</sup> [http://ec.europa.eu/taxation\\_customs/taxation/gen\\_info/economic\\_analysis/tax\\_structures/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm).

<sup>15</sup> [http://ec.europa.eu/publications/booklets/move/17/txt\\_en.pdf](http://ec.europa.eu/publications/booklets/move/17/txt_en.pdf).

<sup>16</sup> Switzerland and Luxemburg are often mentioned in this regard.

<sup>17</sup> [http://www.wto.org/english/tratop\\_e/dispu\\_e/find\\_dispu\\_cases\\_e.htm#res](http://www.wto.org/english/tratop_e/dispu_e/find_dispu_cases_e.htm#res).

<sup>18</sup> <http://europa.eu/scadplus/leg/en/lvb/l31005.htm>.

<sup>19</sup> France and Germany call for EU tax accord. The Financial Times, 01.12.2002.

<sup>20</sup> <http://www.offshore.su/index.php?action=showcat&catid=44>.

<sup>21</sup> <http://europa.eu/scadplus/leg/en/lvb/l31006.htm>.

of capital, illegally transferred outside the country, is allocated in "tax havens", i.e., in jurisdictions, where tax rates are low and there are laws on banking and other information privacy, which allow to conceal the name of the investor of the assets from the authorities of his native country.

In fact, investment of assets outside the country can not be regarded as tax evasion, but it can indicate that similar actions took place in the past and will happen in future. In this way a taxpayer might be making an attempt to conceal his income, not filed with domestic tax authorities. Probably, it would be enough to introduce legislation provisions on economic and money laundering control to ensure exchange of necessary information for disclosure of potential tax evasion.

In case the assets are deposited on an anonymous bank account, and income is not filed for the purpose of income tax, this is the case of concealment of taxable income, i.e., an abuse of tax legislation. In such a case the major task of tax authorities in the country of investor's residence is to disclose the incompliant taxpayer and apply measures of tax administration. In other cases, when the assets are invested in the company, registered in a tax haven exclusively for capital export to avoid taxation in the country of investor's residence, rather than for some commercial activities, an explicit tax evasion in terms of relevant legislation takes place. The country of residence of the investor needs to have sufficient legal grounds both, for obtaining the information on such offshore companies and for further enforced taxation of non-filed assets.

An investor, who has allocated his assets in a tax haven, can later bring them back to the country for other investment purposes. Whereas a trend of the capital inflow looks positive, those assets come back under a false pretence, for the purpose to obtain unjustified tax benefits. The fact of ownership of such assets is usually not identified, as they are acquired in «tax havens». There will be high chances for further outflow of those assets, while their mobility is kept up.

The majority of countries use tax measures alongside with other means of combating capital outflow, negatively affecting domestic tax base. Moreover, they apply legal provisions for retroactive assessment of tax liabilities to be filed in the country, from where the capital was taken out, with due regard to the dividends, gained on that capital. Among other measures, international cooperation is encouraged, addressed to combating harmful tax competition in «tax havens», which are attracting capital inflow from other countries. Problems, related to capital outflow to those «tax havens», give a drive to active development of international cooperation and information exchange network.

Trends of harmonization of tax legislation, combating harmful tax competition and capital outflow are developed in Europe in two ways: firstly, it is harmonization of tax legislation (rates, tax base assessment); and secondly, enhancement of intergovernmental information exchange on taxpayers.

OECD and EU researches, made in regard to harmful tax competition, have revealed: despite an absence of official legal definition of tax competition, it is clear, that this term is understood as "competition of different jurisdictions for tax-

able resources, where favorable taxation regimes are applied for their attraction to a certain country”<sup>22</sup>.

Tax competition can take various forms: it can apply tax and non-tax instruments, it can be open and concealed, fair and harmful, there can be competition in terms of mobile and fixed taxable assets. A number of independent experts consider that in fact, tax competition arises under the impact of tax system reforms for the purpose of taxpayers’ attraction, investment in extra jobs, encouragement and support of economic growth<sup>23</sup>. There is no doubt that those incentives are well justified, and creation of preferential regimes and/or offshore zones in some countries is caused by the lack of sufficient resources to achieve the aims by other means. Understanding of those motives makes OECD and EU, the most active supporters of tax harmonization and transparency (through information exchange), to soften their approach to the problem. Thus, OECD, having set forth a number of strict criteria of “tax haven” definition in the initial report, has later dismissed one of them, i.e. a criterion of the “lack of active business of a company in the country of registration”. Moreover, “application of zero rate or minimal tax rate is admissible, in case the jurisdiction is participating in information exchange with other jurisdictions (rather than offshore)”<sup>24</sup>. OECD criteria include the lack of effective information exchange, insufficient transparency, manipulation with tax regimes for the purpose of risk minimization.

EU takes a similar position. Thus, according to EU Guidelines as of 2004, some country-members (Austria, Belgium, Luxemburg) should either participate in the information exchange, or withhold tax at source of income on the added interest at the rate of 15 per cent from 2004, 20 per cent from 2007, 35 per cent from 2010. Herewith, a part of tax proceeds should be transferred to the country of investor’s residence (75/25)<sup>25</sup>.

Basing on the research results, OECD has proposed to its country-members nineteen recommendations aimed at prevention of the effect of harmful tax competition:

1) recommendations in regard to national legislations of OECD country-members (advice on introduction in OECD country-members tax legislations such provisions, which would eliminate offshore benefits to controlled foreign companies, ensure an access of tax authorities to bank information, introduce an obliga-

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<sup>22</sup> “Harmful Tax Competition, An Emerging Global Issue”, OECD report, 1998, <http://www.oecd.org/dataoecd/33/1/1904184.pdf>.

<sup>23</sup> Wilson J. D., Wildasin D. E. Tax Competition: Bane or Boon? (Materials from the Scientific Conference “World Tax Competition” of 24–25 May 2001). – London: Office of Tax Policy Research / IFS. P. 2–3; Goodspeed T. J. Tax Competition, Benefit Taxes, and Fiscal Federalism // National Tax Journal, vol. 51, no. 3 (Sep. 1998). P. 582; Thomas F. Field. Tax Competition in Europe and America. // State Tax Notes. (31.03.03). PP. 1211–1216.

<sup>24</sup> Part IV. Framework of co-coordinated defensive measures. <http://www.oecd.org/dataoecd/60/33/30901115.pdf>.

<sup>25</sup> <http://europa.eu/scadplus/leg/en/lvb/l31053.htm>, <http://europa.eu/scadplus/leg/en/cha/c11325.htm>.

tion of filing in the country of residence all revenues, obtained outside the country, etc.);

2) agreements between the states on provision of assistance in tax issues (information exchange, cooperation of tax bodies, regulations, excluding usage of contracts with offshore companies, rejection to sign contracts with «tax havens», etc.);

3) recommendation on international cooperation: organization of a Global Forum, working on regular basis<sup>26</sup> on the issues of harmful tax competition for the purpose to implement recommendations on development of OECD country-members, formation of official list of «tax havens», influence over the «tax havens» through the countries, which have close relations with them, development of principles of proper tax administration, cooperation with countries, which do not belong to OECD members, etc.<sup>27</sup>.

The final objective, declared at every meeting of Global Forum and in all initiatives of OECD, is formation of the tax systems, which would make the usage of offshore zones unprofitable and infeasible<sup>28</sup>.

In the framework of OECD project, aimed at combating harmful tax competition, the situation in the countries, regarded as «tax havens», or those ones with preferential tax regimes, is under review on permanent basis. The list of countries, which belong to the above categories, is variable. It should be noted, that Russia, initially entered in OECD «black list» due to its insufficient transparency, was later excluded from that list, when Russia has obtained the status of the Observer (in 2002) in the International Group for Financial Measures for Combating Money Laundering (FMCML), and later on became a member of that Group. Together with verification against criteria of compliance, as a rule, OECD also determines the reason to regard a country as the one of preferential tax regime or «tax haven», etc.<sup>29</sup>

There is much in common about the conclusions, made by OECD and EU:

- Preferential tax regimes negatively affect tax bases of other countries;
- Tax regimes should not be the key factor in taxpayer's decision on capital migration;
- It is necessary to abandon an approach of dual criminality (when legal actions are taken against a suspect in accordance with the laws of the country, where he is staying, rather than the country, which brings a claim against him).

Russia is planning to create its own «black list» of «tax havens» countries. Apparently, it would be reasonable to take as an example the existing OECD black list to coordinate the RF measures with international efforts in this regard. At the same time, it should be mentioned that OECD list is rather short; for instance, it does not

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<sup>26</sup> <http://www.oecd.org/dataoecd/41/49/36031490.pdf>.

<sup>27</sup> <http://www.oecd.org/dataoecd/33/1/1904184.pdf>.

<sup>28</sup> This is confirmed by the results of the recent conference in Seoul in September, 2006: [http://www.oecd.org/document/48/0,2340,en\\_2649\\_33745\\_37414896\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/48/0,2340,en_2649_33745_37414896_1_1_1_1,00.html).

<sup>29</sup> The OECD' project on Harmful Tax Practices: 2006 update on progress in member countries. <http://www.oecd.org/dataoecd/1/17/37446434.pdf>.

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include Cyprus. The list for the purpose of taxation in Russia should be adapted to the national requirements and specifics of tax evasion in Russia.

The majority of countries make use of a complete system to detect “tax havens” for the purposes of their national taxation, rather than one list of “tax haven” countries. For instance, in Brasilia there is a list of all countries with favorable tax regimes, without any criteria or terms of taxation, effective in those tax regimes.

Some countries support the idea that the “black list” can aggravate international relations. For that reason Great Britain preferred an absolutely opposite approach, having compiled a “white list” (a list of “compliant” countries)<sup>30</sup>. Moreover, that list is split into two parts. In the first part “absolutely compliant” countries are enlisted, in the second part – “compliant in general” countries are found (which have some disputable legal provisions). There are “white lists” in Germany, Canada and Switzerland as well<sup>31</sup>..

In Italy there exist several “black lists” (two of them for corporate companies and one for individual entrepreneurs) and one “white list”. Such a variety is explained by the fact that different lists are used for different rules against tax evasion<sup>32</sup>.

In some countries the category “tax haven” is defined by criteria of income tax threshold. If a country applies the rate lower than the established threshold, it should be regarded as “tax haven” Such system is in effect in Hungary (threshold rate is 10 per cent). In Brasilia the threshold is established at the rate of 20per cent (in addition to above-mentioned “black list”)<sup>33</sup>.

Such countries as Korea and Japan take into regard for that purpose effective income tax burden throughout the country. In Korea, in case the tax burden of a foreign legal entity in some country makes less than 15 per cent, the country is considered a “tax haven”. In Japan that threshold makes 25per cent<sup>34</sup>.

In France a company is considered a subject of low tax jurisdiction, in case its tax liabilities are less than 2/3 of taxes, if they were paid in France. A similar scheme is applied in Finland (less than 60 per cent of tax burden payable in Finland) and Great Britain (less than 75per cent)<sup>35</sup>.

Some countries, like France, for instance, demand from taxpayers, claiming for deduction from their tax base the amount, prepaid to some entities in jurisdictions with low tax rates, supplementary documents to justify the deduction. In compliance with Article 238A of the Tax Code of France, French company, claiming for deduction from the tax base the amount, prepaid to foreign company – a subject of favorable tax regime, should confirm that: (a) prepaid amounts match the actual contract value; (b) amounts, prepaid under those contracts, are in line with general standards of business practice.

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<sup>30</sup> <http://www.hmrc.gov.uk/research/report16.pdf>; <http://www.oecd.org/dataoecd/63/11/1915964.pdf>.

<sup>31</sup> [http://www.oecd.org/searchResult/0,2665,en\\_2649\\_201185\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/searchResult/0,2665,en_2649_201185_1_1_1_1_1,00.html).

<sup>32</sup> See reference above.

<sup>33</sup> See reference above.

<sup>34</sup> See reference above.

<sup>35</sup> See reference above.

Herewith, a “favorable tax regime” means that tax liability of the recipient of payment, in accordance to tax legislation of his country, is less than 2/3 of profit tax rate in France. Therefore, in each case, when a French company transfers payments to a “tax haven”, it has to bear extra burden of proof of the legitimacy and adequate amount of such payment. If the legitimacy is not proved, the company is not liable for any tax deduction.

There are similar regulations in Belgium, i.e. Belgium companies have also to provide a proof of legitimacy of payments, transferred to the companies-residents of “tax havens” to have the right to reduce taxable income for the amount of such expenditures.

Combating capital outflow to «tax havens» is supported by international community to a certain extent as a way of counteraction to harmful competition on the part of those “tax havens”. However, it should not result in total exclusion of potential deduction of justified expenses from the tax base.

At the same time, to avoid those restricting rules, a taxpayer can transfer payment through an alternative country, which is not enclosed in the list of favorable tax regimes as per the taxpayer’s country legislation, and in case there are no special provisions in this legislation on interest rates, paid to the residents of «tax havens».

Though such provisions are not included in legislations of many countries, there is a high probability, that even in those countries, where those provisions are not foreseen by law, tax authorities pay special attention to payments, made to companies-residents of tax havens, at least in the course of audits. But if the fact is disclosed, that the payee and recipients are interrelated persons, there is no doubt that an investigation for transfer pricing will be made.

In general one can regard an additional burden of proof, related with payments, made to the companies, registered in tax havens, as a discriminating approach. Actually, it is true. It is extremely important in this case to have a thoroughly elaborated definition of “unreliable” country and what is needed to dismiss the “doubts in its compliance”. Otherwise, the law might have negative side effects, like hindering export-import business flows.

Tax competition between the countries for attraction of taxpayers precludes application of progressive tax rates and prevents the governments to achieve of the target of income distribution, but it assists criminal “money laundering”.

The trends of the recent years demonstrate, that special attention is paid in the Russian Federation to domestic and external tax relations, and therefore, reforms of the Russian legislation are required for simplification and harmonization of legal basis with regard to international standards.

OECD and EU work with the countries, pursuing harmful tax policy, is aimed at efficient exchange of information between tax authorities, combating tax evasion and manipulation with tax regimes, introduction of amendments to tax legislations for harmonization approaches to tax bases assessment and other elements of taxation.

Evaluation of the current state of the Russian Federation tax system in terms of consistency with the tax systems of the basic partner-countries would be infeasible without an integrated definition of the position Russia takes among other international jurisdictions. Solution of the problems, related to both, harmful tax competition and distinctions in regulation of the tax system (special judicial institutions, effective legal instruments, etc.) depends on the plans of Russia in terms of integration in the framework of international tax regulations.

As mentioned above, today the world community in general, and partner-countries of the RF in particular have reached substantial results in harmonization of the tax system for the aim of simplified and effective tax administration in the conditions of global economic integration.

Russian Federation is neither OECD, nor EU member, but still, it is actively leading negotiations on entering WTO. In this regard it should be mentioned, that the majority of Russian leading international economic partners are the members of OECD, WTO, and many of them belong to EU community. One of the major purposes of cooperation within the UE, specified in the EU Treaty, is the policy of tax harmonization. In its framework the EU country-members take an obligation to cooperate in the information exchange on relevant issues. For a number of years EU undertakes and implements decisions and programs on coordination of actions in terms of harmonization of tax systems of country-members. It should be noted, that the decisions of EU in regard to its country-members may be of both, obligatory and advisory nature. Accordingly country-members take orderly, universal and scheduled actions.

OECD, in its turn, sets the targets of coordination of common economic and trade policies, tax policy of country-members, coordination of their policy in terms of assistance to developing countries, support to the worldwide economic exchange on the basis of multilateral parity. OECD decisions, which have consultative and advisory nature, are adopted upon an approval of all members. Therefore, the country-participants can either accept or reject OECD recommendations. As a result of their decision, other country-members (which agree or disagree with the decision) would either provide or restrain from provision of a favorable regime in regard to that country. Mutual understanding is a key point in the international cooperation, including tax issues.

WTO agreements set forth, in particular, parity in trade, which should be ensured by mutual favorable regimes, on the one hand, in regard to export, import and transit operations, relevant customs duties and fees, and on the other hand, a national regime, equally applicable to domestic and external goods in terms of domestic taxes and levies and regulations of national trade, including taxation. Terms of agreements, signed by any country within WTO, are obligatory to the country in accordance with the agreement provisions. The majority of Russian international economic partners have settled those issues and currently joined WTO. Liabilities of the Russian Federation within WTO are also related with harmonization of tax provisions in any form.

Therefore, a conclusion can be made, that the majority of the RF economic country-partners are associated with each other by multiple international agreements, among them – agreements, addressed at combating harmful tax competition on the part of any country, harmonization of national tax systems, as well as mutual information exchange between relevant tax authorities. In view of the above, it is evident, that firstly, Russia needs to join the process of international information exchange on tax issues as soon as possible, and secondly, Russia should take an appropriate position and a vote right in elaboration and adoption of decisions (including tax issues) in global international organizations.

Due to time-consuming procedure of entering an international organization, it would be reasonable for Russia to conclude intergovernmental bilateral agreements on information exchange on tax issues.

It would be also preferable to revise agreements on avoidance of double taxation, which are signed by Russian Federation with a number of other countries. Those agreements play a significant role as in combating harmful tax competition, as in information exchange and cooperation in regard to incompliant taxpayers. Thus, for example, the agreements should foresee adequate measures in limitation of benefits to entities non-residents of the country-parties of the agreement, as well as information exchange in regard to performance of national tax legislation. In the majority of agreements, signed by the Russian Federation and still valid agreements of former USSR, such provisions were not included and their effect is much lower than it could be. Amendments should be made to those agreements on avoidance of double taxation, which have no provisions on limitation of benefits. A positive example of an agreement on avoidance of double taxation is the agreement between Russia and USA, which stipulates: an entity, who lays a claim for the benefits, foreseen in the agreement, can not obtain them only due to an evident residence or confirmed source of income. The entity has to prove a real interrelation with the country, where the benefits are claimed.

As was mentioned above, Russian Federation does not have the lists of countries with “poor tax reputation” and “tax havens”. The lists of offshore countries, published by the RF CB (in the framework of cooperation with FMCML), can not be used for tax administration purposes<sup>36</sup>. Practically all countries have developed criteria of formation of those lists, and many of them apply the standards of OECD and EU. Russia is not a member of OECD, but this fact can not prevent it from application of OECD criteria and indicators for formation of the lists of «tax havens» countries. Such lists can provide an explicit impact on effectiveness and quality of tax administration.

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<sup>36</sup> In other words, if a taxpayer contacts tax administration of a relevant country, it will at least have no impact over his right for expenses deduction; there are legal provisions in many countries in terms of transactions and their tax consequences with such countries. Moreover, the Russian list includes pure offshore countries, but in Europe such lists include the countries, not participating in information exchange, as well as those, where tax rates and assessed tax base are much lower than the standard one.

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Naturally, a deeper reformation for bringing the Russian tax system in line with the worldwide practice in general, and with tax systems of basic economic partners of Russia in particular, should involve a wider range of areas to be reformed. All those areas are outlined in legislations the RF basic economic partners. Insufficient participation of Russia in the international cooperation on tax issues restricts its access to benefits, available to tax authorities of other countries for combating tax evasion and large taxpayers' manipulation with discrepancies of tax regimes in different jurisdictions.

### **Annex 3. The Problems and Prospects of Applying Performance-Based Budgeting (PBB) in Russia**

Performance-based budgeting, as an instrument for improving performance quality, had been successfully applied in the USA, UK, Australia and other developed countries for many decades. Nevertheless, in Russia, although the need for implementing the components of target program methodology in the practice of budget planning has been repeatedly emphasized in basic national programming documents<sup>37</sup>, the first of which appeared as early as 2000, the first real steps toward implementing the principle of cost-effective spending of government funds were taken by the Government of the Russian Federation only four years later. Then, Decree of 22 May 2004, No. 249, "On measures designed to improve the cost-effectiveness of budget expenditure" was adopted, which became the initial point in regulating the procedure for implementing performance-based budgeting (PBB) in the practice of medium-term financial planning at the federal level.

Thus, as the goal of the new budgeting model has been declared to establish a distinct interdependence between the government financial resources being spent and the results obtained. In other words, the reforming of the budgeting process in the Russian Federation is oriented toward a transition from the financing of budget-funded institutions and bodies of authority proper to the financing of the services being provided by them to the population. In the final analysis, according to the authors of reform, this must result in improved quality of budget-funded services, coupled with more economical spending of budget resources.

International experience has shown that the application of PBB can, indeed, ensure improved efficiency and transparency of the management of government finances, when budget funding is allocated not by items of expenditure, but by strategic goals and tactical aims, orientates toward the achievement of certain specific final results. In this connection, budgeting decisions are already based not on the specific amounts to be spent on each item of the economic classification (salaries, utilities, capital repairs, etc.,) or the execution of each specific government function (public education, public health care, law enforcement, land development), but

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<sup>37</sup> See materials of Budget Letters of the RF President in years 2000, 2003, 2005, 2006, and the programs for the socio-economic development of the Russian Federation in the medium term (2003–2005 and 2006–2008).

on a whole entity of budget programs oriented to the achievement of practical results.

The active implementation of PBB as one of the directions of reforming the budgeting process in Russia began in 2004, alongside the onset of the formation of the normative-legal base designed to regulate this procedure. The Government Commission for improving the performance of budget expenditure was created, while the subjects of budget planning began to prepare their first reports on the results and main directions of their activity in the medium term (hereinafter – report). In this connection, certain measures were applied, in order to create incentives for the federal bodies of executive authority to improve the quality of their financial management. Thus, in 2005 and 2006, by order of the Government of the Russian Federation, to all the participants in the experiment aimed at implementing the methods of performance – oriented budget planning the RF Ministry of Finance was allocating every year 180 mln roubles to meet the costs of research, the up-keep and operation of their central apparatuses, including to the remuneration of their staff – 53.8 and 96.1 mln roubles, respectively. These funds were distributed between the federal bodies of executive authority participating in the experiment depending on the degree to which they were applying the performance-based methods of budget planning during the reporting year, as well as the measures implemented by them in order to improve the quality of budget management at the intradepartmental level.

The transition to PBB requires that each budget planning subject (BPS) (federal ministries, as well as the services and agencies headed by the RF President or the RF Government, the federal bodies of legislative and judicial authority, the RF CEC, the RF General Procuracy and the RF Clearing House) should submit to the Government Commission for improving the performance of budget expenditure, the RF Ministry of Economic Development and Trade and the RF Ministry of Finance three iterative versions of its report. While preparing the reports, the federal bodies of executive authority must systematize the goals and tasks of their activity, with their subsequent correlation with the goals of the RF Government, as well as to separate, within this activity, the program and non-program components, distribute their expenditures by each goal, task and program, and to report on the performance-based spending of budget funds.

The results of a selective analysis of the reports prepared in 2005 and 2006 have made it possible to reveal a whole set of systemic gaps in the organization of budget planning, both at the level of BPSs and in the sphere of interdepartmental relations. There is little doubt that the process of eliminating these gaps, in order to finally build an efficient budgeting system, is going to be time-consuming, but even now quite a few things can be improved. Below we are going to discuss the measures to be taken in that direction and the problems that should be provided solutions to as a matter of priority.

First of all, it should be noted that when the goals, tasks, programs and figures stated in the reports are compared to the goals of the RF Government and the potential indices relating to them, it becomes evident that these goals overlap with the

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goals, tasks and programs of BPSs in many instances in a purely fragmentary fashion. Moreover, many goals of the RF Government turn out to be unachievable for lack of proper coordination between BPSs in their attempts to implement certain sub-goals within the broader goals of the RF Government. In the present situation, the role of a coordinating and supervising center is assigned to the Government Commission for improving the performance of budget expenditure, which must not only accumulate and analyze the reports submitted by the budget planning subjects, and to develop proposals for improving the procedure for preparing and submitting the reports, for specifying the main directions and results of the activity of budget planning subjects, for the development of departmental target programs and the improvement of performance of federal target programs, but also to ensure the uniformity of the activity of different BPSs in order to implement the whole system of the RF Government's goals. However, the results of the Commission's activity can hardly be estimated as satisfactory, because so far it has not become possible to ensure the efficient interaction between BPSs and between them and the bodies of state authority of other levels of the RF budgeting system.

The RF Ministry of Economic Development and Trade also has an important role to play in the process of PBB implementation, because it performs the functions of supervising the implementation by BPSs of the declared provisions of their reports, while being fully responsible for the preparation of the summary report on the results and main directions of activity of the Government of the Russian Federation (hereinafter – summary report), designed to become a strategic planning document summarizing the key provisions of the reports submitted by individual BPSs. However, despite being of paramount importance as a component of the system of target program budgeting, the summary report in its present form (prepared by the Ministry of Economic Development and Trade on the principle “bottom to top”, and then “cut up and glue”) has mostly a formal character, performing the function of an intermediary link between the declared priorities for the country's socio-economic development and the complex of measures planned by BPSs for a three-year period, rather than being a carefully elaborated program of comprehensive development, which sets specific targets for the subsequent development of BPSs' plans of action for a medium term.

Besides, it should be noted that because of the underdeveloped mechanisms for implementing joint measures, any broad spectrum of potential directions for improving performance through finding efficient solutions to interdepartmental problems is simply unattainable. Consequently, it becomes possible to improve the performance of budget expenditure within the framework of such a poorly organized system of budget planning only at the level of individual BPSs.

Another important shortcoming in the organization of the process of distributing the expenditures of BPSs among their goals, tasks and programs being implemented is the still existing opportunity for an analytical (or expert's) approach to distributing budget expenditures, with the right not to break up the program's expenditures between several goals being simultaneously achieved by a given target program. The lack of a well-defined procedure for allocating and correlating ex-

penditures with goals, tasks and programs results in a situation when the ministries, as before, at first, for a whole year, pursue a certain activity within the framework of their competence, and then later, during the preparation of the intermediate and final reports, try to fit the actually implemented measures into the goals, tasks and indices determined in the report. Obviously, the budgeting organized in such a way is of little use as a method for financial planning, while the report has not yet become a program of action for the nearest perspective, to be applied in the process of managing government finances.

Moreover, the low quality of the reports sometimes gives rise to erroneous targets being established for the allocation of budget funds to the specific spheres of activity of the federal bodies of executive authority. Here we refer to the subsequent application of the materials cited in the reports in the preparation of the summary report, drafts of the prospective financial plan and the federal budget for the next financial year.

The poor level of organization and low efficiency of planning at all levels of the budget planning system is predetermined not only by the absence of an efficient coordinating center, the lack of proper qualification and budgeting skills of the staff of BPSs, and low degree of automation in the process of preparing and monitoring the reports, but also by the remaining gaps and limitations of prevailing legislation regulating the implementation of PBB. Our analysis of the standard requirements to the preparation and content of a report, as well as the materials of a number of reports prepared by BPSs have made it possible to point out to certain existing *drawbacks*.

*Firstly*, one significant gap, in our opinion, is the lack of the requirement for a BPS to determine, when preparing a report, alongside the development of goals and tasks, also a list of specific measures aimed at the achievement of the declared goals, with the break-up of the expenditures earmarked for such goals into current and capital costs. This would have made it possible to prevent potential misuse, by the ministries, of their right to submit the information concerning the directions of their activity in a broader format, stating their strategic goals and tactical aims in too general terms, which makes more difficult the selection of adequate quantitative parameters for measuring the degree of their achievement. Besides, this feature would greatly increase the practical significance of a report as a program of concrete actions undertaken by a planning subject for a future period, with the separation of the investment component.

*Secondly*, in the provision on reports approved by Decree of the RF Government of 22 May 2004, No. 249, there is no specification of short-term goals, tasks and measures within the framework of a medium-term planning period, which makes it impossible to follow the direct link between this document and the types of expenditures declared by a ministry of a department in its projected budgeting indices. Besides, it appears to be of utmost importance at later stages, as more and more experience in PBB is accumulated, to expand the planning horizon to a period of at least 5 years, which is a necessary prerequisite for organizing the government's investment activity. Otherwise, as things stand nowadays, and in particular

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in connection with the newly created Investment Fund of the Russian Federation, which began its operation from the year 2006, there has emerged a discrepancy between the five-year period established for the provision of state support and the three-year period of planning the fund's maximum volume on the basis of a prospective financial plan.

*Thirdly*, the provision on the reports does not contain any methodological approach, which could make it possible to determine the degree to which certain results of socio-economic development depend on the activity of budget planning subjects, and how much they depend on objective factors.

*Fourthly*, one more drawback is the absence of any methodological approaches to the development of planned indices, which makes more difficult their independent assessment.

Besides, the normative acts adopted at the federal level and addressing the procedure for preparing reports do not determine the schedule of actions to be taken in those cases when target indices are found to be different from planned indices. This largely is due not to the shortcomings of the system of indices applied to determine the performance of budget expenditures, but rather to the objective impossibility to suggest any singly algorithm applicable to such cases. However, each instance of such a discrepancy, revealed by the results of a plan-fact analysis, should be met with adequate and speedy response, otherwise doubts will be cast on the performance of the whole system of budget planning. And it is quite a different matter that only on the basis of an in-depth analysis of each specific situation it will be possible to judge if the deviation of a certain actual value of an index from a planned value can be regarded as a justification for cutting or increasing the volume of financing, or for keeping it at the same level, while changing some other conditions of BPSs' functioning.

*Fifthly*, no normatives have been developed with regard to the mechanism for incorporating, in the indices of activity of the federal bodies of executive authority, the final results of the functioning, within the sphere of their competence, of the regional and local bodies of authority, and so it is impossible to build a functional three-tier structure of planning budget expenditures on the basis of single principles. The elimination of this shortcoming appears all the more necessary in view of the expanding initiatives of the Federation's subjects for implementing PBB in the regional practice of budget planning.

Thus, it can be stated that the results of the first years of implementing PBB in the practice of budget planning at the federal level have revealed the existence of certain shortcomings and gaps both in the existing normative-legal base and in the organization of this process as a whole. Consequently, the prospects for PBB development largely depend on the earliest possible elimination of such "bottle-necks", while special attention should be focused on the following measures.

1. First of all, in our opinion, it is necessary to switch over from the existing structure "strategic goal – tactical aim – target program" to a multi-step structure, like "BPSs' mission – achievable goal of the RF Government – tactical aim of BPSs – budget target program – action". The logic of interconnection between the

components of such an hierarchy is evident. At first, each BPS formulated its mission, which represents a brief definition of one most important goal of government policy, for the achievement of which a given BPS is responsible, or for the achievement of which it has been created. The description of this mission may also contain the information concerning the services being provided by the BPSs, the customers and consumers of these services. Thus, it is the mission that determines the functional peculiarities of a BPS.

Then, in order to ensure the transparency of the contribution of individual BPSs to the achievement of the RF Government's goals, each BPS must select from among the three-tier system of the Government's goals those goals that would be compatible with the directions of its activity during a planned period of time. Also, the selected goals must correspond to the BPS's mission.

After that, the tactical aims of BPSs are determined, which are to reflect the volume of government services to be realized by a BPS during the planned period of time. The aims must be correlated with goals (or socially important results) and the BPS's mission.

After having formulated its tactical aims, each BPS must develop a plan of measures, determining the main phases in the achievement of goals and, most importantly, the organizational structures (subordinated agencies and services, departments of ministries) to be responsible for the achievement of each specific goal or aim. These separate homogenous services or similar types of activity, oriented to finding solutions to specific problems, are then united into target programs. Therefore, a specific type of activity, a function or several types of activity, united into one functional group, can be called a program. The separation of measures into a specific component of planning will thus promote the responsibility of the staff of a BPS for their performance level, as well as improve the quality of monitoring over the intermediate results (monthly or quarterly) relating to the achievement of goals and implementation of programs.

2. For purposes of creating a well-functioning system of quantitative indices of BPSs' activity, it would be feasible, when estimating the performance of budget expenditure, to divide the results of BPSs' functioning into direct (immediate) and final.

Direct results in this instance will be understood as the volume of goods and services being provided by the State. For example, the indices of direct results may be: the number of students to whom educational services under a given curriculum have been provided; the number of patients treated in accordance with the established standards; etc.

As for the indices of final results, they reflect the achievement of social results in the form of a certain level of satisfaction of society's needs, for example, the improvement of education quality, decreased mortality from certain diseases, lower incidence of crime, improved road traffic safety, etc.

It is obvious that the achievement of final results is, indeed, the goal of socio-economic policy, while the provision of government services represents its instrument. This division of the results of the activity of budget planning subjects gives a

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new sense to the indices of social and economic performance, because they can be now measures in terms of quantity. Thus, in order to measure the social performance of budget expenditure it would be sufficient to compare the planned and actual final results (the achievement of a certain social result per unit of expenditure), while economic performance can be measured by comparing the planned volume of services with that of the services actually provided (output volume per unit of expenditure).

It would be most feasible to base the measuring of the results of activity of the recipients of budget funds on the indices of direct results (although there might be some exceptions to this rule). At the same time, the main recipients of budget funds must ensure that the increased immediate results would lead to the achievement of final results, thus reflecting the priorities existing in society.

In order to increase the objectivity of the assessment of BPSs' activity, it is necessary to calculate net final results, that is, without the impact of external factors (the macroeconomic situation, the contributions of other ministries, etc.), for which a special assessment methodology must be developed.

Attention should be focused on the fact that presently the BPSs participating in the experiment are making active attempts at involving the main part of the budget network – that is, subordinate administrators and recipients of budget funds – in the process of implementing PBB. In this connection, it would be logical to assess the activity of a large number of BPSs, and primarily those who organize the provision of government services, on the basis of the indices of their subordinate budget networks. This requires that a concept of reforming the budgeting process at the intradepartmental level should be developed, including the mechanisms for transforming the goals and aims of BPSs into the goals and aims of recipients of budget funds. Naturally, in each specific case there emerge some specific features, which, however, do not change the essence of the matter. Moreover, PBB does not represent any rigid set of methods, fixed and established once and for all – on the contrary, it can be adapted, rather freely, to different conditions of economic life and to different levels of authority.

Thus, in a longer perspective, PBB must become, through a system of applied indices, not just another new method for planning and a new instrument for analyzing budget execution, but an efficient mechanism, capable of revealing, among the deviations, those areas that are open to further improvement.

Beside the improvement of the procedures for preparing the reports of BPSs or the summary report of the RF Government, there still remains one more issue of paramount importance – that of improving the performance level of monitoring procedures, whose logical outcome should be the consideration of the causes and potential legal consequences of a failure to meet the established performance indices.

It seems logical that the control over the implementation of budget funds by ministries of departments should be gradually shifted from the external control of the targeted use of the allocated funds to the internal control of BPSs over the level of performance of their expenditures. The estimates of social and economic per-

formance within the framework of planned activity must be applied in planning expenditures for a next budget year.

The necessity of improving the system of monitoring the results of PBB implementation has also been confirmed by the fact that the estimation of the performance of BPSs on an annual basis makes it possible to critically revise the existing areas of spending and then to eliminate those items of expenditure that are being funded “by inertia”, without any social and economic justification for their existence.

It is necessary to further improve the procedure for monitoring the effectiveness of budget expenditure – both through raising the level of personnel training and better elaborating the target programs, and through building a multi-tier system of control. At the first tier, the control over the performance of budget-funded institutions must be executed by those BPSs to whose jurisdiction those institutions belong. The loosening of control over the areas of spending the funds allocated to the budget-funded institutions switched over to performance-based financing must be synchronized with toughened control over the volume and quality of services being rendered by them. The main administrators of budget funds must perform regular monitoring of the achievement, by budget-funded institutions, of the planned volumes of services, and adjust the volume of financing if the actual performance indices are below or above the planned targets. This will make it possible to make benefit of the main advantage of performance-based financing – the possibility of correlating the volumes of financing with the volumes of services being rendered by the institutions.

Alongside state control, it also necessary to strengthen the measures of non-government control over the volume and quality of the services being rendered, to expand the practices of creating supervisory boards at budget-funded institutions, and to increase the role of consumers’ societies in this process.

At the second tier, the control over the performance of BPSs must be executed by the Government Commission for improving the performance of budget expenditure. This type of control must be implemented within the framework of the consideration, by the Commission, of those sections in the reports submitted by the main administrators of budget funds that deal with the results of their activity during a reporting period, as well as reports on the results of implementation of interdepartmental and departmental target programs (for reference: there has been established, as yet, no normative definition of the procedure for monitoring the results of the implementation of interdepartmental programs for those planning subjects who are not the head institutions in such programs). The results of the assessment of performance of the main administrators of budget funds must be entered into the summary budget report. In this connection, the methodology should be developed for estimating the quality of budget funding administration by the planning subjects.

And, finally, the monitoring system will become complete after the implementation of the third tier of control – that of the control over the performance of the RF Government by the RF State Duma, with the participation of the RF Clearing House.

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For purposes of ensuring the possibility of such a control, the RF State Duma must participate in the assessment of those sections in the summary report submitted by the RF Government and those reports on the results and main directions of activity of budget planning subjects that contain the information concerning the dynamics, over a reporting period, of both planned and actual performance indices. Before being considered by the RF State Duma, these materials must undergo, on a mandatory basis, an expert's estimation by the RF Clearing House.

By way of summing up everything that has been discussed here, we can offer the following conclusions:

1) although in just a few years the method of PBB has become the one in great demand in terms of government expenditure planning – both at the federal and the regional levels of the RF budget system, - no noticeable improvement in the financial management of BPSs has been observed so far. As before, the main problem associated with implementing PBB – that of restructuring the activity of planning subjects through creating an efficient system of managing budget-funded target programs – has remained unsolved. In other words, the final result of PBB implementation must become such an organization of the planned activity of ministries and departments that would be capable of representing nearly all their activity through the prism of the programs and singular measures being implemented by them, and, consequently, of increasing the responsibility of ministries and departments for the results of their activity;

2) the application of PBB in the years 2004–2006 has revealed the existence of important drawbacks and gaps – both in the prevailing normative and legal base and in the organization of the process of budget planning as a whole (the absence of an efficient coordinating center, lack of proper qualification and budgeting skills displayed by the staff of BPSs, low degree of automation of the process of preparing and monitoring the reports, etc.). And, although a certain improvement of the quality of PBB in Russia can indeed be achieved in the nearest future, if appropriate operative measures are taken in order to remove or at least to somewhat soften the revealed problems, a long time will, nevertheless, be required in order to learn to improve the performance of the whole system of managing budget funds.

#### **Annex 4. Accounting Policy for Taxation Purposes: Tax Accounting and Administration**

Federal law No. 137-FZ of July 27, 2006, “On the introduction of amendments to Parts One and Two of the Tax Code of the Russian Federation and certain other legislative acts of the Russian Federation in connection with the implementation of measures aimed at the improvement of tax administration” has introduced the definition of the term “accounting policy for taxation purposes” in the Tax Code of the Russian Federation.

The new version of the first part of the RF Tax Code (item 2, article 11) defines the accounting policy for taxation purposes as the set of means (methods) permitted by the Code applied to determine earnings and (or) expenditures, to recognize,

evaluate and distribute such earnings and (or) expenditures, as well as to take into account other indicators of financial and economic activities of taxpayers necessary for taxation purposes as chosen by taxpayers.

Prior to the approval of the version of the first part of the Tax Code of July 27, 2006, the term “accounting policy for taxation purposes” was already referred to in some provisions contained in the second part of the RF Tax Code; however, this term was not defined.

At the first glance, the introduction of the definition of accounting policy for taxation purposes in the Tax Code does not appear to be an event of any special importance; however, in the context of the trends observed at present in the framework of reforms being implemented with respect to the Russia’s accounting system this change in the tax legislation deserves attention. Besides, this development is important from the point of view of improvement of the tax administration.

### **Accounting policy for taxation purposes and the problem of correlation between financial and tax accounting**

The separation of financial (financial) accounting and tax accounting was finally formed after chapter 25 of the RF Tax Code “Profit tax on organizations” entered into force on January 1, 2002; since that time, tax accounting became compulsory for all Russian enterprises assessing and paying the profit tax.

However, as soon as the new type of accounting was introduced there arose a controversy concerning the feasibility of separation of financial and tax accounting. The main argument against this development was more complicated accounting procedures and higher expenses of organizations associated with bookkeeping. In November of 2002, there were approved the Regulations on accounting “Accounting concerning the payments associated with the profit tax” (RA 18/02)<sup>38</sup>; the text of the Regulations avoids references to tax accounting<sup>39</sup>; however, the procedures governing the accounting for respective items did not become less complicated.

At present, the Concept of development of accounting and reporting in the Russian Federation in the medium term perspective<sup>40</sup> envisages that tax accounting of Russian organizations should be compiled basing on the data formed in the framework of financial accounting by the way of adjustments made in accordance with the rules set by tax legislation<sup>41</sup>, whereas the Tax Code (article 313) permits leaves it to the taxpayer’s choice to use for the purposes of tax accounting either financial accounting ledgers (if they contain sufficient data), to form tax accounting ledgers on the basis of financial accounting ledgers, or to keep own tax accounting ledgers.

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<sup>38</sup> Order of the RF Finance Ministry No. 114n of November 19, 2002.

<sup>39</sup> “These Regulations permit to reflect the difference between the tax on book profits (losses) recognized in the accounting and *the tax on taxable profits formed in the framework of accounting* and reflected in the tax returns as concerns the profit tax in accounting and reporting.” (paragraph 2, item 1 of RA 18/02).

<sup>40</sup> Approved by Order of the RF Finance Ministry No. 180 of July 1, 2004.

<sup>41</sup> See Section 2.1 of the Concept “Improving the quality of information formed in the framework of accounting and reporting”.

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It should be noted that the option to use adjustments does not dispense organizations from the duty to maintain tax accounting, since in order to obtain any adjustment it is necessary as a rule to first have the data on the object of such adjustment both in terms of financial accounting and terms of accounting maintained in accordance with the rules set by the tax legislation. Foreign practices demonstrate<sup>42</sup> that adjustments are used in order to reconcile the amounts of taxes payable (as per accounting records) and real tax payments (as per tax returns) in the framework of accounting and financial reports and not to make the accounting procedures used by companies less complicated.

At the same time, the number of necessary adjustments may be reduced in the case the rules of financial and tax accounting could be converged. In the case the respective provisions are in place in both the financial and tax accounting legislation this issue may be coped with at the level of an organization's accounting policies.

The introduction of an open list of direct expenses in the Tax Code (see item 1 of article 318 of the RF Tax Code) and changes in the regulations concerning the procedures governing the evaluation of work in progress, which now may be set by an organization at its own discretion with respect to its accounting policies for taxation purposes (see item 1 of article 319 of the RF Tax Code), may be classified among the measures already implemented in this sphere. The said changes were introduced in the RF Tax Code by federal law No. 58 FZ of June 6, 2005, "On the introduction of amendments to Part Two of the Tax Code of the Russian Federation and certain other acts of tax and levy legislation of the Russian Federation."

At the same time, this federal law introduced to the RF Tax Code a provision (contained in item 1.1 of article 259), in accordance with which taxpayers (as concerns organizations) should have the right to include expenditures associated with capital investments amounting to less than 10 per cent of the initial costs of fixed assets (with the exception of those acquired on the gratis basis), as well as expenses for additional construction, additional equipment, modernization, technical upgrade, and partial liquidation of fixed assets to the composition of expenses borne during a reporting period. In the case organizations use this amortization premium, it will form a time lag in financial accounting, since it is accrued only in the framework of tax accounting. Of course, organizations may refrain from using this provision in order to converge financial and tax accounting; however, in this case their expenditures for the acquisition of fixed assets will be accepted for deductions for taxation purposes later than in the case they use the amortization premium.

The example discussed above demonstrates that even in spite of the potential reduction of expenditures organizations bear with respect to bookkeeping, it is impossible to completely converge financial and tax accounting. These types of accounting serve different purposes and as a rule have different users of reporting data; respectively, companies developing their accounting policies pursue different

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<sup>42</sup> See: *Nalogovaya reforma v Rossii: problemy i resheniya* (Tax Reform in Russia: Problems and Solutions). Working Papers No. 67R. M.: IET, 2003. Chapter 10.

purposes by choosing one or another method (means) of accounting with respect to certain events and operations.

Yet another problem encountered in the course of analysis of correlation between financial and tax accounting is associated with the sphere of regulation. Artificial convergence of tax and financial accounting via a regulatory system (use of accounting ledgers for calculation of tax liabilities, lack of a separate regulatory base of regulation of tax accounting and respectively use of financial accounting and reporting data for the purposes of tax administration and control) creates prerequisites for the inclusion of a control function in the sphere of accounting information, what infringes on its neutrality and therefore reliability. Consequently, as concerns the creation of favorable conditions for compliance with qualitative characteristics of reporting information accepted in the international practice<sup>43</sup>, the separation of financial and tax accounting appears to be feasible.

Among other measures, the separation of financial and tax accounting envisages the development of a separate regulatory base for tax accounting as a full fledged sphere with own objectives, tasks, users, and accounting policies. The definition of accounting policies for taxation purposes set in the text of the RF Tax Code may be viewed as a step towards an increasing independence of tax accounting; however, at the same time it appears that this step has been taken as a measure aimed at the creation of a conceptual framework of the tax legislation.

It should be noted that a full fledged legal regulatory framework with respect to tax accounting will permit in the future to settle the issue of granting certain group of subjects an option to submit individual (unconsolidated) financial statements directly formed in accordance with the International Accounting Standards (IAS)<sup>44</sup>, what appears to be a more efficient way to reduce the costs borne by organizations in connection with bookkeeping than conversion of methods (means) used in the framework of financial and tax accounting.

The exclusion of references to financial accounting from the tax legislation is a necessary measure aimed at the withdrawal of financial reporting of Russian companies from the sphere of tax administration and control; however, it should be noted that this measure alone is not sufficient for this purpose. In order to avoid excessive interference of control functions in the sphere of financial reporting and maintain financial discipline all necessary tools should be directly set in the tax legislation.

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<sup>43</sup> Understandability, relevance, reliability and comparability of reporting information in the context of different hierarchy of components are indicated both in the framework of the International Accounting Standards (see the Framework for Preparation and Presentation of Financial Statements), and in the framework of the US Generally Accepted Accounting Principles (see the Statement of Financial Accounting Concepts № 2. Qualitative Characteristics of Accounting Information).

<sup>44</sup> The Concept of development of accounting and reporting in the Russian Federation in the medium term perspective envisages that in the future the option to form individual financial reporting in accordance with IAS in stead of Russian Accounting Standards may be granted to a certain group of economic agents (see Section 3 "Stages of development of accounting and reporting in the medium term perspective").

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In this connection, it should be noted that the draft of the federal law “On official accounting,”<sup>45</sup> which should replace federal law No. 129 FZ of November 21, 1996, “On accounting” currently in force, abolishes companies’ obligations to submit their financial accounting records to the tax authorities. According article 17 of this draft law, companies should be still obliged to present their accounting records only to the statistical authorities responsible for the places, where companies are officially registered. However, tax authorities have negative attitude towards this innovation referring to the fact that they need accounting data for their work<sup>46</sup>.

Creation of a separate regulatory base of tax accounting should not be viewed as discontinuation of regulation of financial accounting including its technical aspect, i.e. the documenting of operations, keeping of ledgers and so on. Both financial and tax accounting as a rule serve to reflect the same facts of financial and economic activities and base on the same raw data. Therefore, a reasonable separation of financial and tax accounting in no way restricts possibility of tax control, moreover, after incentives for efficient functioning of the sphere of accounting and reporting are in place and there are interested users of such information tax control is supplemented with public control as well.

Let us get back to the discussion of the example of the open list of direct expenditures set in the RF Tax Code (item 1, article 318). On the one hand, the RF Tax Code does not set any restrictions as concerns the procedures governing the classification of expenditures borne by organizations as direct or indirect, i.e. formally taxpayers have the right to indicate in their accounting policy for taxation purposes that all expenditures associated with production and sales are indirect in order to account for them in the current period in the course of computation of the profit tax. On the other hand, restrictions related to the feasibility of such actions nevertheless exist, since tax authorities may compare lists of direct and indirect expenditures used by organizations in the framework of financial and tax accounting. The fact that in spite of the introduction of the open list of direct expenditures in the tax legislation organizations should have sound reasons to classify expenditures as direct or indirect in the framework of financial and tax accounting is confirmed both by the RF Finance Ministry<sup>47</sup> and the Russian Federal Tax Service<sup>48</sup>.

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<sup>45</sup> As published on the web site of the RF Finance Ministry, [http://www1.minfin.ru/buh/pzinpa\\_prj.doc](http://www1.minfin.ru/buh/pzinpa_prj.doc).

<sup>46</sup> See, for instance, Khvorikov V. P. *Novyi zakon o bukhuchete nazhil vliyatelnykh protivnikov* (The new law on accounting has made influential adversaries). IA “Federalnoye agentstvo finansovoi informatsii.” November 27, 2006 ([http://www.lawlinks.ru/view\\_obzors.php?id=62529](http://www.lawlinks.ru/view_obzors.php?id=62529)), and *Nalogoviki ne khotyat lishatsya prava proverjat bukhgalterskuyu otchetnost* (Tax officials do not want to lose the right to audit accounts). “Glavbukh.” December 6, 2006 ([www.glavbukh.ru/news/4664](http://www.glavbukh.ru/news/4664), <http://www.nalogforum.ru/news.html?idnews=153>).

<sup>47</sup> “Procedures governing the inclusion of expenditures for production and sales carried out within the reporting (tax) period in the composition of expenditures as defined for taxation purposes should be set similarly to the procedures used by the organization for general accounting purposes” (letter of the RF Finance Ministry No. 03-03-04.1.176 of March 2, 2006).

<sup>48</sup> In the publication by Popova E. Yu., State Counsellor 1<sup>st</sup> rank, it is, among other things, stated the following: “The cases, where for the purposes of computation of the profit tax taxpayers include in

At the same time, it should be noted that these restrictions could be more efficient in the case the general (financial) accounting of Russian organizations properly performed its chief function serving as a source of information useful for taking reasonable economic decisions by users outside such organizations. In this case tax control could be supplemented by control on the part of interested users of financial statements; such mechanisms have been developed and are in place in foreign countries<sup>49</sup>.

Prior to 2002, when functions of financial and tax accounting were not significantly separated, regulation had been predominantly carried out via legislation on accounting. For instance, the document systemizing accounting policy requirements was the Regulations on accounting "Accounting policy of organizations" (RA 1/98)<sup>50</sup>.

These Regulations are the fundamental document regulating accounting at the level of organizations. Therefore, having no information on the accounting policy adopted by an organization it is impossible to fully and thoroughly analyze its reporting indicators. The same is true as concerns tax accounting.

At present, tax accounting is a separate sphere and is regulated by tax legislation; therefore it is necessary to systemize requirements to accounting policy for taxation purposes, moreover taking into account the fact that financial accounting can not substitute for tax accounting due to the differences in the organization, objectives and users of these two types of accounting.

### **Accounting policy for taxation purposes and issues of tax administration**

Introduction of the definition of accounting policy in the RF Tax Code is a measure aimed at the systematization of the conceptual framework of the Russian tax legislation and may be viewed as a prerequisite of systematization of accounting policy for taxation purposes *per se*. However, it is only the first step, since federal law No. 137 FZ of July 27, 2006, "On the introduction of amendments to Parts One and Two of the Tax Code of the Russian Federation and certain other legislative acts of the Russian Federation in connection with the implementation of measures aimed at the improvement of tax administration" has only defined accounting policy for taxation purposes leaving unresolved the issues arising in connection with the ambiguousness of provisions of the tax legislation concerning accounting policy.

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the composition of indirect expenditures the expenditures, which in fact are direct expenditures for the respective organizations and form self costs of production in the framework of financial accounting, are rather widespread. However, in such situations organizations should be ready to explain such formation of its direct expenditures." (see: Rossiyskiy nalogovyi kuryer. 2006. No. 9).

<sup>49</sup> For instance, in the USA it is permitted to use LIFO method for the computation of raw materials reserves in tax accounting only in the case this method is used by the company in the framework of its financial accounting (see Internal Revenue Code, § 472 (c)). In Germany, even in the cases where the tax legislation of this country provides for taxpayers a more favorable way to reflect certain items in the accounting, this provision can not be used in the framework of tax accounting if it is not used in financial accounting of the company. (see Tax Law Design and Drafting. IMF, 1998. P. 677).

<sup>50</sup> Approved by Order No. 60n of December 9, 1998, of the RF Finance Ministry.

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The ambiguousness of the respective provisions of the tax legislation results in the lack of system in requirements concerning organization of accounting policy for taxation purposes, its contents, the lack of conditions necessary to implement a consistent application of methods (means) of tax accounting, limited access of tax authorities to the information on accounting policies for taxation purposes pursued by organizations.

At present, provisions concerning accounting policy for taxation purposes are spread across different chapters of the RF Tax Code. For instance, the provision stipulating that procedures pertaining to tax accounting should be set in the framework of accounting policy for taxation purposes as approved by orders (instructions) issued by heads of organizations is contained in article 313 of the RF Tax Code (Chapter 25); the provisions setting the procedures governing the application of accounting policy for taxation purposes are determined by item 12 of article 167 of the RF Tax Code (Chapter 21), and so on.

On the one hand, this may be explained by the fact that taxpayers are permitted to employ alternative methods (means) for determination of indicators of their financial and economic activities with respect to different taxes, including the corporate profit tax and the value added tax. On the other hand, stipulations of the tax legislation concerning accounting policy for taxation purposes and contained in different chapters of the RF Tax Code often overlap or contradict each other.

For instance, item 12 of article 167 of the RF Tax Code stipulates that accounting policy for taxation purposes of a newly created organization should be approved during the first tax period. At the same time, in accordance with item 1 of article 163 of the RF Tax Code the tax period with respect to the value added tax is defined as a calendar month, whereas the tax period with respect to the corporate profit tax makes 1 year as per item 1 of article 285 of the RF Tax Code. Therefore, it remains unclear which tax period corresponding to which tax should be used to comply with the stipulations concerning approval of accounting policy for taxation purposes for a newly created organization. A similar problem arises in regard to changes made in accounting policy for taxation purposes on the initiative of the taxpayer – such changes should be also effected since the beginning of the new tax period (article 313 of the RF Tax Code).

Yet another aspect of the ambiguity problem concerning the provisions of the RF Tax Code dealing with accounting policy for taxation purposes is its completeness. In a general case, accounting policy for taxation purposes adopted by an organization may be deemed complete if it contains all the stipulations, for which the tax legislation allows alternative methods of accounting. It should be noted that the RF Tax Code contains a rather broad range of such provisions, and the problem is that some of these provisions (for instance, the provision concerning the reserves for future expenses related to vacation pay (item 1, article 324.1 of the RF Tax Code), the list of direct expenditures (item 1, article 318) and so on) have the direct references to the stipulation that organizations must reflect these provisions in their accounting policies for taxation purposes, whereas other provisions (for instance, the amortization premium (item 1.1, article 259), the procedures governing the de-

termination of the time of useful service of a fixed asset acquired as a contribution to the authorized (share) capital or under succession procedures (item 1.1, article 259) and so on) have no such references. At the same time, it remains unclear if the tax legislation is infringed on by an organization failing to set the method (means) of tax accounting it opted for and applied in its document concerning its accounting policy for taxation purposes taking into account the fact that the RF Tax Code does not envisage such an obligation and what sanctions may be used against such an organization.

At the same time, an analysis of court practices reveals that there are certain cases, where tax authorities interpret the lack of such stipulations in the accounting policies of organizations as the failure to apply the respective provisions in their tax accounting. For instance, court proceedings are initiated in the situations, where organizations, which are required to separately account for operations being or not being the subject of the value added tax by item 149 of the RF Tax Code fail to include the methods of separate accounting for such operations they develop and apply in the documents setting their accounting policies (it should be noted that the RF Tax Code does not require taxpayers to reflect the procedures governing the separate accounting for operations being or not being the subject of the value added tax exactly in the documents setting their accounting policies). As a result, organizations face additional charges as concerns taxes, penalties and tax sanctions stipulated by item 1 of article 122 of the RF Tax Code. The same situations are faced by the organizations engaged in the sales of goods subject to different rates of the value added tax<sup>51</sup>.

Investigations carried out in the course of these court proceedings revealed that the facts that taxpayers maintained separate accounting were confirmed both by the documents of organizations (other than orders setting their accounting policies, for instance the Guidelines for officers of the financial department "On the methods of separate accounting for taxation purposes" as in the framework of case No. F04-5288/2004 (A45-3291-25), and by accounting ledgers. As concerns case No. A56-13726/03, the tax authorities even did not challenge the fact that the taxpayer maintained separate accounting; however, the tax authorities state that the taxpayer wrongly requested VAT deduction with respect to purchased materials (works, services), which were used in the course of activities not subject to VAT taxation, only on that basis that these provisions were not reflected in the document setting accounting policy of the organization.

In spite of the fact that in all the cases discussed above courts took sides with taxpayers, in this way confirming that the fact that the absence of certain provisions in accounting policies of organizations did not mean that these organizations failed to implement these provisions in their practices, it is still uncertain that this issue is settled for good.

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<sup>51</sup> See, for instance, rulings No. F04-5288/2004 (A45-3291-25) of August 2, 2004, and No. F04/346-1399/A70-2003 of January 26, 2004, of the Federal Court of Arbitration of the West Siberian okrug, as well as ruling No. A56-13726/03 of May 13, 2004, of the Federal Court of Arbitration of the North West okrug.

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It should be noted that the RF Tax Code contains a rather long list of provisions, which should be reflected in accounting policies of organizations in order to avoid such negative consequences as court proceedings or more thorough tax inspections.

Therefore, while determining the completeness of their accounting policies for taxation purposes organizations have to be guided rather by growing risks of court proceedings than requirements set by the tax legislation due to their ambiguity.

The fact that the Russian tax legislation lacks uniform requirements with respect to accounting policy for taxation purposes results not only in the ambiguity of certain provisions of the RF Tax Code, but also in the inclusion in the Tax Code of certain provisions contradicting the stipulations already in force due to fact that principal terms of tax accounting are not clearly defined. As an example, there can be cited the situation regarding the stipulation contained in sub-item 1, item 1 of article 264, in accordance with which other expenditures borne by organizations in relation to production and sales should include the amounts of taxes, fees, and customs duties and fees charged under the established procedures.

This stipulation was effected by federal law No. 58-FZ of June 6, 2005, "On the introduction of amendments to Part Two of the Tax Code of the Russian Federation and certain other acts of tax and levy legislation of the Russian Federation" and contradicts the RF Tax Code stipulations concerning the formation of costs of acquisition of fixed assets (see item 1 of article 257 of the RF Tax Code) and inventories (see item 2 of article 254 of the RF Tax Code), in accordance with which customs duties, fees, and other expenditures related to the acquisition of assets form their costs.

However, in its letter No. 03-03-04/1/130 of February 20, 2006, the RF Finance Ministry referring to item 4 of article 252 of the RF Tax Code, in accordance with which the taxpayer is granted the right to independently determine the group, in which expenditures should be included, in the case such expenditures may be at the same time and on equal grounds classified in several groups, states that the use of this provision should be determined in the framework of accounting policy for taxation purposes.

Yet another example illustrating the ambiguity of the set of terms used in the framework of tax legislation is the interpretation of the term "long technological cycle." While the RF Tax Code defines long technological cycle as a cycle taking more than one tax period (see paragraph 2 of item 2 of article 271), at the same time in accordance with letter of the RF Tax Ministry No. 02-5-10/54 of September 15, 2004, "for the purposes of calculation of the profit tax, long cycle production should be defined as production, which starting and completion dates are in different tax periods notwithstanding the number of days the completion of production requires."

Gaps in the tax legislation as concerns tax accounting and accounting policy for taxation purposes are often closed by letters issued by the financial or tax authorities. Perhaps, this procedure could be viewed as suitable; however, as the

practice demonstrates a large number of different stipulations requiring interpretation results in the fact that published explanations often lack system.

It appears that in the case all necessary stipulations were directly set in laws (or a single document) there could have been much less such situations.

The ambiguity of requirements set in the tax legislation not only makes it more difficult to comply with it on the part of taxpayers, but also creates difficulties as concerns the work of the tax authorities. For instance, the fact that there are practically no restrictions with respect to the choice of different methods (means) of tax accounting across periods facilitates an increase in the possibilities for tax planning and tax evasion.

In the Russian practice, there is enunciated the principle of consistent application of stipulations and rules of tax accounting (see article 313 of the RF Tax Code); however, there are no conditions to implement this principle, since the legislation lacks clear procedures governing changes in the methods of tax accounting as concerns respective events and operations.

At present, article 313 of the RF Tax Code stipulates that accounting policy for taxation purposes may be adjusted in the case of changes in the legislation concerning taxes and fees or applied accounting methods. The latter means that the taxpayer has the right to introduce changes in the accounting policy for taxation purposes on the taxpayer's initiative. However, it remains unclear what rules organizations should use with respect to changes in the methods of tax accounting they apply.

It should be noted that certain criteria are set by the Regulations on accounting "Accounting policy of organizations" (RA 1/98); however, this document does not regulate tax accounting.

In accordance with item 16 of the Regulations, accounting policy may be changed, for instance, in the case the organization develops new means of book-keeping. At the same time, it is stressed that the use of any new method should result in a more reliable presentation of facts of economic activities in accounting and reporting of organizations, or a less labor intensive accounting process without deterioration of reliability of information. Besides, in accordance with the RA 1/98 accounting policy may be changed in the case of a significant changes occurring in the activities of the organization, i.e. reorganization, change of owners, change of the type of activities, and so on. In accordance with item 17 of the Regulations, any changes in accounting policy should be justified.

It appears that in the framework of tax accounting there can be also developed and set the respective criteria ensuring the justification of changes in the methods (means) of tax accounting of events and operations. In this case, the adaptation of practices accumulated in the sphere of financial accounting will play a positive role.

The Russian Tax Code provides the taxpayer with the option to change accounting policy for taxation purposes (as concerns the tax on corporate profits) on the taxpayer's own initiative no more than once a year. However, there is an exception: the procedures governing the distribution of direct expenditures (formation of

costs of work in progress) (see item 1 of article 319) and the procedures governing the formation of costs of acquisition of goods (see article 320 of the RF Tax Code) may be changed no more frequently than once in two years.

As it has been already noted above, frequent or unjustified change of methods of tax accounting, as well as the failures to comply with the limits of reporting or tax periods may result in distortion of amounts of tax liabilities, since in this case organizations face more complicated tax accounting procedures and it becomes more difficult for tax authorities to carry out inspections. In this context, it is of interest to analyze the practices adopted in the USA as concerns the imposition of restrictions on the use of different methods (means) of tax accounting.

In the USA, the organization taking decision to change the method of tax accounting with respect to a certain item should fill in a special form<sup>52</sup>, in certain cases supplementing it with additional documents clarifying both the used and planned to be used methods of accounting. At the same time, there are envisaged two different procedures for obtaining of approval of tax authorities:

1. Automatic accounting method change, which suits the majority of taxpayers<sup>53</sup> and does not envisage confirmation on the part of the respective tax authority; however, it does not mean that submitted documents remain without examination, and
2. A procedure envisaging a thorough examination of the organization's documents and a written approval of the respective tax authority. For instance, the taxpayers, whose documents are already submitted to the tax authorities (including the cases where requested changes in tax accounting methods concern the periods subject to tax inspection), as well as the taxpayers, who have already made a change in the same method of accounting (including under the automatic accounting method change procedures), or applied to change the same method of accounting without effecting the change within the last tax 5 years<sup>54</sup>, are not eligible for the automatic accounting method change.

The taxpayers not eligible for the automatic accounting method change may be refused the approval of change in accounting method in the case the tax authorities decide that the currently used method clearly reflects received income and after weighing the need for consistency in reporting against the request for change will find the change as unfeasible<sup>55</sup>.

As concerns the imposition of restrictions on the possibility to change the methods (means) of tax accounting used by the organization, it is necessary to distinguish between changes in accounting policy for taxation purposes and its expansion.

The RF Tax Code (article 313) stipulates that the taxpayer should determine and reflect in accounting policy for taxation purposes the principles and procedures of accounting with respect to new types of activities in the case the organiza-

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<sup>52</sup> See <http://www.irs.gov/pub/irs-pdf/f3115.pdf>.

<sup>53</sup> IRS Publication 538. Accounting Periods and Methods. P. 29.

<sup>54</sup> See *ibid.*

<sup>55</sup> See *ibid.* P. 28.

tions has engaged in such activities. At the same time, in the framework of RA 1/98 the approval of an accounting method with respect to the facts of economic activities different in nature from the facts taking place earlier or originating for the first time in the organization's activities is not deemed as a change in accounting policy (see item 16).

Therefore, changes in accounting policy differs from its expansion; however, no clear boundary is set by either the RF Tax Code, or RA 1/98, since in the framework of the latter document it remains unclear what is the exact difference between changes in types of activities of the organization and the new types of activities, if there is any at all.

In the situation, where one or another provision in the accounting policy for taxation purposes pursued by the organization is lacking, while the organization uses it in its tax accounting practices becomes a cause for court proceedings or a tax inspection, whereas the tax legislation does not contain any requirement for reflection of this provision exactly in the accounting policy, the taxpayer should be granted the right to supplement the accounting policy with the respective provision in the middle of a tax period (after the completion of inspection). This opportunity may be granted in the case the taxpayer has found out that the document lacks the necessary provisions (including those required by the tax legislation).

At the same time, it should be noted that the document should be supplemented exactly with the methods already used by the taxpayer in practice in order to prevent a change in the method in the middle of the tax period, since the change in accounting methods transgressing the limits of periods may result in a (unintended or intended) distortion of tax liabilities due to nontransparent transitional provisions.

At present, the RF Tax Code fails to provide an answer to the question if it is possible to introduce additions to accounting policy for taxation purposes in the middle of a tax period, for instance, in the case that the organization engages in a new type of activity not in the beginning of the year; it should be noted that the absence of respective provisions in the document setting the accounting policy of the organization means that it infringes on the stipulations contained in article 313 of the RF Tax Code. The RF Tax Code also fails to provide an answer to the question from what exact time the organization has to comply with this stipulation, in other words, what time it has to develop the provisions of its accounting policy for taxation purposes answering the respective new types of activities.

Besides, the tax legislation currently in force does not settle the issue concerning the informing of the tax authorities about the accounting policy for taxation purposes adopted by the organization and changes therein, what, similarly to the lack of transparent procedures governing the changes in the methods (means) of tax accounting, creates additional difficulties with respect to tax administration.

The RF Tax Code stipulates that the taxpayer should provide tax authorities and tax officers (in the cases envisaged by the RF Tax Code) with the documents necessary for the calculation and payment of taxes (see sub-item 5, item 1, article 23 of the RF Tax Code). For instance, among the documents required for the calcu-

lation and payment of taxes there may be named tax returns, as well as the organization's accounting policy for taxation purposes, since the use of certain methods (means) of tax accounting affects the amount of tax liabilities in a given period.

At the same time, the fact that the taxpayer should submit tax returns is reflected in the RF Tax Code (see item 5 of article 174 of the RF Tax Code as concerns the value added tax, item 1 of article 289 as concerns the corporate profit tax, and so on), whereas there is no direct indication that the taxpayer should submit the document (instructions) on accounting policy for taxation purposes to the tax authorities.

Perhaps, legislators proceeded from the assumption that accounting policy for taxation purposes must be among the documents to be submitted by the taxpayer to the tax authorities in accordance with the stipulations contained in subitem 5 of item 1 of article 23 of the RF Tax Code. However, the clause "in the cases envisaged by this Code" contained in this provision is an evidence that this stipulation should be concretized by other provisions of the RF Tax Code, whereas no other provision of the Code sets such a stipulation.

Therefore, formally the taxpayer is not obliged to inform the tax authorities about the accounting policy for taxation purposes adopted by the taxpayer.

As concerns foreign practices, as a rule, the data on tax accounting methods used by the organization are integrated in the forms of tax returns<sup>56</sup>, what permits to settle the issue of informing of the tax authorities.

The forms of tax returns used in Russia, in particular those regarding the value added tax<sup>57</sup> and the tax on corporate profits<sup>58</sup> contain practically no information on the accounting policies for taxation purposes applied by the taxpayers submitting these forms. At the same time, it should be noted that the forms of tax returns are filled in under different procedures depending on the methods (means) of tax accounting adopted by the reporting organizations<sup>59</sup>.

Besides, certain data pertaining to the accounting policy for taxation purposes are presented in the framework of tax returns submitted by foreign organizations reporting on their profit tax<sup>60</sup>. In particular, there is indicated the information on the adopted methods of recognition of earnings, evaluation of reserves, assessment of purchased goods, and amortization.

It should be noted that the issue of informing of the tax authorities about changes in the organization's accounting policy for taxation purposes can not be in all cases settled with the use of tax returns forms.

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<sup>56</sup> See, for instance, the forms of US corporation income tax returns (<http://www.irs.gov/pub/irs-pdf/f1120.pdf>) and depreciation and amortization declarations (<http://www.irs.gov/pub/irs-pdf/f4562.pdf>).

<sup>57</sup> See attachments to Order of the RF Finance Ministry No. 163n of December 28, 2005.

<sup>58</sup> See Attachment No. 1 to Order of the RF Finance Ministry No. 24n of February 7, 2006.

<sup>59</sup> See, for instance, the Procedures governing the filling in of tax returns concerning the corporate profit tax (Attachment No. 2 to Order of the RF Finance Ministry No. 24n of February 7, 2006).

<sup>60</sup> See the form of the tax return with respect to the profit tax on foreign companies (as approved by Order of the RF Tax Ministry No. BG-3-23/1 of January 5, 2004).

At present, the RF Tax Code contains a number of provisions envisaging that taxpayers should develop methods of tax accounting with respect to certain items on their own, for instance, this list includes some direct and indirect expenditures, the procedures governing evaluation of work in progress, the methods of separate accounting for sales operations subject and not subject to the value added tax, as well as the operations subject to the value added tax at zero rate. It is impossible not only to unify these methods with the view to reduce possibilities of tax planning, but also to formalize them in order to provide the taxpayer with the choice of a limited number of options.

In practice there were observed situations, where the tax authorities rejected tax returns if organizations failed to submit their documents concerning accounting policies for taxation purposes<sup>61</sup>. This requirement may result both from the fact that tax authorities need respective information, and the ingress of financial accounting provisions into the sphere of tax accounting.

In accordance with item 15 of the Regulations on accounting "Accounting policy of organizations" (RA 1/98), the important methods of accounting should be disclosed in the explanatory notes being a part of financial accounting statement for the reporting year. It should be noted that financial accounting documents should be submitted to the tax authorities on the compulsory basis similarly to the tax accounting statements; however, in contradistinction to the latter, the former should be supplemented by the disclosure of information on the accounting policy adopted by the respective organization.

Indeed, tax authorities need information on the methods (means) of tax accounting for events and operations used by the taxpayer in order to proceed tax returns; without such information it would be difficult to properly check the contents of tax returns. Naturally, in accordance with article 93 of the RF Tax Code the tax authorities have the right to demand the taxpayer to present necessary documents in the course of a tax inspection. At the same time, this unnecessary and complicated procedure (the documents should be provided within 5 days) may be avoided, if tax returns were supplemented with the data on the accounting policy for taxation purposes.

The problem of informing of the tax authorities is encountered also in the case organization changes its policy for taxation purposes; both in the case this change is initiated by the taxpayer, and in the case of changes in the legislation on taxes and levies.

The RF Tax Code does not envisage any mechanism for informing the tax authorities about changes introduced in accounting policies. This issue is partially settled in the case the tax authorities receive information on accounting policy for taxation purposes on a regular basis, for instance, by rejecting tax returns not supplemented with the respective document. However, even in this case the tax authorities will have to do extra work comparing the previous and new versions of the document (instruction) on the organization's accounting policy for taxation purposes.

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<sup>61</sup> See <http://www.klerk.ru/articles/?57127>.

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This problem may be avoided in the case the forms of tax returns envisage certain fields for the data pertaining to the changes in accounting policy (the introduction of such fields will make more easy to obtain information on changes in the methods (means) of tax accounting if alternative variants are listed in the RF Tax Code), or there are introduced special forms informing the tax authorities about the changes in accounting methods developed by taxpayers on their own in accordance with the legislation (for instance, as concerns changes in the procedure governing the determination of amounts of the value added tax with respect to items subject to the value added tax at the zero rate)<sup>62</sup>.

As concerns changes in accounting policy for taxation purposes resulting from changes in the legislation on taxes and levies, it would be logical if the procedures governing the informing of the tax authorities in each case were also established in a document introducing changes and additions to the legislation.

## Conclusions

The introduction of the definition of the “accounting policy for taxation purposes” in the RF Tax Code creates prerequisites for the independency of the legislative framework pertaining to the regulation of tax accounting and facilitates the development of a conceptual framework of the Russian tax legislation.

Besides, the fact that the accounting policy was defined in the tax legislation may result in the beginning of the so necessary process of systematization of requirements concerning accounting policy; this process may facilitate the settlement of the issues pertaining to the substance and status of the accounting policy for taxation purposes, as well as the introduction of changes in and additions to this policy and provision of the respective information to the tax authorities, which remain at present unsettled in the framework of the legislation currently in force.

The lack of system in the sphere of accounting policy for taxation purposes results in higher expenses borne by taxpayers with respect to compliance with the tax legislation and, accordingly, in a lower degree of compliance therewith and greater difficulties faced by the tax authorities as concerns their work.

It appears that it is necessary to systematize requirements pertaining to organizations’ accounting policies for taxation purposes in a single document.

As the definition of “accounting policy for taxation purposes” was introduced in the list of institutions, definitions and terms used in the RF Tax Code, there was made the first step towards the systematization of its legislative regulation. Further, it would be feasible to add to item 2 of article 11 of the RF Tax Code a fundamental principle, in accordance with which the organization’s accounting policy for taxation purposes should contain all the provisions, where the RF tax legislation permits use of different accounting methods and which take place in the financial and economic activities of this organization. This development will permit to avoid the introduction of numerous amendments to the RF Tax Code’s articles indicating alternative options as concerns the reflection of items in the tax accounting.

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<sup>62</sup> The responsibility for reflecting this procedure in accounting policy for taxation purposes is set by item 10 of article 165 of the RF Tax Code.

In order to introduce systemic requirements to organizations' accounting policies more efficiently, it would be feasible to develop and publish methodological guidelines clarifying the options organizations have as concerns the choice of a method (means) of accounting for certain facts of financial and economic activities, as well as the procedures governing the reflection of this choice in accounting policies for taxation purposes. The development of a unified document will permit to reveal inconsistencies in the regulatory framework in this sphere and remove them.

In the case the systemic requirements to the substance of accounting policy for taxation purposes are in place, it will be possible to make taxpayers responsible for incompliance.

Both the tax and financial accounting should be based on the principles enabling them to function efficiently. For instance, the choice of accounting methods with respect to certain items from the list set by the tax legislation should be limited by considerations of justification and consistency of application thereof as concerns the sphere of enforcement.

Reasonable restrictions with respect to the frequency of changes in the methods (means) of tax accounting are an efficient barrier for tax planning and tax evasion based on the changes in accounting methods.

At the same time, changes in accounting policy for taxation purposes (i.e. modification of accounting methods) should be discerned from additions thereto. Additions to the accounting policy should be defined as new provisions introduced in the document, which do not affect the already adopted accounting methods. Primarily, this concerns new types of activities organizations engage in<sup>63</sup> and provisions already used by taxpayers in practice (as confirmed by other internal documents or tax accounting ledgers), but not yet reflected in taxpayers' accounting policies for taxation purposes. The latter will be especially important in the transition period in the case the decision on systematization of requirements to accounting policy for taxation purposes is carried out after all.

At the same time, it is planned to permit to introduce additions in the document (instructions) on accounting policy for taxation purposes, including the option to introduce such additions within a tax period.

It also appears feasible to introduce special fields in the forms of tax returns in order to reflect main methods (means) of tax accounting with respect to certain items, the list of which should be clearly defined by the tax legislation. It will permit to settle the issue of informing of the tax authorities in the case the method of tax accounting for certain items is changed under a procedure not requiring the approval on the part of tax authorities.

At the same time, in the case all alternative methods are not reflected in the RF Tax Code, it is impossible to inform the tax authorities about the methods of tax accounting adopted by an organization in the framework of tax returns forms. In

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<sup>63</sup> It should be noted that the introduction of new provisions concerning the new types of activities, in which the organization engages, in its accounting policy for taxation purposes, can affect the methods of tax accounting for events and operations already adopted by the organization (for instance, in the case the new type of activities requires separate bookkeeping).

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this case there may be recommended a procedure, under which the organization immediately informs the tax authorities on the changes in its methods after they are approved by the head of this organization (by presenting the document setting its accounting policy for taxation purposes) and later attaches the respective document to its tax returns only in the cases where changes are introduced in the tax accounting methods, the alternative variants of which are not clearly defined in the RF Tax Code. It appears that the complete list of such situations should be set in a unified document systemizing the requirements to accounting policy for taxation purposes.

## Section 3. The Real Sector

### 3.1. Macrostructure of Production

#### 3.1.1. Trends and Factors of Changes in Final Demand

##### Influence of Domestic and External Demand on the GDP Dynamics and Structure

The characteristic feature of 2006 was economic growth rates acceleration accompanied by the positive effect of external economic conditions and domestic social and political stability. The increase in business activity was based on the anticipating growth of investments as compared with the dynamics of final consumption and had the most considerable impact on the nature of structural shifts of the produced and used GDP. While in 2006 GDP increased by 6.7%, the real final consumption of households increased by 10.7% and investments in the fixed assets – by 13.5% (*Table 1*).

*Table 1*

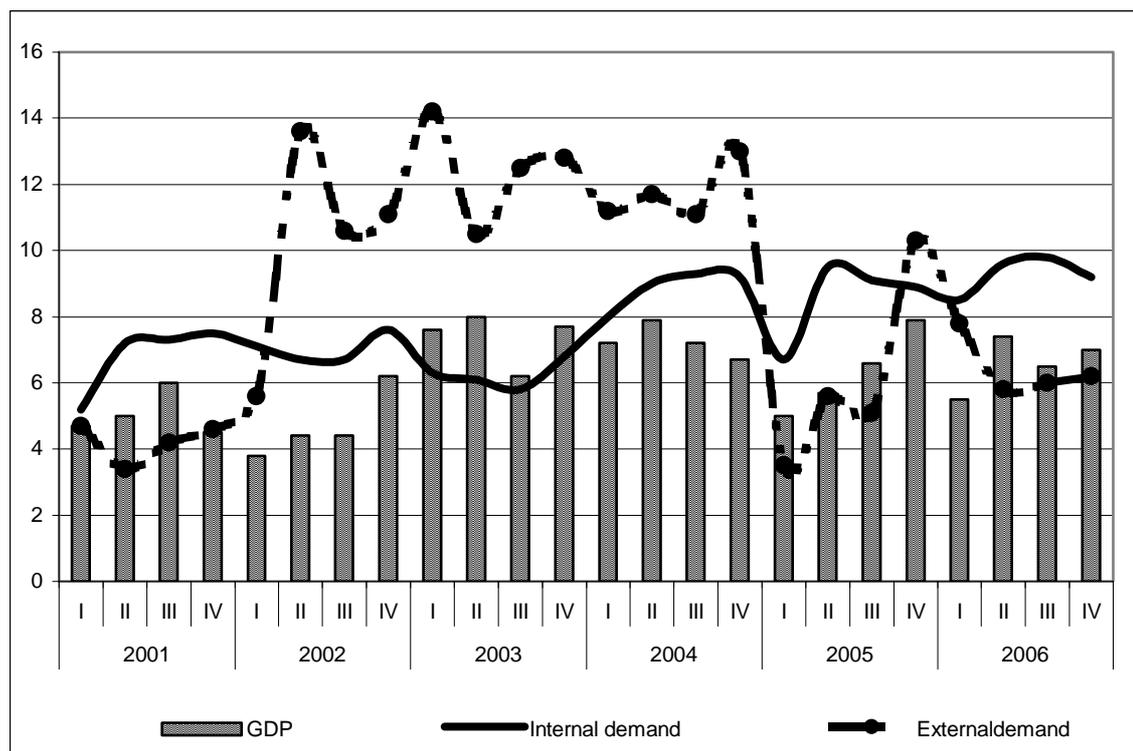
#### Indices of the Basic Macroeconomic Indicators in 1999–2006, as percentage to the previous year

	1999	2000	2001	2002	2003	2004	2005	2006*
Gross domestic product	106.4	110.0	105.1	104.7	107.3	107.2	106.4	106.7
Real households' final consumption	97.1	107.3	109.5	108.5	107.6	112.1	112.7	110.7
Investments in fixed assets	105.3	117.4	110.0	102.8	112.5	111.7	110.7	113.5
Volume of industrial production	111.0	108.7	102.9	103.1	108.9	108.3	104.0	103.9
Agricultural production	104.1	107.7	107.5	101.7	101.3	103.0	102.4	102.8
Freight turnover	105.8	105.0	103.2	105.8	108.0	106.5	102.7	102.2
Amount of communication services	133.1	113.8	119.1	115.6	127.5	129.0	115.7	123.7
Retail trade turnover	93.9	109.0	111.0	109.3	108.8	113.3	112.8	113.0
Paid services for the population	107.0	104.7	101.6	103.7	106.6	108.4	107.5	108.1
Foreign trade turnover	86.7	130.2	103.8	108.1	126.0	132.4	131.5	127.0
Real disposable cash income	87.7	112.0	108.7	111.1	115.0	110.4	111.1	110.0
Real wages	78.0	120.9	119.9	116.2	110.9	110.6	112.6	113.5
Real scale of granted pensions	60.6	128.0	121.4	116.3	104.5	105.5	109.6	105.1
Average annual number of those employed in the economy	100.6	100.3	100.7	100.9	100.6	100.6	100.6	100.4
Number of officially registered unemployed	102.1	77.0	89.1	99.7	94.9	102.8	90.6	95.6

\* Preliminary data

Source: Federal State Statistics Service

The simultaneous expansion of both external and internal markets was the factor of the steady economic development in recent years. Whereas the dynamics of the external demand was formed under the influence of the favorable situation at the world market of fuel and raw materials, the expansion of the domestic market was determined by cumulative influence of business activity growth factors and regular growth in population effective demand.



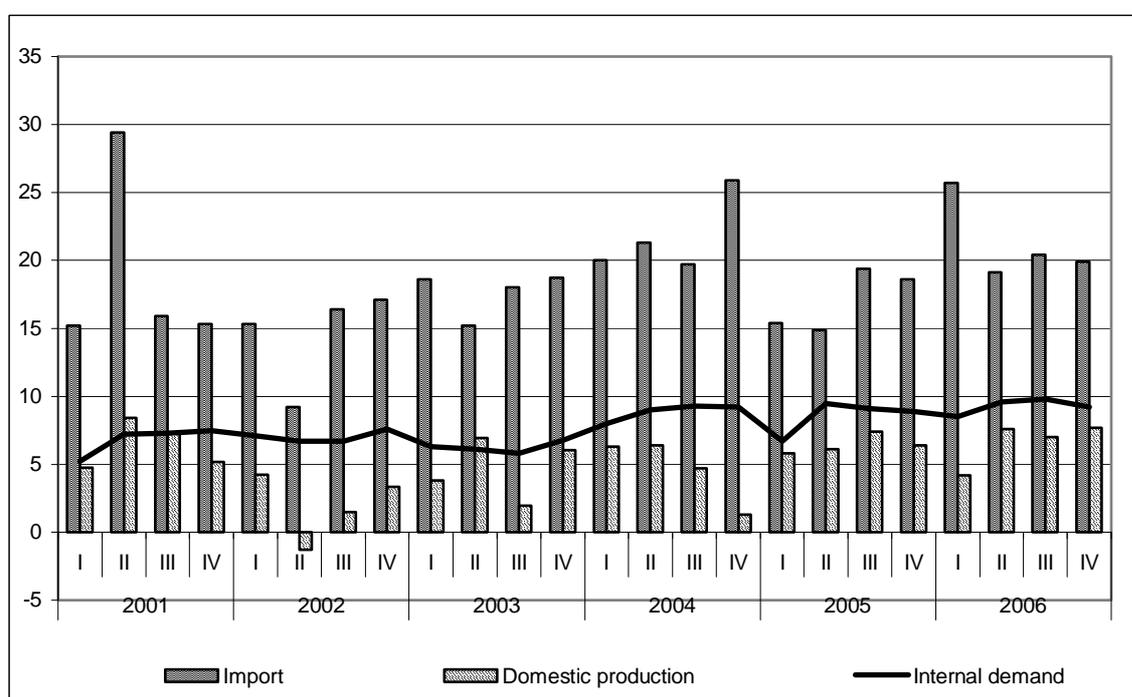
Source: Federal State Statistics Service

Fig. 1. Growth Rates of Internal and External Demand over 2001–2006, as percentage to the respective quarter of the preceding year

The ratio of internal and external demand over 2001-2006 has suffered considerable changes (Fig. 1). In 2003-2006 a gradual improvement in the conditions of trade between Russia and foreign countries was observed due to the anticipating growth of prices for export goods as well as the demand expansion for the main Russian items of export. However in extremely favorable economic situation export growth rates deceleration in terms of physical volume has been observed since quarter IV, 2003, and it is from this period that a gradual increase of internal demand influence on the dynamics of the economy development was observed. In 2005–2006 the slowdown of external demand growth rates proceeded in a more acute form and was provoked by dull dynamics of the physical volumes of oil and oil products export. In 2005-2006 the increase in external demand was on average equal to 6.7% against 12.1% in 2003-2004.

The combined influence of internal factors that control the level of business activity turned out to be sufficient to compensate the ebbing of external demand influence on the economic development rates. In 2006 the increase in internal demand reached 10.0% against 9.1% in 2005 and 7.7% in 2003. The contribution of internal demand into the growth of the GDP in 2006 was estimated to be nearly 78%, exceeding considerably the figure of the so far most successful 2000. The positive dynamics of the internal demand was determined both by the extension of internal production output and the expansion of import scale.

The sustention of population consumption level accounted for the consumer goods import rates acceleration, and together with the long-standing trend for anticipating investments growth as compared with the dynamics of the domestic machine-building production output – for machinery and equipment import. The analysis of the GDP dynamics by the components of final consumption demonstrates that estimated import growth in 2006 was 20.3% against 17.0% in 2002 and minimum over the period economic index of 14.6% in 2002. The formation of this trend was sustained by the growing business incomes from the foreign economic activity and the increase in import efficiency against the background of the gradual ruble appreciation.



Source: Federal State Statistics Service

Fig. 2. The Change in Import Growth Rates and Domestic Goods Production over 2001–2006, as percentage to the respective quarter of the preceding year

In 2005-2006 along with the domestic production rates acceleration the change in the structure of sources of internal demand reserves formation. The differentiation of goods market with respect to demand for import share has increased in the total resources of domestic market.

It was the intensive growth of the physical volumes of export of capital goods and the reserved growth rates of intermediate goods import that had the prevailing impact on import structure in 2006. Machinery and equipment import share in the total amount of import increased up to 48.1% in 2006 as compared with 44.0% in 2005 and 41.2% in 2004. In the structure of the retail trade turnover the share of consumer's goods went up from 40% in 2000 to on average 45% in 2005-2006. In 2006 in view of the trend for growth rates in consumer industries slowing down,

which was initiated by the permanent crisis in the textile, clothing and footwear production, the share of the domestic goods in the resources of retail trade of the non-food market decreased down to 44.3% against 45.7% in 2005 and 51.6% in 2000. The dynamics of food import was restrained by quite strong competitive positions of Russian producers and the share of the import in the amount of goods resources of foodstuffs was stabilized at the level of 34% over 2002–2006.

### The Dynamics and the Share of Gross Saving and Gross Accumulation in GDP

It is demonstrated by comparative by-factor analysis of GDP that it was the investment sphere that reacted most acutely on the changes in the amount and the dynamics of export earnings. Over 2003–2006 growing economy revenues from the foreign trade have obviously stimulated business activity. In 2006 GDP growth rates were equal to 6.7%, investments in fixed assets growth rates were 13.5%, the corresponding figures for 2001-2005 being on average, respectively, 6.3 and 9.0%. Favorable combination of the domestic business activity factors and price situation at the world market of raw materials accounted for the intensive increase of gross saving scales.

In past 7 years the share of gross saving was in the range 31.1-38.7% of GDP as compared with 24.0% in the pre-crisis 1997. In 2006 under the influence of, on one hand, the growing economy revenues from the export and, on the other hand, the decrease in household expenditures gross national saving was equal to 33.4%, which corresponds to the average figure over 2001-2005. Export revenues increasing and investment and credit attractiveness growing, strategic financial resources of the state were increasing. Since 1 January 2004 Stabilization Fund has started to operate in order to decrease the risks, connected with unfavorable external economic situation and as a tool to sterilize excessive money supply due to additional budget incomes from high oil prices.

As of 01.01.2007 the total volume of Stabilization fund was equal to RUR 2346.9 bln. against RUR 1237 bln. as of the corresponding date for 2006 and RUR 522.3 bln. – for 2005.

In 2005 RUR 677.8 bln. from the Stabilization fund were allocated for the following aims:

- to repay the debt for the International Monetary Fund RUR 93.5 bln.;
- to repay the debt to the Paris Club member countries - RUR 430.1 bln.;
- to repay the debt to the Bank for Foreign Economic Affairs for the credits provided to the Ministry of Finance in 1998–1999 to repay and service the foreign debt of the Russian Federation – RUR 123.8 bln.;
- to compensate for the deficit in the Pension Fund of the Russian Federation – RUR 30 bln.

The formation of the Stabilization Fund in the environment of the steady economic growth was one of the reasons for awarding Russia international investment rating as well as for making the decisions on the possibility of accumulated export incomes utilization for investment goals.

Decree of the Government from 25 November 2005 “On the investment fund of the Russian Federation” determined the procedure of maximum volume of the Investment fund formation as (1) the margin between the Federal Budget income, forming the Stabilisation Fund and calculated using the basic price for the crude oil grade Urals and the basic price of crude oil grade Urals decreased by 1 USD per 1 barrel; and (2) forecasted reduction of expenditures for national external debt of the Russian Federation in case of its early repayment. The annual volume of Investment Fund for each year of planning period should not be less than budget commitment for investment projects fulfillment in the corresponding planning period.

In 2006 the means of the Stabilization Fund in amount of RUR 600 bln. were used for early repayment of the debt to the Paris Club. The total saving from the early repayment of the debt will be USD 7.7 bln, including USD 1.2 bln in 2007. These funds have been transferred from the issue of “interest rates expenditures” to “investments”, the volume of the Investment fund having thus increased up to RUR 110 bln against allocated from the 2006 budget RUR 69.7

However, in spite of the increasing volume of the gross national saving, the analysis of operations with assets accounts illustrates the sustention of disproportion in the gross saving, gross accumulation resources and investments in the fixed assets in the environment of the gradually weakening loads of capital transfer operations “with the rest of the world” on the economy. The share of the investments in the fixed assets in 2006 was equal to 16.8% of the GDP, the average level in 2001-2005 being 16.5%. (*Table 2*).

*Table 2*

**Structure of the GDP Use for Gross Saving and Gross Accumulation  
over 2000–2006 as % to the total**

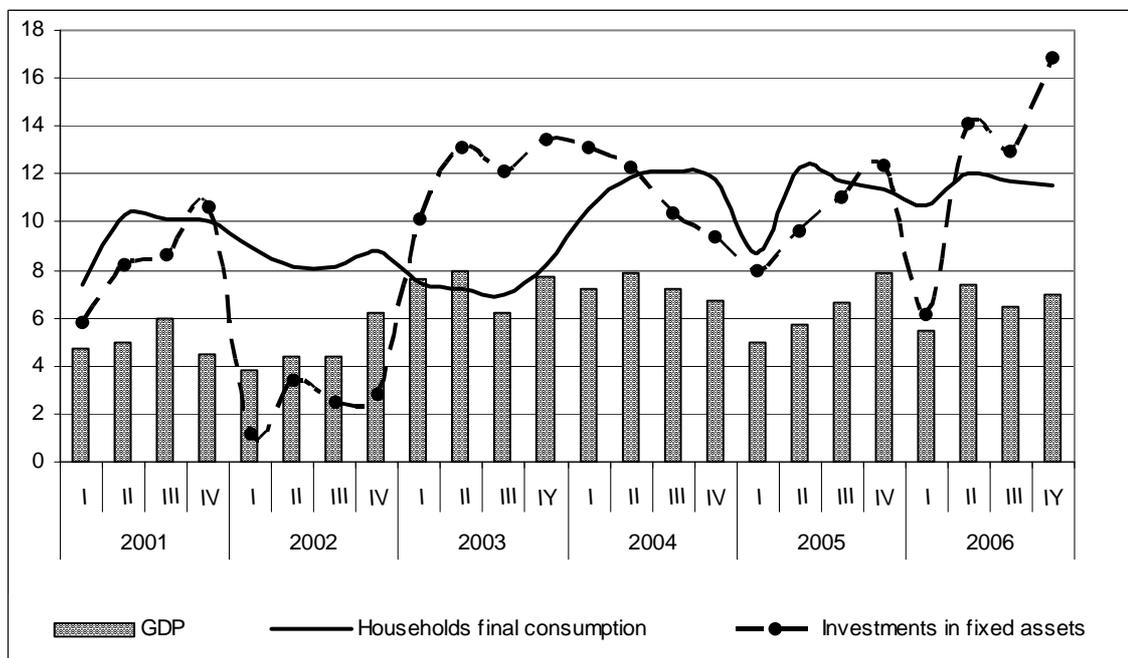
	2000	2001	2002	2003	2004	2005	2006*
GDP	100	100	100	100	100	100	100
including:							
gross saving	38.7	34.2	31.1	31.9	33.1	33.6	33.4
of which:							
Gross accumulation	18.7	21.9	20.1	20.8	20.9	20.1	20.3
Gross accumulation of fixed assets	16.9	18.9	17.9	18.4	18.4	17.8	18.0
Change in material circulation funds	1.8	3.1	2.1	2.4	2.5	2.3	2.3
For reference:							
The share of the investments in the fixed assets in the GDP	15.9	16.8	16.3	16.5	16.5	16.4	16.8

\* Preliminary data

Source: Federal State Statistics Service

As it was demonstrate by the past years experience, it is the very ratio of investment demand and final consumption that reacted most acutely on the fluctuations of export revenues and determined the characteristic features of domestic market operation. Sharp fluctuations of investment expenditures for fixed assets reproduction were compensated chiefly by the smooth change in the dynamics of the final consumption. At the same time it should be taken into consideration that

starting with the second half of 2005 a gradual restoration of investment constituent influence on the dynamics of the economy growth has been observed (Fig. 3).



Source: Federal State Statistics Service

Fig. 3. The Change in the GDP Dynamics by the Components of the Final Consumption in 2001–2006, as percentage to the corresponding quarter of the preceding year

### Households Final Consumption and the Change in Population Standard of Living Parameters

The positive dynamics of final consumption was one of the key factors in domestic market development throughout 2001–2006 – real population incomes, real wages and real scale of granted pensions started to grow steadily. The increase in final consumption scale proceeded in the environment of relatively stable preservation of the ratio between households' consumption and the amount of social transfers, received from the governmental institutions and non-commercial organizations. In 2006 the share of expenses for final consumption in the structure of GDP was equal to 66.6% which is in line with the average figure for the last two years.

Table 3

**Structure of Gross Domestic Product Use over 1998–2004,  
as percentage to the total**

	2001	2002	2003	2004	2005	2006*
Gross domestic product	100	100	100,0	100	100	100
including:						
Expenditures for final consumption	65.8	68.9	68.1	66.9	66.4	66.6
of which:						
Households	48.3	50.0	49.4	49.3	49.2	48.4
Governmental institutions	16.4	17.7	17.6	16.7	16.6	17.3
Gross accumulation	21.9	20.1	20.8	20.9	20.1	20.3
Net export of goods and services	12.7	10.8	11.3	12.2	13.6	12.7

\* Preliminary data.

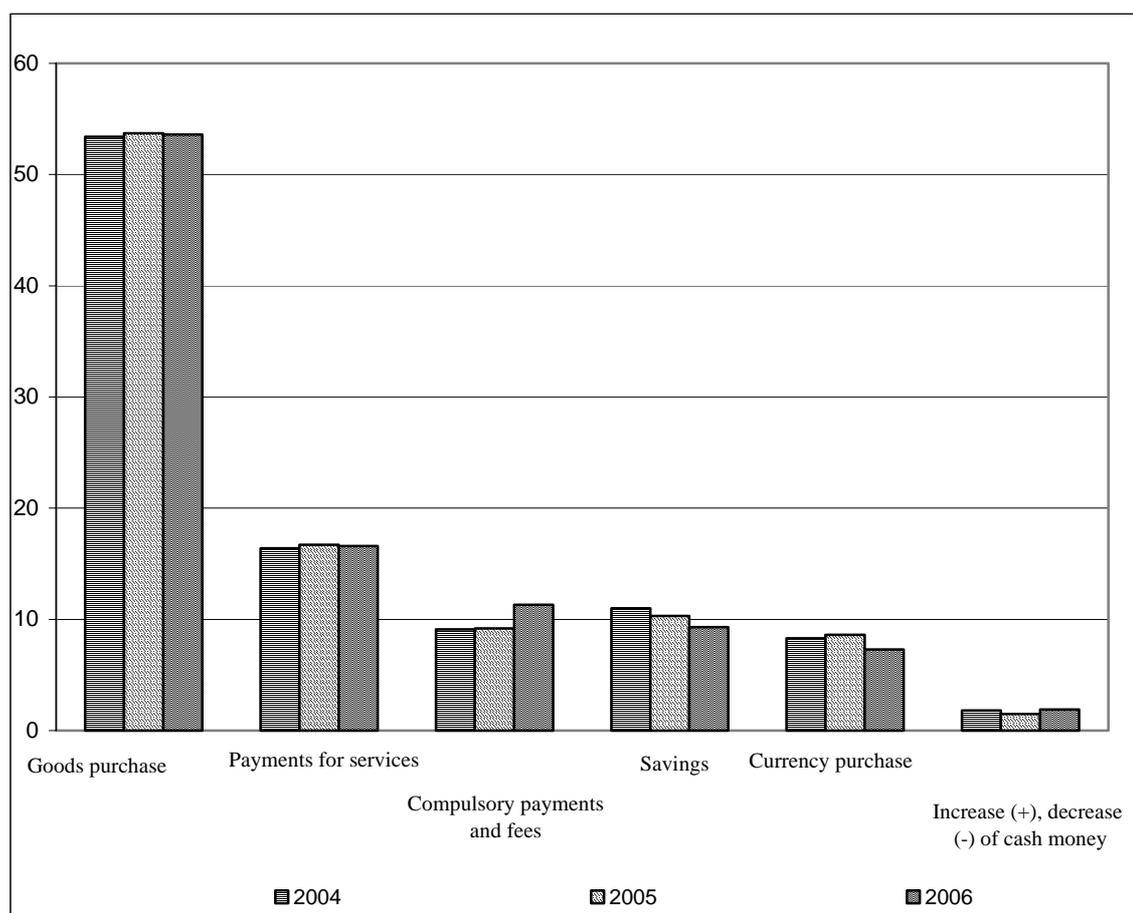
Source: Federal State Statistics Service

In 2000 households final consumption reestablished at the pre-crisis level of 1997 and during the next 6 years it increased by 78.6%. Increase in households consumption volumes was secured by steady population cash income growth. Over 2001-2006 the population real incomes increased by 1.88 times, real wages – by 2.18 times real scale of granted pensions – by 1.48 times. It is the anticipating growth of the wages as compared with other sources of income that had the prevailing influence on the population income dynamics. In 2006 the increase in real population incomes was equal to 11.0% against 11.1% in 2005, of real wages – 13.5% against 12.6% and the real scale of granted pensions – 13.5% against 9.6%. Population incomes increasing, the steady decrease in the poverty level has been observed. The share of people with cash income lower than subsistence level was reduced to 22.5 mln. people in 2006, which comprises 15.8% of the total number of the population, as compared with 25.2 mln. people (17.6%) in 2004 and 42.3 mln. people (29.0%) in 2000.

Structural shifts in the formation of population cash income were accompanied with the change in distribution of the population with respect to the value of average per capita income. In 2006 average per capita incomes having increased by 123.5% and face value of wages - by 124.5%, the share of the population with the average per capita income higher than RUR 12000 has increased by 8.3 p.p., in the range of RUR 12000-6000 – by 2.3 p.p., and with the income lower than 6000 - decreased by more than 10.6 p.p. This, however, has not slackened social and economic differentiation of the population in regard to the income. According to estimations, fund coefficient, which characterizes the ratio of the average values of the highest and lowest incomes of the respective decile groups of the population, was equal to 15.3 times in 2006 as compared with 14.9 times in 2005 and 14.3 times in 2003. Gini coefficient, which characterizes incomes concentration, increased up to 0.410 against 0.406 in 2005 and 0.400 in 2003.

Specific character of incomes distribution also determined the characteristic features of the current dynamics of expenditures and level of savings in the sector of households. Over the last 6 years the change in consumer expenditures was determined by the increase in the expenditures for non-food goods and services proportion, proportion of the expenditures for food decreasing. It should be noted that at the existing level of income the statistical observation fixed the gradual shift of

food sales assortment structure towards more expensive food, and of non-food sales – towards imported goods of better quality. The change in population demand structure and the increase in the share of non-food durable goods sales and furnishing intensified the development of the consumer crediting. The volume of credits allotted for individuals increased by 1.66 times. In 2006 the share of credits allotted for individuals was equal to 23.2% of the whole sum of credits granted by credit institutions against 18.9% in 2005 and 9.8% in 2003. It should be noted that in 2000-2006 the share of sales through trading organizations increased steadily. It was the anticipating growth of non-foods market that had the prevailing impact on the increase of turnover in 2006 as well as in preceding years: the increase in foodstuffs sales was equal to 10.2%, while in non-food goods – 15.6%. The change in consumer behavior is accounted for, to some extent, by structural shifts of prices in the main goods groups. Consumer's prices growing by 9.0% in 2006, prices for foodstuffs increased by 8.7% from the beginning of the year, while for non-food goods – by 6.0%.



Source: Federal State Statistics Service

Fig. 4. Structure of Population Cash Income Use over 2004–2006, as percentage to the total

The dynamics of consumer demand in 2006 was considerably influenced by the increase in demand for services. In comparison with 2005 the amount of paid services for the population increased by 8.1% against the background of price and fees for paid services for population growth rates slowdown down to 13.9% against 21.0% in 2005 and 17.7% in 2004. Fees growth rates slowdown was one of the stabilization factors of the share of expenditures for payments for services in the structure of population cash incomes nearly at the level of 2005.

The factor that hindered the use of savings for the current consumption was still a high investment activity at the housing building.

Population real incomes growth rates accelerating since the second half of 2005 the tendency for restoration of the inclination towards savings has emerged (*Fig. 4*). In the structure of population savings the share of bank deposits and securities purchase was increasing while the expenditures for currency purchase were decreasing. The volume of attracted individual's deposits increased by 35.9% over 2006, including ruble deposits – by 49.2%, against the background of decrease in currency deposits by 4.1% in comparison with December 2005.

### 3.1.2. The Specific Features of GDP Formation by Incomes

The dynamic growth of the population incomes is one of the characteristic features of Russian economy consumer's growth. The sustention of the domestic market dynamics was based on the growth of real wages and was accompanied by the redistribution of incomes from the enterprises to the population. In 2006 the share of workers for wages remuneration in GDP was approximately 44.2% and remained above the figures of 1999-2001 (*Table 4*).

Table 4

#### Structure of GDP Formation by Incomes over 2001–2006, as percentage to the total

	2001	2002	2003	2004	2005	2006*
Gross domestic product including:	100	100	100	100	100	100
Labor remuneration of wage earners (including concealed)	43.0	46.7	47.1	46	43.9	44.2
Net taxes on production and import	15.7	17.0	16.0	17.0	19.7	20.1
Gross profits of economy and gross joint incomes	41.3	36.3	36.9	37	37.4	35.7

\* Preliminary data.

Source: Federal State Statistics Service

High differentiation of the average wages by economic activities was preserved. In the industry the level of wages differentiation was defined by the increase in the gap between the rates of the labor remuneration in extraction and manufacturing industries. The nominal accrued wages in minerals extraction was two times higher than the average in the economy, including in fuel fossils extraction – by 2.3 times. In manufacturing industries the wages were equal to 96% of the average in the economy and 48% of the figures of extraction industries. The exceeding of the average added wages figure by 2.0 and 1.97 times, respectively,

was observed in productions, connected with processing and transportation of fuel fossils. In education, public health service the average wages were equal to 70-78% of the average in the economy, in government administration and military safety security – to 125% and in financial activity – to 230%. The characteristic features of labor remuneration by the kinds of economic activity had a substantial impact on the incomes and expenditures structure formation, population consumer's demand as well as on the nature of employment and labor resources distribution in the economy.

Only 8% in the structure of the employed population account for people who do not work for a wage; these are employers, who attract employees on a regular base to work for their business, self-employed people. This determined, correspondingly, the character of the formation of population income structure and the GDP. More than 66.4% of population income and 44.2% of GDP accounted for the share of labor remuneration of those, who work for wages (*Table 5*). In the structure of the population cash income the share of the incomes from the entrepreneur's activity and property in 2006 was 18.4 % against 20.3% in 2005 and 17.1% in 2002.

*Table 5*

**Structure of Population Cash Incomes 1999–2006,  
as percentage to the total**

	2001	2002	2003	2004	2005	2006*
Cash income - total	100	100	100	100	100	100
Remuneration of labor, including hidden wages	64.6	65.8	63.9	64.9	64.8	66.4
Entrepreneur's activity income	12.6	11.9	12.0	11.7	11.4	11.2
Property income	5.7	5.2	7.8	8.3	8.9	7.2
Social payments	15.2	15.2	14.1	12.9	12.9	13.2
Other incomes	1.9	1.9	2.2	2.2	2.0	2.0

\* Preliminary data.

Source: Federal State Statistics Service

The level and the share of employers' wages in the structure of the GDP had a prevailing influence on the social profile, including labor market. The typical aspect of the period of 2001-2006 was the tendency for the growth in the demand for labor force. Average annual number of the employed in the economy process in 2006 was equal to 68.9 mln. people in comparison with 64.5 mln. people in 2000. It is to be noted, that the change in labor force demand was determined by the shift of the employment to the kinds of activities which provide market services. The formation of this tendency at the initial stage of the economic growth restoration made a powerful effect on the quality of life and gave a stimulus for service sphere development growth rate acceleration. However, against the background of industry growth rate slowdown and import supply acceleration this provoked a trend to the decrease in the average annual industrial and production staff number. In past three years the decrease in employment was observed in almost all branches of industry, the decrease in the number of workplaces being the most intensive in the processing industries. In 2005 the share of those employed in processing industries accounted for 17.2% of the average annual number of those employed in all

kinds of economic activities against 17.7% in 2004 and 18.8% in 2001. The comparison of the labor efficiency dynamics in different kinds of economic activities demonstrates a gradual slackening of the tendency for labor efficiency growth in the industry. With regard to labor efficiency growth rates manufacturing industries are considerably behind the extractive industries (*Table 6*).

*Table 6*

**The Dynamics of Labor Efficiency, as percentage to the preceding year**

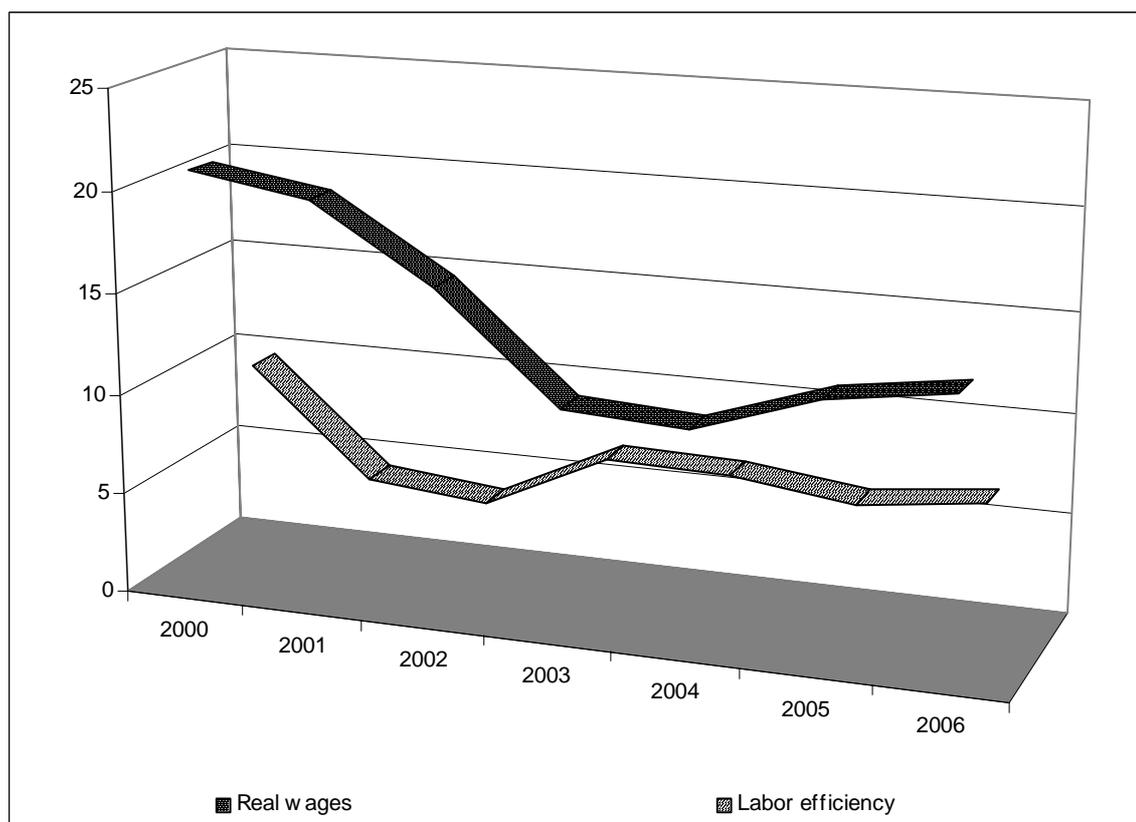
	2003	2004	2005	2006*
Economy as a whole	107.0	106.5	105.5	106.1
<b>broken by kinds of economic activities:</b>				
Agriculture, hunting and forestry	106.0	106.2	100.2	No data
Fishing and fish breeding	102.1	99.2	100.7	No data
Minerals extraction	109.2	107.4	106.1	105.3
Manufacturing industries	108.8	107.5	105.6	104.9
Production and distribution of water, gas and electricity	103.7	100.1	103.9	103.6
Construction	105.3	106.9	105.9	108.6
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	109.8	108.9	107.2	106.0
Hotels and restaurants	100.3	100.4	112.2	No data
Transport and communication	107.5	108.3	100.5	105.2
Operations with real estate, renting, provision of services	102.5	102.1	108.1	No data

\* Preliminary data.

Source: Federal State Statistics Service

Low efficiency in factors of production use is one of the main causes of the decrease in competitive advantages of Russian goods (*Fig.5*). The growth of discrepancy between the rate of labor productivity and wages in favor of the latter had the negative impact on the economic dynamics indices. Over 2000-2006 real accrued wages increased by 2.57 times, while the labor productivity grew by 1.49 times. This rate of labor remuneration growth was accompanied by the decrease in gross economy profit in the structure of the GDP from 42.7% in 2000 to 35.7% in 2006.

In 2003-2004 it was observed that labor efficiency rates and wages rates were brought closer to each other in the environment of production rates acceleration. However the influence of this process on the change of enterprises and organizations' efficiency indices was extremely weak and unstable. The increase in wages and population incomes was accompanied by the redistribution of incomes from the enterprises to the population and lead as a result to the increase in production costs and the decrease in production profitability. In 2004-2005 the dynamics of wages was on average 1.05 times ahead of the growth of labor efficiency, and in 2006 – 1.07 times. However the possibilities of further increase in costs for labor remuneration are more and more limited by the changes in competitive environment at goods markets due to ruble appreciation and the increase of pressure from the import.



Source: Federal State Statistics Service

*Fig. 5. The Dynamics of Labor Efficiency and Real Accrued Wages over 1999–2006, as percentage to the preceding year*

Due to the fact that the prevailing part of population income is formed by labor remuneration the problems of unemployment and provision of employment retained their priority. The total number of unemployed, calculated by the methodology of International Labor Organization, reduced from 8.9 mln. people (13.2% of economically active population) in 1998 to 5.6 mln. people (7.5%) in 2005 and 5.3 mln. people (7.1%) in 2006. Strain coefficient (number of unemployed people registered in the bodies of employment service per one position) decreased to 2.0 people in comparison with 2.5 people at the end of 2005. Simultaneously the tendency for the increase in efficient use of working hours was observed. In 2005–2006 the real duration of the working day throughout the economy as a whole increased at the expense of the decrease in the number of part-time workers and those having mandatory administrative leave. Besides, the trend for the reduction in duration of voluntary leaves was observed in accordance with existing legislation.

The average profitability of Russian economy tends to decrease. The profitability of sold goods and services throughout the economy as a whole was equal to, according to the preliminary estimation, 13.1% against 13.5% in 2005 (*Table 7*). The analysis of profits formation by the kinds of activities demonstrates that balanced financial result was formed by 3/5 by economic activities connected with

goods production and by 2/5 by services provision. However inside the sectors the industries are distinguished that have a prevailing impact on the process of profit formation and use in the national economy.

The industry did not retain leading positions neither in the financial activity growth dynamics nor in the industry structure of incomes formation by the kinds of economic activities. The slowdown in industry financial results was initiated by the reserved dynamics of extractive industries productions. Balanced financial result of fuel fossils extraction in January-November 2006 increased by 7.1% in comparison with the corresponding period of 2005. In processing industries against the background of production costs increase due to the growth of expenses for labor force, internal prices for mineral resources used as sources of power and transportation fees the situation is also unfavorable.

Table 7

**Profitability of Sold Goods, Production (Work, Services) by kinds of economic activity, as percentage**

	2003	2004	2005
<b>Economy as a whole</b>	<b>10.2</b>	<b>13.2</b>	<b>13.5</b>
Including the kinds of economic activity:			
Minerals extraction	19.2	32.5	35.6
including:			
Fossil fuels extraction	18.4	31.8	34.7
Extraction of minerals, excluding fossil fuels	23.8	37.3	42.8
Processing industries	12.4	14.9	15.3
Including:			
Food, beverages and tobacco production	8.2	7.5	7.9
Textile and clothing industry	1.4	2.4	2.7
Leather, leather goods and footwear production	2.8	3.7	5.0
Woodwork and manufacture of articles	5.6	4.6	4.2
Pulp and paper production, publishing and editing	10.4	10.8	11.2
Coke and oil products production	15.5	22.3	21.4
Chemical industry	10.2	13.8	19.3
Rubber and plastic goods production	5.9	4.4	4.6
Other non-metal mineral products production	10.5	12.0	12.3
Metallurgical production and finished metal fabrics	23.7	32.2	26.7
Machinery and equipment production	5.8	7.5	8.2
Electrical, electronic and optic equipment production	8.3	8.4	8.4
Transport vehicles and equipment production	9.8	7.8	6.9
Electricity, gas and water production and distribution	6.4	5.4	5.3
Construction	5.7	4.2	3.9
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	8.9	11.3	9.7
Transport and communication	15.3	13.4	14.4
Including communication	35.8	32.7	33.6
Financial activity	1.0	-0.3	5.8

**Factors of the GDP and the Industry Added Value Economic Growth over 2004–2006**

*2006 was characterized by a trend, which emerged in recent years, towards GDP growth rates slowdown. Whereas in 2003 GDP growth rates were 7.3%, in 2004 – 7.2%, and in 2005 – 6.4%, in 2006 GDP growth increased and was equal to 6.7%.*

*Breaking economic growth down by extensive (main growth factors – labor and capital) and intensive constituents (generalized estimation of which is the total factor efficiency TFE) enables to estimate growth quality, forecast further trends in the economy development<sup>1</sup>.*

*According to the decomposition results the share of the GDP growth rates accounted for by the change in the main factor input increase: in 2003 their contribution was equal to 32.1%, in 2004 – 41.6%, and in 2006 – already 57.9%<sup>2</sup>, the only exception being 2005, in which labor and capital inputs determined 29.9% of output growth rates.*

*In 2006 the increase in the output due to the main factors input was to a greater extent (by 58.6%) accounted for by the change in the level of funds participating in the production. The increase in capital input is mainly determined by the increase of its load – in 2006 this component comprised 41.0% of output growth rates. Despite the increase in investments growth rates (13.5% in 2006 against 10.7% in 2005) the physical volume of the fixed assets varies but negligibly, as the main part of investments is due to the renovation of existing facilities.*

*The increase in labor input is accounted for by the change in “reserves”, i.e. the number of employed people. In 2006 the increase in the demand for labor force led to the increase in the employment level by 0.9%, this figure being, however, lower than employment growth rates in 2004-2005, so the contribution of labor input decreased in 2006. It should be noted that the increase in the number of the people employed was provided by the service sector, whereas in manufacturing sector the employment was decreasing. The change in the time worked out<sup>3</sup> determines only 0.3% of the GDP growth rates, which exceeds the level of 2005, which was characterized by the decrease in the number of hours worked out by one employer a year, but is considerably less than the figure of 2004, when the contribution of this labor input component determined 8.3% output growth rates.*

*In contrast to the GDP growth rates, the dynamics of TFE growth rates did not experience the change of the trend towards growth rates slowdown: efficiency growth rates in 2006 were equal to 2.82 %, which is more than 1.5 times lower than the level of 2003, in which the corresponding figure was equal to 4.96%, i.e. on average the decrease in TFE growth rates over the period was equal to 0.71 p.p. At the same time the contribution of TFE to the output growth rates decreased from 67.9% in 2003 to 58.4% in 2004 and 42.1% in 2006, the exception being 2005, when the change in the efficiency determined 70.1% of the output growth rates. The monetary nature of the indices used for estimation makes TFE estimations dependant on the situation factors and especially on oil prices. On exclusion of oil prices growth component from the TFE figure, efficiency growth free from the*

<sup>1</sup> Method of economic growth decomposition is presented in the book: Factors of the economic growth, “Scientific work” series, № 70, IET, 2003.

<sup>2</sup> Preliminary data – estimation of the fixed assets volume growth in 2006 is based on the assumption that the coefficient of fixed assets retirement and the share of investments in their renewal are constant. The estimation of the extent of facilities load is based on the assumption that the share of energy consumed in the volume of the production output is constant.

<sup>3</sup> Estimation for the year is based on the data for January-September 2006

*situation at the world markets becomes considerably lower. The contribution of technological component<sup>4</sup> into the GDP growth in 2006 makes up for 18 % (50% – in 2003, 13% – in 2004 and 0% – in 2005).*

**Decomposition of the GDP annual growth rates and Gross Added Value by the kinds of economic activity in 2004–2006<sup>5</sup>.**

	GAV	Factors input	Including:						TFE
			Labor	of which:		Capital	of which:		
				The number of employed	Time worked out		Fixed assets level**	The extent of the facilities load***	
Total throughout the economy	7.20	2.99	1.02	0.43	0.60	1.97	0.54	1.43	4.21
	6.40	1.91	0.11	0.30	-0.20	1.81	0.68	1.12	4.49
	6.70	3.88	0.30	0.28	0.02	3.58	0.84	2.74	2.82
Minerals extraction	8.60	0.25	-4.04	-4.04	-	4.28	1.30	2.98	8.35
	0.90	1.35	-0.38	-0.38	-	1.73	1.38	0.36	-0.45
	2.10	-0.07	-1.28	-1.39 <sup>6</sup>	0.11	1.21	1.21	-	2.17
Manufacturing industries	6.70	-1.31	-3.82	-3.82	-	2.51	0.58	1.92	8.01
	5.70	4.05	-0.45	-0.45	-	4.50	0.83	3.67	1.65
	4.90	-0.32	-1.32	-1.36	0.04	1.00	1.00	-	5.22
Electricity, waste and gas production and distribution	2.00	-3.98	-3.72	-3.72	-	-0.26	-0.26	0.00	5.98
	1.30	0.12	0.34	0.34	-	-0.22	-0.22	0.00	1.18
	2.60	0.24	0.14	0.09	0.05	0.09	0.09	-	2.36

\* per one worker.

\*\* on the basis of data on the physical volume of fixed assets

\*\*\* The estimation of the change in facilities utilization throughout the whole economy is based on the data for electricity consumption, in industrial production – on the data for average annual manufacturing capacity of organization, producing different type of goods.

Source: Federal State Statistics Service.

*For the enterprises of the minerals extraction sector, as well as for the economy as a whole, the decrease in GAV growth rates is observed in 2005 with some acceleration in 2006. Furthermore, the decrease in GAV growth rates in this kind of the economic activity in 2005 in comparison with 2006 (0.9% against 8.6%) as well as its increase in 2006 (up to the level of 2.1%) is more significant than in the case of the GDP. In 2004-2006 the enterprises involved in minerals extraction are characterized by the biggest decrease in output growth rates: on average over the period GAV growth rates decrease by 3.25 p.p.*

<sup>4</sup> The final balance left after exclusion of efficiency component, which is accounted for by the dynamics of world prices for oil, is referred to as the technological component.

<sup>5</sup> For each type of the economic activity the first line gives growth decomposition in 2004, second line – in 2005, third line – in 2006.

<sup>6</sup> Preliminary estimation of the number of the employed in the industry production is based on the data on the number of the filled vacant posts in January-September 2006 on the assumption of the constant ratio of those employed in the industry to the number of the filled vacant posts.

*In 2006 the increase in the added value of extraction enterprises was accompanied by the reduction of extensive components, so that the increase in output is defined exceptionally by the TFE growth<sup>7</sup>. The increase in the efficiency almost entirely determines the increase in the output in 2004 as well. The opposite situation is observed in 2005, when the increase in the output was provided for by the main factors input growth against the background of the decrease of their total efficiency.*

*The contribution of the labor input to the output growth rates for this type of the economic activity remains negative over the whole period of 2004-2006, which is defined by the decrease in the number of those employed in the extraction industry. The capital input, in contrast, was increasing due to the growth of both the industrial facilities and the extent of their utilization.*

*Taking into the account the decrease in the number of those employed at the enterprises involved in the minerals extraction and the steady growth of the fixed assets physical volumes, secured by the high level of the investment into this kind of the economic activity, the main cause of the output growth rates reduction in 2004-2006 consisted in the decrease of TFE growth rates (it should be noted that the most significant decrease in added value growth rates in 2005 was accompanied by the decrease in the efficiency). Against the background of the favorable price situation at the world raw materials markets this testifies the deterioration of extraction industries technological characteristics operation. This can be due to the fact that fields, characterized by lower efficiency become involved in the production as well as by the decrease in the quality of the administration in the environment of the considerable growth of the price situation.*

*Manufacturing industries added value growth rates in 2004–2006 decreased steadily: on average over the period GAV growth rates for this type of the economic activity decreased by 0.9 p.p. The structure of manufacturing industry output growth rates is similar to the structure of the extraction industries growth: in 2004 and 2006 against the background of the reduction in the main factors input the prevailing component of the output growth rates is TFE; in 2005 the increase in efficiency defines just 29% of the added value growth rates. Over the whole period of 2004-2006 the decrease in the number of the employed at the manufacturing enterprises determines the negative contribution of the labor input to the output growth rates for this kind of the economic activity; the steady growth in the physical volume of the fixed assets accounts for the increase of the corresponding component contribution, which together with the increase in the intensity of industry capacities utilization accounts for the growth of the capital input contribution. Despite the increase in the TFE growth rates in 2006 on average over 2004-2006 the growth rate of the total factor efficiency of manufacturing industries factors has been decreasing (annual decrease is 1.4 p.p.)*

*The only sector of the industrial production where the increase in the GAV growth rates is observed in 2006 (5.3%) as compared with 2004 (2.1%) is the pro-*

<sup>7</sup> In 2006 the estimation of the TFE growth rates in the industrial production can be slightly overrated, for the extent of the industrial facilities utilization was not taken into the account in the calculations.

*duction and distribution of the gas, water and electricity. This increase however was provided by the increase of the main factors input in the environment of their total efficiency growth rates slowdown (annual decrease is equal to 1.81 p.p.).*

*Thus the increase in GDP observed in 2006 was to a great extent secured by the increase of the main production factors input (labor and capital accumulation) and the increase in the efficiency of its use. The contribution of the efficiency to the GDP increase was equal to approximately 42% not taking into the account the oil prices and 18% after exclusion of the price situation impact at the world raw materials markets.*

*In the industrial sector the estimation of the TFE contribution in 2006 is more significant, which can be connected with the absence of the data on the existing facilities utilization efficiency. According to the rough estimations, TFE is a prevailing factor, which determines the growth in the industrial output. At the same time in 2004-2006 the industrial production demonstrates the trend to TFE growth rates slowdown.*

*A remarkable trend, quite visible upon the sectors analysis, is the decrease in the employment in extraction and manufacturing sectors while the total employment throughout the whole economy is increasing and the employed being redistributed towards the service sector. This trend is characteristic for all the developing economies at the stage of the post-industrial development. It also, however, corresponds to the trends of deindustrialisation (the decrease in the number of those employed in the manufacturing industries) in the environment of so-called "Holland disease". This trend is quite worrying, for it has negative influence on the long-term economic growth and, as known from the world experience, on the quality of the institutional environment.*

### *3.1.3. The Dynamics and the Structure of the Production by the Kinds of the Economic Activities*

#### **Main trends and factors of the change of the produced GDP**

The development of the Russian economy in 2006 was formed under the influence of the following most significant factors: the increase in domestic demand impact; advance growth of manufacturing industries in comparison with extraction industries, advance growth of investments in fixed assets in comparison with GDP and final demand dynamics; acceleration of final commodities import with regard to domestic production; intensive growth of the service sector; anticipating growth of wages in comparison with labor productivity, sustention of high customer demand and population inclination for savings; the acceleration of prices growth rates of manufacturing goods producers and service tariffs.

Table 8

**The Structure of the GDP Produced as Broken by Kinds of Economic Activities in 2002-2006, as percentage in current prices**

Section	Kind of economic activity	2002	2003	2004	2005	2006*
	Gross domestic product	100	100	100	100	100
<b>A</b>	Agriculture, hunting and forestry	5.68	5.51	4.99	4.44	3.90
<b>B</b>	Fishing, fish-breeding	0.27	0.46	0.37	0.32	0.30
<b>C</b>	Minerals extraction	6.01	5.93	8.37	9.58	8.92
<b>D</b>	Processing industry	15.61	14.92	15.76	16.51	16.38
<b>E</b>	Production and distribution of electricity, gas and water	3.32	3.23	3.32	2.91	2.90
<b>F</b>	Construction	4.83	5.41	5.06	4.78	5.09
<b>G</b>	Wholesale and retail trade; vehicles, motorcycles, household appliances and articles of private use service	20.38	19.55	17.83	16.73	16.84
<b>H</b>	Hotels and restaurants	0.82	0.72	0.83	0.79	0.81
<b>I</b>	Transport and communications	9.18	9.53	9.75	8.80	8.48
<b>J</b>	Financial activity	2.75	3.00	3.00	3.44	3.70
<b>K</b>	Real estate operations, rent and service provision	9.50	9.51	8.34	8.46	8.47
<b>L</b>	Government administration and military safety security; essential social security	4.51	4.92	4.71	4.44	4.61
<b>M</b>	Education	2.59	2.41	2.35	2.29	2.43
<b>N</b>	Public health service and social service provision	2.98	2.84	2.78	2.69	2.80
<b>O</b>	Provision of other utilities, social and personal services	1.69	1.66	1.62	1.59	1.73
	Net taxes for products	11.5	12.0	12.72	14.31	14.70

\* Preliminary data.

Source: Federal State Statistics Service

Economic development in 2002-2006 was characterized by simultaneous increase in business activity of both goods and service production. There remained the big share of goods production and quite strong influence of the industry and the construction on the rates of economic growth. In 2006 the share of goods production in the GDP was equal to 37.5%, 75.0% of it being accounted for by industrial production and 13.6% by construction. On the service market it was the acceleration of rates of transport, communication, trade, financial operations, real estate operations services that had the prevailing impact.

Comparative analysis of the Russian economy with regard to the kinds of activities demonstrates, that the ratio of growth rates of the industry, construction and trade had the most significant impact on the nature and structure of development (Table 8, Fig.6). In 2003–2004 the acceleration of production and services output rates by the basic kinds of economic activity up to 7.2% against 3.5% on average over the period 2001-2002 was initiated by the recovery of the investment demand. The dynamic increase of the construction work volumes was supported by the acceleration of industrial production output due to the anticipating growth of investment goods and construction materials production.

From the second half-year of 2004 to the middle of 2005 the decrease in investment activity, the slow-down in industrial and construction works growth rates was observed in the economy against the background of the dynamic extension of the foreign economic activity scales. The leading positions in the formation of the

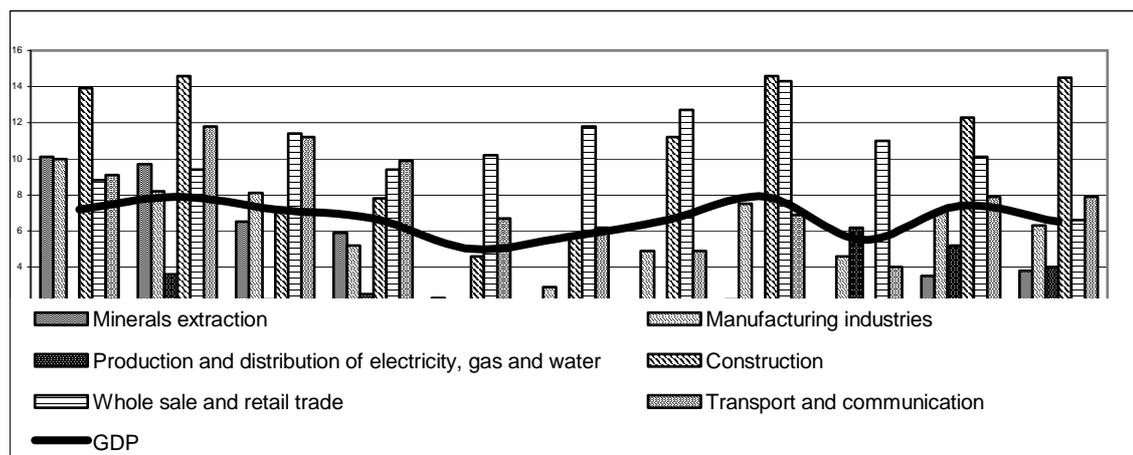
structure and the dynamics of the economic growth since the second half of 2004 were held by the trade and connected with it branches of market infrastructure – transportation, communication, information service, financial and credit organizations. The development of the trade was accompanied by the intensive development of the industry's material and technical basis and the change in provided service structure. The increase in the share organized trade form in the structure of the commodity turnover initiated intensive growth of sales and storage areas, services.

Since the second half of 2005 with the increase of the investment activity in the national economy the trade gave leading positions to the construction. The share of retail and wholesale trade in the produced GDP was equal to 16.8% in 2006 against on average 18.3% over 2002-2005. It should be noted that the dynamic structural shifts were characteristic for the development of this kind of activity. The change in the demand at the world market determined anticipating growth and the increase of the foreign trade share in the structure of the trade turnover. Intensive growth of the wholesale trade was sustained due to the extension of the internal demand market of material and technological resources. The volumes of wholesale trade exceeded the retail trade turnover by more than two times.

The extension of the trade in the country and at the international level determined to a great extent the growth of transportation operation. Commercial freight turnover increased by 2.2% over 2006, while the industrial output went up by 3.9%. Production oriented towards export made the biggest contribution to the growth of the demand for transportation services. The increase in production transport by pipelines mains was equal to 2.1% as compared with 2005. By the rates of main kinds of freight transportation with railway oil and oil products, ferrous and non-ferrous metals, ores, chemical and mineral fertilizers and timber industry enterprises' production kept the leading positions.

The state of the transportation system of Russia is not a direct barrier of economic growth, but its inefficiency leads to increased transport costs and the loss of profits from transit transportation.

Communication remains the most promising and dynamically developing among the kinds of economic activities. In 2006 the volume of communication services increased by 23.7%. The share of the main communication operators comprised 3/5 of the total volume of the communication service volume and more than a half of population communication services. The telephone communication got the biggest spreading among the other kinds of electric communication. This kind of communication gives 4/5 of the incomes, obtained from the industry services, of which 40% is the share of mobile electric communication. At the end of December 2006 the total number of mobile phones subscribers was equal to 152 mln., it increased by nearly 40% as compared with the corresponding period of the previous year.

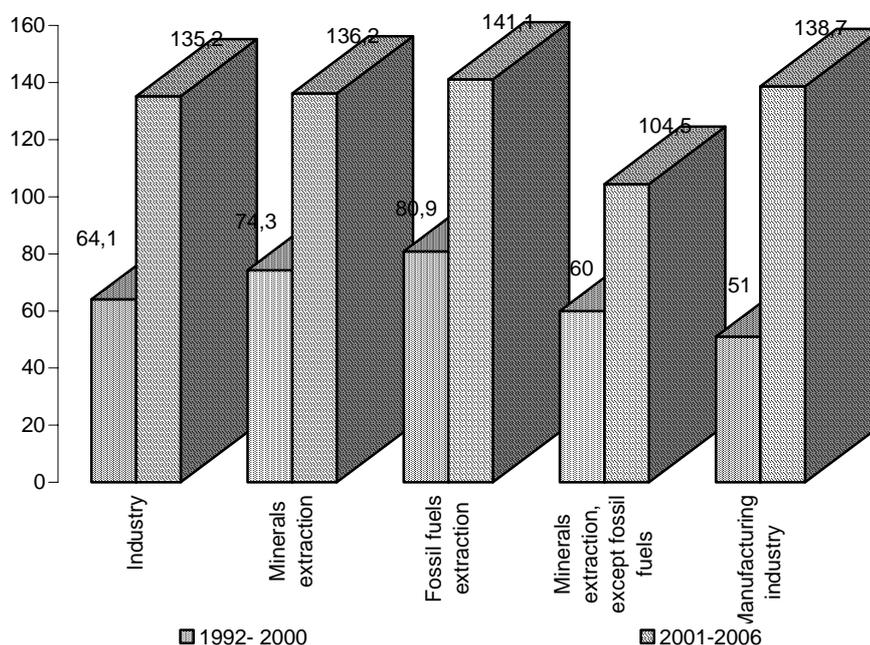


Source: Federal State Statistics Service.

*Fig. 6. The Change in the Production Dynamics by Kinds of Economic Activities in 2004–2006, as percentage to the corresponding period of the preceding year*

#### Industry: Production Rates and Structure

The analysis of industry production in the classification of kinds of economic activity allows estimating the impact on the extraction and manufacturing industries on the nature of the Russian economy growth nature. The comparison of the dynamics of industry indices demonstrates that whereas the Russian industry crisis was initiated by the slump in manufacturing industries in the environment of the reserved decrease of fuel fossils production, the economic growth was based on the increase in manufacturing industries production and the recovery of fossil fuels production at the pre-crisis level in 2003 (*Fig. 7*). Since that moment the structure shifts in industry were determined by the anticipating growth of manufacturing industry in the Russian economy, the minerals extraction production dynamics being reserved. The changes in the industrial production structure were accompanied by transformation shifts within the main factors of production. At first, the general tendency being towards the increase of the investment activity in the economy, the share of the investments in the minerals extraction in the total volume of the investments into the fixed assets throughout the economy decreased from 19.0% in 2001 to 13.4% in 2006, the proportion of manufacturing industry having increased from 15.9 to 16.8%. Secondly, both for manufacturing and extraction industries it was characteristic for 2001–2005 that the demand for labor force was decreasing against the background of the growth of requirements for labor qualification.



Source: Federal State Statistics Service.

Fig. 7. Production Indices Broken by Kinds of Economic Activity

The main trends for the development of enterprises for minerals extraction was formed under the influence of such factors as the reduction of efficacious reserves facilities, low rates of exploration and putting into operation of new oil fields, limitations from transportation and exploration infrastructure. Underexploitation of extraction industries growth potential was also determined by reserved rates of minerals processing in metallurgy and petrochemistry. The existing structure of fixed assets being what it is the further increase of facilities load was accompanied by production capital intensity and the decrease in labor and financial resources efficiency use. This determined the significant impact of the output dynamics volume of the industries of the complex orientated to export on the structure of the industrial production and demand at the domestic market.

It should be noted that it was the slowdown in the fossil fuels extraction that had the biggest impact on the dynamics of the extraction industries in 2005–2006. The production indices in fossil fuels extraction slowed down to 102.5% in 2006 as compared with 107.5% in 2003, and in metal ores extraction - down to 101.8% against 108.5%. In the environment of tax load growth the slackening of motivation for extraction and export volumes increase was observed among oil companies. The formation of this trend was also supported by the fact that, on the one hand, in the environment of the steady dynamics of the world prices for oil and intensive increase in the domestic market prices the trade groups orientated towards export expand, and on the other hand – in recent years the efficiency of oil products export has increased significantly, which determines the change in the marketing policy of the oil companies. In 2006 the oil production growing by 2.4% the sales at the

domestic market increased by 5.4% while the export decreased by 1.2%. The growth of oil products export over the same period was equal to 7.1%.

Table 9

**Indices of Industrial Production by Kinds of Economic Activities  
in 2000–2006, as percentage to the previous year**

	22000	22001	22002	22003	22004	22005	22006
Industry	108.7	102.9	103.1	108.9	108.3	104	103.9
Minerals extraction	106.4	106	106.8	108.7	106.8	101.3	102.3
Fossil fuels extraction	104.9	106.1	107.3	110.3	107.7	101.8	102.5
Minerals extraction excluding fossil fuels	118.2	96.2	99.1	102.5	108.5	96.8	101.8
Manufacturing industries	110.9	102	101.1	110.3	110.5	105.7	104.4
Electricity, gas and water production and distribution	104	101.4	104.8	103.3	101.3	101.2	104.2

Source: Federal State Statistics Service

### Manufacturing Industries

The steady economic growth due to the expansion of the external market demand, on the one hand, and the increase in the capacity of the domestic market, on the other hand, gave additional stimulus for the development of the manufacturing industries. The dynamics of the manufacturing industries differentiates substantially by the kinds of the economic activity, the ratio of the rates of investment and consumer's goods having the biggest influence (*Table 10*). The growth fluctuations by the kinds of the economic activity being rather considerable, the anticipating growth of machine-building production output was the prevailing tendency of the recovery period, which positively affected the level of business activity of connected industries of construction materials and other intermediate goods production. The ratio of growth rates by kinds of the economic activities in 2000-2006 demonstrates the gradual turn from the growth which was orientated towards natural and raw materials potential towards the formation of the resource system for the investments development. In the environment of the production growth the demand for domestic and imported equipment is growing dynamically.

Table 10

**The Change in the Rates of Production by Kinds of Manufacturing Industries  
Economic Activity in 2000–2006, as percentage to the previous year**

	2000	2001	2002	2003	2004	2005	2006
1	2	3	4	5	6	7	8
Manufacturing industries	10.9	2	1.1	10.3	10.5	5.7	4.4
Foodstuffs, including tobacco and beverages production	5.3	8	7.2	6.9	4.4	4.4	5.4
Textile and clothing industry	24.9	7.8	-2.5	1.2	-4	-1.5	7.3
Leather, leather goods and footwear production	7.6	13.7	11.4	11.5	-0.6	-2.7	16.7
Woodwork and wooden goods production	14.1	-2.5	4.2	9.7	8.7	4.5	0.5
Pulp-and-paper production, editing and printing activity	18	9.6	4.1	7.8	5.1	1.2	6.4
Coke and oil products production	2.4	2.8	4.6	2.2	2.4	5.4	6.1
Chemistry industry	15.2	0.3	0.2	5.4	6.6	2.6	1.9

	1	2	3	4	5	6	7	8
Rubber and plastic goods production		26.1	1.6	0.2	5.5	13.5	5.5	11.7
Other non-metal mineral goods production		10.6	3.8	1.2	7.3	8.4	3.5	10.8
Metallurgical production and finished metal goods production		15.3	4.6	5.1	7.2	3.9	5.7	8.8
Machinery and equipment production		5.7	6.4	-8.8	19	21.1	-0.1	3.3
Electric, electronic and optical equipment production		25	8.4	-7.7	43.2	34.5	20.7	-5.5
Transport vehicles and equipment production		10.7	-26.4	-1	14	11.5	6	3.3
Other productions		11.5	8.5	3.9	10.8	10.5	0.7	7.2

Source: Federal State Statistics Service

### The Main Trends of Machine-Building Production Output

The analysis of the dynamics of the investment goods market in recent years indicates that the level of business activity depends considerably on the economy revenues from the foreign economic activity. The reserved dynamics of the investment goods output as compared with the rates of the industrial growth over the last 8 years was observed only in 2002. However already in 2003 the situation experienced fundamental changes. The investment sector replied to the industrial and incomes growth rates acceleration in the export-orientated sector by the intensive increase in the production. The additional factor of machine-building industry growth was the improvement in trade of the high technological equipment produced domestically at the external markets as well as the positive changes in investment environment connected with the gradual decrease of the duties for imported components and equipment and the introduction of industrial assemblage regimes in motor-vehicles production. At the same time it should be noted that the production output in some branches of machine-building is subjected to quite considerable fluctuations.

In 2006 for the first time over the last 4 years the negative dynamics was observed in electric, electronic and optical equipment production after the output increase by 34.5% in 2004 and by 20.7% in 2005.

The development of the Russian electronics over the last 5 years proceeded within the framework of section "Basis for electronic components" of the Federal Targeted Program "National technological basis" the fulfillment of which was envisaged for 2006. In spite of that, however, Russian electronics is in the state of crisis.

In the environment of the dynamic development of the world electronics the state of the domestic technological basis, development and series production of the electronic components basis (ECB) for testifies that the Russian electronic industry is in the state of the deep crisis. The structure of the modern domestic market of electronic equipment is highly dependant on the electronic industry's enterprises possibilities and on the import of foreign produced basis for electronic components and finished goods. The capacity of the domestic market of radio and electronic equipment in 2005 was estimated to be USD 7.9 bln., the domestic production of which being USD 3.5 bln. The positions of the domestic electronic producers at the internal market weakened substantially – the share of the import electronic components base was equal to 65% of the total amount of the electronic

goods, sold in Russia. This is accounted for by a considerable technological lag resulting in the low competitiveness of the Russian ECB.

The main system factors that limit the development of the domestic ECB are:

- moral and physical ageing of the technological equipment and fixed assets of electronic industry due to the lack of investment funds for technological re-equipment over the last 15 years;
- sharp decrease in the production output and the reduction of the assortment of the electronic goods for military purposes produced serially;
- the growth in foreign produced electronic components application with the simultaneous decrease in the level of provision of domestically produced electronic components for the development and serial production of the armaments systems, military and special equipment;
- the situation of the nearly complete absence of the domestic civil sector of the most science-intensive kinds of ECB, applied in computer engineering, communication facilities and telecommunication, navigation equipment etc.

The analysis and development forecast demonstrates that further lag of Russia in production of the electronic components is highly dangerous, since it limits the opportunities for the transformation from the raw materials to innovation economy.

The overcoming of the crisis in the industry depends on the problem of combining the efforts of the government and the private domestic and foreign business. The partnership with the foreign business in this case is defining, as it is foreign firms and enterprises that are the leaders of this industry in the world. Only they have necessary technologies and the experience in this kind of the production organization as well as their effective commercial operation. The capital intensity of the electronic industry being high this model of management restructuring allows to decrease significantly the specific expenses for the production.

Domestic machinery and equipment production increased by 3.3% in 2006, the increase in the import of this kind of goods was, according to the preliminary data, equal to 50.9%. The dynamics of the machinery and equipment output was determined mainly by the extension of the demand for handling machinery, railway, power and agricultural machine-building, instrument making, communication facilities production. Besides, over the last years the steady growth of the demand for the consumer's complex equipment sustained (*Table 11*).

The characteristic feature of the economic growth in 2000-2006 was the recovery of the positive growth dynamics of the agriculture and tractor machine-building. The increase in machinery and equipment output being 1.53 times higher in 2006 as compared with 1999, the tractor and agriculture machine-building output increased by 1.63 times. The output of the tractors with the wheeled mover, motor cultivators and motor cultivators with changing tools, combine harvesters and milking machines grew dynamically. This, however, did not stop recession of the fixed assets in agriculture. The norm for the fixed assets renewals being at the level of 1.0% the retirement coefficient reached 3.1% in 2002-2005, wear and tear of machinery and equipment being 53.7%.

Table 11

**The Dynamics of the Machinery and Equipment Production by Kinds of the Economic Activities in 2000–2006, as percentage to the previous year**

	2000	2001	2002	2003	2004	2005	2006
Machinery and equipment production:	105.7	106.4	91.2	119.0	121.1	99.9	103.3
including:							
Mechanical equipment production						107.3	90.1
Machinery and equipment production for agriculture and forestry *	148.4	129.1	77.6	76.4	130.5	102.0	107.5
Machine-tools construction**	111.5	99.4	81.7	100.5	95.1	99.1	114.4
Production of household appliances not included elsewhere ***	109.5	107.1	115.9	106.6	119.0	103.7	106.8

\* Up to 2005 “Tractor and agriculture machine-building”.

\*\* Up to 2005 “Machine tools and instruments industry”.

\*\*\* Up to 2005 “Machine-building for light industry, food processing and households appliances”.

Source: Federal State Statistics Service

The state of the investment machine-building is the main technological factor, which limits the production reconstruction and modernization on the new technological basis. Though in 2006 the investments in the machine-building increased approximately by 43.6% against the level of 1998, this did not considerably affect the technological and economic characteristics of the industry fixed assets. The average norm of the fixed assets renewals being over the last 2 years at the level of 1.8%, the average age of the equipment in the industry if 21.2 years against 14.3 years in 1998, the proportion of used-up machinery and equipment exceeding 27% (Table 12).

Table 12

**Age Structure of the Production Equipment in the Industry, percentage**

	1995	2000	2001	2002	2003	2004
Equipment – total (by the end of the year)	100	100	100	100	100	100
of which:						
under 5 years old	10.1	4.7	5.7	6.7	7.8	8.6
6–10 years old	29.8	10.6	7.6	5.8	4.9	5.1
11–15 years old	22.0	25.5	23.2	20.0	16.4	12.3
16–20 years old	15.0	21.0	21.9	22.6	22.7	22.5
more than 20 years old	23.1	38.2	41.6	44.9	48.2	51.5
Average age of the equipment, years	14.3	18.7	19.4	20.1	20.7	21.2

\* by big and middle-sized commercial organizations

Source: Federal State Statistics Service

Machine-tools construction is characterized by unsteady output dynamics and sustention of the crisis phenomena (Table 13). As compared with 1999 the machine-tools production decreased in 2006 by 1.9%. For instance, the production of the machine-tool equipment in the nowadays Russia per capita is tenfold lower than in the last years of the Soviet era, and the facilities load is by 3-7 times back of the level of the beginning of 1990ies. The characteristics of the machinery-tool population being exceptionally unfavorable concerning age, degree of wear, technological level, the share of the new generation of machine-tools with high efficiency, precision and accuracy indices, Russian enterprises cannot produce com-

petitive goods in the environment of presently fast growing costs for raw materials and energy. The share of the numerically programming controlled (NPC) equipment in the population of the equipment in operation does not exceed 5%. Abroad, for reference, the proportion of NPC equipment is nearly 50%, and among the enterprises producing production tools (press molds, dies, casting molds) reaches 85%. In this country the production of complex machine-tools in almost undeveloped. For instance, in 2005 in Russia 261 machine-tools with NPC were produced, which is by a factor of ten less than in China and by a factor of hundred – than in Germany.

Table 13

### Production Output in Machine-tools Construction

	2000	2001	2002	2003	2004	2005*	2006*
Metalcutting machine tools, thou.	8.9	8.3	6.5	5.7	5.4	4.8	5.0
Of which the machine-tools with numerical programming control, thou.	0.2	0.3	0.2	0.1	0.2	0.3	0.3
Forge-and-press machinery (excluding the machines with manual drive and treadle), thou..	1.2	1.3	1.2	1.6	1.7	1.5	2.0
Automatic and semi-automatic lines for machine-building and metal processing, a number of sets	11	5	2	1	2	No data	No data
Woodworking	10.2	9.7	8.6	8.1	6.7	4.3	4.4

\* Since 2005 “Machine-tools production”.

Source: Federal State Statistics Service

The structure of the production and the rates of production equipment renewal being what they are the own funds of the machine-tool construction enterprises comprise, according to 2005 data, 78% of the amount of the investments, while in developed countries, in contrast, it is loans, whose share is 70-80% of the investments.

Besides, the countries with the developed machine-tool construction carry out intensive reciprocal trade of this production. According to the UN data, Russia acts as a net importer in 40 out of 45 positions of the machine and technological equipment, taken into account by the statistics. Being the seventh by the amount of the purchase of German machine-tools, Russia is not even among 20 leaders of the exporters of the machine-tools and instruments production to Germany, according to the German association VDW.

According to the operational information, the increase in military industrial complex production was equal to 109.8% in 2006. According to the preliminary estimations, the volume of the export supplies of production for military purpose remained in 2006 almost at the level of 2005.

In 2006 the growth of the investments in military industrial complex by all sources of financing was, according to estimation, 105.6%. The share of own and borrowed funds in the total amount of the investments is estimated, correspondingly, at the level of 67 and 33%. The main amount of the budget funds – around 70% - was directed towards purchase of the new equipment. The steady positive dynamics and anticipating growth of the industrial production output were achieved in the aviation industry (125.2%), in radio and electronics complex (115.3%), in rocket and space industry (113.4%) and in ammunition and special chemicals in-

dustry (110.7%). The industrial production output increased in all the industries with the exception of shipbuilding (84.2% to 2005). The anticipating growth of the military production accounted for the decrease of the share of civil production from 44.3% in 2005 to 42.0% in 2006 of the total production output of the military industrial complex.

Civil production in most branches of the military industrial complex developed unsteadily and extended by 4.2% in 2006 as compared with the previous year, including the increase in shipbuilding civil production was equal to 111.4%, in aviation production – to 108.1%, in rocket and space industry – 106.0%. In 2006 the production of power efficient equipment which can substitute for the import equipment for fuel and energy complex increased, according to the preliminary estimation, by 7.5% against the level of 2005.

Sporadic crisis phenomena of overproduction in motor-car construction as well as steady growth of investment and consumer demand for foreign models against the background of the growing economy and population revenues can be referred to as negative factors which influenced the dynamics of transport vehicles and equipment production in 2005-2006. The dynamics and the character of motor-vehicle construction development was considerably influenced also by the anticipating import growth as compared with the domestic production. This is connected with the fact that many kinds of machinery and equipment are not competitive with the imported analogues by the ratio of “price to quality”, as well as the lack of facilities for production of modern kinds of machinery, which considerably limits the market for motor-vehicles produced domestically.

In 2006 1175 thou. cars were produced in Russia, 280 thou. of which were the foreign brands of cars, produced in Russia. The growth of domestic motor-car construction being 9.9%, the import of passenger cars in real terms by legal entities increased by 30.9%, by individuals – by 88.3%. Domestically-produced cars account for 38% of the market, foreign brands of cars, produced in Russia, - by 14% and new foreign brands of cars produced abroad - 35%.

The main reason for motor-vehicles boom in 2006 was the high solvent consumers' demand. According to the data of the Ministry for the Industry and Energy, whereas in 2005 54% of the cars purchased in Russia were bought in the segment below USD 10 thou., and 18% - in the segment below USD 20 thou., in 2006 the dynamics of the purchase suffered serious changes: 46% of cars were bought in the segment below USD 10 thou. and 23% - in the segment below USD 20 thou. The analysis of the growing import structure allows to notice that the share of the used cars of foreign brands import has decreased.

The import impact is highly differentiated with regard to different sectors of the economy and trade markets. For instance, at the market of the intermediate demand goods import of some kinds of raw materials, components for household appliances, and components for car assembly within the framework of the car assembly projects has a positive effect on the restructuring processes and the level of business activity. At the market of capital machine-building goods the increase of import is one of the key factors for investment projects fulfillment, production

modernization and technological innovations implementation. At the same time the intensification of the competitiveness with import is observed in such industries as, for instance, machine-tool construction, road-building equipment construction, agriculture machine-building, motor-vehicles construction. Low investment activity, high extent of the fixed assets depreciation, outdated technologies remained characteristic for these productions. One of the promising development directions for these fields of activities is the active implementation of industrial assembly and the transfer of the foreign companies' activity in the territory of Russia.

Among the factors, having positive effect on the production dynamics, the increase in goods production by the licenses of the foreign firms with the use of the imported components can be singled out. Anticipating growth of the production output at the enterprises with the foreign funds participation is changing the conditions of the competition. In motor-vehicles construction, for instance, one of the reasons for the decrease in Russian passenger cars output and demand re-orientation towards the foreign producers goods was more flexible price and sales policy of the foreign companies' dealers.

System problem of the transport vehicles machine- building in Russia consists in non-balance between the structure of production facilities, technological level of the transport machine-building production and the demand of the domestic railway transportation for the modern highly efficient rolling-stock. A steady economic growth over the last 7 years led to the increase in freight and passenger transportation, also by railways, which, in its turn, caused a considerable increase in the demand for the production of the transport machine-building. As a result Russian producers started to increase the load of the existing facilities and involve idle non-specialized facilities. Besides, the industry's enterprises suffer from the shortage of the highly qualified workers and engineers.

It was the decrease in the investments into railway transportation by 6.4% in 2006 in comparison with January-September 2005 that had a negative impact on the dynamics of the transport machine-building. The biggest customer for the transport machine-building is the joint-stock company "Russian Railways", which is the owner of 70% of the freight cars, nearly 100% of the passenger cars fleet and approximately 65% of the locomotive fleet. At the moment the conclusion of short-term contracts (within a year) for the supply of transport machine-building production is in practice in Russia presently. In high technological branches of transport machine-building (traction electrical equipment and passenger rolling stock) this does not allow to plan its activity efficiently, including development of the modern grades of the rolling stock. The absence of the long-term contracts conclusion practice is closely connected with price formation system for the production, supplied to JSC "Russian Railways". At present there is no adjusted with JSC "Russian Railways" mechanism of price determination and correction in connection with the changes in prices for materials and components.

The characteristic feature of the transport machine-building is the high proportion of the state funds in industry's enterprises as a consequence of its strategic importance for the national and economic safety. That is why one of the main direc-

tions of institutional development of the transport machine-building is the completion of structure reform on the railway transport and allocation of industrial assets for sale from the structure of JSC "Russian Railways" and their sale into the ownership of private companies. The solution of this problem will allow changing the competitive environment at the market of transport machine-building production and securing equal opportunities for all members of the market.

#### The Dynamics of the Consumers' Demand Commodities

The complex of industries, producing consumers' goods' was not able to sustain steady growth rates for a long time, which is connected to a great extent with the absence of the serious quality changes in technology and structure of production.

With ruble appreciation and shift of the consumers' preferences towards the average price segments by the ratio of price to quality Russian producers cannot compete with import. The exception is the companies which thanks to production modernization and reconstruction, formation of the fundamentally new marketing and logistics system occupies niche positions after 1998 devaluation. The competitiveness of the domestic foodstuffs producers was supported by active investment policy and existing mechanism for import quotas for some kinds of goods. However this created potential was not sufficient for the sustention of the steady production growth rates. The slowdown in the food production as compared with the dynamics of the retailed trade turnover was also observed. In 2005–2006 against the background of the investment support strengthening the increase in foodstuffs productions growth rates is also observed. The growth index in 2006 was equal to 105.4% against 104.3% in 2005 and the minimum over the last 8 years level of 2.9% in 2004.

In production of the non-food goods Russian producers, as a rule, did not compensate the decrease in price competitiveness by the production modernization which, in the long run, led to the decrease in output rates and permanent crisis in textile, clothing, leather and footwear industries.

An important tool for light industry modernization acceleration and production extension was the abolition of the customs duties for import technological equipment. In October 2005 the Government granted the right of duty-free import of 45 kinds of equipment to the domestic companies. According to the data of the Ministry of the Industry and Energy this enabled the enterprises to purchase 160.9 thou. units of modern equipment and to spare RUR 122 mln. In 2006 (January-September) RUR 2.1 bln. were invested in textile and sewing industry, which is 122.3% to the level of the previous year, whereas in leather and footwear production – RUR 0.8 bln (230.0%). Positive influence of the modernization processes was maintained by the change in the norms of duty-free goods import by individuals and the control reinforcement for customs institutions. As a result, in 2006 for the first time since 2002 the positive dynamics of the textile and clothing industry (107.3%), leather, leather goods and footwear production (116.7%) was observed. However the production output throughout these industries being 20-23% of the pre-reform 1991, this did not have much influence on the domestic demand. Textile

and clothing industries belong to the group of processing industries characterized by critical values of the fixed assets depreciation. The retirement coefficient for the fixed assets exceeds by more than four times the index of assets renewal. The absolute decrease of the amount of the fixed assets is proceeding in textile and clothing industry. Production crisis led to the sharp decrease in the demand for labor force. Over the last three years the average number of industrial and production staff in textile, clothing, leather and footwear production decreased by more than 22%. Low attractiveness of these kinds of activities was also determined by the existing labor remuneration level. The wages were equal approximately to 48–54% of the average level throughout the manufacturing industries. On one hand, the fact that material and technical basis and labor qualification do not meet the market criteria determined the decrease in domestic non-food goods competitiveness, on the other – under the existing exchange rates it led to the expansion of niches for import goods. Russian producers of light industry hold one of the least attractive for foreign investors position. At the beginning of 2006 the accumulated amount of the foreign investments into the industry was equal to USD 147 mln. as compared with USD 5781 mln. in food industry.

The condition that weakens the negative influence of textile, clothing goods and footwear on the formation of the market resources of non-food goods produced domestically is the acceleration of household appliances, furnishing goods production. The dynamics of the furniture and construction materials output (107.8%) corresponds to the intensive growth of housing building and high business activity at the real estate market. The nature of these productions operation and the growth of their competitiveness was considerably influenced by new technologies implementation and the increase in assembly production output based on the imported components.

#### The production of Intermediate Demand Goods

The dynamics of the intermediate demand goods production has been in the area of the positive values since 2002. The nature of metallurgical, chemistry and woodworking industry operation was determined by the level of internal and external demand.

Chemistry complex is the basic segment of Russian economy. Its proportion in the industry structure by the amount of goods produced comprises about 5.5%. More than 4.5% of the fixed assets of the country are located in this industry. The enterprises secure about 5.4% of the All-Russian currency earnings. Over 2000-2005 the chemicals production output increased by 1.45 times. Since 2000 the slackening of the development dynamics and systematic decrease in the production profitability is observed in the branch of industry. The situation is aggravated by non-competitiveness of the domestic production at the external market, preferences' shift at the domestic market towards import goods segment and not sufficient purchasing capacity of the producers and the population. The conditions for chemicals import expansion are provided by low consumption quality, limited range of domestically produced chemicals, underdevelopment of domestic market infrastructure, unpreparedness of the consuming economic sectors to process and util-

ize a number of materials, especially polymers. For instance, the average consumption of plastics and many other kinds of chemicals in Russia per capita is by 2-4 times lower than in industrially developed countries. The non-balance between the polymers production and processing leads to the fact that Russia is the importer of finished plastic goods, including those produced abroad from Russian plastics. The share of import in the structure of domestic consumption increased considerably for plastic goods (up to 72%), chemical fibers and threads (up to 65%), synthetic dies and polystyrene (up to 58%), varnish-and-paint materials (up to 50%).

In 2006 the increase in chemicals production was equal to 1.9% against 2.6% in the previous year, the production of rubber and plastics goods increasing by 11.7% against 5.5%. Structural shifts in the chemicals production are accounted for by the recovery of the economic growth in varnish-and-paint (123% versus 2005), basic chemicals production (101.6%) in the environment of unsteady pharmaceuticals production dynamics and the decrease in artificial and synthetic fibers production (*Table 14*).

*Table 14*

**Main Kinds of Chemistry, Plastics and Plastics Goods Production  
Output in 2000–2006**

	2000	2001	2002	2003	2004	2005	2006
<b>Chemistry Production</b>							
Sulphuric acid, monohydrate, tons mln.	8.3	8.2	8.5	8.8	9.2	9.5	9.3
Soda ash (100%), thou. tons	2201	2339	2385	2386	2576	2582	2.8
Hydrate of sodium (100%), thous. tons	1241	1197	1146	1113	1188	1245	1266
Mineral fertilizers – total, thou. tons	12213	13026	13562	14053	15800	16625	16170
including:							
nitric	5818	5890	5968	5995	6591	6725	6879
phosphate, including powdered phosphorite	2379	2391	2513	2593	2802	2766	2772
potash	4016	4745	5080	5465	6405	7131	6511
chemical components for plant protection, thou. tons	10.6	13.0	10.9	8.3	8.4	10.1	11.0
Synthetic resins and plastics, thou. tons	2576	2771	2922	3118	3304	3418	3671
including:							
Polystyrene and styrene co-polymers	92.2	106	108	135	165	228	278
PVC resin and PVC co-polymers	480	487	528	547	563	580	592
polyethylene	923	951	1012	1038	1069	1049	1075
polypropylene	233	260	269	286	294	349	376
Paint-and-brush materials, thou. tons	575	628	606	597	698	721	886
Chemical fibers and threads – total	164	158	159	187	188	158	152
<b>Rubber and plastic goods production</b>							
Tyres for motor-vehicles, agriculture machines, motorcycles, scooters, mln.	29.9	33.7	35.8	38.6	39.5	41.4	39.8
including:							
For trucks, buses, trolleybuses	10.1	11.4	10.9	11.7	11.7	11.7	10.9
For passenger cars	17.7	19.7	22.2	24.2	25.1	27.3	27.6
Pipes and pipelines details from thermoplastics, thou. tons	50.7	61.7	59.6	65.2	75.4	95.0	115.0

Source: Federal State Statistics Service

Key factors, that limit the functioning of chemistry complex, the capacity of the domestic market for chemicals being quite high are:

- high extent of the equipment wear and tear, technological backwardness;
- the anticipating growth rates of prices and tariffs for natural monopolies production;
- the scantiness of investment resources;

- problems with industry's enterprises provision with the main kinds of raw materials, especially hydrocarbons (virgin petrol, condensed gases, ethane, natural gas);
- the decrease in the effective demand for the small capacity chemistry production, in the first row the military industry production.

One of the urgent problems in chemistry and petrochemistry industry development is the effective import substitution and the decrease in the dependence of the domestic market from the influence of the foreign companies, decrease in the economically unjustified import of chemicals for whose production development there are sufficient conditions in the country. The solution of the problem will enable to fill domestic market with high-quality and relatively inexpensive production, satisfy the increasing demand of the domestic market in the chemicals and new materials, expand the assortment of the goods produced as well as the final commodities export volume.

Priority direction of the investment policy is the increase in the investment attractiveness of the chemistry complex at the expense of the decrease in the investment risks and effective protection of the rights and interests of the Russian and foreign investors. As petrochemistry enterprises are rigidly technologically dependant on the oil and gas production and processing enterprises, it is necessary to correlate the amount of the investment in the production equipment renewals and the increase of raw materials base of the corresponding kinds of the activity. Otherwise a non-balance between production capacities of chemistry complex branches and capacities providing it with the main kinds of raw materials. Obviously, the changes in the branches and special structure of the chemistry complex will have positive impact towards direction of the decrease in primary production.

Thereupon the formation of the large science and production integrated structures, which enable to fulfill to the utmost extent the advantages of finished technological chains starting with the production and processing of hydrocarbons raw materials, on which 80% of chemistry and petrochemistry production is based, and up to output and sale of the main of its kinds, is gaining special significance. Currently the processes of vertically integrated structures creation, which aim is to provide final commodities production at the Russian factories, are observed. The petrochemistry holding joint-stock company "Sibur", founded by RAO Gazprom is operating quite steadily. At the end of 1999 oil company LUKOIL purchased control stock of large chemistry enterprises. Large vertically integrated holdings are oil company Tatneft, to which open joint-stock company "Efremov factory for synthetic rubber", open joint-stock company "Nizhnekamsktechugol" and open joint-stock company "Nizhnekamskmachine" belong, AMTEL, to which open joint-stock company "Volgograd factory for technical carbon", open joint-stock company "Kirov tire factory", open joint-stock company "Krasnoyarsk tire factory" belong. Another direction in the vertically-integrated structure development is represented by the formation of Kemerov regional holding "Siberian chemistry company" with the aim to revive chemistry industry of Kuzbass.

## Extraction Industries

### Oil and Gas Sector

Oil and gas sector is the basis for the economy of Russia and plays a leading role in the formation of state budget incomes and active trade balance of the country. The price situation at the world markets had a determining influence on the position of oil and gas sector in the Russian economy in 2006. As nearly 75% of the oil produced in the country is exported in crude or processed form the level of oil world prices is actually the main factor that determines incomes and financial situation of the Russian oil industry.

World prices in 2006 were at an exceptionally high level. In July 2006 the prices for oil reached unprecedented maximum in nominal terms. The average price for oil grade Brent in July 2006 was equal to USD 73.7 per barrel, Urals – USD 69.2 per barrel. The main reasons for such a situation were high world economy growth rates, in particular of the USA and China economies, low level of idle facilities for oil production, which did not enable to increase the production in a short time to satisfy the growing demand for oil. At the same time, OPEC actually refused to sustain world prices for oil in the limits of the principal price range of USD 22–28 per barrel and demonstrated substantial change in the price policy.

Despite exceptionally high level of prices for oil, OPEC conferences, which were held during 2006 confirmed the quotas for oil production for organization member countries which were established in the middle of 2005 at the rate of 28.0 mln. barrels a day again and again. And in October 2006 in the environment of some decrease in the world prices for oil (average price of OPEC basket in October 2006 being USD 55 per barrel), at the advisory meeting of the representatives of OPEC countries it was decided to reduce the volume of oil production by 1.2 mln. barrels a day starting from 1 November 2006. Later at the conference of OPEC in December 2006 it was stipulated to decrease the volume of oil production by OPEC countries by 500 thou. barrels a day more starting with 1 February 2007.

Thus the virtual conduct of OPEC testifies for a considerable shift in price marks of that organization, for its aspiration to sustain oil prices at the level of far above than USD 50 per barrel. At the same time outside OPEC the decrease in oil production growth rates in Russia had a considerable impact on the oil prices dynamics. It can also be noted the presence of quite significant geopolitical risks in 2006 which contributed to the growth of oil world prices, for instance the problems, connected with Iran and Iraq, military operations of Israel in the Lebanon territory.

As a result, the price for oil grade Brent in 2006 was equal on average to USD 65.2 per barrel, the price of Russian oil Urals being USD 61.2 per barrel. The average price for OPEC oil in 2006 was equal to USD 61.1 per barrel. The average price of the Russian oil at the world (European) market was 20.6% higher in 2006 than the average level of the previous year (*Table 15*).

Table 15

**World Prices for Oil in 2000–2006, as USD per barrel**

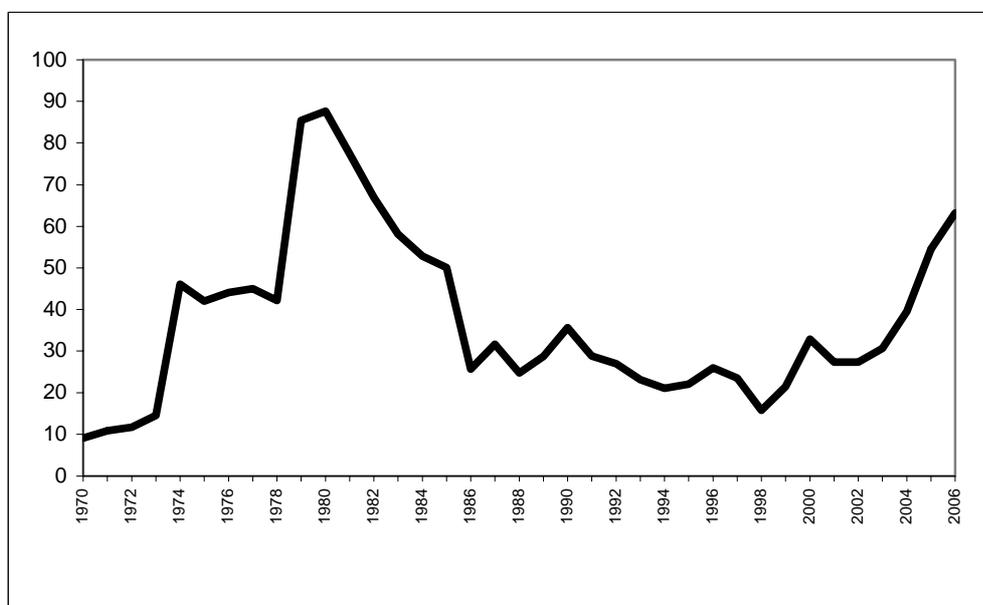
	2000	2001	2002	2003	2004
Price for oil grade Brent, Great Britain	28.50	24.44	25.02	28.83	38.21
Price for oil Urals, Russia	26.63	22.97	23.73	27.04	34.45
Price for oil basket of OPEC member countries	27.60	23.12	24.34	28.13	36.05

Table 15 (continuation)

	2005	2006 1 quarter	2006 2 quarter	2006 3 quarter	2006 4 quarter	2006
Price for oil grade Brent, Great Britain	54.38	61.75	69.62	69.49	59.68	65.16
Price for oil Urals, Russia	50.75	58.25	64.79	65.39	56.53	61.24
Price for oil basket of OPEC member countries	50.64	57.65	64.72	65.68	56.11	61.08

Source: OECD International Energy Agency, OPEC.

The level of world prices for oil, which was observed in 2006, is exceptionally high not only for the period of post-reform development of the Russian economy but also from the point of view of historical retrospective. Over the period since 1900 higher level of world prices for oil in real terms was observed only in 1979–1982. For instance, in 1980 the average annual world price for oil in real terms (in 2005 prices) was equal to USD 87.7 per barrel, being in nominal terms USD 36.8 per barrel (*Fig. 8*). For the sake of comparison it can be noted that in 1998 the average annual price for the oil grade Brent in real terms was only USD 15.7 per barrel. (USD 12.7 per barrel in nominal terms), being on average in 1990-ies USD 24.4 per barrel.



\* Prices of 2005, 1970–1983 – Arabian Light, 1984–2006 – Brent.  
Source: BP.

Fig. 8. The World Price for Oil in Real Terms in 1970–2006\*, USD per barrel

During 2006 the highest prices for oil (USD 73.7 per barrel for oil grade Brent) were observed in July, when Israel started military operation in the Lebanon territory and fears of other countries of the region joining into the conflict arose and of decrease in oil supplies to the world market. In September-October prices for oil decreased considerably (price for oil grade Brent in October being USD 57.8 per barrel). The main reasons of such a fall in world prices were the extension of oil production in the countries, which are not members of the OPEC and relative relaxation of the tension at the Middle East after the end of Israel's military operation in the territory of Lebanon, as well as the abatement of expectations for coercion solution of Iranian problem by the USA administration. In December under the influence of the decrease in oil production by OPEC member countries, which was decided on from 1 November 2006, the price for the oil grade Brent increased up to USD 62.3 per barrel (*Table 16*).

*Table 16*

**Prices for Oil Grades Brent and Urals in 2006, as USD per barrel**

	2006 January	2006 February	2006 March	2006 April	2006 May	2006 June
Price for oil grade Brent, Great Britain	63.05	60.12	62.09	70.35	69.83	68.69
Price for oil Urals, Russia	59.57	57.06	58.11	64.95	65.09	64.51

*Table 16 (continuation)*

	2006 July	2006 August	2006 September	2006 October	2006 November	2006 December
Price for oil grade Brent, Great Britain	73.66	73.11	61.71	57.80	58.92	62.33
Price for oil grade Urals, Russia	69.20	68.49	59.47	55.68	55.95	57.95

Source: OECD/IEA, OPEC.

The development of the gas and oil sector in the Russian economy in 2006 was characterized by the sustention of the tendency for oil, oil products and natural gas production, which evolved in 2000-2005. Oil production, gas condensate included, reached 480 mln. tons in 2006. This figure is by 15.7% lower than pre-crisis maximum, reached in 1987, when oil production was equal to 569.4 mln. tons and by 59% higher than the minimum level of 1996, when the production decreased down to 301.3 mln. tons. The reasons for a considerable growth of oil production in recent years are the expansion of export opportunities, for instance thanks to the creation of the Baltic pipeline system and railway transportation use, as well as the growth in domestic demand.

At the same time oil production growth rates in 2005–2006 decreased considerably. Whereas in 2002–2004 the increase in oil production, gas condensate included, reached 8.9–11% per year, in 2006 the increase in production was only 2.1%. This is the indicator of fast increase reserves depletion in oil production in the country and the evidence of necessity of very active actions to develop new oil fields, in the Eastern part of the country, in particular.

The volume of primary oil processing in 2006 increase by 5.7%, and the extent of oil processing went up by 71.9% (in 2005 this index was equal to 71.6%).

growth of natural gas production, which started in 2005 continued and in 2006 was equal to 2.4% (*Table 17*).

*Table 17*

**Oil, Oil Products and Natural Gas Production during 2000-2006,  
as percentage to the preceding year**

	2000	2001	2002	2003	2004	2005	2006
Oil, including gas condensate	106.0	107.7	109.0	111.0	108.9	102.2	102.1
Primary oil processing	102.7	103.2	103.3	102.7	102.6	106.2	105.7
Motor petrol	103.6	100.6	104.9	101.2	103.8	104.8	107.4
Diesel oil	104.9	102.0	104.7	102.0	102.7	108.5	107.0
Furnace fuel oil	98.3	104.2	107.1	100.3	97.8	105.8	104.5
Natural gas, bln.cu. m	98.5	99.2	101.9	103.4	101.6	100.5	102.4

Source: Federal State Statistics Service

In 2006 the biggest amount of oil was produced by oil companies LUKOIL, Rosneft, TNK-BP, Surgutneftegas and Gasprom. The share of these 5 companies is 75% of the total oil production in the country. The main part of the Rosneft production (68.5%) was secured by Yuganskneftegas, which was apportioned from the YUKOS structure and joined to Rosneft at the end of 2004. At the YUKOS enterprises the decrease in the oil production continued. In 2005 oil production by YUKOS without Yuganskneftegas decreased by 24.5% as compared with the previous year, in January-September 2006 – by 12.5%. As a result the share of the company at the Russian oil market dropped down to 4.5%. At the same time the share of Gasprom at the oil market has increased dramatically thanks to the purchase of the oil company Sibneft. The proportion of Gasprom, including Gaspromneft, which was formed to control Gasprom oil assets in 2006 was equal to 9.6% in the All-Russian oil extraction. As a result the share of the state-owned companies - Rosneft and Gasprom, including Gaspromneft – at the Russian oil market in 2006 reached 26.6%. Production sharing operators produced 1.1% of the Russian oil in 2006. The share of other producers, to which around 150 small scale oil enterprises belong, comprised just 4.1% of oil production in the country (*Table 18*).

The increase in the state-owned companies influence in the oil sector was quite characteristic trend for the recent years. The positions of the state-owned companies strengthened considerably due to the purchase of private-owned companies assets (in 2004 of Yuganskneftegas, in 2005 – Sibneft). In December 2006 Gasprom purchased controlling stock in “Sakhalin-2” project, which is being fulfilled by foreign investors<sup>8</sup>. In future it can be expected that the share of the state-owned companies at the oil market thanks to the fulfillment of the project “Sakhalin-2” as well as possible purchase of oil production and processing assets of oil company YUKOS, which was declared bankrupt last year, by the state-owned companies. The share of the state-owned companies in the all-Russian oil production

<sup>8</sup> Operator of “Sakhalin-2” project is the Sakhalin Energy Investment Company, whose stocks holders are companies Royal Dutch/Shell (Netherlands/Great Britain), Mitsui and Mitsubishi (Japan). Project is fulfilled on terms of production share agreement.

can reach the level of 31% only due to the purchase of the remaining YUKOS assets.

Gasprom, whose share in all-Russian production was equal to 83.9% in 2006, commands as usual in the gas production. At the same time gas production by oil companies has increased. The share of the oil companies in gas production remains, however, quite low. The biggest gas volumes among oil companies are produced by LUKOIL, Rosneft and Surgutneftegas.

Table 18

**The Structure of Oil and Gas Production in 2006\***

	Oil production, mln. tons	The share in the total production, %	Gas production, bln. cu. m	The share in the total production, %
<b>Russia - total</b>	<b>480.5</b>	<b>100.0</b>	<b>656.2</b>	<b>100.0</b>
LUKOIL	90.4	18.8	14.1	2.1
Rosneft	81.7	17.0	13.6	2.1
TNK-BP	72.4	15.1	8.7	1.3
Surgutneftegas	65.6	13.7	14.6	2.2
Gasprom+Gaspromneft	46.1	9.6	552.4	84.2
Of which:				
Gasprom	13.4	2.8	550.3	83.9
Gaspromneft	32.7	6.8	2.1	0.3
Tatneft	25.4	5.3	0.7	0.1
Slav-neft	23.3	4.8	0.9	0.1
YUKOS	21.5	4.5	1.9	0.3
RussNeft	14.8	3.1	1.6	0.2
Bashneft	11.7	2.4	0.3	0.0
NOVATEC	2.6	0.5	28.8	4.4
Operators of production sharing operators	5.1	1.1	1.0	0.2
Other producers	19.9	4.1	17.6	2.7
<b>For reference:</b>				
<b>State-owned compa- nies - total:</b>				
Rosneft+Gasprom+ Gaspromneft	127.8	26.6	566.0	86.3
Of which:				
Yuganskneftegas	56.0	11.7	1.5	0.2

\* According to the organization structure by 31.12.2006

Source: Ministry for Industry and Power, authors' calculations.

In January –September 2006 a considerable growth in prices for oil and oil products at the domestic market was observed due to the increase in world prices. The producers prices for oil, car petrol, diesel fuel and furnace fuel oil (mazut) reached the maximum over the whole post-reform period in 2006. In September 2006 the average internal price for oil (producers' price) in dollar terms reached USD 232.1 per ton, which is the maximum value for oil and car petrol prices over the whole post-reform period (*Table 19*). In October-December 2006 the prices at the domestic market decreased substantially under the influence of world oil prices fall.

Internal prices for natural gas have also increased. The gas producers' prices considerably exceeded pre-devaluation level and reached USD 16.1 per 1 thou. cu. m in September 2006. Average price for gas purchase in the industry, including both the gas production price and its transportation costs and trade and sales extra charge reached USD 58.8 per 1 thou. cu. m. in September 2006. At the end of the

year the gas producers' price was equal to USD 14.4 per 1 thou. cu. m, price for gas purchase in the industry being USD 60.1 per 1 thou. cu. m.

Table 19

**Internal Prices for Oil, Oil products, Natural Gas in US dollar terms over 2000–2006 (average producers' prices, as USD per ton)**

	2000 December	2001 December	2002 December	2003 December	2004 December
Oil	54.9	49.9	60.7	70.1	123.5
Motor petrol	199.3	151.5	168.8	236.9	333.1
Diesel oil	185.0	158.5	153.8	214.3	364.3
Furnace fuel oil	79.7	47.1	66.1	66.0	69.4
Natural gas, as USD per thou. cu. m	3.1	4.8	5.9	4.4	10.5

Table 19 (continuation)

	2005 December	2006 June	2006 September	2006 December
Oil	167.2	207.3	232.1	168.4
Motor petrol	318.2	400.7	478.7	416.5
Diesel oil	417.0	455.9	471.2	426.1
Furnace fuel oil	142.7	191.9	194.9	148.8
Natural gas, as USD per thou. cu. m	11.5	14.0	16.1	14.4

Source: calculated on the basis of the Federal State Statistics Service data.

In January-November 2006 as compared with the corresponding period of the previous year oil export in natural terms decreased by 1.2% while oil products export increased by 7.1% (Table 20). In January-November 2006 the share of export in furnace fuel oil (mazut) production was equal to 75.2%, diesel oil – to 57.1%, motor petrol – to 18.7% (for comparison: in 1999 export share in motor car petrol production was equal to only 7.2%, in 2005 – to 18.5%). In 2006, as well as in 2005 the decrease in light oil products import was observed. In January-November 2006 import of motor petrol decreased by 11.7% in comparison with the corresponding period of the previous year, and the share of import in petrol resources was equal only to 0.02% (for reference: in the first half-year of 1998, i.e. before ruble devaluation the share of the import in petrol resources was equal to just 8.7%, in 2005 – 0.03%).

Table 20

**Oil, Oil Products and Natural Gas Export from Russia, as percentage to the previous year**

	2002	2003	2004	2005	2006 (11 months*)
<b>Oil, total</b>	<b>113.9</b>	<b>117.8</b>	<b>115.0</b>	<b>98.0</b>	<b>98.8</b>
including:					
to non-CIS countries	109.9	118.9	116.3	98.6	99.3
to CIS countries	137.3	112.4	108.3	94.9	95.9
<b>Oil products, total</b>	<b>118.5</b>	<b>103.6</b>	<b>105.5</b>	<b>117.4</b>	<b>107.1</b>
including:					
to non-CIS countries	119.1	102.6	104.9	118.7	105.5
to CIS countries	102.8	132.3	117.9	94.3	143.3
<b>Gas, total</b>	<b>102.4</b>	<b>102.0</b>	<b>105.5</b>	<b>103.4</b>	<b>96.2</b>

\* As percentage to January-November 2005.

Source: Federal State Statistics Service.

For the first time over the last years gas export supplies decreased, which was due to the reduction of its supplies to CIS countries, to which gas supplies reduced by 15.9% in January-November 2006.

As it is demonstrated by the oil and oil products output and export analysis (*Table 21*), approximately 60% of the additionally produced oil was consumed at the domestic market, and 40% was exported in the form of oil products obtained from it. In 2006 net oil and oil products export, according to the preliminary estimation, was equal to 351.1 mln. tons, i.e. increased by 4.2 mln. tons as compared with the previous year. As a result, the share of net oil and oil products export in oil production was equal to 73.1%, net oil export being 51.5% of its production. The share of net export in gas production was equal to 29.3%.

*Table 21*

**The Ratio of Energy Supplies Production, Consumption and Export  
in 2000–2006**

	2000	2001	2002	2003	2004	2005	2006 (estimation)
<b>Oil, mln. tons</b>							
Production	323.2	348.1	379.6	421.4	458.8	470.0	480.0
Export, total	144.5	159.7	187.5	223.5	257.4	252.5	249.5
Export to non-CIS countries	127.6	137.1	154.8	186.4	217.3	214.4	212.9
Export to CIS countries	16.9	22.7	32.7	37.1	40.1	38.0	36.6
Net export	138.7	154.7	181.3	213.4	253.2	250.1	247.4
Domestic consumption	123.0	122.9	123.5	129.8	124.2	123.1	128.9
Net export, as percentage to the production	42.9	44.4	47.8	50.6	55.2	53.2	51.5
<b>Oil products, mln. tons</b>							
Export, total	61.9	70.8	75.0	78.4	82.1	97.0	103.9
Export to non-CIS countries	58.4	68.3	72.5	74.9	78.0	93.1	98.2
Export to CIS countries	3.5	2.5	2.6	3.5	4.1	3.9	5.7
Net export	61.5	70.5	74.8	78.2	81.4	96.8	103.7
<b>Oil and oil products, mln. tons</b>							
Oil and oil products net export	200.2	225.2	256.1	291.6	334.6	346.9	351.1
Oil and oil products net export, as percentage of oil production	61.9	64.7	67.5	69.2	72.9	73.8	73.1
<b>Natural gas, bln. cu. m</b>							
Production	584.2	581.5	594.5	620.3	634.0	636.0	656.0
Export, total	193.8	180.9	185.5	189.3	200.4	207.3	199.4
Export to non-CIS countries	133.8	131.9	134.2	142.0	145.3	159.8	159.6
Export to CIS countries	60.0	48.9	51.3	47.3	55.1	47.5	39.8
Net export	189.7	176.8	178.3	180.5	193.5	200.4	192.5
Domestic consumption	394.5	404.7	416.2	439.8	440.5	435.6	463.5
Net export, as percentage to the production	32.5	30.4	30.0	29.1	30.5	31.5	29.3

*Source:* Federal State Statistics Service, Ministry for the Industry and Power, Federal Customs Service, authors' calculations.

The share of oil products export having increased to some extent, the crude oil export, being 70% of the total export volume, still prevailed in the structure of oil export. It was the furnace fuel oil, which is used as a primary product in Europe for further processing, and diesel oil that comprised the main part of the oil products export. The main part of the energy supplies (85% of oil, 95% of oil products and 80% of gas) was exported beyond CIS.

As it is shown by the analysis of the Russian oil export dynamics over the long period of time in 2006 the total net export of oil and oil products reached unprecedented level and exceeded by 59.5 mln. tons the level of 1988, which was characterized by a maximum oil export volumes (291.6 mln. tons). At the same time the increase in oil products share in oil export was observed, their share increasing from 18.2% in 1990 to 29.5% in 2006 (*Table 22*). In the environment of the sharp reduction of domestic oil consumption (according to our calculations it has decreased from 269.9 mln. tons in 1990 to 128.9 mln. tons in 2006, that is more than by half) the share of oil and oil products net export in oil production increased over this period from 47.7% to 73.1%. In contrast to oil and oil products export the net gas export and its share in production do not exceed the level of 1990ies in recent years though the share of net gas export in its production is a bit higher than in the pre-reform period (29.3% in 2006 against 28% in 1990).

*Table 22*

**Oil Products Net Export in 2002–2006**

	2002	2003	2004	2005	2006 (estimation)
Oil products net export, mln. tons	74.8	78.2	81.4	96.8	103.7
The share of oil products in net export of oil and oil products, as percentage	29.2	26.8	24.3	27.9	29.5

*Source:* Federal State Statistics Service, Federal Customs Service, authors' calculations.

The given data testifies that the export orientation of oil sector in comparison with the pre-reform period has reinforced. It should be, however, taken into account that it is connected not only with the increase of the absolute export volumes, but also with a considerable decrease in the domestic oil consumption as a result of Russian economy market transformation.

High level of the world prices for oil, which was observed in 2006, determined considerable incomes growth in the oil sector of the economy. In January–November 2006 total earnings from oil and main kinds of oil products export (car petrol, diesel oil and furnace fuel oil) reached USD 129.0 bln., which is a record level over the whole post-reform period (*Table 23*). For reference it can be noted that the minimum level of oil export earnings was observed in the environment of world oil prices fall in 1998, when the export profit was only USD 14 bln.

*Table 23*

**Oil and Oil Products Export Earnings in 2000–2006, USD bln.**

	2000	2001	2002	2003	2004	2005	2006 (11 months)
Oil and main kinds of oil products export earnings	34.9	33.4	38.7	51.1	74.6	112.4	129.0

*Source:* calculated on the basis of the Federal State Statistics Service.

The share of power and energy commodities in Russian export in 2006 was equal to 65.2% (in 2004 this index was equal to 56.8%, in 2005 – 64.1%). The proportion of the crude oil in Russian export in 2006 was equal to 33.9% (in 2004 –

32.1%, in 2005 – 34.7%). The data on the structure of Russian export of energy suppliers are demonstrated in *Table 24*.

*Table 24*

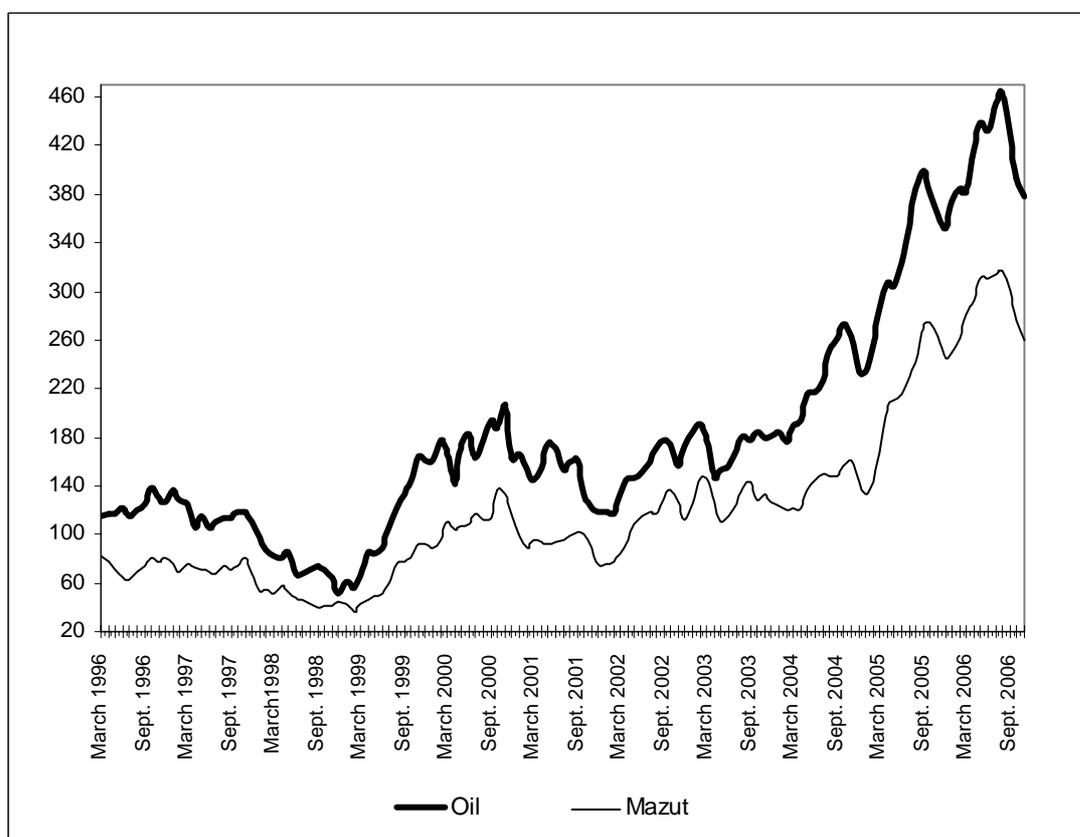
**Value and Share of Fuel and Power Commodities in 2005–2006**

	2005		2006	
	USD bln.	%*	USD bln.	%*
<b>Fuel and Power commodities, total</b>	<b>154.7</b>	<b>64.1</b>	<b>196.8</b>	<b>65.2</b>
<b>of which:</b>				
<b>oil</b>	<b>83.8</b>	<b>34.7</b>	<b>102.3</b>	<b>33.9</b>
<b>natural gas</b>	<b>31.4</b>	<b>13.0</b>	<b>43.8</b>	<b>14.5</b>

\* as percentage to the total volume of Russian export

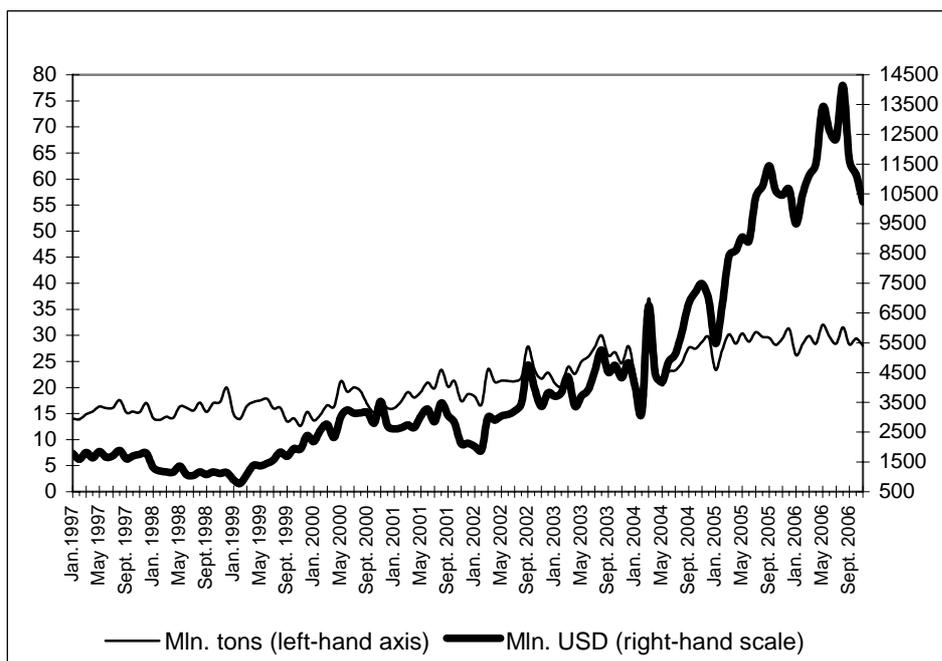
Source: Federal State Statistics Service

The dynamics of separate indices of oil and gas sector development is shown in *Fig. 9–12* (value indices are given in current prices).



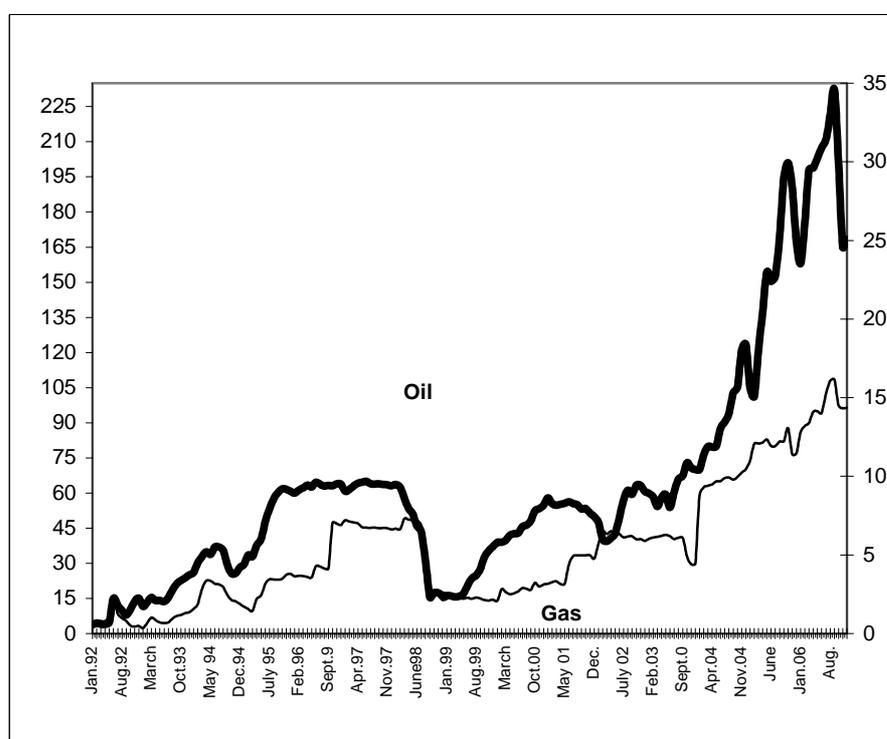
Source: calculated on the basis of Federal State Statistics Service data

*Fig. 9. Average Export Prices for Oil and Furnace Fuel Oil (mazut) in 1996–2006, as USD per ton*



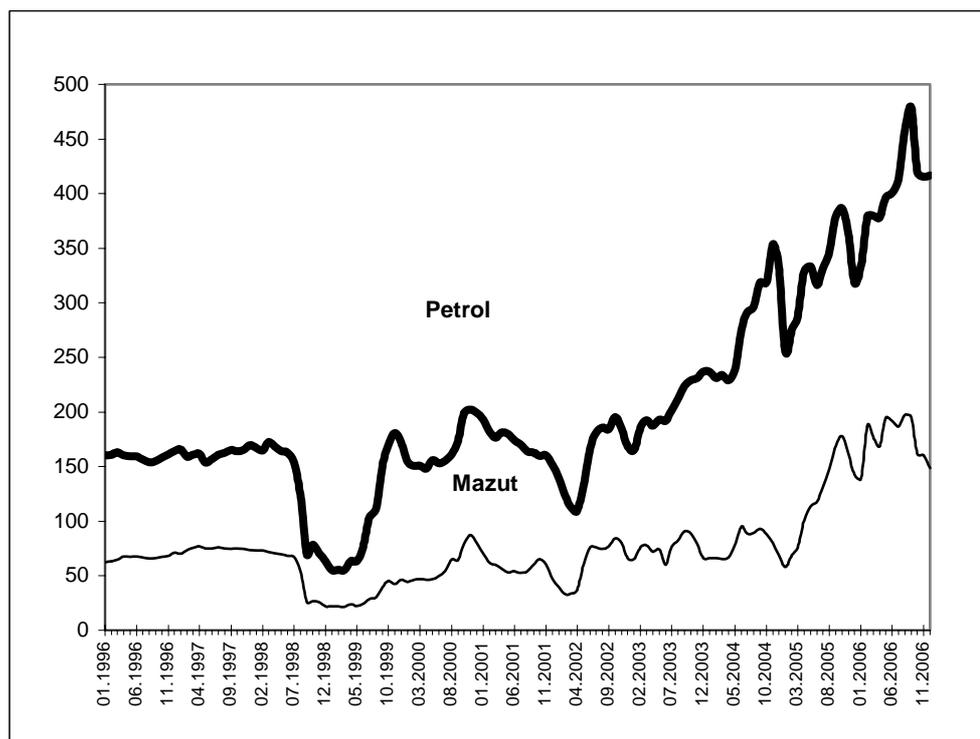
Source: calculated on the basis of Federal State Statistics Service data

Fig. 10. Oil and Oil Products Export in Natural and Monetary Terms in 1997–2006



Source: calculated on the basis of Federal State Statistics Service data

Fig. 11. Average Producers Prices for Oil (as USD per ton – left-hand scale) and Gas (as USD per thou. cu. m – right-hand scale) in Dollar Terms in 1996-2006



Source: calculated on the basis of Federal State Statistics Service data

Fig. 12. Average Producers' Prices for Motor Petrol and Furnace Fuel Oil in Dollar Terms in 1996–2006, as USD per ton

A number of factors provide favorable demand and price prerequisites for the further development of oil sector in Russia. The export opportunities of Russian oil to European countries will expand while the demand for oil in the countries of Western and Eastern Europe is increasing and oil production in the Northern Sea is decreasing. At the same time the growth of export demand for oil in the countries of Asian-Pacific Region, China in particular, as well as the predicted considerable aggravation of their dependence upon the import create favorable opportunities for Russia's access to the markets of this region's countries, first of all China, South Korea and Japan and for considerable growth of oil export in this direction. The export expansion requires the formation of the necessary transport infrastructure, especially for oil supplies to China, oil resources exploration in the East part of the country.

For oil resources development in East part of the country both direct state participation in the projects of transportation infrastructure formation for oil transportation and certain tax policy implementation which will stimulate the development of the new oil fields. Since the development of oil fields in Eastern parts of the country is connected with relatively higher production costs, tax policy should include certain measures to stimulate the investments.

### ***New Elements of Taxation System of Oil and Gas Sector***

In 2006 Russian taxation system of oil economy sector was supplemented by a number of new elements. The main constituents of the existing taxation system of oil sector are the severance tax and the export duty. Severance tax was introduced from the beginning of 2002 instead of three payments, which were in force at that time: royalty, raw materials and mineral base restoration tax and excise-duty for oil. From the beginning of 2005 severance basic tax rate was fixed at RUR 419 per 1 ton, and the coefficient that characterizes the oil world prices dynamics and is applied to the basic tax rate is calculated by a formula:

$$C_p = (P - 9) \times R / 261,$$

where P is the average price level for oil grade Urals in USD per barrel over the taxation period;

R is the average over the taxation period value of USD to RUR rate exchange, which is fixed by the Central Bank of the Russian Federation (*Table 25*).

*Table 25*

#### **Severance Tax Rate on Oil Production over 2002-2006**

	2002-2003	2004	2005-2006
Severance base rate, RUR per ton	340	347	419
Coefficient, characterizing the oil world prices dynamics (Cp)	(P-8)×R/252		(P-9)×R/261

Source: Federal Law No. 33-Φ3 from 7 May 2004, Federal Law No. 126-Φ3 from 8 August 2001.

As a result of correction factor implementation a real tax rate depends significantly on the level of world prices for oil. Thus, the average dollar exchange rate being 28.28 RUR/USD in 2005, Cp coefficient along with the growth of world prices increases from 0 when the price for oil grade Urals is below USD 9 per barrel to 5.5 when the oil price is USD 60 per barrel. The applied taxation rate increases correspondingly (*Table 26*).

*Table 26*

#### **Severance Rate on Oil Production in the Taxation System of 2005-2006, as RUR per ton**

	Oil grade Urals price, as USD per barrel				
	20	30	40	50	60
<b>Severance basic rate</b>	<b>419</b>	<b>419</b>	<b>419</b>	<b>419</b>	<b>419</b>
<b>Cp coefficient</b>	<b>1.1924</b>	<b>2.2764</b>	<b>3.3604</b>	<b>4.4444</b>	<b>5.5284</b>
<b>Real severance rate</b>	<b>500</b>	<b>954</b>	<b>1408</b>	<b>1862</b>	<b>2316</b>

The severance tax introduction enabled to increase significantly the taxation system budget efficiency, to neutralize negative taxation effects of transfer price formation, to ensure the transparency of tax rates ranking, to adjust Russian taxation system to the world practice.

At the same time the existing tax system, which is based on the flat specific severance rate, is intended to be used chiefly under average conditions and does not take into consideration existing differences in oil production conditions, which are accounted for by field characteristics, its location, as well as the extent of its development. As a result, the economy of production at the fields with higher ex-

penses becomes worse, the selective choice of the most effective reserves and the early end of exhausted reserves development is stimulated, oil being lost in the subsoil areas. At the same time the beginning of the development of new oil fields becomes more complicated, especially in unreclaimed regions with undeveloped infrastructure. Higher capital, investment and transport expenses lead to the fact, that in the environment of the existing tax system the realization of many oil fields development projects in new regions does not provide necessary investment return.

The disadvantages of the severance flat rate account for the search of the ways to differentiate tax rate depending on the mining and geological, economic and geographic factors, which characterize real oil production conditions. As a result, a set of suggestions to differentiate severance tax rate was developed by various government bodies, institutes and individual experts.

The analysis of different conceptions of tax rate differentiation depending on the mining, geological, economic and geographic conditions of oil production demonstrates that in the conditions of present-day Russia the complication of administration, potential corruption, the opportunity to manipulate and underdeclare tax liabilities constrain the application of many approaches. The approaches, that can be potentially realized, are only severance differentiation by reserves exhaust and severance differentiation by location, zero rate application in the first years from the start of the development for new oil fields (tax vacations), as well as zero rate application in case of special oil production conditions (superviscous oil).

The existing taxation system was supplemented with a set of new element by the Federal Law No. 151-Φ3 from 27 July 2006, "On amendments to chapter 26 part two of the Tax Code of the Russian Federation and invalidation of specific statutes of the Russian Federation". The main amendments, which came into effect on 1 January 2007, are the following.

1. The severance zero rate is fixed for oil fields of East Siberian oil and gas province in the territory of the Republic of Sakha (Yakutia), Irkutsk oblast and the Krasnoyarsk krai till the achievement of 25 mln. tons of accumulated oil production volume on the subsoil area or for 10 years in case of the license to use subsoil with the aim of exploration and for 15 years in case of the license for simultaneous geological exploration and oil production from the moment of the state registration of the license.

The severance zero rate for the period before reaching of 25 mln. tons of accumulated oil production volume on the subsoil area or 10-year period, calculated from 1 January 2007, is applied to all oil fields of these region in the process of development, if the extent of exhaust does not exceed 0.05.

2. An extra coefficient  $C_e$ , which is applied to severance basic rate and characterizes the extent of oil reserves exhaust in the subsoil area, is introduced.  $C_e$  coefficient is applied if the extent of the subsoil area exhaust is in the range from 0.8 to 1 and is calculated by the following formula:

$$C_e = 3.8 - 3.5 \cdot N/V,$$

where  $N$  is accumulated oil production in the subsoil area;

$V$  is the initially extracted oil reserves of grades A, B, C1 and C2 at the subsoil area.

Thus, for oil fields with the reserves exhaust extent of more than 80% a reducing coefficient, which value varies from 1 (corresponding to exhaust extent of 0.8) to 0.3 (corresponding to exhaust extent of 1), is applied to severance rate. If reserves exhaust rate at the subsoil area exceeds 1,  $C_e$  coefficient is assumed to be equal to 0.3.

3. Regulations that fix severance specific rate for oil production and the procedure of its application are included directly in the Tax Code of the Russian Federation (chapter 26). Before that the application of severance specific rate and  $C_p$  coefficient, which characterizes the world oil prices dynamics, was established by the Federal Laws No. 126- $\Phi$ 3 from 8 August 2001 and No. 33- $\Phi$ 3 from 7 May 2004, for the period up to 31 December 2006.

Thus, from 1 January 2007, the application of severance specific rate for oil production is fortified in the Tax Code, while the regulation on ad valorem rate of this tax, which was present in the Tax Code, is excluded.

Passed amendments envisage that severance preferences for new and exhausted oil fields can only be received when applying a direct method of oil production quantity control at the subsoil area. As applied to exhausted oil fields, this regulation limits substantially the sphere of tax remissions application, for not all exhausted oil fields (licensed lots) have got a direct control of oil production quantity.

Severance remission provision for new oil fields in East Siberia gas and oil province does not lead to the reduction of current budget income, for the development of these oil fields in the environment of the existing tax regulations will not proceed because of low investment return.

Adopted amendments are aimed at the stimulation of the development of exhausted and new oil fields. Severance differentiation with regard to reserves exhaust enables to prolong exhausted fields development periods and increase oil extraction extent. The extension of exhausted fields exploitation provides extra in-payments of severance (collected with the lowered rate) as well as other taxes (profit tax, export duties etc.). Severance rate reduction for new oil fields makes it possible to stimulate the development of East Siberia oil and gas province, create the basis for future income of the state budget.

#### *The Directions of Taxation System Improvement of the Oil Sector*

Possible directions to improve the taxation system of the oil sector are the changes in the criteria of severance vacations provision, application of regional step-down coefficient to the severance rate for the whole period of the development, transfer to ad valorem severance rate, implementation of some kind of net income taxation.

##### 1. Severance Tax Vacations

An important element of the adopted amendments is the establishment of two criteria for privileged severance rate provision for new oil fields in the East Siberian

oil and gas province: the volume of oil production of 25 mln. tons and the period of 10-15 years depending on the kind of license for the subsoil area exploitation.

If just a volume of production (25 mln. tons) is established as a criteria for tax rates allowances, then the privilege can prolong for quite a long time up to the whole period of exploitation for small-scale oil fields. At the same time this could stimulate the development of small-scale oil fields, whose development, as a rule, is connected with higher capital and exploitation costs as calculated per ton of oil produced (higher costs in this case will be compensated by a longer period of privilege implementation).

If the period of zero rate application (10-15 years) is the only established criteria, this will create strong stimuli for oil production acceleration in the first years of development which will lead to the decrease in the level of final oil extraction. The establishment of the upper limit for accumulated oil production (25 mln. tons), at which the implementation of tax privilege expires, does not create incentives for acceleration of oil production at quite big oil fields.

At the same time the presence of such criteria at small-scale oil fields, oil production at which at normal development rates will be considerably lower than 25 mln. tons, creates strong stimuli for their development with the aim to exempt from taxes the biggest possible amount of the oil produced.

The results of estimations for investment profitability in oil production in East Siberia with the different length of the tax vacations, which were carried out in IET with the application of imitation financial model for a typical oil field developing, are summarized in *Table 27*. These calculations take into account the stage of the oil field development, i.e. the oil fields that are ready for development are singled out (lines 2 and 3), which can use severance privilege straight from 1 January 2007, and oil fields, which are not ready for the development, which require some time for additional exploration and making first investments to get a state license for subsoil area exploitation (lines 4 and 5). The time for additional exploration and first investments implementation is assumed to be 2 years from the moment of license registering. Thus, for an oil field, which is not ready for the development, tax vacations of 10 years from the moment of license registering correspond to 8 years from the moment of oil production, 7-year-long vacations correspond for the period of 5 years from the moment of oil production beginning.

Calculations that were carried out testify quite low profitability of the investment in East Siberia oil fields in the environment of the state-of-the-art taxation system (line 1 *Table 27*). At the same time the established criteria for severance allowances provision in the world oil prices range<sup>9</sup> are regarded as excessive (the results of the corresponding calculations are given in lines 2 and 4 of *Table 27*). Ac-

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<sup>9</sup> Most of the recent forecasts of the leading foreign organizations on world oil prices for middle-term and long-term prospects are in the range of USD 40-57.5 per barrel. Thus, in accordance with the basic version of the last long-term forecast by the USA Ministry of Energy, the average figure for the world price for oil in real terms is USD 57.5 per barrel in 2010, USD 52 per barrel in 2020. Long-term forecast for the world oil prices by the International Energy Agency of Organization for Economic Cooperation and Development is equal to USD 55 per barrel (in prices of 2005).

ceptable investment profitability (the price of oil being USD 40 per barrel and higher the internal profitability norm exceeds 20%) is secured by considerably shorter period of tax vacations: 5 years for oil fields, which are ready for the development, and 7 years for the oil fields, not prepared for the development (lines 3 and 5 of *Table 27*). Quite high profitability is secured also by the extension of severance privilege for the first 15 mln. tons of oil produced (line 6).

*Table 27*

**Profitability of Investments in a Typical Oil Field in East Siberia Profitability under Different Period of Tax Vacations, as percentage**

	Oil grade Urals price, as USD per barrel						
	30	35	40	45	50	55	60
1. Severance: existing taxation system	7.2	10.1	12.7	15.2	17.5	19.9	22.2
2. Severance: 10-year tax vacations for an oil field ready for the development	16.4	21.3	26.0	30.6	35.1	39.6	44.1
3. Severance: 5-year tax vacations for an oil field ready for the development	12.1	16.5	20.8	25.1	29.5	33.9	38.4
4. Severance: 10-year tax vacations for an oil field which is not ready for the development	15.2	20.0	24.7	29.3	34.0	38.5	43.1
5. Severance: 7-year tax vacations for an oil field not ready for the development	12.1	16.5	20.8	25.1	29.5	33.9	38.4
6. Severance: tax vacations up to production of 15 mln. barrels	13.3	17.9	22.4	27.0	31.5	36.1	40.7

Source: IET estimations

The analysis of adopted amendments to Chapter 26 of the Tax Code of the Russian Federation, which deals with severance zero rate application at new oil fields of East Siberia oil and gas province, allows drawing the following conclusions:

1. The length of tax vacations should be differentiated not only by kind of the license for subsoil area exploitation, but also by the extent of oil field development: for the oil fields, which are ready for the development or are at an early stage of exploitation, tax vacations should be of shorter length than for the oil fields, which are not ready for the development, as in the former case no time is needed to conduct additional exploration work (or such exploration can be carried out at the same time as oil production) or for the implementation of primary investments.

2. The established length of the tax vacations for the level of the world prices that is forecasted is excessive and can be reduced. According to our estimations, tax vacations for the oil fields of the East Siberia oil and gas province, which are not ready for the development the tax vacations can be reduced from 10 to 7 years, and for oil fields, which are ready for the development or are at the initial exploitation stage – from 10 to 5 years.

3. It would be preferable to establish the application of the scheme with one criterion for severance privilege provision – the amount of the oil produced. And the volume of 25 mln. tons is considered excessive at that. With such a limit the investment profitability seems excessively high, and at the oil fields of middle-scale 45-50% of the oil produced is actually exempt from the severance. As the calculations demonstrate, necessary investment profitability is secured by the limit of 15 mln. tons.

The approach that is suggested has the following advantages:

first, such a criterion (the volume of accumulated production) does not give incentives for oil production acceleration, as severance privilege provision is not limited by a certain period;

second, such a criterion can be uniform, as it can be applied to all kinds of the licenses (both for the licenses for exploration and production and the licenses for geological exploration (search and exploration) and production), for privilege receipt in this case does not depend on the time of the start of production;

third, such a criteria can be applied to the oil fields at different stages of the development (both for the oil fields that are ready for the development or are at the initial stage of exploitation and for oil fields that are not ready for the development).

It should be, however, taken into account that if the only criterion used is the index of accumulated oil production all the oil produced at the small-scale oil fields can be subjected to severance privilege. However, the development of such oil fields, which otherwise can remain undeveloped, is meanwhile stimulated.

## 2. The Application of the Territorial Step-down Coefficient to Severance Rate for the Whole Period of the Development

The introduction of a step-down coefficient to severance rate, which is applied at the development of new oil fields in some regions (for instance, East Siberia), for the whole period of the development can be an alternative for severance tax vacations.

The value of such a coefficient can be defined by calculation from the requirement of the necessary investment profitability during the development of the oil fields in the corresponding territory. For instance, the value of such a coefficient for East Siberia can comprise 0.5. Such a value of the coefficient secures acceptable profitability of the investments in oil production (*Table 28*).

*Table 28*

### **Investment in a Typical Oil Field in East Siberia Profitability under the Application of a Step-down Coefficient to Severance Rate, as percentage**

	Oil grade Urals price, as USD per barrel						
	30	35	40	45	50	55	60
1. Severance: existing taxation system	7.2	10.1	12.7	15.2	17.5	19.9	22.2
2. Severance: step-down coefficient of 0.5	13.0	16.6	20.1	23.6	26.9	30.3	33.6

Source: IET calculations

From our point of view such an approach has several important advantages over the tax vacations scheme:

first, according to this approach, severance is paid from the very start of the production;

second, this approach does not provide incentives for oil production acceleration in the first years of the development. Thus, it does not have distortion effect on the subsoil area managers and production profile;

third, this approach takes into account higher costs for production and sale over the whole period of the development (for instance, in regard to east Siberia higher oil transportation costs take place over the whole period of oil fields exploitation);

fourth, such a coefficient can be uniform, as it is applicable to all kinds of the licenses (both for the licenses for exploration and production and the licenses for geological exploration (search and exploration) and production), and for the oil fields at the different stage of development (both for the oil fields that are ready for the development or are at the initial stage of exploitation and for oil fields that are not ready for the development);

fifth, such an approach provides investor with a lower profit the price for oil growing as compared with the scheme of tax vacations (*Tables 27, 28*).

### 3. Transfer for Ad Valorem Severance Rate

Ad valorem severance rate is a more flexible tax tool as compared with the specific tax rate. The tax basis for ad valorem severance rate application is oil price at the production point, which allows to take in account the difference in oil sales price, which is accounted for by its quality and supplies direction as well as the differences in transportation costs of the oil producers due to their geographic location.

Application of ad valorem fixed rate will lead to the results different from the results obtained with the application of the existing formula for specific severance rate calculation. To preserve the mechanism of tax load progressive dependence on the oil price it is necessary to establish progressive dependence of ad valorem severance rate tax on the Urals price. In this case, on the one hand, tax load in relative terms will grow along with oil price, and, on the other hand, the advantages of ad valorem rate will be in effect. For instance, the tax sum will take into account the real price of sales, differences in costs for transportation and in oil quality.

Different approaches can be used to secure progressive ad valorem rate. First, the progressive dependence of the tax rate on the level of world prices for oil can be determined in the form of a Table, similarly to the existing routine of oil export duty determination. Second, in order to do this a certain formula can be used, which determines the progressive dependence of the tax rate from the oil price.

Not only does this approach allows securing the progressive dependence of the severance rate on the oil price, but also to use the advantages of ad valorem rate.

The application of severance ad valorem rate assumes the use of market prices for oil to calculate taxes, the application of ad valorem rate being otherwise

inefficient, as this creates opportunities for tax payers to underdeclare their tax liabilities by selling the oil produced at too low prices. The determination of market prices for oil is, however, connected with a number of serious problems, which are accounted for by the special features of the Russian gas and oil sector and the absence of developed market infrastructure. Russian market for crude oil is characterized by high concentration of oil production and processing within the framework of vertically-integrated oil companies (VIOC), whose share in oil production and processing is more than 90% in the country, by absence of transparency and limited number of participators, most of whom belong to or are connected with VIOC. Transportation limitations make oil market even more incompetent. As a result, transfer (intracorporative) prices, established by VIOC management, prevail at the internal Russian oil market.

At the same time, before the formation of the developed crude oil market, in our opinion, directive prices (prices established by the government), calculated market prices for oil, determined by a special method on the basis of world oil prices and calculated domestic oil prices, can be used in order to calculate taxes. Calculated domestic oil price for taxation aims is reasonable to determine on the basis of retail trade prices for oil products sales at the domestic market. In contrast to the crude oil market the domestic oil products market is well developed, characterized by a big number of participants and the number of deals, higher transparency, and competitiveness.

#### 4. Net Income Taxation

The taxation of the net income determined in some way is the most perfect form for oil production taxation, applied in a number of developed countries, for instance, in Norway, the Great Britain, and the USA. Such an approach secures really differentiated taxation, since when it is applied not only the gross income, obtained by the producer is taken into account but also costs for oil production at a particular oil field. As a result, no economic obstacles for oil fields development, which are characterized by higher development costs (capital, exploitation or transportation), arise.

There are different forms of such an approach fulfillment. For example, a better taxation system can be created, the basis for severance ad valorem tax rate application being not the value of oil produced but the net income. This way is used in some countries, for instance the USA, to calculate royalty. In this case net income is calculated as the value of oil per wellhead excluding exploitation costs for its extraction (lifting). The value of oil per wellhead is determined by reverse calculation, by the calculation of the net price on the basis of some basic price or independent deals price established by the market.

Ad valorem tax, which is based on oil price per wellhead excluding certain exploitation expenses, allows taking the real conditions of oil production into account, since all mining and geologic, economic and geographic oil field's characteristics are finally reflected in the income, produced by its development. This system of taxation considers not only obtained incomes but also expenses for oil production at a particular oil field, thus securing differentiated approach depending on the real

conditions of oil production (higher expenses mean lower amount of net profit and consequently tax value).

At the same time effective implementation of such an approach in practice in the situation existing in modern Russia is quite difficult since it requires the solution of a number of administration, methodological and technological problems, including the problem of oil market prices determination and application in order to organize registration and control of the incomes and expenses during oil production regarding oil fields (licensed areas).

Application of the tax for additional income from hydrocarbons production (TAI) is another possible form of taxation. TAI taxation base is defined as the value of produced and sold hydrocarbons, decreased by the amount of production output and sales (excluding amortization) costs, production investments and uncompensated expenses of the previous taxation period. Tax rate is determined by the value of P-factor, calculated as a proportion of accumulated from hydrocarbons production and sales income to accumulated capital and exploitation expenses for their production.

In theory, TAI has a number of advantages as compared with the severance tax. In contrast to the severance tax TAI is based on the indices of additional income and P-factor, which reflect real economy efficiency of a particular oil field development. TAI directly takes into account mining and geological, economic and geographic conditions for hydrocarbons production, as it is directly related to the indices of oil field profitability – additional income and P-factor. In case of highly efficient project TAI implementation secures progressive skimming of resource rent for the benefit of the state, the conditions of low efficient project are improving at the same time. An important feature of TAI is the fact that its application intensifies investments in new oil fields development, as the tax is not levied before the total payback of the investments.

At the same time when TAI is implemented it is reasonable to sustain severance tax as a minimum tax, which provides the government with a certain level of tax proceeds from the project fulfillment, first of all, at the initial stages of development and in the periods of low prices. Severance tax, however, should be levied at quite low rates (for example, coefficient being equal to 0.3-0.5) with the implementation of TAI.

It should be, however, noted that the taxation scheme, which is based on TAI is considerably more complicated both in regard to making tax calculations and practical control for their reliability. This creates opportunities for the underdeclaration of tax liabilities by producer, the consequence being the relative decrease in the state budget incomes.

TAI system being the taxation system which is based on the determination of additional income and P-factor, potentially can stimulate the investor to overestimate costs during project fulfillment. The increase of the costs means the decrease in the income amount levied with tax, which leads to the decrease in investor's tax liabilities, P-factor also decreases, reducing correspondingly tax rate. The qualifi-

cation and objectiveness (absence of corruption) of the government control for the project fulfillment costs parameters gains big importance.

Practical application of TAI can be effective only on the condition that the problem of oil market prices for determination and use in order to calculate taxes is solved, otherwise TAI application loses economic base.

Thus, as the implementation of the considered approaches is not possible without creation of particular prerequisites (for instance without solution of the problem for oil market prices for determination and use in order to calculate taxes), the transfer to some net income taxation systems can be fulfilled only in future.

#### 5. Agreements on the Share of Production

The procedure of production share agreement (PSA) enables to secure stable economic and legislation regime for the investor over the whole period of investment project fulfillment, as well as individual approach for the projects of particular minerals fields development. A considerable part of taxation parameters of PSA, and first of all the parameters of the very sector, are the results of talks between the government and the investment companies. The creation of the scale of production share depending on the field development profitability, which is estimated by the values of the internal profit norm or by R-factor, allows imparting flexibility to the system regarding the natural rent impressions and creating acceptable conditions for both high-profitable and low-profitable fields development.

PSA system in Russia has not been development to any noticeable extent. At present there are only 3 PSA, which were concluded in the middle of 1990ies before the entry in effect of the Federal Law "On agreements on share of production" (2 projects are being fulfilled at the Sakhalin island shelf, 1 project – in Nenets Autonomous Okrug ).

Limited development of PSA system in Russia is, in our opinion, accounted for by certain drawbacks, which are characteristic for this system. The drawbacks of PSA system are connected first of all with individualization of conditions for particular projects, which can lead to receipt of unjustified favorable conditions for the implementation of the project in the environment of government officials corruption and insufficient qualification, the consequence of which being the loss of a certain amount of minerals fields development incomes for the government.

PSA system potentially can stimulate the investor to overestimate costs during project fulfillment. The increase of the costs means the decrease in the profitable production and income amount levied with tax, which leads to the decrease in investor's tax liabilities for expropriated for the benefit of the state profitable production and income tax. Besides, the value of the internal profitability norm decreases and consequently the share of the government in profitable production decreases correspondingly.

Factors that are beyond the limits of actual tax legislation are of great importance in case of PSA system regime application. What is at issue is the corruption and the level of qualification of the government officials, who take part both in the negotiation process on PSA conclusion and in process of the regulation of given

projects fulfillment. Corruption and insufficient level of qualification can significantly decrease the efficiency of PSA regime application regarding the receipt of adequate tax proceeds by the government.

Thereupon the implementation of PSA regime should have, in our opinion, extremely limited nature. The application of such a regime at newly licensed fields is acceptable only after negative results of the auction for the granting of subsoil area exploitation on other than production share conditions.

Making any decisions on tax stimulation of the investments in new fields' development should correspond to the real possibilities of the government for administration of implemented taxes. In the present situation Russia it is the application of territory step-down coefficient for oil production over the whole period of the field development that appears to be the best approach.

#### Electric Power Industry

Since 1999 with the overcome for crisis phenomena and reanimation of economic activity the trend for electric power production growth and demand expansion has been retrieving. Over 2000-2006 the increase in electricity production was equal to 16.8%, the volumes of GDP increasing by 58.0% and industrial production – by 49.3% (*Table 29*).

*Table 29*

### **The Dynamics of Electric Power, Industry, GDP and Investments in Fixed Assets over 1991-2006 as percentage to the previous year**

	Electric power production	GDP	Industrial production	Investments in fixed assets
1991	98.7	95	92	85
1992	94.4	85.5	82	60
1993	94.9	91.3	86	88
1994	91.6	87.3	79	76
1995	98.2	95.9	96.7	89.9
1996	98.5	96.4	95.5	81.9
1997	98.5	101.4	102	95.0
1998	99.2	94.7	94.8	88.0
1999	102.3	106.4	111	105.3
2000	103.7	110	111.9	117.4
2001	101.5	105.1	104.9	110.0
2002	100.0	104.7	103.7	102.8
2003	102.8	107.3	107	112.5
2004	101.7	107.2	106.1	110.9
2005	102.1	106.4	104	110.7
2006*	104.0	106.7	103.9	113.5

\* Refined estimations by the Ministry for Economic Development.

Source: Federal State Statistics Service.

The change in the level of electricity consumption in the national economy in post-crisis period is accounted for by the dynamic expansion of domestic market demand under the influence of simultaneous growth in both goods and services production. The share of service production sector was 27.9% of the total volume of electricity consumption in the economy against 27.0% in 1999 and 22.2% in

1990. Besides, growing consumers' demand for electricity due to the increase in household appliances demand and intensive construction of modern housing also had a considerable influence on the dynamics of electricity consumption in service sector.

Formation of new segments of services market – for instance, dynamic development of modern communication systems, data-processing service, financial, credit and insurance organizations – was accompanied by fundamental changes in material and technological basis, work creation and the increase in labor efficiency. The change in the technologies of service rendering on the basis of the increase in the level of electricity application in the labor of those employed in the service sector was the factor that determined the increase in effectiveness of the potential created over the years of reforms utilization. According to the data of electricity balance electricity consumption in service sector over 2000-2005 increased by 16.8%. The dynamics of electricity demand was considerably influenced by the change in market situation (*Table 30*).

*Table 30*

**Electricity Balance of the Russian Federation, kWatt-hour bln.**

Year	Production - total	Received from abroad	Consumed - total	including						Supplied abroad
				industry	construction	agriculture	transport	other branches of industry	line losses	
1990	1082.2	35	1073.8	625.9	18.8	96.4	103.8	144.7	84.2	43.4
1991	1068.2	35.1	1056.1	605.2	16.8	103.4	96.7	150.1	83.9	47.2
1992	1008.5	27.7	992.2	554.6	16.3	102.9	86.7	147.5	84.1	44
1993	956.6	24.7	937.9	512.8	15.1	103.8	76.7	148.9	80.8	43.4
1994	875.9	22.2	856.4	447	13.4	97.7	68.4	150.9	79	41.7
1995	860	18.4	840.4	440.2	12.4	88.6	65.2	150.5	83.5	38
1996	847.2	12.3	827.7	424.9	11.2	85.9	64.9	156.3	84.5	31.8
1997	834.1	7.1	814.4	421.4	10.3	78.1	63.5	156.7	84.4	26.8
1998	827.2	8.3	809.1	412	9.1	75	60	159.8	93.2	26.4
1999	846.2	8.4	832.1	430.3	9	72	60.6	164	96.2	22.5
2000	877.8	8.8	863.7	455.9	10	68.1	60.9	167.2	101.6	22.9
2001	891.3	9.8	875.3	462.8	9.9	63	63.1	171.1	105.5	25.7
2002	891.3	5.2	878.4	462.5	9.4	60.1	76.8	171	107.6	18.1
2003	916.4	8.2	902.9	479	9.3	57.8	75.2	171.1	110.5	21.6
2004	932	12.2	924.3	490.7	9.5	56.4	80.3	174.8	112.6	19.8
2005	953	10.1	941.3	497.0	9.7	55.0	83.2	181.7	114.5	22.5
2006*	991									

\* Preliminary data.

Source: Federal State Statistics Service, Ministry for the Economic Development.

In 2005 the supply of electricity by RAO "UES of Russia" to its consumers increased by 2.4% in comparison with 2004 and heat energy supply decreased by 0.8%. The proportion of the main groups of the consumers did not change significantly in the structure of profitable sales of electricity in 2005. In the structure of profitable heat energy supplies the share of industrial consumers decreased by 4%, the share of housing and communal facilities increased by 6%. Industrial sec-

tor, whose share in 2005 was equal to 48.6% of the total amount of sold electric energy, remained the main consumer at the retail market. The share of energy consumption by the bodies of housing and communal facilities was equal to 12.5%, transport and communication organizations – 11%, population – 7.6%. In the structure of heat energy consumption it is housing and communal service organizations that have the biggest proportion of 47.6%, industrial consumers having the share of 25.4% (Table 31).

Table 31

**The Structure of Electric and Heat Energy Sales to the Main Groups of Consumers by RAO “UES of Russia” in 2005**

	Electric energy sales		Heat energy sales	
	kWt-hour bln.	percentage	Gcal mln.	percentage
Total sales	606.4	100.0	411.1	100.0
Industry	294.7	48.6	104.5	25.4
Agriculture	14.0	2.3	3.5	0.9
And communication	66.5	11.0	4.9	1.2
Construction	6.3	1.0	3.9	1.0
Housing and communal facilities	75.6	12.5	195.9	47.6
Population	46.2	7.6	31.2	7.6
Other fields	102.9	17.0	67.2	16.3

Source: RAO “UES of Russia”

Over 2000–2005 the total demand for electricity in the sector, which produces goods, increased by 10.4%, including in industry – by 16.1%. In Russia on the whole the share of the industry in electricity, consumed in the economy, was equal to 53.1% against 52.8% in 2000 and 58.7% in 1990.

In the structure of electricity consumption by the branches of industry the share of metallurgical enterprises is 36.6% and the share of fuel and energy complex – 34.0%. Correspondingly the dynamics and efficiency of electricity use in these two complexes have a prevailing impact on the level of electric consumption of the industry as a whole. The changes in the structure of electricity consumption by branches of industry are accounted for, on the one hand, by the increase in the share of electric- and power-consuming productions and, on the other hand, low efficiency of resources utilization and technical and technological lag of the production. The dynamics of the demand for electricity structure is considerably influenced by the changes in market structure. Over 2002-2004 the contribution of oil and gas sector in the increase of the demand for electric power in the industry was equal to approximately 45%, of non-ferrous metallurgy – 21%, of ferrous metallurgy - 17%, of chemistry and wood complex and foodstuffs production – of 5% each, construction materials industry – about 6%. In the environment of the existing level of production capacities utilization the demand for electric energy decreased by 3.9% over 2000-2004.

In 2005–2006 the sustention of the trend for the increase in the demand for electric energy in the industry was maintained by the anticipating growth rates of coke and oil products output, metallurgical production and finished metal goods production, some other productions, connected with minerals and raw materials processing. Taking into account that the share of export production of the produc-

tion output in 2006 in the oil production reached 57%, in rolled metals production – 39.7%, it can be assumed that it is the external market situation and the expansion of the demand for the traditional Russian export goods that had the crucial influence on the demand for the electricity dynamics.

In 2005 turbine electric power plants with the capacity of 2.2 mln. kWt were built, which exceeded the amount of 2004 implementations by more than two times. Obviously, this also influenced the sales market and stimulated consumers to connect to the centralized sources of the energy supply (*Table 32*).

*Table 32*

**Putting into Operation of Production Capacities throughout the Electric Power Industry due to New Construction, Expansion, Reconstruction and Technical Re-Equipment**

	1995	2000	2001	2002	2003	2004	2005
Turbine electric power plants, thou. kWt	370.2	562.6	1947.3	912.7	1990.8	933.8	2200
Transmission facilities of the voltage of 35 kV and more, km	4902.1	2680.2	2206.1	2488.3	2820.1	2916.2	No data
Transmission facilities for agriculture electrification of the voltage of 6-20 kV and more, km	6943.0	3122.9	3267.0	3290.7	3808.9	3596.1	No data
Transmission facilities for agriculture electrification of the voltage of 0.4 kV and more, km	5812.0	2776.9	3207.2	3534.7	4268.2	4439.0	No data
Transformation step-down substations of the voltage of 35 kV and more, thou. kVA	4320.8	3356.7	2832.9	2403.3	2095.9	3858.1	2800
Steam boilers at heat and power plants, tons per hour	850.0	1494.8	935.0	1351.0	904.0	605.5	620.3
Heat backbone networks, km	80.6	61.9	61.8	88.7	106.2	79.6	No data
Water-heating boilers at heat and power plants, Gcal per hour	860.0	1372.7	210.0	581.5	440.8	629.8	No data

*Source:* Federal State Statistics Service.

In 2005 RAO “UES of Russia” put into operation 20 energy units of the total capacity of 1903.9MWt, commissioned 15 units of the total capacity of 1279.4 MWt at heat power plants and 5 units at hydroelectric power plants of 624.5 MWt (*Table 33*).

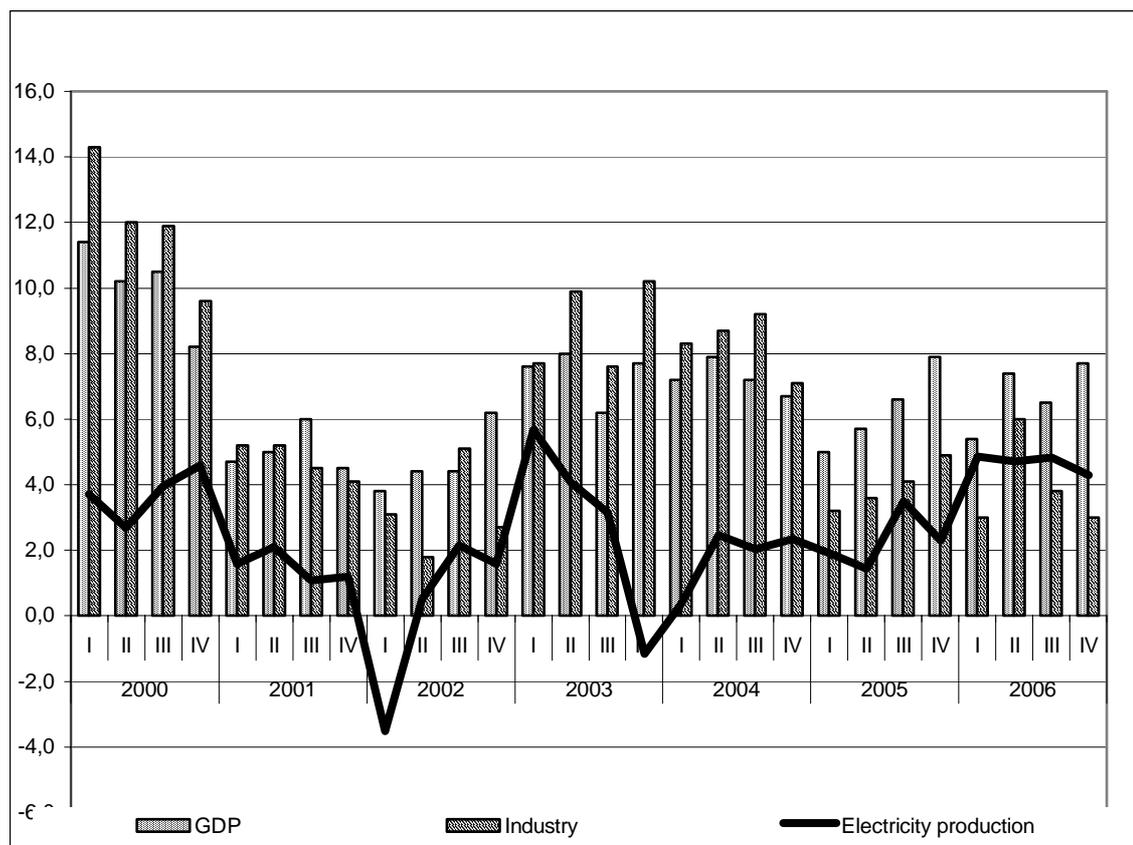
*Table 33*

**Commissioning of Production Facilities by PAO «ЕЭС России»**

	2003	2004	2005
Turbine facilities, MWt	2 087.9	980.1	1 903.9
Steam boiler, separately put into operation, ton per hour	800.0	160.0	420.0
Water-heating boiler, Gcal per hour	15.1	121.0	88.4

*Source:* PAO «ЕЭС России».

So, it was actually the expanded potential of electric energy in 2006 that defined the ratio of development rates of the main kinds of the economic activities and the place of the electric energy industry in Russian economy. In 2006 for the first time over the years of the post-reform development the anticipating growth rates of electric energy production were observed as compared with the dynamics of the industrial growth (*Fig. 13*).



*Fig. 13.* The Change in the GDP, Industrial Production and Electric Energy Production Growth Rates, as percentage to the corresponding quarter of the previous year

However the overcoming of the electricity shortage, especially in the aspect of territory, requires both the increase in investment scales in generation, as well as system solution of the problem of electricity saving technologies implementation.

The extent of the equipment tear and wear being high and the technologies being what they are the increase in specific norms of fuel consumption for energy production and in the electric energy consumption for own needs are observed. Long-term tendency for the decrease in the amount of the investments led to the change in qualitative and quantitative characteristics of the fixed assets in the branch. As compared with the pre-reform level the amount of the investments in the electric energy industry decreased by threefold, the volume of new and substituting equipment commissioning, for instance for generating capacities, - by 3 times, for the objects of electricity network – by nearly 5 times. The coefficient of the fixed assets renewals in the electric energy industry decreased from 4.0% in 1990 to 1.3% in 2004. The process of generative facilities physical ageing is accumulating. By 2004 the capacity resource had been worked out at nearly 17% of the electric power plants in Russia. A significant amount of outdated equipment with the efficiency coefficient below 30% is still in operation. About 10% of the installed

equipment of the electric power substations reached its wearlife limit. A significant part of the equipment in electric energy industry cannot be involved in the production due to its physical and moral depreciation. A high level of fixed assets depreciation in the electric power industry is one of the causes of low capacity load as well as a factor that restricts the opportunities for further production growth. Due to the absence of the opportunity for timely substitution of the fixed assets elements the periods for inefficient machinery and equipment utilization prolonged. In many cases fixed assets are liquidated only when it is nearly totally impossible to use them further due to their physical wear and tear. Because of the ageing of fixed assets the probability of their destruction as a result of anthropogenic catastrophes and natural disasters increases. Fixed assets depreciation increased up to 57.8% in 2004 in comparison with 40.6% in 1990. The combination of the high level of depreciation and capacity load gives evidence of critical loads for the facilities as well as for growing losses during electricity production and transmittance through the networks of common use.

In the situation when the trend for the demand for electricity growth has distinctly outlined, low norms of fixed assets renewal and existing dynamics of the annual capacities commissioning create the danger for the appearance of shortage and became straightforward limitations for the country's economy growth rates.

The dynamics of the fixed assets reproduction in the branch of industry depend on the state of the energy machine-building and energy construction complex. However insufficient volumes and irrational structure of machinery and equipment production does not allow solving the problem of normalization of the process of fixed assets reproduction. Outdated material and technical base of energy and electric technologies machine-building as well as low investment activity became the factors that limit the restoration of the steady trend for economy development and maintenance of high investment demand.

In the environment of the economy growth it became evident that investment management does not correlate with the dynamic processes of economy restructuring. The level and dynamics of the investments in fixed assets are closely connected with the solution of the practical problems of stimulating energy savings and management of the demand for the energy. In order to do this it is necessary to pursue purposeful energy saving policy, which is based on the integral system of economic, legal and administration measures.

The policy of energy saving includes the problems of price and tariff regulation, the change of the methods of amortization calculation for energy-saving equipment, reconsideration of the existing standards, rules and regulations towards reinforcement of the requirements for energy-saving; establishment of the standards for energy consumption and energy losses and obligatory certification of energy consuming appliances and equipment of mass use. In many countries the programs of demand for electricity management are widespread. Such programs assume direct participation of energy companies in the energy-saving stimulation and energy-consumption regimes regulation.

### **3.2. The situation in industry**

The section is based on the data of surveys among the directors of industrial enterprises, which have been conducted by the IET according to the European harmonized methodology on a monthly basis since September 1992 and encompass the whole territory of the Russian Federation. The panel's size is approximately 1100 enterprises, where work more than 15 % of those employed in industry. The panel has a shift towards big enterprises by each of the specified subbranches of the national economy. The return of questionnaires is 65 – 70 %.

These research surveys among the directors of enterprises represent a quick method for collecting data concerning the state of affairs at their enterprises and the expected (or planned) changes in the main indices of their performance. It is a relatively new instrument when applied to economic analysis. The first such survey was conducted by the Ifo Institute for Economic Research (Munich, Germany) in 1949. Soon, this method began to be applied in the UK, France and Italy. From 1962, the EU has been working at harmonizing (making compatible) the results of surveys being conducted in different countries of that continent.

The questionnaire used in a research survey contains a limited number of questions (no more than 15 – 20). These questions are of a qualitative, not quantitative, character. The simple structure of questions and answers makes it possible for the respondents to fill in the questionnaires in a short period of time and without consulting any other staff or documentation. It is of paramount importance that the respondent at each enterprise should be a CEO of the highest level, who has full vision of the enterprise's state of affairs and directly participates in its management. In 2006, 31 % of the filled-in questionnaires were returned by the directors of enterprises, 34 % – by deputy directors, and 24 % – from heads of economic subdivisions.

In the analysis of the results of surveys, a specific derivative index is applied – the so-called balance. Balances are computed as the difference between the percentage of those who have replied “is growing” ( or “is above the norm”) and the percentage of those who have replied “is decreasing” ( or “is below the norm”). The result makes it possible to represent the distribution of answers to each question by simple digits with signs “+” or “-”.

Balance is interpreted as the first derivative, or process speed. If the balance of answers to the question concerning the expected change in prices has the sign “+”, this means that the average prices in the nearest future period are going to grow (there is a prevalence of enterprises who have reported a forecasted growth of their prices). Growth of balance in a month from +10 % to + 17% demonstrates that the average prices in industry are going to display a more intensive growth, because the prevalence of enterprises who forecast growth has also increased). Negative balance implies that average prices will go down (a greater number of enterprises are going to lower their prices). A change in balance from – 5 % to –12 % is interpreted as growth in intensity of price decline.

### 3.2.1. The dynamics of demand for industrial products in 2006

The dynamics of effective demand in 2006 were more than favorable for Russian industry. The demand for domestic products was going throughout the whole year, with good intensity, and in nearly all the branches.

In late 2005, effective demand for industrial products began to grow, and this growth was sufficiently intensive. Russian industry had not been demonstrating such good results at a year's end for a long time. Higher rates of growth in sales (before they were cleared of seasonality) in December were registered in 1999. After it had been cleared of seasonality, the balance of changes in this basic index increased at once by 6 p. p and became equal to +9 %. No such intensive sales growth had been observed during the previous 9 months of 2005. In January 2006, growth in effective demand for industrial products continued. Of course, the initial data demonstrated an absolute decrease in sales, but the intensity of decrease turned out to be less strong than in January 2005 or 2004. After clearance of seasonality, the balance became positive: demand was still growing, and even more intensively than in November – December 2005. Growth in demand for industrial products continued in February, despite the pessimism of the official statistics and the spell of extreme freezing weather. In March, the intensity of its changes (before clearance of seasonality) was + 20 p. p., which is the second high for the whole period of post-default growth (Fig. 14). A more intensive growth in sales after 1998 was observed only in March 2005 (+ 25 p. p.). An increasing rate of growth in sales continued in April.

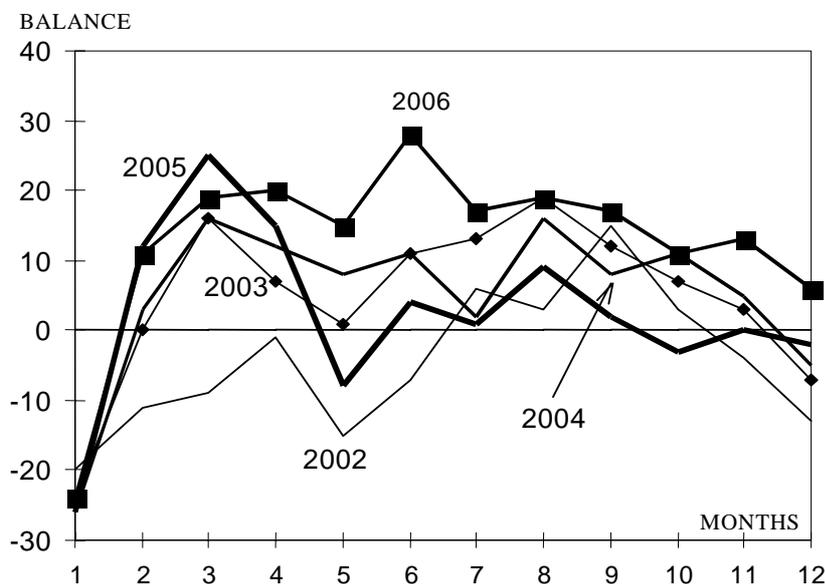


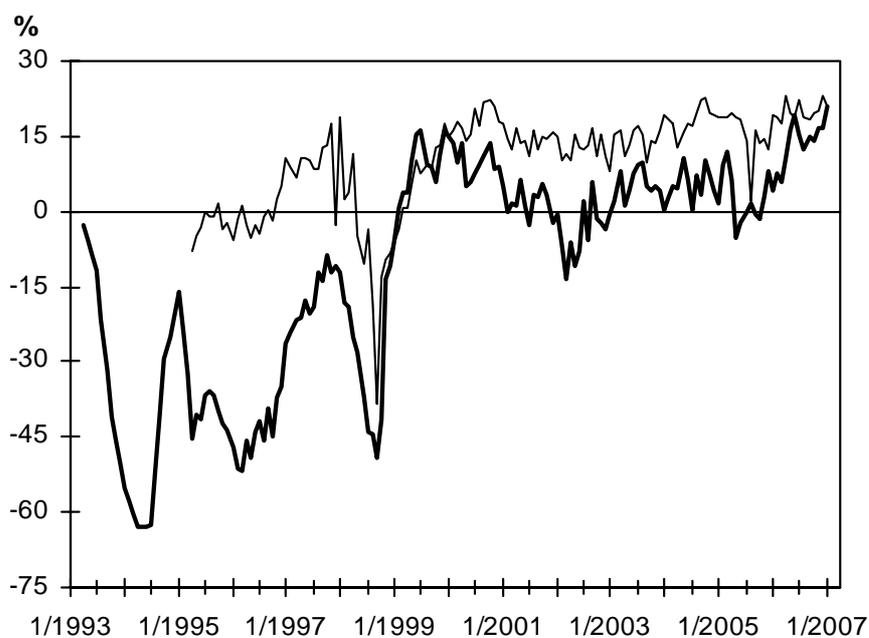
Fig. 14. Monthly dynamics of demand in 2002 – 2006  
(balance = % growth – % decrease)

Source: Hereinafter in this section all the figures and tables have been prepared on the basis of the results of surveys.

The balance of changes in this index reached its 12-month high and became +12 p. p. (cleared of seasonality). The elimination of the accidental component yielded an even more impressive result, such as had not been observed since late 2000.

In May 2006, the dynamics of effective demand avoided its traditional dramatic fall. The rates of sales growth lowered only slightly (by initial data) by comparison with April and displayed the best values against the corresponding months of all the years of follow-up (since 1993). When cleared of seasonality, the results of May 2006 demonstrated an absolute high: no growth in sales of this intensity has ever been seen during all the 14 years of surveying.

In June, growth in effective demand demonstrated yet another record. By all the indices (initial, cleared of seasonality and accidental fluctuations), the intensity of sales growth became higher than all the previous peak values and reached yet another absolute high (*Fig. 14, 15*). At the branch level, sales continued to decline only in the light industry.



*Fig. 15.* Changes of effective demand, cleared of seasonality  
(balance = % growth – % decrease)

However, in July the intensity of growth in demand became lower. The initial data (before cleared of seasonality and accidental fluctuations) demonstrated a reduction in the balance of sales changes (or growth rate) from 28 to 17 p. p. But the latter value in terms of the year 2006 is not disastrous – it is closer to the average rate of growth in sales during the 6 preceding months. As for the June index, it was found to be an absolute high for the whole period of follow-up. After cleared of seasonality, the fall in demand growth in July became equal to only 5 p. p. (from 21

to 16). After the elimination of accidental fluctuations, demand growth once again demonstrated the previous record values of sales growth rate.

The data on the dynamics of demand in August demonstrated a further slowdown in the growth of sales of industrial products. The growth rate of this index (balance of changes) became lower by further 5 p. p. after it had been cleared of seasonality. During July-August, the intensity of growth in demand "lost" a total of 9 p. p. The balance was still far from being negative (that is, an absolute fall in sales), but the obvious "departure" from the high values seen in May and June was disappointing, for the time being – only for the government and analysts. As for industry proper, the satisfaction with sales remains there at the level of 56 %, which means that the majority of Russian enterprises were, nevertheless, satisfied with their product sales volumes.

The intensity of sales growth in September was no more declining, and instead demonstrated growth, as estimated by enterprises in industry on the whole, by 3 p. p., mainly due to growth in the woodwork and timber industry and in the food industry. This index, however, did not change in machine-building.

In October, the intensity of demand growth did not display any fundamental changes. In industry as a whole, the rates of sales growth (when cleared of seasonality) remained at the previous month's level. A slowdown in demand growth (sometimes even down to an absolute low) was registered only at the branch level: in the production of garments, timber and woodwork, cellulose, paper and cardboard, in metallurgy, and in electrical machine-building and electrical equipment.

In November, the growth rates of sales of industrial products, as estimated by enterprises, remained at the level of July – October. When cleared of seasonality, the intensity of demand growth in industry as a whole during that period was between 12 and 15 b. p. The November value of this index was 14 b p. Sales growth was registered in all the branches of industry, with the exception of the production of textiles, garments, electrical equipment and motor-car industry. The highest rates of demand growth (when cleared of seasonality) were observed in the production of cellulose, paper, timber, machines and equipment, radio and communications equipment, and means of transportation.

As demonstrated by computed growth rates (or balances of changes) of demand by six-month periods, the year 2006 was, indeed, very "comfortable" for Russian industry in terms of demand dynamics (*Table 34*). During the first six months, the intensity of demand growth was 10 p. p. – which is not the very best result in seven years (in the second half-year 2000, this value was 11 p. p.), but the second half-year demonstrated impressive results: the balance became as high as 15 p. p., which is a record high for the whole follow-up period.

Table 34

**Changes in effective demand by six-month periods in 2000 – 2006**

Year	6 months	Growth	No change	Fall	No answer	Balancec
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	20	65	14	1	6
2005	1	21	61	17	1	3
	2	17	66	16	1	1
2006	1	25	59	15	1	10
	2	25	64	9	2	15

The average annual data on the changes in effective demand by branch (*Table 35*) have shown that the most rapid growth in 2006 was demonstrated by sales of finished metal products, means of transportation, leather and footwear, as well as medical equipment and measuring appliances. A decline in sales was observed only in woodwork and woodwork products. Textiles demonstrated rather a stabilization of sales volumes that their decline (especially after five years of a continual downward trend). Also noteworthy is the onset of a rather intensive growth of sales of furniture after two years of declining demand. The food industry in recent years has been demonstrating stable but low rates of growth in demand for its products.

Table 35

**Average Annual Balances of Changes (Growth Rates) in Effective Demand, by Branch, in 2000 – 2006**

	2000	2001	2002	2003	2004	2005	2006
1	2	3	4	5	6	7	8
Production of foodstuffs	0	-5	-2	4	3	3	5
Production of textiles	1	-7	-11	-4	-11	-5	-1
Production of garments	8	5	-3	-5	-7	-6	3
Production of leather and footwear	0	9	-8	0	-7	7	22
Timber processing and woodwork	13	0	-2	4	5	-4	-5
Production of cellulose, paper, cardboard	1	-27	5	5	5	0	15
Chemical industry	14	2	0	0	9	13	11
Production of rubber and plastic products	17	-3	-9	9	10	1	7
Production of other non-metal mineral products	8	0	-9	1	0	0	13
Metallurgy	13	-3	-9	8	7	8	18
Production of finished metal products	13	-4	4	5	-8	1	34
Production of machines and equipment	10	9	-12	4	7	0	15
Production of electrical machines and equipment	10	-3	2	12	6	2	13

	1	2	3	4	5	6	7	8
Production of radio, television and communications equipment		16	10	10	1	-2	-10	9
Production of medical equipment, measuring appliances, optical equipment		2	2	-8	7	0	0	20
Production of motor cars, trailers and half-trailers		26	10	-10	14	24	14	4
Production of vessels, aircraft and other means of transportation		-2	0	9	6	2	7	22
Production of furniture		21	1	7	36	-10	-3	13

### 3.2.2. Influence of demand on the status of industrial enterprises

Growth in demand for industrial products, which continued in 2006, resulted in growing sales volumes and made it possible for a greater number of enterprises to achieve normal volumes of sales of their products. On the average, the percentage of such estimations received in 2006 was 56 % (*Table 36*). This is an absolute high for the whole follow-up period. Dissatisfaction with demand was noted in 2006 on the average at 40 % of enterprises (the absolute annual low). As a result, the difference between these two basic estimations of demand became the highest ever – 16 p. p. In other words, the prevalence in Russian industry of those enterprises that were satisfied with the demand for their products reached an unprecedented level.

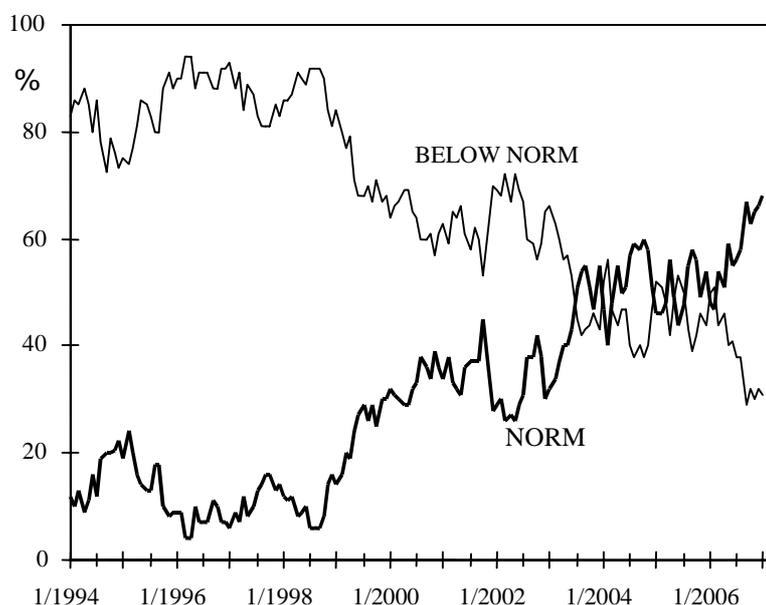
*Table 36*

#### **Dynamics of basic estimations of effective demand volumes (% of number of respondents)**

Year	Norm	Below norm	Difference in estimations
1993	37	55	-18
1994	14	82	-67
1995	14	84	-69
1996	8	91	-83
1997	12	85	-74
1998	10	88	-78
1999	25	72	-48
2000	33	64	-30
2001	35	62	-27
2002	32	65	-33
2003	45	51	-6
2004	53	45	8
2005	51	47	4
2006	56	40	16

The prevalence of those enterprises that were satisfied with demand was registered in 2006 for 10 successive months (*Fig. 16*), and only in January and February the estimations “below norm” were more numerous (but only by 2 – 4 points). In the second half-year the percentage of the answers “normal” demonstrated yet another monthly high – 67 %, and did not go below 60 % until the year’s end. The previous record high (58 %) was exceeded by 9 p. p. As for the percentage of enterprises dissatisfied with demand, it did, quite naturally, go down to an absolute low: in

September, only 29 % of such answers were registered in industry as a whole. The lowest value for 2005 was 39 %, and it also was registered in September.



*Fig. 16.* Dynamics of basic estimations of effective demand

Last year, in terms of the basic indices of demand, became the best for Russian industry throughout the whole follow-up period. It not only yielded the best difference between the basic estimations of demand, but the growth rates of sales in annual terms reached an absolute high. As a result, the 2006 “coordinates” in the space of these two indices were better than the similar “coordinates” of all past years (*Fig. 17*). As seen from the Figure, the coordinates of only two last years belong to a positive (by both coordinates) quadrant in the system of coordinates applied here. This means that industry, during that period only, was able, by increasing sales, to achieve acceptable sales volumes. However, this part of the trajectory did not always demonstrate a positive trend of development. After 2004, when both coordinates became positive for the first time, the results of 2005 demonstrated a slight “drawback”: a slowdown in demand growth resulted in lowering satisfaction with its volumes. However, both values remained positive, that is, demand was still growing, but slower than the enterprises had expected, which resulted in an insufficient increase of its volumes and a lower satisfaction with it.

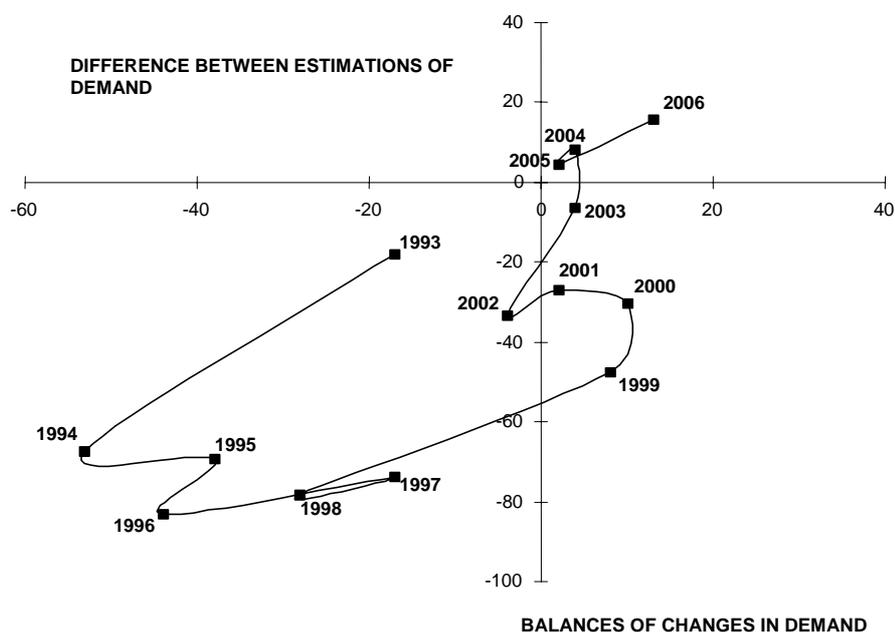
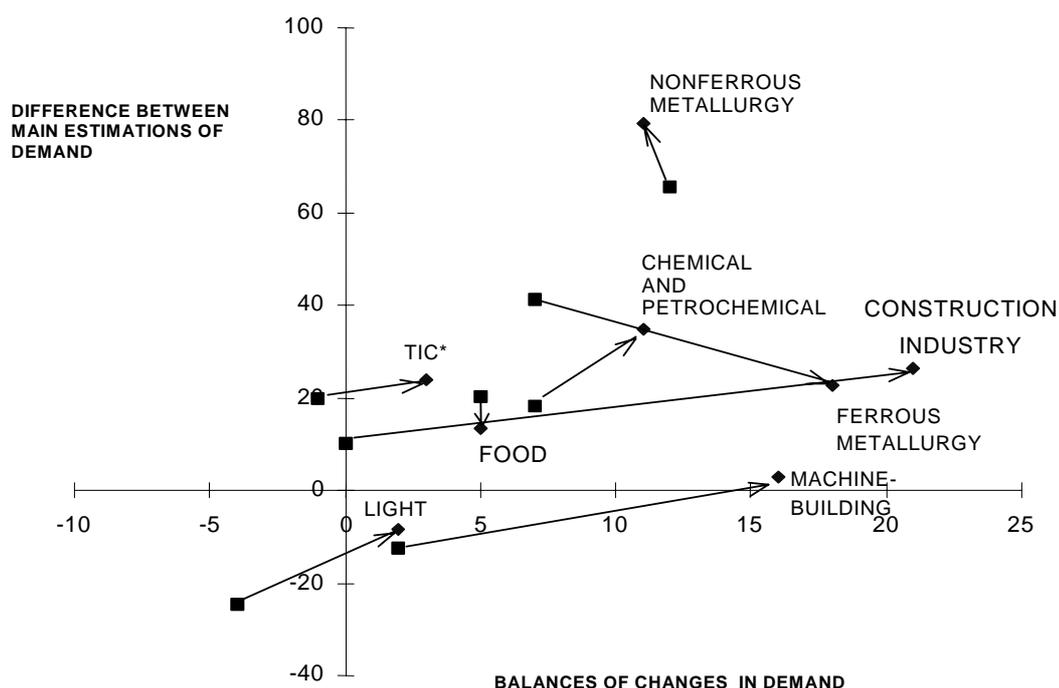


Fig. 17. Changes in the position of Russian industry in the space of basic demand indices in 1993 – 2006

The positive dynamics of demand was for the first time demonstrated by the 1999 surveys: then, the balance of changes (or rate of growth) for the first time became positive. However, the volumes of sales were not yet high enough to yield the prevalence in industry of those enterprises that were satisfied with these volumes. After the difference in estimations in 1998, which was – 78 p. p., in 1999 the difference went up quite noticeably (to – 48 p. p. ), but still remained negative. The rates of growth in demand remained positive in 2000 – 2001, but the achieved volumes were still not satisfactory from the point of view of a majority of Russian industrial enterprises. The difference in estimations was improving (at first to – 30, and then to – 27 p. p. ), but remained negative. At the same time, the year 2001 saw a slowdown in the rates of growth in demand by comparison with 2000, and difference in estimations improved only slightly. The year 2002 became the most unpleasant for Russian enterprises during the post-default period. The results of that year demonstrated negative rates of demand growth and a negative difference in the estimations of its volumes. The 2002 coordinates “went back” to the negative quadrant. The next year saw a substantial improvement of the situation in Russian industry, as shown by the system of coordinates applied here. Rates of growth in demand once again became positive, and the estimates of its volume approached zero very nearly. The latter value implies that the share of those who were satisfied with demand levels became nearly equal to the share of the dissatisfied. There was just one last step to be made. And it was made in 2004.

The position of the majority of branches within the space of main indices of demand between 2005 and 2006 also improved. (Fig. 18). Almost all the industries

(except the light industry) were placed, by the results of 2006, within the positive quadrant, that is, they displayed both growth of demand and a positive difference between its main estimations. Only the light industry failed to achieve a positive difference between the estimations of demand in 2006: there one still can observe the prevalence of those enterprises where normal demand volumes have not yet been achieved. Nevertheless, one doubtless achievement of that branch were the positive rates of demand growth in 2006 and better values of the difference between its main estimations.



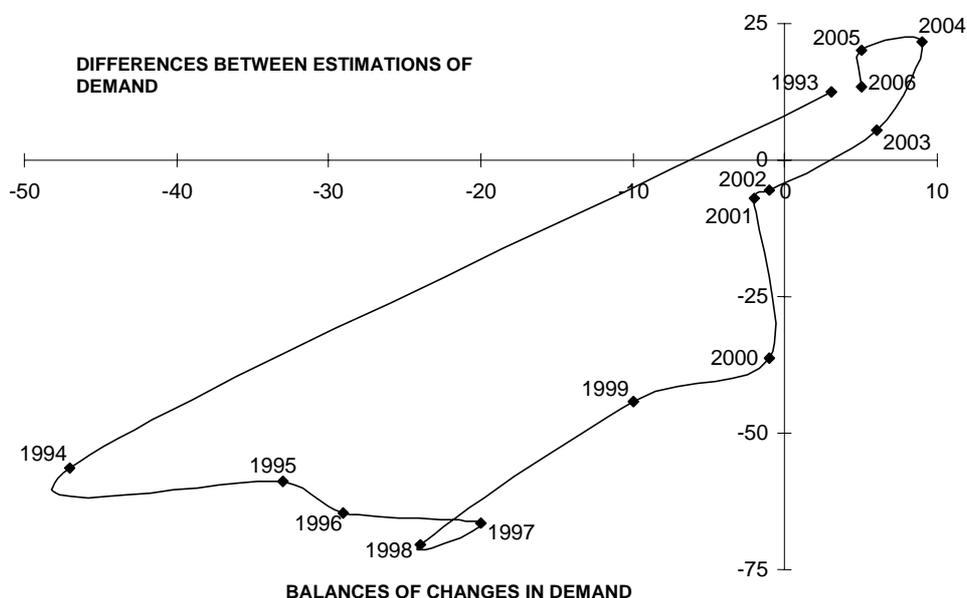
\* TIC – timber industrial complex

*Fig. 18.* Changes of the position of branches of industry within the space of main estimations of demand in 2005–2006

However, as seen from this chart, not all the branches had a positive vector of the changes of the main indices of demand. In non-ferrous metallurgy, the rates of growth in demand became slightly lower, but the degree of satisfaction with its volume increased. In the food industry, while the rates of growth in demand remained the same, the degree of satisfaction with the volumes of sales became somewhat lower. Ferrous metallurgy, while having rather substantially increased the rates of growth in demand, still could not achieve, judging by the decreasing difference between estimations, the desirable volumes of sales. Five branches demonstrated, by the results of 2006, both increasing rates of growth in demand and growing satisfaction with its volumes. The construction industry achieved the highest growth of sales by the year's results, as compared to the results of 2005, while satisfaction increased only slightly: the expectations there, in view of the current construction

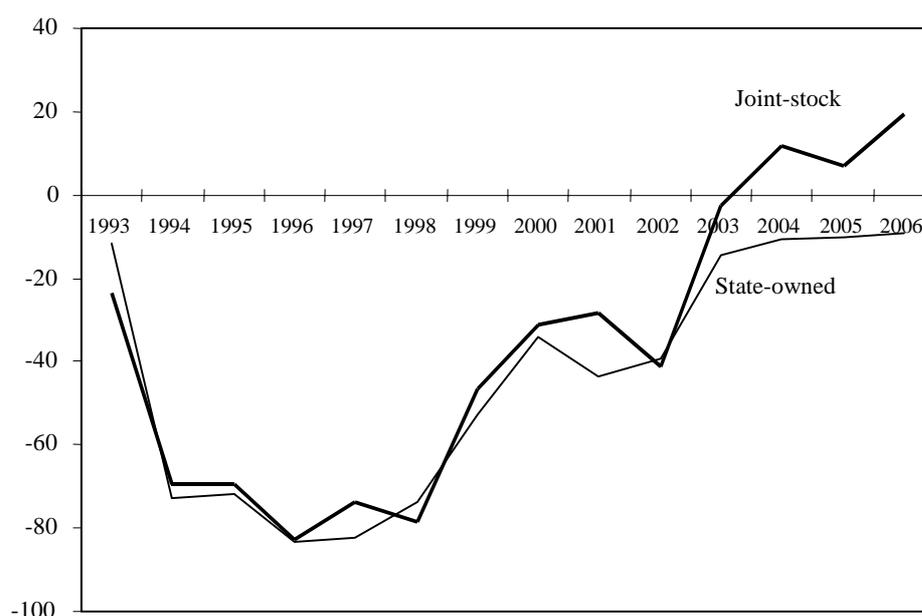
boom, had been somewhat greater. Slightly lower was the increase of the rates of sales growth in machine-building, but that branch's principal achievement was the shift toward positive values of the differences between the estimations of demand – the year's results for the first time demonstrated the prevalence of enterprises satisfied with their volumes of sales. The rates of growth in demand in machine-building have been positive since 1999 (with the exception of 2002), and therefore now the sales volumes there became so great that the majority of enterprises (50 % against 47 %) have become satisfied.

The trajectory of the food industry within the space of the rates of growth in demand and the differences between its estimations has demonstrated certain problems with sales in that branch during the last two years (*Fig. 19*). Firstly, in 2005 the rate of growth in demand became slower by comparison with 2004. At that time, however, this circumstance did not cause strong worries among the enterprises belonging to that branch: the difference between the estimations of demand went down from 22 p. p. to 20 p. p. Last year, the rates of growth in demand did not change by comparison with 2005, and then it became a problem from the point of view of producers, who were forced to rethink their attitude to their volumes of sales. The difference between the estimations "normal" and "below norm" was already 13 p. p., which appeared to be the worst result of the three last years. It should be noted that the demand for the branch's products was growing only during these years. In 1999 – 2002, food enterprises failed to achieve a positive dynamics of demand, although in 2000 – 2002 the rates of decline were very close to zero, while the degree of satisfaction with demand was growing, especially in 2001.



*Fig. 19.* Changes of the position of the food industry within the space of main indices of demand in 1993 – 2006

The improvement of the estimations of demand in Russian industry in 2006 occurred mainly due to the performance of non-state enterprises (*Fig. 20*). The difference between the estimations “normal” and “below norm” became as high as 19 p. p. in that branch. At state-owned plants, the estimation “below norm” prevails, and during the last four years this prevalence has been stable, within the range – 14...–9 p. p. Thus, the state sector still cannot achieve the volumes of demand that would be normal from the point of view of its performance, that is, to adapt to the developed market situation. As a result, in 2006 it fell behind joint-stock companies by 28 points. It should be noted that in the 1990s both these sectors were demonstrating a similar dynamic of estimations, and the first major gap between their estimations occurred as late as 2001, but at that time in both sectors the estimations “below norm” were prevalent. The problems with demand in 2002 once more leveled the difference between the estimations by form of ownership, but the year 2003 already demonstrated the advantages of non-state enterprises, the majority of which managed to achieve “normal” volumes of demand. In 2004 the estimations “normal” among joint-stock companies were voiced by an absolute majority, and such a situation has been maintained until now.



*Fig. 20.* Average annual differences between the main estimations of demand (normal – below norm), by forms of ownership, in 1993 - 2006

A similar differentiation of the estimations of demand by the size of enterprises can also be seen (*Fig. 21*). The leading position in the prevalence of the estimations “normal” in 2006 still remained with big enterprises, among which 59 % were satisfied with the demand for their products, and only 38 % cannot achieve normal volumes of sales. By comparison with the previous year, the difference between these estimations improved by 9 points and achieved an absolute high.

There is no doubt that the situation at medium-size enterprises (with the staff of 501 – 2000) also improved. For the first time during all the 15 years of follow-up, the majority (54 %) of enterprises in that group achieved volumes of demand that were normal for them, and as a result were no more falling so far behind in the difference of estimations from “the leader group” – big enterprises. In the group of small enterprises, there still exist problems with sales: they display a prevalence of the estimations “below norm”. However, the year 2006 also saw an obvious breakthrough in that group, after three years of “stagnation”. Normal volumes of sales were achieved by 43 % (in 2003 – 2005 - only 36 %), while the percentage of the estimations “below norm” went down to 53% (after 61 % in the three previous years).

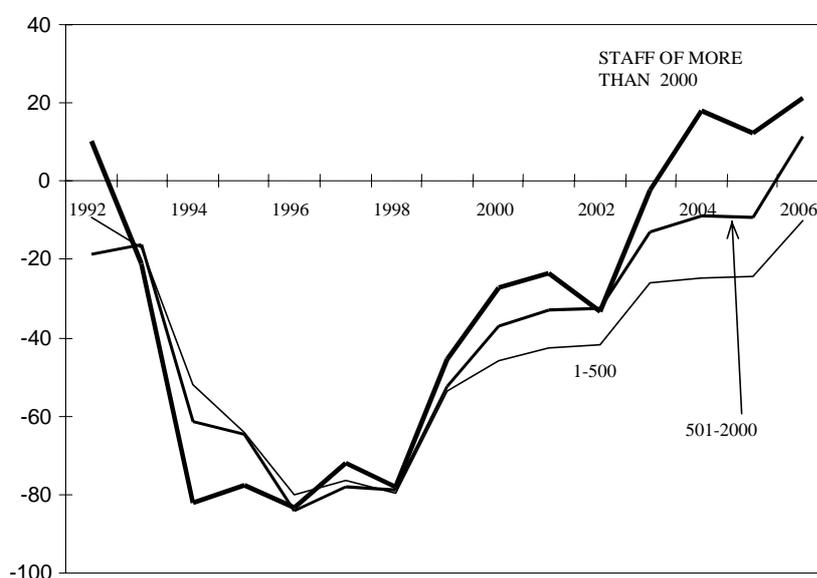


Fig. 21. Average annual differences between the main estimations of demand (normal – below norm) by the size of enterprises in 1993 – 2006

### 3.2.3. Dynamics of competition

In 2006, Russian industry was developing under conditions of stable competition: no important changes in competition intensity among enterprises during last year were noted, by comparison with 2005. The main indices of competition, monitored by the IET since 1995, demonstrated that the level of competition in all three areas (domestic – inside Russia, competition with near abroad, competition with far abroad) remained at its previously observed level – the absolute high throughout the whole period of follow-up (Table 37). To be more precise, all the indices' in fact, went down, but very slightly (by 0.02 – 0.09 points), and therefore it would be more correct to speak about the unchangeability of these indices, especially if one takes into account the fact that in 2005 the growth of the indices

amounted to 0.27 – 0.45 points and was a historic high for all the 12 years of follow-up.

*Table 37*

**Annual indices of competition with different producers**

	Russian	From near abroad	From far abroad	General index
1995	3.39	2.65	2.79	2.94
1996	3.46	2.82	3.01	3.10
1997	3.55	2.81	3.02	3.13
1998	3.52	2.79	3.09	3.13
1999	3.61	2.73	2.87	3.07
2000	3.60	2.70	2.80	3.03
2001	3.73	2.89	2.90	3.17
2002	3.87	2.93	2.96	3.25
2003	3.95	2.92	3.08	3.32
2004	3.94	2.82	3.03	3.27
2005	4.21	3.27	3.49	3.66
2006	4.12	3.20	3.47	3.60

Thus, in 2006 enterprises did not feel that there were occurring any fundamental changes in the conditions for their competition on their sales markets, as compared to the year 2005. Such estimations appear especially unexpected against the background of the prevailing opinion (at least as it is voiced in the mass media and in the public speeches of government officials) that the growing volumes of import are ousting Russian commodities from the sales markets. In truth, Russian manufacturers, whom experts, journalists and government officials are so eager to protect, are voicing very different opinions.

No cardinal changes in 2006 occurred in the spread of competitive markets across Russian industry, either. Competitive markets in this case are understood as the share of enterprises in Russian industry which can report a certain competition with other manufacturers on their sales markets. The share of competitive markets tells nothing about the intensity of competition on those markets – it simply demonstrates the fact of a certain degree of competition that can be felt by enterprises. As shown by the results of our follow-up, industrial enterprises felt the existence of competition with other Russian manufacturers in 2006 on 92 % of the markets, while one year yearlier this index amounted to 94 % (*Fig. 22*). The competition with manufacturers from far abroad increased by 3 p.p., and now 73 % of Russian enterprises do compete with commodities shipped from beyond the borders of the former USSR.

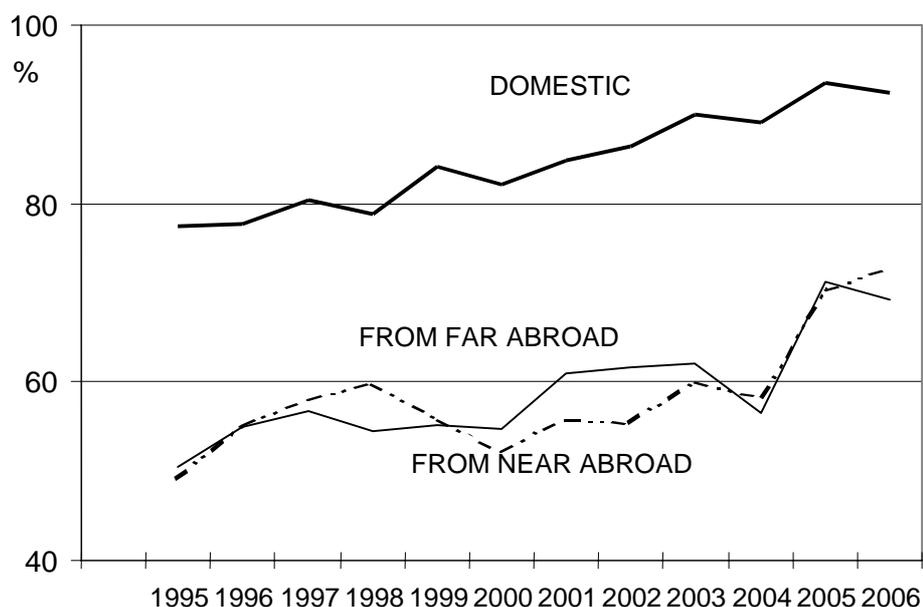


Fig. 22. Dynamics of the share of competitive markets

The highest numbers of markets where commodities were competing with those from far abroad were registered in 2006 in ferrous metallurgy (83 %), timber industrial complex (81 %) and machine-building (78 %). The “other pole” (lowest numbers of markets where commodities were competing with those from far abroad) is represented, which is, by the way, quite predictable and of little interest in terms of economic analysis, electrical power engineering (33 %), fuel industry (35%) and the construction materials industry (46 %). Then follow the food industry (52%) the light industry (61 %) (according to the All-Russian Classifier of Branches of the National Economy [OKONKh]). While the existence of 52 % of markets where commodities compete with those from far abroad in the food industry appears to be quite predictable, the situation in the light industry, where only 61 % of enterprises feel that they are competing with producers located outside the territory of the former USSR, is not quite compatible with the constantly voiced declarations that enterprises belonging to that branch should be protected from imports. In fact, almost 40% of manufacturers there do not notice any competition with imports on their sales markets (Fig. 23). It should be noted that this is true in respect to both “white” and “grey” imports, because the enterprises, when estimating the level of competition they are faced with, take into account all the commodities that are shipped into this country and then enter the sales markets, no matter what their status might be in terms of customs clearance. As for the number of markets where domestic commodities compete with those from near abroad, in the light industry it is slightly higher – 65 %. The decreasing share of markets where commodities compete with imports (both from near abroad and from far abroad) – by 11 and 14 p. p. in 2006 – is associated, most probably, with improved customs control and

the resulting lower competitive capacity of “grey” imports on the domestic market. And almost all the sales markets in the light industry are competitive in respect to Russian manufacturers: 98 % of enterprises in the light industry experience competitions with other Russian manufacturers. And this latter index has remained relatively stable (in the interval of 94 % – 98 %) since 2002.

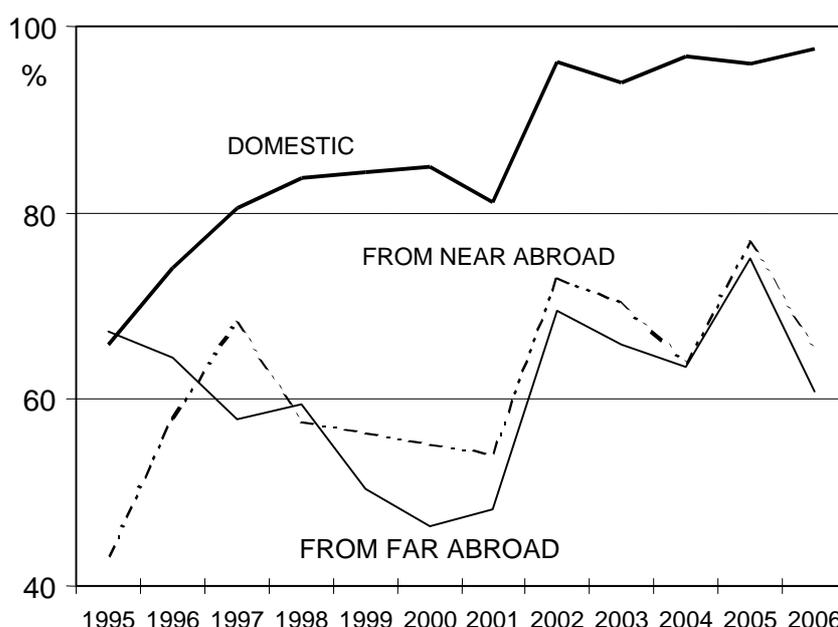


Fig. 23. Dynamics of the share of competitive markets in the light industry

The light industry differs not only by its extremely high share of markets with domestic competition, but also by the highest level of that competition and its growth in 2006. The index of domestic competition in this branch increased during one year by 0.21 points and amounts now to 4.48 (by a 5-point score) – approximately in the middle between the estimations “moderate” and “strong” (Fig. 24). This is a historic high of the 12-year period of following up the competition in that branch. As for the competition with imports, it, on the contrary, became weaker. And the decrease of the indices of competition with imports was also the greatest for the whole period of follow-up: the competition with commodities from far abroad “lost” 0.56 points, with commodities from near abroad – 0.40 points. Presently, the competition with commodities from near abroad is estimated by enterprises in the light industry as being at the level of 3.09 points (that is, “weak” ), while the competition with commodities from far abroad – 3.28 points (slightly above the “weak” level).

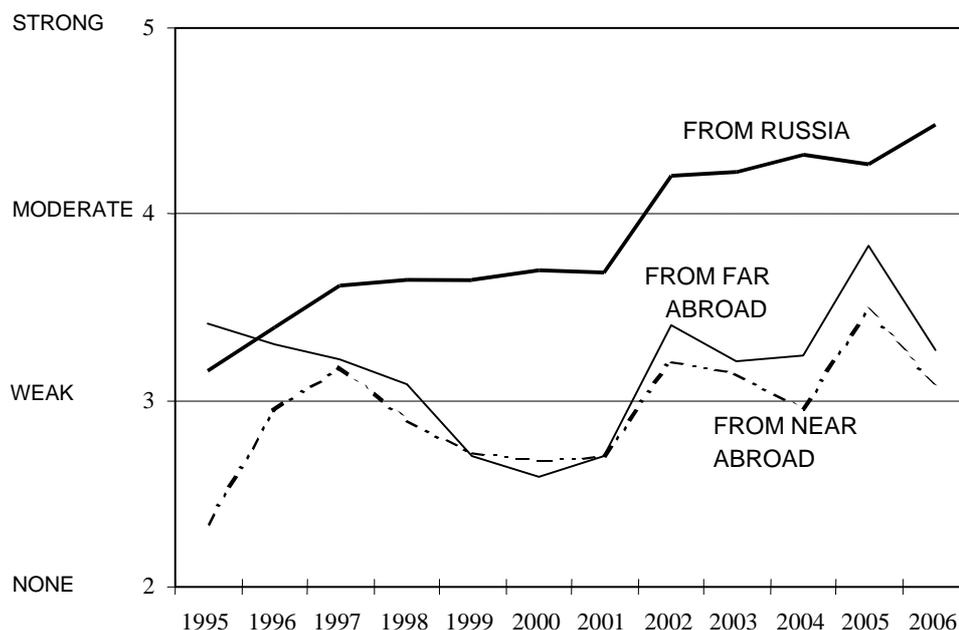


Fig. 24. Dynamics of the levels of competition with different manufacturers in the light industry

In machine-building, the share of competitive markets in 2006 continued to grow in respect to all types of competition (Fig. 25). At the same time, the share of markets with domestic competition has also become very close to maximum: in 2006 this index grew by 2 p. p. and reached the level of 97 %. The highest growth of competitive markets was registered in machine-building in respect of competition with commodities from far abroad: this index grew in one year by 6 p. p. and is now 78 %, which is much higher than in the light industry. And a year ago the competition indices of such markets in both these branches were approximately the same. It seems that the proper regulation of customs control had the strongest impact on the imported commodities produced by the light industry and has no noticeable effect on the markets for the products of machine-building, because in the latter case the share of “grey” commodities is much smaller. On the whole, during the post-default period the share of markets where commodities compete with those from far abroad grew by 20 p.p. and achieved in 2006 its historic high.

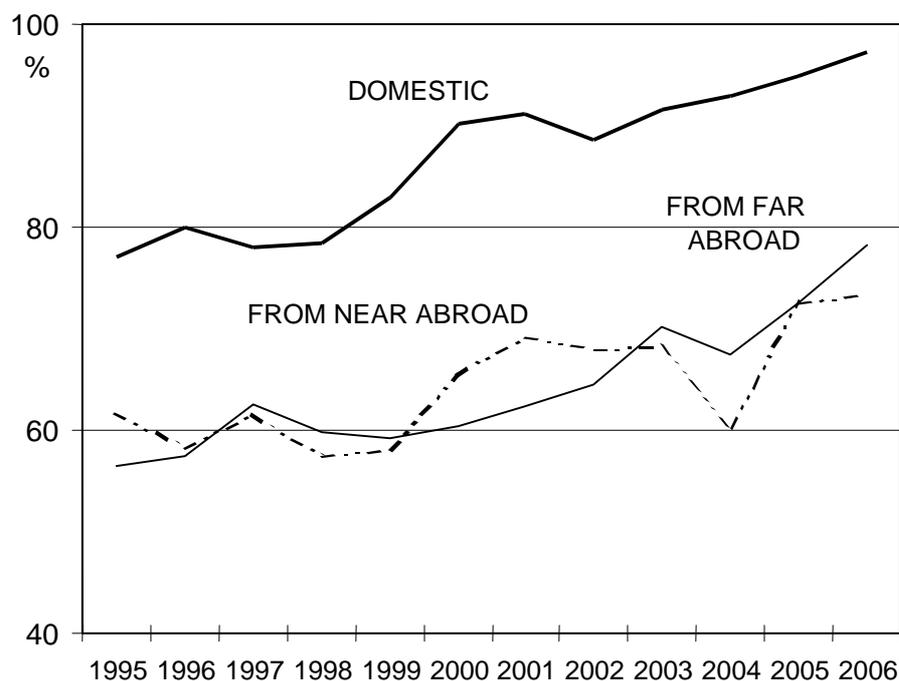


Fig. 25. Dynamics of the share of competitive markets in machine-building

The intensity of all types of competition in machine-building did not change in 2006. Both domestic competition and competition with imports remained at the level of 2005, which was the highest since 1995, when we began its follow-up. Similarly to all other branches, domestic competition remains the most intensive type of competition of the sales markers of Russian machine-building. Its estimation is 4.18 points, or slightly above “moderate”. It is noteworthy that the estimations of domestic competition became higher than “moderate” only in 2005, having been growing from 1995 to 2004 in a quite gradual way from “weak” to “moderate”. Competition with imports from far abroad in 2006 was 3.64 points, competition with commodities from near abroad – 3.22 points. Thus, the estimations of competition with imports in 2006 were within the interval between “moderate” and “weak”, and it is rather unlikely that the intensity of competition with imports will be able to increase in the next few years to the “moderate” level. Also, the level of competition with producers from far abroad in the machine-building branch was found in 2006 to be the highest by comparison with other branches. However, this or a similar picture has been observed in recent years quite often: the machine-building branch, by the intensity of its competition with imports, was either in the first place, or within the group of leaders. And especially so – after the 1998 default. Since 1999, the intensity of competition in that branch amounts, on the average, to 3.26 points (in the light industry – 3.12 points)

In the food industry, the share of markets with domestic competition is stable and high, being substantially higher than the share of the markets with other types of competition (Fig. 26). Domestic competition is felt by the food-producing enter-

prises to be present at 90 – 95 % of markets, and during the post-default period it has demonstrated little changes. In 2006, this index 93 %, falling behind machine-building and the light industry only by a few percent point. The competition with commodities from far abroad could be felt in 2006 only at 52 % of markets, having decreased after 2005 by 4 p. p. However, this last value looks negligible, after that index grew in 2005 by as much as 14 p. p. Thus, the past two years were estimated by the enterprises in the food industry as the most difficult, in terms of penetration of competitive imports onto their sales markets. In 2002, the situation was, from this point of view, the most comfortable one: the competition with imports was seen only on 32 % of markets, having decreased by half by comparison with its pre-default historic high. Foodstuffs from near abroad are now competing with Russian products on 64 % of markets. The growth of this type of market competition demonstrated, during last year, a growth of only 2 p. p. after a leap of 12 p. p. in 2005. After the 1998 default, Russian foodstuff producers have more often to compete with producers from near abroad than with those from far abroad.

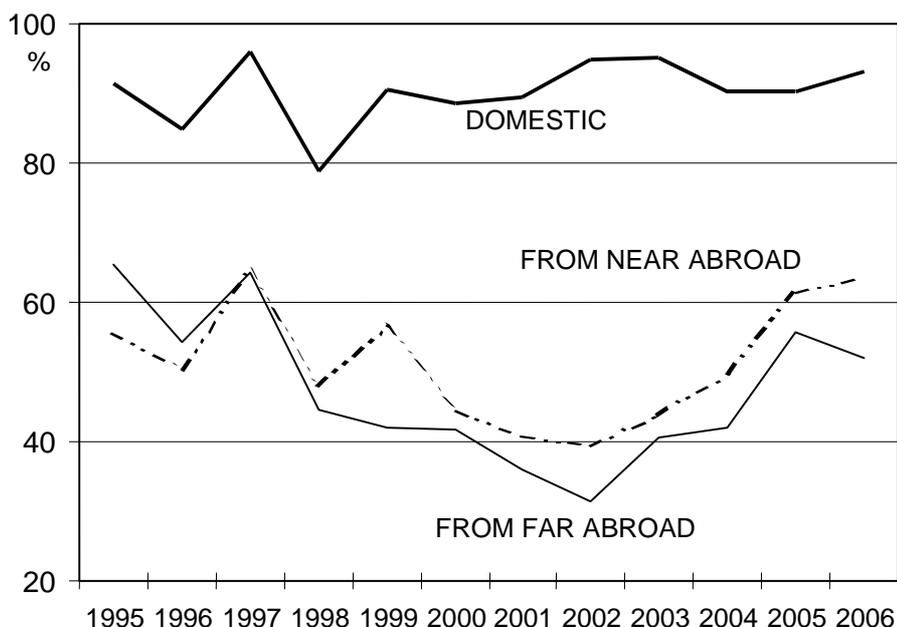


Fig. 26. Dynamics of the share of competitive markets in the food industry

In the food industry – one of very few – the intensity of domestic competition in 2006 increased (Fig. 27). Growth, however, was slight (0.13 points), but resulting was the achievement of a historic high of the intensity of domestic competition – 4.39 points, because this type of competition of the sales markets of the enterprises in that branch of industry is gradually shifting from “moderate” toward “strong”. But is happening, indeed, very gradually, because since 1999 the competition indices in that branch had always been above 4 points (“moderate”), and only during the last two years there emerged a trend of their “breakthrough”. The intensity of competition with imports in that branch has also grown, especially the

competition with foodstuffs from near abroad. But the level of competition with imports there is among the lowest in Russian industry (being higher only than that in the construction materials industry). Now, the estimations of this competition are only higher than “weak”. As for the intensity of competition with products from far abroad, it is even below that level. In 2002, the situation on the sales markets in respect to the competition with imports was very comfortable for Russian producers: they were competing with imports at a minimum number of markets, while the intensity of competition there was very close to “none”.

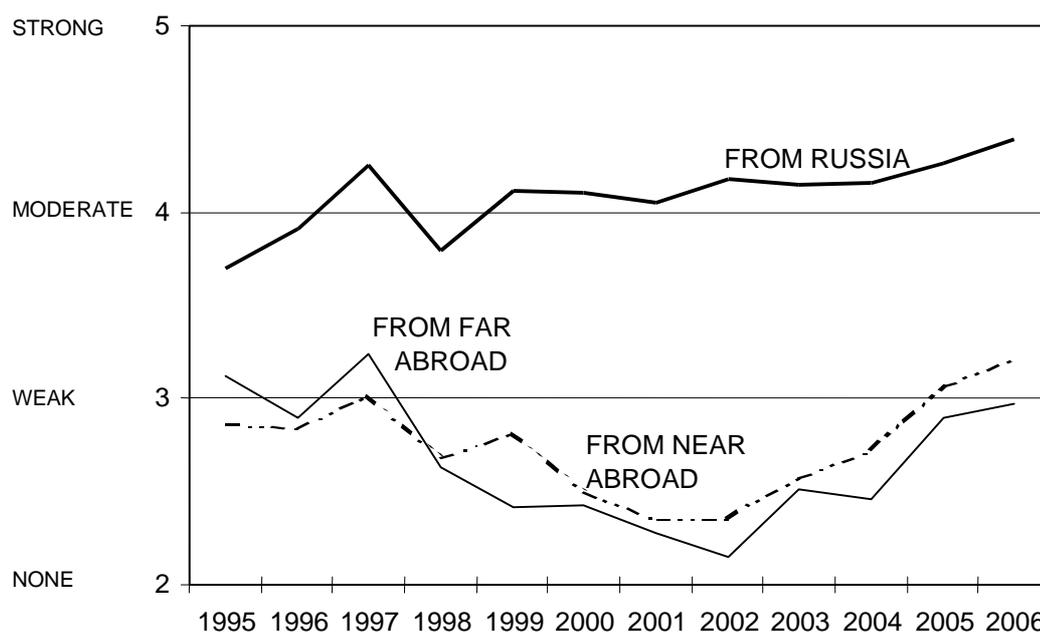


Fig. 27. Dynamics of competition with different manufacturers in the food industry

The highest number of competitive markets in 2006 was registered in the timber industrial complex (Fig. 28). The share of markets with domestic competition is traditionally high there (just as in other branches) – now at the level of 96 %, which is historic high. Growth during last year amounted to only 1 p. p., while growth by comparison with the pre-default peak was only 8 p. p. Thus, domestic competition in that branch was sufficiently intensive and stable, while the high values and absence of any great changes in the few past years demonstrate that this index is near its maximum. As for the share of the markets with competition from far abroad and near abroad, it has visible changes during recent years. Firstly, these indices reached the levels of 81 % and 90 %, respectively, and as a result the branch in 2006 was in the first place by these parameters. No such prominent presence of competitive imports is being felt by the enterprises of any other branch. Even the enterprises in the light industry and machine-building have never had so high competition with imports on their sales markets.

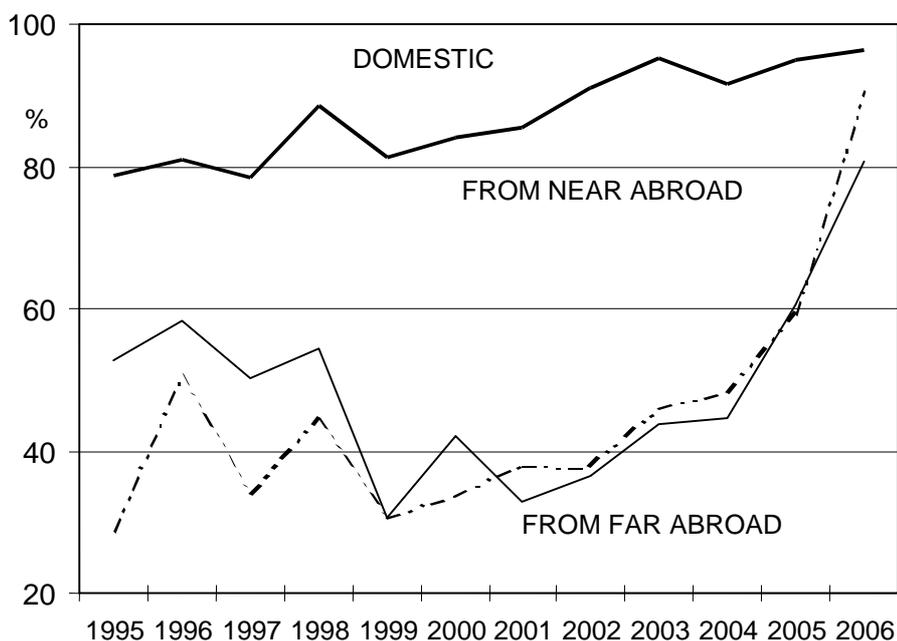


Fig. 28. Dynamics of the share of competitive markets in the timber industrial complex (TIC)

Secondly, since 1999 the penetration of competing imports from far abroad to this branch's sales markets increased from 31% to 81% (that is, by 50 p. p.), and the penetration of competing imports from near abroad during the same period grew from 31% to 90% (59 p. p.). So high expansion of competing imports has not been experienced by any other branch of Russian industry. Thirdly, if this trend of growing imports penetration onto the sale market persists, the enterprises of this branch will have to compete equally often with both Russian and foreign manufacturers. Such a situation has never before occurred in any other branch. Thus, the enterprises belonging to the timber industrial complex have experienced the greatest changes in the scope of their competition with imports during the post-default years, and therefore they are more in need of being protected from imports than all other branches of Russian industry.

However, foreign manufacturers, while actively penetrating the sales markets of the Russian enterprises of the timber industrial complex, have so far created no serious problems for their Russian counterparts. They estimate the level of their competition with imports as being equal to 3.5 points, that is, midway between "weak" and "moderate". It is noteworthy that during the last two years the estimations have grown nearly by one whole point; in 2004 they were between "weak" and "none", while in 1999 - "none". In other words, the sales markets of the enterprises of the Russian timber industrial complex demonstrated the strongest changes in the level of competition with imports.

On the whole, the conditions for domestic competition in the branches of Russian industry in 2006 were very homogeneous (Fig. 29). The only exception was

represented by nonferrous metallurgy. The share of competitive markets in other branches is above 92 %, which requires from the regulating agencies only that they should maintain the existing status quo and prevent market monopolization, as the goal of inducing competition among Russian industrial enterprises has already been achieved. The level of domestic competition has also become sufficiently high: in all the branches this index is above “moderate”.

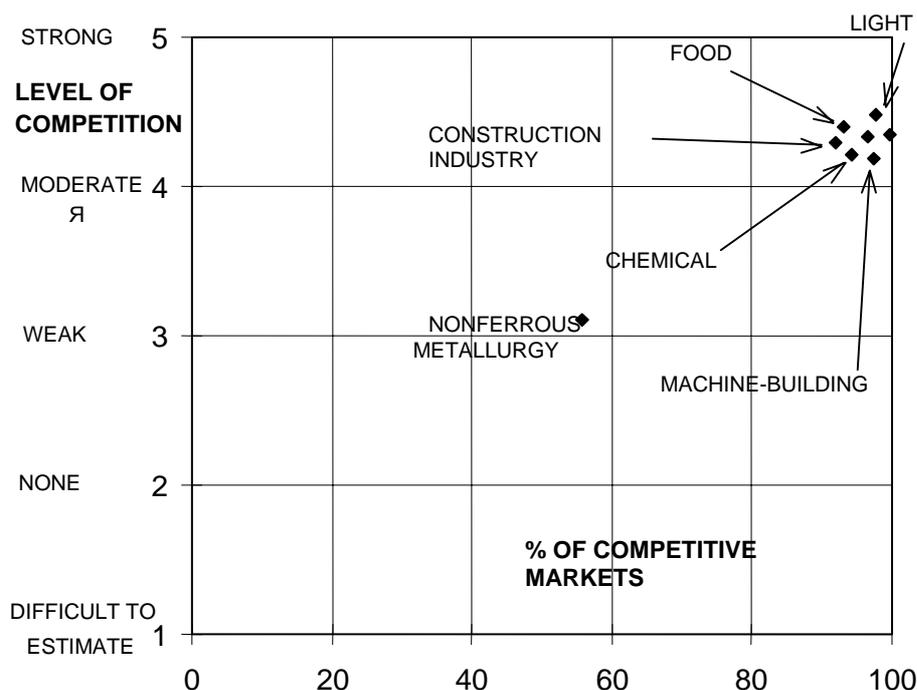


Fig. 29. Branch indices of domestic competition in 2006

Less homogeneous is the competitive environment characterizing the competition with producers from far abroad (Fig. 30). The share of competitive markets in different branches is from 46 % to 83 %. The intensity of competition is estimated as being between 2.76 and 3.64 points. The weakest pressure by imports is being experienced by enterprises in the construction materials industry, the strongest – in metallurgy, machine-building and the timber industrial complex. The situation in the light industry seems to be far from so critical as it could be imagined if one listens to the persistent appeals for the protection of its enterprises. Moreover, the situation there is not so different from that in the food industry, which is traditionally considered to be the most protected from imports. Thus, if we should speak of protecting domestic manufacturers, it must be pointed out that the attention of the State should be focused on those branches which are remarkable not by the activity of their lobbyists, but by the level of imports penetration and the intensity of the competition with it.

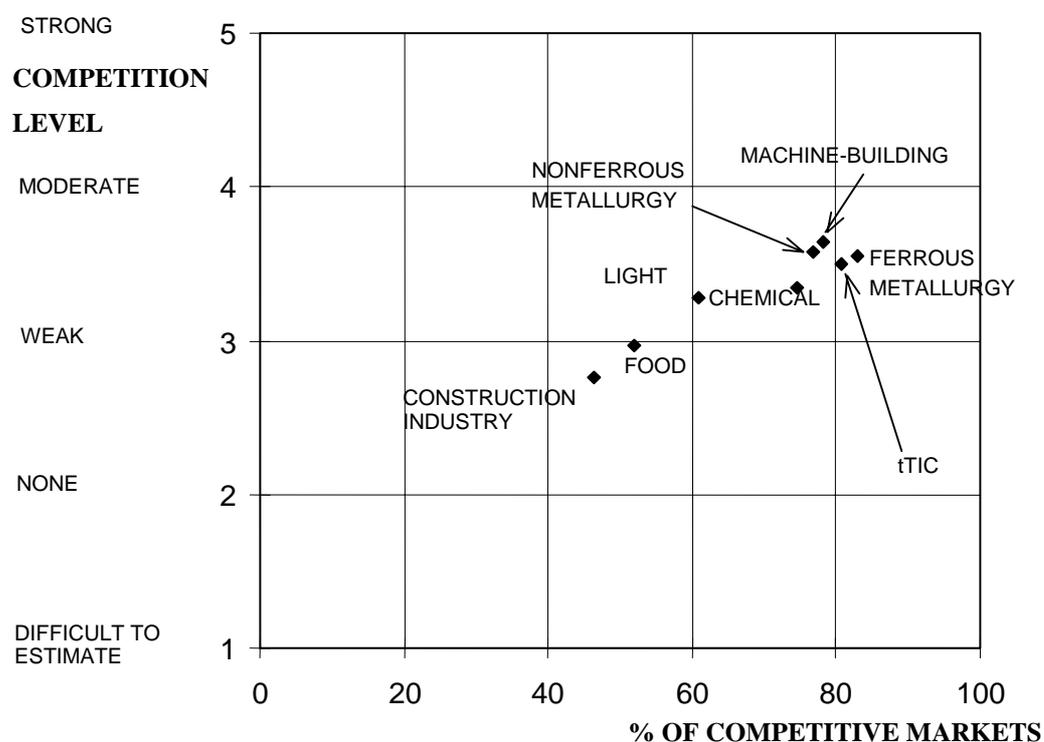


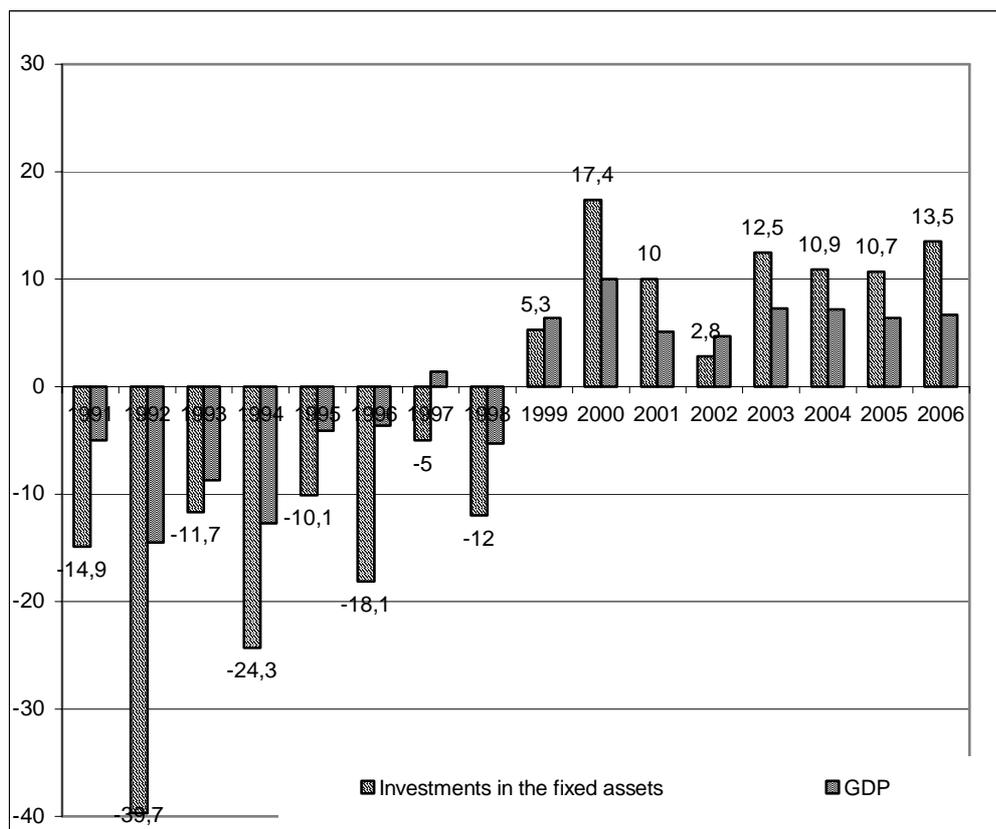
Fig. 30. Branch indices of competition with commodities from far abroad in 2006

### 3.3. Investments in the Real Sector of the Economy

#### 3.3.1. Domestic Investments in Fixed Assets

In Russian economy the trend for investments into fixed assets anticipating growth has been observed since 2000 (Fig. 31). Over the period of 2000-2006 the investments into the fixed assets have increased by 2.16 times, the growth of the GDP being at the same time 1.68 times. It should be noted that the investments dynamics suffered considerable fluctuations over the last seven years.

The high growth of the investment demand in 2000, supported by the dynamics economy incomes growth gave place to the flat dynamics in 2002 due to foreign market factors. The restoration of the anticipating growth rates of investments into the fixed assets in comparison with the GDP dynamics has been observed since the beginning of 2003 and was accompanied by the price growth at the world market of the fuel fossils and raw materials and gradual increase of the domestic market share in the economy dynamics formation. In 2006 the volume of the investments in the fixed assets increased by 13.5%, in the previous year - by 10.7%.



Source: Federal State Statistics Service.

*Fig. 31.* The GDP and Investments in the Fixed Assets Growth Rates in 1991–2006, as percentage to the preceding year

The steady positive production output has changed the situation at the investment sector. The expansion of the investment demand proceeded along with the favorable changes in the price for hydrocarbon and mineral resources situation at the world markets, on the one hand, and activation of the Russian business at the domestic market, on the other hand. The growth of the economy and business incomes determined the demand extension for investment goods. The coefficient of the fixed assets renewal increased from 1.4% in 2000 up to 1.8% in 2003 and 2.1% on average over the period of 2004-2005. The increase in the coefficient of fixed assets renewal was observed in almost every kind of economic activity, this process being the most intensive in infrastructure branches. Thus, the rate of capital renewals in communication industry has increased from 2.1% in 2000 to 7.1% in 2004, in the trade, correspondingly, - from 2.4% to 6.2%, in transportation – from 1.0% to 1.2%. The orientation of the producers towards production modernization and reconstruction caused the increase in the demand for the machinery and the equipment in almost every kind of economic activity. In the investment in the fixed assets structure by kinds of the fixed assets the increase in costs for machinery, equipment and transport vehicles has been observed. Whereas in 2001 the share of investments in the machinery, equipment and transport was equal to 35% of the

whole amount of the investment, in 2005 their proportion exceeded 40% (*Table 38*). As a result in the industry wear and tear of the machinery and the equipment decreased from 62.7% in 2001 to 57.3% in 2005, the share of manufacturing facilities, which are under 5 years old, increased from 4.7% in 2000 to 9.5 % in 2005.

*Table 38*

**The Structure of the Fixed Assets by kinds of Fixed Assets in  
2000–2006, in % to the total**

	2000	2001	2002	2003	2004	2005	2005*	2006*
Investments into the fixed assets - total	100	100	100	100	100	100	100	100
Including the following kinds of fixed assets:								
housing	11.3	11.4	12.2	12.6	12.2	10.9	7.3	7.2
Buildings and constructions	43.1	41.8	41.0	43.5	42.1	42.8	47.1	48.8
Machinery, equipment, transport	36.6	35.0	37.7	37.1	39.8	40.9	38.5	36.2
others	9.0	11.8	9.1	6.8	5.9	5.4	7.1	7.8

\* excluding small enterprises and informal activity parameters.

Source: Federal State Statistics Service.

Development rates of domestic machine building industry being reserved as compared with the investments expenditures dynamics and the fixed assets reproduction characteristics, the influence of the demand growth for import machinery and equipment at the domestic market has increased. The decrease in the import share in the machine-building production consumption was of the short-term nature and was observed in the period from the IV quarter 1998 to III quarter 1999. The dynamics of investments goods output in that period reflected the prompt reaction of the Russian business to the economic shifts at the domestic market. It was the enterprises involved in the production of oil and chemistry industry equipment that had the leading positions in the investment goods output. The development of the infrastructure branches stimulated the increase in output volumes of construction and road-making machines, as well as machine-building production traditionally orientated at the domestic market: railway and metallurgic machine-building.

The sharp increase in the demand for foreign produced equipment fell on 2000, and since then the trend for the anticipating import growth rates of the machinery and the equipment as compared with the development of the domestic machine-building was of stable nature and corresponded with the dynamics of the investment activity. The factors that had the positive influence on the investment activity in long-term and medium-term prospects were the reduction of prices for foreign produced machinery and equipment due to the real appreciation of ruble as well as the utilization of the industrial assemblage technology, the import duties for foreign produced components being therefore decreased.

Within 2003–2006 average annual increase rates of the investment in the fixed assets being 11.9%, of the domestic machine-building production at the level of 8.7%, this index for machine, equipment and transport vehicles import was equal to 37.9%. Investments into the purchase of the foreign produced equipment in the total amount of the investments in the machines, equipment and transport vehicles

were, according to the data of the Ministry for the Economic Development, 21.5% in 2006 as compared with 20.6% in the previous year.

The influence of the economic revenues from the foreign trade on the economic growth rates being positive, their impact on the investment activity dynamics was limited by the trend for the decrease of the level of the gross national savings transformation into the investment expenditures. The share of the gross national saving in the GDP over 2003-2006 was on average 33.1%, of the investments into the fixed assets – 16.6%.

Economic revenues growing in 2005, the trend for the increase of the budget funds share in the investments in fixed assets financing sources retrieved. In 2005 RUR 540.1 bln. of the investments in the fixed assets were financed by budget funds, which was equal to 20.1% of the total amount of the investments in the fixed assets throughout the economy, including 6.7% by the federal budget funds. In 2006 RUR 700.1 bln of the investments in the fixed assets were financed by budget funds, including by federal budget funds – RUR 242.1 bln.

Table 39

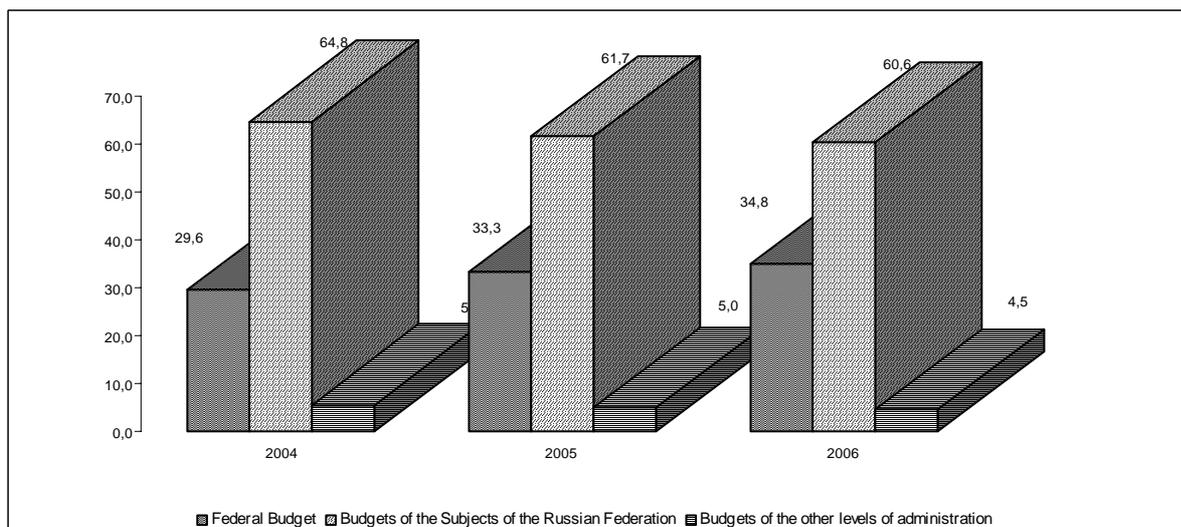
**Structure of Investments in the Fixed Assets as per Financial Sources,  
Percentage to the Total**

	2000	2001	2002	2003	2004	2005	2005*	2006*
Investments in fixed assets - total including a break-down by sources of investment:	100	100	100	100	100	100	100	100
<i>Own capital</i>	47.7	49.4	48.0	46.2	46.8	47.7	45.1	44.3
of which:								
profit	23.4	24.0	20.5	17.2	18.3	22.4	20.6	20.2
<i>Inflow of funds</i>	52.5	50.6	52.0	53.8	52.6	52.3	54.9	55.7
of which:								
bank credits	2.9	4.4	4.8	5.2	7.3	6.5	8.3	8.9
including foreign bank loans	0.6	0.9	0.5	0.8	1.3	1.0	1.0	1.5
loans from other organisations	7.2	4.9	6.0	8.6	7.3	7.3	7.4	5.4
Budget funds:	22.0	20.4	19.6	18.8	17.4	20.1	20.7	19.8
Federal Budget funds	6.0	5.8	6.0	6.5	5.1	6.7	7.1	6.9
Funds from the Subjects of the Russian Federation budgets and local budgets	16.0	14.6	13.6	11.5	11.3	12.4	12.5	12.0
Share of foreign investments in total investments in fixed assets	4.7	4.5	4.1	4.7	5.0	4.8	5.2	6.1

\* small enterprises and informal activity parameters excluded.

Source: Federal State Statistics Service.

The characteristic feature of 2005 and 2006 was the change in Federal budget funds vs. budgets of the Subjects of the Russian Federation funds ratio, allocated for the investments. In 2005 the anticipating growth of investments in fixed assets at the expense of the Federal budget funds had a significant impact on the investment process. The share of the budget funds, which was used for the investments in fixed assets, was 2.63% of the GDP in 2006 against 2.5% of GDP in 2005 and 2.32% of GDP in 2004, including the Federal budget funds being, respectively, 0.91% against 0.83% and 0.68%.



Source: Federal State Statistics Service.

*Fig. 32.* Structures of the Investments in the Fixed Assets Financing at the Expense of the Budget Funds in 2004-2006, as percentage to the total

In 2006 the amount of the public investments grew by 0.3 p.p. of the GDP in comparison with 2005. According to the priorities of the state investment the funds were allocated to modernize and develop strategically important for the country objects of industrial infrastructure, fulfillment of investment projects on the modern technologies implementation for production of competitive production at the machine-building enterprises, as well as to secure the safety of the energy, transport objects and forestry. In 2006 the share of the state investments in the development of the social sphere increased by 5 p.p. and in the development of special (defensive) complex – by 2.8%, while the share of investments in manufacturing complex changed but negligibly.

Public investments from the budget are carried out by the Investment Fund, Federal Targeted Investment Program (FTIP) and Federal Special Programs (FSP). Investments for different social and economic as well as industrial programs, which are recognized as priorities, are financed by FSP. In 2006 the number of the federal special programs and subprograms financed by the Federal Budget reduced considerably. This enabled to concentrate the resources on the priority directions of social and economic development of the country. It is chiefly the construction of particular objects both necessary for FSP fulfillment and not included in the programs that is financed by FTIP. In 2006 the volume of the Investment Fund was equal to RUR 96 bln., of FTIP – RUR 318.95 bln., of FST (in total) – RUR 363.6 bln.

The share of expenses for FTIP in the GDP in 2006 increased up to 1.38% against 1.17% the previous year, the share of the expenses for defense order (special complex) increasing up to 0.28%. In 2006 FTIP financing was equal to 85.6% of the year limit allocated. To a considerably greater extent, than on the whole throughout the constructions and the establishments for the state needs, the year limit for state investments into manufacturing complex has been financed.

According to the data of the Federal State Statistics Service, the limit of the public investments, allocated for 2006, was equal to RUR 150.4 bln, and at the expense of all the sources of financing for object, envisaged by FTIP, construction the investments of RUR 186.5 bln. were used by the end of 2006. On account of the 2006 year limit public investments of RUR 143.1 bln. were financed, including the construction for agriculture complex - RUR 4.7 bln., transport complex - RUR 67.4 bln., special complex - 5.2 bln, social complex – 51.9 bln., in construction complex financing did not take place.

Table 40

**Limits of Public Investments, Allocated for Construction, Financed by Federal Budget in 2005–2006, RUR mln.**

	2005		2006	
	Public investments limit	Investments used by all sources of financing	Public investments limit	Investments used by all sources of financing*
Total	158.4	210.6	150.4	186.5
Including by construction projects for:				
Social complex	48.5	72.0	56.8	69.1
Manufacturing complex	93.2	116.3	71.6	83.0
Special complex	6.9	6.1	6.9	6.2
Other construction, not belonging to complexes	9.7	16.2	14.9	28.1

\* Preliminary data.

Source: Federal State Statistics Service.

The main part of the public investments of FTIP, in the same way as in previous years, was allocated to fulfill the main national, infrastructure and innovation projects, as well as FSP of the development of key economic sectors and industries. Thus, more than one third of the FSP financing was directed towards infrastructure projects in electricity power and transport industry, and provisions for these aims have increased in comparison with 2005 at that. The share of public expenses for electricity power increased from 1.2% in 2005 up to 1.5% in 2006. The expenditures for transportation system development remained prevailing in the structure of FSP budget financing in 2006 and expanded up to 39.4% (against 35.9% in 2005). Budget funds were mainly invested in road building, civil aviation projects and sea transportation.

According to the Federal Targeted Investment Program in 2006 it was envisaged to allocate (by specified list of the Ministry for the Economic Development) public investments for 2802 construction projects but by 1 January 2007 there were 2118 construction projects fully financially provided. In 2006 it was planned to put into commission 1234 construction projects, among them 283 construction projects were put into operation at the total capacity and 59 – partially. Besides, 120 construction projects, planned to be put into operation in following years, were put into commission (34 – at the total capacity, 86 - partially).

Almost at every ninth construction project, envisaged by investment program, construction works did not take place in 2006. By 1 January 2007 1015 construction projects or 36.2% are technically ready in the range from 51.0 to 99.9%.

The growth of economy revenues, the increase in business activity of the bank sector and population savings investment into housing had a positive impact on the nature of investment activity. Fundamentally new feature of the economic growth in the period of 2003-2006 was the shift from the investments in fixed assets financed at the expense of the business' and organizations' own capital to the expansion of debt capital share. This was a graphic evidence of qualitative changes in investment development mechanism, which is orientated on investment resources flow rationalization. As a result of 2006 the share of inflow funds was 55.7% of total amount of investments in fixed assets.

In contrast to 2005 the increase in banks' share of investment financing from 8.3% to 8.9% was observed in investment crediting. The trend for the increase of insurance, investment, industrial and trade companies as well as foreign investment participation in investment activity financing sustained. In 2005 net inward investments were equal to USD 1.3 bln., in 2006 – USD 41.6 bln. Foreign banks credit share in investments in fixed assets financing has grown up to 1.5% against 1.0% in 2005, foreign investment ratio being 6.1% against 5.2%.

Table 41

**Net Capital Export of Private Sector, according to Balance of Payment, USD bln**

	Net capital export of private sector, total	Including:	
		Net capital export by banks	Net capital export by non-financial organizations and households
1999	-20.8	-4.3	-16.5
2000	-24.8	-2.1	-22.8
2001	-15.0	-1.3	-16.2
2002	-8.1	2.5	-10.6
2003	-1.9	10.3	12.2
2004	-8.0	3.5	-11.5
2005	1.3	5.9	-4.6
I quarter	1.5	-2.7	4.2
II quarter	-5.3	-2.5	-2.9
III quarter	9.1	6.4	2.7
IV quarter	-4	4.6	-8.6
2006	41.6	25.1	16.5
I quarter	-4.7	-3	-1.7
II quarter	19.8	9.9	9.9
III quarter	12.7	8.7	4.0
IV quarter	13.7	9.4	4.3

Source: Central Bank of the Russian Federation

Low real value of the credit resources under the average level of profitability existing in the economy accounted for the expansion of enterprises debtors sector. Among the factors that positively affect the credits dynamics and other borrowed funds the growth of the organized forms of the population savings can be

distinguished. The share of funds, directed towards share holding in construction was equal to 3.4% from the total amount of the investments in the fixed assets.

The increase in the investment activity in branches of infrastructure and the increase in demand for these branches' service is the indicator of growth potential, the investment policy in this sector being orientated towards the solution of long-term problems. Over the period of 2002-2005 the share of transport, communication and trade increased by 7.1 p.p. and was equal to 29.8% of the total volume of the investments in the fixed assets. Over the years of reforms, the share of transport in the structure on the investment in the economy real sector nearly doubled, in 2005 its share being 20.4% against 15.1% in 2002. Whereas in 1992 the share of the investments in communications was equal to less than 0.6% of the total amount of the investments in the national economy, in 2002 it reached 3.4% and in 2005 – 5.5%.

Table 42

**Structure of Investments in the Fixed Assets by Types of Economic Activities**

	2000	2001	2002	2003	2004	2005	2005*	2006*
<b>Total</b>	<b>100</b>							
Including break down by types of economic activity:								
Agriculture, hunting and forestry	3.0	4.0	4.6	4.1	4.1	4.0	3.2	4.0
Industry	40.4	40.4	38.6	38.1	38.3	36.8	40.6	41.5
of which								
Minerals extraction	18.1	19.0	16.9	15.9	14.8	13.4	15.2	17.3
including fossil fuels extraction	16.7	17.5	15.5	14.4	13.4	11.8	13.5	15.8
Manufacturing industries	16.3	15.9	15.9	15.6	16.5	16.8	17.6	16.4
Electricity, gas and water production and distribution	6.0	5.5	5.8	6.6	7	6.6	7.8	7.8
Construction	6.4	5.2	5.4	4.9	3.6	3.5	2.9	3.3
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	2.7	2.9	3.6	3.5	3.6	3.9	2.8	2.9
Transportation	18.5	19.2	15.1	17.5	17.6	20.4	22.1	21.3
Communication	2.7	3	3.4	4.8	5.6	5.5	6.7	5.5
Financial activity	0.8	0.8	1	1.2	1.4	1.3	1.3	1.1
Operations with real estate, renting, provision of services	15.2	14.7	18.1	17.7	17.6	16.6	11.5	10.6
Education	1.3	1.5	1.5	1.4	1.5	1.5	1.8	2.1
State administration, military safety security; compulsory social security	1.5	1.5	2	1.6	1.5	1.5	1.8	1.8
Health care and provision of social services	2.6	2.4	2	2	2.2	2.2	2.3	2.5
Provision of utilities, social and personal services	3.9	3.5	3.8	2.6	2.5	2.4	2.6	2.9

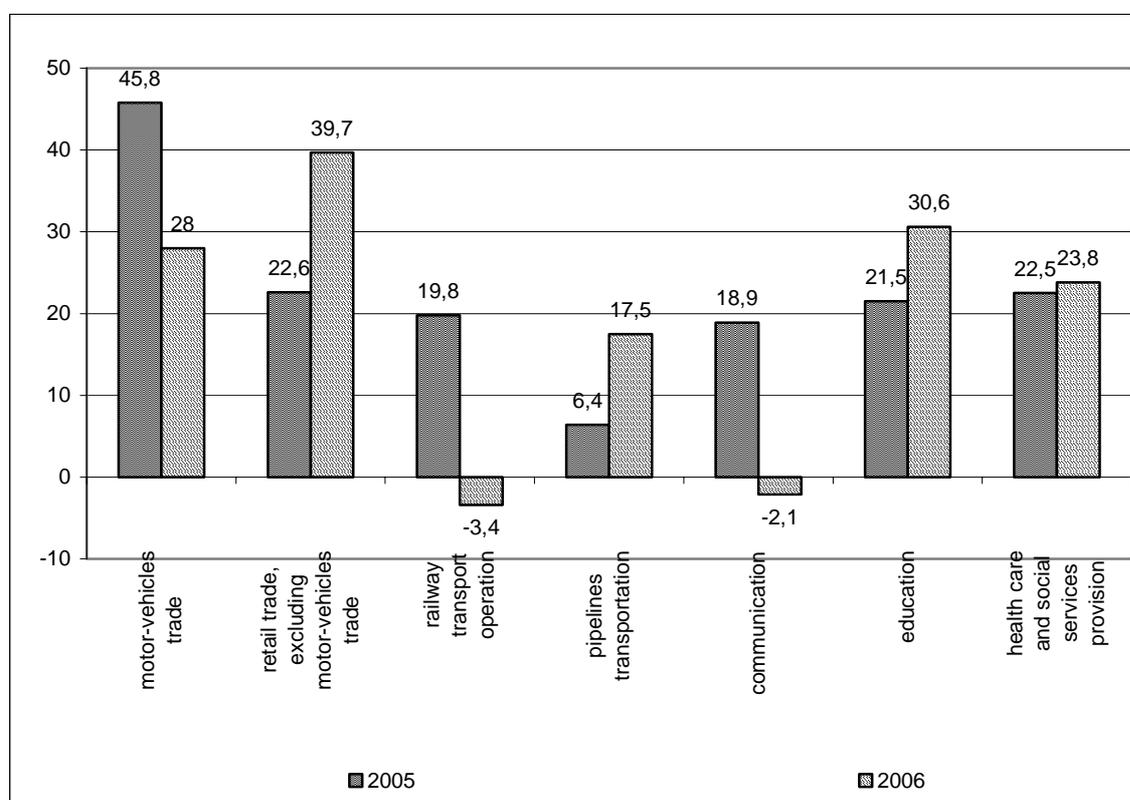
\* excluding small enterprises and informal activity parameters.

Source: Federal State Statistics Service.

In 2006 the trend for the growth of investments in the fixed assets in transportation and trade, as well as in the kinds of activities, orientated to the provision of

social services – education, health care - sustained. Characteristic feature of the investment process in the transportation was the change in the structure of investments by kinds of economic activity. The dynamic growth of the pipeline transportation was maintained by the increase of its share in investment expenses up to 39.9% of the total amount of the investments into transportation (34.8% in 2005). In 2006 the reduction of the scale of the investments in railway transport and communication, for which the period of the restoration growth of 1999-2005 was characterized by the growth of the investment activity, was observed.

It should be noted that against the background of the steady growth of the demand for trade services redistribution of the investments by kinds of activities is proceeding in the environment of retail trade and motor vehicles trade material and technical basis expansion, the increase in investments into which was equal, respectively, to 149.7 and 128.0% against the level of 2005.



Source: Federal State Statistics Service.

*Fig. 33.* Change in the Investments in Fixed Assets Growth Rates by Kinds of Services Provided in 2005 and 2006, as percentage to the preceding year

The share of the investments in the fixed assets by kinds of activities in goods production in 2006, exceeded the level of the previous year by 4.3 p.p., which was due mainly to the acceleration of the investments in industry and agriculture growth. The increase in agriculture investments in 2006 was equal to 40.6%, and its

share in investments in fixed assets structure increased up to 4.0%, increase in comparison with the preceding period being 0.8 p.p.

It was fuel and energy production that traditionally had the most significant impact on the dynamics and structure of the investments into the industry. The growth of the Russian economy in 1999-2001 was characterized by extremely high investment activity rates in fuel industry. Against the background of favorable domestic and foreign market situation the investment activity was defined by the increase in the volumes of investments in oil production by 2.3 times, in oil processing and gas industry – by 2.1 times the investment growth being 1.58 on the whole in the industry and 1.36 in the economy. The proportions of the investment distribution between extraction and processing industries of oil complex changed towards the increase of oil production share. The increase in business activity was accompanied by drawing of reserve facilities into production and investments flows rationalization. As a result the coefficient of capital renewals in oil industry increased from 1.7% in 1999 to 2.9% in 2000 and 4.2% in 2001. In 2000 thanks to new constructions, 2.8 thou. oil wells were put into operation, in 2001 – 3.8 thou. More reserved dynamics of investments in oil processing was accompanied with the evolution of the trend to stabilize the proportion of intensified oil processing.

In 2002 in the environment of the change of the situation at the world market of hydrocarbons and the decrease in the production profitability down to 20.7% against 66.7% in 2000 and 46.5% in 2001 the investments in oil production industry decreased by 15.6%. The restoration of the positive investment activity dynamics in 2003 relaxed the tension but did not change the situation. Over the period of 2004-2005, despite the growth of world prices for hydrocarbons the average annual rate for investment decrease was observed at the level of 15.5%. One of the reasons for sustention of this trend was perhaps connected with tax reclamations for “YUKOS” activity and their assets sales.

*Table 43*

**The Investment Dynamics and Goods Profitability in Oil Production and Oil Processing Industry over 1999–2005**

	Investment growth rates as percentage to the preceding year in comparable prices		Production profitability, percentage	
	Oil production	Oil processing	Oil production	Oil processing
1999	125.8	74.7	57.9	32.1
2000	151.1	240.0	66.7	34.5
2001	123.6	115.5	46.5	24.0
2002	84.4	90.6	20.6	15.5
2003	104.6	98.1	20.7	19.1
2004	79.7	108.7	36.3	22.5
2005*	90.8	104.7	37.3	22.7

\* Calculation based on the Federal State Statistics Service Расчет data on kinds of economic activity and investments in crude oil and gas production figures in 2005.

Source: Federal State Statistics Service.

The characteristic feature of 2004–2005 was unstable dynamics of investment activity in fuel industry, which is accounted for to a great extent by the factors of the market situation. The proportion of the fuel fossils production in 2005 was 11.8% of the total investment volume against 15.5% in 2002. The decrease of the impact of

the fuel industry in the investment process was initiated by the decrease of oil production industry in the total amount of the investments from 12.7% in 2001 to 7.0% in 2004 and 5.3% in 2005.

Table 44

**The Proportion of the Investments by Branches of Fuel Industry in the Total Amount of the Investments in Fixed Assets in the Economy in 1999–2005, as % to the total (in current prices)**

	1999	2000	2001	2002	2003	2004	2005
Fuel industry – total	14.0	18.5	19.2	18.2	16.2	15.2	13.5
including:							
Oil production and oil processing	9.6	13.4	14.4	12.1	11.0	8.3	7.1
Oil production	8.8	11.6	12.7	10.6	9.7	7.0	5.3
Oil processing	0.8	1.8	1.7	1.5	1.4	1.4	1.7

Source: Federal State Statistics Service.

As it is shown by the analysis of the investment activity indices in the context of oil companies, the total amount of the investments of 10 biggest oil companies decreased by 13.9% in 2004. The reserved investment behavior of oil companies was of short-term nature. In 2005-2006 the positive dynamics for investment assimilation, efficiency of oil wells exploitation fund usage increased at the expense of diminishing the number of idle ones.

Table 45

**Investments Use by Oil Companies in 2002–2006 rr.**

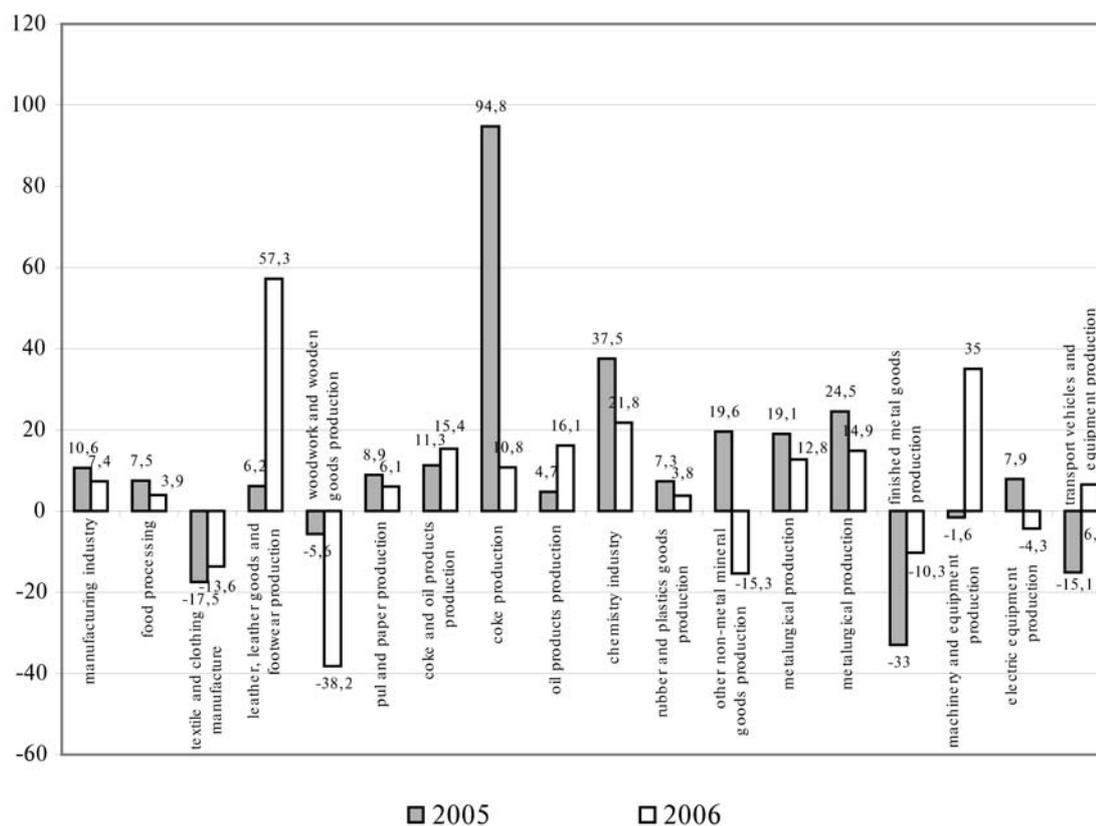
	In current prices, RUR bln.					Growth rates in % to the preceding year in comparable prices*			
	2002	2003	2004	2005	2006	2003	2004	2005	2006
Investments - total	147.0	167.0	167.1	222.1	309.8	103.0	87.1	118.6	120.9
including									
Exploring and production drilling - total	49.7	61.8	65.8	85.4	123.4	112.6	92.7	115.8	125.1
of which:									
Exploring drilling	9.4	10.6	9.8	12.7	17.4	102.6	80.0	115.9	118.7
Production drilling	40.3	51.1	56.0	72.8	106.0	114.9	95.4	115.8	126.2
Equipment not included in construction estimates	35.1	32.4	36.5	51.1	60.0	83.9	97.8	125.1	101.7
Industrial construction	57.8	69.4	62.0	83.1	124.5	108.9	77.8	119.5	129.9
Investments for non-production purposes	4.4	3.4	2.8	2.5	2.0	69.3	72.3	78.6	69.3

\* – according to the existing methodology previous year's prices are adopted as comparable prices

Source: Ministry for the Industry and Energy Data.

The characteristic feature of 2006 was the overcoming of the trend for the decrease of the share of the investments in minerals extraction, which was observed since 2002. As a result of 2006 the increase in the investments in the minerals extraction was equal to 22.2% against the decrease by 0.3% in 2005, and in electricity, gas and water production and distribution – 2.2% against the decrease by 0.4% in the preceding year. The overcoming of the decrease in the investment activity in this kind of economic activity was accounted for by the increase in investments in

power industry by 8.3% in comparison with the previous year. The dynamics of gas production and redistribution was considerably influenced by the priority shifts in investment activity towards pipeline net development. Consequently, as a result of the decrease in investment amount in gaseous fuel production and distribution was equal to 38.1% against the growth of 17.4% in 2005.



Source: Federal State Statistics Service.

Fig. 34. The Change in the Investment in Fixed Assets Growth Rates by kinds of Economic Activities in 2005 and 2006, as percentage to the preceding year

In 2006 the investments infixed assets growth rates deceleration down to 7.2% against 10.6% in 2005 was observed for manufacturing industries. The share of the manufacturing industries in the structure of the investments in the fixed assets throughout the economy was equal to 16.4% in 2006 against 17.6% in the preceding year. The incomes concentration remaining high within export-orientated productions and mechanisms of interindustry capital transfer being weakly developed it could have been hardly expected that the investments rates would accelerate and nature of the capital reproduction would change fundamentally. The analysis of the investments dynamics and structure demonstrates that the trend to decrease in the share of the investments in the machine-building production is characteristic for the Russian economy. The share of the enterprises producing capital goods was equal to 2.2% in 2006 against 2.7% in 2002. Under the existing age, technological and reproduction structure of the fixed assets low rates

of investments in the machine-building were the factors restricting the production development rates of final and intermediate goods output. The structure of capital goods production being what it is the import remains one of the main sources for capital renewals, production reconstruction and modernization.

Whereas the investment activity in food production as well as textile, clothing and tanning industries was determined by the increase in the domestic market demand, the metallurgical and chemistry industries were considerably influenced by the increase in demand of the external market. For instance, in 2006 the trend for anticipating growth of the investments in the metallurgical industry retrieved once again (112.8% against 2005) against the background of the decrease in the investment activity in the final metal goods production (89.7%), which lead as a result to the decrease in the final goods export.

The development of the chemistry and petrochemistry industries involves the solution of system problems of structural nature – guaranteeing the conformity of the production output, quality and range of chemistry and petrochemistry production with the total demand of the domestic and external markets. The internal market capacity for chemistry production being relatively high, the main factors restricting the chemistry complex operation are the high rates of the equipment physical depreciation, technology backwardness and investment resources limitation. Taking into account that petrochemistry productions are rigidly dependant in production and technological terms on oil and gas processing production, it seems sensible to compare the amount of the investments in industrial base renewal and the expansion of the raw materials base in the corresponding kinds of activities. Otherwise the situation of non-balance of production capacities of chemistry industry and its provision with the main kinds of raw materials can be reproduced. Thereupon the formation of the large science and production integrated structures, which enable to fulfill the advantages of finished technological chains starting with the production and processing of hydrocarbons raw materials, on which 80% of chemistry and petrochemistry production is based, and up to output and sale of the main of its kinds to the utmost extent, is gaining special significance. Currently the processes of vertically integrated structures creation, which aim is to provide final commodities production at the Russian factories, are observed. Obviously, it will be changes in branch and specific structure of the chemistry complex towards the reduction of raw materials production proportion and the increase in the products of high extent of processing proportion that will have the positive influence on the level and dynamics of the investment expenses. For fuel and power enterprises the strengthening of the trend for the decrease in the investments in oil processing is one of the urgent problems. It should be noted that against the background of high world prices for hydrocarbons low transformation and diversification of export incomes towards the investments in the production reconstruction and modernization had a negative impact on the figures of the economy growth.

### 3.3.2. Foreign Investments in the Russian Economy

In 2006 USD 55.1 bln. of foreign investments flowed in the Russian economy, which exceeded by USD 2.5 bln. the figure of the previous year. The growth rates of the foreign investments in 2006 were equal to 102.7% the average annual rate over the period 2002-2005 being at the level of 139.2%.

Table 46

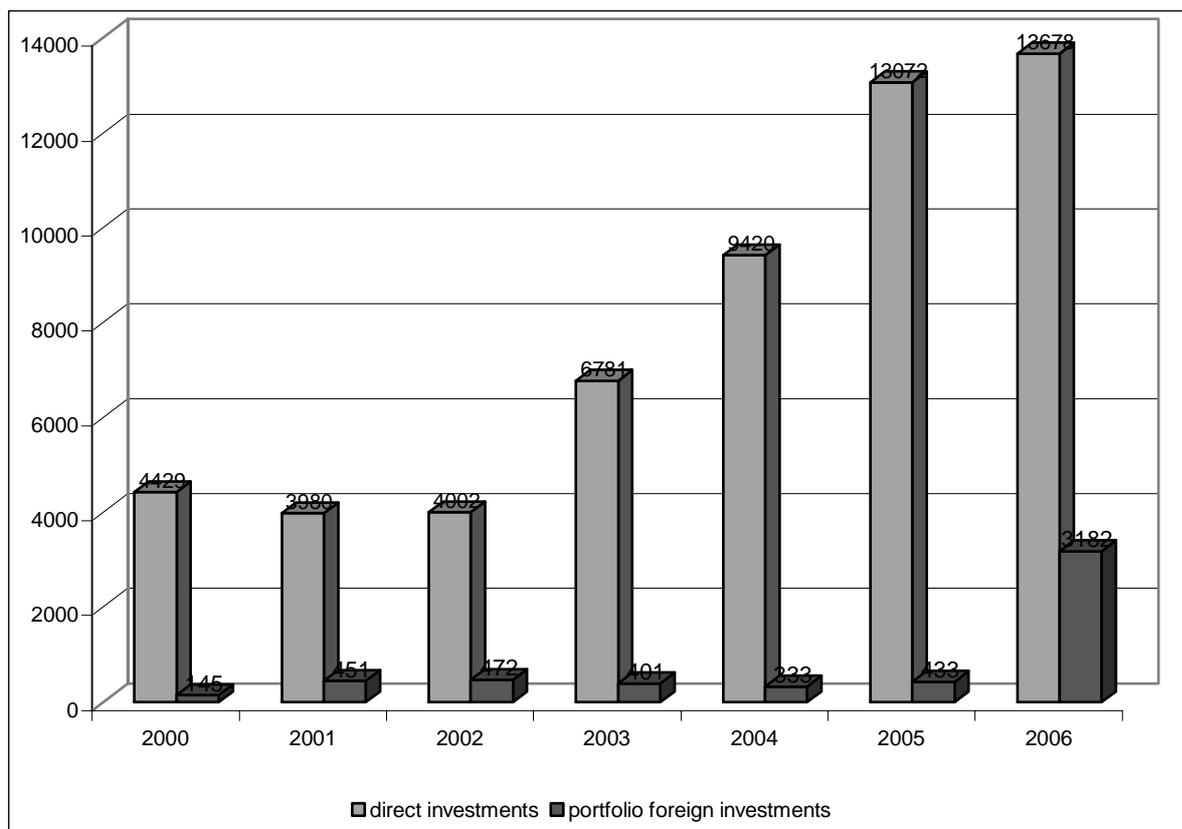
#### Inflow of Foreign Investments in the Russian Economy in 2002–2006

	USD mln.				As percentage to the previous year			
	Total	Direst	Portfolio	Others	Total	Direst	Portfolio	Others
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	84.98	147.1
2004	40 509	9 420	333	30 756	136.4	138.9	83.0	136.6
2005	53 651	13 072	453	40 126	132.4	138.8	136.3	130.5
2006	55 109	13 678	3 182	38 249	102.7	104.6	700.0	95.3

Source: Federal State Statistics Service.

Analyzing the dynamics and the structure of the foreign investments it should be first of all taken into account that nearly 3/4 of the total amount of the investments, flowing into non-financial sector of the economy, belong to the group of “other investments” – trade credits, foreign countries governments credits extended under the provision of the Government of the Russian Federation, international organizations credits, other credits and bank deposits. Bearing in mind high proportion of this component in the structure of the foreign investments, the change in the dynamics influences greatly the total foreign investment rates figure in the non-financial sector of the economy.

Another characteristic feature of the foreign investments in the Russian economy is the low proportion of the portfolio investments. Over the last 3 years the share of portfolio investments on average did not exceed 1% against 3.2% in 2001 and 2.4% in 2002. The trend for the decrease in the portfolio investments, which was observed in 2003-2004, in 2005 was substituted by the positive dynamics. The specific feature of 2006 was almost sevenfold increase in portfolio investments, direct investments growing but slightly and other investments having negative dynamics.



*Fig. 35. The Amount of Direct and Portfolio Investments Made to Non-financial Sector 2000–2006, mln.USD*

The positive dynamics of the direct investments was observed since 2002, their growth being anticipating in comparison with portfolio investments up to 2006 as well as compared with the internal domestic investments in fixed assets, in 2006, however, the increase in the direct foreign investments was only 4.6% versus 38.8% in the previous year. As a result the share of the direct investments in the total amount of the foreign investments made to the Russian economy in 2006 was equal to 24.8%, which roughly corresponds with the level of the preceding year.

Portfolio investments growth acceleration was connected with the increase in the activity of the foreign investments at the stock market. Investments in shares and stocks grew by 8.8 times and were equal to USD 2.9 bln. Other foreign investments, defined as trade credits, foreign countries governments' credits extended under the provision of the Government of the Russian Federation, as well as international organizations' credits and bank deposits for the first time over the past 10 years demonstrated the negative dynamics.

The foreign investments growth slowdown was accompanied by the change in their flow structure by the kinds of the investment activities. The increase in the investments into industry slowed down to 1.2% against 20.6% in 2005. For the first time over the last 5 years the absolute reduction in investments in trade was observed. In 2006 high rates of foreign investments growth sustained in transport and

communication, their proportion in the total amount of the foreign investments as a result increased up to 9.6% against 5.0% in 2004.

Table 47

**Inflow of the Foreign Investments by Kinds of Economic Activity  
in 2004–2006**

	In USD mln			As % to the preceding year			As % to the total		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Industry	20 170	24 318	30 603	163.6	120.6	101.2	49.8	45.3	44.7
Transport and communication	2 033	3 840	5 297	187.7	188.9	137.9	5.0	7.2	9.6
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	13 037	20 461	13 089	124	156.9	64.0	32.2	38.1	23.8
Real estate operations, renting and provision of services	2 572	2 602	5 988	75.6	101.2	230.1	6.3	4.8	10.9
Financial activity	1 001	1 813	4 698	156.4	181.1	259.1	2.5	3.4	8.5
Other industries	1 697	617	885	98.3	36.4	231.8	4.2	1.2	2.6

Source: Federal State Statistics Service.

The foreign investments in the industry growth rates slowed down. For the first time since 2000 the decrease in the amount of the investments in manufacturing industry was observed.

According to the state of affairs by the end of 2006 the accumulated foreign capital in the Russian economy comprise USD 142.9 bln., exceeding the figure of the previous year by 27.8%. The share of the direct investments in the accumulated foreign capital was equal to 47.5%, port folio investments – 3.4%, other investments, fulfilled at the returnable routine – international organizations credits, trade credits – having the biggest proportion of 49.1%.

In the total amount of the accumulated foreign investments, made to the Russian economy, the leading positions are still held by Cyprus, Netherlands, Germany and Luxembourg, whose share was equal to 63.6% of the total amount of the accumulated investments and more than 80% of the accumulated direct investments.

In the structure of the accumulated by the end of 2006 investments it is the direct investments that prevail, whose share was 47.5% against 44.5% in the previous year.

Against the background of the economic growth acceleration the Russian economy is becoming more and more attractive for foreign investors. One of the main guiding lines for the new investors to come to the Russian market and for already operating investors to wish to increase the amount of the investments is the ratings of the world agencies Fitch, Moody's and S&P (see chapter 2.5.3 of this review).

Table 48

**Accumulated foreign investments as broken down  
by Major Investing Countries**

	Accumulated by the end of 2006		Including (USD mln):			As percentage to the previous year	
	total, (USD mln)	as % to the total	direct	portfolio	others	total	direct
Investments - total	142 926	100	67 887	4902	70 137	127.8	136.5
of which the major investing countries including:	123 871	86.7	58 502	4245	61 124	124.9	134.5
Cyprus	32 276	22.6	22 796	1358	8 122	167.4	163.8
Netherlands	23 451	16.4	19 234	62	4 155	124.0	119.3
Luxembourg	22 870	16.0	587	203	22 080	109.0	130.2
Germany	12 260	8.6	3 320	1692	7 248	126.1	122.3
Great Britain	11 801	8.2	2 907	169	8 725	92.5	142.2
USA	7 698	5.4	4 588	507	2 603	112.5	105.2
Virgin islands (GB)	4 259	3.0	2 410	102	1 747	172.9	200.8
France	3 699	2.6	1 058	0.0	2 641	94.4	116.9
Switzerland	2 832	2.0	1 353	151	1 328	119.8	119.9
Japan	2 725	1.9	249	1	2 475		

Source: Federal State Statistics Service.

The increase of the investment activity will be assisted not only by awarding Russia high credit ratings by the leading world agencies but also by the efforts of the Government to change the investment climate in the country for the better.

### 3.4. Foreign Trade

#### 3.4.1 Foreign Trade Turnover

In September 2006 International Monetary Fund issued regular semi-annual report on the world economy situation and short-term development prospects.

In first six months of 2006, as it is stated in the report, the steady growth of the world economic trend sustained. In 2006 the rates of the world GDP increase, according to the forecast, should have been equal to 5.1%, while in 2007 they will slow down to 4.9%. The current economic upsurge is the most stable since the beginning of the 70ies. Favorable forecast is based on such positive factors as moderate inflationary pressure, which is not supposed to grow due to a moderate increase in interest rates of large countries central banks, expected balancing of domestic demand in developed countries, as well as situation stabilization at the world financial market. Business activity in most regions and countries was at the level of or above of that predicted.

It is multilateral liberalization of the world economy, as well as taking measures against the strengthening of protectionist pressure that remain important conditions for the world economy growth.

Table 49

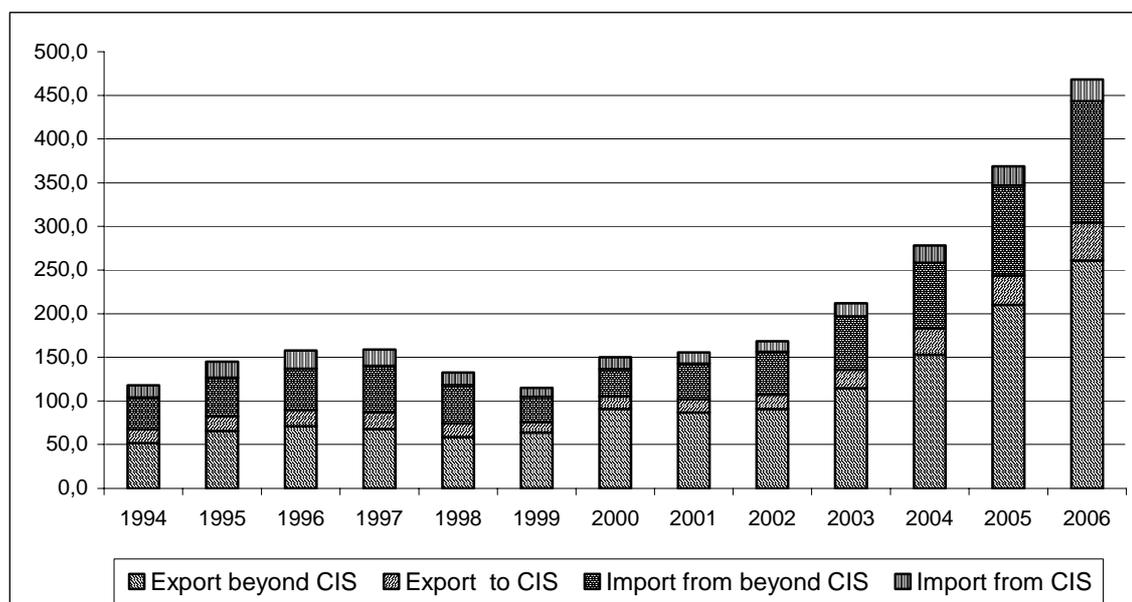
**Dynamics of the World GDP and the World Trade  
(as percentage to the previous year)**

	2004 r.	2005 r.	2006 r. <sup>1)</sup>	2007 r. <sup>2)</sup>
<i>GDP</i>				
<b>World as a whole</b>	5.3	4.9	5.1	4.9
Industrially developed countries	3.2	2.6	3.1	2.7
USA	3.9	3.2	3.4	2.9
EU countries	2.1	1.3	2.4	2.0
Canada	3.3	2.9	3.1	3.0
Japan	2.3	2.6	2.7	2.1
Other developed countries	4.6	3.7	4.1	3.7
Developing countries and countries with economy in transition	7.7	7.4	7.3	7.2
Countries of Central and Eastern Europe	6.5	5.4	5.3	5.0
CIS countries	8.4	6.5	6.8	6.5
Russia	7.2	6.4	6.5	6.5
Asian countries	8.8	9.0	8.7	8.6
China	10.1	10.2	10.0	10.0
<b>Goods and services world trade</b>	10.6	7.4	8.9	7.6
<i>Import</i>				
Industrially developed countries	9.1	6.0	7.5	6.0
Developing countries and countries with economy in transition	16.4	11.9	13.0	12.1
<i>Export</i>				
Industrially developed countries	8.8	5.5	8.0	6.0
Developing countries and countries with economy in transition	14.6	11.8	10.7	10.6

Footnotes. <sup>1)</sup> Estimation. <sup>2)</sup> Forecast

Source: The Bulletin of Foreign Commercial Information No 125.

In 2006 indices, characterizing Russian foreign trade, grew steadily and reached record over the last 15 years levels. Russian foreign trade turnover, calculated on the basis of balance-of-payments methodology, was equal to USD 468.4 bln., exceeding significantly yearly figures of the previous years (Fig. 36).



Source: Central Bank of the Russian Federation

Fig. 36. Russian Foreign Trade Turnover (bln. USD)

The increase in foreign trade turnover in 2006 is accounted for by a significant growth in monetary volume of export sales thanks to a favorable situation at the world market, particularly at the market of mineral resources used as sources of power, as well as noticeable import growth due to the increase in domestic demand.

In comparison with 2005 Russian foreign trade turnover went up by 27%. At the same time the turnover with countries, which are not CIS members, grew at higher rates. Over 2006 it reached USD 399.7 bln., which is by 27.5% higher than the corresponding figure of 2005. Russian trade turnover with CIS countries increased by 24% and reached USD 68.7 bln.

Foreign trade surplus in 2006 was equal to USD 140.7 bln., which is much bigger than in 2005 (USD 118.3 bln.). This is mainly due to price situation factor.

#### *3.4.2. Situation at the World Market*

According to the estimations of the Bank of Russia, the world prices, taking into account the structure of Russian export by the set of goods, which include 80% of its cost, were 22% higher than in 2005.

From January to the middle of August prices for oil at the world market increased most of the time. In the second half of August and in September a significant drop in prices was observed.

In 2005 OPEC member countries called off the limits of official price range for the basket, which was USD 22–28 per barrel. From March 2006 price interval for oil basket was declared by the marks of USD 50 and 60 per barrel.

The average price for oil grade Brent was by 19.8% higher, for oil grade Urals - by 21.1% more expensive in 2006 in comparison with 2005. Unprecedented maximum for OPEC basket is price mark of USD 72.67 per barrel, which was observed on 8 August 2006.

In 2006 prices for oil products were on average higher than in 2005 (premium petroleum being 18%, diesel fuel – 15%, furnace fuel oil – by 30% more expensive).

Within January-October 2006 natural gas went up in price by 36% in Europe and fell in price by 20% in the USA in comparison with the corresponding period of the previous year.

In 2006 world prices for the production of the Russian fuel and energy complex were 25% higher than in 2005.

In 2006 the world market was characterized by the growth of demand and prices for ferrous and non-ferrous metals. In the environment of world demand increase the expansion of international trade of metal production was observed.

In December 2006 the world prices (West European market) were equal to: reinforcing steel – USD 530-550 per ton (increased by 21% as compared with January 2006), rod – USD 490-510 per ton (increased by 15%), girders and channels (300-600 mm) – USD 520-540 per ton (increased by 2.9%), hot-rolled sheet – USD 600 per ton (increased by 56%), cold-rolled sheet – USD 620 per ton (in-

creased by 20%) and zinc-coated sheet – at the level of USD 700 per ton (increased by 25%).

Favorable situation at the foreign market persisted for non-ferrous metals exporters as well, the level of world prices for all non-ferrous metals reached a maximum over the period of more than last 13 years. In May 2006 the average prices for aluminum and copper were top since 1994. The prices for nickel reached peak level in August 2006 (*Table 50*).

The increase in prices at the world market of non-ferrous metals was caused by demand increase, low level of reserves at exchange stocks and anticipating growth of prices for raw materials for their production (alumina, copper and zinc concentrates).

The biggest increase in prices was observed for zinc and nickel as a result of a significant growth in demand for these metals, especially from the enterprises, manufacturing coated and stainless steel (Asian countries, especially the Republic of China).

At the world market of non-ferrous metals, according to the results of London Metal Exchange quotations with the immediate delivery period, the prices at the end of December 2006 were: aluminum – USD 2824 per ton (increased by 13% as compared with January 2006), copper – USD 6375 per ton (increased by 30%), nickel – USD 34300 per ton (increased by 2.3 times), zinc – USD 4230 per ton (increased by 82,5%), lead – USD 1645 per ton (increased by 17%), tin – USD 11190 per ton (increased by 45%).

*Table 50*

#### Average Annual World Prices

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Oil (Brent), USD per barrel	221,33	117,4	114,1	115,9	228,19	224,843	225,022	228,83	337,4	554,38	665,15
Natural gas, USD per 1 mln. BTU	-	11,9642	22,5469	2,1876	4,3442	3,9764	3,3857	5,461	5,993	8,870	12,2
Petroleum, USD per gallon	0,71	0,615	0,511	0,529	0,887	0,7922	0,755	0,891	1,197	1,508	1,81
Copper, USD per ton	2574,9	2369,7	1775,3	1539,9	1863,9	1613,6	1592,9	1785,6	2808,2	3606	6851,4
Aluminum, USD per ton	1590,2	1554,0	1413,5	1318,0	1550,0	1444,7	1350,7	1424,7	1693,2	1871	2619,4
Nickel, USD per ton	8053,9	7312,4	5352,5	5239,5	8624,0	5966,0	6175,1	9580,8	13757	14692	22038

Source: calculated on the basis of London Metal Exchange, International Petroleum Exchange (London) data

### 3.4.3. Export

Sustaining favorable situation at the world market had a positive influence on the development of Russian export, which exceeded the annual figures over the last 17 years in 2006. In 2006 the monetary value of Russian export was equal to USD 304.5 bln., which is 25% higher than in 2005. At the same time the growth proceeded both due to the increase of export sales to non-CIS countries (growth

by 24.3%) and to CIS countries, where goods worth USD 43.4 bln. were exported, which exceeded the corresponding figure for 2005 by 29.5%.

Table 51

**The Dynamics of Russian Export**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Export, as USD bln.	89.7	86.9	74.4	75.6	105.0	101.9	107.2	135.4	183.2	245.3	304.5
including:											
non-CIS countries	71.1	67.8	58.7	63.6	90.8	86.6	91.0	113.9	152.9	211.6	261.1
	Growth rates, as percentage to the previous year										
Quantity index	100.1	101.8	99.7	109.4	110.2	104.2	115.0	109.5	110.7	104.7	105.8
Price index	108.6	98.1	84.2	92.1	128.2	93.8	86.0	113.4	122.7	126.9	119.7

Source: the Central Bank of the Russian Federation, the Ministry of Economic Development and Trade

Nevertheless throughout 2006 the trend for the decrease in growth rates of Russian export outlined. In August its volume increased by 30.3%, whereas in September – by 19% and in October – only by 12.2%, in November – by 14.9% as compared with the corresponding months of 2005. This is happening due to the drop in oil prices, which began in the middle of the year, as well as the growth of competition at the markets, where Russia was a traditional supplier. For instance, in the Middle East fresh capacities are being put into operation in chemical industry, China is reducing Russian metallurgy import because of the increase in domestic output.

According to the data of the Bank of Russia, efficiency index for exportation of the set of goods, including 75% of the Russian export value, was on average equal to 1.06 within January-August 2006, in January-August 2005 being 1.14.

The profitability of raw materials export decreases mainly due to the change for the worse in the situation at the world market of mineral resources used as sources of power by the end of the year, of non-raw materials export – due to the appreciation of ruble. The decrease in export growth rates starts to have a slow-down effect on the development of the economy.

In export structure the significance of mineral resources used as sources of power continued to increase: in all more than 80% of the increase in monetary volume of export sales was accounted for by mineral products.

High export growth rates were mainly accounted for by a considerable increase in world prices for raw materials. Oil, oil products and gas export in terms of value increased by 33.6%, while other goods export – by 12.7%.

The average world price for oil grade Urals was at the level of USD 57.1 per barrel in December 2006. As a result, even though in the fourth quarter the prices for oil dropped by 14.7% as compared with the preceding quarter, the average price for this Russian oil grade in 2006 was equal to USD 61.0 per barrel, being 21.1% higher than the figure of 2005.

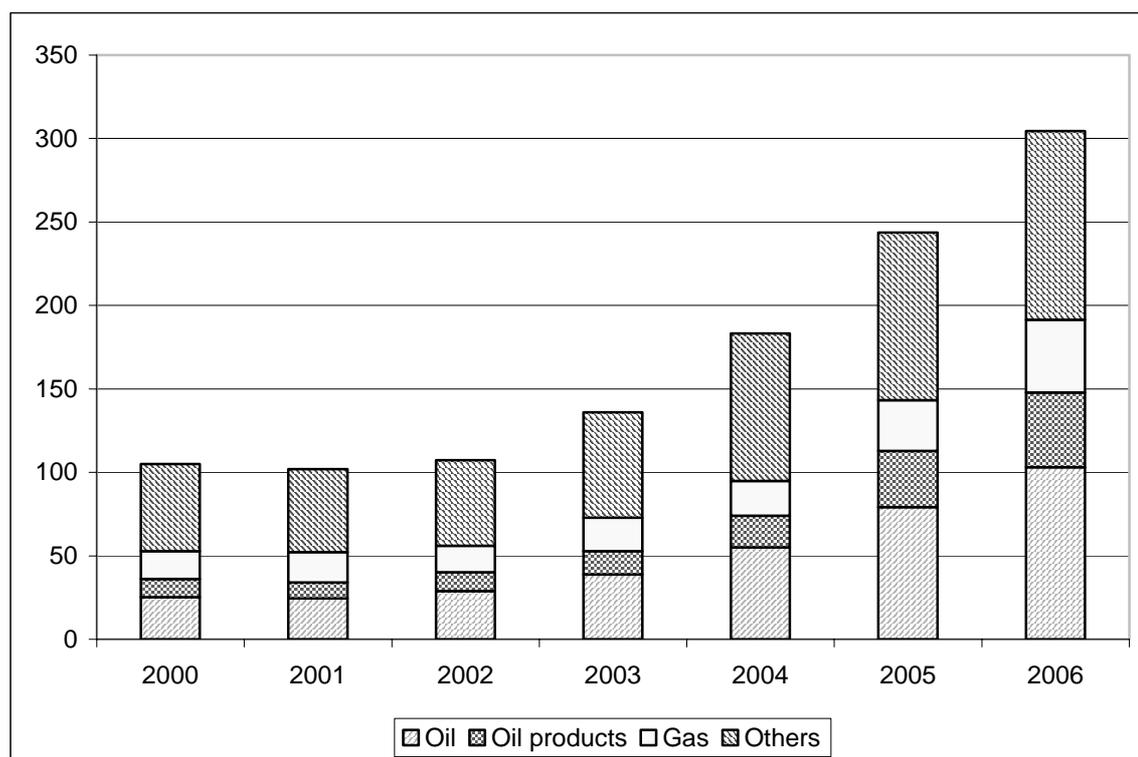


Fig. 37. Russian Export (bln. USD)

In 2006 the profit of Russian oil exporters increased by 22% from USD 79.216 bln. last year to USD 96.675 bln.

According to the Federal Customs Service data, last year the volume of Russian oil export shipment was equal to 227.538 mln. tons, which is by 2.4% lower than in 2005 – 233.147 mln. tons. Crude oil supplies to non-CIS countries decreased by 1.6% - from 214.435 mln. tons down to 211.171 mln. tons. At the same time the monetary volume increased by 23%. The suppliers' profit was equal to USD 90.755 bln. against USD 73.826 bln. in 2005. Crude oil supplies to CIS countries decreased by 12.5% - from 18.711 mln. tons down to 16.367 mln. tons. In pecuniary terms export to CIS countries increased from USD 5.39 bln. up to USD 5.919 bln. The export volume of oil products in monetary terms increased by 31.4% up to USD 44.217 bln. against USD 33.65 bln. in 2005. The physical volume of oil products export supplies was equal to 102.278 mln. tons, which is by 6% more than last year – 96.451 mln. tons (*Fig. 37*).

Shipping of diesel fuel increased by 6.7% up to 36.057 mln. tons, exporters' profit – by 25% up to USD 20.246 bln. The volume of motor petrol supplies increased from 5.922 mln. tons up to 6.268 mln. tons, exporters' profit – from USD 2.477 bln. up to USD 3.403 bln. Black oil supplies increased from 45.843 mln. of tons up to 47.534 mln. tons, in pecuniary terms – by 34.5% up to USD 13.718 bln.

In 2006 gas export from Russia decreased by 3% down to 182 bln. cu. m from 187.2 bln. cu. m in the corresponding period of 2005. Exporters' profit grew by 40% - from USD 30.424 bln. up to USD 42.16 bln. Gas export supplies from the

Russian Federation to non-CIS countries increased by 1.3% - from 159.8 bln. cu. m up to 161.8 bln. cu. m, whereas to CIS countries decreased by 26.3% - from 27.4 bln. cu. m down to 20.2 bln. cu. m.

Table 52

**Monetary Volumes of Russian Export of Oil, Oil Products  
and Gas (as USD mln) and Their Proportion in the Aggregate  
Volume of Russian Export (%)**

	Oil		Oil products		Gas	
	USD mln.	%	USD mln.	%	USD mln.	%
1992	6662	12.4	2202	4.1	6389	11.9
1993	8061	13.5	3061	5.1	6964	11.7
1994	8948	13.3	3398	5.0	7939	11.8
1995	12297	15.2	4108	5.1	13381	16.5
1996	15578	17.6	7442	8.4	14683	16.6
1997	14346	16.2	7145	8.1	16420	18.6
1998	10254	13.7	4262	5.7	...	...
1999	14101	18.8	4713	6.3	...	...
2000	25284	24.1	10938	10.6	16644	16.1
2001	24576	24.1	9402	9.4	18303	18.3
2002	28950	27.0	11227	10.5	15897	14.9
2003	38816	28.6	14064	10.5	19981	15.0
2004	55024	30.0	18998	10.5	20918	11.5
2005	79216	32.5	33650	13.6	30424.2	12.9
2006	96675	31.7	44217	14.5	42160	14.1

Source: Federal Statistics Service, Federal Customs Service data

Russia remains a large-scale exporter of metals, which is the evidence of competitive capacity of Russian goods.

Metals and metal goods are the goods group of second importance in Russian export. The share of this goods group was equal to 13.9%, having decreased by 0.4 p.p. as compared with 2005.

In 2006 metal and metal goods export was equal to USD 40.1 bln. (121.7% versus 2005), including to CIS countries USD 36.5 bln. (120.7%), to CIS countries – USD 3.6 bln (133.2%).

Ferrous metals export decreased by 0.2% and was equal to USD 17.8 bln, including to non-CIS countries – USD 16.1 bln (decrease by 2.1%), to CIS countries – USD 17.1 bln (increase by 22.4%). The main export product is rolled metal whose share in ferrous metals export value is equal to 60%.

In 2006 the physical volume of ferrous rolled metals export (prepared raw materials, profiled iron and sheet products) was equal to 28.4 mln. tons (96.4% versus 2005). At the same time the rolled metal export to non-CIS countries decreased by 6.2% (being 25.5 mln of tons), including profiled metal – by 24.9%, sheet goods – by 14.5%. Export of half-finished products increased by 4.3%.

Export prices for steel half-finished products and sheet goods increased by 3.6%, for profiled iron – by 11.9% over 2006. The main increase in prices fell on the II half-year of 2006.

The decrease in the physical volumes of the export of ferrous metals rolling was caused by the limitations implemented by many countries for the import of Russian metal production, as well as the decrease in the supplies to the Asian region which is accounted for by the increase of China rolling supplies to the main sales markets, first of all in countries of East and South-East Asia.

Thereupon the export of sheet products from Russia to Asia region has diminished by nearly 80% (including to China – by 93.5%), the export of profiled iron – by 605%, including to China – by 20%.

Russian exporters of ferrous metals were able to redirect the supplies to other external markets. The rolled metal export to North America (USA, Canada), Europe, South America, and countries of Africa has increased. Middle East is still a promising market. In 2006 the supplies of ferrous metals produced in Russia were made to 90 countries of the world.

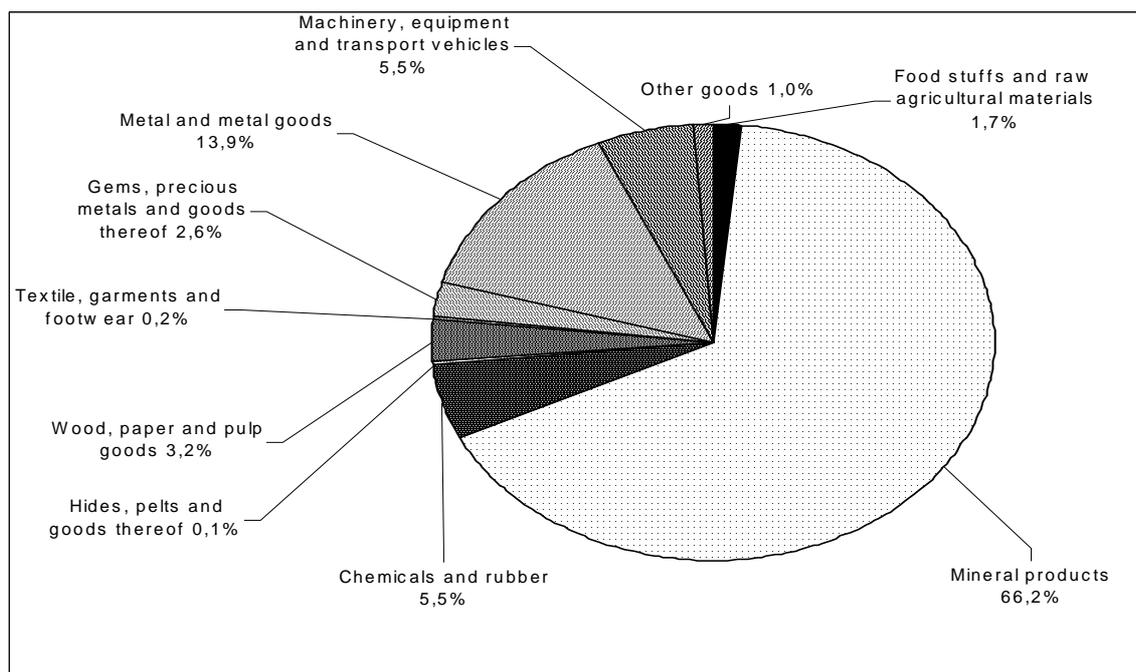
In 2006 there increased physical volumes of export supplies of cast iron (by 15.6%) and iron ore materials (by 24.2%), decreased export supplies of coke (by 45.4%), ferroalloys (by 12.5%), steel pipes (by 12.4%). At the same time the supplies to non-CIS countries of cast iron (by 14.5%) and iron ore materials (by 30%) increased, but supplies of coke (by 55%), ferroalloys (by 13%), steel pipes (by 30.3%) decreased as a result of supplies decrease to EU countries because of limitations implementation for seamless pipes.

Russian metallurgists operated most successfully at the markets of CIS countries. The ferrous metals rolling export to CIS countries increased in 2006 by 26.8% against 2005, including profiled iron – by 25.8%, of sheet products – by 22.2%, of steel pipes – by 24.1%.

The monetary volume of main non-ferrous metals (aluminum, copper, nickel) export to non-CIS countries exceeded the level of 2005 by 50.2%. The export growth was reached mainly due to the increase in export prices. Thus, average prices for aluminum grew up by 24.4%, for nickel – by 55.6%, for copper – by 87%. At the same time the physical volumes of export of unprocessed aluminum went up by 9.6%, of nickel decreased by 0.7%, of purified copper – by 12.8%.

It is remarkable that the equipment and machinery export grew up intensively in monetary terms: in 2006 monetary volume of this goods group increased by 29.7% against 2005. Thus, despite the fact that considerable appreciation of ruble against dollar and euro must have a negative impact on technological export, the positive dynamics sustains. Nearly half of machinery and equipment export is made to CIS countries, against whose currencies ruble appreciated negligibly. Another explanatory factor is a gradual implementation of the government program of financial and guaranteeing support of industrial export, which lead to the conclusion of several big contracts.

Nevertheless the share of machinery, equipment and transport vehicles in the total volume of the Russian export remains at the low level of 5.5% (in 2005 it was 5.3%).



Source: Federal Customs Service

Fig. 38. Commodity Structure of Russian Export in 2006 (percentage)

Thus, the main problem of Russian export is still its inefficient commodity structure. Fuel and raw materials orientation of the country, which is acceptable at a certain stage and under certain circumstances, does not evolve into more developed forms, connected with the increase in the extent of the processing of raw materials, which restricts considerably the possibilities of Russian presence expansion at the world market.

The main part of deep processed products export consists of the metal wares, machinery, equipment and the chemistry industry production.

Metal goods, supplied for export, include metal constructions made from ferrous metals and aluminum, aluminum foil, stranded wires, razors and blades, tanks, cisterns, pipes, sticks and other goods.

In recent years steady growth of the chemistry production export is sustained, however the decrease in world prices for oil and oil products in the second half of 2006 accounted for the decrease in the export growth rates of this kind of commodities. In 2006 export supplies of chemistry and petrochemistry industries production comprised USD 11.6 bln., i.e. 103% against the level of 2005.

Enterprises of the industry export more than 1/3 of chemicals produced. The main items of Russian export are mineral fertilizers (32%), chemical rubber (9.5%), ammonia (6%), aromatic hydrocarbons (5.3%), car tires (5.3%), plastics (5.3%) and synthetic resins (5.1%).

Wood and paper goods export, including furniture, was equal to USD 9.3 bln. in 2006, being 114.3% against the level of 2005. At the same time the physical volumes of the export growth rates slightly decreased in 2006. Thus, in 2006 round

wood export growth was equal to 106.9% against 115.7% in 2005, carving wood export – to 107.8% (117%), veneer – to 102.9% (107%). At the same time the physical volumes of these goods export to CIS countries are characterized by anticipating growth rates (122.7, 132.9, 136.4% respectively).

In the structure of light industry export unbleached cotton fabrics comprise the main part. Higher demand for domestically produced cotton fabrics in non-CIS countries is due to relatively low prices and 100% content of cotton, there being no dash of man-made fabrics. In 2006 cotton fabrics of 337.1 mln. sq. m (96% against 2005) worth USD 120 mln. were exported. At the same time cotton fabrics of 157.4 mln. sq. m (85% against 2005) worth USD 62 mln. were exported to non-CIS countries.

Favorable situation at the world market secured a considerable growth of contract prices for the main items of Russian export. Over 2006 the average weighted contract prices for oil in non-CIS countries increased by 24.8% in comparison with 2005. The average export contract price for Russian oil in 2006 was equal to USD 429.8 per ton. In August 2006 the average contract price for oil reached its maximum level of USD 485.4 per ton. Since September 2006 the trend for price decrease evolved, price being approximately USD 400 per ton by the end of the year, which corresponds to the price level of January-February 2006 (*Table 53*).

Average export prices for cast iron, ferroalloys, iron ore materials, coke supplied to non-CIS countries decreased in comparison with 2005 by 10.9%, 5.7%, 23.8% and 34.4% correspondingly, and for steel pipes went up by 18.5%.

Export prices for unprocessed aluminum increased in 2006 in comparison with 2005 by 25.7%, for copper – by 87.7%, for nickel – by 59.2%, for aluminum wares – by 15.2%, for copper goods – by 78.5%.

*Table 53*

**Average Export Prices for Main Russian Export Goods  
(Supplies to non-CIS Countries, as USD per ton)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Crude oil	133.5	118.5	74.4	110.9	179.9	156.4	162.4	181.2	231.9	344.3	429.8
Oil products	129.9	115.7	75.7	94.5	171.9	145.2	147.9	180.2	230.3	340.6	430.1
Natural gas thos.m3	84.2	88.6	72.2	55.31	85.91	105.21	91.4	112.3	113.6	154.7	-
Ammonia	125.6	113.0	83.1	53.0	97.5	81.7	72.4	118.5	158.3	176.2	195.7
Nitrogen fertilizers	128.0	90.3	58.3	36.8	57.9	61.8	60.6	76.0	103.1	139.1	146.0
Potash fertil- izers	7.2	79.7	87.4	86.4	86.6	76.8	74.9	77.8	94.3	133.9	150.3
Round tim- ber, m3	59.4	57.5	46.9	43.5	43.4	45.6	44.8	47.8	56.2	59.6	63.8
Cellulose	407.3	373.5	342.9	274.0	352.2	293.4	300.0	321.7	371.9	386.1	436.7
Commercial paper	473.7	383.4	394.0	349.5	386.6	421.7	332.2	338.3	387.9	455.3	498.6
Cast iron	136.8	124.2	104.3	66.8	80.7	86.2	91.1	126.8	242.7	274.4	244.4
Ferroalloys	1114	819.2	740.8	548.2	625.6	601.7	625.7	634.6	1097.8	1582.5	1492.3
Copper	2143	2099	1655	1495	1675	1465.3	1371.4	1564.9	2587.6	3389.8	6361.7
Nickel	7272	6733	5140	5761	8629	5730.9	6143.9	8584.0	12660.0	14242.5	22674.4
Aluminum	1500	1401	1352	1157	1296	1176.3	1036.9	1050.0	1162.1	1299.2	1633.5

Source: Federal Customs Service

Export quota (the share of export in production) in 2006 increased regarding oil, oil products, coal, unprocessed wood materials; decreased in case of gas, mineral fertilizers, flat sections, pulp, commercial paper, passenger cars and trucks.

Table 54

**Share of Export in the Output of Major Products (%)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Crude oil	41.5	41.7	41.6	45.2	44.2	44.8	46.5	49.7	53.1	56.1	54.0	57.0
Oil products	25.8	32.4	34.7	32.9	33.6	36.3	35.5	40.8	40.9	42.1	46.7	47.8
Natural gas	32.2	33.1	35.2	34.5	34.6	33.2	31.2	31.2	32.7	33.9	34.2	31.3
Coal	17.1	15.8	14.5	15.7	16.7	25.7	22.2	23.8	30.8	52.9	51.8	53.8
Mineral fertilizers	83.9	85.9	80.6	86.5	83.2	82.9	81.8	78.1	76.1	78.5	74.5	62.7
Round wood	22.3	23.2	29.3	34.1	40.1	42.4	53.4	51.0	46.1	49.6	60.1	61.2
Chemical wood pulp	74.8	85.7	82.8	77.6	79.1	82.4	83.7	85.1	82.9	77.5	79.7	79.2
Commercial paper	71.1	72.2	70.1	74.6	70.6	69.0	67.4	68.6	66.0	65.6	61.2	57.3
Iron and steel flat sections	53.1	59.7	58.6	63.5	60.6	55.3	43.0	50.5	47.1	46.1	48.4	39.7
Passenger cars	16.7	10.4	4.9	8.3	7.3	12.2	10.1	12.3	11.7	11.8	12.5	10.7
Trucks	25.4	17.4	10.7	9.6	8.3	7.0	12.3	20.8	19.3	23.0	22.8	20.6

Source: Federal Statistics Service, Federal Customs Service

### 3.4.4. Import

Russian import reached in 2006 its maximum over the last 15 years level, considerably exceeding previous years figures. Over 2006 the goods worth USD 163.9 bln. were imported, which is by 30.8% higher than the similar figure of 2005. Goods worth USD 138.6 bln. were imported from non-CIS countries, growth being 34%, from CIS countries – worth USD 25.2 bln., growth of 15.6%. In the total amount of import the share of non-CIS countries was equal to 84.6% in 2006, in 2005 – 82.6% (Table 55).

Table 55

**Import to Russia (as USD bln.)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Import, total	68.1	72.0	58.0	39.5	44.9	53.8	60.5	76.1	97.4	125.3	163.9
including: non-CIS countries	47.3	53.4	43.7	29.2	31.4	40.3	48.2	60.1	76.4	103.5	138.6
Growth rates, as % vs. the previous year											
Quantity index	98.1	121.1	89.0	84.4	129.2	129.1	117.6	119.2	124.2	122.4	130.1
Price index	100.2	94.8	92.3	82.1	86.7	94.3	93.4	98.7	106.1	106.5	105.5

Source: the Central Bank of the Russian Federation, the Ministry of Economic Development and Trade

The growth of the domestic demand due to the incomes increase in the environment of ruble appreciation continued to have intensifying influence on the increase of physical volumes of import for nearly whole range of goods.

Real effective ruble exchange rate against the currency basket of the main Russia's trade partners went up by 7.4% in comparison with December 2005. At the same time real ruble exchange rate against US dollar increased by 16.7%, against euro – by 5.6%.

Real effective ruble exchange rate averaged through January to December 2006, in comparison with January-December 2005 increased by 9.4%, to US dollar increase being, in particular, 10.7%, to euro – 11.5%.

It should be remembered that in 2005 real effective ruble exchange rate to the currency basket of Russian main trade partner countries went up by 10.5%, real exchange rate of ruble to dollar increasing by 3.9%, to euro – by 18.8%.

One additional factor, which affected the growth of import supplies, was the improvement in customs regulations. The difference between the volume of declared goods and goods really imported in 2006 was the lowest over 10 years. Whereas in 1996 invisible import reached the proportion of 44.7% of the official, in 2006 it decreased to 20.7%, being 29% in 2005.

The increase of import was observed over almost all range of goods. The machine-building production import developed most dynamically. In 2006 the proportion of this kind of production in the structure of Russian import reached the level of 48.1%, exceeding 2005 figures by 3.6 p.p. The monetary volume of machinery, equipment and transport vehicles import increased by 52.3% in 2006 in comparison with 2005.

The increase of the total amount of the import of machinery and equipment was assisted by the sustaining trend for official import of household appliances and radio electronics growth. Thus from January to September 2006 import supplies of mobile phones to Russia increased more than by 3.3 times, which is equal to 19 mln. of phones, in comparison with the corresponding period of 2005, the average price of the phone being imported increased over this period from USD 39.3 to 149.2. Total value of the imported mobile phones increased by 12.75 times – up to USD 2.84 bln.

From January to September 2006 there were by 2.56 times more of laptops imported than in the corresponding period of the previous year, customs value of supplies increasing by 4.6 times up to USD 163.6 mln. Such growth of import supplies is most likely accounted for by the measures against illegal goods import and undercharging of the declared customs value.

The additional stimulus for the increase in machinery and equipment import in 2006 was nullification of import customs duties for a large list of technological production items, analogues of which are not produced in Russia.

The share of foodstuffs and agriculture raw materials in the total amount of Russian import in 2006 decreased down to 15.6% against 17.5% in 2005. The monetary volume of this kind of goods increased by 25%. The biggest increase was observed for meat and meat products, sugar, confectionery and fruit import.

The proportion of the third in the order of importance goods group – chemistry industry production – decreased from 17 to 16.2%. In 2006 chemistry

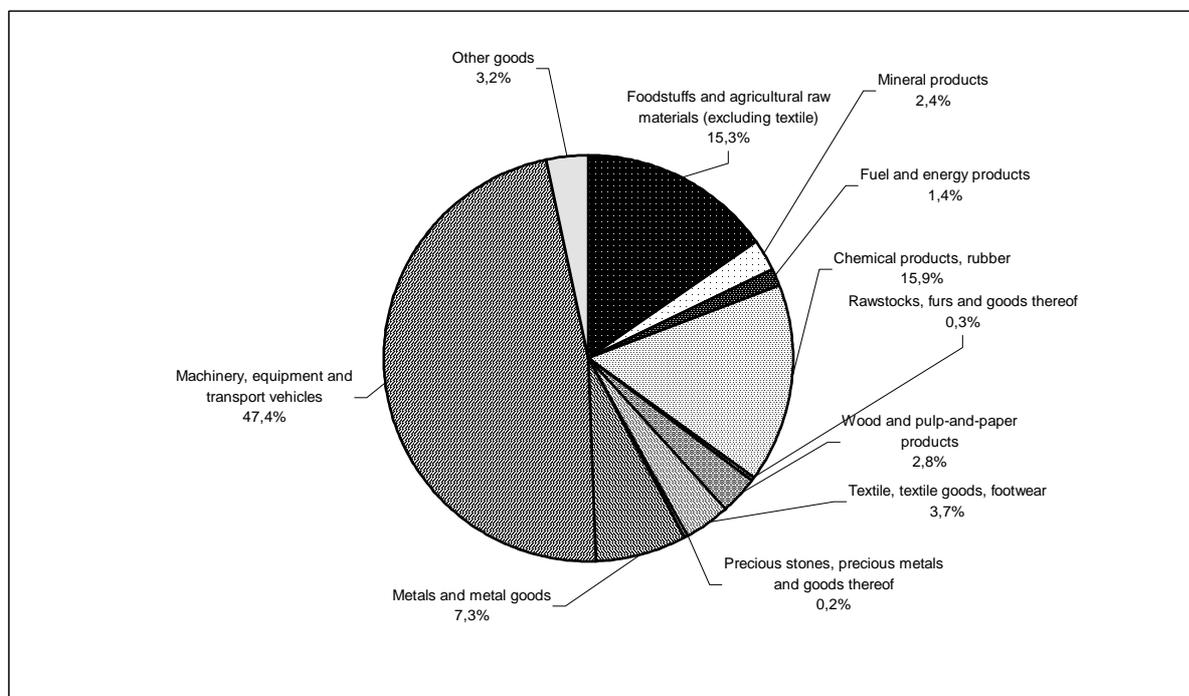
production import comprised USD 21.2 bln., which is 134% against the level of 2005.

Goods range and assortment for chemistry and petrochemistry production import is considerably larger than export assortment, which is orientated towards raw materials, and represents mainly the deep processed goods. The main import nomenclature is plastic wares, varnish-and-paint materials, plastics and synthetic resins, polyester fibers and plants protection substances.

Among other items of import supplies it was textile production and footwear supply that was characterized by high growth rates. In 2006 the goods of light industry worth USD 4.8 bln. were imported, which is by 158.4% higher than over the corresponding period of the previous year.

Monetary volume of clothes and footwear export in 2006 went up by record 87%. Footwear import from CIS countries was 58.3% (in total USD 6.5 mln.) higher, and from non-CIS countries by 2.1 times higher (in total 651.5 mln.). It should be remembered that in 1996 customs duty for footwear at the rate of 20% was implemented, after which legal import of footwear decreased nearly by half. The situation was radically changed only in 2006 when the double scale of rating was introduced: for expensive footwear the duty was reduced to 10%, for cheap remained at the level of 20%.

The growth of population real incomes contributed to the increase in luxury goods import. Import of rawstocks, furs and respective goods increased by 63.1%, of precious stones and metals and goods thereof – by 26.7%.



Source: Federal Customs Service of the Russian Federation

Fig. 39. Goods structure of Russian Import in 2006 (%)

In May 2006 the trend for anticipating growth rates of import to Russia against Russian export evolved. While in the 1<sup>st</sup> quarter of 2006 the export supply grew up by 34.5% as compared with the corresponding period of the previous year, the import supply - by 23.5%, in the 2<sup>nd</sup> quarter their growth rates were almost equal – 28.6 и 29.1, correspondingly, and in the 3<sup>rd</sup> quarter the export growth rates were far behind the import figures – 23.1 and 31.6, correspondingly. In the 4<sup>th</sup> quarter 2006 this lag grew further: export grew up by 16.8% in comparison with the 4<sup>th</sup> quarter 2005, while import - by 35.7%.

The trade balance surplus growth rates declined as a result. While in 2004 as compared with 2003 the balance grew by 43.4%, in 2005 – by 37.8%, in 2006 it grew only by 18.9%.

In 2006 positive trade balance in the amount of RUR 140.6 bln was formed. At the same time the disequilibrium coefficient of the foreign trade (the ratio of trade balance surplus to foreign trade turnover) was a bit lower than in 2005 (30 and 32.1% correspondingly).

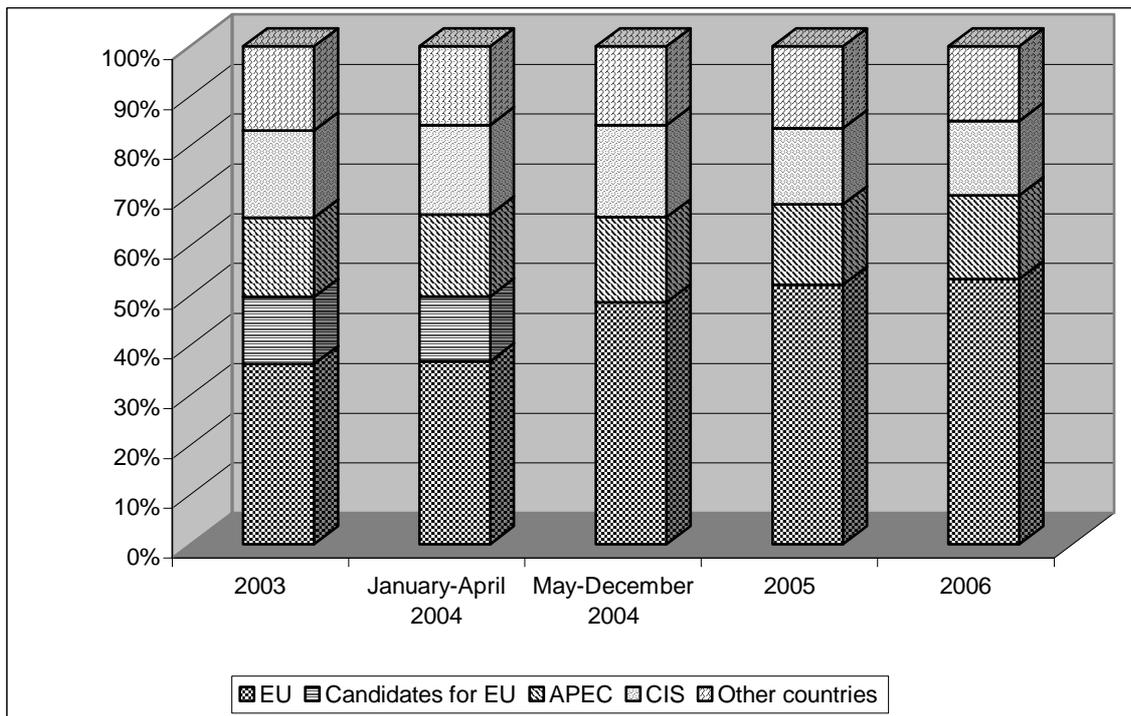
In 2006 the index of foreign trade environment with non-CIS countries – the ratio of export and import prices – was equal to 1.14, being 1.22 in 2005.

#### *3.4.5. Geographic Structure of Foreign Trade*

The EU remains the biggest economic partner when geographic structure is concerned. Its share in 2006 was equal to 52.7% of Russian goods turnover (in 2005 – 52.0%). (Fig. 40) the share of CIS countries continues to decrease: whereas in 2005 its share was equal to 15.2% of the Russian trade turnover, in 2006 it was 14.7%, at the same time the share of the countries of Euro-Asian Economic Community remained approximately at the same level of 7.7% (in 2005 it was 7.8%).

The trade collaboration with the countries of Asia-Pacific Economic Cooperation expands. Their share in Russian trade turnover increased up to 17.1% against 16.2% in 2005.

The major Russian trade partners among non-CIS countries in 2006 were Germany, with the turnover of USD 42.9 bln. (130.1% against 2005), Netherlands – USD 38.5 bln. (145.1%), Italy – USD 30.8 bln. (131.4%), China – USD 28.6 bln. (141.0%), Turkey – USD 17.0 bln. (135.6%), the USA – USD 15.3 bln. (140.7%), Poland – USD 14.9 bln. (130.9%), the UK – USD 14.0 bln. (126.9%), France – USD 13.5 bln. (137.5%), Switzerland – USD 13.4 bln. (114.7%).



Source: Federal Customs Service of the Russian Federation

Fig. 40. Geographic Structure of Russia's Foreign Trade

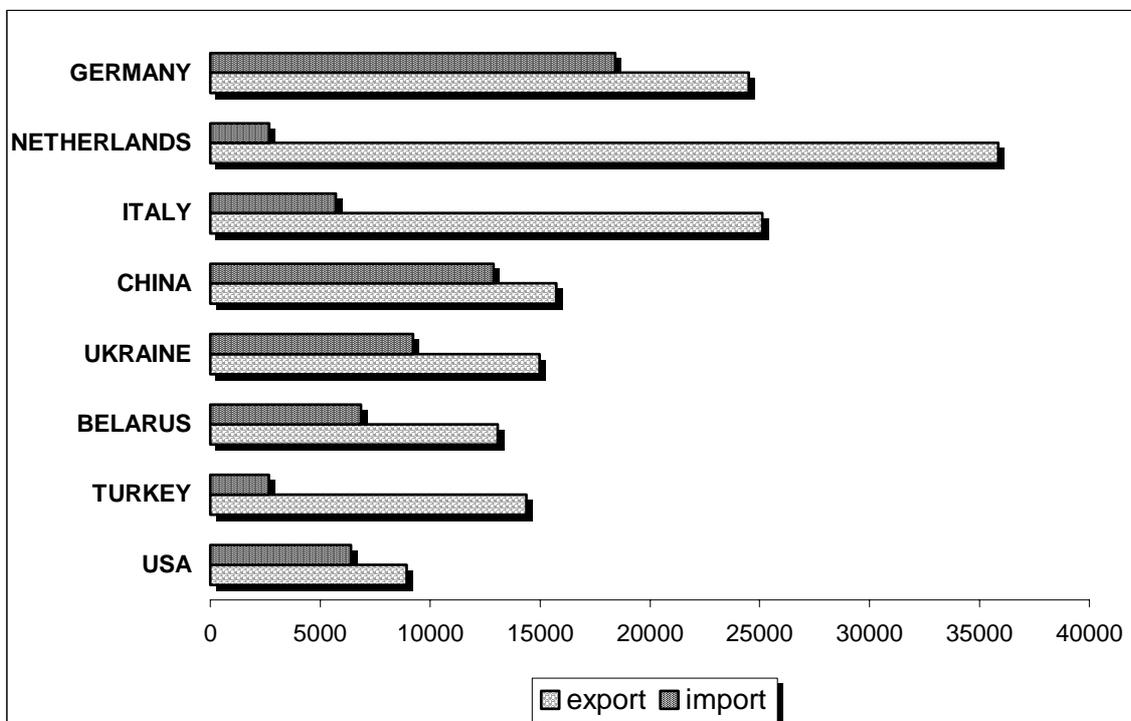


Fig. 41. Principal Trade Partners (USD mln.)

In contrast to export where the increase of monetary volumes to non-CIS countries was a bit lower than to CIS countries (+24.3 and +29.5%, correspondingly), in the import geographical structure it was the cooperation with non-CIS countries that developed notably more intensively than with the partners among CIS countries (in comparison with 2005 – 34% against 15.6%). This was also promoted by significantly bigger appreciation of ruble exchange rate to dollar and euro than to CIS countries currencies. Thus, according to the National Bank of Belarus data, the real appreciation of Russian currency over 10 months of 2006 to Belarusian ruble was 5.6%, to hryvna – 2.5%, to Kazakhstani tenge – the depreciation of 0.9%. Besides, structure causes are also of some importance: the most demanded group of import commodities – machinery and equipment – is purchased chiefly in non-CIS countries.

As a result of 2006 the leader among CIS countries in the trading volume with Russia was the Ukraine, the growth of commodity turnover with which was 19.7% up to USD 24.197 bln. The Russian export to the Ukraine increased by 20.8% up to USD 14.978 bln, while import – by 17.9% up to USD 9.218 bln. The second place is held by Belarus. The commodity turnover between Russia and Belarus grew by 25.9% up to USD 19.934 bln. Kazakhstan, the volume of mutual trade with which increased by 31.2% up to USD 12.808 bln, holds the third place.

#### 3.4.6. Foreign Trade Regulation

In the sphere of tariff regulations the issues of import and export customs duties amendments for a set of goods were considered.

In connection with the change in the world prices for oil the export duties rates for oil and oil products were reconsidered for a number of times (*Table 56*).

*Table 56*

#### **Export Duty Rates for Oil and Oil Products in 2005-2006 (USD per ton)**

	<b>Oil</b>	<b>Oil products</b>	
		light	dark
<b>2005</b>			
1 February	83.0		
16 March		68.2	36.7
1 April	102.6		
24 April		81.4	43.8
1 June	136.2		
27 June		104.1	56.0
1 August	140		
23 August		106.6	57.4
1 October	179.9		
29 October		133.5	71.9
1 December	179.6		
<b>2006</b>			
1 February	160.8		
7 March		120.7	65
1 April	186.4		
6 May		137.9	74.3
1 June	199.8		
26 June		146.9	79.2
1 August	216.4		
20 August		158.1	85.2
1 October	237.5		92.9
1 December	180.7	134	72.2

*Source:* Decrees of the Government of the Russian Federation

In July 2006 the Federal Law No 145-Φ3 "On making amendments to the asset 3 of the Law of the Russian Federation "On customs tariff". The law establishes that the export duty rates both for oil and oil products will be adopted for two calendar months, but put into effect on the 1st day of the second calendar month, which follows the end of monitoring period, and the resolutions of the Government of the Russian Federation on their introduction should be promulgated no later than 10 days before their implementation. This will enable to synchronize the time of the entry into force of the resolutions on the export duties correction both for crude oil and for oil products.

The mechanism that existed earlier had a considerable drawback of the significant gap in time (20 days) between the period during which new duties rates were calculated and the period in which new rates came into effect. The significant gap in time led to the loss of the additional incomes to the Federal Budget. For instance, according to the estimations, over May-June of 2005 the growth of customs rates being USD 2, the losses over just 20 days were equal to approximately USD 6 mln., within January-February of 2005 the duties growth rates being USD 17, the losses over 20 days reached USD 60 mln. The entry into the effect of the Law No. 145-Φ3 will contribute to the raising of additional financial funds to the Federal budget.

In the sphere of the customs and tariffs trade turnover regulation the special attention was given to the making decisions directed to the protection of the domestic market from the increasing goods import, support for domestic producers, attraction of additional investments to goods production in Russia as well as to the increase of the competitiveness of Goods produced in Russia at the world markets.

The Government of the Russian Federation adopted 44 decrees on the change in the goods nomenclature and customs duties rates.

Thus, with the aim to assist the technical reequipment of the Russian economy the Government of the Russian Federation adopted the decree from 24 March 2006 No. 168 "On temporary rates of the import customs duties for some kinds of technological equipment", according to which the duty free customs regime was introduced for a long list of the technological equipment used in agriculture, medical industry, timber industry complex, machine building and other branches of industry.

To stimulate further development of motor car construction in the territory of the Russian Federation the duty free import regime for components, used to produce units and assemblies of motor transport vehicles was adopted (the decree of the Government of the Russian Federation from 16 September 2006 No 566 "On making amendments to the Customs Tariff of the Russian Federation with regard to the motor-vehicles components imported for industrial assemblage").

In order to fulfill the program on aeroengine SAM146 production for Russian regional aircraft RRJ the export duties rates for utilities and raw materials for aeroengines production and technological equipment, used in aviation industry, were called off according to the decree of the Government of the Russian Federation from 26 September 2006 No589 "On temporary import customs rates for utilities and a number of primary goods for aeroengines production"; the decree of the

Government of the Russian Federation from 22 June “On temporary import customs rates for technological equipment for aviation industry”.

In order to protect the economic interests of Russian producers of agricultural products, the Government of the Russian Federation adopted a number of decrees:

- from 17 April 2006 No 214 “On approval of the import customs duty rate for some kinds of native and modified starch”. Implementation of uniform import customs duty rate for all kinds of starch was caused by the necessity to eliminate unreliable declaration of the goods crossing the border;
- from 25 July 2006 No 456 “On making amendments to the Customs tariff of the Russian Federation with respect to some kinds of cheeses”. This decree introduced special import duty rates for cheeses for the period of 9 months in order to protect the market of hard cheeses from the increased import of such products, to increase the domestic output of these goods, to make the competitive conditions equal for domestic producers and importers.
- from 13 August 2006 No 488 “On approval of the import customs duty rate for partially processed fats and oils, margarine products and spreads”. The increase of the import customs rates for this kind of the product will enable to increase the volume of the domestic fat and oil production.

To implement paragraph 8 of the Government of the Russian Federation instruction from 11 October 2004 No МФ-П13-5577 on the decrease of the import duties rates for agriculture raw materials that does not grow in the territory of the Russian Federation, the RF Government adopted a number of decrees, according to which the duty free regime is introduced for not roasted coffee, cacao beans, peanuts (from 13 August 2006 No 487 “On approval of the import customs duties rates for non-roasted coffee”, from 13 August 2006 No 486 “On approval of the import customs duties rates for cacao beans, whole or splintered, raw or roasted”, from 13 August 2006 No 489 “On approval of the import customs duties rates for some kinds of peanuts”).

In order to protect Russian goods producers applying trade protection mechanisms – special protective, antidumping or compensatory measures – the investigations were carried out, as a result of which some special protective measures were implemented regarding the increased import to the Russian Federation.

On the basis of investigations findings some measures were applied:

- special protective duty regarding the increased import of incandescent lamps from 3 March 2006 for 3 years time (the decree of the Government of the Russian Federation from 28 January 2006, No 50);
- antidumping duty for the import of some kinds of steel pipes from the Ukraine from 31 January 2006 for 3 years time (the decree of the Government of the Russian Federation from 29 December 2005, No 824);
- compensatory duty for import of sticks for concrete reinforcement from the Ukraine from 23 January 2006 for 1 year 8 months (the decree of the Government of the Russian Federation from 21 December 2005, No 791).

At present antidumping investigations regarding high-carbon ferromanganese, hardware for machine-building, flat cold-rolled metal from the Ukraine are

taking place, compensatory investigation into white sugar from the Republic of Belarus is being carried out.

From 21 December 2006 the protective measures at the market of breeches have been introduced: breeches import with the exception for some countries production is taxed with 8% duty rate. Importers consider this resolution to lead to the monopolization of the Russian market, and domestic producers, on the contrary, are of opinion that this will step up the competition.

The special duty is imposed on all the breeches with the diameter from 508 to 1420 mm, excluding those originated in developing countries, which are privileged according to the national system of the Russian Federation. There are 104 such countries all in all (the list, for instance, includes the breech producers from China, Argentina and Mexico).

Last May the Fund for the Development of the Pipes Industry (FDPI) appealed to the Ministry for the Industry and the Energy with a suggestion to introduce the quotas to set a limit for the use of import pipes at the construction of the big projects of 30%. In the spring the tariff measures were considered sufficient to protect the market from the import in the Government (according to the Federal Customs Service data from January to October 2006 the import comprised 1.1 mln. tons worth USD 1.2 bln.). It was decided to change the conditions only in November when the decree of the Government of the Russian Federation "On measures of Russian breeches producers protection».

The duties will primarily affect the Ukrainian producers of breeches, whose production will be subjected to the additional customs load. Last December the Ukrainian breeches were subjected to the duty of 8.9%.

The characteristic feature of 2006 was the intensification of the operation of the Federal Supervision Service for Consumer's Right Protection in the sphere of import supplies regulations to Russia. Thus, from 27 March 2006 the supplies of Georgian and Moldavian wines and wine materials to Russia were limited in accordance with the resolution of the Federal Supervision Service for Consumer's Right Protection because of the quality complaints.

In April 2006 the import of Moldavian and Georgian cognacs, wines and sparkling wines was banned. The volume of their supplies to Russia was estimated to be at the level of USD 75 mln. per year. In April the decision was made to ban the import to the territory of the Russian Federation of the mineral water marks "Borjomi" and "Nabeglavi" from Georgia because they did not meet the quality requirements of the Russian Federation.

During 2006 the Federal Supervision Service for Consumer's Right Protection implemented the following bans for the import of:

- any agricultural products from Poland due to detected by Federal Supervision Service for the Agriculture mass violations during certificates and customs papers registration;
- vegetable products from Holland because the authorities of this country could not provide the Federal Agency for Veterinary and Phytosanitary Supervision products absolute guarantee of safety;
- cane sugar from Belarus, because Belarus was used as a transit country for the duty free import of sugar from other countries;

- canned fish from Latvia because of the detected by the Federal Supervision Service for Consumer's Right Protection exceeding of maximum permissible concentration of benzopyrene in them;
- meat and cattle from Sweden. The ban was accounted for by the Federal Agency for Veterinary and Phytosanitary Supervision because of the danger of the mad cow disease spread;
- meat from the Ukraine;
- cooled fish and seafood from Norway because of the exceeding of cadmium maximum permissible concentration detected by Federal Supervision Service for Consumer's Right Protection.

In the beginning of 2006 the Government of the Russian Federation again introduced the measures to make the conditions of so-called shuttle business operation tougher. From 26 February 2006 the decree of the Government of the Russian Federation No 29, making amendments to the Statute on the implementation of the uniform customs duties rates and taxes in respect to the goods carried across the border by individuals.

Shuttle business started developing in the beginning of the 90ies when it became the main source of income for many citizens, as well as thanks to the possibility of free import of goods worth less than USD 5000 by individuals. Officially the duties were not imposed only on goods imported for the private use, but this privilege, in fact, opened the channel to the duty-free commercial import. Moreover, at the beginning the shuttle traders, not registering their commercial activity and selling goods at the open-aired clothes markets, did not pay any taxes, excluding the fee for the right to sale, coming in the local budgets.

As a result shuttle trade was characterized by an extremely high efficiency level: for a long time the profit rate remained higher than 100% for one trip. This efficiency and the scale of turnover led to the formation of the developed infrastructure around shuttle business, including whole sales markets, tourism and transportation companies in Russia as well as hotels, shops, stocks and plants in Turkey, China and other countries—suppliers, which specialized on Russian clients servicing.

In order to regulate shuttle business and impose real control over it, on 23 December 1993 the Government of the Russian Federation adopted the decree No 1322 "On the regulations of transportation across the customs border of the Russian Federation the goods, not intended for any industrial or any other commercial activity, by individuals". New regulations put normal and shuttle import on a par. Individuals could bring into the country goods worth up to USD 2,000 duty-free. For the goods exceeding this quota the uniform customs rate was introduced of 60% of their customs value.

According to the decree of the Government of the Russian Federation from 3 June 1995 No 553 the uniform rate was decreased by half – down to 30%, however in order to counteract the underdeclaration of the customs value specific duties were introduced (in ECU per item or per kilo). This included clothing and footwear, TV sets, video games and cartridges for them, toys, leather and fur clothes.

In connection with the necessity of compensation for budget losses because of the abolition of the export duties in 1996 the conditions for individuals goods transport

into the territory of the Russian Federation from foreign countries became stricter once again. According to the decree of the Government of the Russian Federation from 18 July 1996 No 808 «On the regulation of transportation across the border of the Russian Federation goods not intended for any industrial or any other commercial activity by individuals» the norms for the duty free goods transport to the territory of the Russian Federation by individuals were decreased from USD 2000 to 1000 on the condition that the total weight of the goods does not exceed 50 kg. The goods of any commodities group with the worth up to USD 10,000 (no more than 200 kg) were imposed with the customs duties of the uniform rate of 30% of the customs value, not less, however, than 4 ECU per kilo.

From 1 January 2004 the Statute on the implementation of the uniform customs duties rates and taxes for the goods transported across the border of the Russian Federation by the individuals for the private use came into effect, adopted by the Government of the Russian Federation on 29 November 2003 No 718. According to it, the individuals could import goods without paying customs duties whose total value did not exceed RUR 65,000 and the total weight is less than 50 kg (with exception for transport vehicles).

In the new wording of the Statute the norms for the duty-free luggage transport were reconsidered. Now it is possible to import goods without paying the customs duties if the weight does not exceed 35 kg. The frequency of goods crossing the Russian customs border has also been changed. Whereas earlier it was possible to transport duty free goods not oftener than once a week, now it is possible only once a month. The changes did not influence the monetary value of imported goods. As before individuals can transport goods without paying customs duties and taxes with the total value less than RUR 65,000 with the exception for transport vehicles.

The aim of the changes is to create competition environment equal for all participants of the foreign economic activity. The regime of goods import by individuals that existed before gave the commercial structures the opportunity to import goods without paying customs duties with the help of the shuttle traders, who were specifically employed for this aim. As a result the Federal Budget did not receive considerable sums both from customs and domestic taxation.

Besides, Russia is actively working on its accession to the WTO and shuttle business is included neither in WTO regulations nor in the regulations of the international trade. What's more, the goods imported into the country duty-free by the shuttle business are the cause of discontent among domestic producers. As imported by the shuttle traders to the country luxury objects are not levied with the excise duties or value added tax, the individuals with high level of incomes are excluded from the taxation. Finally, shuttle business implies rather high level of crime. The goods are not subjected to the due certification on the quality, and infringing goods are often imported. As a result the domestic markets gets overstocked with the import of poor quality.

In 2006 the Government of the Russian Federation paid more attention to the security of free, or at least, nondiscriminatory access of the goods and services to the foreign markets.

By the number of export limitations Russia can be considered as one of the most discriminated countries in the world. Whereas at the beginning of January 2001 the number of limitations did not exceed 100, 111 measures are in force against Russian goods according to the data for 11 December 2006, including 47 antidumping duties, 3 price limitations, 1 assortment limitation, 1 import ban, 2 extra taxes, 2 tariff quotas, 1 plant sanitary measure, 2 excise taxes, 1 tax regulation of foreign trade and 39 measures implemented by the Republic of Belarus. 10 antidumping and 10 special protective investigations as well as 11 revisions of antidumping measures are being carried out.

19 countries (Australia, Argentina, Belarus, Bulgaria, Brazil, Venezuela, India, Kazakhstan, Canada, China, Mexico, Peru, Uzbekistan, the USA, Thailand, Ukraine, SAR, Azerbaijan), as well as EU countries apply protective measures against Russian goods, the damage from which to Russia was equal to USD 2039 mln. Two more countries – Philippines and Indonesia – started investigations.

In the process of the work on the liberalization of Russian goods access to the foreign markets the Government of the Russian Federation has achieved the following:

- within the framework of the five-year revision of the antidumping duties for steel double tees produced in Russia in order to prolong the measure, initiated by Korean producers, South Korea acknowledged the market status of the Russian economy and the measure was called off as a result;
- the prolongation of the antidumping measures for the certain kinds of oxoalcohols, ferrosilicon in India and of cold-rolled sheets in SAR was prevented;
- the antidumping measures against silicon carbide, aluminum foil of the Russian company “RUSAL-holding” in EU were abolished;
- the reconsideration of the antidumping measure, initially implemented on the condition of non-acknowledgement of the Russian accounting data for hot-rolled steel sheet in Canada;
- in June 2006 the Ukraine called off the decree No 473 from 2004 “On withdrawal of sugar and starch molasses from the free trade regime with the Russian Federation”, which led to a considerable increase in Russian goods prices at the Ukrainian market.

As a result of the work intended to protect the interests of the Russian exporters in China it should be noted that despite the fact that against Russian goods 5 antidumping measures are in effect and 3 antidumping investigations are being carried out the implementations of these measures do not do any serious damage to those Russian producers that are really interested in the Chinese market. The only serious obstacle known is the presence of the antidumping duty against synthetic rubber at the rate of 14 to 38%. Two Russian producers and the Ministry for the Economic Development and Trade having actively participated in the procedure of revision, the Chinese side decided to decrease the duty by 19 times.

As a result of the work carried out to find out new obstacles and liberalize the conditions for the access of Russian goods to the Belarus market, 75 administrative sanctions, the damage of whose operation is USD 2.8 bln, were detected. Russia supposes that there are 19 export limitations for Russian goods access to the market that should be abolished. Russia supposes that Belarus should call off 19

limitations on Russian goods access to the market of the republic. The matter concerns 9 trade barriers, 2 quotas limitations and 8 administrative sanctions.

For instance, import to the Republic's territory of the Russian malt beer, sugar, produced from cane raw sugar, as well as ocean fish, seafood and products of its processing is carried out only through shelters. Besides, Belarus introduced general licensing of imported tobacco goods. The import is also hindered by a number of administrative sanctions and quotas.

Belarus imposed a ban on purchasing foreign motor-vehicles of big and middle grade for municipal, local and long-distance passenger traffic.

At the same time up to 2007 Belarus was the only country of CIS, which bought Russian crude oil at prices much lower than the world prices. In 2005 the average price for oil grade Urals for Belarus was USD 29.1 per barrel, while on average at world market it was USD 50.4 per barrel. This was due to the fact that export duty was not included in the price. For its part, in accordance with the bilateral agreement on the creation of common tariff and non-tariff regulation, Belarus, following Russia, should have increased export tariffs for oil and oil products and transfer 85% of the duty for the oil products produced from Russian raw materials to the Russian budget. This agreement, however, was not observed: allocations to the Russian budget were not made, Belarus export duties were more than 30% lower than Russian's. For instance, from 1 December 2006 Russian export duty for light distillates and gas oils was equal to USD 134 per ton, Belorussian – to USD 75.8; furnace fuel oil, lubricating oils and used oil products export duty from Russia - USD 92.9 per ton, while from Belarus – USD 72.2 per ton.

As this situation violated state-of-the-art agreements Russia introduced export duty for oil supplies to Belarus at the rate of USD 180.7 per ton since 1 January 2007. As retaliation Belarus introduced transit duty for Russian oil at the rate of USD 45 per ton. Russia however refused to pay it. After it became known that Russian fuel was taken away by Minsk to pay for new duties, Russian side stopped crude oil pumping through the Belarus's part of pipeline.

As a result, oil supplies to some European countries were stopped on 8 January 2007. After signing Russia- Belarus agreement on January 12, 2007, oil supplies to Europe were recommenced in corpore.

The signed agreement presupposes the establishment of duty for oil, exported to Belarus in the years 2007, 2008 and 2009 at the rate of 29.3; 33.5 and 35.6% from the Russian export duty, correspondingly, and the introduction of export duties for light oil products by Belarus in accordance with the Russian legislation.

To compensate for privileged oil supply schemes for Belarus abolition, the Ministry of the Economy of Belarus announced a sharp rise in transit costs for Russian oil starting from 15 February 2007.

According to the government decree tariffs for oil transit services net of VAT are established at the rate of USD 1.26 to 3.5 per ton for 100 km. Heretofore tariffs in force for oil transit through the territory of Belarus were adjusted with the Ministry of Fuel and Energy of Russia as long ago as December 1995 and did not change since then: they were equal to USD 0.41- 0.6 per ton. The Russian oil of 80 mln tons per year is on average transported through the territory of Belarus. Do these

tariff rates come into the effect, this will considerably affect the profitability of Russian oil transit through Belarus.

In 2006 the negotiation process on Russia's accession to the World Trade Organisation continued.

In November 2006 the representatives of Russia and the USA signed the protocol on Russia's accession to the WTO. The agreement with the USA as well as other similar agreements signed by Russia within the framework of the accession to the WTO defines the conditions of goods and services access to the Russian market.

The Russian position according to which no duty will be decreased on the date of Russia's accession to the WTO, and tariffs liberalization for separate kinds of goods will be fulfilled in the transition periods from 1 to 7 years.

Average weighted rate on agricultural and industrial production will be decreased by 3 p.p. But for a number of articles the duties will be decreased more sharply. Thus, Russia agreed to open partially the chemicals market (in 3-4 years the decrease of duties rates down to 5-6% will take place), passenger cars (the duties are supposed to be lowered from 25 to 15%) and civil aircrafts (from 20 to 7.5-12%).

Tariff quotas for beef, pork and poultry import will be in the range of existing parameters up to 2009, after which on conclusion of the negotiations with the suppliers interested in them their operation can be prolonged.

Prohibitive duty for alcohol will remain unchanged, duties rates for foreign wines and cognacs as well as champagne and whisky will decrease from 20 to 12%.

The search for the compromise in the sector of the financial service was the most difficult. Russia did not assume the liabilities for access of the direct branches of the foreign banks to the market and secured the possibility of 50% quotas implementation for the foreign participation in bank and insurance systems. At the same time Russian side agreed to grant access for the direct insurance companies branches to the market in 9 years time after Russian accession to the WTO.

Georgia remains the only country with which Russia has not concluded bilateral negotiations on the subject of WTO.

In the autumn 2006 the multilateral negotiations on Russia accession to the WTO were suspended upon the request of Georgia. After consultations Georgia took off its embargo on negotiation process.

As a result of negotiations with Georgia, carried out in the context of WTO on 25 January 2007 Georgia waived all its claims for Russia except one. The issue, connected with the operation of check-points in Abkhazia and South Ossetia, remains unsolved. This claim Georgia considers as the consequence of Russian liabilities in bilateral agreement on Russia joining to WTO, which was completed in 2004. As a result of the negotiations the resolution to exchange legal agreements on the subject of the check-points operation at the borders, to give evidence to Georgian party of our customs procedures conformity with WTO regulations, and to make clear the legal character of Georgian claims of the view of our bilateral agreements was made. Next meeting of delegations is scheduled for the end of February, 2007.

Besides the issues of checkpoints operation in Abkhazia and South Ossetia, Georgia also brought up a subject of wine and mineral water supplies to Russia. In Spring 2006 the supplies of wine and mineral water to Russia were banned in

accordance with the resolution of the Russian consumers' supervision organization because of quality complaints.

Besides Georgia, Russia has to sign an agreement with Guatemala, with which all the issues of bilateral talks have already been adjusted.

Mechanism of the final accession to the WTO involves the following stages:

- 1) conclusion of all negotiations;
- 2) conduction of the final meeting of the Working Party and General Council;
- 3) ratification of the Agreement on the Accession to the WTO by legislative authorities;
- 4) information of WTO headquarters about this;
- 5) exactly in 30 days after the information letter has been sent the country becomes WTO member.

It is known that Russia is carrying out negotiations in 4 directions. Bilateral negotiations on tariffs and services (first and second direction) can be considered as the most advanced. Though even here certain problems exist.

1. Despite the fact that 56 out of 152 countries, which have their membership in the WTO have concluded their negotiations with Russia, others can express their desire to conduct bilateral negotiations at any time. Cambodia, which is a new member to the WTO, is an example. At the end of December 2006 Vietnam is accessing the WTO. The possibility that it will express the desire to start bilateral talks with Russia cannot be excluded.
2. A number of countries, with which the agreements have already been concluded start inclining to reconsider them. The most characteristic example of this is Georgia.
3. The conclusion of the Ukraine accession to the WTO program, which is ahead of ours, is highly possible. It is also possible that the signing of the bilateral agreements with the Ukraine will be a difficult process.

The situation with the negotiations on the system questions, i. e. the discussions on the Working Party report, which is the third direction, is also difficult. The latest wording of the report was presented in autumn 2004. In March 2006 the last, 30<sup>th</sup> meeting of the Working Party was conducted. The fact that, according to the information available, the date of the new meeting has not been scheduled, testifies the absence of the subjects to be discussed. It can be supposed that one of the problems with report writing is not content problem, but staff problem. Besides over the last years Russia adopted a number of laws, which were not discussed at the meetings of the Working Party but can raise the questions among its members. These laws are connected with the Special Economic Zones, state orders, special international sanctions, new amendments to the Customs Code, Tax Code, Civil Code, intellectual property. Besides, any new legislation acts that have been or will be soon adopted should be presented by Russian side for discussion. This will also take some time.

The system of meat quotas distributions, state trade enterprises regulations, agreements on industrial assembly cause dissatisfaction of a number of partners.

The talks on the agricultural issues, comprising the fourth direction, are, in our opinion, on quite an early stage of negotiation process. The conclusion of these can be accelerated only by agreeing with the conditions suggested to us.

### 3.5. Russian agrifood sector: basic trends in 2006

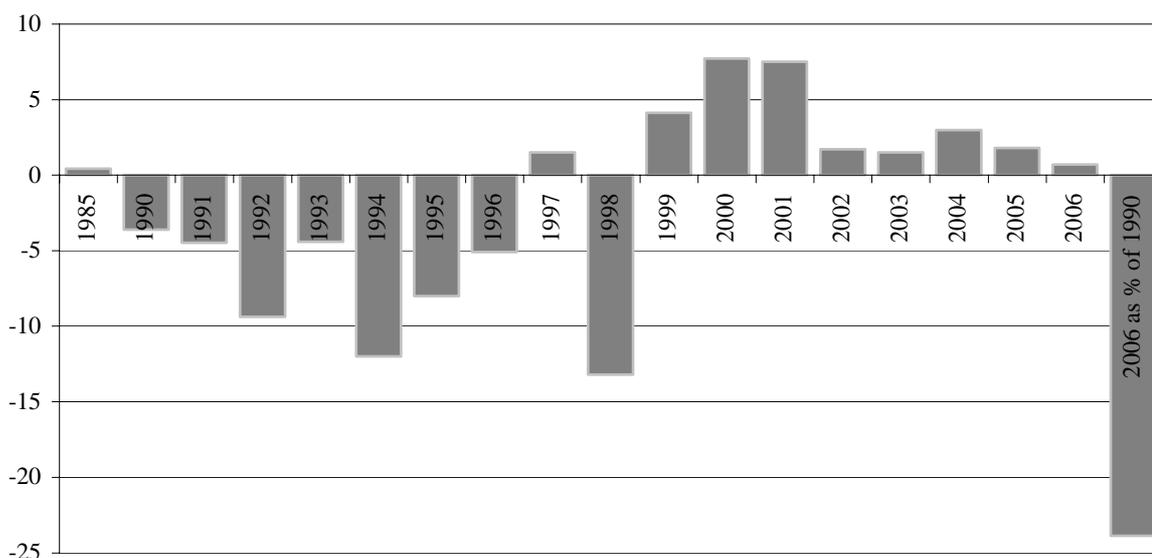
#### 3.5.1. Agricultural performance

##### General outlook

After several years of rapid recovery growth following the 1998 crisis Russian agriculture continues growing at a slower pace (*Fig. 42*). This growth is primarily driven by crop production (the respective indices equaling 107.5% in 2004, 103.7% in 2005 and 101.3% in 2006) while livestock breeding in 2005-2006 displayed marginal growth after contraction in 2004.

Crop production still accounts for over half of farm output although its share is gradually shrinking.

The current output of Russian agriculture is slightly over so of the pre-reform level. After a short decline following the 1998 crisis imports started to restore. Exports grow quite rapidly too but their increase is smaller. As a result the negative balance of trade in agricultural and food products continues to expand. So, the key factors of agricultural growth in 1999-2001 are exhausted and further progress requires other stimuli.



Source: Federal Service of State Statistics.

*Fig. 42.* Russia: percent change of annual gross agricultural output in 1985-2006

In addition to intra-sector factors, growth was strongly hindered by macro-economic trends. For instance, the strengthening of ruble during the examined period lowered the competitiveness of domestic output on the home market (by 3-5%) and the competitiveness of exported products on the world markets. The rising

prices for fuels and oils strongly impaired profitability of grain production and eventually induced contraction of areas planted in grain crops.

At the same time structural shifts are taking place that enable us to speak of positive developments in the sector. As mentioned in 2005 annual survey, the process of producers' bifurcation is underway – some of them are actively developing, modernizing production and involving investments while others become more and more marginal and go bankrupt. The latter segment of the agrifood sector pulls the average efficiency and growth indicators down.

Producers' bifurcation proceeds in line with further shaping of regions with intensive farm production. Just 7 regions – Moscow, Leningrad and Novosibirsk oblasts, Krasnodar and Altay krais, Tatarstan and Bashkortostan republics – currently produce one third of the country's milk output. In 2005 milk production in these regions grew by an average 0.6% (0.1% average weighted) while the total national indicator fell by 3%. 1/5 of the domestic output of whole milk products is produced in 3 regions – Moscow, Saint Petersburg and Krasnodar kray<sup>10</sup>. The concentration is all the more noteworthy as in the Soviet economy production of milk was dispersed all over the country and in the last decade of Soviet period milk cattle inventories demonstrated the biggest increase in Magadan and Murmansk oblasts, in Kamchatka and Sakhalin. In other words, zones of intensive production of some agricultural products are forming. These regions have better average indicators of productivity and profitability; although their growth rates may be not impressively high, it's quite explainable given relatively large production volumes.

The sector structure of agriculture is shaping as well: some sectors prove their competitive advantages on international and domestic markets while others are shrinking at a higher or lower pace. For instance, the output of sunflower seeds, vegetables and potatoes is growing and is now above the Soviet period level (*Fig. 43*). Production of grain is primarily constrained by domestic demand limitations and vague perspectives on the world market.

Despite generally poor performance of the livestock sector, some segments therein demonstrate very high growth (*Fig. 50*). For instance, the annual growth rates in poultry meat production amounted to 17%. The intensive production of pork is growing as well.

The situation in food industry is similar. Output of some products (e.g. vegetable oils and white sugar) has already surpassed the pre-reform level. Production of a number of food items has been nearly restored - e.g. sausages, pastas, margarine and some other products. Production of meat and milk products is constrained by population's purchasing power but is still growing (*Table 53*).

Real personal incomes increased by 10%, retail food turnover – by 10.2%. It means that the overall elasticity of demand for food remains still rather high. This fact can also be one of the explanations of the speedy rise of prices for meat being one of the most income elastic products. The structure of meat consumption is optimizing. In Russia the share of beef in the overall meat consumption is very high. In 2005 sales of poultry grew faster than total meat sales (by 10.3% versus 5%). At

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<sup>10</sup> Data of the Federal Service of State Statistics.

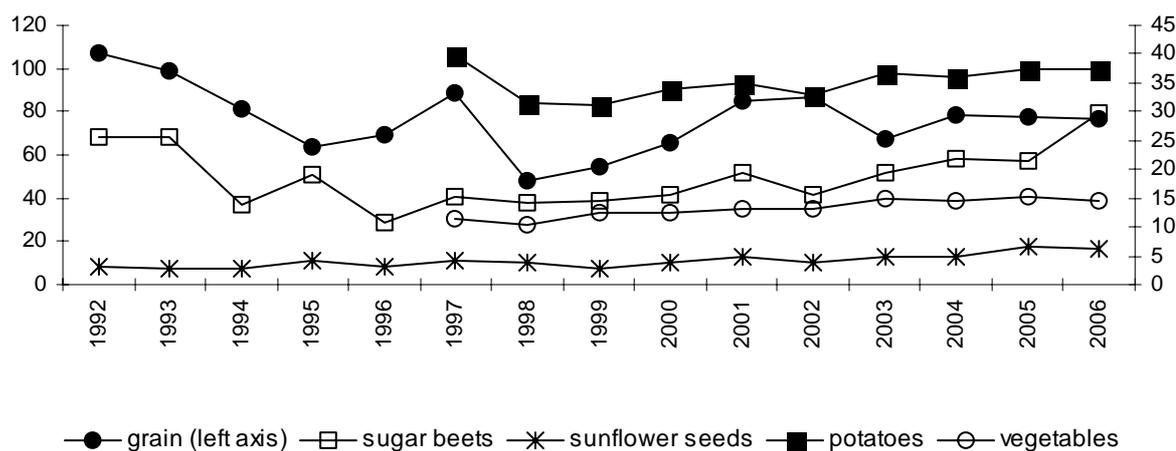
the same time, the demand for cheese and fruits (products that are largely consumed by higher income groups) expanded even more – by 10% and 11.4% respectively<sup>11</sup>.

A positive development factor was a certain improvement in rural social sphere. For the first time wages in agriculture grew faster than in mining or manufacturing. Wages earned in farm production still constitute the basis of rural residents' well being. Employment in rural areas was up 1.6 percent points as compared with 2004. Although the shifts are not yet large, it's the trend that is important.

All these positive processes are going on in spite of an actual withdrawal of federal authorities from the agrifood sector regulation. Budget support of the sector is in fact transferred to the regional level while measures still implemented at the federal level are largely non-efficient.

### Crop production

Crop production in Russia is very unstable and largely depends on weather conditions. At the same time some sectors demonstrate high competitive advantages both on domestic and world markets, rapidly restore production on a new technological basis while others are gradually shrinking. For instance, the output of sunflower seeds, sugar beets, vegetables and potatoes is growing at a high rate and is now above the Soviet period indicators (*Fig. 43*). Growth of sunflower production began from the very start of reforms. For the most part it was extensive, i.e. areas planted expanded at the expense of other crops (first of all grains). From 2001 yields of sunflower seeds are growing as well – producers started applying highly productive hybrids and mineral fertilizers (*Table 52*), i.e. transferred to intensive production methods.

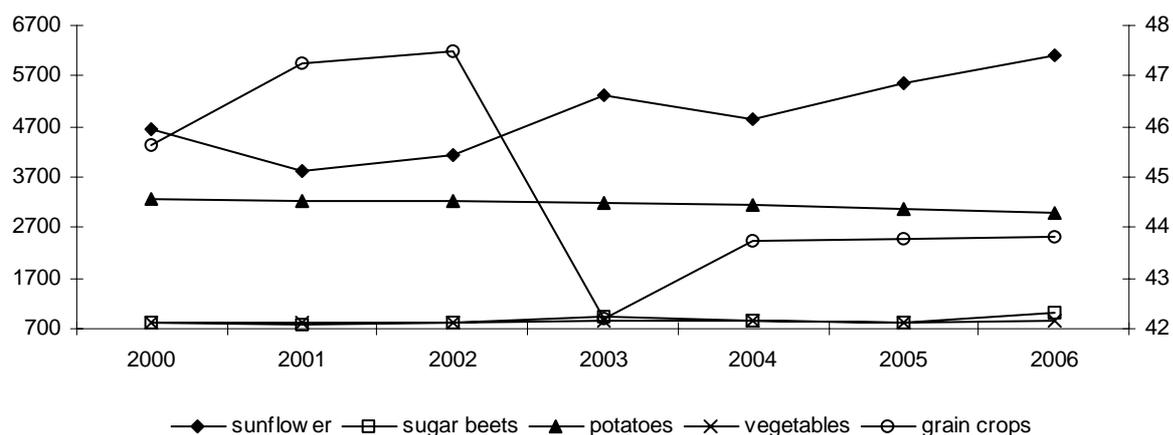


Source: Federal Service of State Statistics.

*Fig. 43.* Gross output of basic farm crops, million tons

<sup>11</sup> Ibid.

Sunflower and grains compete for the same areas and in Russia there is quite an apparent negative correlation between their acreages (*Fig. 44*). In the last 5-8 years areas under potatoes slightly decreased while gross output of this crop steadily increases beginning from 2002. Although the most part of potatoes in the country is produced by household farms (91.4%), the share of large producers in the recent 5 years is getting larger implying expansion of intensive production in potato growing as well.

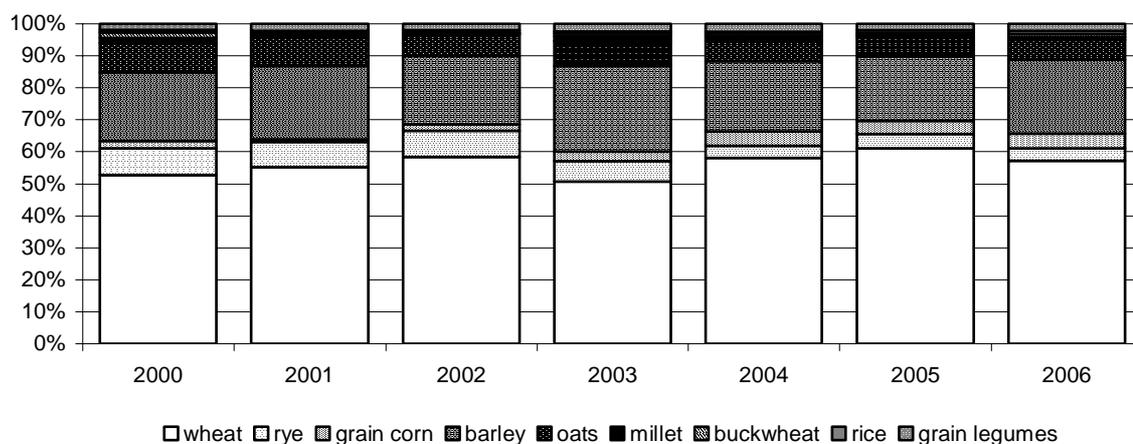


\* - grain crops – million hectares (right axis).  
Source: Federal Service of State Statistics.

*Fig. 44.* Areas planted in selected farm crops, thousand hectares\*

Grains remain the basis of Russian crop production, wheat being the dominant one. Structure of grain production varies a lot by years (*Fig. 45*) but an apparent trend is the shrinking of traditional production of rye and a certain expansion of corn production. In the last 5 years gross output of corn increased 4 fold while outputs of rye, oats, millet and buckwheat reduced by 10-20%. One of the factors thereof is the situation on the world markets. The growth of demand for corn was most remarkable in the US due to the rapid development of ethanol production. The 2005 US Energy Policy Bill stipulates wider use of biological fuel (on the basis of grains) – up to 7.5 million gallons by 2012 which is twice above the 2005 level<sup>12</sup>. At the same time the domestic factor is also important – the growing interest of Russian livestock producers in corn as a fodder crop due to its much better nutrition value (as compared with wheat).

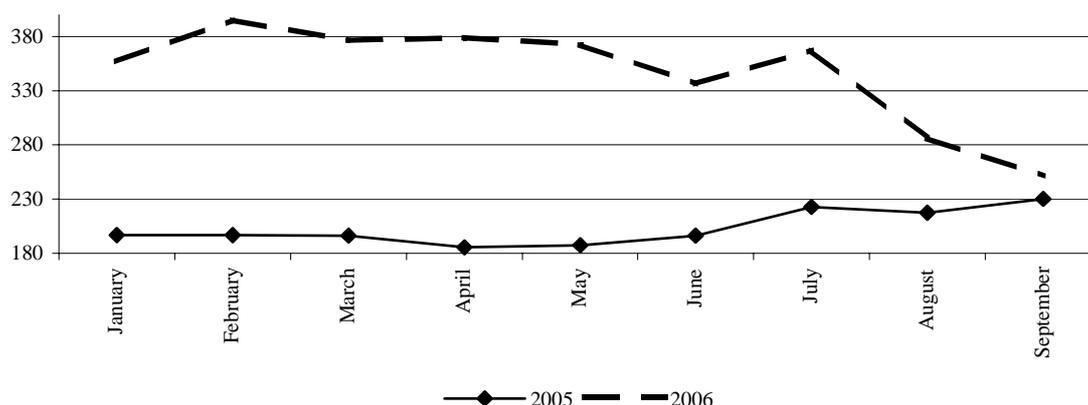
<sup>12</sup> USDA (2006). USDA Agricultural Baseline Projections to 2015. Baseline Report OCE-2006-1. USDA. Washington, D.C.



Source: Federal Service of State Statistics.

Fig. 45. Structure of Russian grain production: gross output of selected grain crops as % of the total

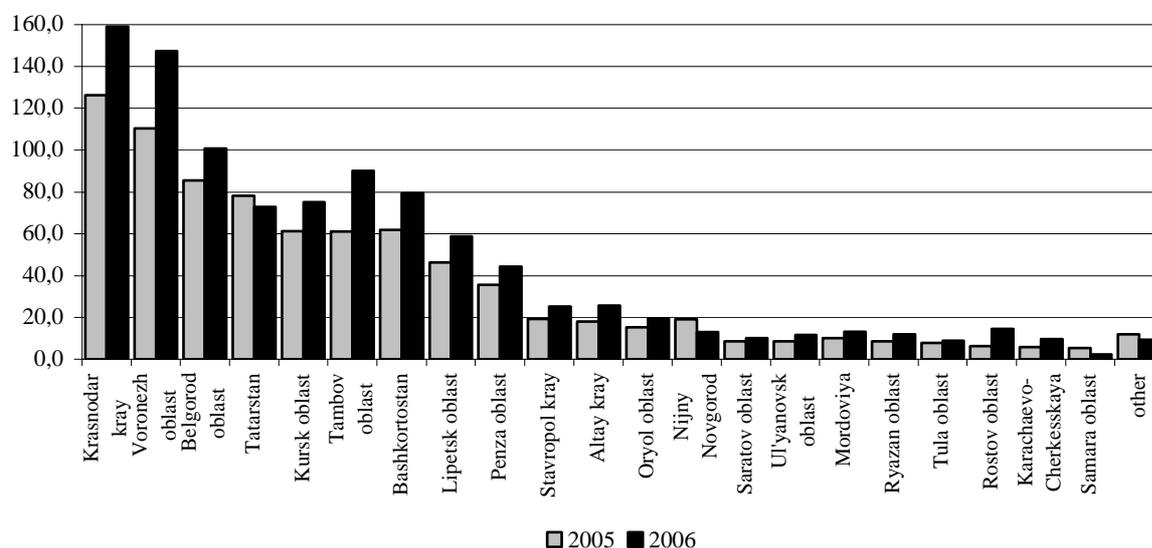
The growth of sugar beet production (Fig. 43) started after the revision of sugar trade regime. In 2003 a new regime of regulating foreign trade in sugar was adopted envisaging introduction of variable import duty. Variable duty is bound to the difference between price at the New York Board of Trade and the domestic support price. This regime resulted in larger acreage under and bigger outputs of sugar beets; besides, the share of beet sugar in the total sugar output increased noticeably (from 26% in 2002 to 52% in 2006 – see Fig. 48) surpassing the pre-reform level. According to our estimates the rate of white sugar support grew from 29% in 2001 to 49% in 2004 (percent equivalent of producer support estimate - PSE). However, the growth of sugar beet production in 2006 is due to higher world prices (Fig. 46) rather than the new sugar regime.



Source: www.mcx.ru

Fig. 46. Prices for raw sugar at the New York Board of Trade (Contract 11), dollars per ton

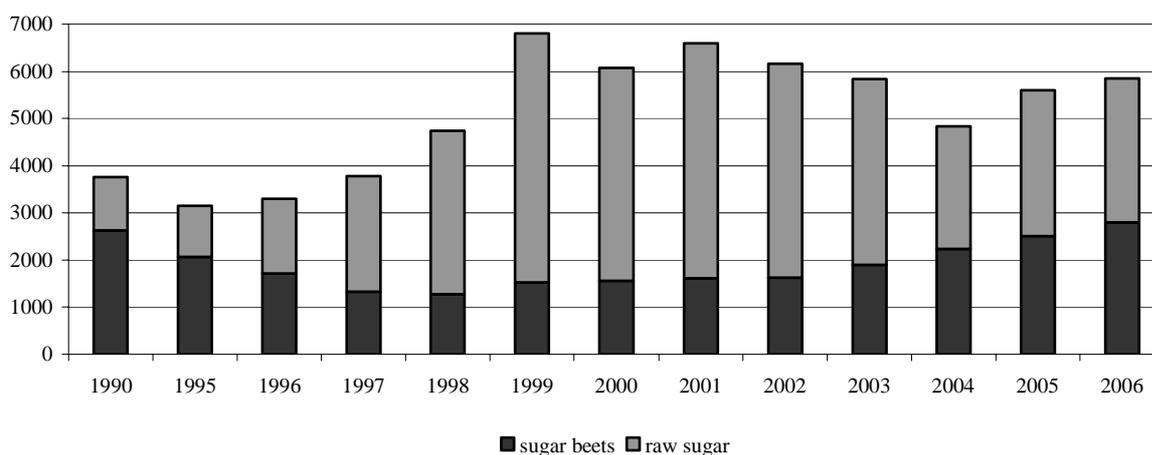
In 2006 the total area planted in sugar beets expanded by almost 24% (Fig. 44). The acreage grew in almost all traditional regions of sugar beet production except Tatarstan Republic (Fig. 47).



Source: Federal Service of State Statistics.

Fig. 47. Areas planted in sugar beets by regions, thousand hectares

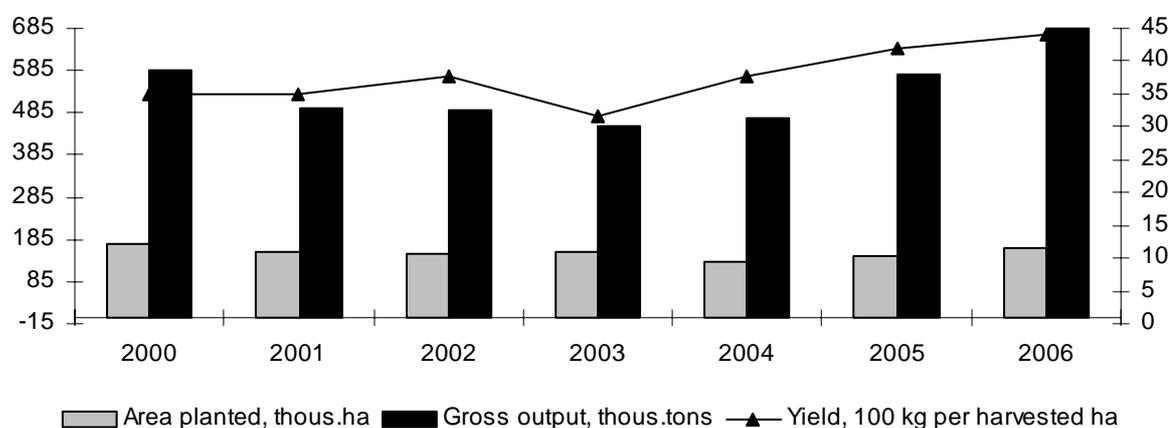
The productivity of sugar beet production is improving as well. Yields are growing for seven years running; in 2006 the indicator was up almost 40% and averaged 298 metric centners per hectare.



Source: Federal Service of State Statistics.

Fig. 48. Production of white sugar out of sugar beets and raw sugar, thousand tons

The change in regulation of rice import starting from 2003 also resulted in larger domestic production of this crop: its gross output and yields are growing for the third season in succession (*Fig. 49*).



Source: Federal Service of State Statistics.

*Fig. 49.* Rice: areas planted, gross output and yields

One more notable trend is the rapid growth of rape production in the last three years. According to expert estimates its output in 2006 reached 0.5 million tons versus 0.1 million tons in 2004. The external factor thereof was surely the EU decision to enlarge production of biological fuel that in Europe is mainly made out of rapeseeds. Today the EU declares the target to expand the use of oilseeds for producing biological fuel – by 2010 5.75% of their gross output should be used for this purpose<sup>13</sup>. European experts forecast that by 2013 energy production will account for 30%, i.e. over 15 million tons, of the overall oilseeds consumption in the EU versus 3.6 million tons in 2003 and 8 million tons in 2006<sup>14</sup>. This could not fail to result in higher prices for rapeseeds. Growth in domestic livestock sector is the internal factor of expanding production of rape – a valuable fodder crop. One more determinant of bigger gross outputs of rape is the fact that in the last year about j thereof was produced in Tatarstan known for its rather authoritarian policies in the agrifood sector, i.e. expansion of rape growing in the republic could be due to intra-regional policy eventually conditioning higher national indicators.

Following a long recession rooted back in the Soviet period, the Russian flax sector started to demonstrate positive trends after 1998. The growth is due to a more intensive primary agricultural production and a considerable modernization of processing plants. Regional re-specialization of flax production is underway: the West Siberian region becomes one of the major producers of flax fiber while its processing is traditionally concentrated in the European part of the country. Growth in the sector is not so much conditioned by domestic demand as by foreign de-

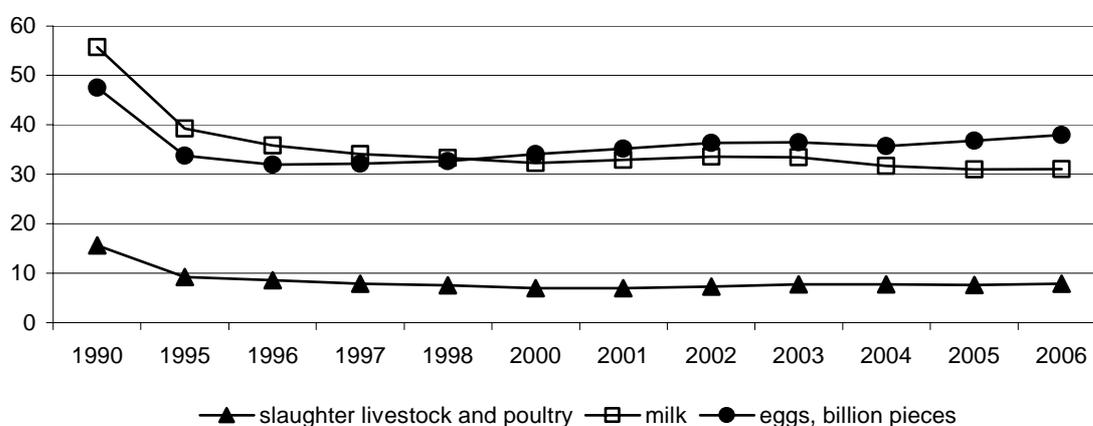
<sup>13</sup> European Commission (2005). Biomass Action Plan [SEC(2005) 1573], Brussels.

<sup>14</sup> European Commission. (2006). Prospects for Agricultural Markets and Incomes in the European Union, 2006-2013. Directorate-General for Agriculture. Brussels.

mand for raw material, the product of primary or the initial stage of secondary processing. It is generally known that prices for raw materials on the world markets are very volatile making the situation in the Russian flax sector very unstable. After the period of growth, in 2006 the output of flax reduced by one third.

### Livestock production

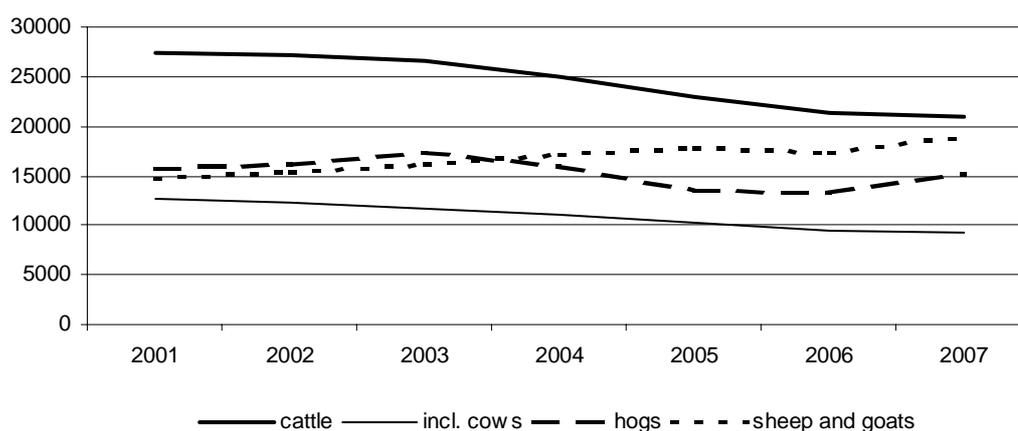
The situation in Russian livestock production is generally worse than in crop production. Livestock inventories continue falling; the output of basic livestock products is either slightly reducing or marginally and unsteadily growing. However, efforts targeted at the accelerated development of this sector that were made in 2006 resulted in some improvements (*Fig. 50* and *Fig. 51*).



\* - live weight.

Source: Federal Service of State Statistics.

*Fig. 50. Gross output of basic livestock products, million tons\**

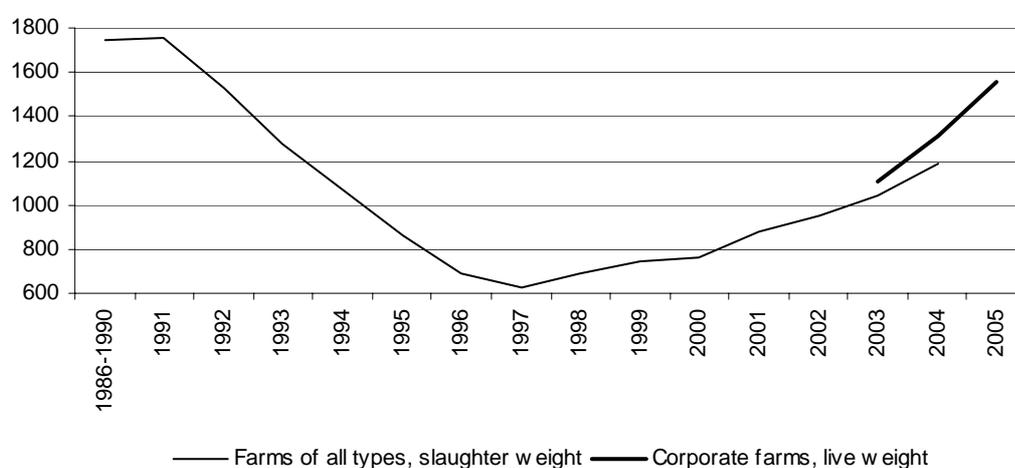


Source: Federal Service of State Statistics.

*Fig. 51. Livestock inventories as of January 1, thousand heads*

Despite generally poor performance of the livestock sector, some sub-sectors therein are quite rapidly recovering. In particular, poultry meat production grew by an average 17% a year throughout the surveyed period (*Fig. 52*). Intensive feeding of hogs is growing as well; in 2006 their inventories started to increase noticeably (*Fig. 51*). Thanks to the intensive feeding of poultry and hogs the total meat output in 2006 was up 4.6%<sup>15</sup> (in recent years the share of households in the output of pork and in hog inventories is steadily falling meaning that production increase is provided by large farms applying intensive technologies).

The upsurge of pork production in 2006 resulted in the drop of purchase prices: they lowered by 2% (in nominal terms)<sup>16</sup> after rising by 1/3 in 2005. This raises doubt about further production growth and inflow of investments in the sub-sector.



Source: Federal Service of State Statistics.

*Fig. 52.* Production of poultry meat in Russia, thousand tons

The country's averages of livestock productivity are steadily improving (*Table 57*); annual milk production per cow is already well above the pick figures of the Soviet period.

*Table 57*

### Livestock and poultry productivity in Russia

	2000	2001	2002	2003	2004	2005	2006
Annual milk production per 1 cow, kg	2343	2553	2808	2979	3070	3292	3603
Annual egg production per 1 laying hen, pieces	264	273	279	285	292	301	251

Source: Federal Service of State Statistics.

In some regions intensive feeding of hogs and poultry grows at the rate far exceeding the average Russian indicators. For instance, in 2006 production of pork and poultry meat in Moscow, Belgorod and Penza oblasts, Krasnoyarsk and Stav-

<sup>15</sup> Federal Service of State Statistics.

<sup>16</sup> RF Ministry of Agriculture.

ropol krays grew by 130-160%. These regions form as specialized zones of hog and broiler production. Similarly, regions specializing in dairy production emerge – they are characterized by accelerated (as compared with the country's average) rates of growth and higher productivity indicators.

### 3.5.2. Financial performance of farm producers

Since 1999 the financial performance of Russian agriculture is steadily improving. The share of profitable farms is growing as well as their profitability. This process was mainly determined by the after-effects of 1998 crisis. The only exception was 2002 when agriculture was affected by the sharp drop of prices received by farm producers. Besides, the sector benefited from much stronger government support and growing investments. The farm debt rescheduling campaigns also contributed to the improvement of performance indicators.

A qualitative leap in farm producers' financial performance took place in 2004: its positive balance remarkably grew and the share of profitable enterprises exceeded 50%. The number of farms having overdue debts and the size of these debts are steadily decreasing.

It's generally believed that the most important factor of better financial performance of farm producers is the implementation of farm debt rescheduling program effective since 2003. According to data of the RF Ministry of Agriculture by October 1, 2006 agreements on debt rescheduling were signed by 12388 agricultural producers (about 40% of their total number and 64% of the ones having overdue debts). From October 2005 the number of entities participating in the program is actually stagnant since few new agreements are signed while the dropping out continues. Accordingly, the amount of restructured debts reduces. Overall 80.6 billion rubles of participating farms' debts were restructured including 41.6 billion rubles of fines and penalties of which 29.7 billion rubles were written off. At the same time 12570 agricultural producers cannot participate in the financial recovery program: almost 5 thousand enterprises go through the bankruptcy procedure, 4.5 thousand are unable to make current payments according to the rescheduling terms and the rest cannot join the program due to other reasons. Besides, 3.5 thousand agricultural producers lost the right to participate in the program having failed to meet current commitments; moreover, in almost one thousand enterprises rescheduling was suspended.

The process of bankrupting farm producers is rapidly intensifying: while in 2004 3455 bankruptcy proceedings against agricultural entities were initiated, by early November 2005 6210 bankruptcy cases were under examination. In 10 months 2006 4970 bankruptcy proceedings were initiated. It had a positive effect on the sector's average financial performance (*Table 58*). In 2006 the share of profitable entities in agriculture for the first time exceeded the corresponding figure in economy at large (67.4% in January-September 2006). The sector's general profitability increased two fold, net profits – by almost 30% while credit indebtedness fell by 20%.

Apparently the improving financial performance of the sector at large is due to the increase of efficiency in the upper producer groups, their higher attractiveness for investors. Investments in fixed capital continued to grow (by 43% as compared with January-September 2005) although in 2005 they had already more than doubled. Foreign investments in agriculture also grew at higher pace: their amount enlarged by 30% as compared with the previous year (in 2004 – by 20%). Beginning from 2002 the amount of foreign investments grows not only in food industry but also in primary agricultural production (*Fig. 53*).

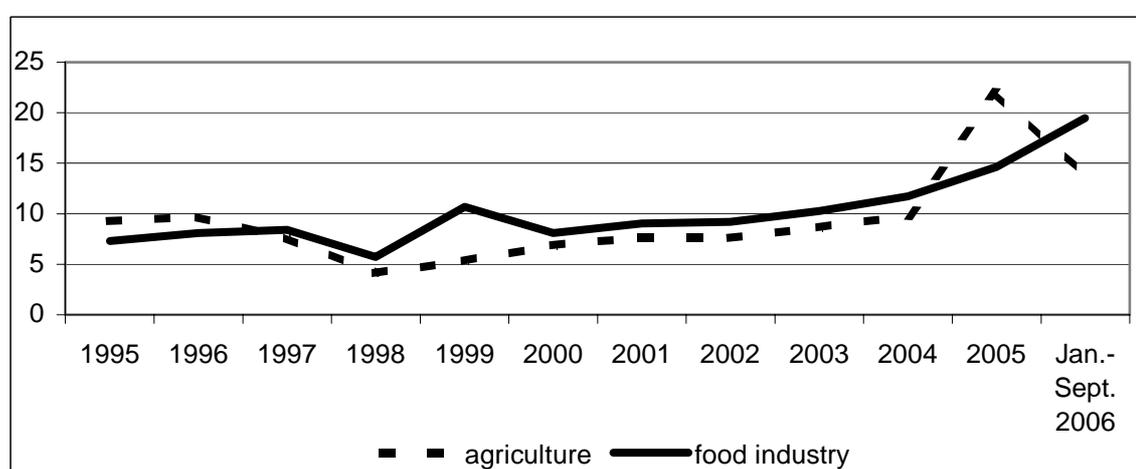
So, it would be a mistake to think that the observed improvement of agricultural producers' financial performance is entirely due to the implementation of farm financial recovery law.

Table 58

**Financial performance of agricultural producers**

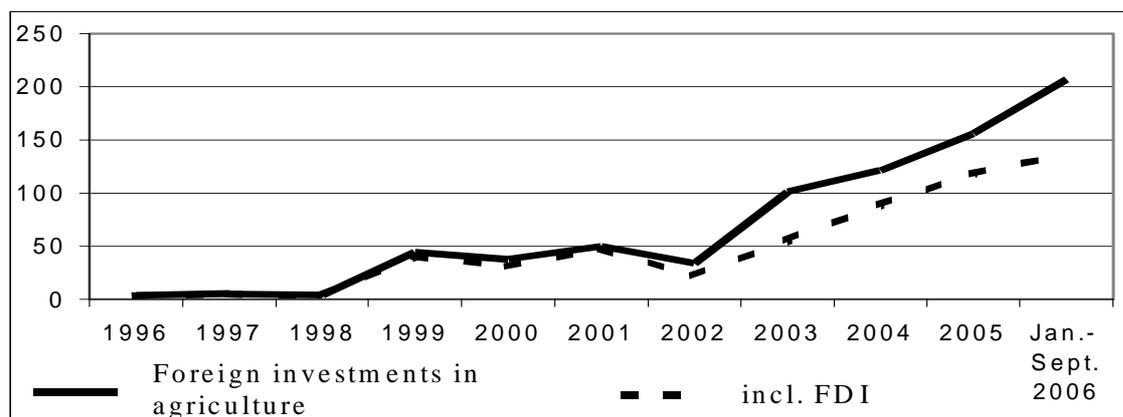
	2000	2001	2002	2003	2004	2005	Jan.-Sept. 2006	Jan.-Sept. 2006 as % of 2005
Profitability of goods, works, services and assets sold, %	6.3	9.3	1	2.7	6.4	7.5	14.9	199
Profit less loss, billion rubles	16.1	25.6	-1	2.2	34.7	32.6	41.8	128
Share of profitable entities, %	47	44	42	49	62.2	59.6	71.7	120
Number of entities having overdue creditor indebtedness, %	23.9	23	21.8	18.9	16.5	13.3	10.6	80
Overdue creditor indebtedness, billion rubles	144.1	162.9	162.3	149.9	113.9	85	67.1	79

Source: Federal Service of State Statistics, [www.gks.ru](http://www.gks.ru)



Source: Federal Service of State Statistics, [www.gks.ru](http://www.gks.ru)

*Fig. 53.* Direct investments in the agrifood sector, billion rubles (constant 1995 prices)



Source: Federal Service of State Statistics, [www.gks.ru](http://www.gks.ru)

Fig. 54. Foreign investments in Russian agriculture, million US dollars

### 3.5.3. Structural adjustment of Russian agriculture

The basic trend in the current farm structure development in Russia is the sharp polarization of both large corporate farms and small producers.

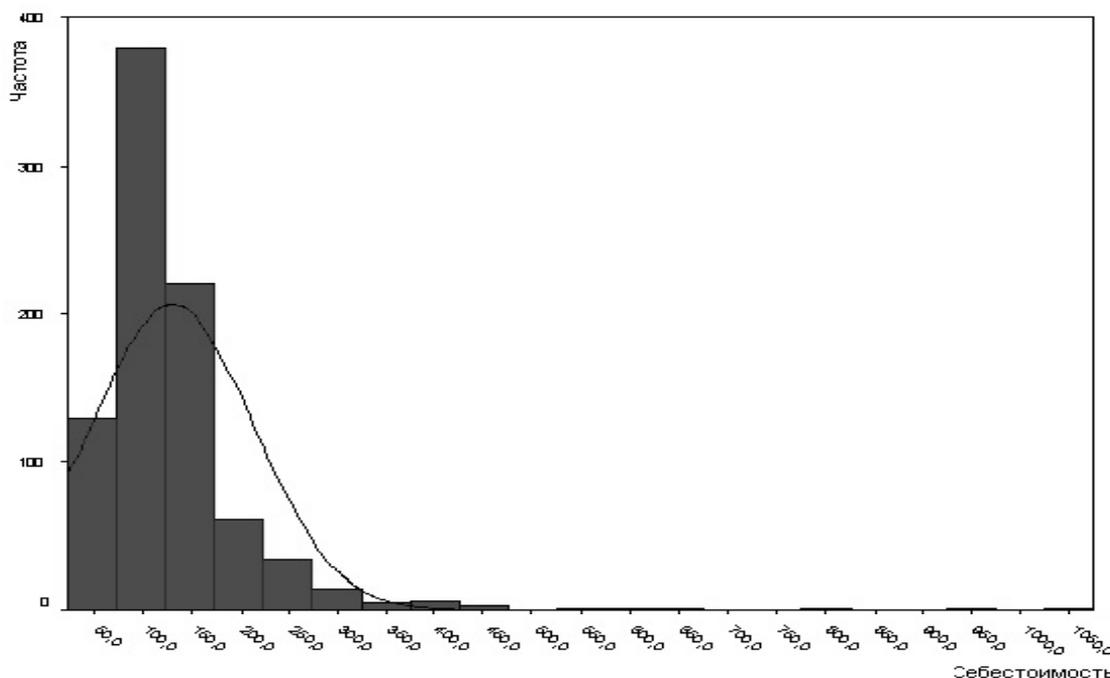
Corporate farms – heirs of collective and state farms differ greatly by their performance indicators. For instance, unit production costs at farms located within one area (i.e. in relatively homogeneous conditions) may differ dozens times. Our study embracing 6 regions of the country and 4 basic products revealed that in the three surveyed years (2000-2003) the frequency distribution curve of farms by unit production costs has an apparent right tail. An example of such distribution is shown on Fig. 55.

It should be noted that the mode values of unit production costs of basic products are far below (as in the grain case) or comparable with the world indicators (as in case of milk, major kinds of meat and sugar). This means that at producer level the most part of farm sector is quite competitive.

What are the basic causes of this “tail”? Why don’t production factors outflow from “tail” farms to the mode or advanced farms?

One of the reasons is the state support of insolvent farms. This support is provided not in the form of direct subsidies but through various kinds of “producer financial recovery” schemes succeeding each other throughout the reform years. The latest law on financial recovery was adopted in 2002 and came in force after the period examined in the study. However, before 2002 farm debts were also regularly written off (“restructured”) and efforts were made to preserve financially unstable producers. The practice of creating farms-“doubles” got widely spread – the actually bankrupt enterprises transferred to them their assets that were not encumbered by debts. In early 2000s up to 40% of registered agricultural producers in fact didn’t operate which was largely the effect of this practice. Such farm policy results in forming of the right tail of low-profit producers and thus reduces the sector’s average efficiency. Moreover, the disappearance of non-efficient producers

from the market would free a market niche for the most efficient ones that would be able to enlarge production and hence to further improve their efficiency.



X axis – unit production costs, Y axis – frequency.

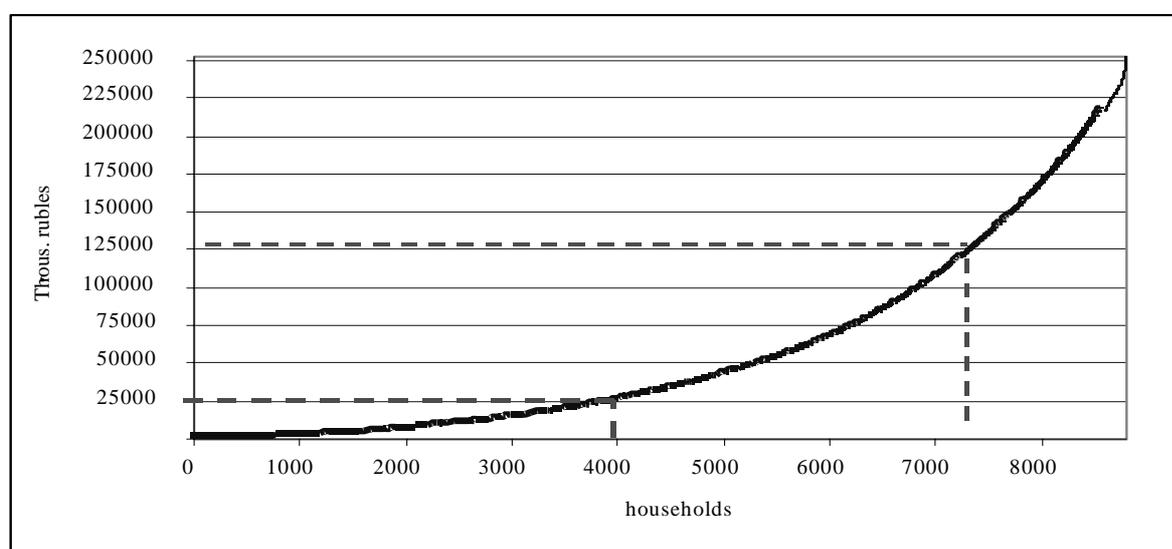
Source: E.Serova, O.Shick. Soft budget constraints as a factor of financial insolvency of Russian agriculture. In: Proceedings of the II Congress of Russian association of agricultural economists. Moscow, 2006.

*Fig. 55.* Distribution of corporate farms by grain unit production costs: the Rostov oblast case (rubles per 100 kg, 2000)

Why do then agrifood sector administrators adhere to the policy that preserves the status quo with non-profitable producers? The principal cause behind that is the two so far unsolved problems: the lack of efficient farm bankruptcy mechanism and the absence of strong rural development policy targeted at the creation of alternative rural employment. An efficient farm bankruptcy mechanism should tackle several key problems: the maximum preservation of production complex integrity or at least production resources in agriculture, rational utilization of valuable farmland and most importantly – the ensuring of income sources for rural population in the affected areas. The world practice offers solutions for these problems but we cannot afford discussing them in this paper. Still, the current Russian policies evidence that so far the only way out is recognized – preservation of non-efficient farms somehow addressing social issues. Unfortunately, this is a blind alley undermining competitiveness of the sector at large.

On the other hand, small individual producers (in Russia – household farms) are also extremely polarized. Our study based on the results of pilot census conducted in 2005 in 6 districts of 3 Federation’s constituent members (in the framework of All-Russia Agricultural Census) allowed us to estimate the extent of this po-

larization. Pilot census data were used to construct households' distribution curve by gross agricultural output. The results were similar in all the surveyed districts – from 42 to 71% of households produce less than 5% of the respective district GAO. On the average they possess less than 0.1 ha of land and have no livestock or poultry. *Fig. 56* illustrates the trend using one district as an example. No doubt, such households are purely subsistence plots producing farm products for personal consumption; sporadic sales of their output account for a small share of family money incomes. On the other hand, about 20% of household farms produce over j of the district GAO. These are surely market-oriented commercial producers, actually individual private farms that do not register as such just in order to avoid taxation and to preserve access to concessionary services of large “mother” farms.



Source: E.Serova, T.Tikhonova. Who is the actual agricultural producer among Russian household farms? In: Proceedings of the II Congress of Russian association of agricultural economists. Moscow, 2006.

*Fig. 56.* Distribution of household farms by gross output in one of the surveyed districts

The land market in agriculture got actually paralyzed after the adoption of new land legislation in 2001-2002 due to the extremely high transaction costs. The law on agricultural land transferability is constantly corrected and supplemented in the State Duma: as of now about 65% of the original text has been amended but the situation remains actually the same.

#### 3.5.4. Production of agricultural inputs

Farm machine building follows the trend of agriculture – after a short upsurge in the early 2000s its growth is slowing down (*Table 59*). Still, producers of grain harvesters managed to enlarge export supplies 5 fold as compared with 2000 thus supporting the upward trend in the sector. Exports of tractors remain insignificant and therefore shrinking domestic demand results in their smaller production. Cur-

rently annual domestic production of farm machinery amounts to about 1 billion dollars. Imports total about 2/3 of this amount, exports – 10-12%<sup>17</sup>.

Table 59

**Production of selected farm inputs, thousand pieces**

	1990	1995	2000	2001	2002	2003	2004	2005	2006
Tractors	214	21.2	19.2	14.2	9.2	8.1	8.7	5.5	5.5
Tractor ploughs	85.7	4	2.8	3.1	2.3	1	1.2	1.8	1.1
Tractor seeders	51.1	1.6	5.2	6.4	5.3	4.2	5.7	6.5	5.2
Tractor cultivators	101	2	4.7	5.6	5.6	6.2	6.7	8.6	6
Grain harvesters	65.7	6.2	5.2	9.1	7.5	5.4	7.9	7.5	6.9
Mineral fertilizers, million tons	16.0	9.6	12.2	13.0	13.6	14.1	15.7	16.6	16.2

Source: Federal Service of State Statistics.

Production of mineral fertilizers is still export-oriented while domestic consumption grows at a low rate. However, their application for producing the most profitable crops displays much better dynamics.

Table 60

**Application of mineral fertilizers in Russian agriculture**

	2000	2001	2002	2003	2004	2005
Applied total, million nutrient tons	1.4	1.3	1.5	1.3	1.4	1.4
Per 1 ha of planted area, kg						
all crops	19	19	21	21	23	25
cereals	20	22	25	24	26	29
sugar beets	119	139	166	177	223	252
flax	73	58	49	49	45	51
sunflower	6	8	12	13	14	15
vegetables and melons	84	82	92	97	115	114
potatoes	155	154	160	186	184	181
fodder crops	13	12	11	11	10	9
Share of fertilized area, %	27	28	30	29	31	32

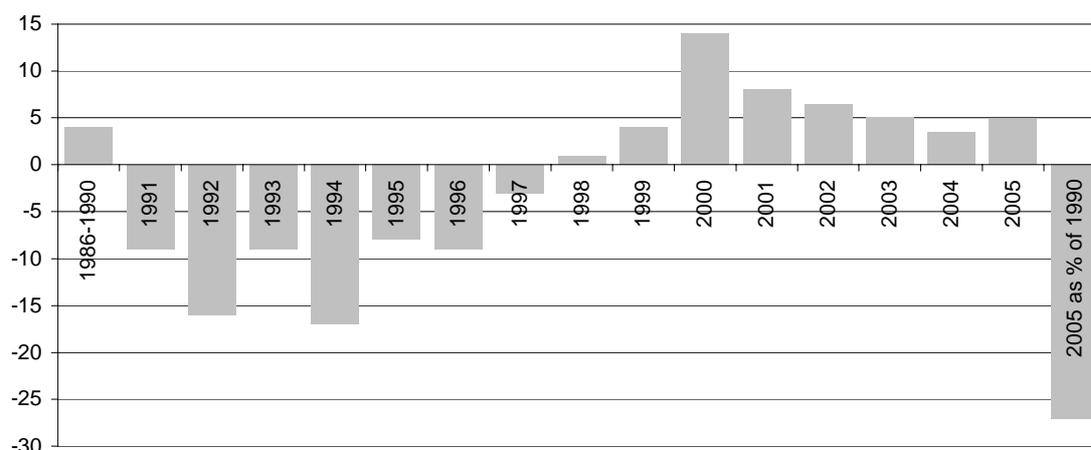
Source: Federal Service of State Statistics.

### 3.5.5. Food industry

In the Russian food industry production grows at noticeably higher rates as compared with agriculture but here too the growth is slowing down versus 1999-2001 indicators (*Fig. 57*).

Similar to agriculture food industry displays very different dynamics by sub-sectors. Production of some food products, e.g. vegetable oils and sugar, has already exceeded the Soviet period indicators. Pre-reform production levels of some other products, e.g. sausages, pastas and margarine are nearly restored (*Table 61*). Growth in the milk and meat sub-sectors is strongly constrained by income trends in the lower income groups but is still continuing at a rather high pace.

<sup>17</sup> Data of "Soyuzagromach".



Source: Federal Service of State Statistics.

Fig. 57. Russian food industry: percent change of annual output

Table 61

**Production of basic food products, thousand tons**

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Meat	6484	2370	1900	1510	1315	1113	1193	1284	1456	1677	1698	1827	2100
Sausages	2283	1293	1296	1147	1087	948	1052	1224	1468	1700	1832	1957	2100
Butter	833	421	323	292	276	262	267	271	279	285	271	277	n.a.
Dairy products*, million tons	20.8	5.6	5.3	5.2	5.6	5.6	6.2	6.7	7.7	8.5	8.7	9.5	10.0
Vegetable oils	1159	802	879	687	782	881	1375	1281	1197	1598	1867	2206	2600
Granulated sugar	3758	3155	3294	3778	4745	6808	6077	6590	6165	5841	4852	5588	5800
Flour, million tons	20.7	14	11.8	12.2	12	12.7	12.1	12	10.9	11.2	10.8	10.2	10.2
Groats	2854	1418	988	992	1085	899	932	994	951	890	893	926	966
Pasta	1038	603	444	453	554	707	704	764	821	874	950	982	n.a.
Margarine products	808	198	200	222	239	379	462	515	536	542	561	630	n.a.

\* - in liquid milk equivalent

Source: Federal Service of State Statistics.

The demand for food products grows faster than average real incomes. The demand for fruits and cheese (i.e. very income-elastic products) expands at the highest rate – in recent years their sales increase by over 10% annually. Sales of poultry meat also grow fast – faster than the overall meat sales implying change in the structure of meat consumption.

The most expectable trends in the development of food industry in the coming years are the consolidation of assets, establishment of large national companies (primarily through taking-over/affiliation of provincial enterprises) and further growth of foreign investments.

One more noticeable development trend is the strong impetus to integrate both up and down the food chain.

**3.5.6. Foreign trade in agricultural and food products**

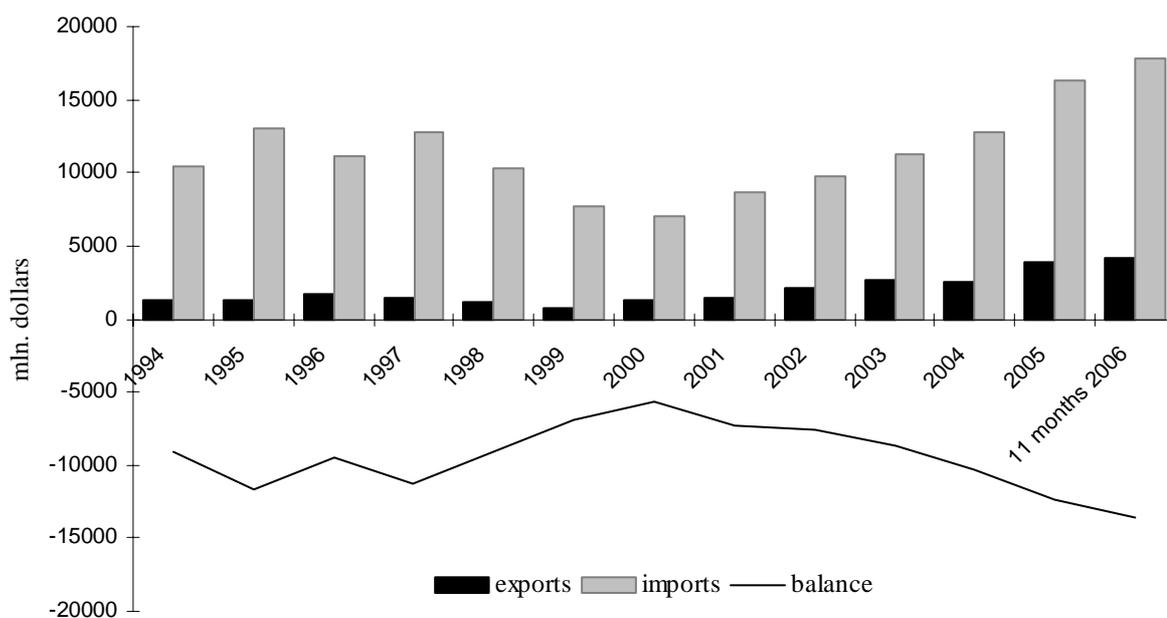
The role of Russia on the world agricultural and food markets is steadily growing: in recent years the volume of foreign trade in respective commodities in-

creased remarkably and in 2006 reached 22 billion dollars – the record level for the last 12 years.

The growth of foreign trade turnover is due to the expansion of both imports and exports (*Fig. 58*). It's noteworthy that exports grow faster: in 11 months 2006 their value was over 3.5 fold above the 1998 indicators while that of imports – only 1.7 fold.

While in the first after-crisis years the enlargement of export supplies was primarily due to the ruble devaluation, at present the trend is supported by the strengthening of domestic agriculture's position on the world markets of some products. Imports continue to increase due to the sustained growth of consumer demand in the situation of slowing down progress in the domestic agrifood sector.

Although growth rates of agricultural and food exports were usually above those of imports, Russia still retains its status of traditional net importer of these commodities. The negative trend in the dynamics of agrifood foreign trade deficit that took a start in 2000 still continues (*Fig. 58*). The negative balance of trade in respective items amounts to about 13 billion rubles.



\* - less trade with Belarus.

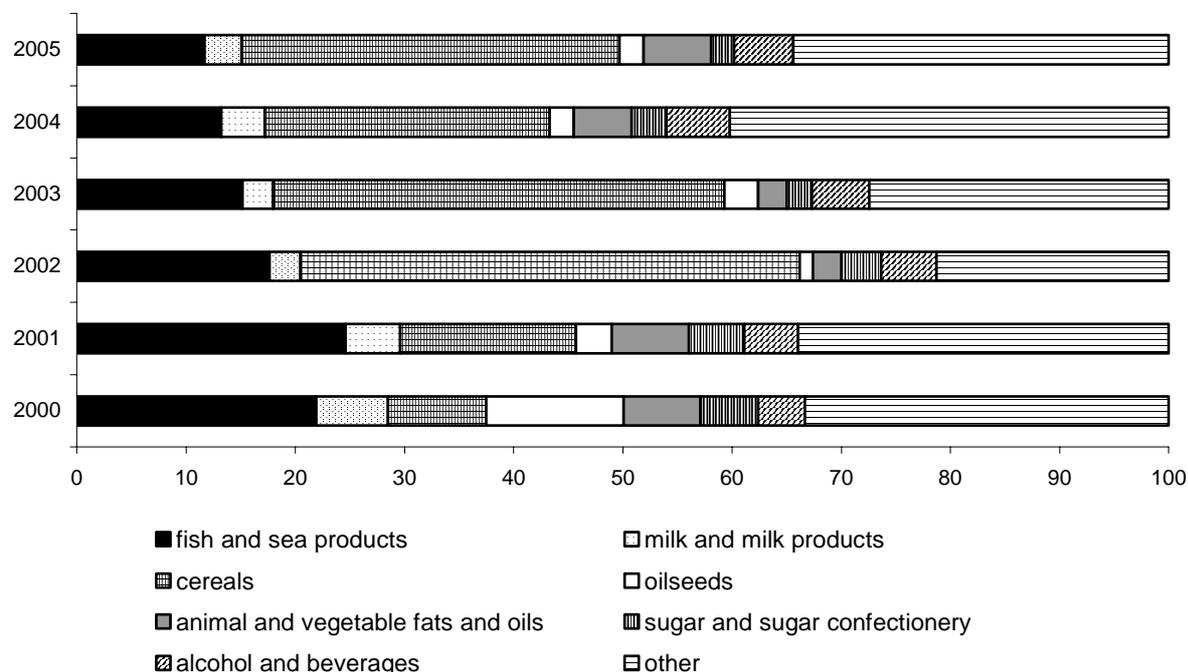
Source: calculated using data of RF Federal Customs Service.

*Fig. 58. Foreign trade in agricultural and food products, million dollars\**

The recovery growth that started in the domestic agrifood sector in 1999 revealed the basic segments where Russia has competitive advantages on external and home markets. This had an obvious impact on the commodity structure of foreign trade.

Grains became the principal item of Russian export having surpassed such a traditional item as fish and sea products (*Fig. 59*). In 2005 they accounted for

34.6% of the total food exports. The share of oilseeds in the export structure fell while that of sunflower oil increased (*Fig. 59, Table 62*).



\* - less trade with Belarus.

Source: calculated using data of RF Federal Customs Service.

*Fig. 59. Structure of Russian agricultural and food export, %\**

*Table 62*

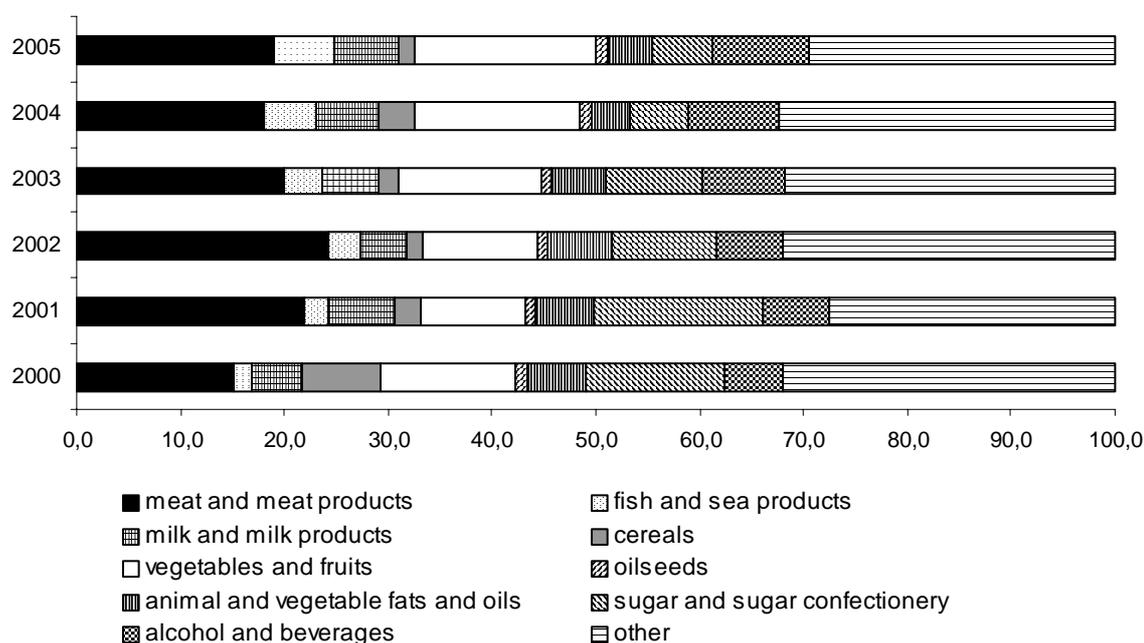
**Exports of basic agricultural and food products in 2000-2006,  
thousand tons\***

	2000	2001	2002	2003	2004	2005	9 months 2006 as % of 9 months 2005
Frozen fish	290.6	324.1	292.8	255.0	142.5	243.1	103.1
Wheat and wheat/rye mix	419.0	1635.7	10259.3	7587.9	4671.3	10319.6	93.8**
Barley	539.4	1594.7	3026.2	3099.0	955.0	1767.7	n.a.
Wheat flour	165.7	n.a.	122.8	288.6	134.3	231.0	105.8
Sunflower oil	194.8	115.3	74.2	84.1	145.1	313.6	264.8
Sunflower seeds	1114.9	n.a.	86.8	292.1	124.4	284.7	261.2
Bread and bakery products	34.3	36.9	38.6	52.6	64.4	75.3	106.1
Condensed milk and cream	73.7	45.6	35.0	11.3	35.4	41.2	76.5
Chocolate and cocoa products	25.7	35.1	35.1	42.2	54.2	69.4	94.1

\* - less trade with Belarus.

\*\* - 11 months 2006 as % of 11 months 2005.

Source: RF Federal Customs Service.



\* - less trade with Belarus.

Source: calculated using data of RF Federal Customs Service.

Fig. 60. Structure of Russian agricultural and food import, %\*

Table 63

Imports of basic agricultural and food products in 2000-2006,  
thousand tons\*

	2000	2001	2002	2003	2004	2005	11 months 2006 as % of 11 months 2005
Beef	282.3	459.2	504.6	507.8	510.9	696.2	101.4
Pork	212.9	369.6	602.0	535.2	455.2	562.9	
Poultry meat	687.2	1383.3	1375.2	1190.0	1101.3	1318.5	97.5
Condensed milk and cream	48.0	85.4	11.8	26.5	35.9	35.5	24.5
Butter	45.4	81.4	94.1	114.0	70.3	66.0	142.5
Sunflower oil	149.5	182.8	175.7	200.8	160.4	131.2	74.4
Wheat and wheat/rye mix	2631.3	916.2	264.8	640.7	1364.1	577.1	2.9 fold
Corn	702.2	206.8	448.9	209.5	448.8	200.6	150.3
Meat products and canned meat	20.6	25.1	19.2	24.7	34.3	33.7	77.1
Raw sugar	4546.6	5410.4	4441.0	4112.0	2582.9	2892.9	83.2
White sugar	271.4	143.1	163.2	151.1	200.1	144.9	75.6
Citrus fruits	472.2	562.1	701.3	781.1	858.4	952.6	125.1
Coffee	20.3	21.6	25.7	32.0	29.4	39.7	133.5
Tea	158.3	154.4	165.3	168.9	172.1	179.6	96.1

\* - less trade with Belarus.

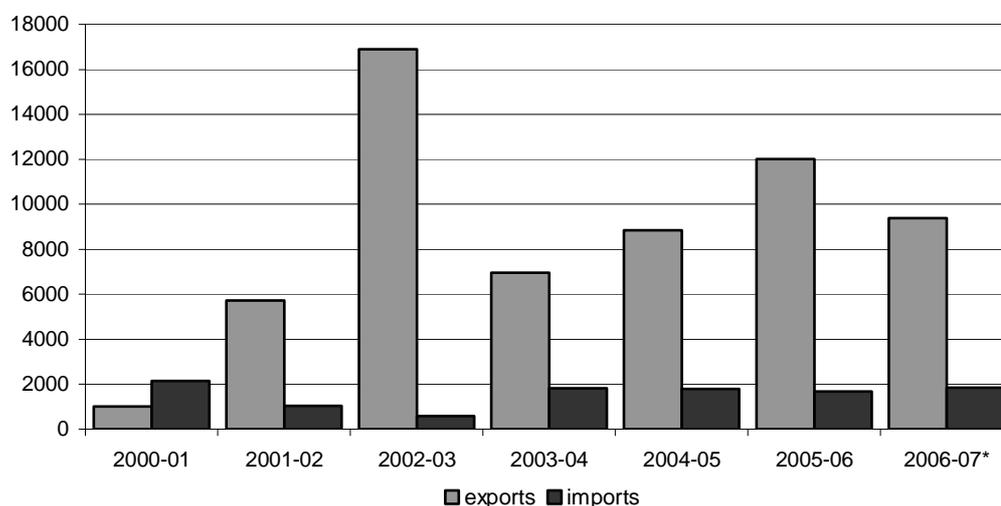
Source: RF Federal Customs Service.

The commodity structure of import has also changed in recent years. After the introduction of meat quotas in 2003 imports of meat (except beef) fell but already in 2005-2006 started to restore (*Table 63*). It's noteworthy that import supplies of meat exceed the set quotas. Meat still remains the principal item of Russian agri-food imports accounting for 20% thereof (*Fig. 60*).

The government foreign trade policy also influenced dynamics of sugar imports. Despite its bottlenecks (see the foreign trade policy section) the mechanism of variable import duty on raw sugar enforced in 2004 still resulted in smaller supplies from abroad (*Table 63*) thus encouraging rapid development of domestic sugar beet production. The trend became most apparent in 2006.

### Russia becomes a stable exporter of grain

All pessimistic forecasts saying that Russia has traditionally been an importer of grain, has no export infrastructure and therefore cannot export more than 5 million tons of grain a year have been disproved by massive export shipments that started in 2002 (*Fig. 61*). They were encouraged by low prices on the domestic market and high prices on the world market. Having appraised the benefits of grain export, private business started to make large-scale investments in the construction of respective port facilities. The government also allocated funds from the federal budget for partial subsidizing of interest on long-term credits for construction of port elevators. Now it's obvious that Russia becomes a stable exporter of grain. It occupied its niche on the world market exporting annually from 5 to 10 million tons depending on the domestic market situation.

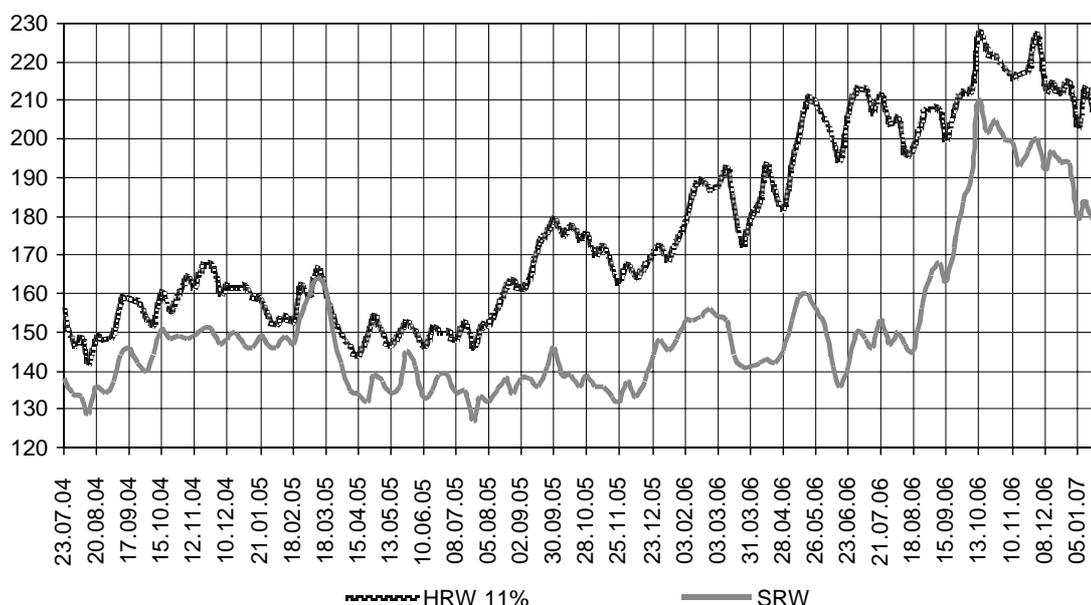


\* – forecast.

Source: WJ InterAgro.

*Fig. 61. Exports of grain from Russia, thousand tons*

In 2006 the competitiveness of Russian grain export was to some extent impaired by higher domestic prices for grain due to the development of livestock sector (hog and poultry production) and bigger consumption of grain for feeding purposes. However, the negative effect of this factor was somewhat mitigated by the upward price trend on the world market (Fig. 62). The foreign trade prospects for Russian exporters are not clear enough. In late 2006 – early 2007 growth of the world prices was superseded by their fall (Fig. 62) due to better crop forecasts in the US and EU. On the other hand, the still rather high prices on the world markets will result in smaller demand from African and Middle East countries being the key buyers of Russian grain. It should be noted that in recent years the geographic structure of Russian grain export changed. India became one of the largest importers of grain from Russia. Due to the effective quota restrictions on supply of grain to the EU Russian traders gradually move to other regions - in 2006 the EU countries accounted for only 9% of the total Russian grain exports (Fig. 63).



SRW – soft red winter wheat.  
HRW 11.0 – hard red winter wheat, protein content 11% (moisture 12%).  
Source: WJ InterAgro.

Fig. 62. Prices for US wheat, \$/ton FOB Gulf

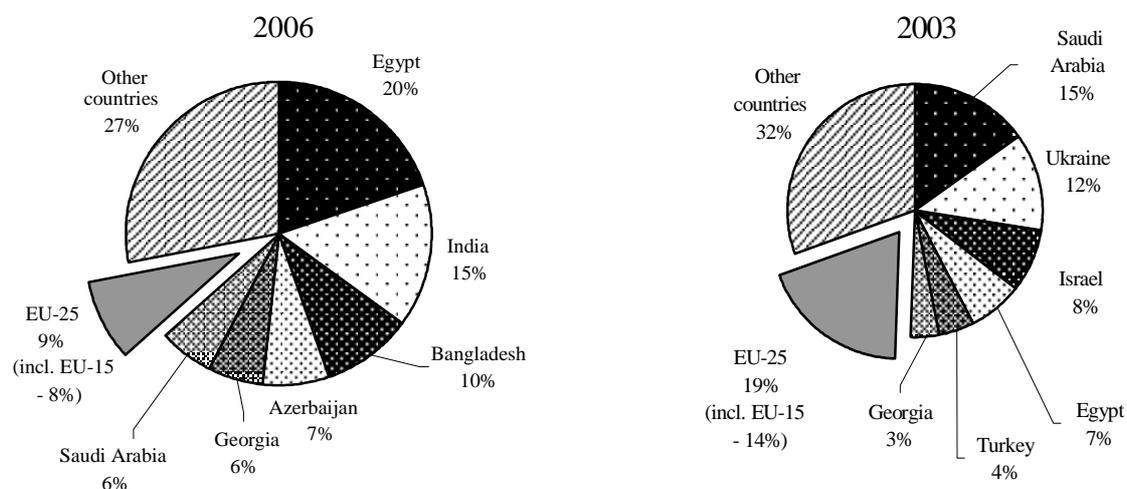
Table 64

**The world wheat supply and utilization balance**

	2002/2003	2003/2004	2004/2005	2005/2006	2006/2007*
Production	565	556	629	618	587
Trade	107	103	110	108	109
Consumption	601	595	616	622	607
Ending stocks	165	125	138	135	117

\* - estimate.

Source: International Grains Council (IGC), <http://www.zol.ru>.



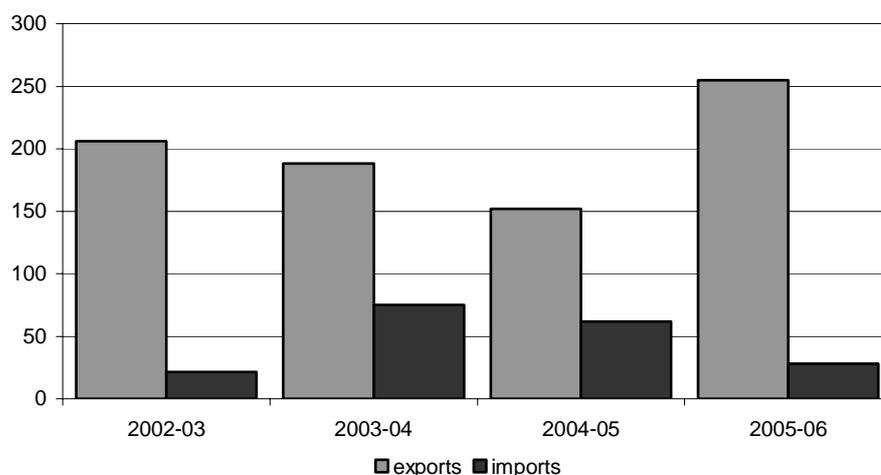
Source: calculated using data of WJ InterAgro.

Fig. 63. Geographic structure of Russian grain export

These are not only exports of grain that expand in recent years – exports of flour grow as well (Fig. 64). This is due to smaller domestic consumer demand for flour conditioned by diminishing population and decreasing average per capita consumption of flour in Russia<sup>18</sup>. So, the expansion of foreign demand can well become the factor counteracting stagnation of flourmill industry. From 2000 to 2006 the output of flour fell by 15.7%, output of bread – by 14%.

State policies don't always favour the expansion of grain export. In 2004 its volume fell notably due not only to poor crop in 2003 but also to the introduction of temporary restrictions on export of rye, wheat and wheat/rye mix. Grain interventions carried out in the country affect exporters' interests: they are supposed to raise domestic prices but no compensation is envisaged for exporters. In 2006 conditions for Russian grain export deteriorated due to higher transportation and port service tariffs. In 2007 railway tariffs were raised once again.

<sup>18</sup> According to data of the "SovEcon" Analytical Center the average per capita consumption of flour in Russia fell from 96 kg in 2000 to 92 kg in 2006.

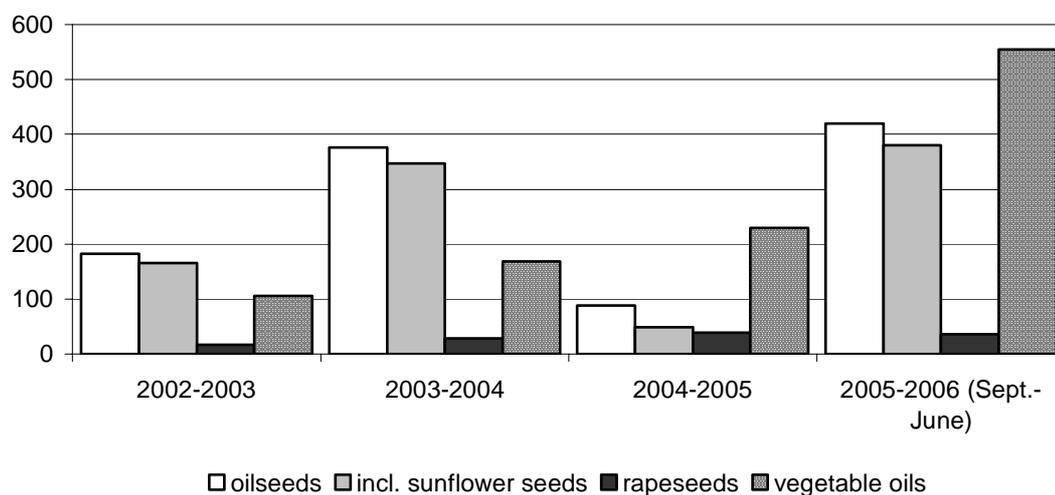


Source: WJ InterAgro.

Fig. 64. Russian exports and imports of flour, thousand tons

### Growing exports of oilseeds

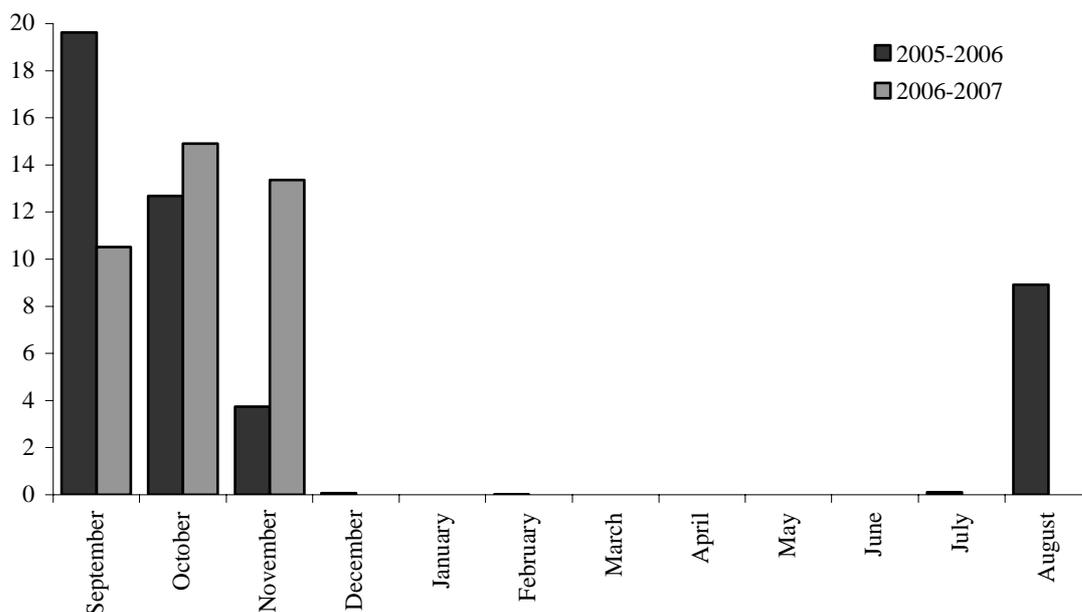
In recent years export supplies of sunflower oil are growing (Fig. 65). This trend originated in 2000 and was conditioned by expansion of processing facilities and larger domestic output of vegetable oils. As a result in 2005 Russia became a net exporter of sunflower oil while preserving its status of net exporter of sunflower seeds.



Source: WJ InterAgro.

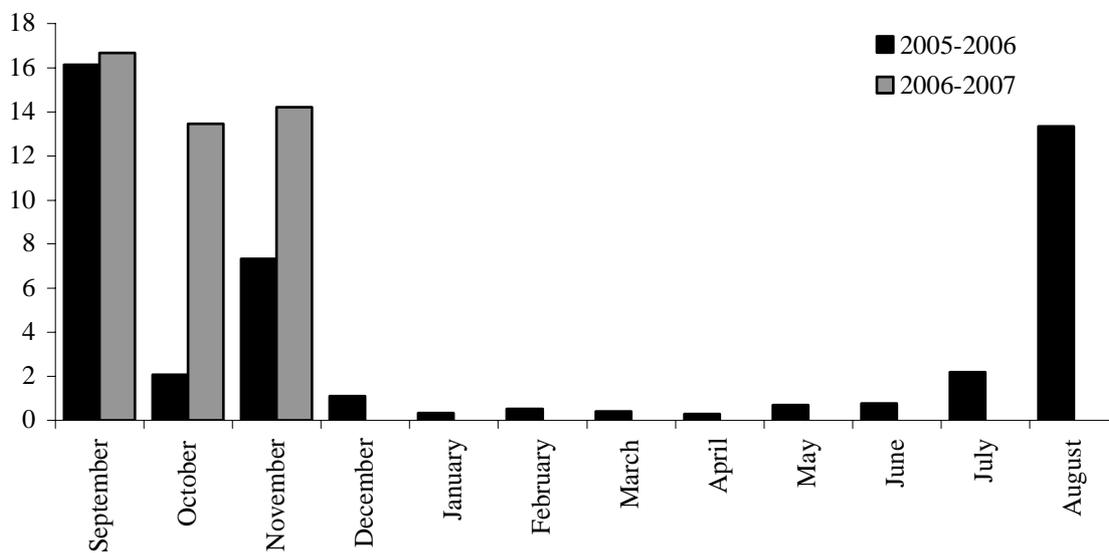
Fig. 65. Exports of oilseeds and vegetable oils from Russia, thousand tons

A new trend on the Russian market of oilseeds is the growing exports of rapeseeds (Fig. 66, Fig. 67). In recent years the world market of this crop is intensely developing due to the expanding manufacturing of biological fuel out of it.



Source: WJ InterAgro.

*Fig. 66. Exports of rapeseeds from Russia in 2005/2006 and 2006/2007 MY, thousand tons*

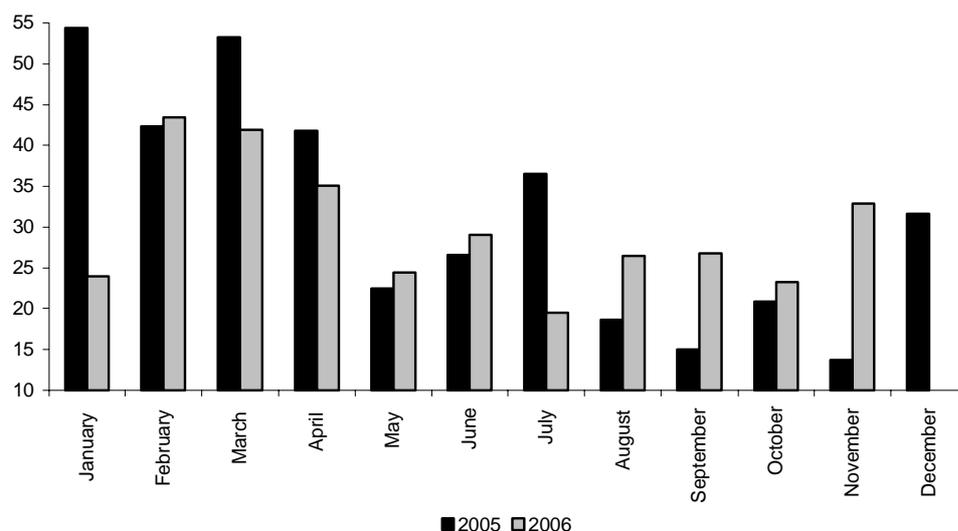


Source: WJ InterAgro.

*Fig. 67. Exports of rape meal from Russia in 2005/2006 and 2006/2007 MY, thousand tons*

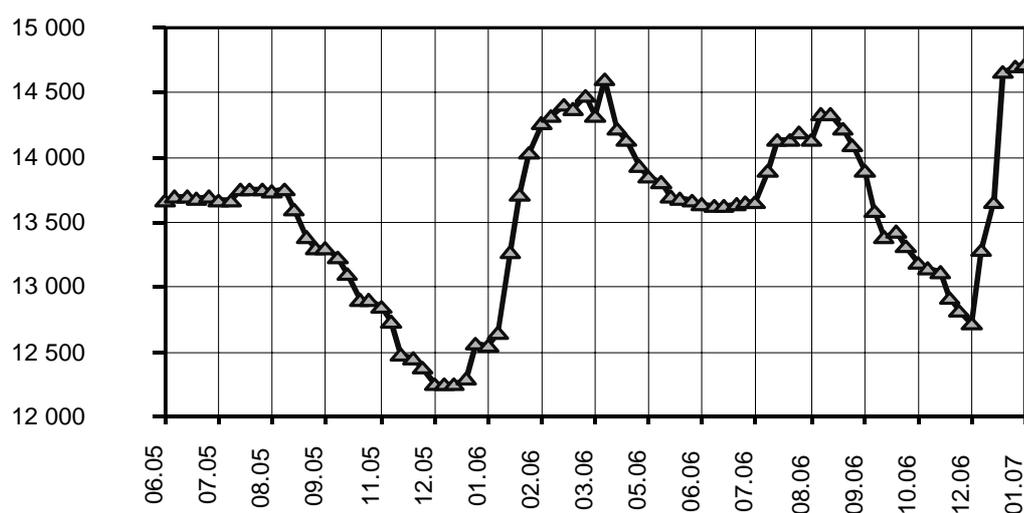
### Regulation of rice import

In January 2006 the import duty on rice was elevated from 10% but not less than 0.03 EUR per kg to 0.07 EUR per kg. This measure resulted in some curtailment of imports and an upsurge of domestic prices beginning from 2006 (Fig. 68, Fig. 69). In December 2006 import of rice to Russia was banned completely entailing one more price leap (Fig. 69).



Source: WJ InterAgro.

Fig. 68. Imports of rice to Russia, thousand tons



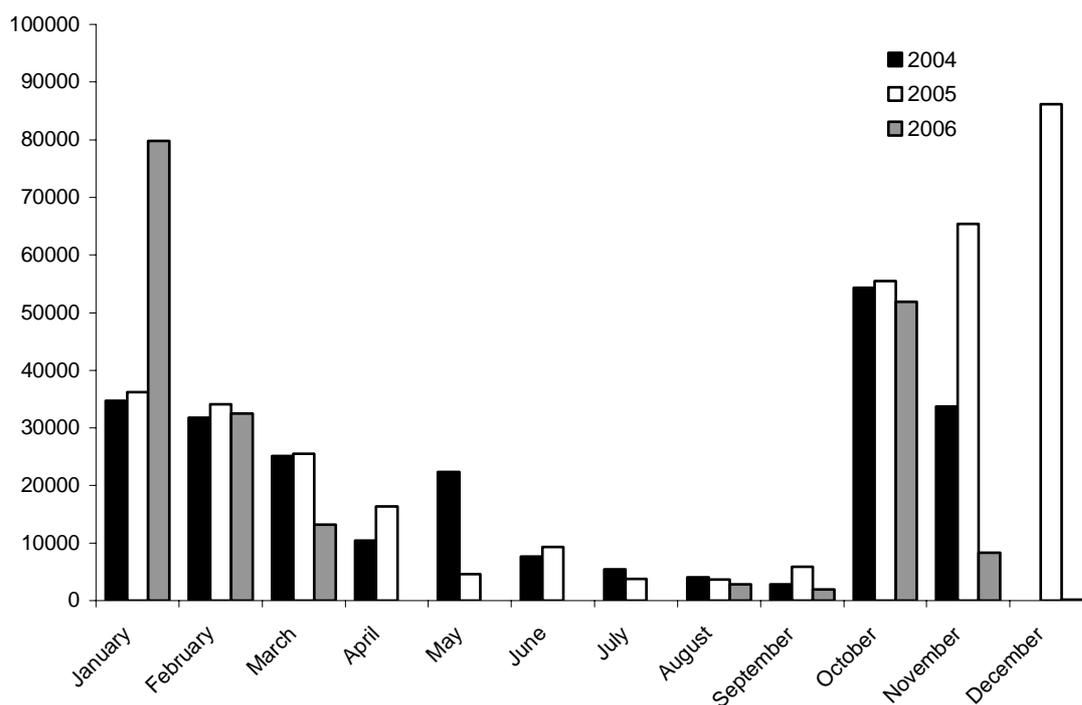
Source: WJ InterAgro.

Fig. 69. Average prices for rice #1, rubles per ton EXW

We would remind that the regulation of rice import became more active beginning from 2003 when duty thereon was raised. This measure also resulted in higher prices. Historically rice is grown in few regions of our country (primarily in Krasnodar kray) unable to meet market demand in full. Some quantities of rice have always been imported from abroad but they have never been large enough to depress domestic production of this crop.

### Regulation of sugar import

In December 2003 a new mechanism of sugar market regulation was introduced in Russia – the variable import tariff. Its effect was lessened by the actual lack of constraints on supply of sugar from the CIS countries accounting for 90% of the total Russia’s sugar imports. 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. Besides, in order to synchronize measures designed to regulate import of selected sugar-based products tariffs thereon (230 EUR/ton) were imposed. The mechanism of sugar import regulation resulted in larger domestic production of sugar beets. In 2006 sugar output exceeded 3 million tons – a historical record for Russian sugar industry.



Source: “New Informational Technologies”.

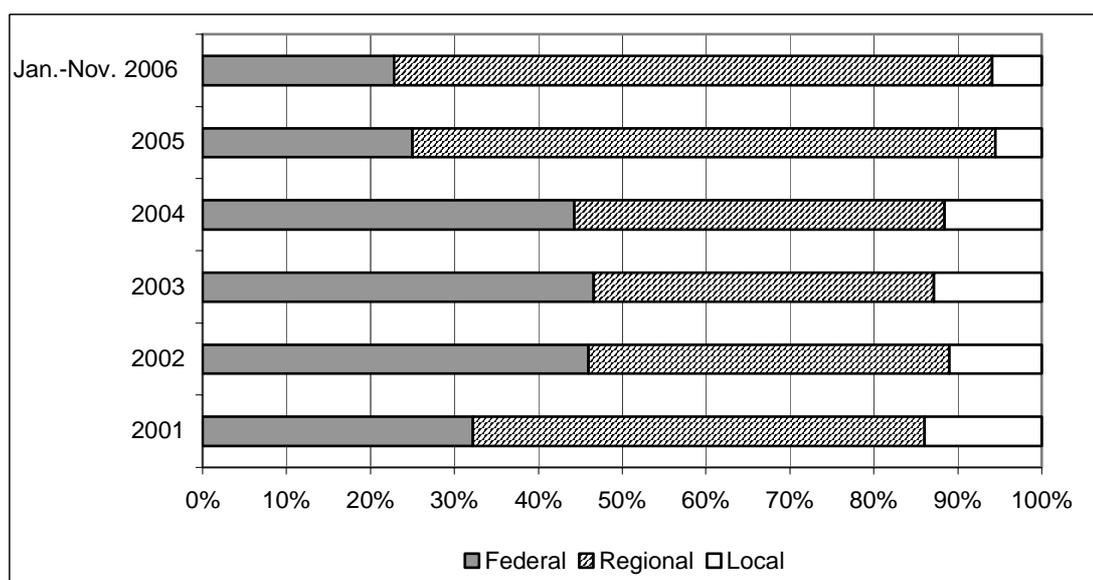
Fig. 70. Russian imports of sugar from Belarus, tons

A special problem is the duty-free import of beet sugar from Belarus. Under this guise the country exported to Russia cane sugar that according to customs regulations is subject to import duty. It’s obvious that such situation affected not

only Russian producers but also the RF budget. After the stiffening of control over import of sugar from the CIS countries supplies of white sugar from Belarus reduced (*Fig. 70*). To finally settle the problem the two countries signed an agreement according to which Belarus assumes self-restriction of white sugar export to Russia: in 2007 180 thousand tons will be supplied, in 2008 – 100 thousand tons. In 2005 Belarus exported to Russia 346 thousand tons, in 2006 – 190 thousand tons of sugar<sup>19</sup> while the total Russian sugar imports in 2005 amounted to 145 thousand tons, in 2006 – to about 100 thousand tons<sup>20</sup>.

### 3.5.7. Agrifood policies

In 2004-2006 important changes were made in the mechanism of budget support to agriculture. In compliance with Federal Law No. 95 of July 4, 2003 and Federal Law No. 199 of December 29, 2004 the subsidizing of agriculture was transferred to the competence of Federation's members. These laws delineate farm sector regulation competences only for 2005 but both the 2006 budget law and the proposed draft budget for 2007 also base on their provisions. As a result the share of federal budget in the consolidated budget expenditures on agriculture fell to a record low level – 23% (*Fig. 71*).



Source: [www.minfin.ru](http://www.minfin.ru)

*Fig. 71. Structure of consolidated agricultural budget*

The vesting of regions with exclusive powers to regulate agriculture will have the most destructive effect on the sector. First of all, regions-donors able to fi-

<sup>19</sup> According to railway statistics of "New Informational Technologies".

<sup>20</sup> Since there is no customs border between Russia and Belarus, supplies from this country are not included in import totals.

nance support to agriculture on their territories are primarily located in the climatic zones that are the least fit for farming. The shifting of farm budget support's gravity center from the federal to regional level leads to the encouraging of agricultural production in these regions implying non-efficient public resource utilization.

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. And all this took place despite high share of federal funds. The transfer of agricultural financing authority to regions will support the trend. 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 (meanwhile Russia wants to join this organization with its anti-protectionism principles).

#### Outcomes of transferring agricultural support authority to the regional level

The share of farm sector in the economy of regions, having the highest budget capabilities to finance it, is generally low. It's objectively conditioned by the fact that these regions are located in areas with the worst natural conditions for agricultural production. *Fig. 72* shows the distribution of Russian regions by their budget capabilities<sup>21</sup> and the role of farm sector in the economy<sup>22</sup>. It's obvious that the correlation between these two indicators is clearly negative.

According to these indicators all Russian regions can be divided in 4 groups. Since the area of regions in *Fig. 72* stretches from the left upper corner to the right lower corner, groups 1 and 3 are more numerous than the two remaining.

Let's examine the shifting of agricultural production to non-agrarian regions with high budget capabilities that started after the transfer of farm support authority to the regional level (*Fig. 73*). It's interesting to track the strengthening of this trend as time passes. Two years passed since the new delineation of competence was enacted. In the first year grain production was not biased at all – first, regional subsidies are primarily targeted at supporting livestock sector and, second, the time lag of policy effects in crop production is longer due to technological specifics. However, by November 2006 the shifting of grain production to non-agrarian though rich regions became apparent: their share in the total national grain output grew by 1.4% as compared with 2002-2004. The role of high-income non-agrarian regions in production of meat became more important as well – in 2005 their share in the total Russian output of slaughter livestock and poultry increased by 3.4% as compared with the 2002-2004 average, in January-November 2006 – by 4%. The

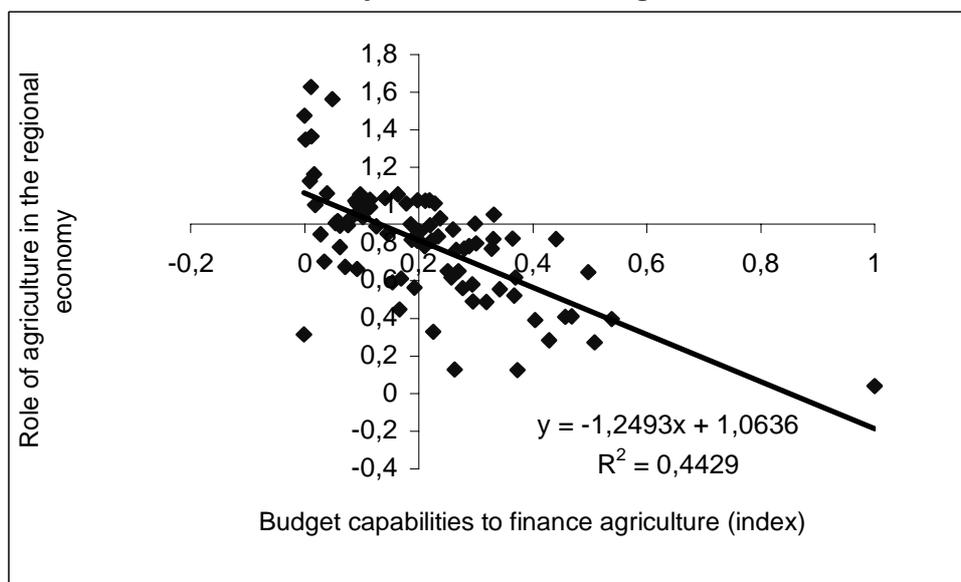
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<sup>21</sup> Index of budget capabilities:  $Find = EXPind + TRANSFind$ ;  $EXPind = EXP_{2002-2004} / N_{2002-2004}$ , where  $EXP_{2002-2004}$  – average expenditures of regional budget in 2002-2004,  $N_{2002-2004}$  – region's population in 2002-2004;  $TRANSFind = TRANSF_{2002-2004} / EXP_{2002-2004}$ , where  $TRANSF_{2002-2004}$  – average transfers to the region's budget from the federal budget in 2002-2004.

<sup>22</sup> Index of farm sector's role in the economy:  $AGRind = AGR_{2002-2003} / GDP_{2002-2003}$ , where  $AGR_{2002-2003}$  – average gross agricultural output,  $GDP_{2002-2003}$  – average gross regional product in 2002-2003.

2006 indicators displayed bias in the production of milk – the share of the first group grew by 2% while that of traditional agrarian regions fell by 4%.

The presented results show just the general trend – a serious shift of production could not occur in just one year. But even this marginal bias resulted in a certain loss of the sector’s efficiency and one should understand that as time passes both the bias and the efficiency loss will become greater.



Source: calculated using data of the RF Ministry of Finance and the Federal Service of State Statistics.

Fig. 72. Distribution of regions by budget capabilities and the role of agriculture in their economy

The need to retain at least some functions in subsidizing agriculture in order to avoid the above mentioned negative effects made the Ministry of Agriculture change the respective system by converting some subsidies into inter-budget transfers to the agrifood sector. Beginning from 2006 subsidizing of pedigree stockbreeding and elite seed breeding, subsidizing of interest rate on credits, support to insurance and even supply of seeds to northern regions are financed only in the form of inter-budget transfers. First, it makes the agricultural budget non-transparent – less than one half of subsidies to agriculture is financed under the sub-title “Agriculture” of the functional expenditures’ classification while the rest is included into the title “Inter-budget transfers”. Second, this type of subsidizing seriously distorts regional agricultural policies. Since federal transfers are granted on the co-financing terms, all regions start to implement the named programs in order not to lose federal transfers (i.e. each region will have a program of supporting, for instance, production of flax and hemp). The efficiency of respective federal programs as well as of spending regional budget funds on their co-financing will be extremely low. Besides, regions will become short of funds for implementing their own programs that are often more efficient than the federal ones and are more adjusted to regional priorities of agricultural development.

<b>Group 1.</b> High incomes (Find>0.9), low share of agriculture (AGRind<0.2)		<b>Group 2.</b> High incomes (Find>0.9), high share of agriculture (AGRind>0.2)	
	<b>2005</b>	<b>2006 (I-XI)</b>	
<b>Grain:</b>	<b>-0.5%</b>	<b>+1.4%</b>	
<b>Meat:</b>	<b>+3.4%</b>	<b>+4.0%</b>	
<b>Milk:</b>	<b>0%</b>	<b>+2%</b>	
<b>Group 4.</b> Low incomes (Find<0.9), low share of agriculture (AGRind<0.2)		<b>Group 3.</b> Low incomes (Find<0.9), high share of agriculture (AGRind>0.2)	
	<b>2005</b>	<b>2006 (I-XI)</b>	
<b>Grain:</b>	<b>-0.06%</b>	<b>-1.3%</b>	
<b>Meat:</b>	<b>-3.6%</b>	<b>-5.5%</b>	
<b>Milk:</b>	<b>0%</b>	<b>-4%</b>	

Source: calculated using data of the Federal Service of State Statistics.

*Fig. 73.* The changing role of high-income non-agrarian regions in the national agricultural production<sup>23</sup>

So, the principal problem of agricultural budget is the provisions of Federal Law No. 95. Unless they are abandoned, it will be impossible to implement normal agrifood policies.

#### National Project “Development of the agrifood sector”

2006 became the first year of implementing the National Project “Development of the agrifood sector”. Initially the Project’s term was 2 years but later the decision was taken to extend it into 2008-2009.

In 2006-2007 the National Project’s financing should amount to nearly 35 billion rubles (*Table 67*). This is quite a large sum – in 2006 funds allocated to the Project will account for 20% of the total federal expenditures on agriculture. In 2008-2009 the National Project will get almost 48 billion rubles.

The priority National project “Development of the agrifood sector” has three components: “Accelerated development of livestock sector”, “Facilitation of small-scale farming” and “Providing of young specialists (or their families) with affordable dwellings in rural areas”.

The following basic measures are envisaged to fulfill the task of accelerated development of livestock sector:

1. Extended availability of low-interest long-term (up to 8 years) credit resources for construction and modernization of livestock complexes. The principal implementation mechanism is the subsidizing of interest rate in the amount of 2/3

<sup>23</sup> The role of N group in production of a selected product (Share) was calculated by the formula:  $Share = YQ_i / Q_{RF}$ , where  $Q_i$  - is the output of this product in  $i$ -region within N group,  $Q_{RF}$  – the total output of this product in Russia.

of the Central Bank's discount rate on credits to commercial banks for the term up to 8 years for construction and modernization.

2. Larger supplies under the system of federal leasing of pedigree livestock, machinery and equipment for livestock production. The principal mechanism is the enlargement of "Rosagroleasing's" authorized capital. Interest on the use of "Rosagroleasing's" authorized capital for supplying pedigree livestock is cut to 0% per annum making leasing cheaper by 20% on the average. The term of leasing machinery and equipment to livestock complexes is extended to 10 years.
3. The guaranteed rate of foreign trade protectionism in livestock production. The principal mechanisms are the setting of quotas and customs duties on meat in 2006-2007 and further till 2009 in accordance with the existing inter-governmental agreements and the abolition of import customs duties on technological equipment for livestock production having no domestic analogues.

Facilitation of small-scale farming is to be ensured by the following basic measures:

1. Larger crediting of household and individual private farms and their cooperatives. The principal mechanism is the subsidizing of interest rate on credits received by them in commercial banks in the amount of 95% of the Central Bank's discount rate.
2. Support to developing the network of procurement, supply and marketing, agricultural consumer and credit cooperatives. "Rosselkhozbank" will use allocated funds for providing credit, informational and methodical support to these cooperatives. Besides, "Rosselkhozbank" is supposed to participate in agricultural consumer credit cooperatives as an associated member.
3. Development of crediting on the mortgage of land plots. In 2006-2007 a set of federal laws needed for establishing the system of crediting on land mortgage is to be adopted. In 2006 "Rosselkhozbank" will carry out pilot projects.

The basic tool for housing young specialists in rural areas is the construction and purchase of dwellings by entities at the account of subsidies from the federal budget (not more than 30%), from budgets of RF members (not less than 40%) and employer's own funds (30%) and granting of these rural dwellings to young specialists (or their families) under the commercial rent agreement.

Beginning from 2007 additional tasks were included into the Project: state support of sheep and reindeer production, drove breeding of horses and industrial fish-farming; extending the availability of credit resources for purchasing pedigree livestock, machinery and equipment for livestock production (credits on term up to 5 years). The most part of these tasks (except fish farming and horse breeding) are not new directions of state support – they simply insert programs effective in recent years into the National Project. In this way these directions get larger funds – in 2007 expenditures on pedigree stockbreeding will double as compared with 2006, 2.5 billion rubles are additionally allocated to medium (5-year) term credits and 8.6 billion rubles – to 8-year-term credits (versus 3.4 billion rubles in 2006 and the initially envisaged 3.18 billion rubles for 2007) (*Table 67*).

Formally the execution of the Project started in January 2006. However, the level of its readiness by this time was so poor that the first three months of the year were spent on elaboration rather than an actual implementation of the Project. Within this period its objectives and tools were defined more clearly, normative and methodical documents as well as implementation logistics were developed. Live-stock sector projects were prepared in regions that envisage subsidizing of long-term investment (up to 8 years) credits; an Expert commission for selecting these projects is working in the RF Ministry of Agriculture. "Rosselkhozbank" started selecting household farms for granting them credits; cooperatives are forming in regions. A lot is done for the Project's extension. In particular, the web-site of the RF Ministry of Agriculture contains a comprehensive description of the Project's contents and progress, a special brochure is issued. A hot line of the Centre for informational backup and monitoring of the priority National Project's implementation is opened in "Rosselkhozbank".

So far the Project's implementation is at the initial stage; therefore it's too early to appraise its actual efficiency on the basis of the sector's performance indicators. In January-November 2006 agricultural growth rate equaled 102.2% that is somewhat below the 2005 annual indicators (102.4%). The inventories of cattle and dairy cows continue falling although the Project is primarily targeted at growth in this particular livestock sub-sector. By December 2006 the number of cattle reduced by 2.7%, that of cows – by 5.6%. At the same time the number of hogs notably grew (by 10.7% as compared with December 2006). The output of milk in 2006 is slightly up as compared with the previous year (by 0.3%)<sup>24</sup>.

In 2006 1195 Project participants got credits to the amount of 53.2 billion rubles for financing 1400 projects in livestock production. The distribution of soft credits between federal districts<sup>25</sup> on the whole corresponds with their share in milk output (*Table 65*). However, while growth rates in production of milk and slaughter livestock and poultry were really the highest in the federal districts that received the largest share of funds under the National Project, the latter failed to stop the decrease of cattle and dairy cow inventories – it was the deepest in Central, Volga and Siberian regions despite their being the major beneficiaries of the Project in its "accelerated development of livestock production" part. At the same time hog inventories in these regions grew quite noticeably. This implies that agricultural producers probably use Project funds for hog breeding to a greater extent than envisaged by the project initiators since this sub-sector has shorter payback period and high profitability.

In the framework of the Project "Rosagroleasing" bought 50.2 thousand heads of cattle, 6.6 thousand heads of hogs and 48.1 thousand heads of sheep to the total amount of 3 billion rubles. Besides, 1 billion rubles was spent on purchasing equipment for livestock production and processing of respective output that allowed to modernize 78.7 thousand stalls.

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<sup>24</sup> Social and economic situation in Russia – 2006, [www.gks.ru](http://www.gks.ru).

<sup>25</sup> The territory of Russia is divided into 7 federal districts each including several oblasts or republics.

Thanks to the Project the turnover of this state corporation has grown enormously: in 2006 “Rosagroleasing” bought twice more pedigree animals than during all the preceding years of its operation while in 2005 only 6 thousand animals were supplied on leasing terms<sup>26</sup>. However, the total purchase of livestock in 2006 may exceed the previous year indicators just marginally – in 2005 farms bought 54 thousand heads of livestock. The average purchase price was slightly over 50 thousand rubles per one head or somewhat below the world market price (due to the purchase of pedigree livestock from domestic producers).

Table 65

**“Development of livestock production”: financing and effect  
by federal districts**

	Financing under “development of livestock production” title	Share in milk output, 2006	Milk output growth rate, 2006/ 2005*	Growth rate of livestock and poultry production 2006/ 2005	Growth rate of cattle inventories 2006/ 2005**	Growth rate of cow inventories 2006/ 2005**	Growth rate of hog inventories 2006/ 2005**
RF total	100	100	100.1	104	96.7	95.7	110
Central	27%	28%	97.6	108.1	93.6	91.6	117.1
North-West	6%	10%	98.3	99.8	95.3	93.4	103.1
Southern	10%	9%	101.9	105.6	100.8	100.9	117
Volga	41%	31%	102.2	103.1	97	95.2	106.3
Urals	4%	6%	102.1	99.5	98.4	96.8	103.1
Siberian	11%	15%	97.8	104.2	95.9	96	103.3
Far East	1%	1%	98.7	103.2	93.2	95.4	97.2

\* January-September.

\*\* October 1, 2006 as % of October 1, 2005.

Source: www.rost.ru, www.gks.ru

The major banks-participants of the priority National Project are “Rosselkhozbank” (Russian Agricultural Bank – 57% of the total number of signed credit agreements and 32% of the total amount of credit resources) and Sberbank of Russia (Russian Savings Bank – 31% and 41% correspondingly). As compared with the previous year the amounts of crediting grew by an order – up to 40 billion rubles from 3.4 billion rubles in 2005.

In 2006 the number of borrowers exceeded 130 thousand versus 2.5 thousand in 2005, household farms being the major contributors to this increase. Individuals engaged in household farming account for about 55% of extended credits, individual private farmers – for 32% and agricultural consumer cooperatives – for the rest<sup>27</sup>.

The development of crediting on land mortgage has started. In 24 regions of the Russian Federation “Rosselkhozbank” granted credits to the total amount of 2.1 billion rubles on the mortgage of about 84 thousand hectares of land. The cred-

<sup>26</sup> <http://www.rosagroleasing.ru/docs/report20061124.pdf>

<sup>27</sup> [http://www.mcx.ru/dep\\_doc.html?he\\_id=797&doc\\_id=11041](http://www.mcx.ru/dep_doc.html?he_id=797&doc_id=11041)

its were taken for construction and reconstruction of livestock complexes, purchase of farm machinery, equipment, spare parts, fuels and oils, seeds and seedlings, additional farmland plots and for development of smallholder farms.

In 2006 over 2000 agricultural consumer cooperatives were set up. Their forming was most intense in the federal districts that got more funds under the National Project (*Table 66*). Leaders in this field are Mordovia Republic, Belgorod and Orenburg oblasts and Sakha Republic (Yakutiya)<sup>28</sup>.

*Table 66*

**“Facilitation of small-scale farming”: financing and effect by federal districts**

	Financing under “facilitation of small-scale farming” title, %	Cooperatives formed, %
RF total	100	100
Central	20	28
North-West	2	10
Southern	19	9
Volga	38	31
Urals	4	6
Siberian	14	15
Far East	3	1

Source: [www.rost.ru](http://www.rost.ru), [www.gks.ru](http://www.gks.ru)

The system of subsidizing interest rate on credits to agriculture is implemented in Russia from 2000 and proved to bring good results. Several years ago long-term credits also became eligible for this program. The inclusion of this measure in the National project in general does not raise any doubt. However, slightly over 3 billion rubles per annum are envisaged for this purpose (*Table 67*) although the corresponding 2006 Budget indicator is about 13 billion rubles. In other words, this item of the National project does not seriously influence the level of state support in this field. At the same time, the National project envisages subsidizing of large and long-term (up to 8 years) credits although its own term is only 2 years (and may be extended into 2 following years). This means that investors joining the National project on these terms get involved in very risky investment projects since there is no certainty about continuation of interest rate subsidizing after the National project’s term is over. There is a danger that regional authorities will use “administrative resource” to make large agribusiness companies participate in such projects, and the potential risk will become quite real for them.

The program of developing livestock production envisages rather large investments in import of pedigree livestock from abroad. There are plans to buy 100 thousand heads of livestock and to lease them to agricultural producers. (By the way, this is in fact an official admission of the domestic selection’s complete failure). One should clearly understand that import of highly productive breeds from

<sup>28</sup> [http://www.mcx.ru/index.html?he\\_id=981&news\\_id=2981&n\\_page=1](http://www.mcx.ru/index.html?he_id=981&news_id=2981&n_page=1)

abroad *per se* does not guarantee high animal productivity in Russia since the latter is pre-conditioned by compliance with certain technological standards, reconstruction of premises, skilled management. Many Russian regions have already funded import of pedigree livestock from regional budgets but these efforts proved to be non-efficient. Certainly, there are private businesses that are capable to meet all the requirements but the prescribed implementation scheme leaves no hope for success of this particular project component. Indeed, it starts with allocating 8 billion rubles to limited liability company “Rosagroleasing” for the enlargement of its authorized capital. This state corporation is supposed to buy pedigree stock that will be distributed between agricultural producers on preferential terms. Life shows that our agrarian bureaucratic system knows no other way of distribution than the one by so called limits that are set for regions, districts and agricultural producers. This means that pedigree livestock will be supplied not to the farms (or not always to the farms) that are capable to use it properly. “Rosagroleasing” is not interested in the efficient use of received funds: the corporation gets allocations not specifically for leasing operations but for the enlargement of its authorized capital conditioned by conducting of leasing operations. The scope of these operations is expectedly not fixed in the documents.

Purchase of 100 thousand heads of pedigree livestock within 2 years is proclaimed. It's quite a large number for the respective world market. Experts say that the available supply is shorter. This means that in order to implement the project livestock with worse quality parameters will be bought. Besides, an *a priori* announcement of such a sizeable purchase will inevitably result in higher world prices. In other words, not the best livestock will be bought at overstated prices.

Credits to small producers are to be supported by subsidizing of interest rate that will amount to 100% of the RF Central Bank's discount rate (95% will be funded from the federal budget and 5% - from budgets of the Federation's members). Such a subsidy actually means a negative interest on bank credits. Agricultural producers could enjoy similar super-beneficial credit terms in 1992 (then individual private farmers got credits at 8% per annum while average bank interests were as high as 120%). This resulted in an intense criminalization of the sector, mass abuses, dissipation of resources and finally – in the bankruptcy of Agroprombank. The advocates of this measure proceed from good intention to provide access to bank credit for small producers but disregard the fact that there are no barriers to prompt creation of small entities just in order to receive such a beneficial credit. To get the status of a household farm it's enough to buy a house in a village and to till 0.01 ha for planting potatoes.

Similar to its first part, the second part of the National project is also inconsistent. It envisages support to cooperatives marketing milk from households. The authorities still think that rural residents can earn money for decent living by selling milk of 1-2 cows. What's the logic then? On the one hand, we assist development of large-scale production by importing highly productive pedigree livestock for large commodity corporate farms and by facilitating their modernization, and, on the other hand, we support old women with their tiny milking business. But these are

competing sectors. When supporting milk collecting cooperatives we create competitors for large commodity enterprises that will buy imported highly productive dairy cattle. Rural population urgently needs help in the form of providing alternative income sources (the more so in case the first part of the project succeeds – then rural employment will further fall since handling of productive cows at farms with advanced technology requires 3-4 less workers than today) but why should it be solely household milk production?

What are the expected results of all the named measures? 130 thousand stalls are to be created. Let's suppose that half of them will be created in dairy cattle production and the sector will attain the European level of 8 thousand liters of milk produced per cow annually. Even given this super good performance milk output will increase by slightly over 0.5 million tons per annum while currently the gross domestic output of milk exceeds 30 million tons. The outcome of all the planned measures will be the growth of milk output by 4.5% and meat output – by 7% within 2 years. Let's suppose that the profitability of milk production will become incredibly high – 30%. If so, the profit from additionally produced milk will be about 5 billion rubles. Even in case milk production gets only one fourth of the National project's funds, the efficiency of their use will be below 100%. The situation for meat is similar.

There is one more problem that can have long-term negative effects. The major measure targeted at the development of cooperatives in the framework of the National project is the enlargement of "Rosselkhozbank's" (Russian Agricultural Bank's) authorized capital by 9.4 billion rubles within 2 years. "Rosagroleasing's" authorized capital is also to be enlarged by 8 billion rubles in order to implement such measures as import of pedigree animals and renovation of fixed capital in livestock production. So, the implementation of the National project is largely (56% of the envisaged expenditures) confined to the transfer of budget funds to state corporations-monopolists. The intended monopolization of input and financial markets in agriculture hinders their normal development and affects farm producers' access to these resources. On the other hand, neither "Rosselkhozbank" nor "Rosagroleasing" needs enlargement of authorized capital to fulfill functions assigned by the Project. They could cope with their mission even if these funds were simply transferred to their management.

Besides, the initial stage of the Project's implementation revealed some other risks. In particular, the lack of standard designs of livestock farms may result in financing of technically deficient and too expensive projects.

The super-soft crediting of rural residents may also bring negative effects. First, it opens an opportunity for fraud on the credit market. The situation was similar in 1992 when individual private farmers got credits at 8% per annum while the average interest rate in the economy at large surged up to 210% provoking re-sale of these credits. Second, these credits are primarily used for consumer purposes (there is information about a rapid growth of consumer crediting in regions after the Project was launched) implying no sources for their reimbursement. Finally, low-interest money in countryside accompanied by higher prices for alcohol (due to the

new regulation of alcohol market in the country) will inevitably bring about an upsurge of hard drinking and shadow turnover of home-brewed alcohol in rural areas.

One of the basic problems of agricultural and rural development in Russia is the excessiveness of agricultural labour aggravating as productivity of this sector grows. Nowadays the commodity agricultural production accounts for only 1/3 of rural employment. The excessive able-bodied population is ousted to the sector of household farming that produces competing agricultural output with lower productivity. Such a dualism on the rural labour market cannot fail to result in lower incomes from agricultural employment. The opportunities for alternative employment in rural areas are still very scarce and include mainly gathering of wildy growing species, non-formal intra-village services and infant rural tourism. This employment is non-formal and non-regular. It primarily attracts marginal population ousted from principal employment. In this situation the country needs strong rural development policies oriented towards creation of adequate off-farm employment in rural areas. Regardless of this, in the framework of the National Project rural residents can get credits only on agricultural activities that will further aggravate the situation.

Moreover, this complicates implementation of the programs for creating alternative employment already launched in regions. For instance, Perm kray succeeded in establishing municipal funds of rural crediting that for several years have been granting small and tiny credits to rural population for any economic activities. Cooperatives created in the framework of the Project credit only farming. Therefore, not to lose a part of federal financing parallel cooperatives need to be founded in the region.

All state support in the form of credit on mortgage will be provided through only one bank – “Rosselkhozbank”. In case such crediting becomes a commercially profitable project, this approach will engender unjustified monopoly of one bank on the respective market with all the associated monopoly costs for borrowers. If one supposes to develop crediting on mortgage as a social project (commercially non-profitable) this will inevitably result in bankruptcy of “Rosselkhozbank” which was already the case with its predecessor “Agroprombank” in 1994-1995 when it granted commercially disadvantageous credits to agriculture. Both scenarios contradict the goals of national agrifood sector development.

Finally, there is one more serious deficiency of the Project’s logistics. The National Project does not comprehend all the agricultural policy issues. At the same time its implementation requires so much effort from the sector’s administration that all other fields of work get simply halted.

### Subsidizing of prices for fuels and oils

Farm producers’ complaints about growth of prices for fuels and oils could not be ignored in the agricultural policies (*Fig. 75*). The decision was taken to start direct subsidizing of prices for fuels and oils used by farm producers beginning from 2006. 5 billion rubles (about 10% of the federal agricultural budget) are allocated in the budget for partial compensation of their cost. The principal danger of

this measure is that no mechanism of control over the use of subsidized fuels and oils is envisaged to prevent their outflow to parallel markets. Similar measure in the West European countries is combined with either distribution of subsidized fuel per hectare of cultivated area or with its colouring. Besides, in Europe this subsidy actually implies abolition for farmers of very high excise on fuel (about 70%) that coupled with control over use of this fuel exclusively in agriculture results in lower cost of this input. In Russia excise on fuel is not an essential factor of price growth. Since prices for fuel for farm producers tend to rise during periods of mass agricultural works (*Fig. 75* illustrates the trend – in 2005 and 2006 prices for fuels and oils surged in April and October) the main problem is not the price for fuel *per se* but the peak demand for it. Peak demand for fuels and oils coincides with simultaneous sale of farms' output resulting in seasonal drop of prices for agricultural products. The outcome is price disparity affecting agriculture. Thus the problem should be solved not by subsidizing prices for fuels and oils (the subsidy will eventually outflow to the fuel and energy complex) but by enabling farm producers to extend the sale of their output throughout the marketing year, to get credit on the security of this output and to consequently buy the necessary inputs more evenly during a year.

#### The law “On agricultural development”

After four years of Russian agrarian establishment's continuous work on Law “On agricultural development”, it has at last been adopted by the State Duma and signed by the President (on December 29, 2006).

The start of recovery growth in the domestic agrifood sector after 1999 necessitated legal regulation of agrifood policies. By this time a rather strong agribusiness sector emerged in the country that was interested in and able to lobby for adoption of such legislation, market-consistent agrifood policy tools formed on both the federal and regional levels. It should be also noted that similar legislation efficiently works in almost all developed countries. The most illustrative example of such a law is the so-called *US Farm Bill* adopted each 5-7 years starting from the 30s that details the US agricultural policies in the medium run.

At the beginning of 2000s the consistency of medium-term farm policies also became an urgent problem in Russia. Growth in the sector after the 1998 crisis, the involvement of large investors in agriculture and affiliated sectors necessitated predictability of state interventions on agricultural and food markets within the investment terms – at least 3-5 years. So far agricultural policies based on annual budget laws and annual government resolutions on support to agriculture. Thus the first and principal objective of the new law was the extension of state policy planning term in the sector.

One would think that given the ongoing budget reform and the transfer to 3-year-term budget planning the idea of agricultural law embracing 3-5 years should have got the most vigorous support from the Federal Ministry of Finance. But the actual collision when passing the law was the confrontation of the Ministry of Agriculture and the Ministry for Economic Development and Trade with the Ministry of

Finance that was flatly against adopting the law with definite budget parameters of state agrifood policies for 3-5 years. The outcome of this long confrontation was a compromise: instead of a law (or two laws) setting parameters of state policies in the medium run, a framework law was adopted envisaging State program for 5-year term with detailed outlining of tools and scale of agrifood sector financing. In the current situation the passing of the Law “On agricultural development” is surely a progress fostering development of the domestic agrifood sector.

The new law introduces the notion of State program that is fully consistent with the concept of result-oriented budgeting. The Program is to set priority targets for agrifood sector development in the medium (5-year-long) term. These targets involve designation of specific tasks to be carried out through respective sub-programs. Sub-program is a set of government regulation tools in the sector. Each sub-program specifies goals and, respectively, indicators of their achievement, mechanisms of state regulation and the amount of funds to be allocated from the federal budget in each year of the program’s implementation. In principle, State program of this kind should provide a stable basis for development in the agrifood sector, make its investment climate more attractive and serve as a guide for agribusiness.

According to this law, when working out agrifood policy decisions the government must (!) involve producer unions and associations concerned. It’s a remarkable step forward not only in elaborating of realistic and balanced agrifood policies but also in forming of civil society in the country. Though, the law requires such unions and associations to produce “over two thirds of the total output of selected agricultural and food products and materials on the territory of Russian Federation”. So far, there is hardly any union in the country conforming to this requirement. On the other hand, the prospects for real participation in agrifood policy shaping may encourage producers to form real associations widely representing the sector and having more democratic (as compared with the existing ones) operating rules.

According to the law, State program is the basic document establishing agrifood policies for 5 years. Its implementation is the responsibility of RF Ministry of Agriculture that has to make annual reports not on the performance of agrifood sector in general (which was the case so far) but on the implementation of specific sub-programs within the State program, i.e. on the results of its work. The law envisages preparation and promulgation of an annual National report of the Ministry of Agriculture. Moreover, a year before the end of State program an expert commission is formed including representatives of agrifood sector, independent analysts and government officials (their share is limited to one third of the total number of commission members in order to make the assessment of government’s activities under the State program really extramural and independent). The task of this expert commission is to evaluate the results of State program’s implementation, to estimate the efficiency of designated tools and to decide what has to be preserved, what has to be adjusted and what – to be abandoned. The commission’s conclusions have to be promulgated but they are only recommendatory for the govern-

ment – a useful input for working out a next State program. This is the so-called feedback. Presently many tools of agrifood sector’s state regulation continue to be applied just due to inertia and lack of information on their efficiency. The expert estimation of Program’s performance is to improve the situation.

Altogether the described measures make the procedure of shaping agrifood policies in the country more transparent, democratic and quite consistent. No doubt, it will actually be such if agrifood market operators wish and are able to participate therein and do not keep aloof.

For the first time the law established the list of information essential for agrifood markets and the regularity of its publishing that the government has to observe. This information is to be placed on the website of the Ministry of Agriculture ensuring equal access for all the parties concerned (presumably a farm producer having no access to Internet does not need the up-to-date market information badly). One more important aspect of the adopted law is the ultimately accepted postulate that rural social development is a component part of domestic agricultural policies.

The law inherited a lot from the previous law “On state regulation of the agrifood sector”. Its text largely consists of description of possible government regulation tools; some articles depict mechanisms of specific sub-programs (e.g. support of credit, insurance, interventions). These articles *a priori* have no legal implications: it’s absolutely impossible to answer one essential question – the state must or just can carry out these measures? In case it must but funds thereon are not allocated in the federal budget approved by the legislative assembly, who is to blame? Therefore we find that a large part of the adopted law should be regarded as “white noise”, a tribute to legal immaturity of the country’s agrarian establishment. At least, there won’t be any harm from these provisions.

The State program for 2008-2012 should be worked out by April 2007; otherwise all the envisaged measures won’t be included in the budget for 2008 and 2008-2010. The program should not be too ambitious, i.e. attempt to fully revise the effective agricultural policies. To our mind, the complex arrangement and marginal correction of the currently applied policy tools on the federal level can be a good start for the new system of agrifood sector regulation in Russia.

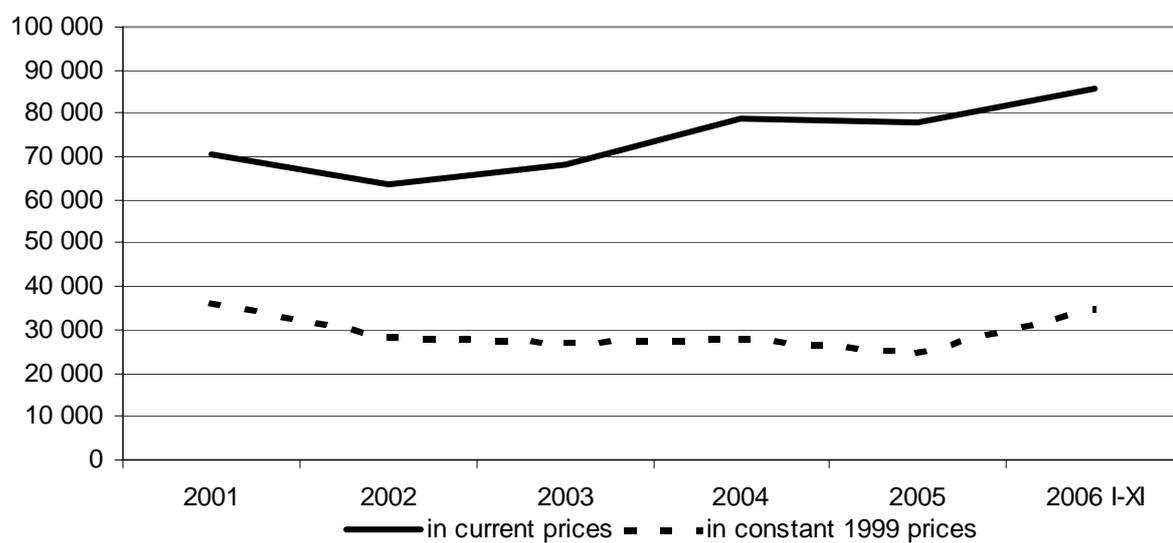
Table 67

**Financing of the National project “Development of the agrifood sector”,  
billion rubles**

	2006	2007	Total
1	2	3	4
<b>Accelerated development of livestock sector</b>			
Subsidizing of interest rate	3.45	3.18	6.63
Enlargement of “Rosagroleasing’s” authorized capital	4	4	8
<b>Facilitation of small-scale farming</b>			
Subsidizing of interest rate	2.9	3.67	6.57
Enlargement of “Rosselkhozbank’s” authorized capital including assigned to:	3.7	5.7	9.4

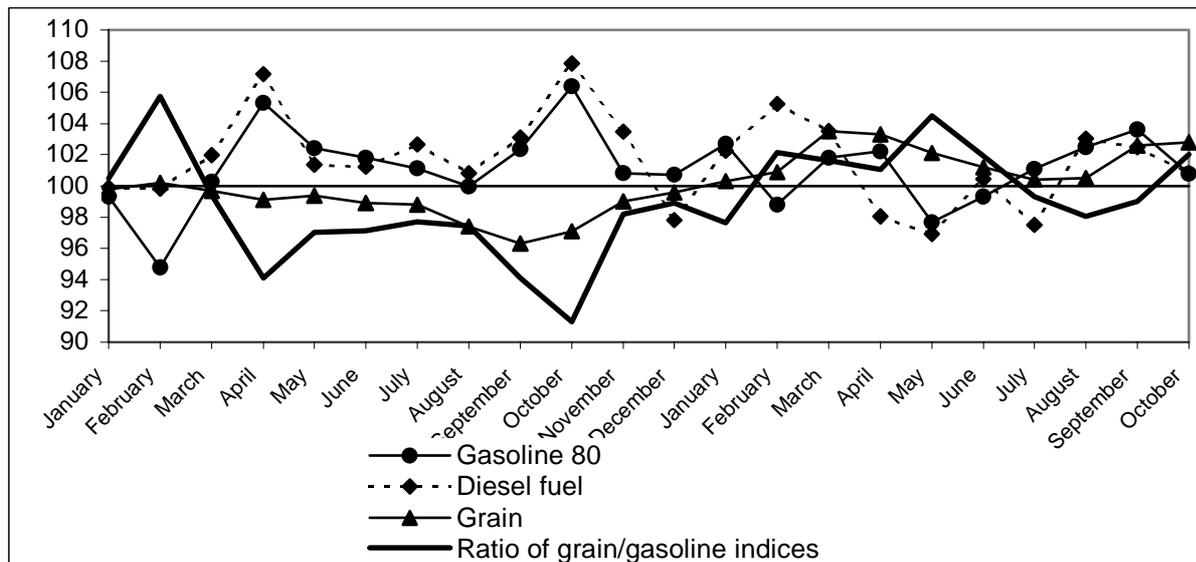
	1	2	3	4
development of the network of consumer cooperatives engaged in procurement, input supply, marketing and processing of output produced by smallholder farms		2.6	3.5	6.1
development of rural credit cooperation		1.0	1.0	2.0
creation of crediting system based on land mortgage		0.1	1.2	1.3
Methodological and informational support		0.15	0.15	0.3
<b>Subsidizing of construction (purchase) of dwellings for housing young specialists (or their families) in rural areas</b>		2.0	2.0	4.0
<b>TOTAL</b>		<b>16.2</b>	<b>18.7</b>	<b>34.9</b>

Source: RF Ministry of Agriculture.



Source: www.minfin.ru

Fig. 74. Consolidated budget expenditures on agriculture, million rubles



Source: RF Ministry of Agriculture [www.mcx.ru](http://www.mcx.ru), Federal Service of State Statistics [www.gks.ru](http://www.gks.ru).

*Fig. 75. Prices for agricultural products, gasoline and diesel fuel in 2005-2006, as % of the previous month*

## Section 4. Social Sphere

### 4.1. The Population's Finances and the Consumer Market

**Money incomes.** The year 2006 saw continuing growth of the population's real money incomes, which had begun in 2000 – a post-crisis year. During 2000–2005, the growth rate of real disposable incomes of the population against the previous year's level was fluctuating between 10% and 15%, and in the first half-year 2006 it amounted to 11.2%, while in the year 2006 as a whole – to 10%.

In the three past years, the same month-by-month “picture” of income fluctuation was repeating itself: in January, the real incomes of the population, owing to the typical January leap of inflation and decreased economic activity, on the one hand, and large-scale payments to the population in December, on the other, are only slightly higher than 50% of the December incomes. Then, in the first and second quarters, a rather slow growth of incomes can be seen, in the third quarter and during October–November almost no growth of incomes can be seen, and in December one more leap occurs. Growth of incomes in December by comparison with November is more than 40%, while growth of salaries is relatively lower – approximately 25%, and so accelerated growth is demonstrated by property incomes, and incomes from entrepreneurial activity, and other incomes.

On the whole, in 2006 the average per capita incomes of the population, computed by month, amounted to 9,911 roubles (in December – to 14,757 roubles). Due to a number of equalizing social allowances (being paid within the framework of the ongoing “monetization of privileges”), the interregional differentiation of incomes was somewhat leveled: thus, e. g., the average per capita incomes registered in the city of Moscow were in September 2006 by 3.5–6.4 times higher than the corresponding induces computed for the oblasts within the Central Federal Okrug, while a year earlier this ratio had been 4–6.8 times. The interregional differentiation of incomes remains the highest in Moscow – the difference between the incomes of the most prosperous 20% and the least prosperous 20% of the population is greater than by 20-fold; this ratio is also increasing in other oblasts of the Central Federal Okrug, but it is still no greater than 6–7-fold.

Real wages in the first half-year 2006 increased by comparison with the corresponding period of 2005 by 12.3%, while during that year as a whole – by 13.5%. The growth rates of real wages in 2006 by were 3.5 p.p. ahead of the growth rates of the population's real incomes. Throughout the year, arrears of wages were decreasing, alongside the decline in the number of employed, which in 2006 was 600,000 against 1,300,000 in December 2005. The interregional differentiation of wage levels was somewhat less prominent than the differentiation of incomes – the gap between the leader region (Chukotskii Autonomous Orkrug) and “the outsider” region (Dagestan) was by 5 times.

Table 1

**The structure of money incomes of the population in 2000–2006 (in %)**

	2000	2001	2002	2003	2004	2005	2006
Total money incomes	100	100	100	100	100	100	100
Incomes from entrepreneurial activity	15.4	12.6	11.9	12.0	11.7	11.4	11.2
Wages	62.8	64.6	65.8	63.9	65.0	64.8	66.4
Social payments	13.8	15.2	15.2	14.1	12.8	12.9	13.2
Property incomes	6.8	5.7	5.2	7.8	8.3	8.9	7.2
Other incomes	1.2	1.9	1.9	2.2	2.2	2.0	2.0

Source: the Rosstat.

The share of wages in the structure of money incomes was found to be the highest since 1992 (*Table 1*). In a majority of Russia's regions in 2006 (September data, with the exception of Moscow, St. Petersburg, Samara Oblast, Tambov Oblast and Volgograd Oblast, Perm Krai, the Republics of Bashkortostan and North Osetia-Alaniya), average wages were higher than average per capita incomes, although in Moscow – due to a fundamentally different structure of incomes – it amounted to only 60% of the level of average per capita incomes. It should be noted that in recent years the ratio of average wages to average per capita money incomes became higher – mainly because of the shrinking share of the so-called “unobservable” economy (in 2005 it was 53 %, while in 1997, prior to the crisis, – only 41%).

The inter-branch differentiation of the average wage levels by type of economic activity decreased, as compared to the year 2005. The status of those employed in the public health care system became markedly better – by late 2006 their wages already amounted to 78% of the average Russian level, while a year earlier to only 70%. At the same time, during the analysis of statistical data it was taken into account that, from January 2006 onward, the Rosstat began to publish data by “pure” type of economic activity, generated on the basis of the information submitted by organizations by each of their actual type of activity. In 2005, the data were distributed by “economic” types of business activity, when the information concerning all the types of activity being carried out by an organization was linked to its main type of activity.

In 2006, the material status of pensioners, by comparison with that of the employed, was steadily becoming worse. The ratio of the average pension to the average monthly wage, which decreased in the previous years from 31.6% in 2001–2002 to 27.6% in 2005, by the Q III 2006 had gone down to 25.6% (which roughly corresponds to the ratio that existed in the post-crisis year 1999) At the same time, the purchasing power of pension increased, as compared to the early post-crisis period: while in late 1999 the average pension was by 25% lower than the subsistence level of a pensioner, in late 2006 in the central areas of Russia, where the official subsistence level is computed, it was already approximately by one quarter higher than that same index.

The ratio of the average wage to the subsistence level of the employable population in 2006 somewhat improved – thus, e. g., in Q III 2006 in Moscow it

amounted to 3.2, having been 2.8 a year earlier, while in St. Petersburg – to 3.35 and 2.99, respectively.

The poverty level and the degree of inequality of the population by income level in Russia are noticeably higher than in the developed world and the countries of Central Europe. The results of household surveys published by the Rosstat have demonstrated that the year 2006 once again saw the resumption of growth of the population's inequality by income level, and the share of the highly prosperous population in society's total income become larger. The prices of commodities and services constituting the subsistence basket were growing more rapidly than the general consumer price index. In this connection, accelerated growth was observed both in respect of foodstuffs and non-food commodities, and particularly – that of tariffs on services. Throughout 2006, a rather sharp rise in the value of the subsistence level occurred. On the whole during that year, the subsistence level in those regions where that index was computed grew approximately by 20 % (Q III 2006 against Q III 2005)

In 2005–2006, the procedure applied in Russia for computing the subsistence level was changed, after the enactment of Federal Law of 31 March 2006, No. 44-FZ, "On the consumption basket on the whole in the Russian Federation". However, despite the requirements established by the law, the Government of the Russian Federation did not approve the new Methodological Recommendations for determining the size of the consumption basket for the main socio-economic population groups across the Russian Federation and in subjects of the Russian Federation. As a result, at the federal level no official subsistence level index in 2005–2006 was established.

Presently, the average annual subsistence level indices in Russia are established by the bodies of state authority of the Federation's subjects, while no centralized control over the uniformity of approaches, to be applied by regional authorities when establishing the poverty criterion, is practiced.

The differences in subsistence levels by regions cannot be explained exclusively by the differences in the levels of prices only. Another reason is that in accordance with Russian legislation the commodity composition of the consumption basket also varies by regions. The territorial variances in the composition of the consumption basket depend on the differences in the population's actual needs, which, in their turn, depend on the differences in nature and climate, territory size, availability of social institutions, transport, communications, national and regional consumption patterns, and other factors.

In Q III 2006, the lowest subsistence level indices were established in Dagestan, Tambov Oblast, Lipetsk Oblast and Orel Oblast, in Kabardino-Balkaria, North Osetia-Alania, Kalmykia and Karachaevo-Cherkessia – between 2,416 and 2,635 roubles per month per capita. The highest indices were registered in Koriak Autonomous Okrug and Chukotskii Autonomous Okrug – 9,232 and 8,147 roubles, respectively.

The latest official data concerning the numbers of the poor, obtained on the basis of the subsistence level established by the Government of the Russian Fed-

eration in 2004 (no legitimate subsistence level index having been established for the year 2005 in Russia) offer the estimate of 25.5 mln, or 17.6% of the country's total population. However, if the estimation is based on the number of this population category generated as the sum of those groups that can be established on the basis of the subsistence level indices approved by the authorities of subjects of the Russian Federation, the result will be by 5 mln higher.

Poverty levels in Russia widely vary by regions. The highest poverty levels (more than one-half of total population) were registered in Ust'-Ordynskii Buriatskii Autonomous Okrug, the Republic of Ingushetia, and Komi-Permiak Autonomous Okrug. The least poverty can be observed in the cities of Moscow and St. Petersburg, the Republics of Komi and Tatarstan, and in Yamal-Nenets and Khanty-Mansi Autonomous Okrugs.

In this country, poverty is more typical of rural areas: the share of rural population among the poor is higher than among those who are not poor, and amounts to 60%. Among the poor, the share of families with children is also high: thus, among the families with both parents and 1–2 children the poor constitute more than 50%, while among the families with 3 children or more – three quarters. Among single parents with three or more children the poor constitute 85%. Two-thirds of temporarily unemployed and more than one half of all recipients of disability pensions belong to poor families. In the structure of the poorer strata of the population, the share of employable persons who work but cannot earn enough to provide adequately for themselves and for their dependents is rather prominent.

**Money expenditures and retail turnover.** In 2006, the share of the population's expenditures on commodities and services, as a percentage of the total incomes the population, remained virtually unchanged (in January through November 2006 it amounted to approximately 72.0%, just as one year earlier). During the same period, the share of the population's savings became slightly lower, while the share of expenditures on the acquisition of hard currencies during the same period decreased rather noticeably (from 8.5% to 7.4%).

Growth in retail turnover (in terms of mass of commodities) remained stable and high in 2005–2006 – at the average level of 12–13% per annum. The highest growth against the previous year's level was achieved in Q IV primarily due to the December leap (growth of commodities turnover in December against the November level is approximately 20%). The structure of commodities turnover demonstrated a certain decrease of the share of nonfood commodities – from 46% in 2005 to 45.5% in January through November 2006 (less than 45% in Q IV 2006). In the subgroup "foodstuffs", in recent years the share of alcoholic beverages became noticeable lower from 10.5% in 2002–2003 to 9% in 2006. The year 2006 also saw decreased consumption, as compared to 2005, of vodka and grape based wines, while at the same time, during the same year the consumption of beer increased by 12%, and that of champagnes and sparkling wines – by 8.5%. In 2004–2006, the share of consumption of beer, champagnes and sparkling wines (in absolute alcohol values) grew from 26% to 29%.

In the group of nonfood commodities, the most noticeable growth was demonstrated by sales of motor cars, whose share in total commodities turnover in 2006 was approximately 10% (in 2005 – approximately 8.5%).

In the total volume of retail turnover growth in 2006 the highest share was represented by growth in the turnover of trading organizations – it increased by 15%, while market turnover volume increased by 5%. Resulting from the implementation of new measures in the sphere of migration policy in 2007 (the restriction of, and then a ban on trading by foreigners at retail markets), one can expect further acceleration of turnover growth in the stationary retail network, alongside a noticeable shrinkage of turnover at retail markets.

## 4.2. Labor Market

Between 1999 and 2006 the labor market displayed an overall favorable dynamic determined by positive trends to growth in main macroeconomic indicators. Main indicators of the state of the labor market likewise displayed positive dynamics. High rates of economic growth have had a positive impact on the labor market. Specifically, the level of employment and real salaries and wages were on the rise; new job opportunities arose and workforce was used more vigorously. Concomitant the economic upswing was a considerable rise in labor productivity. The volume of wage arrears fell drastically, while since 1999 real salaries and wages have been growing at a pace greater than the production growth rates.

Labor supply (the number of the economically active population) (see *Table 2*) also posted growth during the period in question. Interestingly, it proved to be greater for women than men.

*Table 2*

### The Number of Economically Active Population (as Thos.)

	2000	2001	2002	2003	2004	2005	2006
Economically active population, total	72332	71411	72421	72835	72909	73811	74200
men	37499	36905	36997	37206	37079	37511	n/a
women	34833	34506	35423	35629	35831	36300	n/a

*Source:* Rosstat

The trend was ensured by a rise in the overall quantity of labor resources. Between 1999 and 2006 the market began to absorb the young generation born between 1983 and 1990, i.e. in the period of growing birth rates. But, according to the Rosstat's estimates of the projected population numbers in Russia, since 2007 the number of the able-bodied-aged population will start declining steadily, and so will the proportion of the able-bodied population since 2008.

During the period of the economic upturn (1999-2006) employment has been growing steadily. The growing demand for labor resources was met thanks to the rising labor activity and fall in unemployment, as well as the growth in working hours. For the first time ever since the start of the transitional period the number of working hours and that of the employed population were on the rise. Since mid-

1990s the average length of labor in the national economy has grown at 4% (while between the start of reforms and mid-1990s it had fallen by 10%).

The advancement of Russia's economy fueled the renewal of favorable employment trends (according to various estimates, it allowed creation of additional 3 to 5 m. jobs). Notwithstanding the renewal of economic growth, the indicators of jobs creation remained relatively low. Thus, while the growth in GDP was steady between 1999 and 2006, the level of employment remained practically unchanged (*Table 3*).

*Table 3*

**The Dynamic of Main Indicators of the State of Labor Market in 2000–2005  
(Value Indicators in Comparable Prices; as % to the Prior Year)**

	2000	2001	2002	2003	2004	2005	2006
The average number of employed in the economy, Thos.	64327	64710	65359	65666	66407	66939	67340*
Growth rates in the average annual number of employed		100.6	101.0	100.5	101.5	100.8	100.6
Number of unemployed, Thos.	7059	6288	6155	5683	5775	5208	5326
Number of unemployed registered with the state employment bodies (as of end-year), Thos.	1037	1123	1500	1639	1920	1830	1800
The average nominal calculated labor compensations to organizations' staff, as RUR	2223.4	3240.4	4360.3	5498.5	6739.5	8550.2	10736
The average real calculated labor compensations to organizations' staff (with account of CPI)	120.9	119.9	116.2	110.9	110.6	110.0	113.5
GDP:							
Total, RUR bn.	7306	8944	10831	13243	16966	21598	26621
Per capita, RUR	49835	61267	74536	91607	117969	150915	

*Note.* \* preliminary data.

*Source:* Rosstat

Different sectors posted uneven growth rates in employment. Thus, the so-called "formal" sector, which is formed mostly by large and medium-sized enterprises, continued to cut jobs even in the conditions of economic growth. During the six-year period in question (1999-2005) it got rid of 3 m. (10%) of its employees.

It was the informal sector that became a "jobs generator". This sector comprises employees of small-sized businesses, self-employed, and individual entrepreneurs. Post-reform, it grew by 10 m. employees (from 20.9 m. up to 30.9 m.).

Such polar reactions by enterprises from the different sectors suggest that they incur different costs associated with job creation. New job opportunities apparently continued to arise almost exclusively on the informal or semi-informal basis, because of overregulated labor relations in the formal sector. So, by contrast to the EU-15 states, the economic upturn and growth in Russia was paired by the rise in new job opportunities, with their number in the formal sector being unlikely to match the growth in volumes of output. The number of regular jobs in the formal sector of the economy has declined vis-avis the growing number of temporary and

occasional jobs in the informal sector. That entailed a growing segmentation of the labor market.

The “business card” of the national labor market became diverse “atypical” arrangements, such as part-timers, compulsory administrative leaves, secondary employment and employment in the formal sector, delays with payment of salaries and “shadow” labor compensations, in-kind salaries and production of goods and services by and within households. While with the start of the economic upturn these atypical forms began to decline (for instance, the level of the compulsory part-time employment plunged below 1%), they still embrace a great proportion of the national workforce. Some experts<sup>1</sup> estimate the proportion of non-standard jobs in the national economy being between 25 and 30%.

Post-reform, the structure of employment by kinds of activities underwent considerable changes (*Table 4*), for numerous transformational shocks caused growth in employment in some sectors of the economy and its fall in others.

Table 4

**The Average Number of Employees in the Economy by Kinds of Economic Activities (as %)**

	2000	2001	2002	2003	2004	2005
<b>Total in the economy</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
Of which by kinds of economic activity:						
agriculture, hunting and forestry	13.9	13.1	12.5	11.8	11.2	11.1
fishery	0.2	0.2	0.2	0.2	0.2	0.2
mining	1.7	1.8	1.8	1.7	1.6	1.6
processing production	19.1	18.8	18.4	18.1	17.7	17.2
production and distribution of oil, gas and electricity	2.9	3.0	2.9	2.9	2.9	2.9
construction	6.7	6.7	6.8	6.9	7.1	7.4
wholesale and retail trade; repair of vehicles, motorcycles, home appliances and items of personal consumption	13.7	14.6	15.1	15.8	16.3	16.6
hotels and restaurants	1.5	1.5	1.6	1.7	1.7	1.7
transport and communication	7.8	7.9	7.8	7.9	8.0	8.0
finance	1.0	1.1	1.1	1.2	1.3	1.3
real estate – transactions, rent and provision of services	7.0	7.2	7.5	7.4	7.3	7.3
public administration and provision of military security; compulsory social provision	4.8	4.7	4.8	5.0	5.2	5.2
education	9.3	9.2	9.2	9.2	9.2	9.0
health care and provision of social services	6.8	6.7	6.7	6.8	6.8	6.8
provision of other communal, social and personal services	3.6	3.5	3.6	3.5	3.5	3.7

Source: Rosstat.

<sup>1</sup> See: Gimpelson, Kapelyushnikov, “nestandartnaya zanyatost v rossiyskoy ekonomike”. M., 2006, GY-VSHE Publishers

The recent changes in the sectoral structure of employment in Russia have resulted in its becoming more “standard” and similar to the one characteristic of the developed economies. Specifically, the secondary sector of the economy has shrunk, while the tertiary one has expanded, and, as a result, the bulk of the national workforce shifted into the services sector. But the distinguishing feature of the Russian employment is concentration of employees (within the services sector) in the sphere of social services, while the developed economies display a greater concentration in the business services sector.

The aforementioned processes continued to progress between 1999 and 2006. The leading sectors continued to maintain a considerable contribution to the change in the sectoral structure of employment: in the industrial sector, job losses accounted for 2% against the growing share of the services sector (it was trade that posted the greatest growth rate (nearly 2%) in employment among subsectors of the tertiary sector).

In the period of the economic upturn, job opportunities arose primarily in the services sector. At this point, it should be noted that this structural change practically resulted from an absolute contraction in employment in the sphere of material production (over 10 m.), while the increment in employment in the services sector being relatively insignificant (some 2-3 m).

The common opinion of Russia lagging behind market economies in terms of maturity level of the services sector is no longer correct. The situation has changed dramatically. While the pre-reform Russian economy, whose secondary sector covered over 40% of all employees, indeed, was overly industrialized, post-reform, the share of the sector in question slid by j, i.e. to 30%. Meanwhile, the share of those employed in the services sector grew by nearly 15 p.p., and currently the sector employs a. 60% of all Russian employees.

At the outset of reforms, in the conditions of the intense transformational crisis during which Russia lost nearly half of its GDP, it was a rise in unemployment that steered greatest concerns, as it was expected to be in proportion to the decline in volumes of output. However, even in the period of the greatest decline in GDP, the level of unemployment in Russia never reached 15% - the national market “adjusted” itself to the shocks primarily by means of price flexibility (non-payments of wages), rather than quantitative flexibility (*Table 5*).

During the period of economic growth (2000-2005) unemployment in Russia was on the decline both in absolute and relative terms. The question as to whether the fall in unemployment resulted from the flow of the unemployed into the composition of employed or economically inactive individuals remains unanswered.

Meanwhile, the indicators of the stagnant unemployment (in which individuals are in search for a job for more than a year) continued to remain significant. The proportion of the unemployed registered by bodies of the state employment agency was on the rise but is still low, with just a negligible part of the unemployed applying to the state employment agency.

Table 5

**The Number of Unemployed**

	2000	2001	2002	2003	2004	2005	2006*
The number of unemployed, Thos.	7059.1	6287.9	6154.7	5683.3	5775.2	5208.3	5326
Unemployment level (as % of the economically active population)	9.8	8.8	8.5	7.8	7.9	7.1	7.2*
The number of the registered unemployed (Thos.)	1037	1123	1500	1639	1920	1830	1766
The number of unemployed in search for a job over a year (%)	42.3	36.9	38.8	35.7	38.4		
Load of the population not employed in labor activities per 1 opened vacancy. persons	1.6	1.3	1.7	1.9	2.1	2.5	2.0

Note. \* preliminary data (as of end-month)

Source: Rosstat.

Like in other transitional countries, the number of the unemployed per vacancy appears great, while the proportion of the unemployed that receive unemployment relief is fairly small (20-30%). It testifies to the fact that the outflow of the jobless thanks to their getting jobs is mostly blocked by the absence of vacancies, rather than the existence of incentives that have a negative effect on the rise of job offers. While presently the attention to the situation in the employment sphere has somewhat languished and appeared focused more on other aspects of the labor market's functioning, unemployment still poses a pressing challenge to a number of regions.

The situation on the labor market is a derivative from the general economic situation in a region. That is why the group of territories with the worst indicators of the functioning of the labor market comprises primarily regions with relatively modest indicators of economic development. Those are, first of all, republics in the North Caucasus with their depressive labor markets. Thus, in the 1<sup>st</sup> half 2006 the unemployment level in the Southern Federal Okrug made up 11.3% (displaying a 0.5% fall vs. the prior year) against the nationwide average rate of 7.0%. In the Republic of Adygeya, the respective indicator was 14.0%, in Dagestan – 21%, in Ingushetia – 61.2%, Kabardino-Balkaria – 21.1%, Kalmykia – 14.9% While in other regions in Russia the nature of unemployment is mostly structural one, in the national republics practically all the volume of unemployment is explained by an insufficient demand for workforce, which is associated with the absence of points of economic growth. The bulk of the unemployed falls on rural areas. Unemployment in the national republics is quite long – while in other Russian regions the proportion of permanently jobless is relatively small (34%), in the republics it lasts longer, while the proportion of stagnantly unemployed being very high (over 60%).

In Russia, cross-regional differences in the conditions of the labor market appear far greater than in other countries with similar conditions, which reflects a great level of heterogeneity of the regions. The cross-regional differences are, as a rule, inertia-driven, i.e. the regions that had been more successful at the outset of the transitional period, as a rule, displayed better performance ever afterwards,

which testifies to a long-standing nature of the differences. Creation of job opportunities and existence of vacancies is noted largely around huge urban conglomerates with a fairly diversified industrial structure (especially with a huge and expanding services sector, mature infrastructure and qualified workforce). By contrast, the employment prospects are extremely low and unemployment rates are high in monosectoral (highly specialized) industrial regions that suffer from idiosyncratic shocks of demand.

In the period of the economic upturn the dynamic of growth in salaries and wages was more considerable vis-avis moderate growth rates in employment, with both nominal and real salaries and wages being on the rise (*Table 6*). The rise in salaries and wages has recently accelerated, as the gaps in the levels of salaries have. Not only enterprises restructuring resulted in a substantial growth of labor productivity, which in turn manifested itself in a notable wage rise, but it had a favorable impact on the “insiders” (i.e. the staff that have kept their jobs or succeeded in finding new ones).

The gap in labor compensations payable to qualified and non qualified staff, which had been shrinking prior to 1998, once again found itself expanding. According to some estimates, the return from the university education has grown in the 2000s. The gender differences in the level of labor compensations continue to persist and have even intensified. Interestingly, for women a higher educational level neutralizes the intensification of the gender differences.

The period of the 2000s saw the renewal of the debate on the minimum salary as a regulator of labor compensations. It forms the marginal low index, which reduces the differentiation of labor compensation. It accounts, as a rule, for less than 20% of the average wages and often even a. 10% of those, and, accordingly it fails to play the part of inhibitor of the staff’s incomes. This enables corporations to retain low-paid jobs, which by itself steers differentiation of labor compensations.

The minimum labor compensation (MLC) of RUR 1,100 is effective as of May 1, 2006. Should MLC be raised up to the subsistence level, it might affect the federal budget and a broader circle of economic interconnections. An accelerated raise of MLC up to the subsistence level, which is scheduled for 2008, will predetermine an advanced rise of the labor compensation indicators. An overly advanced rise in the labor compensation fund is associated primarily with the fact that a radical rise of MLC will entail an adequate rise of a considerable fraction of higher salaries and wages in the economy to maintain a certain differentiation between labor compensations payable to employees of different qualifications.

If one assumes that, resulting from the compression of all higher wages, their noted growth rate is twice inferior to that in MLC (i.e. the correlation between MLC and the average wage will be 20% instead of the current 8-10%), the amounts of the employers’ additional obligations with respect to labor compensations should grow drastically. Hence, there should emerge a danger of the rise in MLC vis-avis the low-qualified employees’ labor productivity rate. A centralized rise of MLC has an impact on the whole “line” of labor compensations and not only on those payable to low-paid employees. While effects from the rise in MLC so far have been

moderate, from now on they should be intensifying. One should take into account sizeable and fairly steady cross-regional and cross-sectoral differences in levels of labor compensations that further aggravate the problem of raising MLC in individual sectors and Subjects of RF. An perfect illustration of the differences in question is the indicator of the proportion of employees whose wages due are lower than the able-bodied population's subsistence level. Thus, according to Rosstat, over 50% of the number of those employed in agriculture, culture and fine arts have their wages due under the able-bodied population's subsistence level. The same situation is noted with regard to over 1/3 of those employed in the education, trade, public catering, health care and physical culture, and the light industry.

Accordingly, the employers' expenses on labor compensations are differentiated with account of such sectoral differences. Expert calculations show that if the employers' additional costs, under the constant number of employed in the respective industries, account in the fuel and electricity sectors for less than 10% of the labor compensation fund, in the light industry, trade, public catering and education they would be comparable with the level of LCF, while in the agrarian sector would be in excess of LCF.

In terms of regions such a decision will entail a series of effects that would be different, due to the state of the economy of a given region. First, the regions with the current level of the average salaries and wages lower than the average nationwide ones will see a greater gap between the growth rates in salaries and wages and growth rates in MLC, while a rise in MLC in the wealthier regions does not have a catastrophic impact on the dynamic of the average salaries and wages. Second, even with account of contraction of differentiation in terms of salaries and wages due to employers' qualification in the poorer regions, an additional burden on the employers may account for over half of LCF, while in the wealthier regions the rise in LCF is going to be relatively insignificant.

So, the Russian labor market to some extent faces numerous challenges inherent in the developed economies' labor markets: with the future quantity of labor resources in the economy to be declining and structural disproportions between demand and offer of workforce to be persisting, there continues to exist the pressing challenge of acceleration of the pace of generation of job opportunities that imply adequate labor conditions and decent compensations.

It was the Labor Code enacted in late-2001 (promulgated in February 2002) that was to create conditions of an efficient functioning of the national labor market in a new market environment. It replaced the previous Code of Acts on Labor and a great number of by-laws passed over past decades. The newly enacted Labor Code was further amended in 2006.

The new law on labor became a fruit of compromise between different political groups, which is why it is not surprising it contains provisions adequate to market realities and restrictions inherited from the Soviet era. Experts are unanimous in their opinion of the Labor Code maintaining its restrictive nature compared with similar acts adopted by developed countries.

The Russian labor market is formally overly regulated, however, it demonstrates a great deal of flexibility. By systematically breaching the labor law, corporations secure advantages for themselves and exercise a distorting impact on the functioning of the labor market.

Meanwhile, provisions of the labor law, which most experts regard as serious blocks to creation of job opportunities, are not perceived as such by enterprises, for their significance is lower than that of other, more critical, restrictive requirements.

In the area of labor relations, the prevailing role is played by administrative barriers, such as numerous licenses and permits on exercise of entrepreneurial activities, a burdensome tax administration and incomplete legal provisions.

### **4.3. Migration processes**

In 2006, for the first time in the contemporary Russian history, the demographic problem was paid serious attention in the annual Presidential Address to the Federal Assembly of the Russian Federation<sup>2</sup> as a “most acute problem facing Russia today.” The factors behind this attention are the long term and annual decline in the size of the population of the country and ageing of the population. In order to settle the demographic problem there was proposed to focus the government’s attention on the lowering of death rates, effective migration policy and on increasing of birth rates. The Address focuses primarily on this latter objective. Last year, both the legislative and executive branches of government concentrated their efforts exactly in this area. Less attention was paid to the two other demographic problem components (mortality rates and migration). According to the logic indicated above, the Birth Rate Improvement Program will suffice to reverse the trend towards depopulation, which has been observed in Russia for the second decade running. Nevertheless, demographic calculations reveal that even in the framework of the most favorable scenario of implementation of this program and a real increase in the number of births it will be impossible to reverse the downward trend as concerns the natural population growth rates.

*“Let us assume that in 2007, after the start of implementation of the Presidential strategy, the number of second and third children will really begin to grow. As a result, the number of birth will of course increase also; however, this growth will be checked by a rapid decline in the number of potential mothers, women in the age group from 15 to 49 years. All the women to enter in this group in the next 18 to 20 years have been already born, therefore, their number is known and in the early 2020s it will be almost one third below the present level.*

*In the case it is assumed that a miracle will happen and there will be again registered the best indicators in Russia over the last 40 years, i.e. 42 per cent of*

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<sup>2</sup> Annual Presidential Address to the Federal Assembly of the Russian Federation. Verbatim record of the speech made on May 10, 2006. See: [http://www.kremlin.ru/appears/2006/05/10/1357\\_type63372type63374type82634\\_105546.shtml](http://www.kremlin.ru/appears/2006/05/10/1357_type63372type63374type82634_105546.shtml)  
450

*first-born in the total number of births and 2.2 births per one woman (these indicators were registered in 1987 and were observed for one year only), in 2025 about 2 to 2.1 million children will be born in Russia. This number is above the present 1.5 million, but below 2.5 million registered in 1987, when there was much more women of procreative ages. However, if there will be no such a success and there will be registered not the record high birth rates of 1987, but a more usual birth rate observed in the early 1980s (now it is the birth rate in France, which is the best in Europe – 1.9 births per one woman; the Russian birth rate at present is 1.3), and if a more difficult task to keep this rate is accomplished, in 2025 there will be born about 1.8 million children (about 55 per cent of the will be first-born, whereas second children will make about one third of the total number of births). Of course, these figures also look good; however it is insufficient to compensate the number of deaths, which is to increase even in the case of declining death rates, just because the share of seniors will grow. Therefore, natural growth of the population will all the same be negative.”*

*A. Vishnevsky*

*Comments of the “Demoskop Weekly” to abstracts from the Annual Presidential Address to the Federal Assembly of the Russian Federation of May 10, 2006 //Demoskop Weekly. No. 245 – 246. May 1 – 21, 2006*

In this situation, even if the present needs of the labor market persist (and do not increase), the country will inevitably need migrants.

Economic realities observed at present consist of the following components: the general tension on the labor market (according to the data presented by Rosstat the number of vacancies at enterprises registered with employment agencies increased from 333 thousand in September of 1996 to 1 140 thousand in September of 2006), a deficit of unskilled labor and structural imbalances observed on labor market of certain regions, especially those most dynamically developing and tertializing, a lack of trained labor resulting from a decline in the prestige of respective jobs and the collapse of the system of secondary professional education.

In the situation, where the size of employable population rapidly declines (as observed since 2007) by more than 1 million people a year), there will arise a general deficit of labor supply, especially unskilled labor.

In accordance with an official forecast published by Rosstat of Russia, the size of the population being in the employable ages shall decline from 90.1 million persons to 76.6 million persons in the period from 2007 to 2020; at the same time according to the forecast the migration based increase in the Russia’s population growth will make from 150 thousand persons in 2007 to 430 thousand persons in 2020<sup>3</sup>.

<sup>3</sup> Predpolozhitelnaya chislennost naseleniya Rossiyskoi Federatsii do 2025 g. (The estimated size of the population of the Russian Federation up to year 2025). M.: Rosstat, 2005

The long term migration policy of Russia has to proceed from these economic realities as compared with political demands of the society. It is presumed that this policy should not exclude, but necessarily complement the complex of measures aimed at an increase in the birth rate.

#### *4.3.1. Regulating migration: the legislative framework in 2006*

In 2006, the Russian legislation concerning the sphere of migration was supplemented with several new documents. Two federal laws concerning the procedures governing registration and stay of foreign citizens in Russia came into force on January 15, 2007. Besides, since November 9, 2006, there has already been enforced the new procedure governing the imposition of penalties and administrative restrictions, which was introduced in the framework of the RF Code of Administrative Offences (with the exclusion of certain provisions, which entered into force simultaneously with federal laws of January 15, 2007).

In 2006, there were adopted the following legislative acts in the sphere of migration:

- Decree of the RF President No. 637 of June 22, 2006, "On the measures aimed at the provision of assistance to voluntary migration of fellow countrymen residing abroad to the RF" (published on June 28, 2006);
- The Governmental Program aimed at the provision of assistance to voluntary migration of fellow countrymen residing abroad to the RF; Plan of measures aimed at the implementation of the Governmental Program aimed at the provision of assistance to voluntary migration of fellow countrymen residing abroad to the RF (approved by Decree of the RF President No. 637 of June 22, 2006);
- Federal law of the RF No. 109 FZ of July 18, 2006, "On the registration of foreign nationals and stateless persons migrating to the RF (adopted by the State Duma on July 30, 2006, approved by the Federation Council on July 7, 2006, published on July 20, 2006, enters into force since January 15, 2007);
- Federal law of the RF No. 110 FZ of July 18, 2006, "On the introduction of amendments and additions to the federal law "On the legal status of foreign nationals in the RF" and on the annulment of certain provisions of the federal law "On the introduction of amendments and additions to certain legislative acts of the RF" (adopted by the State Duma on July 30, 2006, approved by the Federation Council on July 7, 2006, published on July 20, 2006, enters into force since January 15, 2007);
- Federal law of the RF No. 189 FZ of November 5, 2006, "On the introduction of amendments to the RF Code of Administrative Offences (as concerns increase in responsibility for infringements on the procedure governing employment of foreign nationals and stateless persons in the RF)" (adopted by the State Duma on October 20, 2006, approved by the Federation Council on October 27, 2006, published on November 9, 2006);

In order to enforce these laws, in 2006 the RF Government adopted a number of regulatory and legal acts:

- Resolution No. 271 of May 5, 2006, "On the introduction of amendments to the Regulations on the use of migration cards as approved by Resolution of the RF Government No. 413 of August 16, 2004";
- "Amendments introduced to the Regulations on the use of migration cards as approved by Resolution of the RF Government No. 413 of August 16, 2004" (approved by Resolution of the RF Government No. 271 of May 5, 2006);
- Resolution No. 622 of October 20, 2006, "On the approval of the rules concerning the provision of state support from the federal budget to the subjects of the Russian Federation included in the Governmental Program aimed at the provision of assistance to voluntary migration of fellow countrymen residing abroad to the RF";
- "The rules concerning the provision of state support from the federal budget to the subjects of the Russian Federation included in the Governmental Program aimed at the provision of assistance to voluntary migration of fellow countrymen residing abroad to the RF" (approved by Resolution of the RF Government No. 622 of October 20, 2006);
- Resolution No. 665 of November 11, 2006, "On the approval of the quota concerning the issuance of invitations for foreign nationals to enter the Russian Federation for performance of labor activities for year 2007";
- Resolution No. 681 of November 15, 2006, "On the procedures governing the issuance of authorization documents as concerns performance of temporary labor activities by foreign nationals in the Russian Federation";
- "Rules governing the issuance of authorization documents as concerns performance of temporary labor activities by foreign nationals in the Russian Federation" (approved by Resolution of the RF Government No. 681 of November 15, 2006);
- Resolution No. 682 of November 15, 2006, "On the approval of the quota concerning the issuance of work permits for foreign nationals arriving to the Russian Federation under procedures not requiring visas";
- Resolution No. 683 of November 15, 2006, "On the approval of the acceptable share of foreign employees used by economic agents operating in the sphere of retail trade in the territory of the Russian Federation";
- Resolution No. 783 of December 22, 2006, "On the procedures governing determination of requirements concerning the attraction of foreign employees and formation of quotas for performance of labor activities by foreign nationals in the Russian Federation by executive agencies (enters into force since January 15, 2007);
- The Rules governing determination of requirements concerning the attraction of foreign employees and formation of quotas for performance of labor activities by foreign nationals in the Russian Federation by executive agencies;
- Resolution No. 797 of December 23, 2006, "On the approval of the Regulations concerning the licensing of activities related to employment of citizens of the Russian Federation outside the Russian Federation";

- Regulations concerning the licensing of activities related to employment of citizens of the Russian Federation outside the Russian Federation”;
- Resolution No. 798 of December 23, 2006, “On the approval of the procedures governing the submission of notification on the attraction and use of foreign nationals arriving to the Russian Federation under procedures not requiring visas” (published on December 31, 2006, enters into force since January 15, 2007).

As it follows from the list indicated above, three of four legislative acts and the majority of supplementary regulatory documents concern legalization of activities performed by labor migrants and the struggle against illegal migration. The innovations introduced by these documents can be summed up as follows:

- the institute of registration of foreign nationals has been abolished; there has been introduced registration of migrants based on the notification procedure, therefore, nobody has the right to refuse to register a foreign national;
- foreign nationals may be registered both at their places of residence and employment;
- employers has been granted the option to submit applications for Permits for attraction of foreign employees not only in person, but also by mail (registration of migrants is also possible in person or by mail notification); on the basis of the issued permits employers should make labor contracts with the attracted foreign nationals and forward the respective data to regional employment agencies and tax inspections. It should be noted that each foreign employee should have a work permit. Absence of such permits should be the basis for suspension of Permits for attraction and use of foreign labor issued to employers;
- the new legislative initiatives classify foreign employees depending on the fact if the exchange between Russia and the respective countries is regulated under a visa regime or is visa free (CIS member countries with the exception of Turkmenistan and Georgia);
- employers have to obtain and transfer to foreign employees arriving from the countries with visa based exchange work permits prior to the start of their work in Russia; as concerns employees not needing visas, they have the right not to submit applications personally; however, in any case they need migration cards;
- there has been significantly reduced time, within which state authorities should hand employers and migrants the respective authorization documents;
- there have been significantly increased fines (up to Rub. 800 thousand) and toughened measures with respect to employers attracting and using labor of foreign employees staying in Russia without the duly made documents;
- there has been adopted a new version of article 18.10 of the RF Code of Administrative Offences in accordance with which illegal performance of labor activities by a foreign national or a stateless person should result in a fine ranging from 20 to 50 minimal wages and (optional) administrative deportation from Russia;
- there has been introduced a new administrative offence – infringement on the regulations pertaining to the entry in the Russian Federation of a foreign national or a stateless person or the procedures governing the stay (residence) of

such persons in the Russian Federation, including those where the announced aims of entry in Russia is at variance with the activities actually performed in the period of stay (residence) of such persons, infringement on the rules of registration of migrants, travel or the procedures governing the choice of the place of stay or residence;

- there have been envisaged penalties concerning Russian citizens providing housing or transportation to foreign nationals or stateless persons staying in the territory of Russia, which infringe on the established procedures and rule of registration of migrants;
- there have been introduced restrictions (in some cases even prohibition) with respect to the acceptable share of foreign employees in the sphere of retail trade;
- there has been introduced a quota (6 million persons for year 2007) as concerns the attraction of foreign employees arriving to Russia under a visa free procedure; the quota pertaining to the issuance of invitations to foreign nationals arriving to Russia in order to perform labor activities makes 308842 in 2007;
- it has been allowed to suspend Permits for attraction and use of foreign labor issued to employers in the cases where employers fail to notify migration agencies about the places of temporary stay of foreign employees within 3 days, where employers fail to notify tax authorities, under the jurisdiction of which these employers are, about the arrival of foreign nationals to their places of work or residence within 10 working days, and where employers fail to notify migration agencies about infringements on the terms of labor contracts or civil law work contracts on the part of foreign employees within 3 days.

#### *4.3.2. Economic consequences of the legislative process concerning migration*

Let us attempt to evaluate the economic consequences of the legislative acts indicated above not touching on the social and humanitarian context of these acts. The newly introduced provisions are primarily aimed at the separation of labor flows from the CIS member countries, from where on the visa free basis the overwhelming number of foreign employees arrives to Russia, and those arriving under visa regimes. In order to legalize employees arriving without visas there has been abolished a number of provisions; however, at the same time there was introduced a package of new stipulations, which include industry specific shares of foreign employees and quotas. Simultaneously, the RF Code of Administrative Offences introduced some significantly more tough penalties with respect to RF citizens using labor of foreign employees without the respective registration required by law, or renting their housing or vehicles to such employees. Therefore, behind the facade of liberalization of the labor migration treatment there is seen the intention to regulate many of its aspects.

Expert estimates of the number of foreign employees working in Russia throughout the year (4.9 million persons<sup>4</sup>) reveal that the quota set for year 2007 (6 million employees, or 9 per cent of the average annual number of all employees in

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<sup>4</sup> Mukomel V. I. *Migratsionnaya politika Rossii (Russian migration policy)*. M., 2005. pp. 196 – 197.

the Russian economy) should not seriously limit the number of invited foreign employees<sup>5</sup>. According to the Government's resolutions concerning quotations, regional quotas should be determined in advance and may be adjusted throughout the year. However, in spite of the documented data, on which the quotas should be formed (December 15, 2006), even in early January of 2007 regional quotas were not made public yet. This lack of information in such a large and spatially diverse country as Russia is a rather disquieting circumstance. This uncertainty may have the most negative results in Moscow and St. Petersburg, as well as in other regions accumulating large flows of foreign labor: delays relating to the approval of quotas accompanied by the general underdevelopment of the service migration infrastructure will create serious problems for migrants wishing to obtain a legal status and will form fertile ground for a growth in corruption. It is estimated that for Moscow the quota for attraction of foreign labor will make 600 thousand persons, including 150 thousand migrants with visas and 450 thousand migrants without visas<sup>6</sup>. It is yet unclear what can happen with the migrants staying in Moscow in the excess of the planned quota.

It is important that the migrants, who have arrived to Russia prior to the enactment of the new legislative documents, will have first to leave the country and come back later, since it involves significant expenses. Different studies carried out in Russia reveal that illegal employment is most widespread in the country, and 90 per cent of illegal migrants work<sup>7</sup>. A significant share of this group (at least one third) consists of the migrants, who have been staying in Russia for a long time; often such migrants have families and sometimes have no ties with countries of their origin.

The new legislative documents do not envisage any options of setting "floating quotas," which is important and profitable for certain categories of employers: for instance, even in the case they need seasonal workers they will have to obtain annual permits and pay the respective state duty. As it turns out, in order to avoid frequent rotation of workers employers operating in such industries as construction or agriculture will be interested to either register their employees for longer periods, or attract laborers able to perform different operations, for instance painting and electrical works. This situation is unfavorable primarily for small and medium sized companies, since large companies will be able to shift workers from one project to another.

A similarly important problem is related to the fact that foreign migrants are prohibited for employment in retail trade. There are several economic consequences of this decision.

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<sup>5</sup> The Federal Migration Service of Russia evaluates the number of migrants from the CIS member countries present in Russia to make 10 million persons, i.e. it is significantly above the quota introduced on the initiative of this organization.

<sup>6</sup> Pertseva E. Kvota na gastarbaitera (Quota for the migrant worker) // *Gazeta*. December 1, 2006.

<sup>7</sup> Problemy nezakonnoi migratsii v Rossii: realii i poisk resheniy (po itogam sotsiologicheskogo ob sledovaniya) (Problem of irregular migration in Russia: reality and search for solutions (results of the sociological survey) / IOM, Bureau of the International Organization for Migration in Russia. M.: Gendalf, 2004. p. 497.

The Russian labor market, which has been characterized by “non-market” behavior for a long time since the beginning of market reforms, is, in fact, only forming, the mechanisms of its internal tuning are not completely clear, and the real regional occupational proportions lack clear understanding<sup>8</sup>. In this situation, attempts to regulate one dynamically developing sector of the economy<sup>9</sup> across the whole territory of the country seem to be an example of a premature decision failing to take into account regional specifics. In a number of Russia’s regions, especially those neighboring with Ukraine and, especially, with China, the consequences of implementation of Resolution No. 683 can seriously complicate life of the local population, which is used to buy clothes and footwear (at least) at Chinese, Vietnamese, Ukrainian and other ethnic markets. Here, it should be noted that there have already been made certain attempts to replace foreigners with Russia’s citizens in the Far East and in Siberia; however, all these attempts completely failed: markets practically suspended operations, but the number of domestic vendors there did not grow<sup>10</sup>.

Besides, the measures undertaken by the government to improve competitiveness of domestic goods as compared with goods imported to markets by migrants should result in a growth in prices and higher inflation rates, especially in border towns and regions. However, it can hardly be expected that foreign employees really leave this sector of the economy. Most probably, there will occur yet another surge of shadow economy in this sphere, what no doubt bring about all usual consequences: growing prices of goods including all “migration risks”, rampant corruption, increasing staff of regional governmental agencies engaged in the enforcement of the new Resolution.

An analysis of the data collected in the course of different sociological surveys of migrants reveal that retail trade absorbs from 25 per cent to 45 per cent of foreign employees<sup>11</sup>. Simple computation demonstrates the following:

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<sup>8</sup> It should be noted that regional occupational proportions lack clear understanding not only in Russia, where the labor market is not very flexible as yet. “Ascertaining labour scarcity for each and every occupation at specific points in time, and for each region within a country, is difficult, so that governments inevitably use simple labour market tests and allow agencies considerable latitude in administering labour market-based migration policies. In some cases, the government takes a *laissez faire* approach.” See: Towards a fair deal for migrant workers in the global economy. Report VI. International Labor Conference, 92nd Session, 1-17 June 2004, International Labor Office. Geneva, p. 118.

<sup>9</sup> By the way, it should be noted that although at present it is only one sphere of activities, perhaps in the future the number of such spheres will increase. At least the respective Resolution (No. 683) permits to advance proposals aimed at the limitation of foreign employees in other sectors of the economy as well.

<sup>10</sup> See, for instance: Dyatlov V., Kuznetsov R. ‘Shankhai’ v tsentre Irkutsk. Ekologiya kitaiskogo rynka (‘Shanghai’ in the center of Irkutsk. Ecology of the Chinese market / Baikalskaya Sibir: iz chego skladyvayetsya stabilnost (Baikal Siberia: what is stability composed of) / Editorial board: V. I. Dyatlov, S. A. Panarin, M. Ya. Rozhansky – M.; Irkutsk: Natalis, 2005. p.p. 166 - 187

<sup>11</sup> Prinuditelnyi trud v sovremennoi Rossii: nereguliruyemaya migratsiya i trgovlya lyudmi (Forced labour in the Russian Federation today: irregular migration and trafficking in human beings). M.: ILO, 2004. p. 52.

- from 1 to 2 million people will lose their jobs and will have to flow to other sectors of the economy, return to their countries of origin, or become illegal aliens;
- due to the fact that until now in Russia, similarly to other East European countries, foreign employees have been primarily concentrated in only two sectors – trade and construction – the measures aimed to close one of these sectors for migrants should trigger massive redistribution processes on the labor market;
- even if it is assumed that local population really begins to sell goods at markets (the development, in which the Russia's citizens do not strongly believe themselves, basing on the evidence presented by the data published by VTsIOM<sup>12</sup>), it will require a whole army of handlers of goods, assistant workers, sorters of merchandise, and other unskilled laborers, which could be even harder to employ among the local population than vendors.

Among the main positive developments there should be mentioned the legally set option for employers or contractors of works (services) to attract and use foreign workers arriving from visa free countries without permits for attraction of foreign employees on notification basis. It means that employees entering Russia without visas become free agents and will be able relatively free compete with the local residents for jobs, what, in the end, should prevent declines in the prices of labor in certain spheres of activities and result in a rise in labor productivity.

However, the stipulations set by the “Rules, under which executive agencies should determine the requirements for attraction of foreign employees and formation of quotas for labor activities performed by foreign citizens in the Russian Federation,” in accordance with which employers should submit applications informing the respective regional agencies about their needs for foreign employees for the next year until May 1 of the current year, will still make the life of employers difficult. The exactly same time – until May 1 of the current year – employers will have to adjust their applications.

At last, it should be noted that in 2007, the first year of enforcement of the new migration legislation, the most important thing will be the lack of clear and transparent procedures governing registration of migrants, issuance of work permits and developed rules and regulations rather than changes in the respective legislative framework.

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Materials of a collective study “Transformatsiya postsovetskogo prostranstva: otrazheniye v migratsiyakh” (Transformation of the Post-Soviet Space: Its Reflection in Migrations) (2002 – 2005) (Grant No. 980-0789-3 of the Ford Foundation) of the Center for Migration Studies, in which the author took part as a contractor.

<sup>12</sup> Almost half of Russia's citizens (47 per cent) state that they either are ready to take jobs resulting from the restrictions concerning the right of foreigners to work at markets and vending kiosks, or know people, who could take such jobs (36 per cent). However, 40 per cent of respondents stated that they do not know personally any Russia's citizens ready to take such jobs. Seven per cent of respondents do not believe that Russia's citizens will be able to efficiently replace foreigners at markets. This national poll was conducted by VTsIOM on November 25 and 26 of 2006. There were polled 1600 people in 153 localities situated in 46 oblasts, krajs and Republics of the Russian Federation. The statistical error of the survey is below 3.4 per cent.

The second main objective of the new Russian migration policy will be the attraction of compatriots for permanent residence in the country. The CIS member countries should become the main donor of this process, although the adopted documents concern also other territories. It is planned to implement the adopted Program of voluntary migration of fellow countrymen within three years. The Program envisages facilitation of resettling of 300 families in 12 selected "pilot" regions (the Primorsky, Khabarovsk and Krasnoyarsk krajs, as well as the Amur, Irkutsk, Novosibirsk, Tyumen, Kaluga, Lipetsk, Tambov, Tver, and Kaliningrad oblasts). The recipient regions are divided into three categories: "a," "b" and "c," depending on their social, economic and demographic situations; respectively, migrants are eligible for different terms of assistance. For the implementation of the Program there are provided rather significant resources amounting to Rub. 17 billion. At the same time, the only direct benefit is a fast granting of citizenship free of bureaucratic barriers. Besides, the government compensates expenditures borne with respect to travel to the new place of residence, payment of the state duty for official registration, provides a compensation package, for which members of the Migration Program are eligible (services of preschool, school and professional education, social amenities, health care and employment service), resettlement benefits (for migrants to regions of the "a" and "b" categories<sup>13</sup>), monthly allowances provided in the case migrants have no earnings for the first six months of residence in regions of the "a" category).

As it follows from the adopted documents, the government does not guarantee employment and housing to migrants. These issues should be (but not necessarily) solved in the framework of regional resettlement programs. On the one hand, such an approach offers migrants an opportunity to solve economic problems they face, does not provide grounds for excessive expectations, which could not be satisfied, and can become one of indirect criteria for selection of migrants: no compatriots from economically and socially inactive groups of the population will not migrate on such terms. Besides, such measures should prevent complaints on the part of local residents, since the traditionally most important issue in Russia – the housing problem – is not solved in the framework of this Program by giving priority to migrants. On the other hand, in the situation, where the contingent of the most mobile population of the Republics of the former Soviet Union has already left these territories, whereas those remaining in the CIS member countries have already adapted to the changed political conditions existing in the former Republics, where are observed no armed conflicts and economies are mostly developing at rates exceeding those observed in Russia, the measures envisaged by the Program can prove to be insufficient to motivate people resettle to Russia. In this case, the measures envisaged by the Program can fail to attain its objectives.

The Head of the RF Federal Migration Service, K. Romodanovsky, whose organization was vested with the development and implementation of the Program, has published the estimates concerning the inflow of compatriots in the framework

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<sup>13</sup> For the people migrating to regions of "a" category this amount should make Rub. 100 thousand, for migrants to regions of "b" category this amount should make Rub. 70 thousand.

of the Program: up to 50 thousand persons in 2007, up to 100 thousand persons in 2008 and up to 150 thousand persons in 2009<sup>14</sup>. Thus, the estimated inflow should make about 300 thousand people over three years<sup>15</sup>. At the same time, the implementation of the Program, however well it is thought out, can encounter two serious difficulties: the unwillingness of the new independent states, which also face demographic problems (at present or in the future), to let go their citizens wishing to migrate to Russia, and the growing phobias of the Russian population with respect to migrants and certain ethnic groups. As yet, state institutions has not clearly thought out and designed the policies they should pursue with respect to promotion of the Program concerning the attraction of compatriots, development of a campaign against anti-migrants attitudes of the Russian society and the overcoming of their own imperial mentality resulting in the firm belief that if Russia wishes it, millions of former Soviet citizens will flow to the country.

#### *4.3.3. Dynamics and structure of migration flows*

The official data characterizing migration processes provide evidence that the number of migrants is insufficient to compensate for the natural decline in the size of the Russia's population not to mention the future decrease in the able bodied population group.

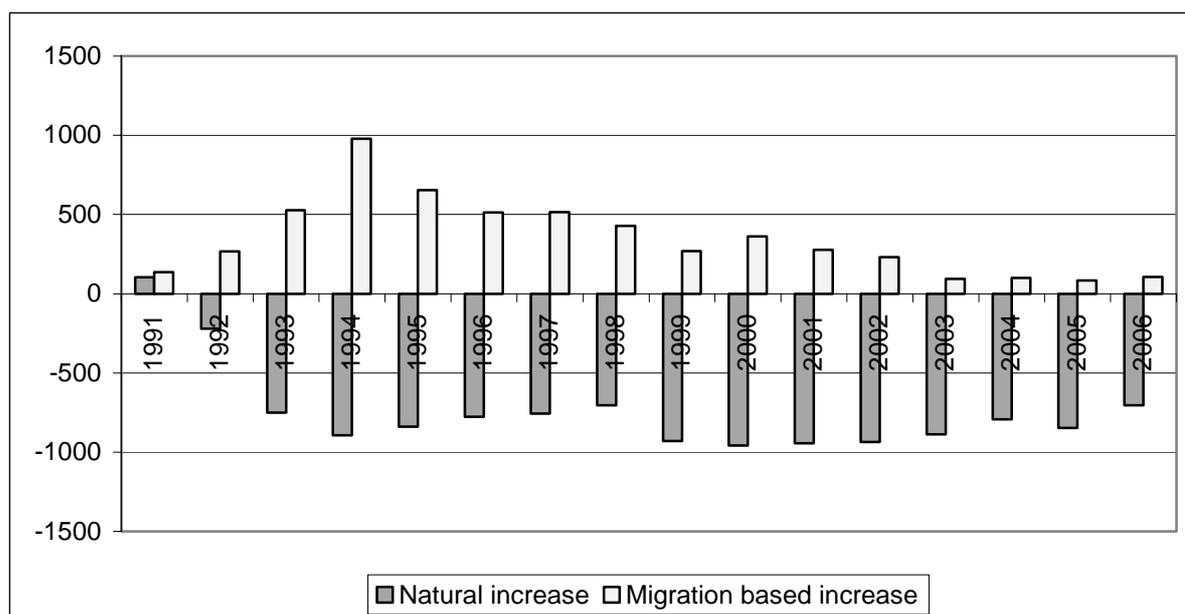
According to the data presented by Rosstat, the size of the Russia's resident population made 142.3 million people as on November 1, 2006, thus declining by 479.6 thousand people, or 0.34 per cent, over the first 10 months of 2006 (in comparison with the figures registered as on the respective date of the preceding year, the size of the Russia's population fell by 615.5 thousand people, or 0.43 per cent). In January through October of 2006, the natural decline in the size of the population made 114.3 thousand people in comparison with the figures registered in the respective period of 2005. The migration based increase in the population compensated the decline by 18.1 per cent.

The data presented in *Fig. 1* demonstrate that since 1992, when the natural decline in the size of the country's population was first observed, the amount of migration based increase permitted to compensate for the natural depopulation processes only in 1994. Year 2006 was not an exception among the last years, when migration only slightly smoothed negative demographic processes. An insignificant increase in the migration component in the compensation for the natural decline observed in 2006 was generated not by a growth in the number of migrants seeking permanent residence in Russia (this figure amounted for 4.7 per cent as compared with the data registered in 2005), but primarily due to a decline in the documented emigration from the country (which decreased by 24.2 per cent).

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<sup>14</sup> Vandysheva O. Glava FMS Konstantin Romodanovsky uveren, chto migranty dlya Rossii – blago (Konstantin Romodanovsky, the head of the Federal Migration Service, is sure that migrants are an asset for Russia) // Komsomolskaya Pravda. December 29, 2006.

<sup>15</sup> For comparison purposes it should be noted that according to a Rosstat forecast for years 2007 through 2009 the natural population decline will be up to 2340.5 thousand people.



Note: the data for year 2006 are the author's estimates, which take into account the data for the period from January through February of 2006 as adjusted for the data for the period from November through December of 2005.

Source: Information on the social and economic situation of Russia in 2006, <http://www.gks.ru>

Fig. 1. Components of the total increase in the size of Russia's population, 1989 through 2006 (in thous. persons)

### Immigration

In the early and mid-1990s, Russia was among the leading countries as concerns the number of migrants flowing in the country. Over the last decade, this situation has significantly changed. According to the official data, in 2006 only no more than 185 thousand migrants entered the country, what was 3.5 times below the level registered 10 years ago and more than 6 time below the record high figures observed in 1994, the peak year in terms of migration to Russia from the CIS member countries and the Baltic States. The decline in the number of people migrating to Russia in the 2000s is determined by significant factors of economic, political and administrative nature: stabilization of the political situation and waning of active conflicts observed in the former Soviet Republics, which accounted for a mass inflow of forced migrants to Russia in the 1990s; a gradual decline in the "difference of economic capacities" of the other countries of the former Soviet Union and Russia; a decrease in the number of people ready to migrate to Russia; more tough and complicated nature of the Russian legislative framework as concerned granting of citizenship and permanent residence, as well as registration procedures. An important factor was a gradual reassessment of the dominant forms of migration – reorientation from permanent migration to temporary labor migration, at least, as concerned the use thereof as a tentative (assessment, auxiliary) stage prior to permanent migration.

Similarly to the situation observed in the preceding years, the overwhelming majority of migrants arrived to Russia from the CIS member countries (95.2 per cent, or 96.1 per cent taking into account the migration from the Baltic States). As concerns the absolute figures of immigration, Kazakhstan retained its leading position. However, in the case the current migration trends persist, Uzbekistan can challenge the role of Kazakhstan already in 2007, for the first time in the 1990s. In general, the first three top countries as concerns immigration (alongside with the two countries indicated above this group also includes Ukraine) account for 59.1 per cent of the number of migrants entering Russia.

The modest general dynamics of migration to Russia from the CIS member countries (an increase in the number of migrants by 5 per cent observed in January through October of 2006 in comparison with the figures registered in the respective period of 2005) were determined by a mix of opposite trends, which include:

- a sharp decline in the number of migrants from Byelorussia (by 21.1 per cent) and especially from rapidly developing Kazakhstan (by 28 per cent);
- a significant growth in the number of people immigrating from Armenia (1.8 times), Azerbaijan (1.7 times), Moldova and Tajikistan (1.3 times), which as it seems, should be viewed as a statistical artifact: the introduction of the new legislation concerning Russia's citizenship in 2002 and related to this fact toughening of the migration legislation has significantly deteriorated the inadequate procedures of migration registration<sup>16</sup>. Most probably, there was really observed a certain increase in migration from these countries, although not such a significant one.

At the same time, the migration exchange with Ukraine and Kazakhstan became more equal as there were registered three migrants from these countries per one immigrant from Russia leaving for these states. The migration exchange with Byelorussia has been still negative for Russia.

One third of the migrants from the CIS member countries and the Baltic States arrive to the Central federal okrug; however, the South and Volga federal okrugs are also attractive for migrants.

### Emigration

As the new practices of international labor exchange (work under labor contracts, study or training abroad) take root in Russia alongside with country-wide introduction of mass communication culture and informatics, it resulted in a sharp (almost 2 times) decline in migration aimed at permanent residence in countries outside of the NIS from Russia in 2006 as compared with the figures observed in 2005. Over the time elapsed since the start of market reforms the most skilled professionals have either left the country or adapted at last to the new economic reali-

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<sup>16</sup> For more details see: Chudinovskikh O. S. Prichiny i posledstviya krizisa rossiyskoi migratsionnoi statistiki (Causes and consequences of a crisis in the Russian migration statistics) // Otechestvennye zapiski. 2004. No. 4. P. 176 – 190. Mkrtchyan N. V. Vozmozhnye prichiny snizheniya immigratsii v Rossiyu v 2000 – 2001 godakh (Possible factors behind a decline in the immigration to Russia in 2000 and 2001) // Voprosy statistiki. 2003. No. 5. P.p. 47 – 52.

ties<sup>17</sup>. The “brain drain” facilitated by the economic problems faced by Russia (low wages and salaries, lack of jobs answering the level of education and training of persons seeking employment, uncertain career prospects<sup>18</sup>), as well as the spontaneous liberalization of the border regime in the 1990s significantly declined in the 2000s and was replaced by “labor pendulous international migration.” Therefore, in this sphere (in parallel to the similar processes relating to immigration to Russia from the former Soviet Republics) there was observed a partial reorientation from permanent forms of migration to temporary ones. Similarly to the situation in Europe, the concept of “resident” population in Russia is gradually becoming more ambiguous<sup>19</sup>, whereas labor migration of researchers becomes a reliable way to establish international contacts, universalize science and knowledge, and, in the end, to promote globalization.

The composition of skilled professionals emigrating from Russia has also changed: while in the early 1990s the main concerns related to scientists of world wide repute and leaders of scientific schools and disciplines, in the 2000s the urgent problem was the emigration of graduates of prestigious Russian higher education establishments, as well as students and postgraduate students studying abroad, who sought there permanent residence. In the case these trends become more pronounced, it may facilitate, alongside with creation of other problems, additional “ageing” of the country’s population<sup>20</sup>.

The interest in ethnic migration continued to wane. The new round of political problems in Israel, one of the main countries for Russia in terms of ethnic migration, observed in 2006 just made this trend, which has existed for a long time, more clear. However, the main changes occurred not in connection with Israel, but with Germany – in January through October of 2006 immigration to Germany declined

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<sup>17</sup> According to the data collected in the framework of survey “Russian students abroad: prospects of return to Russia” yet in 2001 60 per cent of respondents (Russian citizens) being students abroad indicated that they can return to Russia in order to work in accordance with their future professions only on the condition that certain professional environment exists in Russia. The majority of respondents (61 per cent) noted that the optimal model of professional and migration behavior of people migrating abroad for study can be described as the orientation to reside abroad with the possibility to perform their professional activities in Russia on the basis of temporary labor contracts or by the way of short professional visits. // Ledneva K. Ne poteryayet li Rossiya svoikh Platonov i Nevtonov? (Will Russia be able to retain its Newtons and Platos?) / Demoskop Weekly. No. 55 – 56.

<sup>18</sup> As concerns the factors behind the “brain drain” observed in the 1990s, for more details see: Ushkalov I. *Intellectualnaya migratsiya i bezopasnost* (Intellectual migration and security) / *Migratsiya i bezopasnost v Rossii* (Migration and security in Russia). G. Vitkovskaya, S. Panarin, eds. The Carnegie Moscow Center. M. 2000. P.p. 109 – 151.

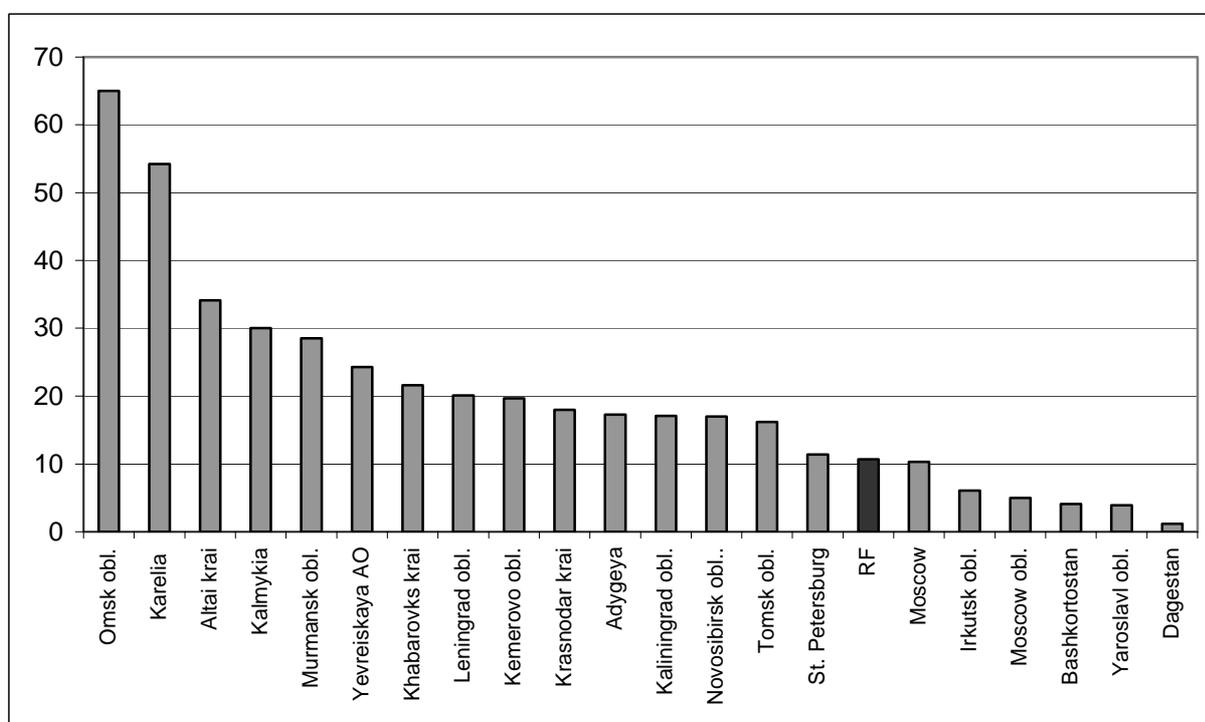
<sup>19</sup> Across the major part of Europe, the permanent resident migration continues at present as a result of prior temporary migrations via reunification of families and creation of new families // *Materialy Soveta Evropy: “K strategii upravleniya migratsiyeyi”* (Towards a migration management strategy.), CDMG (2000) 11 rev., Brussels, 2000.

<sup>20</sup> At the same time, the age composition of the current migration from Ukraine, Byelorussia, Moldavia and even Kazakhstan does not facilitate rejuvenation of the age structure of the Russian population – *Menshe detei, bolshe pozhilykh lyudei* (Less children, more seniors) / Demoskop Weekly. 2005. No. 185 – 186, January 10 – 23. <http://demoscope.ru/weekly/2005/0185/barom02/p>

2.8 times in comparison with the figures registered in the respective period of 2005.

At the same time, there began to be observed opposite flows, for instance, as concerns Israel there were registered 75 immigrants from this country per 100 people leaving Russia for Israel. The same process was observed also with respect to Germany (35 people returning to Russia per 100 immigrants from Russia to Germany). Traditional trends persisted only with respect to migration to the USA (12 repatriates per 100 people leaving Russia for the USA).

In 2006, the trend towards immigration abroad primarily from Russia's regions, which has been observed over several years, persisted. Large cities, which provide their residents with a wide range of opportunities as concerns careers, take lower and at most middle positions with respect to immigration.



Source: Information on the social and economic situation of Russia in 2006, <http://www.gks.ru>

Fig. 2. Intensity of immigration to countries outside the NIS in January through October of 2006 (immigrants per 100 thousand persons)

### Illegal immigration

The number of illegal migrants in Russia is considered to be large; however, by definition, difficult to be quantitatively estimated and, therefore, being a tool of political, administrative and economic manipulation. The range of estimates made public in 2006 is very broad:

- World Bank – about 3 million to 3.5 million people<sup>21</sup>;
- Expert estimates – 3 to 4 million people<sup>22</sup>;
- K. Romodanovsky, the Head of the RF Federal Migration Service – 10.2 million people (November – December of 2006<sup>23</sup>), 5 million people (January of 2007).

The spread of the figures cited above is evidence of the difficulty of the problem to evaluate the number of illegal migrants in Russia. It should be also noted that while the figures presented by the expert community correlate, although slightly, with each other, the estimates published by bureaucrats are, most probably, determined by current political trends; otherwise it would be difficult to explain the difference in estimates making 5 million people within 3 months.

The problem of direct quantitative evaluation of the amounts of illegal migration is related to the analysis of the structure of migration flows. Illegal migration consists of several different components: one part is presented by migrants since long resetting to Russia and permanently residing there with their families, but due to various reasons having no legal status; yet another part is labor migrants temporarily residing in the country in search of earnings and often having no families; and the third part is seasonal migrants and shuttle traders frequently traveling between Russia and their countries of origin.

It is difficult to evaluate the “contribution” of each of these groups in the total number of illegal migrants staying in Russia; however, otherwise any general estimates are meaningless (with the exception of being used for political manipulation purposes), whereas the making of efficient decisions becomes impossible. In West Europe, the amounts of temporary labor illegal migrants are estimated to make 10 per cent of the number of legal migrants<sup>24</sup>. In the case this formula is used with respect to Russia, it turns out that this group of migrants should make 70 thousand people (the RF Federal Migration Service officially registered 706 thousand people in the first six months of 2006), what hardly reflects the real situation.

The overwhelming majority of illegal migrants (up to 90 per cent<sup>25</sup>) flow in Russia from the neighboring countries of the former Soviet Union. Other 10 per cent of illegal migrants arrive from countries outside the NIS, primarily from South East Asia.

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<sup>21</sup> Migration and Remittances. Eastern Europe and the Former Soviet Union / Ed. by Ali Mansoor and Bryce Quillin. The World Bank, Europe and Central Asia Region, 2006. p.3

<sup>22</sup> Zayonchkovskaya Zh. A., Mkrtychyan N. V. Migratsiya. Naseleniye Rossii (Migration. Population of Russia). 2003 – 2004. Odinatstyi – dvenadtsati yezhegodnyi demograficheskiy doklad (Eleventh – twelfth annual demographic report). A. G. Vishnevsky, Executive Editor. M.: Nauka, 2006. P. 315. Mukomel V. I. Migratsionnaya politika Rossii: postsovetkiye konteksty (Russia's migration policy: post-Soviet contexts). M., 2005. P. 194.

<sup>23</sup> Vremya novostei. December 12, 2006.

<sup>24</sup> Molodikova I. N. Osnovnye etapy i metody regulirovaniya trudovoi migratsii v zapadnoyevropeiskikh stranakh (Major phases and methods of regulation of labor migration in West European countries) // Trudovaya mobilnost v SNG: sotsialnye i ekonomicheskiye efekty (Labor mobility in the CIS: social and economic effects). Zh. A. Zayonchkovskaya, Executive Editor, Moscow, 2003. P. 270 – 285.

<sup>25</sup> Problemy nezakonnoi migratsii v Rossii: realii i poisk resheniy (Problem of irregular migration in Russia: reality and search for solutions). M.: Gendalf, 2004. P. 496.

As concerns the three components of illegal migration – illegal entry, illegal stay and illegal employment – illegal employment is the dominating factor<sup>26</sup>. The data collected in the framework of a survey of migrants residing in Russia less than 2 years revealed that 46 per cent of them are not registered at their places of work<sup>27</sup>. The fact that migrants have no work permits (30 per cent of respondents as established in the course of the study “Irregular migration in / from Russia”<sup>28</sup>), as well as undocumented labor relations are evidence that in the 2000s in Russia there formed a situation, where employers see the illegal status of migrants as a benefit due to a number of economic factors (cheap labor, lack of rights as concerns migrants, tax evasion, flexible labor schemes, opportunities to infringe on working conditions, open ended working days and so on).

In the 1990s and 2000s, the segregation of labor niches as “local,” “migrant” and “mixed,” as well as the use of illegal employees and processes of formation of ethnic labor networks were frequent developments also in other East European countries.

### Internal migration

In 2006, the trends, which have been observed in the sphere of intraregional migration in Russia, persisted. во внутрирегиональной миграции в России продолжились тенденции, начавшиеся ранее.

*A. Stabilization of the number of internal migrations.* The extrapolation of the data on the number of interregional migrations occurring in January through October of 2006 to the whole year demonstrates an almost carbon copy of the situation observed in 2004 and 2005 (see *Fig. 3*), when intraregional migrations embraced 0.6 per cent of the country’s population and yet another 0.75 per cent of migrants resettled within their respective regions.

*B. Persistence of directions of migrations, areas of outflow and inflow of migrants.*

As concerns the vector of intra-Russian migrations, the South West direction of the flow persisted. Only two federal okrugs – Central and North West, which include both Russian capitals – demonstrated a positive migration balance. At the same time, the intensity of increase in population based on internal migration in the Central federal okrug is 4 times above the figures registered in the North West federal orkug. The main factor behind this difference between these two leading okrugs is the size of the zone, from which migrants actively outflow there. While North East, as earlier, attracts migrants only from the north of the European part of the

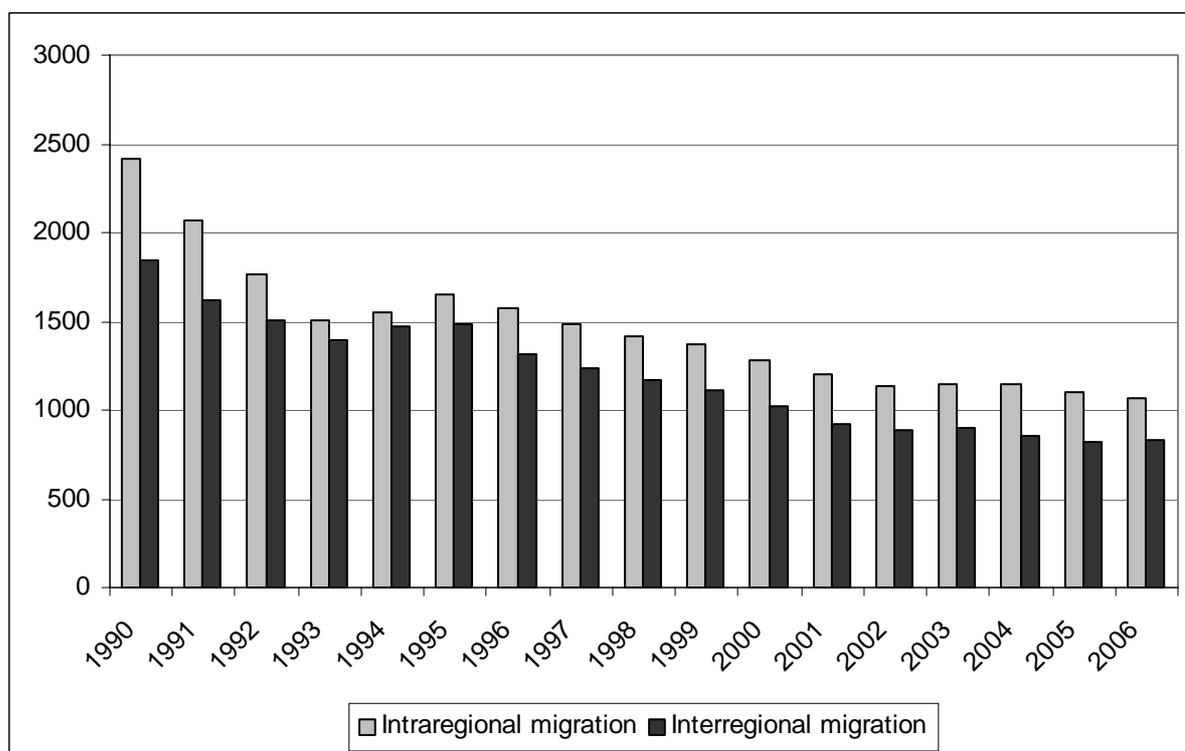
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<sup>26</sup> Problemy nezakonnoi migratsii v Rossii: realii i poisk resheniy (Problem of irregular migration in Russia: reality and search for solutions). M.: Gendalf, 2004. P. 496.

<sup>27</sup> The data obtained in the course of the study “Transformatsiya postsovetского prostranstva: otrazheniye v migratsiyakh” (Transformation of the Post-Soviet Space: Its Reflection in Migrations) (2002 – 2005) (Grant No. 980-0789-3 of the Ford Foundation) of the Center for Migration Studies.

<sup>28</sup> Problemy nezakonnoi migratsii v Rossii: realii i poisk resheniy (Problem of irregular migration in Russia: reality and search for solutions). M.: Gendalf, 2004.

country, the Center is the locality, where people migrate from almost all regions of Russia.



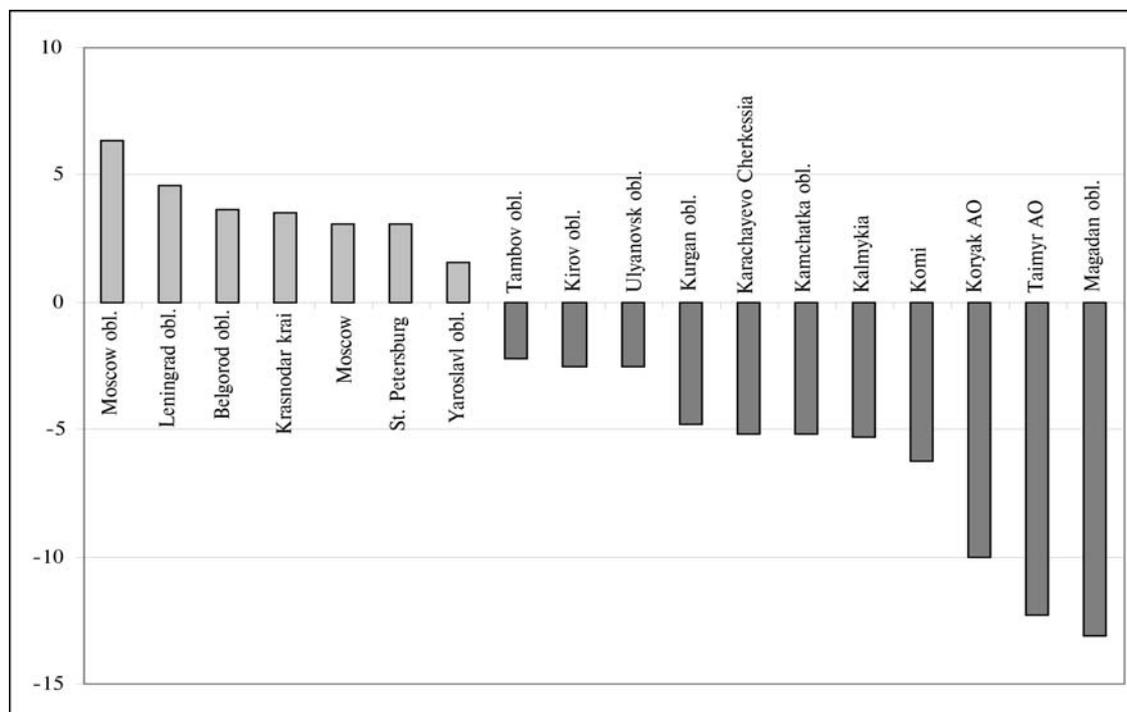
Source: 1990 – 2005 – the data published by Rosstat, 2006 – the author's estimates on the basis of the data published by Rosstat in January through October of 2006. See: <http://www.gks.ru>

Fig. 3. Internal migration in Russia in 1990 through 2006 (thous. persons)

In contradistinction to the Central and North West federal okrugs, the Far East has since long participated in the exchange of population with all okrugs. It was not an exception that in 2006, when over 10 months of that year the migration based decline in the population of this region made about 19 thousand people. The rate of this decline decreases due to a drop in the migration capacity of many of the regions of the Far East federal okrug, where population declines rather significantly. Thus, only over 5 years – from 2001 through 2005 – the okrug lost almost 130 thousand people, the number equal to three fourths of the population of the whole Magadan oblast.

In 2006, only 20 Russia's regions demonstrated a migration based increase in their population as concerns intra-Russian migrations, whereas all other regions were characterized by an outflow of population. It should be noted that only 4 regions (Moscow and St. Petersburg with their oblasts) accounted for 70 per cent of the total internal migration based increase in the size of population. Therefore, almost the total amount of internal net migration relating to resettlements from places of permanent residence is registered in the capital agglomerations. The most intensive inflow of migrants is demonstrated by the Moscow oblast (see Fig. 4), what is caused by the benefits presented by a massive and differentiated Moscow

labor market in combination with cheaper housing and less tough (as compared with Moscow) registration requirements. The opposite situation is observed in the regions situated in the Far East and Siberia (especially in autonomous okrugs), as well as certain crisis stricken regions in the European part of the country.



Source: Information on the social and economic situation of Russia in 2006, <http://www.gks.ru>

Fig. 4. Intensity of migration based increase as concerns intra-Russian migrations in January through October of 2006 (migrants per 1 thousand persons)

*C. Actual absence of attractive regions in the east of the country.*

Eastern regions continue to be less attractive for internal migrants – only 4 regions (the Republic of Altai, Aginsk Buryat Autonomous Okrug, the Kemerovo and Tomsk oblasts) demonstrate migration based increase in the size of the population, and only in the Kemerovo oblast it is significant. Both oil extracting okrugs of West Siberia and regions, where there are situated cities, the population of which exceeds one million residents (the Novosibirsk and Omsk oblasts) are characterized by an outflow of people.

*D. Increasing social and economic differentiation of regions, as well as the growing differentiation in terms of real incomes and purchasing power of the population, becomes a more and more significant factor affecting intra-Russian migration flows.* At the same time, the fact that regions of the European part of the country constitute a large and territorially compact conglomerate of territories characterized by economically and institutionally similar conditions and “middle” general levels of social and economic development lessens migration activity of the population.

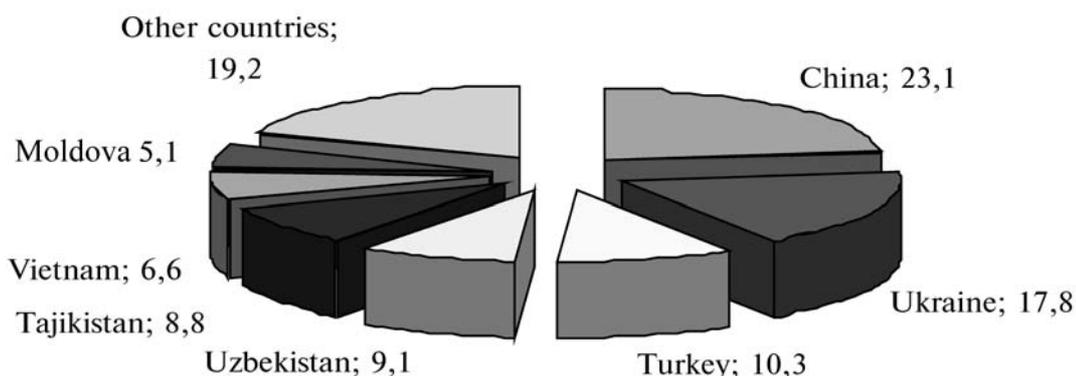
### Temporary labor migration

In the 1990s, the development of temporary labor migration, especially in the framework of the CIS, was explosive. This type of migration flows performed a range of important social and economic functions and acquired a massive scale as it was typical in the rest of the world. .

According to the data presented by the RF Federal Migration Service of the RF Ministry of Interior, the inflow of foreign employees in the national economy on the legal basis increased from 129 thousand persons in 1994 to 702.5 thousand persons in 2005, i.e. 5.4 times. In the first six months of 2006, 706 thousand foreign employees worked in the country's economy. In comparison with the respective period of 2005, the number of foreign citizens legally employed in the Russian territory increased 1.5 times. The persistent rapid growth of the scale of the inflow of temporary labor migrants in Russia is evidence of the respective needs experienced by the Russian labor market and the clearly more attractive nature of temporary labor migration as compared with permanent migration. The latter circumstance may be explained by the fact that temporary migrants do not need to purchase expensive housing in Russia, completely change traditional ways of life, and create suitable conditions for their families.

The format of temporary labor migration permits to ignore these needs, but at the same time have jobs and incomes. Due to these specifics, this type of migration is most characteristic for men (the share of men makes 83 per cent), of which the overwhelming majority (more than 90 per cent) are men at the ages ranging from 18 to 49.

According to the official data, in the first six months of 2006, citizens of 137 countries of the world worked in Russia. In spite of the broad geography of countries, from where people migrated to Russia, only 7 countries account for about 70 per cent of the total number of legal foreign employees (see Fig. 5).



Source: the data presented by the RF Federal Migration Service of the Ministry of Interior.

Fig. 5. Countries of origin of foreign labor in Russia and their share (in %) in the number of foreign employees in the first six months of 2006.

The group of countries being exporters of temporary labor migrants to Russia established yet in the early 1990s. Since that time, changes occurred only as concerned their shares in the numbers of migrating workers. The main change is the constant decline in the share of the Ukraine segment (for comparison: in 1994 the share of Ukraine made 43 per cent) and a growth in the number of migrants from the Central Asian countries.

Similarly to the situation observed in preceding years, according to the data presented by the RF Federal Migration Service of the RF Ministry of Interior foreign employees concentrated in several sectors of the economy: construction (40 per cent); wholesale and retail trade; repair of motor vehicles (28 per cent); agriculture, hunting and forestry (5 per cent); manufacturing industries (8 per cent); transport and communications (4.5 per cent). As in the majority of other countries of the world, the main factor generating employment of foreign migrants is the lack of labor force in certain sectors of the economy, occupations and types of activities. Primarily, these are the spheres of employment characterized by large numbers of unattractive jobs. Therefore, even in spite of unemployment registered in Russia at large and its regions there persists the need for labor forces having the necessary level of skills. Due to this circumstance, there exists a contradiction: on the one hand, Russia, similarly to any other state considering itself to be a developed country, wishes to attract skilled workers. On the other hand, in the postindustrial situation, characterized by much higher requirements concerning the quality of jobs on the part of national labor force and the fact that local residents are not ready to take non-prestigious jobs, there increase the need for street cleaners, waste collection workers, baby sitters, loaders, park keepers and people of similar occupations, which have to be imported.

Although the real scale of employment of foreign labor is unclear, it seems that its sectoral structure on the whole follows the distribution of officially employed foreign migrants.

Although on the whole the share of officially registered foreign workers in the total number of employees (about 1 per cent) is significantly below the figures observed in developed countries of the world<sup>29</sup>, it is rather high in certain regions of the country (capital cities, oil and natural gas extracting okrugs of Siberia, Primorsky krai, Yevreiskaya Autonomous Oblast and Sakhalin oblast) and has a much more significant effect on local labor markets than the national one.

In spite of the view that migrants steal jobs from local population and thus affect the levels of wages, salaries and employment, which is widespread in the society<sup>30</sup>, there has been revealed no clear correspondence between the number of of-

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<sup>29</sup> The share of foreign employees makes 24.6 per cent in the labor force of Australia, 18.1 per cent – of Switzerland, 11.7 per cent – of the USA, 10.0 percent – of Austria, 8.8 per cent – of Germany, 5.8 percent – of France // Migration Policy Issues IOM, №2, march 2003, p.2

<sup>30</sup> The data collected in the framework of a survey conducted by the Levada Center (July of 2005) provide evidence that 35 per cent of respondents have negative attitudes towards the inflow of migrants, since migrants take the jobs, which could be taken by local residents // Mukomel V. I. Migratsionnaya politika Rossii: postsovetiyskiye konteksty (Russia's migration policy: post-Soviet contexts). M., 2005. P. 203.

ficially registered foreign employees and the level of unemployment in Russia. For instance, in 2005 the total number of unemployed in the country declined at the background of a growth in the number of foreign employees in Russia. It should be noted that in a number of developed countries of the world there also was not found evidence that migration affects unemployment levels<sup>31</sup>.

Therefore, it can be stated that the main result of developments observed in the sphere of migration last year was not real changes in the scale and structure of migration flows, but an active process of migration related law making forming mixed expectations of future changes.

#### **4.4. Social-Cultural sphere**

##### *4.4.1. Education*

In 2006 the development of the national educational system was determined mostly by the following factors:

- 1) demographic situation;
- 2) growth in the budgetary funding;
- 3) introduction to the general education of the principle of standardized per capita financing;
- 4) emergence of the so-called priority national project entitled "Education";
- 5) introduction of the Unified state examination.

Last year saw the continuation of experiments and the rise of new ones in the educational sphere. More specifically, there continued experiments on introduction of a unified state examination (USE), profile education in the higher school, and experiments with the structure and content of the general education. As concerns the new experiments, one can single out the launch of the one on transition towards the standardized per capita financing in the primary education and secondary vocational training, creation of multi-level educational institutions on the basis of leading institutions of the primary vocational education (PVE) and secondary vocational education (SVE), and implementation of courses for practice-oriented Bachelors on the basis of leading colleges, among others.

In 2006, the educational system begins its transition towards a sectoral labor compensations system. One of the models of the new (sectoral) labor compensations system in the general education was tested in Tyumen oblast, followed by Samara oblast in summer 2006. Clearly, in the course of implementation of comprehensive regional projects in the framework of the noted national project on education the year of 2007 will see the continuation of introduction of new models of the sectoral labor compensations system.

1. The immediate effect of the 2006 *demographic situation* in the educational sphere was reduction or discontinuation of growth in the number of students. This phenomenon manifested itself in different ways, so far as different levels of the educational system are concerned. The demographic decline so far has been most notable in the school education. By contrast, the vocational educational system,

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<sup>31</sup> Ibid, p. 204.

including its primary, secondary and the higher sub-systems had been experiencing the rise in the number of students until 2004–2005. In 2004, the negative demographic wave battered the primary vocational training system, the number of students of which began to decline (at the annual pace of 2.7%). In parallel with that, the enrollment to the secondary vocational education and the paid sector of the public high education began to drop, too, albeit the number of students at SVE and the higher vocational education institutions was on the rise. In 2005, there occurred a decline in the admission on the budgetary basis to public universities, which found themselves in competition for enrollees with HPE institutions. In 2005–06, for the first time since 2000, the non-public universities have seen a fall in admission (*Table 6*).

*Table 6*

**Dynamic of Admission to Public and Non-Public Universities  
in 2000–2006 (as Thos. Students)**

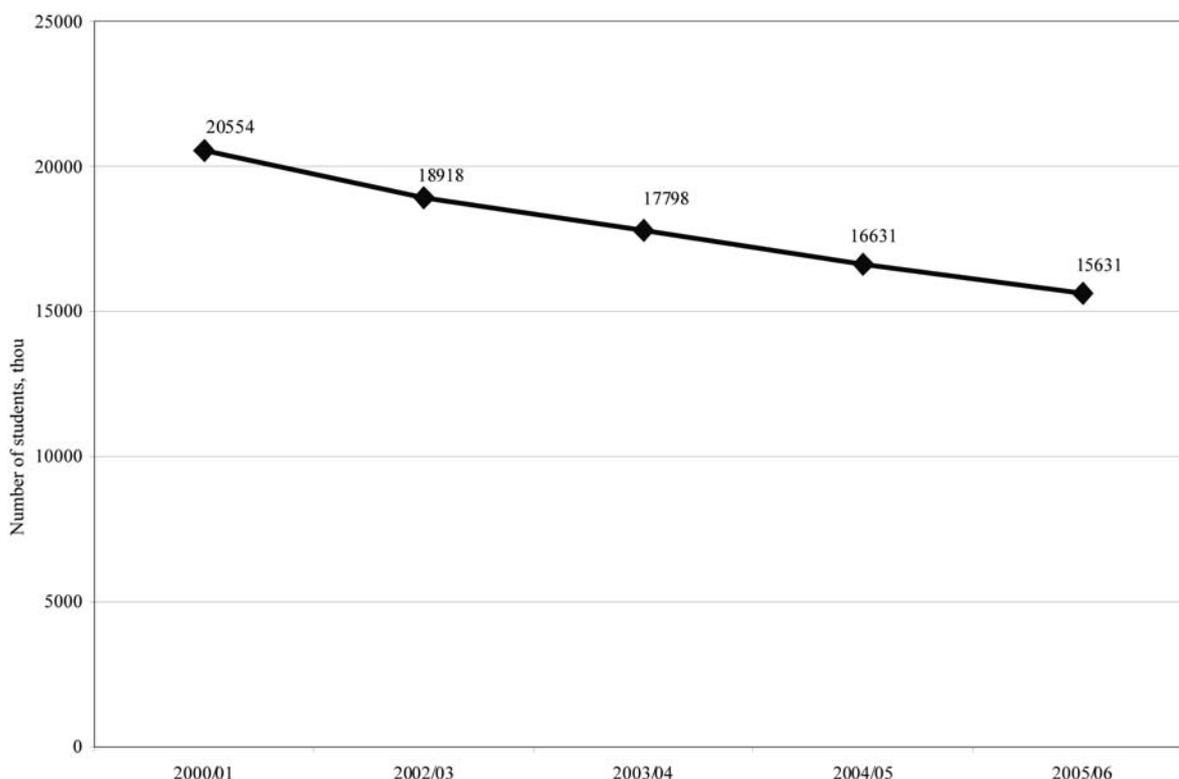
Years	Public and municipal universities			Non-public universities
	Total	“Budgetary” admission	Paid admission	
2000/01	1140.3	586.8	553.5	152.2
2001/02	1263.5	587.9	675.6	198.2
2002/03	1299.9	608.0	691.9	204.0
2003/04	1411.7	622.6	789.1	231.7
2004/05	1384.5	628.6	755.9	274.5
2005/06	1362.7	609.7	753.0	268.0

Source: Rosstat.

By the system of the high education on the whole in 2005–06 educational year the admission plunged at 1.6%, with the budgetary one falling at 3.0%. Meanwhile, the contraction in paid admission to the public universities accounted for a meager 0.4%. Thus, the recent admission policy provides an indirect evidence of the fact that in the conditions of the demographic decline the government has taken a course towards a relative reduction in the number of “budgetary” students, albeit still adhering to the framework of the legal provision, which implies that public universities should admit at least 170 individuals as budgetary students per 10,000 of the population. In 2005–06 educational year the number of students in Russia was 495 per 10,000 of the population, with the proportion of budgetary students making up 210. But the proportion of the budgetary admission in the overall number of students admitted for the first year at public universities has been steadily on the decline over recent years. Because of the decline in the number of graduates from the secondary school, the contraction in the number of budgetary students in public universities basically might be increased up to the rate, which would meet the requirements of the aforementioned legal provision, thus making up the number of budgetary students equal 2.45–2.5 m. Should it happen, admission of budgetary students should make up no more than 500,000 a year (with account of those rejected). But, as the decline in the number of secondary school graduates will continue to the level of 850,000–900,000 a year (the basic figure for 2010), the propor-

tion of those who will be admitted to the public universities on the paid basis should decline, at least, to 40–45% (vis-à-vis the current 55%). That would happen only providing the currently existing “overhang” is still there, with the volume of university admission being considerably (at 15–20%) superior to the number of secondary school graduates. Otherwise, i.e. in the event the said overhang disappears, the proportion of paid students in the public universities may experience a far greater fall. This leads to a quite natural question about the future of non-public universities and branches of public and non-public universities (in 2005–06 educational year, the number of the former was 413, while that of the latter – a. 2,000). It will be the correlation between tuition fees in the public educational sector and those in the non-public educational sector that should play a critical part in their competition for students.

In 2006, schools saw the number of their students decline. In 2005–06 educational year, the number of students in schools of general education dropped by 6.0% vs. the prior year (*Fig. 6*).



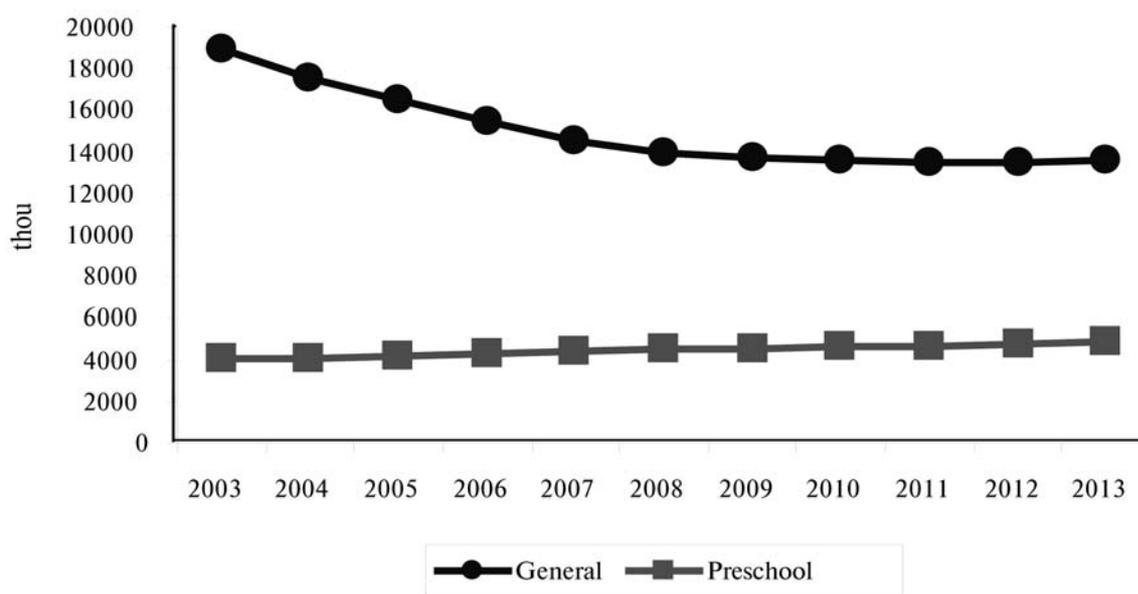
Source: Rosstat.

*Fig. 6.* The Number of Students in Schools of General Education in 2000/01–2005/06 educational years (thousand)

In all, between 2000 and 2006 the number of students in schools of general education has fallen by nearly j, which resulted in considerable cuts in the schools network and the number of teachers. Between the 2000–01 and 2005–06 educa-

tional years, the number of schools was declining at a rate of some 1,200–1,500 units a year, and in the 2005–06 educational year it displayed a far intense decline, that is, by over 1,700 units. In all fairness, it should be noted that while the number of students fell by 25%, the number of schools declined by 8%, while that of teachers – by 10.1%. In the 2005–06 educational year alone, the number of pupils fell by 6% and that of teachers – by just 2.4%. As a result, lately the number of students per 1 teacher was declining steadily: from 11.7 students per teacher in the 2000–01 educational year to 9.9 in the 2005-06 educational year. Interestingly, non-public schools displayed an opposite trend – in the 2005-06 educational year alone, the number of students grew by 2.8% vs. the prior year, while the number of teachers remained unchanged. For reference, the students- to- teacher ratio in private schools is 4 to 1. The figures evidence an inefficient organization of the system of general education in Russia on the whole. To be fair, though, one should take into account the notorious Russian distances, a low population density in many regions and a poor transport infrastructure. Thus, the low efficiency of the educational system to a significant degree is steered by these external factors.

Because of demographic reasons, the fall in the number of students in school will continue for another several years (until 2010), followed by some stabilization (*Fig. 7*).



Source: Rosstat.

*Fig. 7.* Dynamic of the Number of Pupils in the Pre-School Institutions and Schools

In 2006, the preschool institutions experienced a rise in the number of children, albeit a small one (*see Fig.7*). Underlying the process were two causes: on the one hand, the birthrate has been on the rise since the early-1990s (from 9.0 up to 10.2 births per 1,000 of the population), which resulted in the rise of the number of children attending the preschool educational institutions (PEI). On the other

hand, PEI have delivered their services to an increasing number of children of the preschool age, for economic growth compelled their mothers to get back to work and leave their children with PEI. As of early-2006, by some preliminary estimates, the number of children in need of the PEI services accounted for 830,000. Meanwhile, only as many as 60% of the children (the average rate nationwide) at the age of 5 to 6 attends PEI, which raised the question as to whether it was appropriate to introduce a national analogue to the Western preschool system in the country, especially for children from the needy families, for the sake of their preparation for the general school. This would allow to equalize the starting conditions for children from different income groups and to enhance the quality of the primary school education. This work was in progress in 2006, however, no clear decision has been made as yet.

2. *The growth in budgetary funding.* In 2005–2006, both public and private sources spent more money on education. Between 2000 and 2003 the proportion of budgetary expenditures (from the budgets of all levels) on education in GDP grew considerably, and it *de-facto* stabilized against the rise in absolute volumes of spending. The same trend was displayed by the federal budget educational expenditures, including those on the high professional education (HPE) (*Table 7*)<sup>32</sup>.

Table 7

### The Federal Budget Expenditures on Education

	2000	2001	2002	2003	2004	2005	2006	2007
Federal budget expenditure on education (as RUR bn)	38.1	54.5	81.7	99.8	121.6	160.5	201.6	278.0
Federal budget expenditures on the higher education (as RUR bn)	22.5	31.3	44.4	56.8	72.1	114.7	155.1	214.0
The share of the federal budget expenditures on education in GDP (as %)	0.5	0.6	0.8	0.8	0.7	0.7	0.8	0.9
The share of the federal budget expenditures on the higher education in GDP (as %)	0.3	0.3	0.4	0.5	0.4	0.5	0.6	0.7
The share of expenditures on education in the federal budget expenditures (as %)	3.8	4.1	4.1	4.1	4.9	4.6	4.7	5.1
The share of expenditures on the high education in the federal budget expenditures (as %)	2.3	2.4	2.2	2.3	2.8	3.2	3.6	3.9

Source: Rosstat, MinFin RF.

Private (non-public) spending on education is fixed in the Russian statistics as “the volume of paid services in the educational system” with account of latent and informal activities in this area. The dynamic of the volume of paid services in the

<sup>32</sup> As the 2007 federal budget has been already passed, the Table also includes the 2007 federal budget expenditures on education.

educational system exposes their steady growth, the rate of which is advancing the growth rate of the budgetary expenditures on education (*Table 8*).

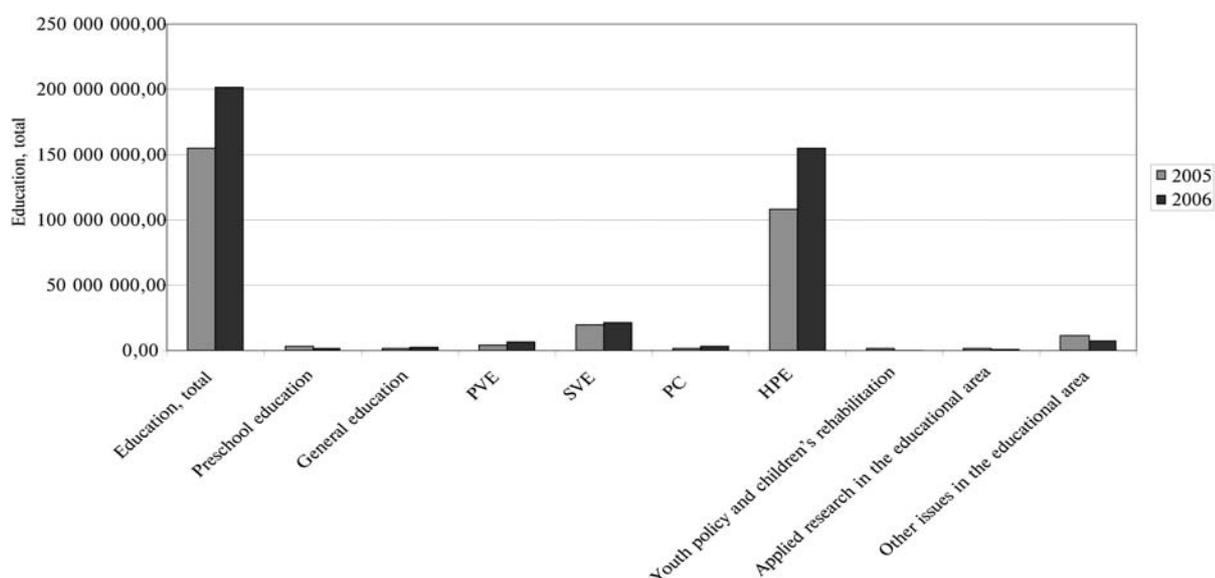
*Table 8*

**The Volume of Paid Services in the Educational System in 2000–2006**

	2000	2001	2002	2003	2004	2005	2006 (estimated)
Volume of paid services in the educational system, .as RUR bn.	41.5	56	72.9	95.4	118.7	147	183.8
As % to GDP	0.6	0.6	0.7	0.7	0.7	0.7	0.75

*Source:* Rosstat, the 2006 population’s spending as estimated by the author.

The year of 2006 saw a sharp rise in the federal budget spending on education vis-à-vis the prior year. The rise was particularly notable in the area of the high education, which, according to the division of powers between levels of the government now falls under jurisdiction of the federal government. In 2005, practically all the PVE institutions were re-assigned to the regional level (with the federal center still maintaining control over 250 PVE institutions out of more than 3,800) and so was done with a part of SVE institutions. While comparing the federal budget spending across the levels of the educational system in 2005 and 2006, one can note the situation as follows (*Fig. 8*).



*Source:* Rosstat, MinFin RF.

**Fig. 8. The Federal Budget Spending on Education in 2005 and 2006**

In 2005, the proportion of expenditures on the high education in the federal budget was 70%, while in 2006 it rose up to nearly 77%. With the general growth in funding of education from the federal budget accounting for 1.3 times, the expenditures on the high school grew 1.43 times. As the number of the “budgetary stu-

dents” remained practically unchanged, the changes in funding fueled a drastic rise in the budgetary spending per budgetary student in public universities: whilst in 2004 the average budgetary spending per 1 budgetary student was just RUR 18,000, it grew up to RUR 25,600 in 2005 and 37,500 in 2006, i.e. more than doubled in current prices over the past three years.

It should also be taken into account that in the high school the budgetary funding of tuition is based upon a peculiar ratio, that is, the “weight” of an internal student equals 1; that of an internal-and-by-correspondence one – 0.2, and by-correspondence – 0.1. In the 2005-06 educational year, the first category accounted for 65% of the total number of the budgetary students, the second one – 5%, and the third – 30%. This means that in 2006 the tuition costs per 1 budgetary internal student made up RUR 54, 200, and those were just direct costs of the delivery of the educational service<sup>33</sup> (Fig. 9). Given that, to ensure the comparison between the federal budget spending per 1 student (i.e. payment by the government to a university for tuition services provided to the student) and tuition fees paid by students themselves, we do not take into account costs of students’ stipendiums (Fig. 10).

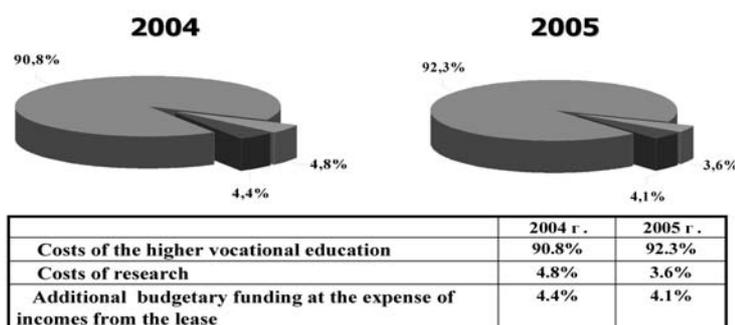
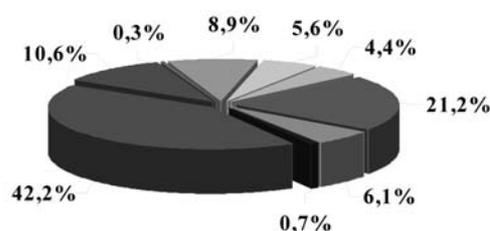


Fig. 9. Structure of the Budgetary Funding of Universities under Jurisdiction of the RF Ministry of Education, in 2004 and 2005

<sup>33</sup> The structure of the budgetary funding of universities under the jurisdiction of the RF Ministry of Education is given for 2004 and 2005, as the 2006 data is still missing, however, it can be suggested that differences in the structure should be negligible.



42.2%	Salaries and wages
10.6%	Charges on labor compensations
0.3%	Communication services
8.9%	Public utilities services
5.6%	Property maintenance costs
4.4%	Other services
21.2%	Stipendiums
6.1%	Growth in the value of capital assets
0.7%	Growth in the value of material stock

*Fig. 10.* Structure of Actual Costs of Universities under Jurisdiction of the RF Ministry of Education, at the Expense of Budgetary Funds, in 2005

Lately the proportion of the costs of the high education for the population in the overall volume of the population's expenses on education (by preliminary estimates, nearly RUR 184 bn. in 2006 alone) roughly accounted for 50%.

If one compares the population's expenses on the high professional education with the respective federal budgetary spending, the proportion of the former was declining steadily – from 83.8% in 2003 to 59.3% in 2006 r.<sup>34</sup> of the total volume of the federal budget financing of the HPE system(*Fig. 11*).

The tax agency has recently tightened control over the targeted use of budgetary funds (i.e. they have to be spent exclusively on tuition services to budgetary students). As in 2005 and, especially in 2006, as noted above, the budgetary funding of the high education began to grow at a constantly increasing pace, the costs of paid educational services were forced to catch up with that, which is proved by statistical data on the rise in the costs of the paid tuition (*Fig. 12, Tables 9 and 11*):

<sup>34</sup> In 2003, the proportion of the population's spending on the higher education relative to the respective costs incurred by the federal budget reached its peak by making up nearly 84%, while in 2006 it fell to 59.3%. In 2007, according to our forecasts it may further decline to 58.4%

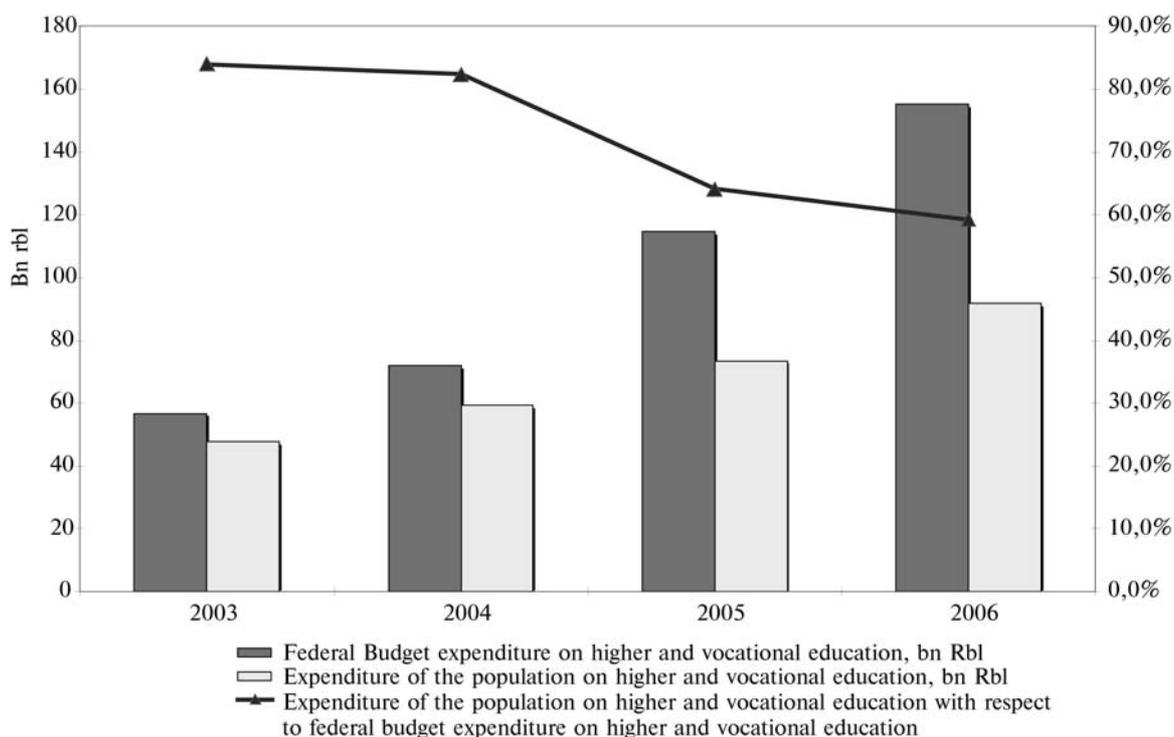


Fig. 11. The Federal Budget expenditures on the high education in 2003–2006 and the population’s spending on tuition at public universities

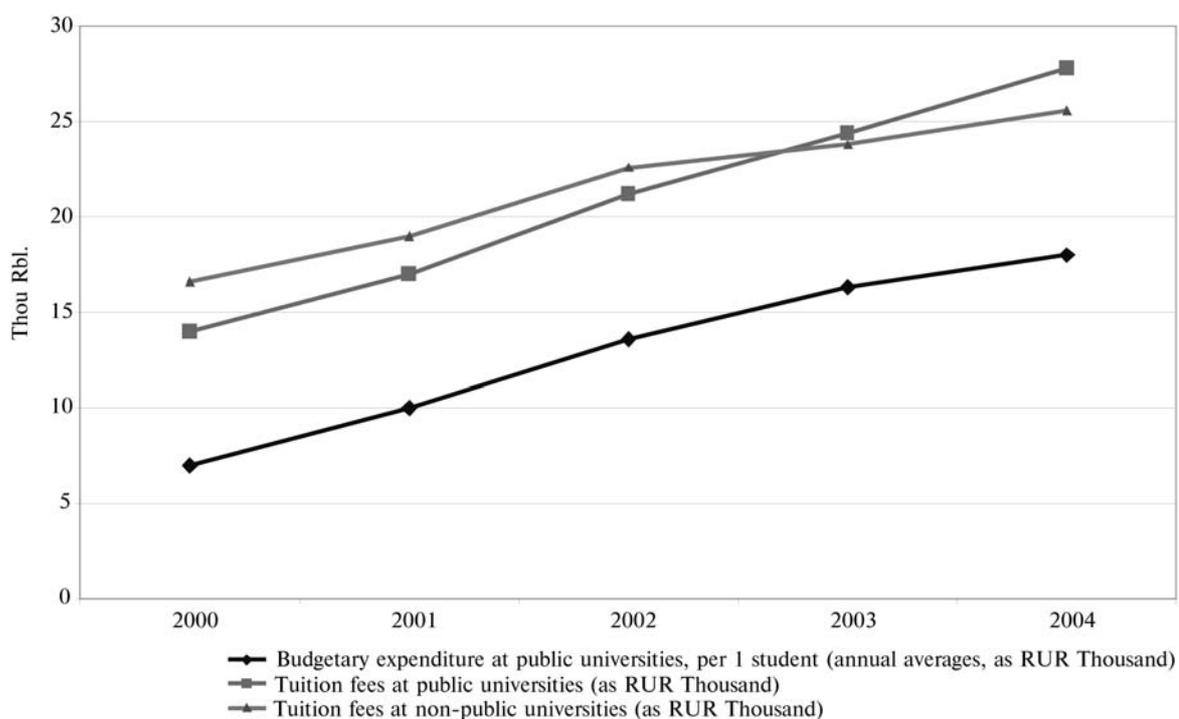


Fig. 12. Budgetary Expenditures per 1 Student and Tuition Fees at Public and Non-Public Universities in 2000–2004

Since 2003 the tuition fees at public universities have advanced vis-avis those at non-public universities. It could be regarded as a manifestation of the fact that in terms of quality of education public universities had won the race with non-public ones and the consumer was ready to pay more for their services than for those delivered by non-public universities. This interpretation was easy to sell, for both the society and the university community share rather a common (and firm) belief of the non-public education as a second-grade institution. However, we have every reason to believe that underlying the public universities' "victory" lies a different cause, that is, the rise in the budgetary spending per 1 budgetary student and, as noted above, the tax agency's stance on public universities' tuition fees (which should not be lower than analogous budgetary expenditures). In 2003, the universities whose tuition fees had been lower than the respective budgetary expenditures were compelled to comply with the tax agency's request. To cite a particular example, their tuition fees rose from RUR 9–12,000 (equivalent to USD 300–400, by the 2003 exchange rate) to RUR 16,500 (USD 550), i.e. at 37.5–85%, which has posed a great increase in tuition fees for the population in subsidized regions<sup>35</sup> (*Table 9*).

*Table 9*

**The Rise in Budgetary Expenditure per 1 Budgetary Student and Tuition Fees for Paid Students in 2000–2004**

	2000	2001	2002	2003	2004
Budgetary expenditure at public universities per 1 student (annual averages, as RUR Thousand)	7.0	10.0	13.6	16.3	18.0
Growth rate in budgetary expenditure at public universities per 1 student (as % to the prior year)	100	142.9	136.0	119.9	110.4
Tuition fees at public universities (annual averages, as RUR Thousand)	14.0	17.0	21.2	24.4	27.8
Growth rate in tuition fees at public universities (as % to the prior year)	100	121.4	125.3	115.1	114.0
Tuition fees at non-public universities (annual averages, as RUR Thousand)	16.6	19.0	22.6	23.8	25.6
Growth rate in tuition fees at non-public universities (as % to the prior year)	100	114.4	118.9	105.3	107.6

Meanwhile, the rise in the population's incomes in 2003–2005 was such that at the time public universities were still able to partly compensate for the shortage of budgetary funds at the paid students' expense, for the average annual income growth rates were ahead of the growth rates in tuition fees. (see *Tables 9 and 10*).

<sup>35</sup> It should be noted that this has played an extremely negative part in the experiment on introduction of the public nominal financial obligations (PNFO). In 2003, in the second year of conduct of the experiment, the tuition fees were raised drastically as a result of the tax agency's requirement, however, the population perceived that as a direct consequence from the introduction of PNFO.

Table 10

**Dynamic of the Population's Average Monetary Incomes  
per Capita in 2000–2005**

	2000	2001	2002	2003	2004	2005
The population's average monetary incomes per capita (monthly), as RUR	2281	3062	3947	5170	6410	8023
Growth rate in the population's average monetary incomes per capita (as % to the prior year)	100	134.2	128.9	130.9	124.0	125.1

Source: Rosstat.

The fundamental change in situation has begun since 2005, with the budgetary expenditures on educational activity per 1 student practically catching up with the average tuition fee charged by public universities, while the population, which by the time had found itself already involved in the system of paid high education, began to exhaust its possibilities to for catching up with the price rise, as the growth rates in tuition fees at public universities began to outpace those of the population's average incomes per (see *Tables 10 and 11*):

Table 11

**The Rise in the Budgetary Funding of Universities and Estimated Increase  
in Tuition Fees at Public Universities in 2005–2007**

	2005	2006	2007
Budgetary expenditures at public universities per 1 student (annual averages, as RUR Thos.)	25.6	37.5	54.2
Growth rate in budgetary expenditure at public universities per 1 student (as % to the prior year)	100	146.1	138.5
Tuition fees charged by public universities (annual averages, as RUR Thos.)	31.2	38.7 (estimated)	54.5 (forecasted)
Growth rate in tuition fees by public universities (as % to the prior year)	100	124.0	137.0

As the 2007 tuition fees charged by public universities *must* exceed on average RUR 54,500 will lay an overly burden on the population, which may radically change the situation in the university education area.

The situation will, of course, vary across the RF Subjects, but one should take into account that a great part of the population's educational costs on the whole and those for the high education in particular, falls on the capital cities – Moscow and St. Petersburg, as well as Moscow, Tyumen and Sverdlovsk oblasts. In other regions, fueled by the growing budgetary funding, a “compulsory” increase in paid tuition services may result in a situation in which a considerable proportion of the population would be gradually deprived of these services. The process forms a real threat primarily to the subsidized regions, whose population's average incomes per capita remain low. Our computations on 2004 and 2005 show that growth rates in

average incomes per capita in 32 regions were lower than the respective average nationwide index<sup>36</sup>.

Thus, all these regions have found themselves in the zone of risk, except Moscow, where the average income level (in absolute terms) still allows withstanding a rapid rise in tuition fees, but a household has to spend an increasingly growing share of its income on payments for educational services (and not necessarily the university's ones). In addition, the noted group will be joined by the RF Subjects (another 6 regions) where the growth rate of average monetary income per capita has lately outpaced the average nationwide one, while the absolute value of the incomes remained low. Thus, yet in 2005 as many as 37 regions have entered the zone of risk with respect to the population's payments for the high education<sup>37</sup>.

In 2006, the increment in the population's average per capita income was 23.5%, while the increment in the budgetary expenditures on education per 1 student posted a 46%-plus growth. Assuming the growth rates in the population's average per capita incomes across the RF Subjects should not experience any considerable change in the annual average terms (and the data for the first half-year prove this assumption), most Russian regions have already begun entering the zone of risk in terms of accessibility of the paid high education services. In compliance with the 2007 budget, the increment in the budgetary expenditures on education per 1 student should make up, as noted above, 38.4%, which will make this tendency yet more visible.

Accordingly, the government should shortly forge a certain policy in high education the area with regard to the public universities' paid educational services. It seems that against the backdrop of the fall in the number of students at high school and the already started contraction in the "budgetary" admission the stake was made on keeping a fairly huge number of paid students. But, as already noted, the rise in the budgetary funding may begin to restrict the access to paid educational services for residents of many Russian regions. The combination of these two factors may result in a rise of social tension in certain Subjects of the Federation and affect the financial situation of many regional universities.

This context may give a rise to a sound solution, that is, promotion of the concept of educational loans, which so far has been debated in a very general form (albeit some experiment in this area was already announced).

While considering the problem of promotion of the educational loans system, one should take into account that today in many depressive regions universities form a sort of "social safeguard" for the local youth. This is associated with high unemployment rates. Should the access to the high education be restricted in such

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<sup>36</sup> So far as 2006 is concerned, Rosstat so far has provided the respective data only through September.

<sup>37</sup> It should be noted that in 2003 (the last year on which the official data are available) the average annual tuition fee charged by the Moscow-based public universities) was RUR 42, 200 vis-avis the average nationwide figure of 24,200 (1.7 times more) and under the budgetary expenditure per 1 student totaling RUR 16,300 (2.6 times more). With a rapid rise in the budgetary expenditures, even Moscow will unlikely to keep up with this correlation, and in all likelihood the "costs" of the budgetary education and those of the paid one should begin to gradually converge.

regions, it may fuel generate dramatic social challenges, such as a stagnant unemployment within the noted group, coupled with the rise of criminal and extremist groups, drug addiction and alcoholism. Because of these threats, the problem of accessibility of the high education and preservation of the university network in the regions needs to be addressed in a very balanced and cautious way.

This equally necessitates a careful and well thought-out selection of possible avenues for the promotion of educational loans and the government participation in them. As concerns the possible arrangements, those worth a particular attention are:

- 1) privileged educational loan, to be disbursed under the government's guarantee to paid students (enrollees) in the regions in which the local residents' capacity in terms of payment for educational services is close to exhaustion;
- 2) the budgetary admission to be extended in the most problematic regions, while residents in other regions are granted an easier access to educational loans;
- 3) the budgetary admission to the leading national universities (university centers) is extended, while the youth in problem regions is granted a facilitated access to student loans (i.e. the ones to cover expenses associated with education, to be disbursed under privileged terms);
- 4) there also exists a possibility to practice a combination of the aforementioned approaches.

Each of the above options has its pluses and minuses, and accordingly, their social, economic, legal and educational effects need to be examined in every detail.

*3. Introduction of the standardized per capita financing in the general education.* This idea dates back to the Soviet time, specifically, 1998.

Later, Art. 41 of the 1992 statute "On education" declared that the funding of educational institutions should be exercised on the basis of standards computed per capita by each type, kind and category of educational institutions. But the Act in question has failed to provide answers to some questions, without which an introduction of the novelty was extremely problematic. More specifically, unanswered remained the following questions:

- Is the per capita standard determined by the need in funds or by the capacity of the budget? In other words, whether the standard of financing fully meets the educational institution's need in funds, or it merely secures as much funds as the budget can afford allocating for the educational process?
- Does the standard in question fix a minimum need in funds per student, or a "normal", i.e. the existing standard?
- Does the standard ensure the most efficient consumption of budgetary funds by a given educational institution, or is it an economic mechanism allowing the most efficient distribution of budgetary funds between educational institutions?
- Should the standard be unified across all the schools, or should it be differentiated (if one abstracts from the objective regional differentiation?).

As a result, the said Article of the Act had been vegetating in oblivion for more than a decade, as without a clear answer, financial agencies interpreted the stan-

dard in question exclusively as the “standard of needs”, that is, the volume of financing which should fully secure the school’s per-student needs. However, lacking such volumes of funds, the financial agencies continued to finance educational institutions’ operations according to the current practice.

On August 29, 2001, the State Council of RF ruled that the obligation to exercise expenditures on the general education should be divided between the Federation’s Subjects and municipalities: while the former had to supply funds to finance the educational process (and, primarily, teachers’ salaries), the latter became responsible for maintenance of buildings and facilities belonging to institutions of general education.

Underlying this decision was constant and growing wage arrears to teachers and teachers’ strikes. The decision was legitimized by Federal Act No. 123-FZ of July 7, 2003, “On introducing amendments to individual legislative acts of the Russian Federation in the part concerning institutions of general education”, and since 2004 some regional budgets have begun an experiment by allocating subventions to local budgets for the sake of implementation of the educational process<sup>38</sup>. In 2005, the transition towards this system started in most Subjects of the Federation. That helped improve the situation with financing in the sector as a whole, albeit wage arrears still exist there. The process continued in 2006.

Meanwhile, the allocation of subventions on education to municipalities from regional budgets raised the problem of principles underlying distribution of the respective funds and *de facto* fueled the transition towards the standardized per-capita principle of financing of the general education. The subventions began being calculated proceeding from the number of students in a given municipality, i.e. according to the per capita principle. But that exposed a problem – namely, while regions allocate subventions basing on the per capita principle, local administrations, as a rule, distribute the funds between schools to cope with different challenges, such as preservation of the schools network and their cadres, among others. Note that because of demographic reasons, the contraction in the number of students leads to an annual contraction in the number of schools and teachers roughly at 1–2%. The process would be far more intense, were the funds be allocated in a strict adherence to the standards.

Thus, it is possible to draw a conclusion that while the regional level of management of the educational system has begun to rest its operations upon the network optimization principles, the municipal level pursues the task of social stability, rather than increase in economic efficiency of the use of resources in the general education area.

The year 2006 saw the launch of an experiment on testing the mechanism of standardized financing of the SVE institutions. The experiment will be conducted for three years (2006-2008). In 2006, there existed only the legal basis of its con-

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<sup>38</sup> In addition to the three Subjects of RF that had earlier launched the experiment (Samara and Voronezh oblasts and the Republic of Chuvashia). Beyond the experiment framework and practically simultaneously with Voronezh oblast and the Republic of Chuvashia the practice of the standardized per capita financing was launched by Yaroslavl oblast.

duct, but the Statute on conditions of its conduct makes it evident that its results are going to be fairly limited, for the experiment centers exclusively on the system of budgetary financing of SVE institutions.

4. *National project "Education"*. In 2006, the national educational system has entered the period of intense activities associated with the implementation of the priority national project "Education". Let us consider main outputs by individual avenues of promotion and support of the educational sphere approved by the Presidium of the Council on implementation of the priority national projects under the RF President (protocol No.2 of December 21, 2005).

So far as the avenue entitled "Support and promotion of the best models of the national education" is concerned, its main blocs of measures provided for encouragement of universities and institutions of general education that vigorously introduce innovational educational programs; provision of support to talented youth; rewarding the best teachers.

In compliance with RF Government Resolution No. 89 of February 14, 2006, last year, it was planned to allocate from the federal budget as much as RUR 8 bn. for support to 10 universities and 3,000 schools. In 2007, the respective amount will be increased up to RUR 18 bn., to be distributed between the universities that won the 2006 competition and another 20 universities, and 3,000 schools.

On May 19, 2006, results of the competition for support of innovational universities were announced. The victors became 17 universities, which became entitled for a RUR 5 bn-worth support from the federal budget. The selection was based on the following criteria:

- a high quality and effectiveness of their innovational educational programs;
- the implementation of such programs should lead to qualitative changes in the level of education, R&D works, and efficacy of their introduction;
- resources employed for implementation of such programs should match the scale of the declared objectives;
- the planned output should be justified and stable.

As well, the selection committee took into account efficiency of the organizational and financial support of the program by a university's external partners and envisaged effects in the economic, social and scientific areas. The funds allocated to the victors were designated for targeted spending on innovational educational programs, including retraining and upgrading of tutors' qualification; purchases of experimental equipment, software, and modernization of the university facilities<sup>39</sup>.

As noted above, after winning the 2006 national competition, as many as 3,000 institutions of general education received the government support. The victors became institutions that vigorously introduced innovational educational programs, and they were represented both by advanced educational institutions of general education (lyceums and gymnasiums) and regular schools (a. 50% of the total number of the victors). The respective funds (RUR 3 bn) were allocated from the federal budget to regional ones in the form of subsidies. The financial support

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<sup>39</sup> The formation of the network of innovational educational programs is considered in a greater detail in Section 4.5 of the 2006 IET annual issue.

was a targeted one and it was designated for purchases of laboratory equipment, software and methodological literature, modernization of the material and technical and educational base, retraining and upgrading of qualification of the staff of the institutions in question.

To award the best schoolteachers for their outstanding performance and significant contribution to education, the government ruled to allocate annually RUR 1 bn. to award 10,000 such teachers with a RUR 100,000 bonus payable to each of them.

In 2006, the government ruled to award 1,250 young (aged between 14 and 25) winners in the nationwide and international scientific competitions with individual RUR 60,000-worth bonuses. Another 4,000 young prize-winners in the national, as well as regional and inter-regional competitions received a RUR 30,000 –worth bonus each

The avenue entitled “Introduction of modern educational technologies” provided for granting access to the Internet to at least 1,800 educational institutions in 2006, and the mission had been completed by December 2006. As of December 14, 2006, as many as 2,980 communication channels were established, thus making it possible for educational institutions to be Internet- connected in 2007. It is envisaged to have another 34,940 schools Internet-connected and have an unlimited access to WWW by the end of 2007. The ultimate goal of this project is get all the schools connected to the Internet, while a more specific goal is to secure a normal bilateral access to educational resources, including the Federal Center for Informational Educational Resources.

In 2006, Russian schools received educational equipment worth a total of RUR 2.3 bn. Given that regions have co-financed the project, the number of such schools should be no less than 8,000. The funds will be allocated in proportion to the number of students in urban and rural localities in a given region, with the quota doubled for rural schools. As well, it may well happen that the equipment will be supplied first to the schools that participated in the aforementioned competition of innovational schools and those that failed to win it, but matched the criteria of participation in that.

The avenue entitled “Creation of the world-class national universities and business schools” suggests establishment by 2008 two university centers and two business schools in Russia.

Pursuant to Federal Government’s Resolution of November 4, 2006 No. 1518-p and the one of November 23, 2006, No. 1616-p, to ensure training of highly qualified specialists and boosting up competitiveness of the locomotive sectors of local economies in the Siberian and Southern federal okrugs, the respective rulings implied establishment of *two new* federal public institutions of general education (FPIGE) HPE *“The Siberian federal university”* and *“The “Southern federal university”*. The former institution is established by amalgamating, on the basis of Krasnoyarsk state university, three other ones, namely, Krasnoyarsk state architectural and construction academy, Krasnoyarsk technical university and the State university of non-ferrous metals and gold. Likewise, “the Southern federal university” is

established by means of amalgamation on the basis of Rostov state university of Rostov state academy of architecture and fine arts, the local state pedagogical university and Taganrog state radiotechnical university.

With their 30,000 students and faculty outnumbering 8,000, the new universities will focus primarily on training cadres for large innovational projects and those who will form the army of researchers capable to develop modern technologies on the basis of research centers that will be formed under the universities. That should allow students mastering skills and ensure an efficient combination of education and research and practical activities.

In early 2007, the Government should be in receipt of proposals on the future development of the noted universities, including modernization of their educational and research processes, solidification of the material and technical bases, capital construction and improvement of the labor compensations systems, and recommendations on their integration into operations of the network research organizations under the Russian Academy of Sciences situated in the territories of the respective federal okrugs<sup>40</sup>.

As a follow-up to the initiative by the RF Ministry for Economic Development and Trade and FPIGE HPE “Saint Petersburg state university”, the RF Government has ruled to establish on the basis of the university’s Department of Management a special structural subdivision, that is, business school – the Higher School of Management (Resolution No. 576-p). Last year, as much as RUR 350 m has already been allocated for this purpose.

The avenue entitled “Improvement of the level of pedagogical work at schools” suggested additional monthly compensations payable to schoolteachers. Since January 2006 at least 900,000 Russian teachers have begun receiving additional monthly compensations for out-of-school activities. The basic rate of the compensation is RUR 1,000 for a standard group of students, and it varies in proportion with their actual number. The basic standard group for urban schools (25 students) differs from that for rural ones (14). The 2006 federal budget earmarked RUR 7.7 bn for this project.

So far as the avenue entitled “Development of the system of vocational training in the army” is concerned, the national Defense Ministry, together with the RF Ministry of Education and Science proposed to launch an experiment on extending opportunities for conscripts to receive a primary vocational training. The initiative was approved and the experiment started on January 1, 2006, on the basis of special military training camps. The project will be funded from the resources the Defense Ministry allocates in the subsection “Primary vocational training” under the section “Education” in the 2006 federal budget.

While in 2006 there appeared 25 pioneer military training centers, in the first half of 2007 there should be established yet another 75 ones. A voluntary enrollee will be able to earn a standard state diploma in primary vocational training by specialties the list of which the Defense Ministry should work out with account to actual

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<sup>40</sup> On the innovational universities established in the framework of the national project “Education”, for details see Section 4.5 of the 2006 IET annual issue.

capacity of military units, the length of a given course, and job opportunities in specific territories.

It should be noted that developed in 2006 proposals on development of this particular avenue of the national project were consequently reflected in Federal Act of January 6, 2007, No. 1-FZ "On amending individual legislative acts of the Russian Federation on matters of accessibility of the secondary vocational training and the high professional education to the military personnel (citizens) that carry (-ied) military service under contract". The amendments introduced to Federal Act "On education" (of January 13, 1996, No. 12-FZ) and 'On the high and post-university professional education" (of August 22, 1996, No. 125-FZ) suggest that "military personnel (except officers) that carry out the military service under contract and the permanent duration of the military service under contract of whom is no less than three years, providing a successful passing of entrance examinations, enjoy, following procedures set by the RF Government, the right of the *hors concours* admission to the state and municipal educational institutions of the secondary and high professional education, as well as preparatory departments of the federal public educational institutions of the high professional education. Tuition provided to these categories [of the military personnel] is paid for out of the budgetary sources by the internal and by-correspondence form of training or by correspondence form of training".

Plus, the citizens that have carried, no less than for three years, military service under contract in the Armed Forces of RF, also enjoy the right of the *hors concours* admission to the HPE institutions in the event they have successfully passed entrance examinations. In the event, upon a duly expiration of their contract with the Ministry of Defense, they for the first time have enrolled for a university preparatory department, the costs of their tuition is covered by the federal budget. Once they become students at the university, they are entitled for a stipendium in an amount at 50% greater than that set for other internal students at the federal high education institutions.

In addition, in 2006, in the framework of implementation of the "Rural schoolbus" project, as much as RUR 1 bn. was allocated from the federal budget for procurement of school buses. It is envisaged that the respective funds will be earmarked in proportion to the number of students in rural areas, with the doubled quota granted to subsidized regions.

In 2007, there should appear two new avenues of the national project:

- governmental support to the training of workforce and specialists for highly technological production (with the RUR 1.8 bn-worth support provided to no less than 60 institutions of primary and secondary vocational training);
- governmental support to the Subjects of the Federation that introduce comprehensive education modernization projects, including modification of the labor compensations system and wages increases for teachers (in total, in the nearest 3 years RUR 16.3 bn will be allocated for 40 regions).

Table 12

**The Federal Budget Expenditures on Implementation of the Priority National Project “Education”, as RUR mln**

	The national project avenue and kinds of expenditures	Planned for 2006	Actually earmarked in 2006	Completion, as %
<b>1.</b>	<b>Support and promotion of the best models of the domestic education</b>			
1.1.	Stimulation of the universities that vigorously introduce innovational educational programs (by 17 universities)	5000	5000	100
1.2.	Stimulation of the schools that vigorously introduce innovational educational programs	3000.0	3000.0	100
1.3.	Support of talented youth, including (by regions):	200.0	197.67	98.84
1.4.	Awards to the best teachers	1000.0	1000.0	100
<b>2.</b>	<b>Introduction of modern educational technologies</b>			
2.1.	Internet for schools	1500.0	1000.0	66.7
2.2.	Equipping schools with visual aids and equipment	2300.0	1321.8	57.5
<b>3.</b>	<b>Creation of the world-class national universities and business schools</b>	<b>3000.0</b>	<b>350.0</b>	<b>11.6</b>
3.1.	Creation of the world-class national universities университетских центров мирового уровня	2000.0		
3.2.	Creation of two business schools	1000.0	350.0	35
<b>4.</b>	<b>Improving the level of pedagogical work at school</b>			
4.1.	Additional monthly compensations for out-of-class activities	7685.7 <sup>41</sup>	11680.0	152.0
<b>5.</b>	<b>Rural schoolbus</b>	<b>1000.0</b>	–	
	Informational support and project management costs	280.0	257.0	91.8
	Costs, total	24965.9	24548.5	98.3

Source: basing on the data of the RF Ministry of Education.

Thus, the 2006 record of implementation of the priority national project “Education” evidences that it has catalyzed the government structures’ activities with respect to the most pressing challenges in the educational area and allocation of additional financial resources. But the question remains unanswered as to whether the avenues and concrete steps made under the project form a logical system that would help the national educational system mature further to a qualitatively new level, or they simply help solve, in the operative mode, certain, persisting for long, challenges, thus fitting quite well in the traditional forms of management, such as, for instance, the federal program of promotion of education.

5. *The 2006 Unified state examination outputs.* In 2006, educational structures of 79 regions have embarked upon the new USE system, with over 830,000 school graduates passing the examination (72% of their overall number), which is at 10% more than in the prior year. While 46 regions (58%) held USE by practically all the standard majors, 22 regions (28%) held it by 3 to 7 subjects, and 11 regions (14%) – by 1–2 subjects. Some regions abstained: the Republic of Ingoushetia,

<sup>41</sup> Subsidies provided for by the Federal Act “On the 2006 federal budget”. The discrepancy with the figures in the “Actually earmarked” column is explained by additional allocations out of the federal budget to 28 Subjects of RF with account of payment of holiday compensations.

Chechen Republic, Primorsky krai, Stavropolsky krai, Kemerovo oblast, Nizhny Novgorod oblast, Orel oblast, Koryaksky autonomous okrug, Evenk autonomous okrug.

It should be noted that in contrast to 2005, there was a considerable growth in the number of regions wherein more than 90% of the 2006 graduates were passing exams on mathematics and the Russian language (on mathematics 29 regions vs. 22 in 2005; on Russian – 24 vs. 12 in 2005). The examinations results already allow various comparisons, to build an assessment of the quality of education by major subjects and a comparative analysis between institutions of general education in terms of quality of tuition.

Overall results of the examinations proved to be similar to those reported in 2005, and they correlate with results of recent monitoring. While the 2006 graduates demonstrated somewhat better performance by some basic subjects (for example, the number of those who earned the maximum score (100 out of 100) has grown vs. the prior year by all the subjects (except for literature), their results in mathematics and literature have proved to be lower than those registered in 2005.

In compliance with statute of January 20, 2006, No.14 of the RF Ministry of Education “On participation of the public educational institutions of the secondary and high professional education under the jurisdiction of the RF Ministry of Education in the experiment on introduction of the unified state examination in 2006”, the admission to universities and special institutions of high education was conducted basing on the USE results by 100% of specialties by special institutions of high education and universities that had already took part in the experiment, and by 50% of specialties – by universities that participated in the experiment for the first time, except for Moscow-based special institutions of high education and universities, which, again, made decisions on admission basing on the USE results on their own.

Of 23 federal ministries and agencies that have their own educational institutions, 19 have coordinated the participation of the said institutions in the experiment, following the below procedures:

- the experiment is conducted in the form set by the aforementioned statute of the RF Ministry of Education by the institutions whose founders are: the RF Ministry of Finance, the RF Ministry of Economic Development and Trade, the RF Ministry for Nuclear Energy, The Federal Agency for Media, the RF Agency for River Fleet, the RF Agency for Sports, the RF Agency for Culture, the RF Agency for Forestry, the RF Agency for Fishery, the Federal Tax Service;
- participation by 50% of specialties: universities under jurisdiction of the RF Agency for Aviation, the RF Agency for Communication, the RF Agency for Health Care, the Russian Railways, the RF Ministry for Agriculture;
- only taking into account of the USE results: the institutions whose founders are the Supreme Court of RF, the RF Ministry for International Affairs, the RF Ministry of Defense, the RF Interior Ministry, and the RF Ministry for Emergency Situations;

- refused from conducting the experiment and taking into account the USE results: the institutions under the Federal Security Service (1), the RF Ministry of Justice(6), and the Federal Customs Service (1).

Table 13

**Main Indicators of the Expansion of USE in the Educational Sphere in RF**

<i>year</i>	<b>Number of the RF Subjects participating in USE</b>	<b>Number of subjects by which USE is conducted</b>	<b>Number of graduates opting for USE</b>	<b>% of graduates opting for USE in their total number</b>	<b>Number of universities and their branches</b>	<b>Number of special institutions of high education</b>	<b>Number of ministries and agencies</b>
2001	5	8	30,000	2.3	16	–	3
2002	16	9	298,921	22.8	123	79	10
2003	47	12	654,115	49.5	464	928	20
2004	64	13	820,338	60.3	946	1,525	29
2005	78	13	853,495	61.6	1,543	1,765	15*
2006	79**	13	830,415	63.5	1,650	1,889	19
2007 plan	83***	13	840,000	70.0	1,800	2,000	23

*Notes.* \* with account of the reduction in the number of the federal ministries and agencies of the RF Government made in the course of the current administrative reform;

\*\* with account of the integration of Perm oblast and Komi-Permyatsky autonomous okrug into Permsky krai;

\*\*\* with account of integration into Krasnoyarsk krai of Taymyr and Evenk autonomous okrugs, effective as of January 1, 2007.

*Source:* the RF Agency for Supervision in the Educational Area.

By the 2006 USE results, over 500,000 enrollees entered universities, of whom 35% came from other cities and 25.5% - from rural areas. For the first time ever disabled entrants (those ear-, vision- and locomotorium-challenged) were also granted an opportunity to take part in USE.

Meanwhile, the RF Agency for Supervision in the Educational Area believes that some universities that accepted the 2006 USE certificates would run to extremes, for they either set an extremely high threshold for the excellent score (starting from 95), or accepted entrants who demonstrated very poor performance (scoring 15-24). Thus, in the former case universities lost a part of promising enrollees (for they switched to less demanding institutions), while in the latter – they obviously accepted not the best and the brightest. It should be particularly noted that, if translated into school marks, by many subjects the USE score 30 is an unsatisfactory result. As by 2009 it is planned to make USE compulsory for all graduates, no Russian university would accept such enrollees, even on the paid basis. In 2007, there will be 83 regions to take part in the experiment (except for the Chechen Republic, Primorsky krai and Nizhny Novgorod oblast), and the number of graduates passing it should make up over 840,000 (75% of their total number). The examination will be conducted by all 13 subjects, but their number will vary from region to region. For example, in 2007, in Moscow the only compulsory subject will be Russian, while passing examinations on yet another 9 subjects (mathematics, physics, chemistry, literature, biology, geography, Russian history, social science, and English), students will be able to choose between the form of test and the traditional form. All the universities and special institutions of high education headquarter-

tered in the city of Moscow and Moscow oblast (except for Moscow Lomonosov University) will account the USE score as entrance examinations.

The results of the statistical data on USE, an analysis of surveys on graduates and entrants and their parents, as well as on representatives of the university faculty have evidenced a greater objectivity of the USE results. According to VTSIOM (as of June 2006), 43% of the surveyed citizens of RF positively consider an opportunity to enter a university without additional examinations (as concerns the younger generation aged between 18 and 24 years, this opinion is shared by the majority of 59%). They emphasize positive elements of USE: an opportunity to enter a university without additional examinations, equal opportunities for graduates from different schools, and simplification of the entrance procedures.

In 2006, the USE system has undergone further modifications, which should contribute to its future advancement.

To increase the accessibility of vocational training for young residents in remote regions, there was created and tested a technology of organization and conduct of USE in remote territories (such as areas in the Komi Republic, Republic of Sakha (Yakutia), Khabarovsk krai, Irkutsk, Kamchatka and Tomsk oblasts, as well as Khanty-Mansy autonomous okrug – Yugra and Chukotka autonomous okrug); young people from the needy families continued to take part in the testing of a unified system of the competition-based admission by correspondence to universities and special institutions of the high education (i. e. without traveling to a university campus), which means considerable saving for their households. As many as 66 universities in 5 regions and 40, 336 enrollees took part in this experiment in 2006, with the number of those ultimately admitted under this particular arrangement accounted for 19, 785 (vs. 12, 182 reported in 2005).

It should be noted that the conduct of this particular experiment has resulted in extension of the application of informational technologies both in the educational process and in the course of design of an attesting technology for institutions of general education. Plus, the use of USE results for the sake of enhancement of standards of the general education and educational programs has resulted in the rise of a new generation of textbooks and manuals.

Meanwhile, the protection of the USE controlling and measuring apparatus has been fairly lax. This is evidenced by the fact that last year the USE results were canceled in 19 locations where it had been conducted, as they had proved to be far higher than the average score across a region. That is why in 2007 all tests that will score 95-plus shall become subject to an additional verification. Finally, there were substantial delays with issuance of the USE certificates in many regions, and graduates failed to send them to the universities on time.

While discussing the 2006 results of the experiment with introduction of USE, many regions and councils of university rectors voiced the necessity of organization and conduct of USE in “one wave” (in 2006, it was held in two waves: by schools (May and June) and by universities (July). That would allow to save a certain part of financial and human resources, but, on the other hand, there exist groups of potential enrollees who would objectively miss the USE in June (such as

demobilized conscripts – 0.9% of the total number of the participants in USE at the stage of university entrance examinations; citizens of the CIS countries – 1.3%, children of the RF citizens who reside overseas – 0.09%, and foreign citizens – 0.02% of the total number of the USE participants. It is worth noting that in 2006 the proportion of the enrollees who took part in the “second wave” accounted for 68.5% of the total number of the USE participants. Hence, it seems appropriate to develop in 2007 standardized legal procedures of conducting USE in the “one-wave” mode and design special technologies for those enrollees who, because of objective reasons, will miss USE in May and June.

As well, given the importance of the current monitoring of the quality of education over the whole school term, it is planned to continue the experiment on conducting an independent evaluation (testing) for the ninth-formers (the so-called “small USE”), for students in the primary school (at the end of the fourth year), as well as at secondary vocational training institutions and colleges, and for the 2<sup>nd</sup> and 3<sup>rd</sup> –year university students.

Meanwhile, the RF Government has submitted to the Federal Duma a bill entitled “On introducing amendments to the RF Act “On education” and the Federal Act “On the high and post-university professional education” in the part of introduction of the unified state examination”. The Duma has conducted the first hearing in autumn 2006, and fairly heated debates exposed an ambiguous attitude towards the general mandatory transition to the USE system.

There are three issues on which the debate centers: the set of the compulsory subjects for USE; selection criteria of universities, the admission to which implies an additional examination; and the extension of the circle of competitions the victory in which grants the right of entrance to institutions of high education. Obviously, as the modifications associated with the legitimization of USE appear so significant, they require the most detailed account of all criticisms and proposals on the said bill, so that to make sure the public at large positively accepts its final version and its implementation does not pose even minimum risks to the educational system.

Many years of work on a new form of organization of the public sector were crowned with the promulgation of Federal Act No. 174-FZ of November 3, 2006, “On autonomous institutions” and the respective amendments made to the legislation on non-for-the-profit organizations, education and culture.

The preparation of the bill fueled serious concerns amid professional communities in the areas of culture and education, as they spotted in that the danger of commercialization of the social and cultural sphere and privatization of its property complex. A difficult, multi-stage process of conciliation of various agencies’, as well as professional and social organizations’, stances has resulted in a compromise between different approaches to identification of rights and obligations of the institutions of the new form and their founders.

On December 30, 2006, the Federal Duma passed Federal Act No. 275-FZ “On procedures of formation and consumption of the targeted capital of non-for-the-profit organizations”, which may have a great influence on the development of

the non-public non-for-the-profit sector and its institutions in the educational sector in particular<sup>42</sup>.

At the end of the year the RF Government produced its Resolution of November 11, 2006, No. 671 "On approval of a model concession agreement with regard to objects of education". The agreement comprises the concessionaire's obligations on creation and/or reconstruction of the object of the concession agreement; the concessionaire's obligations on exercise of activities, as per the agreement in question; procedures of allocation of site(s) to the concessionaire; the period of validity of the concession agreement, etc. It was particularly emphasized that so far as specific objects of education are concerned, the concession agreement should be strictly consistent with the model agreement, but it may also contain provisions not regulated by the latter, but bound not to conflict with the RF law. Clearly, the hope is that the Resolution should ensure concession operations in the educational sector and help attract additional investment. Besides, it should ensure a more efficient use of the public or municipal property, and higher quality of educational services to the population. Meanwhile, the unanswered question is as to what kind of specific economic advantages it would grant to the business community, as well as the government and municipal administrations. It is yet more serious a question, as the Resolution merely follows a provision of Art. 10 of the Federal Act on concession agreements and simply formally introduces into the legal filed a model concession agreement with regard to educational objects. Meanwhile, regardless of the subject of the agreement, basic terms and conditions of a concession agreement can be found in the noted Article of the said Act. Hence, an analysis of the legal form of the agreement does not allow to expose where efficiency, as well as economic benefits, lie, thus leaving the issue open for further discussions. From the economic and legal perspective, the concession agreement poses a modified and far narrow version of a rental agreement, albeit overly imperatively biased towards protection of the state interests (as it unequivocally shifts all the risks onto the concessionaire. One has to admit that, compared with other civil law institutions, concession in its present form does not grant potential investors with any additional commercial or legal rights, nor it gives them any additional protection of their interests. Some experts believe that by some matters a rental agreement can protect potential investors better than the concession one, which is proved by a comprehensive analysis of the Federal Act on concession agreements and terms and conditions of the Model Agreement introduced by the Resolution in question. That is why it is very likely that the concession agreement in its present form would remain insufficiently attractive to private investors.

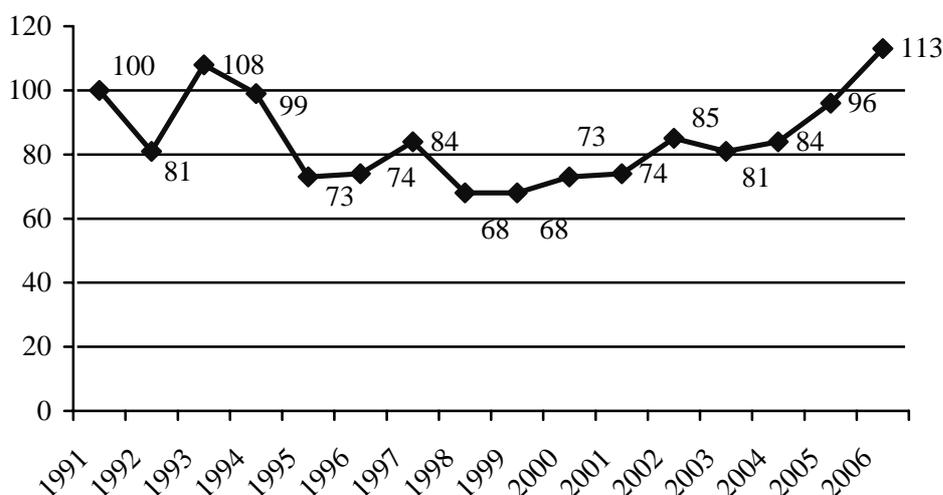
So, the progress with concessions in the educational sector will require a further development and detalization of the legislative base, thus enabling private businesses to efficiently promote their commercial interests in the part that does not conflict with those of the citizens and the state.

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<sup>42</sup> See a more detailed review of this and some other acts in *Annex 1* of the 2006 IET annual issue.

#### 4.4.2. Healthcare

The preceding year was distinguished with a row of remarkable events in the sphere of healthcare. First of all, it should be mentioned, that the volume of budget financing in 2006 (federal budget and social tax proceeds, addressed for medical insurance of employees), has grown by 18 per cent in real terms and exceeded the level of budget expenditures for healthcare of 1991 (see *Fig. 13*). This is doubtlessly a remarkable turning point, which relieves the problem of financing shortage, generated by political and economic crisis of the 1990-s, and brings forward problems of fair and effective utilization of available resources for medical assistance to the population.



Source: estimates made on the data of the Russian Statistical Service based on index deflators of GDP.

*Fig. 13.* Government expenditures for healthcare in real terms (1991 = 100 %)

The first priority for the government in the preceding year was implementation of the National Project.

#### Priority National Project in Healthcare

Institutional traps, where the healthcare system got stuck<sup>43</sup>, and reluctance of power elite to take unpopular measures even with minimum social and economic risk have led to the situation, where the only possibility to relieve the burden of accumulated problems was targeted financing of selected areas in healthcare. Such strategy implemented in the Priority National Project. Although the top authorities of the Ministry of Healthcare and Social Development and authorized representatives of the RF President Administration have repeatedly pointed out, that reforms in healthcare are inevitable and the National Project is a preparatory step for further reforms to be implemented after 2007, that project actually happened to be an alternative to institutional changes.

<sup>43</sup> Russian economy in 2005. Trends and prospects. M.: IET, 2006. P. 347.

Expenditures for the Project, covered from the RF federal budget, Federal Fund of Mandatory Medical Insurance and Social Security Fund were estimated in 2006 in the amount of RUR 97.3 bn, or 10 per cent of aggregate national expenditures for healthcare. Development of primary medical assistance and implementation of high technologies in healthcare were pointed out as priority trends of the Project.

Table 14

**Expenditures for implementation of Priority National Project in healthcare sphere, RUR, bn**

<b>Project objectives and types of expenditures</b>	<b>Planned for 2006</b>	<b>Actually invested in 2006</b>	<b>Performance, %</b>
<b>Funds of the RF federal budget</b>			
<i>Priority "Development of primary medical assistance"</i>			
Training and supplementary training of general (family) practitioners, physicians and pediatricians of territorial clinics	0,2	0,15	75
Monetary benefits to general (family) practitioners, physicians, pediatricians and nurses of territorial clinics	15,4	14,6	95
Monetary benefits to personnel of medical assistance and maternity services, medical assistants and nurses of ambulance service	5,2	4,1	79
Diagnostic equipment for municipal clinics	14,3	14,3	100
Vehicles for ambulance service	3,6	3,6	100
Immunization of population	4,5	4,5	100
Preventive measures against HIV, detection and treatment of infected patients, prevention of hepatitis B and C	2,8	2,8	100
Inspection of newly-born babies to exclude galactosemia, androgenital syndrome, mucoviscidosis	0,4	0,4	100
<i>Priority «High technologies in medical services for population»</i>			
Construction of high-tech medical centers	12,6	3,6	29
High-tech medical assistance	9,9	9,8	99
<i>IT support and Project management</i>			
<i>Total expenditures from federal budget</i>	<i>69,5</i>	<i>58,5</i>	<i>84</i>
<b>Assets of Federal Fund of Mandatory Medical Insurance</b>			
Supplementary medical examination for employees of medical system in the age of 35–55 years old	2,0	1,6	80
Additional compensation for primary medical assistance, provided to unemployed pensioners (upgrading of tariffs in the framework of territorial programs of mandatory medical insurance by 25 per cent)	6,4	4,4	100
<i>Total expenditures from Federal Fund of Mandatory Medical Insurance</i>	<i>8,4</i>	<i>6,0</i>	<i>71</i>
<b>Expenditures from RF Social Security Fund</b>			
Fees for medical assistance, provided to women by government and municipal clinics for the period of maternity leave and baby birth ("baby birth certificate")	10,5	9,0	86
Payment for supplementary medical examination and primary medical assistance to working individuals	7,0	3,9	56
Supplementary medical examinations of employees of harmful and(or) dangerous industries	1,9	1,9	100
<i>Total expenditures from RF Social Security Fund</i>	<i>19,4</i>	<i>14,8</i>	<i>76</i>
<b>Gross Total</b>	<b>97,3</b>	<b>79,3</b>	<b>82</b>

Source: RF Ministry of Healthcare and Social Development; <http://www.mzsrff.ru/main/>.

Development of primary medical assistance is a key trend for raising the level of availability, quality and effectiveness of healthcare system. Medical assistance at the outpatient stage is a key indicator of the level of availability and quality of

healthcare in general. Functioning of primary medical assistance provides a direct impact over the indicators of the health of population and effectiveness of health-care system in general (statistical data on sick leaves, in-hospital stay, applications to ambulance assistance, average time of queuing to a doctor, etc.). However, there aroused problems in the system of primary medical assistance, that required immediate solution; a delay would cause a destructive effect on the availability of this type of medical assistance to population. The low salary level has resulted in the downfall of attractiveness of doctors' profession to the young generation. An average age of general practitioners was permanently growing, and the majority of them has reached pension age. As a result, shortage of personnel and low professional level of general practitioners of local clinics were observed. There were problems not only with the quality of medical assistance, but even with an access to the doctors.

Supplementary monetary compensations are envisaged in the framework of the National Project for the doctors, providing primary medical assistance (physicians and pediatricians of local clinics, general practitioners) and nurses, working with them, in the amount of RUR 10,000 per month and RUR 5000 per month accordingly. Therefore, their salaries have grown times 2.2–2.8. The total expenditures for that target have reached RUR 14.6 bn. Moreover, RUR 4.1 was addressed to personnel of medical assistance and maternity services, doctors, medical assistants and nurses of ambulance service (RUR 5 000 per month to the doctors, RUR 3 500 per month to medical assistants and maternity nurses, RUR 2 500 to other nurses).

Extra monetary compensations to the personnel of primary medical assistance system provided positive results in solving the problem of personnel shortage. The number of doctors, engaged in primary assistance level, has grown within a year by 9.7 per cent (from 66.9 thousand to 73.4 thousand), the number of nurses – by 9.3 per cent (from 74.9 thousand to 81.9 thousand). Thereby, the number of vacancies for those positions was reduced and the rate of double job holding in the sphere of primary medical assistance has reduced from 1.6 до 1.3. Those changes provided positive effect on the access to primary medical assistance.

In the course of Project development, in autumn of 2005, it was planned to make a transfer to the new form of compensations to the doctors and nurses through a system of financial incentives as of performance results, rather than by flat increase of their salaries. However, it has not been done. Extra compensations to the personnel of primary level were substantiated by the increased work load. Monetary compensations are paid on the basis of supplement agreements to employment contracts, where all additional types of work are specified (supplementary medical examinations, prescription of medicines to patients, enjoying social benefits, immunization of population, etc). In practice, supplementary agreements were signed only formally; there was no consistency between the raised compensation and performance results. The employees of primary level take the increased compensations for granted, rather than an incentive for better performance. Thus,

according to the feedback, the Project measures have not provided an explicit effect over the quality of work of primary level personnel.

The growth of the level of compensations to employees of primary level was not accompanied by simultaneous increase of salaries of professional doctors, what lead to some social tension in medical institutions. Later on professional doctors were granted extra compensations for medical examinations of employees of budgetary sphere and additional investigations for of employees, engaged in harmful and(or) dangerous industries. According to the Project framework, 4 mln of patients in 2006 and 8 mln in 2007 were supposed to undergo supplementary medical tests. Actually regular examinations have been started only in summer 2006, and covered no more than 2.9 mln of patients. Supplementary tests were arranged for 3.8 mln employees.

There were purchased 6.8 thousand of ambulance vehicles, which allowed replacing 1/3 of ambulance car park. As per the estimates of the Ministry of Healthcare and Social Development, an average time of waiting for an ambulance was reduced from 35 to 25 minutes. Out-patient clinics were equipped with 22.7 thousand units of diagnostic equipment for total amount of RUR 14.3 bn. A large-scale upgrading of equipment made at the level of primary medical assistance; has greatly extended an access of patients to medical assistance (clinics have received 8.8 thousand ECG recorders, 4.1 thousand units of ultrasonic equipment, 3.6 thousand of endoscopes, 3.3 thousand of X-ray installations and 2.9 thousand of laboratory equipment). However, one can expect local problems of qualified personnel deficit to handle the new equipment, problems with spare parts and expendable materials, etc.

In this regard, a standard approach of targeted financing of selected problematic areas to improve the situation in healthcare is implemented in the framework of the Project. The key point of such an approach is: to solve specific problems by supplying required equipment to certain types of medical institutions. However, it is not clearly specified, what measurable results are to be achieved with the help of new equipment. Nevertheless, there is no direct correlation between quantity/quality of newly purchased equipment and quality and availability of required medical services, provided to population. Apparently, one can not expect explicit positive results without substantiation of measures and resources addressed to relieve the problems of availability and quality of specific types of medical assistance and without designation of Project performance indicators, justifying the investment of funds.

However, monitoring and analysis of effective utilization of acquired equipment are left outside the National Project framework. Supervision over equipment utilization is within the authority of Russian Healthcare Control and the RF Subjects, but neither methodology, nor funds for monitoring of equipment effective utilization are foreseen.

The project makes a stress on strengthening centralized administrative control over its performance, but for the majority of objectives any changes in control technology functions are not foreseen. Project performance management is ac-

completed through the standard administrative methods of control over implementation of planned actions on the part of management bodies; only the list of indicators, on which the information is requested from regions, has been extended. There is a risk that, on the one hand, the standard forms of control will not help to get the information, required for adequate evaluation of effectiveness of Project activities, and on the other hand, they will not become a reliable barrier against inefficient usage of the funds, allocated for the Project.

National Project financing included the funds for implementation of government order for free medical service with the help of high-tech (expensive) equipment for the amount of RUR 9.9 bn (versus RUR 6.3 bn in 2005). 128 thousand of patients have enjoyed the treatment. The basic investment component of the Project is the construction of 15 high-tech medical centers within two years. In 2006 the investments were planned in the amount of RUR 12.6 bln, but in fact only RUR 3.6 bln were spent. Construction of seven centers has been started in Astrakhan, Penza, Krasnodar, Cheboksary, Krasnoyarsk, Tyumen, Khabarovsk. Nevertheless, there is a risk in spite of a larger number and extended capacity of medical assistance, that “informal” ways of payment for medical services will take place both, in the new and old clinics. Naturally, the effect of large volume of government-financed high-tech medical assistance will be considerably reduced, if the practice of “informal inducements” to medical personnel, paid by the patients, is sustained.

Reviewing the National Project in terms of government guarantees of free medical services, one should mention that no changes are expected in regard to free services to all social types of population. Nevertheless, it is foreseen to allocate more resources to certain guarantees (to primary, emergency and high-tech medical assistance) to make them less dependent on the situation and ensure wider access for the citizens of the country.

At the same time, the Project makes provisions for measures of free additional services to a number of target groups of population: examination of newly-born babies for galactosemia, mucoviscidosis and androgenital syndrome (expansion of neonatal screening); extra examinations of employees, extra medical examinations of employees, engaged in harmful and(or) dangerous industries. In fact, it means expansion of government guarantees of certain types of medical services to the above categories of population.

Strategy of targeted financing of selected problem areas in terms of government guarantees to the population is focused on the growth of medical service capacities, on dismissal of resource restrictions in regard to some healthcare components. However, this strategy maintains the gap between guarantees and financial provisions of other sectors of healthcare system and has little relation to the institutions, ensuring the guarantees.

Apparently, realization of the Project in 2006–2007 is supposed to demonstrate enhancement of the situation in the most problematic segments of healthcare system, i.e., in primary and high-tech medical assistance. It should be pointed out, that priorities of investments, planned within the framework of the Project are well justified. The results of the project might be immeasurable as compared with

the budget expenditures for its implementation. There is a risk that the project, based on extensive input of funds in problematic areas without institutional changes, might not bring the expected results.

#### Pharmacological Support to Socially Supported Categories of Population

Whereas the results of the National Project in 2006 were primarily virtual, functioning of the system of supplementary pharmacological support to the groups of population, receiving subsidies from federal budget, implemented in 2006, was marked by significant events.

It should be reminded, that Federal Law No. 122-FZ as of August 22, 2004 (On amendments to the legal acts of the Russian Federation and recognition of certain legal provisions of the Russian Federation as null and void in view of newly adopted federal laws "On amendments and revisions to the Federal Law", "On general principles of legislative (representation) and executive bodies of government power of the Subjects of the Russian Federation" and "On general principles of local governance in the Russian Federation" has granted the right for free medicines to the following categories of population<sup>44</sup>:

- Disabled war veterans and eligible categories;
- WW participants and eligible categories;
- Veterans of military operations;
- Disabled (adults and children);
- Persons, suffered radiation exposure.

The amount of subsidies for medicines, allocated to socially supported categories from the federal budget in 2005, made RUR 50.8 bn, whereas the cost of medicines, provided to socially supported persons, made RUR 44.0 mln. Those ones, who had a right for subsidies had a choice either to get a package of social services, including free medicines, or their equivalent in the form of monetary compensation. As a result, the number of voluntary recipients of a social package has reduced by 51.4 per cent of the total number of citizens, who were included in the Federal Register of persons, entitled for government social support (See *Table 15*).

RUR 29.1 bn were allocated for the program of supplementary pharmacological support to socially supported categories in the federal budget of 2006. The reduction of the program financing as compared with 2005 was corresponding to the reduced number of persons, who chose to stay within the program. Though the number of those people has been reduced two-fold, the list of medicines, included in the program, was still growing. In the first half-year of 2006 the number of prescriptions (66.0 mln) has exceeded by 8 per cent the number of recipes, prescribed in 2005 (61.3 mln), and the monetary equivalent of invoices, issued by distributors, has reached RUR 27.4 bn.

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<sup>44</sup> Specified in Article 6.1 and 6.7 of the Law No. 178-FZ as of 17.07.1999 and Enclosure No. 1 to the Order of granting a package of social services for certain categories of citizens, approved by the Order of Ministry of Healthcare and Social Development No. 328 as of 29.12.2004.

Table 15

**Indicators of program implementation aimed at additional medicine provision for the citizens eligible to receive state social assistance from the federal budget**

	2005	2006	2007
Number of citizens included in the Federal register eligible to receive state social assistance <sup>a)</sup>	14,456	16,301	16,878 <sup>b)</sup>
Overall number of recipients of set social services, Thousand <sup>a)</sup>	12,584	8,373	8,297
The share of recipients of set social services in the number of citizens included in the Federal register, %	87.1	51.4	49.1
Cost of set social services per person a month, Rbl., Including on medicine, Rbl.	450 350	477 424	513 <sup>c)</sup> 456
Federal budget expenditure on the program of additional medicine provision, bn Rbl.	48.3	39.1 <sup>d)</sup>	40.9 <sup>e)</sup>
The sum billed to be paid for supplied medicine according to the program of additional medicine provision	44.0	62.0	

a) – as of 01.2001 corresponding year.

b) – as of 01.10.2006.

c) Approved from 01.04.2007.

d) Originally approved 29.1 bn Rbl., in December 2006 additionally appropriated 10 bn Rbl.

e) Including: 6.0 bn Rbl. – paying for medicine delivered in 2006, 34.9 bn Rbl. – payment for the deliveries in 2007.

Source: Minzdravsotsrazvitia RF; [http://www.mzsrff.ru/inform\\_fz/](http://www.mzsrff.ru/inform_fz/).

Financial management of supplementary funding of pharmacological provision, in pursuance of Federal Law No. 122-FZ was implemented by the federal and regional funds of mandatory medical insurance. In November 2006 a large group of officials of the Federal Fund of Mandatory Medical Insurance was taken under arrest on charge of corruption, which was an unprecedented case within the last fifty years in the Russian history.

Even before the introduction of the new system of medicines' supply in January 2005 it was obvious to the experts, that the new system was associated with high corruption risk. Such factors as formation of the list of medicines, subject for free distribution among socially supported categories, which could be amended within a year, usage of qualification method, rather than tender procedure, to select suppliers of medicines, who were granted the priority right to distribute pharmaceutical products to the regions; poorly developed and intransparent system of control over justification of suppliers' prices, subject for government registration and upper limits of distributors' fees for medicines; insufficient verification, if the number of pre-paid recipes matches the number of actually received ones – created the loopholes for corruption schemes within the new system of medicines' distribution. The above-mentioned actions of law-enforcement structures confirm that in all likelihood, those loopholes were not neglected.

Apparently, corruption practice and boosted prices for medicines enlarged the expenditures for extra medicines, designated for the system of surplus pharmacological provision as compared with the estimated budget. There is a number

of evidences, when prices, paid for the medicines, designated for socially supported categories, exceeded those ones in open trade. The vast scale of such practice is recognized by the RF Ministry of Healthcare and Social Development, but there is no published information on the dynamics of prices in the system of pharmacological support<sup>45</sup>.

However, the budget deficit could be more rationally explained by other reasons. The basic failure of the new system is the lack of clearly predefined norms of medicines' consumption. The doctors could voluntarily define the amount of prescribed medicines. The Ministry authorities explained it by an intention to cover a postponed demand of socially supported categories for medicines and to define actual demand, basing on practice. Moreover, there was a confidence, that expenditures, allocated from the budget in 2005, which exceeded the total amount of expenditures of 2004 (RUR 7.9 mln), would be quite sufficient for medical treatment. And actually that was true for the year of 2005.

However, it should be noted, that nearly 1/3 of regions received medicines through regulated distribution. The final amount of medicines, to be allocated for socially supported categories, was determined upon applications of clinics and their further negotiations with higher healthcare authorities<sup>46</sup>. In 10 per cent of cases they made applications for the upper limits of admissible amounts of medicines.

The declared right of socially supported groups to get necessary medicines for free, restricted only by an established list and a doctor's readiness to prescribe them, has resulted in an upswing of demand for free medicines. In 2006 another failure of the newly created system was revealed. The approach, which provided a choice to socially supported groups between pharmacological support and its monetary compensation, brought up a problem of unfavorable selection, which is a typical bottleneck of social security system. Monetary compensations were chosen by those, who applied for free medicines only occasionally. As opposed to them, regular consumers of medicines, who suffer of serious chronic diseases and can expect their aggravation, have preferred the benefit of free medicines. However, the average cost of healthcare portion of a standard social package (i.e., pharmacological support and health resort vouchers), the equivalent of which is paid to those who chose monetary compensations (RUR 424 in 2006), was estimated as an average figure for the majority of socially supported population. Now, when about a half of that group with the highest demand for medicines has stayed in the program, the expenditures for their support will be higher, than the cost of initially estimated average package, multiplied by the number of program participants.

As a result of all the above factors, expenditure liabilities of the program of supplementary pharmaceutical support too the socially supported groups of population in 2006 have exceeded the expenditures of the preceding year.

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<sup>45</sup> Please, refer to the information on monitoring results of implementation Federal Law No. 122-FZ as of 22.08.2004 for 9 months of 2006 to: [http://www.mzsrrf.ru/inform\\_fz/548.html](http://www.mzsrrf.ru/inform_fz/548.html).

<sup>46</sup> Data base on "Organization of Financing and Management of Healthcare in Russian regions". [http://www.socpol.ru/research\\_projects/pdf/proj14\\_2005report.pdf](http://www.socpol.ru/research_projects/pdf/proj14_2005report.pdf).

The total amount of invoices, issued by the suppliers of medicines, has reached RUR 63 bln by the end of the year. To cover the deficit, RUR 10 bln was allocated from the federal budget in 2006. With account to RUR 5 bn, saved in 2005 and spent in 2006, the total expenditures for medicines, provided to the socially supported groups in 2006, should amount to RUR 50.1 bn. The difference between that amount and the invoices of suppliers makes RUR 12 bln. As per the information of the Federal Fund of Mandatory Medical Insurance, the invoices for at least RUR 3 bn, which inconsistent with relevant requirements, will not be paid. The issue of payment under the other invoices for RUR 9 bn is still open.

Another step, made as a reaction to the deficit, was a cut-down of the list of medicines, provided to the socially supported groups, which was reduced by nearly 15 per cent from November 1, 2006. 74 items were excluded from that list, among them – medicines for treatment of HIM, AIDS and tuberculosis. These medicines will be supplied within the framework of prioritized national Project "Health" and targeted federal program "Prevention and combat against diseases of social character". 436 items are left in the list, approved by the Ministry of Healthcare and Social Development. It is planned to take under special control over prescriptions of nearly 78 medicines for treatment of diseases of blood, cancer, disseminated sclerosis, cardio-vascular system. The general trend of those measures is quite justified. However, basing on the experience of medicines' provision before 2005, one can hardly predict, how the control functions will be performed. The above experience leads to conclusion, that the balance in the system of surplus medicines supply (i.e., a stable balance between its liabilities and their funding) will be reached through noticeable and irregular downgrading of the level of social security due to increased burden of expenses for medicines to some categories of socially unprotected population.

#### **4.5. The Situation in Science and Innovation Activity**

##### *4.5.1. The Main Directions of State Policy in 2006*

In 2006, the main directions of state policy in the sphere of science and innovations were as follows: further improvement of the mechanisms of target program financing, including the determination of new priority areas and critically important technologies; the formation of appropriate mechanisms and instruments for promoting innovation activity (venture funds, technoparks, indirect regulation mechanisms). Toward the year's end, the personnel problems faced by science once again became the focus of attention. At the same time, the rate of organizational transformations going on in the government sector of science became slower.

The government's activity was mainly focused at the development, coordination and approval of the normative-legal acts that addressed the sphere of science and the promotion of the innovation activity. Certain amendments were introduced to the Federal Law "On science and the state policy aimed at science and technologies", as well as to Part IV of the Civil Code, which had to do with the rights to the results of intellectual activity. In the course of last year, some 25 presidential

decrees and decrees and ordinances of the Government were issued, which addressed the problems of regulation in the sphere of science and innovations. At the same time, the practical measures aimed at restructuring the government science sector and creating new organizational forms were implemented on a very moderate scale, precisely because the institutional conditions were just evolving.

In the sphere of target program planning, the development of FORCYTE (or FORECAST) began. This computer simulation method is new for Russia and is applied for determining the most promising directions of scientific and technological development, in coordination with the existing socio-economic conditions and the potential consequences of the implementation of new technologies. This method is now being applied in more than 30 countries across the globe and represents a process of selecting strategic areas of scientific and technological development at the national level, with due regard to the opinions voiced by the major subjects within a national innovation system. The method has been implemented with the highest degree of success in those countries where there exist well-developed horizontal connections and long-established interaction networks, supported at the government level. In Russia, the FORCYTE procedures, similarly to many other initiatives, were developed in accordance with the departmental principle. The Ministry of Public Education and Science, the Ministry for Communications and Information and the RF Ministry of Industry and Energy (Minpromenergo) began to elaborate their own procedures for applying FORCYTE.

Simultaneously, the Ministry of Public Education and Science completed the revision of the list of priority directions and critical technologies that had been started in 2005. As a result, the previously existing 9 priority directions and 52 critical technologies were replaced by a set of 8 priority directions and 35 critical technologies<sup>47</sup>. As follows from the comparison of the new and old lists of priorities (*Table 16*), they do, indeed, coincide in many points.

Certain directions were merged with others, and the direction "Industrial technologies" was taken off the list, which, however, happened by no means because it had become less of a priority, but simply because it did not belong to the sphere of jurisdiction of the Ministry of Public Education and Science. Other departments, such as the Minpromenergo, are developing their own priorities, including those in the sphere of industrial technologies. The departmental priorities are not coordinated at the interdepartmental level, and generally there is no coordination involved in the process of the determination of priorities. At the same time, to the Ministry of Public Education and Science, in accordance with the RF Strategy In the Sphere Of the Development of Science and Innovations During the Period Until the Year 2015, the role of a top agency is, in fact, assigned – the agency that is to determine the country's priority directions for scientific and technological development. Thus, the department-based approach to the selection of new priority directions has not been abolished. In this connection, our comparison of the ap-

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<sup>47</sup> Priority directions for the development of science, technologies and technical equipment in the Russian Federation and the List of critical technologies of the Russian Federation. Approved by the RF President as of 21 May 2006, Pr-842.

proaches to the selection of priority directions, critical technologies and the development of the FORCYTE procedures led to the conclusion that the FORCYTE method had fallen victim to the Russian practices of department-based forecasting and target-setting even before the onset of its practical implementation.

Table 16

**Lists of Priority Directions for the Development of Science, Technologies and Technical Appliances in the RF**

2002 list*	2006 list
Information and telecommunications technologies and electronics	Information and telecommunications systems
New materials and chemical technologies	Industry of nanosystems and materials
Technologies of live systems	Live systems
Ecology and rational use of nature	Rational use of nature
Energy - saving technologies	Power engineering and energy saving
Prospective armaments, military and special equipment	Prospective armaments and military equipment
New transport technologies	Transport, aviation and astronautical systems
Astronautical and aviation technologies	–
Industrial technologies	–
–	Safety and antiterrorist measures

\* List of priority directions for the development of science, technologies and technical equipment in the Russian Federation, approved by the President of the Russian Federation on 30 March 2002, Pr-577.

Source: RF Ministry of Public Education and Science.

**4.5.2. Financing Priorities and Development of an Approach Based on Target Programs**

The year 2006 saw continuing growth of budget spending on research and development. This growth had begun in 2002, when “The fundamental principles of the policy of the Russian Federation in the sphere of the development of science and technologies during the period until the year 2010 and beyond” were adopted, which determined the rate of annual growth of budget allocations to science. From that moment, when the annual size of budget funding is being determined, the absolute indices stated in that document are taken as the baseline. The growth rate of budget allocations to science in real terms was lower (*Table 17*) than that indicated in the Fundamental Principles, but at the same time much higher than that in the countries with stable science complexes.

Table 17

**Dynamics of Growth of Expenditures in the Federal Budget Allocated to Civilian Science**

Indices	2002	2003	2004	2005	2006
Approved budget, bn roubles	30.3	40.2	46.2	56.0	71.7
Budget in 2002 prices, bn roubles	30.3	35.9	37.0	40.3	47.5
Budget growth in real terms as % of previous year	–	18.4	3.1	8.9	17.9

Source: RF Ministry of Finance and computations performed by the IET.

Our analysis of the structure of the research and development budget has shown that it remains conservative, especially from the point of view of the distribution of financing by department. The main recipients of the budget funding allocated to research and development are, as before, the following state department

(in the descending order): the RAS, the Federal Agency for Science and Innovations (Rosnauka), the Russian Academy of Medical Sciences, the Siberian Branch of the RAS, The Russian Foundation for Basic Research (RFBR), the Far-Eastern Branch of the RAS, the Federal Agency for Education (Rosobrazovanie), the Urals Branch of the RAS. As seen from this sequence, these agencies mainly belong to the academic sector. Scientific funds received the amount of funding precisely corresponding to that they were entitled to under existing legislation: 6 % of the aggregate expenditures allocated to civil science – to the RFBR, 1.5% – to the Fund for promoting the development of small-size forms of enterprises in the sphere of science and technology, and 1 % – to the Russian Humanitarian Scientific Fund (RHSF).

Despite the declared reform of the academic sector in the sphere of science and the need for integrating science and education, the assignments earmarked under the subitem “fundamental research” for the research organizations of the RAS are ten times bigger than the funding under the same item allocated through the Rosobrazovanie to higher educational establishments. It is planned that 77% of the funding under this item should go to six state academies, while all the higher educational establishments, including Moscow State University, will receive only 7.4%. While the funding is being distributed in this manner, it would not be easy to implement an equal integration in the sphere of research and development. From the point of view of the actual amounts of funding being allocated, the gap between academic scientific organizations, as those that carry out research, and higher educational establishments that are responsible for education is by no means going to become narrower.

Substantial budget funds were allocated in 2006 through the system of federal target programs. Last year, the implementation of the Federal Target Scientific and Technological Program (FTSTP) “Research and development along the priority directions of the development of science and technologies in the years 2002–2006” was completed. An analysis of its results made it possible to better adjust certain conditions and approaches, which found their reflection in the new Federal Target Program “Research and development along the priority directions of the development of scientific and technological complex of Russia in the years 2007–2012”<sup>48</sup>.

*The first point* that has been proved by the results of the FTSTP’s implementation is that, after all the initiatives had been put together within the framework of a single program, the implementation of some of them proved to be of little effect. The program-based approach is not the best possible one to be applied when new organizations are being created, or when there is a need to provide financing for the material base of research (e. g., centers for shared use of equipment – SSU). It would be more feasible, at least at the initial stage, to finance such projects by way of subventions, and not on the basis of contracts for research and development.

*The second point* is that developers have limited opportunities for attracting off-budget funding; there were some instances when the requirements for co-

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<sup>48</sup> Approved by the Government’s Decree No. 613 of 17 October 2006.

financing were not complied with, or the funding was attracted in volumes much smaller than those promised. This may in part be explained by the fact that financing was allocated to works in which the private sector had no interest. Accordingly, there has emerged the problem arising from the need for more precisely defined procedures and criteria for experts' selection of projects. Another possible reason may be that the terms of a state order are too vague, and thereby the State secures the right to diminish the volume of allocated funding in an event of a diminished budget financing allocated to the said purposes, which, in its turn, represents an obstacle from the point of view of a private co-investor, for whom it would be difficult to plan the development works under such conditions. And finally, the third reason is the poorly determined rights to the results of those research and development works to which state support has been allocated. The State, as a rule, includes in its contracts a clause whereby it may transfer intellectual property to third parties for its own needs. On the whole, everything that had to do with intellectual property was determined in the FTSTP rather vaguely. Besides, no funding was earmarked in those projects for the search of patents and the protection of intellectual property.

*The third point* is that no mechanism for interdepartmental interaction was elaborated. Foreign experiences have shown that, under contemporary conditions, the implementation of large-scale programs of the FTSTP's scope requires the simultaneous participation of different departments "responsible" for different aspects of a program. In this latter case, a program's goals (educational and commercial, in addition to scientific proper) can be achieved with the highest degree of efficiency. This, if the Rosobrazovanie, the Fund for Promoting the Development of Small-Size Forms of Enterprises in the Sphere of Science and Technology, as well as other departments, join their efforts within the framework of the FTSTP, a combined effect may be produced as a result. The Rosobrazovanie will be in charge of the adjustment of the public education standards in some selected areas, while small-size enterprises will become involved in the implementation of projects and in the first stages of their commercialization through the Fund. Branch departments may issue certificates for the development of selected critical technologies. This will make it possible to find comprehensive solutions to certain problems associated with research, personnel and innovations.

Last year, certain results of the implementation of major innovational projects of state importance (the so-called mega-projects) were summarized, these projects having been financed through target programs within the framework of the FTSTP. In 2006, 6 mega-projects supported by the Ministry of Public Education and Science were to be completed. So far, no generalized data concerning the results achieved in course of their implementation have been published. Perhaps the reason for this is inadequate monitoring procedures, because no funding was allocated to such purposes in the Program's budget.

The principal and, in fact, the only criterion of the successful outcome of mega-projects was the standard requiring that the volume of sales should be five times higher than the volume of allocated budget funding. As far as this index is

concerned, the results of the projects vary considerably. Thus, the aggregate excess achieved in all the completed projects is less than threefold (the State invested 3.68 bn roubles, and the sales of new products amounted to 9 bn roubles<sup>49</sup>), while in one project the excess of sales volume over the volume of allocated budget funding was eightfold.

The available information concerning some of the most successful mega-projects has made it possible to summarize the achievements, as well as to point to certain problems that had emerged during their implementation. By way of example, the following successful mega-projects can be mentioned here:

- “The development of technologies and serial production of a new generation of sealing and fire-proof materials for general industrial use”, within the framework of which the appropriate technology was developed and the serial production of sealing and fire-proof materials of a new generation, designed for general industrial use, was launched. These materials are applied in nuclear and thermal power engineering, in railway transport, in transport machine – building, in aerospace industry, in the oil and gas sector, in chemical industry, and in the housing and utilities complex.
- “The development of technologies and the launching of the production of appliances and equipment for nanotechnologies”, the result of which was the production of appliances and equipment for nanotechnologies in accordance with a new technology and its supply to the enterprises and organizations working in the fields of biotechnologies, nanodispersion materials, new pharmaceuticals, and to centers for nanotechnologies and microscopic probing. Besides, this new equipment is purchased by the EU member states, the countries of South-East Asia and the USA.
- “The creation of technologies and the launching of the industrial production of metal materials with twofold improvement of their most important exploitation properties”, under which new compoundings of high quality steels and welding materials were developed for purposes of import substitution, designed for floating and stationary rigs for oil and gas extraction under the extreme conditions of the northern seas’ shelves, high-pressure underwater pipelines, arctic icebreaker tankers, and construction structures. These technologies are designed for dual purposes<sup>50</sup>.

The achievements of these projects are represented by personnel reestimations that occurred during their implementation. Complex teams were formed, capable of finding solutions to large-scale and complicated problems. As a result, several new projects have been launched in partnership with some big businesses.

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<sup>49</sup> Summary of the report by A. Fursenko addressing the issue “Improvement of mechanisms for developing and implementing the most important innovation projects of national significance”, 7 December 2006. See <http://www.mon.gov.ru/news/announce/3231/>.

<sup>50</sup> Cit. from the report by A. Fursenko addressing the issue “Improvement of mechanisms for developing and implementing the most important innovation projects of national significance”, 7 December 2006. See <http://www.mon.gov.ru/news/announce/3231/>.

In some of the mega-projects, a new administrative approach was applied – the outsourcing of the managerial and monitoring functions, which yielded good results. External management makes it possible to follow-up development works being implemented under projects with a higher degree of objectivity and speed, and to make appropriate adjustments wherever necessary.

The problems encountered in course of the implementation of mega-projects were associated both with the existing normative and legal restrictions and with the shortcomings inherent in the instrument of a mega-project proper. The problems of normative - legal regulation relate to aspects like the mechanism for accepting intellectual property on an account, the organization and effectuation of government procurement, and disposal of property in the form of special equipment necessary for research and development. The main gap in the system has occurred because the existing system of contracts does not take into account the peculiar features of the implementation of partnership projects where the State and private businesses act as co-investors.

The drawback of the instrument of mega-projects is that the financing for research and development comes from the budget only, while private companies allocate no funds to these purposes. Besides, research and development is carried out, as a rule, only by research organizations, while industrial companies are responsible for organizing production and sales. This scheme only slightly differs from the traditional Soviet system of “vnedrenie” [implementation]. From the point of view of promoting private investments in research and development, more progressive is the approach when research organizations and businesses co-finance research and development. In this case, the research and development activity will be mainly aimed at providing solutions to the problems faced by Russian industry, while at the same time this approach may promote the development of new small- and medium-sized science-intensive enterprises.

In addition to mega-projects, special priority in 2006 was given to the program oriented to the development of nanotechnologies. In August, the Ordinance of the RF Government concerning the coordination of works in the sphere of nanotechnologies was issued<sup>51</sup>. The critical degree of obsolescence of specialized equipment for research was recognized as the principal problem faced by this sphere. Therefore, in the 2007 budget, a substantial growth in expenditures on the development of research and technological infrastructure for nanoindustry was envisaged. The draft programs, beside the upgrading of the material base and equipment for research, envisage the creation of a system for information exchange in this sphere, personnel training for research and development and for practical application of nanomaterials and nanotechnologies, the formation of research-and-education complexes, centers for collective education, etc. Resulting from this multitude of goals, the project became eclectic and failed to receive the approval by the Ministry for Economic Development and Trade. As of the end of January 2007, the draft program for the development of nanotechnologies had not yet been

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<sup>51</sup> Ordinance of the RF Government “On the program for coordinating the activities in the sphere of nanotechnologies and nanomaterials in the Russian Federation”, No. 1188-r of 25 August 2006.

coordinated between the departments. Meanwhile, under the aegis of the Ministry of Public Education and Science, the Interdepartmental Task Force for issues relating to the coordination of activities in the spheres of nanotechnologies and nanoindustry was created. Its task was to submit to the government quarterly reports on the state of affairs in the said spheres. Besides, the Rosnauka announced a tender for obtaining the status of a head organization under the program in the sphere of nanotechnologies. This organization is to become the first national laboratory.

#### *4.5.3. The Personnel Policy of the State*

In late 2006, the personnel policy, and more particularly, the issues relating to the attraction of young people into the sphere of science, once again became the focus of the government's attention. In November, a special interdepartmental task force was created for dealing with the issue of reproduction of manpower in the sphere of research and education. The purpose of that task force was to coordinate the state measures designed to support the personnel employed in the government sector of science and in higher education<sup>52</sup> and to find appropriate solutions to the problem of reproduction of manpower in the academic sphere. The interdepartmental task force must develop yet another program – this time with the status of a federal target program, with the working title “Scientific and scientific-educational cadres of innovational Russia for the years 2008–2012”. The Ministry of Public Education and Science set the goal of attracting to the sphere of science, through the implementation of various initiatives, no less than 3,000 young scientists. So far, approximately 1,500 young researchers have become involved in government programs, and not all of them do, indeed, stay in the sphere of science for a lengthy period of time. Among the commission's members, there are scientists, administrators of research institutes, rectors of higher educational establishments, as well as government officials. No representatives of businesses have been included in the commission, although the business community is becoming more and more actively involved in the training and retraining of personnel, including for the research and development departments of commercial companies. Their participation could have been beneficial and could have resulted in new approaches to resolving the existing cadre problems being generated.

Almost simultaneously the government's initiative in respect to cadres was augmented by the participation of state scientific funds, which organized new targeted competitions in order to support young researches. In November, the Russian Humanitarian Scientific Fund (RHSF) announced a targeted competition in support of young scientists to be held in the year 2007, and in December the Fund in support of the development of small-size forms of enterprises in the sphere of science and technologies, backed by the Rosnauka and the Rosobrazovanie, launched the program “Participant in youth scientific – innovational competition” (or “U.M.N.I.K.”). The RHSF will be providing targeted support to the young, by

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<sup>52</sup> Ordinance of the RF Government of 16 September 2006, No. 1303-r, “On the interdepartmental task force for resolving the issues of manpower reproduction in the sphere of science and technologies”.

means of sponsoring their resident training courses at research centers, trips for work at libraries and archives, or their participation in scientific conferences abroad. As a result, the establishment of new connections will be promoted, as well as a more active involvement of young cadres in the international scientific community. The program "U.M.N.I.K." of the Fund in support of the development of small-sized forms of enterprises is designed to support young (aged under 28 years) students and researchers, to whom grants will be allocated in order to enable them to implement research and development projects at small-sized enterprises.

The initiation of programs by funds may be regarded as the first step aimed at promoting personnel mobility. This is an important positive shift in personnel policy. Mobility contributes to the development of new areas of research, including interdisciplinary, the expansion of general outlook and the improvement of researchers' qualifications. In fact, mobility is a mechanism for diffusing knowledge. At the same time, presently in Russia the internal mobility of personnel both inside the government sector and between sectors is minimal. It should be borne in mind, however, that its development is restrained not only by the lack of any special programs aimed at encouraging mobility, but also by the general economic and administrative situation in the country, which is characterized by an undeveloped housing market, regional differentiation of the population by income levels, and rigid personnel structure in the government sector of science.

No matter how important may be the competitions organized precisely in order to attract more young people into science, they still are aimed at a single, and quite limited, target group, because they involve only those persons who are already employed in research. At the same time, vast reserves are hidden among students. Therefore, the involvement of young people in science must begin as early as during their undergraduate years, through their participation in real research activity. In this field, rich and variable foreign experience is available, as well as some interesting domestic initiatives, which date back to Soviet times. Different methods are practiced throughout the globe in order to stir an interest in science, among them – lectures to freshmen students who are working toward a bachelor degree, delivered by eminent scientists, who are capable to speak of the latest achievements in their specific fields and at the same time establish a certain benchmark for an academic level of research. Another possible approach is to develop specific programs of advanced studies for future scientists. This approach used to be well developed in the Soviet system of higher education. The third approach consists in implementing special research programs for students. Nowadays, however, this approach is being practiced on a very limited scale: if back in the early 1990s no less than 10% of all the funding allocated to higher educational establishments and earmarked for research and development had to be spent on students' research activity, presently, according to the data presented by the Ministry of Public Education and Science, this index has decreased threefold.

Solutions to the personnel problems were looked for also within the RAS' system, and took the form of a pilot system of remuneration. In April 2006, the Gov-

ernment's Decree "On the implementation, in the years 2006–2008, of a pilot project aimed at improving the system of remuneration of the research staff and directors of research institutions, and the research staff of the research centers of the Russian Academy of Sciences" was issued, whereby a list consisting of 410 organizations was established, the staff of which was to be involved in the pilot project. In accordance with that decree, from 1 May 2006 the sum of remuneration to be paid to the research staff was to be composed of a fixed salary, the rates for which were also determined by the decree, and bonuses paid as incentives. Both these components were to be funded from the budget resources. Off-budget resources have remained a supplementary source of income for scientists. Simultaneously with the introduction of the new system of remuneration, within the period of three years the number of research staff employed at the research institutions and research centers of the Russian Academy of Sciences is to be cut by 20 %. In this connection, the decree determines the precise number of the employees of the RAS' research institutions which must be achieved as a result of these reductions: as of 1 May 2006, the total number of staff employed at the institutes within the RAS system was 112,370 including 55,281 of directors and researchers. By 1 January 2009, these indices must be equal to 89,896 and 44,225, respectively<sup>53</sup>.

The development of approached to determining the size of bonuses to be paid as incentives continued, in fact, throughout the whole year. The main subject of discussion was the principles to be applied for establishing the additional payments and the criteria for estimating the performance and efficiency indices of research activity. The Ministry of Public Education and Science and the RAS presented two different approaches: the Ministry had developed a system of strict quantitative estimation indices<sup>54</sup>, while the RAS' Presidium had focused its attention on the qualitative estimation, augmented by a limited number of quantitative indices<sup>55</sup>. The actual coordination of the criteria and procedures was completed only toward the year's end<sup>56</sup>.

The final document took a sufficiently well-balanced shape: the system of quantitative indices was preserved, but at the same time 15% of the funding allo-

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<sup>53</sup> Decree of the RF Government "On the implementation in 2006–2008 of the pilot project for improving the system of remuneration for the research staff and directors of research institutions and the research staff of the research centers of the Russian Academy of Sciences", No. 236 of 22 April 2006.

<sup>54</sup> Proposals of the Ministry of Public Education and Science of Russia concerning the procedure and terms for the application of bonuses paid as incentives to the research staff and directors of research institutions and to the research staff of the research centers of the RAS (24 May 2006). See <http://mon.gov.ru/science-politic/news/2507/>.

<sup>55</sup> Types, procedure and terms for the application of bonuses paid as incentives to the research staff and directors of research institutions and to the research staff of the research centers of the Russian Academy of Sciences. See <http://www.ras.ru/feu/zarplata.aspx>.

<sup>56</sup> Order of the Ministry of Public Education and Science and the Ministry of Public Health and Social Development "On approving the types, procedure and terms for the application of additional allowances paid as incentives aimed at improving the performance of the research staff and directors of research institutions and the research staff of the research centers of the Russian Academy of Sciences", No. 273/745/68 of 3 November 2006.

cated from the Fund for incentives for research institutes could be distributed at the discretion of an institute's academic council. Besides, the director of an organization may use up to 30 % of the Fund's resources for the inducement of the research staff performing research under the RAS' programs. And, finally, an academic council may make decisions concerning the establishment of adjustment coefficients in the range of 0.5 to 1.5, to be applied to the quantitative indices. Thus, approximately one half of the Fund's resources will be distributed in accordance with the strict quantitative criteria. Among these, the principal ones are the indices of publications, including citations, the numbers of patents, the number and size of monographs, the participation in conferences, the development of academic educational courses and the training of supreme-qualification personnel. Some of the indices seem to be dubious from the point of view of compatibility with the goal of estimating the research performance level. Thus, for example, the citation indices are very useful for the follow-up of the development of certain areas of science, for determining among them those that are new and growing (science maps). However, when individual scientists and organizations are estimated in this way, there emerge too many factors that can distort the results: group citations, self-citation, negative citation, the impossibility to estimate performance levels in those areas where access to publications may be restricted because of state secret, etc. Moreover, as demonstrated by the experience of countries with developed science and technology, the bibliometric indices are relevant only for natural and some technical sciences, and therefore are not applied to the estimation of performance of social sciences and humanities. Much will also depend on the specific adjustment coefficients established for each index, on the conferences that are to be taken into account when generating the summary estimation, on the types of monographs, etc. Thus, the system that has been suggested is rather flexible, and the positive effect of its implementation may be higher than the various potential side effects.

At the same time, it should be noted that such a complex system for computing the individual level of scientists' performance is not being practiced in countries where science is well-developed (in the USA and Western Europe), because it is bulky, labor-consuming and is capable of reflecting the real state of affairs with a certain degree of approximation only. Besides, it is appropriate only for scientists engaged in fundamental research. The introduction of such a system in Russia can be explained, first of all, by the insufficient scope of the grant-type financing of fundamental science.

In its approach to the planned cuts in the number of budget-funded staff, which were to take place alongside the implementation of the pilot system of remuneration, the RAS Presidium applied the leveling principle: each institute, irrespective of its performance level, was to cut, during last year, some 7% of its research staff. Quite early on, it became obvious that this approach is destructive: in "strong" institutes it was rather difficult to select the necessary 7% of staff to be dismissed, because the staff structures there were well-balanced, and any further cuts could result in lower performance, while in some other institutes more than 20% of staff

was redundant. The cuts also meant that no new young employees could be accepted. To prevent this, the RAS Presidium introduced an adjustment measure, by entering into plan 500 additional budget-funded vacancies specifically to be filled by young scientists. If the target staff reduction indices remain the same, then this innovation will mean greater cuts among the other age groups. By the year's end, the RAS Presidium had acknowledged the failure of the leveling principle when applied to staff number reduction. However, if the individual approach is to be applied to each of the academic institutes, specific criteria must be developed for determining the scope of personnel cuts in every specific case. This will give rise to the same problem as that which emerged when the approaches to estimating the size of incentive bonuses were being developed: what must be the quantitative and qualitative criteria? What should be the degree of formalization of the selection procedure? If expert's estimations are to be applied, who will perform them? So far, no answers to all these questions have been provided.

The problems of ensuring a well-balanced personnel structure have to do not only with the reproduction of manpower in science, but also with the need to balance these structures by type of activity (scientists, engineers and technicians, auxiliary personnel). The problem of inadequate personnel balance is becoming more and more acute in Russia. In a majority of research institutes belonging to the fields of natural sciences and technologies, the shortage of engineers, laboratory assistants and technicians is growing, which results in poorer generation of knowledge and lower opportunities for its proper protection, promotion and transformation into new products and technologies. From this point of view, the system of remuneration being introduced within the RAS network is aggravating the situation still further, because it results in producing a greater gap between the sizes of salaries assigned to researchers and to all the other categories of personnel.

If one compares the situation in Russia with those in developed countries, in the latter case one can observe a higher percentage of engineers, technicians and auxiliary personnel. In the government sector of science in the USA, researchers proper comprise 42.2%, engineers – 21.6%, technicians – 27.4%<sup>57</sup>. In Russia there exists no statistics as to the number of engineers; some of them are included in the category “researchers”, and some – in “auxiliary personnel”, and so no correct comparisons with foreign countries can be possible. Nevertheless, it is evident that in Russia scientists do prevail in the government sector of science, where their percentage is 51.3% and has remained unchanged for several recent years. At the same time, the number of technicians is 9.8% of the total staff employed in research and development, while that of auxiliary and other types of personnel is 38.9%<sup>58</sup>. The recommended average weighted indices of the research and development staff for the OECD member states (which can be found in the international standards for science and innovations – the so-called “Frascati Manual”) represent

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<sup>57</sup> The data for 2001. Source: Morrison R., Green M. Scientists, Engineers, and Technicians in the United States: 2001. NSF, 2005, tab. 1, p. 10–21.

<sup>58</sup> The data for 2004. Source: Indikatory nauki (Indices of Science). A collection of statistics. M.: SUHSE, 2006, p. 117.

50% for researchers, 25% for engineers and technicians, and 25% for all other types of personnel that provide support to research and development<sup>59</sup>. At the same time, at the government level (by representatives of the Ministry of Public Education and Science) there has been voiced the intention to further change the personnel ratios toward increasing the percentage of scientists proper. These plans can be explained only by a lack of proper understanding of the situation in this country's research institutions as it really exists, and of the objective demands intrinsic to the organization of the research process.

#### 4.5.4. *Organizational Changes in the Government Sector of Science*

Last year, the restructuring of the government sector of science was very slow. Organizational reforms were restricted by the absence of legislation on the new organizational forms applicable to the spheres of science and education. Only as late as November 2006, the Federal Law "On autonomous institutions" was passed, which introduced a new type of a state institution – an autonomous institution<sup>60</sup>. This form may become especially attractive for the organizations in the former branch sector, which presently are performing in the organizational - legal forms of an institution or a unitary enterprise.

In the academic sector of science, the fundamental principles of future transformations were laid down by the amendments to the Federal Law "On science and state scientific and technological policy", which were adopted in December last and introduced certain changes into the principles of functioning to be applied to the academies of sciences with the state status. Now, the academies of sciences have become state not-for-profit organizations. Accordingly, the Charter of the RAS is to be approved by the RF Government on the recommendation of a general meeting of the RAS, while the President of the RAS will, as before, be elected by a general meeting, but the appointment to that post is to be approved by the RF President. The state academies of sciences will have to submit to the RF President and the Government annual reports on the situation in Russian science, reports on their scientific and organizational-economic activities, and proposals concerning the priority directions for the development of science. These measures are designed to increase the transparency of the academies' activity.

At the same time, the regulation of financial flows and property have remained unchanged, although the Law does introduce certain formulations that may be interpreted as a preparatory stage before the onset of more serious reforms. In particular, the funding from the federal budget for fundamental research will be allocated to the state academies of sciences in accordance with the fundamental research program, and there is no indication in the Law as to how the financing effectuated within the framework of this program will be combined with the basic (by estimate) financing of research organizations. In accordance with the Govern-

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<sup>59</sup> Frascati Manual. Proposed Standard Practice for Surveys on Research and Experimental Development. OECD, 2002, p. 221.

<sup>60</sup> For more details concerning Federal Law of 3 November 2006, No. 174-FZ, "On autonomous institutions", see *Annex 1* of this overview.

ment's assignment concerning the Law's implementation, the draft fundamental research program will be elaborated jointly by the Ministry of Public Education and Science, the Ministry of Public Health Care and Social Development, the Ministry of Agriculture, the Ministry for Regional Development, and the Ministry of Culture in cooperation with the RAS and the other five state academies. This will mean the strengthening of the role of the Ministry of Public Education and Science and other ministries in the activity of the academies.

Simultaneously, the state academies of sciences will retain their right to determine independently the number of staff and the system of remuneration in their subordinate organizations, the main directions for spending their received funding, while the reduction of staff numbers in the academies and their subordinate organizations cannot be used as the grounds for reducing the amount of funding allocated to the state academies of sciences in the federal budget for a current and the following years.

Thus, so far the innovations that have been introduced cannot be regarded as revolutionary: the candidacy of the President of the RAS, indeed, has always had to be coordinated with the RF President and the Government. The coordination of the content of the Charter may create certain difficulties for the Academy's Presidium, but the fundamental financial and property aspects of the RAS' activity have already been established in the amendments to the Law on science.

Last year, little attention was paid to branch science at the government level. Discussions would periodically arise only in respect of the issue of the reorganization of the network of state research centers (SRC), the majority among which belonged to the field of branch science. However, the effectively revised list of SRCs, which now contains 51 centers instead of the former 58, was submitted for the consideration by the Interdepartmental Commission for Scientific and Innovational Policy only at the very end of December. Later on, it is intended that the role of quantitative indices in the selection of SRCs should be increased, with the establishment of their "threshold values". Besides, proposals have been put forth that the organizations, to which the status of a SRC is to be granted, should be rotated<sup>61</sup>. During all these discussions, one important issue has been overlooked – that of the present significance of this status. It should be remembered that the status of a SRC was introduced in the early 1990s in order to preserve, in the situation of crisis, some of the then existing branch institutes with unique material base. Nowadays, there is no crisis in the sphere of budget financing, and substantial funding is allocated to the programs, and so there exist no real grounds for preserving this status as such. Moreover, past experience have shown that the granting of such a status did not help in maintaining those institutes, to which is had been granted, as the leading ones in their respective fields, and they began to develop along very different lines.

In effect, there occurred a natural destruction of the formerly existing branch science, while no sufficient stimuli existed for the development of research and development departments within commercial companies. All this has resulted in the

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<sup>61</sup> Poisk, No. 1, 12 January 2007, p. 4.

shortage of organizations actually capable of turning the results of applied studies conducted by the institutes of the government sector into actual developments and into finished products. The crisis in the branch science may also have its impact on the situation in fundamental science, because it quite often happens so that the problems being solved by fundamental science are actually formulated as a result of applied work. It appears that this problem must be dealt with not by means of revising the position of the “institutes with a special status”, but through developing and implementing a system of measures aimed at encouraging the private sector to provide financing for research and development.

In higher educational establishments the restructuring of science was also developing very slowly. It took the shape of research institutes being merged with higher educational establishments. The majority of research institutes react negatively to their being turned into structural subdivisions of higher educational establishments. They are afraid of the increased control on the part of the administrations of higher educational establishments, of the loss of their integrity as research organizations, and of the “dispersion” of scientific projects among the numerous chairs existing in higher educational establishments. The administrations of the latter, in their turn, believe their mergers with research institutes to be a positive step in the direction of integration between education and science. It is expected that positive effect will be achieved due to a closer cooperation between the institutes and faculties. This should result in an inflow of funding into higher educational establishments, to be allocated to research and development. At the same time, given that higher educational establishments still preserve their form of state institutions, the opportunities for innovation activity available to the research institutes being merged with them are very far from becoming more advantageous – indeed, they are now restricted in such opportunities, because the form of a state institution, coupled with legislation that regulates the activity of higher educational establishments, imposes serious restrictions on the actual implementation of innovation activity. Consequently, there might be fewer incentives also for conducting research and development. Meanwhile, the strengthening of research activity at higher educational establishments remains an important goal: according to the data collected by the Rosobrazovanie, only 13% of the tutorial staff of higher educational establishments actually participate in research, while 10–15% of the off-budget funds of higher educational establishments is allocated to research and development<sup>62</sup>. The situation may be significantly improved if the ideas that lay the basis of the program for the support of innovation-oriented higher educational establishments are efficiently implemented into practice.

#### *4.5.5. The Formation of a Network of Innovation-Oriented Higher Educational Establishments*

The idea of forming a network of innovation-oriented higher educational establishments saw in the year 2006 its practical implementation. The initiative aimed at selecting and providing targeted support to those higher educational establish-

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<sup>62</sup> Poisk, 3, March 2006, p. 5.

ments where various innovation programs are being implemented – both in the fields of education, organization and management and in the field of science – is very timely indeed. The labor market at present is becoming more and more dynamic, and therefore there exists demand for specialists with new areas of competence. The growing requirements of employers to the quality of education promote the growing role and importance of scientific research at higher educational establishments. So far, according to the estimations of employers, higher educational establishments have been preparing specialists with a satisfactory level of basic knowledge, slightly outdated professional knowledge, and very little competence (that is, the ability to practically implement their acquired knowledge, communication skills, skills of team work, and ability of self-education)<sup>63</sup>. The worrying circumstance is that the higher educational establishments estimate all the above-listed qualities of their alumni to be at a much higher level. From this it follows that either they deliberately overestimate their own achievements, or lack proper orientation as to which specialists and with which abilities are now in demand among employers.

During the competition of innovation program, higher educational establishments were granted an opportunity to make known their most advanced ideas and developments, which later may be introduced into the system of higher education at a much larger scale. For the implementation of their plans, higher educational establishments could ask for a sum amounting to between 400 mln and 1 bn roubles, while at the same time guaranteeing the availability of additional off-budget funding for the implementation of their projects in the amount of no less than 20% of budget allocations. By the competition's results, budget funding for the implementation of innovation projects was granted to 17 higher educational establishments.

The initial results of the activity of higher educational establishments within the framework of their innovation programs have made it possible to summarize both the main positive aspects and the problems areas that were revealed during the implementation of this initiative (*Table 18*).

The main advantage of this program has been the absence of any rigid requirements to the content of innovation programs and the practical support provided to the sprouting advanced ideas, which are being generated at higher educational establishments, and not imposed on them "from above". This initiative has made it possible to learn the skills of a program-based approach and to mobilize the available personnel resources, and also promotes the emergence of new leaders. It is also characteristic that in the educational programs developed at the innovation-oriented higher educational establishments priority has been given to the notion of competence. Besides, at the innovation-oriented higher educational es-

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<sup>63</sup> According to the results of the study of the Analytical Center "Ekspert" "Vuzy i rabotodateli o vypusknikakh i reforme vysshei shkoly" ("Higher educational establishments and employers – about graduates and reform of the higher education system"), conducted in 2005 in cooperation with the V. Potanin Charity Fund and the companies "Rusal" and AFK "Sistema" (Source: Ekspert, No. 4, 30 January 2006).

establishments there should appear an impetus for promoting the development of science, since research and development, in effect, represents for them one of the necessary components of strategic development programs. The positive effects go beyond the framework of the habitual activity of those higher educational establishments that have become winners in the competition, because the program being implemented by the innovation-oriented higher educational establishments has stirred the whole higher education community and made other higher educational establishments think of strategies for their own development.

Table 18

**Positive Aspects and Problems Areas in the Implementation of Innovation Programs by Higher Educational Establishments**

Positive aspects	Problems
Freedom in choice of innovation programs, encouragement of initiatives "from below"	Insufficient clarity in determining terminology and government's requirements to programs of higher educational establishments
Opportunities for merging personnel resources for implementation of a big project, formation of new teams and emergence of new leaders	Rigid regulation of timelines, directions and principles of spending budget resources
Learning skills necessary for implementation of program-based approach	Insufficient time for project planning
Growing activity of community of higher educational establishments, greater attention of higher educational establishments to forming strategies of their development	Excessive bureaucratization of reporting by higher educational establishments
Improvement of management skills, including those of organizing purchases and other organizational measures	Low level of planning at higher educational establishments, lack of specialists competent in marketing and purchases
Emerging impetus for creating new educational programs, with due regard for competence development, promotion of internal and external mobility of students and professors	Problems in attracting off-budget funding

Some of the innovation-oriented higher educational establishments may grow into research universities. A research university, as it is commonly understood, has a prominent orientation toward postgraduate education and doctorates, an expanded spectrum of disciplines being taught, promotes integration of science and education, possesses state-of-the-art equipment, enjoys well-established connections with industry, participates in the processes of technologies commercialization, has a well-developed infrastructure (a campus) on its territory, as well as an infrastructure for interaction with its alumni and donors.

The problems that arose during the implementation of innovation projects may be subdivided into two groups: those associated with the conditions and restrictions imposed by the State, and those derived from the activity of higher educational establishments proper. To the first group belong the rigid requirements imposed on spending, belated organization of the competition, which resulted in shorter time having been allocated to the implementation of project initiatives, excessively bureaucratic reporting procedures (at the first stage, higher educational establishments had to submit the reports on their activity on a weekly basis).

In its turn, at the level of higher educational establishments there was found the shortage of managers with modern qualifications and of specialists in purchases and marketing. Some problems were also associated with the need to at-

tract off-budget funding, as had been declared in the application forms: in particular, only two higher educational establishments managed to receive funding from RF subjects.

By way of summing up the first steps made in implementing the programs of innovation-oriented higher educational establishments, it can be concluded that this initiative should produce long-term positive effect on the sector of higher educational establishments. Serious obstacles, however, can arise from the controversy between the planned innovative approaches and programs for the development of higher educational establishments, on the one hand, and the rigid standards imposed by the RF Ministry of Public Education and Science, on the other, as well as by the restrictions imposed by a number of federal laws. In particular, during the implementation of innovation program the greatest problems emerged due to the application of the Federal Law “On the placement of orders for the supplies of commodities, performance of works, provision of services for state and municipal needs” (of 21 July 2005, No. 94-FZ).

Last year, the concept of creating “federal” universities in this country has also been developed. The Chairman of the RF Government signed an ordinance concerning the establishment of two federal universities – Siberian and Southern<sup>64</sup>, which, besides providing high-quality education, must also become centers of innovation activity<sup>65</sup>.

#### *4.5.6. Promotion of Innovation Activity*

As far as the support and promotion of innovation activity is concerned, the year 2006 became a certain “transition period”: the conceptual decisions as to the creation of new structures and mechanisms (technoparks, venture funds, technology implementation zones (TIZ)) were made in 2005, while they were to start functioning from the year 2007 onward. Therefore, last year was the time for preparing the normative-legal environment necessary for the creation and functioning of the new organizations and mechanisms. The main focus of work was placed on the development of the projects for venture financing, technoparks and technology implementation zones. Much attention was also paid to improving legislation in the sphere of intellectual property and the development of measures for indirect promotion of research and innovation activity.

#### The Formation of Financial and Technological Infrastructure

The State has initiated the simultaneous support of several forms of venture financing for the development of small-sized innovation-oriented businesses. The year 2006 saw the formation of two types of venture funds – “The Fund of Funds” and the Specialized Venture Fund in the Sphere of Information and Communica-

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<sup>64</sup> Ordinance of the RF Government of 4 November 2006 No. 1518-r concerning the creation of the federal state institution for higher professional education “The Siberian Federal University” (SibFU) and Ordinance of the RF Government of 23 November 2006 No. 1616-r concerning the creation of the Southern Federal University.

<sup>65</sup> For more details on the creation of federal universities, see Section 4.4.1 of this overview.

tions Technologies. Both schemes were borrowed from foreign experience, where they had been applied most successfully.

For the implementation of the first model, the open-end joint-stock society “Russian Venture Company” (“RVK”) was created, where the State was the holder of 100% of the joint-stock capital. RVK will carry out competition-based selection of venture asset managers and purchase stakes in venture funds established in the form of a closed-end share fund by the selected asset managers. In RVK, an external board of directors was formed as a preventive measure against corruption, or at least as a measure for lowering the degree of corruption. The budget of “The Fund of Funds” is equal to 15 bn roubles, which is to be allocated from the Investment Fund. It is planned so that the budget component in each of the hi-tech companies created at the expense of the venture funds should comprise between 25% and 49%. In order to promote the inflow of private investments to those companies, the State is going to claim only 1/5 of the rate of refinancing established by the Bank of Russia for the rate of return on invested budget funds, that is, only 3% of interest per annum. The rest will go to private investors.

The second model of venture financing represents the establishment, for the period of three years, of the open-end joint-stock society “Russian Investment Fund for Information and Communication Technologies”, with the purpose of developing enterprises and the infrastructure for the sector of information and communications technologies. Late in the year, the government approved a transfer of 1.45 billion roubles to that fund, and another 1.5 bn roubles must be provided by investors. The principle of budget financing of small-sized companies from that fund is the same as in the first model: budget funding is to be supplemented if no less than 51% is provided by investors.

The positive aspect of the modern phase in the development of the mechanisms for venture financing is that several models of funds are being tested simultaneously. While “The Fund of Funds” is important for an overall activation of venture financing, as well as for providing the necessary experience of dealing with venture resources, specialized venture funds, as demonstrated by international experience, are most successful in terms of market, because only they are capable of providing a high level of experts’ estimation of projects and thus lowering the risks involved.

Until now, the small size of the budgets of venture funds proved to be a serious impediment to the development of venture financing. When the funds’ size is below \$ 10 million, no long-term development or any efficient operational activity can be possible, as shown by actual practice. As estimated by representatives of the business community, an efficiently functioning venture fund must possess a budget of no less than \$ 20 mln for investing in innovation projects<sup>66</sup>. Thus, in the new funds this problem has been solved.

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<sup>66</sup> National Report “Informatsionnoe razvitie – osnova uskorenogo rosta ekonomiki Rossiiskoi Federatsii” (“Information development is the basis for an accelerated growth of the Russian Federation’s economy”). M.: Assotsiatsiia menedzherov (Association of Managers), 2006, p. 64.

When the projects of venture funds are being implemented, continual monitoring is very important, because international experiences in the development of such programs vary greatly. Moreover, the practice of organizing state venture funds has produced, as a rule, negative results<sup>67</sup>.

There also exists one circumstance that may complicate the functioning of a venture company and the venture funds created with its participation. This is the absence of a flow of projects eligible for venture financing. As has been acknowledged by officials from the Ministry for Economic Development and Trade, the main goal consists in finding the necessary amount of projects to be covered by the substantial funds being accumulated in RVK<sup>68</sup>. Logically speaking, before any venture funds are created, it is necessary to implement appropriate measures aimed at generating a critical mass of such projects. The experience of countries where venture financing is well-developed (USA, Israel, Canada, Australia) has shown that the success of projects based on venture financing is usually provided for by a *system* of programs encompassing all the stages of the innovation cycle – from small-sized grants to big venture projects<sup>69</sup>. In Russia the preliminary stages, and particularly the stage of seed investment, are sustained only by “The Fund for Support...” (the START program), which is far from being sufficient for this country, with its great scope. As for “business angels” (private informal investors who invest in unknown young entrepreneurial companies), who also provide financing for the initial stages of innovation projects, this institute is as yet undergoing the initial stage of its own formation.

The legislative and normative base, which will make it possible to establish venture funds, must be formed by the end of Q I 2007. Meanwhile, local authorities in 13 RF regions have already begun to form venture funds. Within the framework of prevailing legislation, local authorities establish venture funds in the form of commercial organizations; however, this organizational – legal form is contrary to the basic meaning of venture financing.

In addition to venture fund, in the sphere of information technologies (IT) 7 specialized technoparks are presently undergoing the stage of their formation (IT-technoparks). And simultaneously, amendments to the RF Civil Code were adopted, aimed at creating favorable conditions for the taxation of organizations working in the field of information and communications technologies<sup>70</sup>. In accordance with the law, the rules for computing the rate of the single social tax (SST) by such organizations were changed (with the exception of those organizations which are residents of technology implementation zones (TIZ). In order to pay SST at a

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<sup>67</sup> Russian Economic Report, December 2006, No. 13. The World Bank Economics Unit, p.23.

<sup>68</sup> Sredstv na innovatsii v Rossii bol'she chem. dostatochno (There are more than enough resources for innovation in Russia) // Poisk, No. 52, 29 December 2006, p. 7.

<sup>69</sup> Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study, Part I, The World Bank, January 2006, p.28–29.

<sup>70</sup> RF Federal Law of 27 July 2006 No. 144-FZ “On making amendments to Part II of the RF Civil Code in the part of creating favorable taxation conditions for those taxpayers whose activity is in the sphere of information technologies, as well as the introduction of other changes aimed at improving the efficiency of the tax system”.

privileged rate, organizations must be accredited; no less than 70% of their financing must come from foreign sources, while their average staff number should be no less than 50 persons. Thus, this privilege is not aimed at encouraging any company in the IT sphere, but only those, which perform in the regime of outsourcing, and thereby export of IT products can be promoted. In fact, it is the first attempt to connect three instruments necessary for promoting innovation activity, and so far it has been made in the IT sphere only: technoparks where small-sized innovation companies are to be located; a venture fund capable of providing them with financing; and privileges to those companies that export their IT services.

In March, the Ordinance of the RF Government was issued, whereby the government program "Creation in the Russian Federation of technoparks in the hi-tech sphere" was approved<sup>71</sup>. The program is planned for the period of 2006–2010, during which IT technoparks should be created in 7 regions – Moscow Oblast, Novosibirsk Oblast, Nizhny-Novgorod Oblast, Kaluga Oblast, Tumen Oblast, Tatarstan and St. Petersburg. In the newly established technoparks, the formation of engineering and transport infrastructure will be funded from the budget. All other expenditures are to be covered mainly from private sources. In 2007, the technoparks' administrative bodies are to be formed, the pre-project and project works for the beginning of construction should be carried out, and the program for promoting the entry of Russian technologies onto the global market developed.

The development of TIZ last year was associated, first of all, with the elaboration of a great number of normative-legal acts (a total of more than 40), necessary for providing solutions to issues relating to the construction of technical infrastructure (including for regulating the procedure of rendering services in the sphere of urban development and land relations in the territories of those zones). The second area of the government's activity was the formation of appropriate organizational structures capable of ensuring the interaction between the federal executive bodies and regional authorities, as well as bodies of local self-government. In particular, the supervision councils of special economic zones were created. At the same time, the initiatives coming "from below" were not numerous, which can be seen by the low number of organizations willing to become the zones' residents. In the Tomsk TIZ, only one resident was registered, while the other three TIZ had two residents each<sup>72</sup>. Such results can be explained by the fact that so far the attitude of the business community to technology implementation zones has been quite guarded. As shown by a survey conducted by the Association of Managers, the majority of businesses (67%) chose the position of expectant observers, 11% of the respondents displayed a negative attitude to the very idea of a TIZ, and a similar number are prepared to participate in the zones' development<sup>73</sup>.

<sup>71</sup> Ordinance of the Government No. 328-r of 10 March 2006.

<sup>72</sup> Sources: The composition of residents of the TVZ: Dubna <http://www.rosez.ru/sezdubna/rezident.html>; Zelenograd <http://www.mostvz.ru/node/10>; St. Petersburg <http://www.rosez.ru/zonespb/rezidents.html>; Tomsk <http://www.rosez.ru/zonetomsk/rezidents.html>.

<sup>73</sup> The survey took place in October and November 2005 among 150 companies working in various segments of the market. Source: National Report "Informatsionnoe razvitie – osnova uskorenogo rosta ekonomiki Rossiiskoi Federatsii" ("Information development is the basis for an accelerated

The adequacy of the measures that are designed to promote innovative development can be assessed by analyzing the parameters of innovation receptiveness and innovation activity of Russian businesses.

### The Innovation Activity of Businesses

The formal induces applied for measuring the innovation activity of businesses have remained in Russia at a low level. By the index of expenditures on intra-firm research and development, which demonstrates the economy's ability to absorb acquired knowledge by turning it into new commodities, services and technologies, Russia falls behind not only developed industrial countries, but some developing countries as well. According to the World Bank, companies' expenditures on research and development, measured as percentage of sales, amounted in Russia to 0.3%, while in the countries with growing economies – China, Brazil and India – this index was in the interval of 0.46–2.5%.

Various studies of the level of innovation activity at Russian enterprises have shown that it is sufficiently high; however, many innovations represent, in fact, small improvements designed to help a company to survive, and not to promote its development. The majority of companies spend their resources on the improvements of existing product (43%) or improvement of an existing process (32%)<sup>74</sup>. The number of strategic innovators among the innovation-oriented Russian companies is approximately 9%, while in the EU countries – approximately 22%<sup>75</sup>. Therefore, not the fact itself of certain measures being implemented by a company, that may be placed within the category of innovation activity, is important, but the level of expenditures on such measures and, primarily, expenditures on research and development. And here, the overall picture is far less optimistic: companies' expenditures on research and development in this country do not exceed 8% of total expenditures on technological innovations, whereas in European countries it amounts approximately to 20%. Companies' expenditures on purchases of patents and licenses are even lower – less than 2%<sup>76</sup>.

Several reasons for the low innovation activity in the national economy can be pointed out. *Firstly*, it is the monopolist status of many Russian companies. Recent studies have shown that monopolists – that is, those who take up more than 50% of

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growth of the Russian Federation's economy"). M.: Assotsiatsiia menedzherov (Association of Managers), 2006, p. 37.

<sup>74</sup> National Report "Informatsionnoe razvitie – osnova uskorenogo rosta ekonomiki Rossiiskoi Federatsii" ("Information development is the basis for an accelerated growth of the Russian Federation's economy"). M.: Assotsiatsiia menedzherov (Association of Managers), 2006, p. 30.

<sup>75</sup> Arundel A., Hollanders H. (2005). EXIS: An exploratory Approach to Innovation Scoreboards. <http://trendchart.cordis.lu/scoreboards/scoreboard2004/pdf/EXIS.pdf>.

<sup>76</sup> Kuznetsov B., Kusyk M., Simachev Yu., Chulok A., Tsukhlo S. Osobennosti sprosa na tehnologicheskie innovatsii i otsenka potentsial'noi reaktzii rossiiskikh promyshlennykh predpriatii na vozmozhnye mekhanizmy stimulirovaniia innovatsionnoi aktivnosti (The peculiar features of the demand for technological innovations and an estimation of the potential response of Russian industrial enterprises to the potential mechanisms for stimulation of innovation activity) // VII International Scientific Conference "Modernization of the economy and the State". M.: HSE, 5 April 2006.

the national market for their main product – comprise approximately 20% of all Russian companies. It should be borne in mind that this domination takes place on very narrow and specific markets – probably even “niche” markets<sup>77</sup>. There also exists a negative relation between innovation activity and a company’s monopolist status. In a monopolistic sector, in absence of any external competition, the demand for innovations must inevitably be low. Thus, innovation passivity is associated with the weakness of external and internal stimuli, namely an insufficient competition level. Studies have shown that the level of innovation activity is much higher at those enterprises which have to compete with imports, as well as at those that work on foreign markets (export their product). Therefore, demonopolization must become a major goal, if technological backwardness is to be overcome.

*Secondly*, it is the structural problems faced by the Russian economy and the domination of raw-materials sectors. Sectors where product is constantly changing (being upgraded or improved) display the highest demand for innovations. Raw-materials sectors are less inclined towards innovation processes, despite the fact that the leading producers of oil, gas and raw materials do promote the development of both their own research and development and of their outsourcing. Nevertheless, the high oil prices remain a serious destimulating factor.

*Thirdly*, a certain problem is associated with the fact that indirect regulation has so far not been directed at the promotion of innovations. Presently, the tax system is neutral in respect of the goal of innovative development. The problem is represented not only by the absence of several norms, but by the need for a serious improvement of tax administration.

Thus, venture financing, technoparks and zones are important, but they are not the key mechanisms for supporting innovative enterprising. For big companies, indirect regulation measures are more effective, while in the interaction of the government sector of science an important aspect is the clarity and lack of controversy in the norms regulating the rights to intellectual property.

#### Regulation of the Rights to Intellectual Property Created at the Expense of Budget Funding

In late 2006, Part IV, Section VII of the RF Civil Code, entitled “Rights to results of intellectual activity and means of individualization”, was adopted. It was to replace the six basic laws on intellectual property (IP).

Part IV of the Civil Code, nevertheless, has failed to ultimately clarify the situation existing in the sphere of regulation of the rights to intellectual property created at the expense of budget funding (Chapter 77 of the Civil Code “Right to use results of intellectual activity as part of single technology”). The greater part of the Code builds upon the European concept, from which it follows that the rights to IP initially belong to the author, and only in some instances they may be transferred to the

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<sup>77</sup> B. Kuznetsov. Vliianie konkurentsii i struktury rynkov na razvitiie i povedenie promyshlennykh predpriatii; empiricheskii analiz (The influence of competition and market structures on the development and behavior of industrial enterprises: an empirical analysis) // International Scientific Conference “Modernization of the economy and the State”. M.: HSE, 5 April 2006.

employer, which should be specially agreed upon. At the same time, in Chapter 77 it is implied that the fact of financing represents the grounds for rights to arise. And thus it is the State who becomes that economic subject which in each specific case resolves the issue of transferring the rights to IP.

In Item 1 of Article 1546 of Chapter 77, "Rights of the Russian Federation and subjects of the Russian Federation to technology", the conditions are determined under which the right to a technology should belong to the Russian Federation. If a single technology has been created to satisfy the needs of state defense or security, and also in an event when the RF, prior to the creation of a single technology or afterwards, has undertaken the financing of the works involved in bringing the single technology to the stage of practical application, then the right to the technology should belong to the RF. And finally, if the performer of works has failed, during the period before the expiry of six months after the completion of the work of creating the single technology, to execute all the actions necessary for the exclusive rights to the results of intellectual activity, which are part of a technology, to be recognized as belonging to him, or for such rights to be acquired, then the RF should become its owner. Firstly, it should be noted that the use of the terms "defense capability" and "national security" is not quite lawful, because the Civil Code regulates only the civil normative - legal relations. Secondly, the transfer of the rights to IT to the State in the event when it has undertaken to finance the works may, in effect, be interpreted broadly – that is, that the rights should be transferred to the State no matter what the actual volumes of funding from the state budget have been.

Thus, presently it is not easy to estimate as positive the general consequences of the introduction of Part IV of the Civil Code in respect to the rights to intellectual property created at the expense of budget funding. Meanwhile, the protection of property rights, including intellectual property, represents an indicator that can significantly lower a country's rating in terms of its competitive capacity. In 2006, according to the World Economic Forum, Russia moved from the 53th place that it had occupied in 2005 to the 62<sup>nd</sup>, while being the 114<sup>th</sup> in terms of the level of property rights protection.

### Indirect Regulation of Innovation Activity

The discussion of measures aimed at creating indirect incentives was going on quite actively throughout last year. The President's Administration, in cooperation with representatives of the RF State Duma, developed a package of draft laws, which incorporated 14 new laws and amendments to prevailing legislation. Resulting from it having been coordinated with representatives of various departments, this proposed package was cut rather extensively. The draft federal law "On making amendments to Part II of the RF Civil Code in the part of creating favorable tax conditions for financing innovation activity" was approved at the government's meeting in late January 2007. In this document, it is envisaged that five amendments should be introduced into the Civil Code:

- On exempting from VAT the incomes on patents and licenses to innovation technologies (Article 149);

- On excluding, from among the objects of taxation to be levied by the profits tax, the funds received on a reimbursable basis by research organizations and funds for the support of science and education (Article 251);
- On including into the costs on which the profits tax is to be levied, a part of funds spent on research and development not only by research organizations, but also by innovation-oriented organizations (Article 259);
- On expanding the list of expenses by the amount of which the taxpayer applying the simplified taxation system should diminish the amount of received incomes (Article 346.16);
- On raising the amount of standard expenditures in the form of deductions to the Russian Fund for Technological Development (RFTD), as well as to other departmental and interdepartmental funds for financing research, from 0.5% to 1.5% (Article 262).

As can be seen from this list, the regulation measures are aimed mainly at supporting small-sized enterprises and research organizations, and have no bearing on the incentives existing for big businesses. The increased amount of deductions to the RFTD is important, however this measure is not a critical one either, because enterprises can, but are not obliged to make any transfers to departmental and interdepartmental funds. Thus, the suggested package of measures, although it does represent a positive shift in the sphere of incentives for innovations, is, nevertheless, not radical. The poll conducted among 570 industrial enterprises by the IET in October-November 2005<sup>78</sup> showed that the majority of those enterprises believed that the most effective incentive for innovations was the incremental tax exemption. The incremental tax exemption is the diminishment of the taxable base for the profits tax by a certain percentage of the annual increment of an enterprise's expenditures on research and development. This type of exemption is widely applied abroad, and it is most efficiently applied as an incentive for companies orientated toward dynamic growth of innovations and expenditures on research and development.

The development of indirect regulation measures has revealed the existence of several terminological and methodological gaps. This is one of the reasons why the consideration of the other tax initiatives has been postponed. Another problem is represented by the definition, for purposes of taxation, of the notions of research and development and innovation activity. It is quite understandable that without a well-developed terminology and clear basic definitions it would be difficult to apply the suggested exemptions and privileges, because the subject of regulation has not been determined precisely.

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<sup>78</sup> Kuznetsov B., Kusyk M., Simachev Yu., Chulok A., Tsukhlo S. Osobennosti sprosa na tehnologicheskie innovatsii i otsenka potentsial'noi reaktsii rossiiskikh promyshlennykh predpriatii na vozmozhnye mehkanizmy stimulirovaniia innovatssionnoi aktivnosti ( The peculiar features of the demand for technological innovations and an estimation of the potential response of Russian industrial enterprises to the potential mechanisms for stimulation of innovation activity) // VII International Scientific Conference "Modernization of the economy and the State". M.: HSE, 5 April 2006.

The main discussion was generally centered around the definition of research and development by means of a variety of possible types of activity (for example, the drawing-up of an exhaustive list), but such an approach is labor-consuming and not the most efficient one. Foreign experience has shown that it is more convenient to define research and development through types of expenditures, which can also be better understood. Then tax exemptions and privileges would be applied to a certain list of expenditures (salaries, costs of materials necessary for carrying out research and development, purchases of software, etc.).

There exists no official definition of an innovation-oriented enterprise or of innovation activity, either – and not for purposes of taxation only: the term “innovation activity” itself is absent from federal legislation. It has been suggested that the definition of innovation activity should be based on the notion of objects of non-military turnover, which can be found in the RF Civil Code (objects of intellectual property, projects, technological products, new equipment, financial assets, etc.). Although the positive aspect of such an approach is the presence of those basic components by means of which innovation activity is defined, nevertheless, in the RF Civil Code it appears to be too complicated and to allow for a broad interpretation of innovation activity. At the same time, the Ministry of Public Education and Science once more decided to revive its activity aimed at elaborating the Law on innovation activity. The draft which exists today represents a certain collection of general definitions, which it would be difficult to apply for purposes of defining the object of taxation. If one borrows foreign experience and defines an innovation-oriented enterprise by the criterion of the level of expenditures on research and development, then it may become quite operational in terms of indirect regulation.

On the whole, the increased attention to indirect incentives represents a positive trend, and besides, the measures designed to encourage particularly the private sector to provide financing for research and development are also of paramount importance.

## Section 5. Institutional Problems

### 5.1. Institutional development in 2000s

Among the formal terms and expressions that would characterize most precisely the year 2006, the following may be selected: “predictability”, “stability” and “prevailing trends of the past years”. The institutional trends of the several previous years, however, are pretty ambiguous. Moreover, by early 2007 some vague inconsistencies or, to be more precise, substitution of notions of institutional development that may play a principal role on a long-term basis came to the foreground.

#### 5.1.1. *Politics versus economy: asymmetry of mutual influence*

All quantitative indicators of the development of the Russian economy in 2006 demonstrate an economic revival (for more detail see above)<sup>1</sup>. By late 2006 capitalization of the Russian companies was \$908 billion; thus Russia may be considered one of the major developing markets, with China only being ahead for this indicator in 2006.

The dynamically growing Russian economy (by formal quantitative indicators) demonstrates higher economic (credit) ratings of the country. In 2006 according to the largest rating companies (Fitch и Standard&Poors), Russia had a “BBB+” credit rating denominated in foreign currency which meant that the country acquired a new “investment quality” at the international financial markets and reduced costs for Russian borrowers. Next expected step for Russia will be moving to A-level ratings. OECD Council at its meeting of January 26, 2007, included Russia in the 3<sup>rd</sup> (from the top zero down to seven) group of credit risks where such countries as South Africa, Israel, India, Thailand, Morocco, Latvia, Hungary, Bulgaria, Rumania and other states are present.

The economic growth coupled with higher financial indicators of the companies (the growth of consolidated returns and, according to the survey results of the Center of Economic Market Situation under RF Government, in December 2006, satisfaction of the companies with their financial position across the industry) was accompanied by an unprecedented increase of private capital net inflow. According to the RF Central Bank, in 2006 the net inflow of private foreign capital into Russia increased by almost 40 times vs 2005 (\$41.6 billion including \$25.1 into the banking sector vs \$1.1 billion in 2005 and outflow of \$8.4 billion in 2004). Repatri-

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<sup>1</sup> Herein and in sections 5.2 through 5.5. the sources used are official web-sites, pres-releases and interviews with the Leaders of the RF Ministry of Economic Development and Trade, Federal Agency for Federal Property Management, Federal Antimonopoly Service, Federal Service on RF Financial Markets and other federal government authorities; information materials of “Prime-TASS”, “Interfax”, “RBK”, “lin.ru” Project, and regular publications such as “Commersant”, “Vedomosti”, “Izvestia”, “Vremya Novostey”, “Finance”, “Expert”, “M&A”; ratings of specialized agencies and organizations, corporate sites and other sources of 2006 – 2007. In writing this section of the report the author also used the relevant materials by A. Abramov, E. Apevalova, G. Malghinov, and K. Yanovsky and materials from numerous published research papers of Institute of Economy in Transition (IET) and Academy of National Economy under RF Government on the problems of institutional development (see: [www.iet.ru](http://www.iet.ru)).

ated Russian capital (see Section 5.4 describing the growth of investments from the traditional off-shores) apparently accounts for a considerable share in this inflow, however, no clear distinction can be made between residents and non-residents. Nevertheless the assessments of direct foreign investments into Russia in 2006 are pretty close ranging from \$28.4 bio (UNCTAD) to \$31 bio (Bank of Russia).

The year of 2006 also saw an essential growth of external financing of largest banks and companies (IPO and corporate bonded loans at the internal and external markets). In 2006 the external debt of non-financial companies and commercial banks amounted to \$135.4 billion and \$78.5 billion, accordingly. The external debt of the Russian corporate sector jumped up to \$57 billion against \$54.5 billion in 2005. In 2006 the aggregate value of 18 major IPO (including Rosneft) was about \$21 billion. Corporate bonds became a driver of debt market emission: their volume grew from RUR260.6 billion in 2005 to RUR465.3 billion in 2006 (or by 1.8 times). The overall amount of RUR-denominated bonds at the market including federal securities, corporate and regional bonds increased from RUR 1.5 trillion in 2005 to RUR 2.2 trillion in 2006 or by 1.4 times.

According to the analysts of some investment banks, in 2007 IPO total volume of the Russian companies may reach \$20–\$22 billion, and with account of Sberbank and Vneshtorgbank - \$30 - \$40 billion. Around 60 Russian companies plan IPO in 2007, however, (due to the market situation) only some 30 companies will be able to do this realistically. There is a more pessimistic outlook: according to Citigroup Global Markets, in 2007 the Russian companies will not be able to exceed the 2006 indicators (2007 forecast: 32 IPO and \$18.4 billion), after the 2008 presidential elections the situation will be close to that of 2005 (in 2005 - \$5.2 billion, and 2008 forecast is 18 IPO and \$4.7 billion). The current sharp growth of IPO is associated directly with the determination to be secured against *risks of a new phase of the political and business cycle* after March 2008.

The boom of initial public offering in 2006-2007 in the context of political risks finds its confirmation when the specific motivations of the Russian companies are being analyzed<sup>2</sup>. It is the consumer sector (about 80% of the IPO participants recently) that gets investments for its business development; this sector unlike the feedstock companies does not generate major cash nor has a simplified access to bank credits. The sector began to show its interest in IPO back in 2003 when the companies in the absence of a proper loan base and considerable debt burden had to look at stock placement. The major part of the consumer companies who were actually ready for IPO *were using this practice*. Another motivation for the companies with no bright prospects for development or those in need of finances to support deals on acquisition of new assets, compensation of “exit” of the partners/shareholders from businesses, etc. was the fixed value of the company and drawing up cash funds for the shareholders’ needs. A huge number of major feedstock companies-issuers that have no need in getting investment resources via IPO strive to increase and fix their capitalization as an “insurance” against their exits if

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<sup>2</sup>Y. Korotetsky, L. Moskalenko, M. Talskaya. IPO is out of fashion // *Expert*, 2006, № 39, p. 19–27.

the largest shareholders will have to dispose their ownership due to adverse political reasons. Some of the companies have secured themselves already by fixing their values having sold part of the stocks and legalized the remaining assets. Apparently a bonded loan is a cheaper source of external financial resources, though it does not insure the company against political risks.

The global expansion of a large number of Russian major private companies (groups of companies) in 2005-2006 was associated not only with the rationale of corporate development, the desire to strengthen their positions on new markets and search of facilities for investment but also with their preparation for the upcoming political and business cycle in Russia.

These considerations apply to some larger state companies though the latter's motivations may be different (see section 5.2). At the end of January 2007 the Head of the Federal Agency for Federal Property Management, announced a possibility of another public offering of Rosneft stock up to 25% (worth around \$20 billion), however this announcement was almost immediately disowned by G. Gref, Head of the Ministry of Economic Development and Trade. These contradictory approaches, as some believe, are the evidence of more serious attempts to transfer the largest possible portion of the Rosneft state owned stock to private ownership by March 2008 with the subsequent legalization for the sake of a narrow group of the stakeholders.

The election cycle, according to some forecasts, will obviously push down the amount of direct foreign investments (where it is difficult to separate foreign and Russian repatriated funds) in 2007. The forecasts are unanimous concerning the expected decline however the driving factors are different. Standard&Poors believes the expected decline is linked to the ongoing processes of boom decline at the feedstock markets that stimulated investments into the feedstock assets of the developing countries and nationalization of energy assets in Russia, Bolivia, Venezuela and Ecuador. The Russian Union of Industrialists and Entrepreneurs explains the decline by future political risks related to parliamentary and presidential elections in Russia. There is also a problem of preparedness of the Russian companies<sup>3</sup>.

Political risks that are not directly related to the election cycle are pretty essential for most conservative foreign institutional investors unlike the Russian owners.

One can give a reliable example of a rating developed for a number of years by one of the largest and most conservative global investors – U.S. Pension Fund - California Public Employees' Retirement System (CalPERS) which assets amount to \$225 billion (see section 5.4.). Whenever CalPERS enters a developing market,

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<sup>3</sup> In 2006 Tatneft initiated delisting at NYSE. Tatneft example is indicative for the Russia's corporate sector. According to AIM (Alternative Investment Market) data of London Stock Exchange, in 2006 shares of 7 companies of Russia and some other post-Soviet states were listed here while in 2005 there were 15 such companies. This is an outcome of the absence of adequate financial control required for listing (consolidated reporting, financial statements, etc). Though 2007 trends are assessed as positive, the value results of 2006 will hardly be exceeded.

it gives to the market a certain “quality mark” attractive for other major institutional investors.

In 2006 out of four BRIC countries (Brazil, Russia, India and China), Russia and China received less than 2.0 scores (CaIPERS method) meaning that these markets are shut down for investments. The 2007 forecast (1.9 scores) shows that Russia will remain at the previous year level while China’s score increased from 1.6 to 1.7. The main problems of the Russian market in 2006 were: low political stability, imperfect labor laws and insufficient openness of the market. In assessing civil liberty where 1 means the highest level and 7 – no liberty at all, Russia was given 5 scores. In terms of independence of courts and legal protection Russia received 1 score out of 3 scores possible which is much worse than in China. Russia was assessed at lowest scores in terms of courts independence, legal protection of property rights, inefficient fight against organized crime and biased courts’ pronouncements issued in favor of the government authorities.

CaIPERS method could be equally indicative if we tried to assess the input of the key factors impeding further improvement of the investment climate in the country. With account of impact of certain factors in building up ratings, *the negative impact of specific country (government) factors is increasing vs “market factors” quality.*

Similar negative assessments of the civil society and political system in Russia may be found almost in all traditional ratings for 2006 regarding these problems (Freedom House ratings of civil liberty and mass media freedoms; World Economic Forum of global competitiveness; Oxford Analytica of creditors’ rights compliance; the Heritage Foundation and Dow Jones Co; Indem Foundation; World Economic Forum, World Bank, Transparency International and others - of economic indicators). *A number of ratings became much worse vs 2004-2005 (Table 1).*

Table 1

**Changes in the ratings of political stability, economic and civil liberties in Russia in 2005 – 2006**

Rating	2005	2006	Lower rank/scores or close to Russia (BRIC countries)
Civil liberties (by Freedom House)	5 – no liberty	5 – no liberty	China (6)
GCI, World Economic Forum (Global Competitiveness)	53 rank	62 rank	Brazil (66)
GCI, World Economic Forum (protection of property rights)	108 rank (in 2004 – 88)	114 rank	
Economic freedom rating, the Heritage Foundation and Dow Jones & Company, Inc.	4 <sup>th</sup> group – no freedom at large	4 <sup>th</sup> group – no freedom at large (54.01 scores out of 100, 120 rank)	China – 54.02 scores 119 rank India – 55.60 scores, 104 rank
Political stability (by CaIPERS, weight in country rating, %)	27.6 (in 2003 – 20.5)	29.2 (30.6 – for 2007)	
CaIPERS rating (investment threshold is 2 at maximum 3)	Total 1.8 (in 2002 – 1.15)	Total 1.9 Country – 1.6	China – 1.6 scores

Source: Rating Developers formal websites.

According to 2006 economic freedom rating made by the Heritage Foundation and Dow Jones & Company, Inc., out of 157 states Russia ranked 120, getting

54.01 scores (maximum was 100) which was lower than the 2005 rank. Out of other BRIC countries China was placed 119 (54.02 scores), Brazil and India – 70<sup>th</sup> (60.89 scores) and 104<sup>th</sup> (55.60). Russia scored least in the following areas: no corruption (24.0%), free investments (30.0%), property rights protection (30.0%), freedom of finance (40.0%). Low score in “freedom of finance”, according to the rating agency, was given because of inefficient banking system, deficiencies in banking supervision and transparency, and restrictions of access to banking and insurance business for nonresidents. The low rating in the property rights protection means that Russia does not ensure such protection properly: “the judicial system is corrupted and biased, and ensuring the implementation of contacts is a real challenge”.

As for *short-term trends*, the situation is rather trivial. The developed *asymmetry of economic and political factors of the Russian economic development* has been obscured so far by general indicators of economic rise, instable feedstock market situation and government finance parameters (budget surplus, Stabilization fund, and gold and currency reserves), and also by indicators of extreme profitability of the Russian stock market.

The *investors* may describe this situation as “Clod Frolo dilemma” (section 5.4): a high profitability temptation up to a certain limit is stronger than the economic freedom, investors’ rights and government interference concerns.

From the *government* point of view, economic wealth measured with formal current indicators and ratings proves the correctness of the selected political route (broadly, including the issues of protection of property rights, the judicial system, etc.).

It is worth noting that the *Russian companies* that as said above are most sensitive to potential political and business cycle risks are those that have least illusions.

The *population* is extremely perceptive of the abilities of the government authorities to take effective actions in the area of economic policy (*Tables 2-3*).

*Table 2*

**Why there is no sizable economic growth in Russia now?  
2003-2006 population survey results , in %**

	2003	2004	2005	2006
1. Red tape, corruption and bribery with the highest bodies of state authority	34	34	31	34
2. Plunderous policy of the major Russian businesses/oligarchs and their disinterest in the national economic revival	38	34	29	33
3. Incorrect economic policy of the government	27	22	34	32
4. The government does not have an economic program	22	22	29	27
5. Capital outflow from Russia/flight to off-shores	25	27	26	26
6. Theft of managers (profits withdrawal and appropriation)	28	20	21	24
7. Fixed assets worn-out	13	11	11	17
8. High taxes on entrepreneurial activity	15	10	13	13
9. Russian goods are not competitive with Western goods	9	10	10	12
10. No investments into the Russian economy	11	11	12	12
11. Business is not legally protected	9	7	7	9
Other	7	7	6	5
Difficulties in responding	12	12	9	11

*Source:* “Levada-Center”, [www.levada.ru](http://www.levada.ru).

As *Table 2* shows, for the entire period of 2003–2006 the weight of such factor as “bureaucracy, corruption and bribery in the high echelons of power” remained unchanged (and the largest among all other 12 factors). At the third and the fourth places are the factors “incorrect economic policy” and “the absence of the economic program” which were strengthening their significance in 2003 through 2006. The second factor – “the plunderous policy of the major Russian businesses/oligarchs and their disinterest in the national economic revival” – was losing its value in the same period. “The absence of legal protection for the business” is not significant for the community; this may be explained by confusion of notions (the respondents seem to mix up legal protection and corruption). *Table 3* apparently demonstrates that during 2000 – 2006 not less than 2/3 of the population kept thinking that the Russian government was not able to develop a substantiated economic program for Russia<sup>4</sup>. In any case the data in *Table 3* add up to the conclusion that the “government” and the “market” in Russia has been moving into opposite directions during 2000’s.

*Table 3*

**Has the Government of Russia got a well defined economic program?  
The 2000–2006 survey findings, in %**

	2000 May	2001 April	2002 August	2003 August	2004 August	2005 August	2006 April
The Government has got a well defined and thoughtful economic program	22	21	16	18	21	19	24
There is no well defined program but only very high-level outline of what shall be done	38	37	39	38	35	40	33
There is no such program, and decisions are taken given current circumstances	22	30	33	34	34	31	33
Difficult to answer	19	13	12	10	11	11	10

Source: “Levada-Center” [www.levada.ru](http://www.levada.ru).

The problem of asymmetry of economic and political factors of the development of the Russian economy becomes highly critical if viewed from a *long-term perspective*, moreover if to assume that the sources of the current economic growth, budget revenues and funds to support social programs are closely related to the market situation.

*5.1.2. Political versus economic institutions: public polls and their problems*

In the 1990’s which one could call a period of initial establishment of a new institutional structure of economy in Russia the following components (criteria) were typically used: privatization, legislation (the scope and quality of the new legislation and the law institutions) banking sector status (independence of banks,

<sup>4</sup> We’d like to cite a statement made during the period of launching the 2004 administrative reform: “...while the government authorities having decided to increase their impact on the economy, demonstrate certain incompetence. There is a simple explanation to this. The government has not been dealing with economy at least for twelve years. It was involved in solving budget-related issues. There are no people in the current government who might know the real problems of the economy and how to deal with those problems... Therefore any attempt of the government to remove private capital from the solution of strategic issues in the sectors where this capital operates would lead to stagnation” (T. Gurova, “Give me the wheel, Party” // *Expert*, 2004, No 15, p. 34).

isolation and the law institutions) banking sector status (independence of banks, their business skills and practical distribution of credit resources, and also the level of supervision and the payment system), and the role of the government (whether it is market-oriented or not and how efficiently it manages the state owned sector). All subsequent additions were highly specialized, we believe. This standard was expanded in the 2000's by including various assessments of "the corporate governance quality", of "economic and legal factors of the financial markets development" and "the boundaries of the institutional capacity". Apparently significant was also a growing interest to the problems of effective courts and enforcement in general<sup>5</sup>. The most acute current issue is a systematic problem of adequate quality of the political institutions.

Since various groups and individuals typically derive benefits by "exploiting" economic institutions, a conflict tends to arise between various options of the public choice which is eventually resolved in favor of the groups having more political power. The distribution of the political power in the society is defined by political institutions and depends on the distribution of resources. *Economic institutions that promote economic growth emerge where political institutions, firstly, give the power to those groups that are interested in having a highly diversified ownership rights enforcement system, and, secondly, where political institutions set up effective restrictions for the actions of the power authorities and, thirdly, where the power authorities have no possibility to generate considerable rent for themselves.*<sup>6</sup>

The said restrictions are true for assessing institutional changes in Russia during 1990–2000. In terms of application, the most important issue is how realistic is the *today's* discussion of the development of the above positive effects. Indeed we are not able to discuss the whole range of the functioning problems of the Russian political system in this paper. The above requirements to the quality of political institutions speak for themselves and apparently are the subject matter of the remote future for Russia.

Let us discuss only one issue as a possible argument – are there in the current Russian society any groups that could ensure the existence of a diversified system of ownership rights enforcement, given the above assumptions. Whatever approaches may be used, it makes sense to discuss primarily the problem of "the middle class".

There are various methodologies to identify "the middle class" ("normative" of "relative", "market-based" or property-education based", etc.). Using then one can receive a wide range of estimates. Even in the ex-USSR the quantitative estimates in the period of 80-90's of the last century varied from 11% to 30% of the population. The estimates spread for Russia of the 1990's is also large – from 6% to 25%

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<sup>5</sup> See, e.g.: The establishment of the institutional framework of the market-based economy, World Development Report, 2002. World Bank, 2002; From plan to market. World Development Report 1996. The World Bank. Oxford University Press, 1996; EBRD Transition Reports 1995–2006.

<sup>6</sup> See.: Acemoglu D., Johnson S., Robinson J. Institutions as the Fundamental Cause of Long-Run Growth. – In: Aghion Ph., Durlauf St., eds., Handbook of Economic Growth, North Holland, 2004.

(prior to 1998 crisis). As for the period 2002 – 2004, the majority of estimates tend to coincide: 14% to 25% of the working population.<sup>7</sup>

According to Institute of Sociology of the Russian Academy of Sciences<sup>8</sup>, in 2003–2006 given the inflow of “oil dollars” into Russia, the size of the middle class keeps reducing – from 25% down to 20% (economically active urban population)<sup>9</sup>. The marginal growth of the middle class up to 1/3 of the population size may take 10 – 15 years (provided the structure of the economy remains unchanged). The authors of the report believe that the chances of the middle class to grow at the expense of “the old middle class” are close to zero since the latter is decreasing which is a paradox. In other words it becomes clear that in the developing economic model (of state monopoly type) there is a trend to reduce this middle sub-class. As a way out of this situation it is proposed to focus on the enhanced development of high technologies sectors rather than small and mid-size businesses. This trend likewise a growing social and economic indifference of the middle class has been noted by T. Maleva, Head of Institute of Independent Social Studies<sup>10</sup>.

The specific mechanisms leading to this reduction are of secondary interest for us. What is essential for us is that in 2000 *no positive dynamics of the potential social base was observed (supported by empiric evidences) for indirect (via political representation) formation of effective economic institutions.*

Moreover, those institutions that in 1990-es opposed the expansion of demand for effective economic institutions are functioning today though in modified form. If prior to the early 2000'es (we recognize that the terms are conventional) the model of oligarchy capitalism was pursued, now we are typically speaking of the “state capitalism” in its Russian variation ( see below for details).

In this context the model of negative interaction (vs efficient market relations) establishes itself where some entrepreneurs (not a very representative segment) hold political power de facto or have a monopoly access to the center of political decision making. Afterwards these entrepreneurs using the judicial system as a tool against their competitors stop being motivated to establish and strengthen private property relationships<sup>11</sup>.

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<sup>7</sup> See e.g.: E. M. Avraamova and others. Edited by T. Maleva. *Middle classes in Russia: economic and social strategies*. Moscow Carnegie Center. Moscow, 2003. (“the share” of the middle class is recorded at 20%). The data of All-Russia Center of Life Level and “KOMKON” (2004) go beyond the domineering estimates – 9%, and Rating Agency “Expert” which estimates of the middle class segment vary from 14% in 2000 up to 25%-30% in 2005.

<sup>8</sup> “Urban middle class in modern Russia”. Analytical report. M., Four criteria were used to identify middle class representatives: education, profession, income and integrated self-assessment of the social status. It should be noted however, that the income threshold for the middle class is only RUR10.5 thousand/month/household member. The report makes a distinction between “the old middle class” (small businesses) and “new middle class” (primarily top managers in the fuel and energy complex and other sectors of economy).

<sup>9</sup> A reverse trend prevails in the world: annual surplus of the middle class makes about 1%, according to some estimates.

<sup>10</sup> Stagnation of the middle class. 24.01.2007, <http://abarus.ru/news>

<sup>11</sup> Unequal distribution of wealth and relative inefficiency of production creates situations where most wealthy owners are not interested in solid protection of property rights: see Polishchuk L., Sav-536

According to the new institutional economic theory, the bureaucracy, its low productivity and absence of accountability which have been frequently criticized may be analyzed, on analogy with separation of property from control in a company, as a two-tier system of the principal and the agent where the government officials play the role of agents (controllers and employees) and the electorate that of the principal. However, unlike the corporate owner, the electorate may not have a clear common goal, and this restricts their abilities to organize an effective monitoring of the politicians and government officials<sup>12</sup>. This brings us back to the issue of the formation in modern Russia of an adequate social base that would be objectively interested in public control and monitoring and would have sufficient economic resources and the level of political power.

### 5.1.3. *Protection of property rights versus finance*

Primarily we should clarify why the idea of the protection of the property rights has been persistently placed at the core of any problem related to institutional development<sup>13</sup>. Recently in analyzing private property historical and geographical factors have been more often selected as a focus. By the beginning of the 21<sup>st</sup> century new-classic and new institutional researchers elected to determine the key features of the markets under their review at least partially by the established property relations and the system of enforcement of the property rights and the contractual obligations. The expansion of the new-classic models manifests in particular in the coverage of the ‘in-depth’ level (according to O. Williams) where the basic institutional structures like ownership and law enforcement are installed.

“The new comparative economics” that have recently claimed to be an independent trend of the new institutionalism made a thorough research of the genesis of the law systems and how they affect the property relations and their enforcement<sup>14</sup>. The following conclusions are proposed based on the findings of the econometric analysis in various countries:

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vateev A. Spontaneous (non)emergence of Property Rights. – *The Economy of Transition*, 2004, Vol. 12, №1. S. Guriev and K. Sonin write: “While the rich have the advantage in setting up a private guards company and establishing good relations with the government officials, they are not encouraged to lobby the establishment of good government institutions, and therefore there is no demand for such institutions that would protect the property rights and moreover support competition. The problem is that the middle class (in this particular event associated with the small business) can not create the political demand for the good institutions due to the insignificant share it holds in the national economy and because of high costs on coordination”. (S. Guriev, K. Sonin. *The wealth and the growth // Expert*, 2003, № 24, p. 46–47. See also: K. Sonin. *Institutional theory of unlimited redistribution. // Issues of Economy*, 2005, № 7, p. 4–18.

<sup>12</sup> E. G. Furuboten, R. Richter, *Institutions and the economic theory*. – St-Petersburg, 2005, p. 547.

<sup>13</sup> See also: works by V. Mau and K. Yanovsky in “*Institute of Economy in Transition: research papers*” dedicated to the regional and international comparison of the primary (basic) set of the political rights that absolutely prevail over any other political and economic freedoms such as life safety, security of property and independence of the judicial system and mass media.

<sup>14</sup> For details see, e.g.: R. Enton, A. Radygin and others. *Corporate governance and self-regulation in the system of institutional changes – M, IET*, 2006, section 1.

- the higher is the level of development of the private property institutions (the level of guarantees that would not be expropriated by the government and the ruling class), the larger is their positive impact on the long-term economic growth, investments and the efficiency of the financial markets<sup>15</sup>;
- the improved implementation of the principles of the private property is an absolute requirement for more intensive development of the financial markets;
- protection of the property rights ensures preconditions for more intensive expansion of investments and higher rates of the economic growth<sup>16</sup>;
- in those countries where the courts enjoy more independence, the property rights are better protected and an improved environment is created for intensive economic growth<sup>17</sup>;
- the successful transplantation of the legislative norms and law institutions is connected not only with the choice of a legislation system but rather with the law enforcing practices in the given country (as in Russia);
- the more corrupted are the government officials the smaller is the chance to strengthen market-related institutions and competition mechanisms (given that the administrative discipline remains at the same level).

The protection of the property rights (sometimes this notion is used as a synonym of the law enforcement) and the financial system are considered base economic institutions. Each of these is a subject for a separate study in terms of their relevancy and conformity of their current status in Russia to the economic rationale<sup>18</sup>. What is meaningful in the context of our analysis is that the mutual influence of those institutions in their current status seems to be *negative*.

A weak system for protecting property rights (due to the absence of a clear government strategy regarding state sector and privatization transactions, inertia meaning that the law is considerably behind economic activity; high degree of uncertainties and contradictions in the business law; low quality of judicial and law enforcing practices; the expansion of rights of the departments and ministries to interpret the law; poor government supervision; opposition to the establishment of self-regulating institutions; ongoing banks and corporate risks associated with protection of deposits and securities; absence of regulation in the area of new financial tools; current and long-term problems with land and real estate markets, etc.) , curbs back the development of the financial system as a key long-term tool of transformation of financial resources into capital.

In their turn, a high level of concentration, fragmentary and close nature of the Russian financial system in general, the absence of coordination and strategy of its

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<sup>15</sup> See.: Acemoglu D., Johnson S., Robinson J. Institutions as the Fundamental Cause of Long-Run Growth. – In: Aghion Ph., Durlauf St., eds., Handbook of Economic Growth, North Holland, 2004.

<sup>16</sup> La Porta R., Lopes-de-Silanes F., Shleifer A., Vishny R. Legal Determinants of External Finance // "Journal of Finance", Vol. 52, 1997.

<sup>17</sup> La Porta R., Lopes-de-Silanes F., Pop-Eleches C., Shleifer A. Judicial Checks and Balances // "Journal of Political Economy", Vol. 112, 2004.

<sup>18</sup> See: Russian economy in 2005. Trends and prospects. M, IET, 2006, section 4.

development<sup>19</sup>, regular disproportions and non-transparency of the banking system, still high dependency of the Russian stock market on the international liquid cash flows and short-term portfolio investments tend to weaken long-term demand for a stable protection of the property rights (investors). The modern economic literature generally recognizes that in the assessment of the level of law enforcement and protection of the property rights the *financial market plays a key role* (since unlike the commodity market, long-term relations between the borrower and the lender are at stake).

According to the Frazer Property Index, Russia refers to the group of least developed countries. Its index value is between 4–5 (where 10 is the top value, and 0 – is the lowest), which is similar to the indexes of Nicaragua, Philippines, Syria, Pakistan and Ukraine.

According to IET this is in line with the current level of investments. Elasticity of the investment growth for Property Index statistically estimated on the basis of international comparison is 0.4 with a 5-year lag. In other words 1% Index growth results on average in 0.4% during the next five years. Thus for Russia with 4.4% Index growth (2004 estimate) up to 6 (this is the level of Greece, Korea, Slovakia and India) or 7-8 points (Mexico, Hungary, Hong Kong, Italy, Spain and Israel), the increase of investments by 2-3 points (of GDP) may be expected. Following the method of Index calculation we may assume that as a result of the development of the judicial reform (higher independence of courts via radical increase of costs of removal of judges appointed by the new procedure, and introduction of a new procedure of appointment of federal judges: qualification board with the participation of the entrepreneurs' trade union, law defenders and Human Rights Commissioners) the Frazer Property Index may grow by 3-4 points on the average ( up to 7-8 points).

It is worth noting that uncertainty both macroeconomic and institutional has always affected investments negatively. A number of empirical studies proves the existence of a stable negative link between the level of investments into GDP and institutional variables characterizing the degree of protection of the property

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<sup>19</sup> Modern economic literature traditionally divides financial systems into “banking” (bank-based financial system, relationship-based financial markets) and “market” (market-based financial system, arm's length financial markets); but this classification has become obsolete primarily due to the development of securities' markets within the traditional banking systems. The recent studies performed in 150 countries have not revealed any obvious advantages neither of the “bank loan model” nor of the “securities model”. According to the financial services view, it is the quality and accessibility of financial services that have prime importance, and secondly, the structure of the financial system may have secondary importance since the banks and the securities markets deal with similar economic tasks; thirdly, banks and securities markets may effectively supplement each other and enhance competition in the area of corporate control by providing alternative options of funding investments; and finally, the division by the type of the financial system does not explain the differences in the rates of the long-term growth and establishment of new companies. However, the relationship between the law system and the financial system is an axiom. The review and the data by Expert, 2005, № 44, p. 70–76.

rights<sup>20</sup>. The review results of a large number of countries show that in the countries with the favorable situation in the area of the property rights the investment processes get accelerated with a time lag of 5 years. This means that *the absence of institutional changes or moreover the aggravation of the investment climate by certain directions may lead to negative consequences for investments in the near future or serve as a limitation of investment growth into major capital of the Russian economy.*

This is an endless topic; and only two examples will be discussed here. In 2006 during IPO process the Russian companies engaged not less than \$17 billion from Russia and another \$17 billion by placing ruble-denominated bonds. According to Rosstat, out of \$17 billion received from the distribution of shares only \$2.5 billion (or 14.7%) were invested into fixed capital. As for how the \$17 billion generated from the placement of corporate bonds were used, statistics show that only \$60 million (or 0.4%) were employed for the creation of the new fixed capital. Of course, one may account for inaccuracies of the official statistics, however the basic conclusion will hardly be changed: the funds received by issuing shares and bonds are not invested into fixed assets and therefore do not affect economic growth. One can assume that the core cash flow is used for refinancing and acquisition of debts from their current owners. There are processes at the current Russian stock market that are similar to those at the U.S market in the late 1980's known as LBO (leverage-buy-out) transactions funded from the issuance of IPO and "junk" bonds. These transactions were actually mass-scale borrowing of funds at the stock market by using a credit lever to buy companies and their assets. The key risk of such transactions is a low efficiency of the acquired companies which may not be enough to repay the debts. In the U.S. this junk bond market crashed in 1989 with borrowing companies becoming bankrupt.

Here is another example: in 2006 the share of GDP market capitalization increased up to 92.7% against 61.5% in 2005. The same year Russia became one of the world leaders in attracted direct foreign investments. The internal loan share in GDP for the year which dropped in 2005 from 25.9 down to 20.6% of GDP, remained in 2006 almost at the previous year level. The gap between the indicators of capitalization and internal loan is an evidence of serious disproportions between the level of development of the banking system and the growth of the Russian companies (for more detailed analysis, see section 5.4).

The problem of mutual influence of the property rights protection and the financial markets may be also viewed in the context of transplantation of the legal norms. Some analysts believe that the legal system in the ex-USSR was least perceptible to such transplantation. The difficulties in that case could be explained not by that in the course of the post-communist law reforms ineffective legal norms were implemented at least from the viewpoint of economic efficiency. According to K. Pistor, M. Raiser and S. Gelfer, many former USSR states received technical as-

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<sup>20</sup> Clague C. Introduction, in Clague C. ed., *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries*. Baltimore: Johns Hopkins University Press, 1997.

sistance from the USA, and now can boast of remarkable protection of the investors' rights. On paper, if these documents are trustworthy, these rights are better protected than in some highly developed Western countries like Finland and Germany. It is unlikely that the level of development of the financial markets will correspond to such high level of legal norms support<sup>21</sup>.

#### 5.1.4. Legislative system versus protection of the property rights

Two directions of this topic may be identified – quality and appropriateness of the law and constraints set by the systematic corruption that decrease efficiency of the law enforcement practices (in addition to the quality of the enforcement tools). This topic is highly comprehensive and diversified and we will discuss just a few representative trends.

In terms of the problems solved by the legislation, the evolution of objectives set in the mid-term programs of social and economic development during the 2000'es is very specific. (*Table. 4*).

*Table 4*

### **Basic objectives and tasks of the major institutional transformations in the 2000'es Programs of the Russian Government**

Areas of the economic policy	Plan of Actions of the RF Government in the area of social policy and economy improvement for 2000–2001 approved by RF Government Resolution of July 26, 2000, No 1072-r (with amendments)	Program of a mid-term social and economic development (2002–2004), approved by RF Government Resolution of July 10, 2001 r. No 910-r	Program of a mid-term social and economic development (2006–2008), approved by RF Government Resolution of January 19, 2006 r. No 38-r
1	2	3	4
Protection of the property rights	Implementation of actions for active protection of the property rights to assist in the creation of the favorable business climate	Establishment of the favorable business climate based on protected property rights and actual mechanisms ensuring the transfer of the property rights	Reliable protection of the property rights, reforming of the law protective and judicial system; development of independent and public mass media and institutions of the civil society
Privatization	Privatization of the major number of the federal government companies and federal government owned shares	Privatization is founded on the principle of buyers' equality	Increase of the efficiency of privatization and acceleration of the reforming rates of the state sector
State property management	Increase of the efficiency of the state property management	Qualitative increase of the efficiency of the property management and performance of the state enterprises	Law improvement to optimize the state sector, and increase profitability of using property
Corporate Governance and protection of shareholders' rights	Development of a Business Ethics Code	Creation of mechanisms for protection of the shareholders' property rights. Improvement of the applicable laws and formation of judicial tools for protection of shareholders' interests	Improvement of the mechanisms for protection of shareholders' rights.. The law sets the balance of rights and interests of various groups of shareholders

<sup>21</sup> Pistor K., Raiser M., Gelfer S. Law and Finance in Transition Economics. – Economics of Transition, July 2000, Vol. 8, N 2, pp. 325-368

1	2	3	4
Bankruptcy and protection of creditors' rights	Protection of the rights of creditors, owners, shareholders (participants) of the established and liquidated companies ликвидлируемых организаций	Formation of the legal environment ensuring effective protection of the interests of creditors and owners	Balance of rights, interests and responsibilities of the participants of the bankruptcy cases and procedures
Development of a stock (financial) market	Creation of the environment ensuring the development of investment institutions, increase of the number of financial tools. Development of infrastructure and tax treatment. Improvement of the tools for stock market regulation	Enhancement of the role of the stock market in attracting investments. Creation of the environment for development of institutional investors. Encouragement of investment activities. . . Development of infrastructure	Expansion of the range of financial tools. Creation of equal competitive and comfortable conditions for the financial market players. Improvement of the system of market regulation, tax treatment and infrastructure.
Development of a land and real estate market	Creation of the environment for effective use and development of real estate to meet the needs of the community and individuals	Essential expansion of the legal framework for the real estate market development. Establishment of the system of legal federal and municipal regulation of the real estate market	Land and real estate are involved into business turnover

Indeed, the formal progress by specific directions of institutional transformations (that were also fixed in the mid-term programs as objectives and dealt with gradually in some way) is obvious. Among most remarkable achievements of the 2000's is a modification of the Federal law "On the Joint-Stock Companies" (2001), new laws "On Bankruptcy" and "On the Federal and Municipal Unitary Enterprises" (2002), new wording of the law on competition (2005 – 2006); the Concept of improvement of the corporate laws by 2008 adopted in summer of 2006, several clauses of which have been implemented already (modification of Article 80 of the Law "On the Joint-Stock Companies"); the development of a number of procedural innovations in the area of corporate conflicts in 2006-2007, etc.

Nevertheless, as seen from Table 4, for 2000–2008 *the basic objectives change but insignificantly*. The general conclusion on the stagnation of the institutional transformations based on the formal grounds only would be ambitious, however, the comparison above gives grounds for the assumption of insufficient legal and regulatory support of the processes of the development of economic institutions in the long term period.

A list of several meaningful legal acts which need has been discussed since late 1990's can serve as the evidence of this conclusion: "On the restructuring and liquidation of commercial entities", "On the affiliated persons", "On the responsibility for execution of transactions using confidential corporate information" ("On the insiders' transactions"), "On the self-regulating entities", "On nationalization in the Russian Federation", "On the central depository" etc. The reasons for a long delay in passing these legal acts are diversified, however the need in the establishment of transparent legal framework on these issues remains acute.

There are some examples below of how *the law lags behind the economic reality* (protection of the property rights) (Table. 5).

Table 5

**Inertia of the Law in 1990–2000**

<b>Issue</b>	<b>Most acute period</b>	<b>Legislative decision</b>	<b>Basic (probable) grounds for the decision</b>	<b>Impact</b>
Minorities' stock dissolved	1995–2000	Amendments to the law "On the Joint-Stock Companies" , 2001	Consolidation in major companies mainly completed	The issue ceased being a problem due to economic reasons
Transfer prices against minorities	1995 – early 2000' es	Changes in the Tax Code early 2000 'es	Political reasons	Selected pressure on major companies
State-owned assets removed; no control over the state companies' management	1990'es – early 2000'es	3Law "On the federal and municipal unitary entities" , 2002	Strategic decision of gradual liquidation of unitary enterprises	For those state enterprises that have the administrative resource formal restrictions are introduced
Bankruptcy as a tool for company appropriation	1998–2002	Federal Law 'On bankruptcy", 2002	Public campaign against appropriations via bankruptcy	The appropriation market use other instruments like courts, registers, falsification of documents, etc.
Raiders (unfriendly acquisitions)	2002–now	Draft amendments in the procedures, 2007	Public campaign against raiders	–
Unfriendly appropriation of land (forecast))	2006 – mid-term	Current projects enhance uncertainty and corruptions	The issue of intensification of conflicts in this area does not actually exist	–
10-year statute of limitations for privatization transactions	2000–now	The period is reduced to 3 years, 2005 r.	Demonstration of efforts to strengthen property rights protection	In court practices the statute of limitations changes are easily overcome. The court decision is considered to be enough

Mergers and acquisitions called "raids" in the popular press is one of the most broadly discussed topics of today. Unfriendly acquisitions were not surprising back in the 1990'es, and the 2000'es were characterized by a stable growth of M&A transactions (with no state holdings). According to the available data, in 2006 the amount of mergers and acquisitions with the participation of Russian companies amounted to \$55-\$60 billion which roughly corresponds to the 2005 level ([www.mergers.ru](http://www.mergers.ru)); Ernst & Young analysts speak of \$65 billion (the growth is higher by 1/3 vs 2005). In 2007 the M&A market with the involvement of the Russian companies may increase by 25-30% or more if in 2007 there will be large-scale transactions with the shares of energy companies and abroad.

The problem of "alien acquisitions" (only those that do not refer to the corporate law and classic raid – which is a purchase of shares but based on falsification of documents, and therefore subject to the criminal law for corruption) is not significant. According to the Ministry of Internal Affairs, in 2005 the value of disputable assets was about RUR200 billion or 12% of the total amount of 2005 M&A transactions. However, it is these transactions that recently have been causing significant public (or pseudo public) protest. The RF Government introduced to the State Duma a whole set of amendments in the Arbitration and Procedural Code of Russia, RF Code of Administrative Offences, Tax Code and other laws in January 2007. (the notion of a corporate dispute was introduced; the possibility for minority share-

holders to join their claims into one “collective claim”; all the elements of a corporate dispute could be united into a sole process at the arbitration court at the place of registration of a claimant; settlement of security actions, etc). The problem, however, may not be solved in the framework of corporate and procedural amendments given criminal nature of most notorious acquisitions.

As many believe, in 2006-2007 the ‘raider’ problem became more serious in the area of land property. According to IET estimates (see section 5.3), the current legislation does not create proper conditions for taking land into private property but on the opposite has a trend to enhance ambiguity of interpretations and expand arbitrary actions of administrations. As an example let us see look at the most acute problems<sup>22</sup> of appropriation of land under privatized enterprises:

- unjustified exclusion by the federal and regional authorities of the considerable number of land plots from the list of lands subject to buy-outs;
- unacceptable costs of land buy-out for the majority of the enterprises; absence of reduced prices for small and mid-size businesses, or payments by installments as well as crediting tools to provide access to land for a bigger number of enterprises;
- marginally high prices of land buy-outs established in some of the regions and overestimated cadastre values of land;
- administrative subjectivity in setting boundaries of land plots as a result of deficiencies in the urban development legislation;
- problems of interaction between the federal and regional authorities in the area of delineation of land ownership and distribution of revenues from land sales and rent.

The principle of distribution of authorities as a basis of a modern law-abiding state seems to play a most important role in the “political and legal infrastructure” as it ensures proper environment for a sustainable economic growth. The decisions of those authorities that in practice act as an arbitrator who supervises property sales, implementation of contractual obligations and rules of the market game should be the evidence of the “actual” independence of the courts from the executive power.

*The formation of a “double standard” and various rules of the market game for different classes of the participants* is a specific feature of the institutional development in 1990’es and 2000’es. Such double standard for private owners at the

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<sup>22</sup> Equally serious problems exist in other areas of land relations. In Moscow, for instance, in spite of the provided by the Housing Code rights of owners to the residential premises, it is so far unrealistic to “form” a land plot under a multi-storey building (with the privatized housing stock, not for a new development) in order to implement further the right of land common ownership. One of the formal invented reason to refuse to do this is the need to preliminary delineate Moscow territorial units. The city development plans of the Moscow administrative areas are not approved by the law *in detail* and for a long-term period which gives rise to “current” updates and amendments depending on the market situation and specific interests. In both cases this may lead to spontaneous development of lands including those that are currently under apartment houses. Well known are the conflicts in the 2000’es connected with enforced removal of residents from the buildings in the central zone of Moscow pretending these buildings are in the state of emergency.

federal and regional levels creates very serious obstacles on the way of the establishment of the favorable institutional environment and local institutional changes in the area of property rights protection, corporate governance, financial markets, budget limitations, etc.

In other words the existence of this “double standard” results in that the market mechanisms work well in the limited space which has a trend to reduce itself in the context of the concept of the formation in Russia of the “state capitalism model” (see section 5.2). Though the long-term objectives of creating sustainable and flexible institutional environment (applied to the market mechanisms) remain unchanged, an undisputable priority is the formation of basic pre-requisites for their implementation – legislative, judicial, procedural and regulatory framework to assure the unified market rules. It should be stressed that the only relatively effective limitation in application of various rules in the “double standard” system may be an independent institution of courts that would have to take over the function of unification of the rules for all market players. Therefore the prospect of the development of economic institutions encouraging economic growth in Russia to a great extent depends on the adequate functioning of the existing political institutions.

An ideal illustration of the “double standard” and of what is private property in Russia and how valuable is its relation with the supreme political power like in the ancient oriental countries (unlike in the modern Western world) may be two radically different alternatives of ending a business established by almost equal methods (though not always legitimate) during one and the same period (about 10 years) provided this business is quite solid and profitable. The first alternative is that the company gets destroyed and its assets are nationalized, with no discussion of the market price of the transaction and possible ways of moving the proceeds outside the country (like in “Yukos” case). The second alternative is the transaction of acquisition of “Sibneft” by “Gazprom” where the beneficiary received \$13 billion together with the opportunity to legitimately dispose the acquired assets both in Russia and abroad including new asset acquisitions in Russia in 2006. Between these two extreme options there is a wide range of possible compromises that are traditionally considered in Russia as “proposals which one can hardly decline”. The said transactions can not be called market ones since they had only an illusion of a fair market price, and the government still keeps its arguments from the “Yukos” case.

Finally, one should mention *corruption* as a systematic factor that affected institutional changes during 1990 – 2000’s. As mentioned before, the higher level of corruption is in the government authorities, the least opportunities remain to strengthen market institutions and competition mechanisms.

These dependencies creating a vicious circle result from potential changes in the distribution network when the establishment of new political and economic institutions is opposed (directly or indirectly) by those officials who usually generate benefits (illegitimate) from the current norms and provisions. In certain cases effective market relations are substituted for competition at the “political markets”. Naturally the players do not manifest their real aims. Therefore certain “regulators”

keep appealing to the interests of various groups while pursuing their own interests and aspirations.<sup>23</sup>

One citation seems to be relevant here: "In characterizing the Russian economic and political system it is hardly enough to apply the "neutral" term "corruption". This term is senseless. One should describe the system as a mechanism functioning on the principles of corruptive loyalty".<sup>24</sup>

Presently there are various estimates of the corruption scale in Russia; and all the analysts speak of the corruption growth in the 2000'es. According to A. Buksman, Deputy, General Attorney of Russia, the corruption amounts to about \$240 billion per year (the method of assessment is unknown). "Indem" Foundation believes that the intensity of business corruption in 2001 – 1005 dropped by 20% however its volume increased manifold (in 2001-2005 the gross amount of bribes was up to 90%); this is explained by the increasing involvement of the government in the economics and redistribution of rent.

#### 5.1.5. State capitalism versus de-nationalization

The problem of interference of the government in the property relations is as old as the property itself<sup>25</sup>. John Lock believed that political power represents the right "to create laws... for regulation and maintenance of property"<sup>26</sup>. According to E. Furuboten and R. Richter, an economic institution must recognize a key fact that the transfer of individual property rights should be made voluntarily. The basic constitutional rules therefore should be based on the principle of inviolability of the private property rights. The state, however, has the power which may be directed not only at the protection of private property but also at its withdrawal<sup>27</sup>. Therefore, the basic condition of the functioning of a market-based economy in addition to the constitutional framework is a valid commitment of the government to respect private property<sup>28</sup>. A successful market requires, in addition to the adequate system of property rights, a *politically safe foundation* that sets up rigid constraints to possible confiscation of wealth by the state<sup>29</sup>.

In the modern world the neoclassical (neo-liberal) approach to the state as a main source of economic instability becomes more and more exotic both in the

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<sup>23</sup> See: A. A. Yakovlev. Possible strategies of economic agents regarding corporate governance institutions. / Development of demand for legal regulation of the corporate governance in the private sector. Research Papers, MONF, № 148, 2003, p. 51.

<sup>24</sup> K. Rogov. Loyalty mechanisms // Kommersant, 2006, 13 of November.

<sup>25</sup> In D. North classification the first economic revolution took place when there was a transition from nomads to a settled way of life and when for the first time a centralized (at the level of first prototypes of the government establishment) protection (guarantees) of the property rights to land was required that would provide to the owners stimuli for higher productivity and efficiency. See: North D. Structure and Change in Economic History. – New York and London: Norton, 1981, p. 81.

<sup>26</sup> J. Lock. Works in three volumes. – M: "Thought" 1988, V. 3, p. 343.

<sup>27</sup> E. Furuboten, R. Richter. Institutions and economic theory. – STP 2005, p. 335–337.

<sup>28</sup> North D.C. Economic Performance Through Time // American Economic Review, 1994, 84, pp. 359–368.

<sup>29</sup> Weingast B.R. Constitution as Governance Structures: The Political Foundations of Secure Markets // Journal of Institutional and Theoretical Economics, 1993, 149, pp. 286–311.

English-American and European research tradition. “There are not many grounds to believe that the market can function in a situation with a non-state economy”<sup>30</sup>. A standard new constitutional set of the state functions well where the state receives, together with the right of enforcement in the respective areas including specifications and property right protection, minimization of the information asymmetry of the market players, provision of the material channels of the commodity and services exchange, judicial (and otherwise, in the role of “a third party”) settlement of contractual and other relations, standardization of measures and weights and provision of public benefits (defense, science, education and healthcare). The government interference is reasonable even in those situations where a need arises to compensate for certain external factors and delineate “worthy” and negative public needs<sup>31</sup>.

By the end of 1990 – early 2000’s the government involvement in the corporate sector of Russia was quite unfocused and existed in the form of numerous scattered unitary entities with bad management or no management at all and blocks of shares of newly established joint-stock companies almost in all sectors of the national economy. Integrated structures formed by the state initiative and with the state participation at the initial stage of privatization functioned mainly in the fuel and energy complex and also in natural monopolies.

The period of 2000–2004 was characterized by certain actions to increase efficiency of management of the scattered assets by integrating them into state holdings in such sectors as nuclear energy, railways, defense industry, support to the air and marine transports and postal communications. Any increase of the government stake in the capital of individual companies outside the integration processes was an exception. Restructuring of natural monopolies began in parallel to this process.

In the same period the attempts to establish (expand) control over main financial flows of the Russian economy and to make business dependent on the state institutions became more pronounced in spite of the decisions to de-regulate, administrative reform and further privatization plans. The key feature of the period 2005–2006 was a shift in priorities in favor of direct government involvement in the economy<sup>32</sup>. The following trends may be identified in this process:

- increasing activity of the operating state holdings and companies that decided to expand their businesses and make it diversified through mergers and acquisitions (“Gazprom”, “Rosneft”);
- involvement of new players (“Rosoboronoexport”, RAO EES of Russia”);

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<sup>30</sup> E. B. Atkinson, J. E. Stiglitz. Lectures on economic theory of the state sector. – M., Aspect Press, 1995, p. 18.

<sup>31</sup> См.: Eggertsson T. Economic Behavior and Institutions. Cambridge, 1990; Transaction Costs, Markets And Hierarchies. Oxford, 1993 и др.

<sup>32</sup> For details see: A. Radygin. Russia in 2000–2004: on the path to the state capitalism? // Issues of Economy, 2004, № 4, p. 42–65; A. Radygin, G. Malginov. Corporate control market and the state // Issues of Economy, 2006, № 3, p. 62–85.

- the strategy of integrating scattered assets still owned by the state into holdings becomes secondary; however the new structures begin acting, though on a selected basis, at the corporate control market as independent entities;
- expansion goes beyond the fuel and energy sector, though it is still premature to talk about multi-sector conglomerates;
- the interests shift from the assets of “problematic” or “unfair” companies (from the viewpoint of the state) towards the assets of “neutral” or “loyal” owners;
- a more extensive practices of such methods as increasing shares in the charter capitals of the companies up to the amount allowing to make a decisive impact on the companies’ activity;
- active participation of largest state banks (crediting, guarantees, direct purchase of shares) in the processes of expansion of the government involvement in the companies’ capital;
- a need to get a political consensus regarding possible major deals inside the country and with involvement of foreign companies as a necessary component of such business decision.

Back in 2005, according to some forecasts, it was envisaged that in 2006 – 2007 the following companies might become the subject of nationalization by the state companies: “Norilsky Nickel” (51 % of shares, \$8 billion), “Promstroybank” (\$1.5 billion), the Urals Mining and Enrichment Company - UGMK (\$5 billion), “Suirgutneftegas” (62% of shares, \$20 billion), “Vossibneftegas” (\$130 million), “Tomskneft”, “Samaraneftegas” “Achinsk NPZ”, Angarsk Oil Petroleum Company (jointly \$8.5 billion), Syzran NPZ, Kuybishev NPZ, NovoKuybishev NPZ (\$0.5 billion), TNK-BP (50% of shares owned by the Russian shareholders:\$9–10 billion), “Syloviye Mashiny” (\$450 million), “Uralkaliy” (\$2 billion), “Silvint” (\$1 billion)<sup>33</sup>.

The bigger part of those transactions has not been executed, but this does not mean that in 2006 the state expansion weakened (see also sections 5.2 and 5.4). According to Alfa-Bank analysts, during one year the share of the Russian companies’ stock owned by the state grew from 29.6% to 35.1%<sup>34</sup>.

“Gazprom” activity in 2006 (against the growth of the company’s external debt) is quite expressive:

- Shtockman field development was monopolized;
- Shell, Mitsubishi and Mitsui consortium bought a control block in “Sakhalin-2” project under the threat to stop the project because of non-compliance of the environmental law (in 2006 it was announced that the right of development of all new fields of the energy carriers at the shelf would be granted to state companies only);
- The companies engaged in the development of a largest in Russia Yuzhno-Taibei gas field were taken over;
- Large blocks of shares of energy companies (RAO EES of Russia, Mosenergo, OGK-1, OGK-2, OGK-4, OGL-6 and others) were acquired;

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<sup>33</sup> Mergers and Acquisitions, 2005. № 12 (34). p. 13–15.

<sup>34</sup> B. Grozovsky. Chief owner of the country. // Vedomosti, 13 of February 2007

- Early 2007 a control block of shares of the Siberian Coal and Energy Company (SUEK) producing 1/3 of the energy coal in Russia was acquired;
- “Gazprom” and “Rosneft” was offered to buy out the shares of the Russian shareholders in TNK-BP while “Gazprom” expressed interest in getting rights to a 75% block of shares in Kovykta gas condensate field (simultaneously the tax, environmental and other regulatory authorities should issue claims to TNK-BP). The analysts note an obvious slow down of the production rates in the oil and gas industry in 2005 – 2006 as compared to 2000-2004 as a result of the oil and gas assets placed under control of the state corporation<sup>35</sup>, and due to gas shortage for internal consumption in the national gas balance starting 2007.

One of the 2006 deals at the M&A market with the involvement of the state companies was the purchase by FGUP “Rosoboronoexport” last fall of 66% of shares of a leading titanium and magnesium producer (30% of the world production) JSC “VSMPO-Avisma”<sup>36</sup> (the deal value is \$700 million). In the shadow of this event was the acquisition by “Oboronprom”, a “Rosoboronexport” subsidiary, of the control block in “LEPSE” (Electric Engineering Company in Kirov), one of the major Russian companies producing electric equipment for the defense and car building industries. Further plans of “Rosoboronexport” expansion may be related to metallurgy and not only in Russia. In summer 2006 the “Rosoboronexport” management raised the issue of the establishment of a state holding that would be a monopoly in the production of specialized steels. Early 2007 CJSC “Russpetstal”, a “granddaughter” of “Rosoboronexport” purchased 100% in JSC “Metallurgical Plant “Krasny Octyabr” (Red October) «in Volgograd. Among possible future acquisitions there may be Chelyabinsk Metallurgical Plant (JSC “Mechel”), Zaporozhie titanium and magnesium plant, Volnogorsk and Irshansk mining and enrichment complexes (GOKs) in Ukraine, Metallurgical Plants “Electrostal” (in the city of Electrostal of Moscow region), “Serp i Molot” (“Hammer and Sickle” (Moscow) that are producers of specialized steels for the defense industry.

Since “Rosoboronexport” increases control over the assets and diversifies the sector structure as a result of various profiles of the respective companies (helicopter manufacturing, metallurgy, car and defense industries), the company may be encouraged to restructure itself by setting up a managing company that would be completely owned by the state. The companies under its control including “Rosoboronoexport” as an entity that received the monopoly right to exercise military and technical cooperation with foreign countries may become subsidiaries. In future some of the subsidiaries may issue shares additionally.

The functions of a major state financial institutions – Vneshtorgbank (99.9% shares owned by the Russian federation) – are not limited to the processes of expansion of the state into the banking sector where the total amount of the M&A transactions did not exceed \$3.5 billion in 2006 (e.g. the take-over of “Promstroy-

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<sup>35</sup> V. Milov. The echo of ownership re-division. // Forbes, February, 2007, p 30.

<sup>36</sup> In 1998 the control block of “Avisma” shares (Berezniki of Perm region) was acquired by Verchne-Saklinsk Metallurgical Production Consortium (VSMPO) in Sverdlovsk region after which two companies actually integrated.

bank” in St-Petersburg). In 2006 this bank participated in the buy-out of ALROSA shares and in the mergers made by “Rosoboronexport” structures.

During 2005-2006 privatization was noted for quite opposite processes. In the 2006 spring message to the Federal Assembly Russia’s President confirmed again the need of privatization (“the state should keep in its ownership only the property which is absolutely required to perform its functions”).

In spite of a formal number of blocks of shares put for sale and the decisions to reorganize unitary enterprises, the situation is close to critical. Every year not less than 50% of transactions is suspended due to the absence of demand, and the quality of management of the state owned property is hardly different from that of the 1990’es. It looks like the situation in this sector is closely connected with modification of views regarding the role of the state sector in the Russian economy<sup>37</sup>.

From the one hand, one of the tasks of 2006 – 2008 is to create at least the “illusion” of completing the privatization as a component of the institutional reforms – to sell federally owned blocks of shares and to restructure the sector of state unitary entities. –The effect of the process both for the government and the concerned entities is secondary as compared to possible political gains. On the other hand, the increasing state expansion which manifests itself either in the overall economic strategy, or a trivial re-division of property in favor of groups close to power, or opposition of the concerned ministries, objectively removes from the privatization process major and most profitable state owned assets.

#### 5.1.6. *Stability versus stagnation*

The problem of stability of the ownership structures and the appropriation rules the reverse side of which is the protection of property rights is most critical in the present Russia. David Hume, a famous Scottish philosopher and economist, stated that no one can doubt that the agreement of the distribution of property and the *stable possession of this property is the most needed condition*, and after such agreement is concluded, not much is to be done. “Stability of possession” like “the transfer of property by consent” and “fulfillment of commitments” are three basic natural laws (in the terms of the natural right doctrine)<sup>38</sup>. The significance of stability of these relations for the economy in transition is reassured in certain cases by similarity of the institutional issues and the formation of a developed system of private property relationships.

The most pessimistic forecast of the development of the property-related relationships in Russia looks like the following<sup>39</sup>. Indeed there are no constructive decisions in Russia to go away from the power-property re-division reality<sup>40</sup>. The latter

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<sup>37</sup> In April 2006 Yu. Petrov, Head of RFFI, announced that as a result of the privatization some 30-40 major state holdings should appear in the strategic sectors of the Russian economy .

<sup>38</sup> Hume D. A Treatise of Human Nature. Ed. by Mossner E.C. London, 1969, p. 578.

<sup>39</sup> See: N. Popadyuk. Is the private property in Russia really private // Issues of economy, 2006, № 1, p. 152–153.

<sup>40</sup> The notion of the “power-property” introduced by L. Vasiliev means primarily that this economic category applies to the entire society; this is “a syncretical integrity of the power and property where they are inseparable making a sole phenomenon which is “the power-property”: the power (posses-550

has all the grounds to reproduce itself. All individual fluctuations of corporate or local business models similar to private property will, times and again, fall under this power-property continuum because of its immanent logics which sets up the behavior model of the so called private entrepreneurship. The practical logics behind this is like this: the property represented by particular persons will start linking itself with the power to realize its private interests and eventually merging with the power using the latter as a guarantee from possible “flaks”, while the power, if the private property is “legitimate” in the country, will continue attempts to possess private property being caught in corruption and getting prestigious top management positions in the so called big private business. The Russian power-property may be called re-distributional because new teams of the government officials who periodically come to power with the help of “democratic procedures” resolve the previous problems in a more “fair way (transactions of privatization, even when the statute of limitations is reduced to 3 years, etc.). Such is the framework setting the rules.

In the modern new institutional economic theory the stability of the institutional environment is described by the following main criteria: 1) general stability of the established property structures and the appropriation rules during the entire period of *long-term investments as a key feature*; 2) political and legal stability; 3) valid capacity of the judicial system; 4) the culture of contracts and “commitments” inspiring confidence”. None of the said criteria permits speaking about maturity of the institutions established in Russia during the last 15 years. On the contrary, all the above gives grounds for the following conclusions:

1) The asymmetry of economic and political factors of the development of the Russian economy in the 2000'es is obscured so far by the general indicators of the economic recovery, unstable feedstock market, and the indicators of the state finance (budget surplus, Stabilization Fund, gold and currency reserves), and of exceptional profitability of the Russian stock market. In the 2000'es a negative impact of the “state” factor increases while the quality of “the market factors” gradually decreases. The conclusion of *the actions of the “state” and the “market” going into opposite directions* in Russia during the 2000'es is confirmed by the data of sociological surveys and country ratings.

2) In a *long-term perspective* this problem of asymmetry of economic and political factors of the Russian economic development becomes critical primarily in the context of the roles of the political institutions required for the formation of effective economic institutions, if to assume moreover that it is the market that is the source of the current growth of the economy, budget revenues and funds for social programs support.

3) During the 2000'es a *contraction of the potential social base* for indirect (via political representation) formation of effective economic institutions is ob-

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sion) generates the notion and the concept of the property while the property emerges as a function of the possession and power”. (L. Vasiliev. History of the East. – M., High School, 2001, Vol. 1, p. 42.). The term “re-distributional property” is a variation of the “power-property” in the specific historical context of the Russian state.

served. Those institutional mechanisms that in the 1990'es opposed the expansion of demand for effective economic institutions are functioning now but in a modified form. If before the 2000'es (the terms are conventional) we talked about "oligarchy capitalism", presently the most common term used is *the "state capitalism" in its Russian modification*.

4) In the mid of the 2000'es the risks brought into entrepreneurship (in its legalized forms) by the institutions and regulative function of the government remained significant, however, the impact of a new factor became more pronounced: the government was obviously restoring its *direct interference into the economy*. There was also a strong probability of the relationship between the expansion of the direct and indirect interference of the government and *the growing corruption* in the 2000'es.

5) The mutual influence of such institutions as the property rights protection and the financial system in their present form is rather *negative*. The absence of institutional changes or aggravation of the investment climate by certain directions may have negative consequences for the investment dynamics in the near future or curb the investment growth into the fixed assets of the Russian economy.

6) During entire period of 2000–2008 *the basic objectives of mid-term social and economic programs change but insignificantly*. The general conclusion on the stagnation of the institutional changes based on such formal base only would be too ambitious, however the above comparison gives grounds to assume that the legislative and regulatory support to the processes of the development of economic institutions in the long-term is inadequate. One can talk of *a chronic gap between the legislation and the economic reality*.

7) A specific feature of the 2000'es institutional development is the *formation of the "double standard" and different rules of the market game for various classes of the players*. The establishment of the double standard at the federal and regional levels creates insurmountable obstacles on the way of the formation of the favorable institutional environment in general and also put brakes to local institutional transformations in the area of the property rights protection, corporate governance, financial markets, budget restrictions, etc.

8) By the end of the 1990'es - early 2000'es a situation emerged in the country where the economic laws were relatively well developed but the law enforcement remained very critical. In the mid 2000'es the focus apparently changed: though the diseases of the Russian system of law enforcement were still acute a certain shift took place in the framework of the economy legislation (and its interpretations) which, on the one hand, increased uncertainty of implications of various economic actions for the business in terms of the government reactions, while from the other hand, tightened the relations between the government and the private business. The problems of the Russian law enforcement system supplemented with the trends of expanding uncertainties and restoration of rigid legislative norms *apparently increase the risk zone in the property rights area*.

## 5.2. Public Sector Transformation and Property Relations Policy

### 5.2.1. Public Sector Status: Quantitative Aspect

Similar to the previous several years, public sector overall quantitative status as of mid-2006 was provided in the Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009 approved by the RF Government Directive No.1184-r of August 25, 2006. This document contains data on the number of Federal State-Owned Unitary Enterprises (hereinafter - FGUPs) and stock-holding companies with the RF Government participation as of June 1, 2006.

Let us review the last few years' quantitative dynamics of the entities with the above-mentioned organizational and legal status by each of the public sub-sectors at the federal level.

#### Federal State-Owned Unitary Enterprises

Table 6 below presents the dynamics and industry-based profile of FGUPs in 2003–2006.

*Table 6*  
**Dynamics and Industry-Based Profile of Federal State-Owned Unitary Enterprises in 2003–2006**

Industry (sub-sector)	as of June 1, 2003		as of June 1, 2004		as of June 1, 2005		as of June 1, 2006		% of the number as of June 1 2005
	number	%	number	%	number	%	number	%	
Nonmaterial sphere	4357	44,2	4069	44,1	3617	43,6	1817	25,3	50,2
Industries, incl.	2224	22,6	2064	22,4	1870	22,55	1624	22,6	86,8
- engineering	908	9,2	827	8,95	734	8,85	660	9,2	89,9
- soft industries	193	2,0	193	2,1	194	2,3	187	2,6	96,4
- construction materials manufacturing	81	0,8	80	0,9	68	0,8	55	0,75	80,9
- food-processing	60	0,6	61	0,65	55	0,7	55	0,75	100,0
- metallurgy	49	0,5	37	0,4	34	0,4	30	0,4	88,2
- chemical industry	46	0,5	43	0,5	39	0,5	34	0,5	87,2
- other industries	887	9,0	823	8,9	746	9,0	603	8,4	80,8
Agriculture	1329	13,5	1237	13,4	1111	13,4	913	12,7	82,2
Construction	1035	10,5	978	10,6	903	10,9	752	10,5	83,3
Transport, communications	851	8,6	809	8,8	725	8,75	612	8,55	84,4
Forest management	64	0,6	65	0,7	67	0,8	53	0,75	79,1
Other sub-sectors	–	–	–	–	–	–	1407	19,6	–
Total	9860	100,0	9222	100,0	8293	100,0	7178	100,0	86,6

*Source:* Federal Property Privatization Forecast Plan (Program) for 2004 and Key Areas of Federal Property Privatization for the period up to 2006; Federal Property Privatization Forecast Plan (Program) for 2005; Federal Property Privatization Forecast Plan (Program) for 2006 and Key Areas of Federal Property Privatization for 2006–2008, Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

As results from Table 6, the overall number of FGUPs has decreased by 2682 enterprises i.e., almost by 27% for the last 3 years (between June 1, 2003, and

June 1, 2006). In particular, during the period between June 1, 2005, and June 1, 2006, this number decreased by 13.4%. With this, during the period between June 1, 2005, and June 1, 2006, the absolute reduction of unitary state-owned enterprises (by 1115) was the biggest versus the reduction during the period between June 1, 2004, and June 1, 2005, (by 929), and during the period between June 1, 2003, and June 1, 2004 (by 638).

FGUPs industry-based profile benchmarking seems to be not 100% correct due to the fact that a new category ("Other Industries") appears in 2006, meaning the industries that do not fall under the basic classification of industries (and this category comprises 19.6% of all FGUPs). It is because of this that we can see significant reduction of non-material sphere unitary enterprises share: from 25.3% vs. 43.6% as of mid-2005. As for the industries falling under basic classification, the share of practically each of them has decreased slightly (agriculture, construction, transport & communications, forest management); the overall share of industrial production remaining at the same level. Out of heavy industrial enterprises the majority state-owned unitary enterprises belong to engineering (9.2%) and soft industries (2.6%), with the share of these sub-sectors growing slightly compared to 2005.

The greatest absolute reductions in the number of state-owned unitary enterprises for the period between June 1, 2005, and June 1, 2006, took place in agriculture (198 entities), construction (151 entities), transport & communications (113 entities). If we take the number of unitary enterprises as of June 1, 2006, as % of their number as of June 1, 2005, we may state that the most significant reduction (by over 15%) took place in such sub-sectors as forest management, construction materials manufacturing, construction, transport & communications<sup>41</sup>. And the number of state-owned federal unitary enterprises in food processing remained the same.

It is necessary to emphasize that analyzing the quantitative dynamics of FGUPs<sup>42</sup> was based on their number as of specific date, which allows for judging only about the most general trend of that or another specific sub-sector shrinking. The available statistics data does not allow for evaluating the comprehensive demography of such business entities, the specific scale of their set-up, termination and transformation into entities with other organizational and legal statuses, i.e., does not allow for analyzing the whole totality of actions resulting in the specific number of such entities at a specific point of time. The outcome of industry-based profile of state-owned unitary enterprises is that if we do not focus on the changes in classification, than we can say that the share of entities belonging to compatible sub-sectors has changed insignificantly.

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<sup>41</sup> Without accounting for the nonmaterial sphere enterprises, which cannot be compatible due to segregating "Other Industries" category in 2006 (did not exist in 2005).

<sup>42</sup> The same comment is relevant for analyzing the number of joint-stock companies with federal government interest.

## Joint-Stock Companies with Federal Government Interest

Table 7 below presents the dynamics and industry-based profile of such entities in 2003–2006.

Table 7

### Dynamics and Industry-Based Profile of Joint-Stock Companies with either Federal Government Interest or which are Subjects to the “Golden Share” Regulation, 2003–2006

Industry (sub-sector)	as of June 1, 2003		as of June 1, 2004		as of June 1, 2005		as of June 1, 2006		% of the number as of June 1 2005
	number	%	number	%	number	%	number	%	
Nonmaterial sphere	1918	45,6	1781	45,6	685	18,1	356	9,6	52,0
Industries, incl.	1350	32,1	1253	32,1	2078	54,9	1772	47,6	85,3
- engineering	225	5,4	209	5,4	187	4,95	663	17,8	354,5
- food processing	43	1,0	40	1,0	54	1,4	141	3,8	261,1
- metallurgy	34	0,8	32	0,8	28	0,75	101	2,7	360,7
- construction materials manufacturing	21	0,5	20	0,5	19	0,5	53	1,4	278,9
- chemical industry	19	0,4	18	0,5	46	1,2	98	2,65	213,0
- soft industry	16	0,4	15	0,4	9	0,2	27	0,75	300,0
- other industries	992	23,6	919	23,5	1735	45,9	689	18,5	39,7
Construction	492	11,7	457	11,7	287	7,6	380	10,2	132,4
Transport, communications	383	9,1	356	9,1	459	12,1	396	10,6	86,3
Agriculture	46	1,1	43	1,1	229	6,1	363	9,7	158,5
Forest management	16	0,4	15	0,4	45	1,2	99	2,7	220,0
Other sub-sectors							358	9,6	...
Total	4205	100,0	3905	100,0	3783	100,0	3724	100,0	98,4

Source: Federal Property Privatization Forecast Plan (Program) for 2004 and Key Areas of Federal Property Privatization for the period up to 2006; Federal Property Privatization Forecast Plan (Program) for 2005; Federal Property Privatization Forecast Plan (Program) for 2006 and Key Areas of Federal Property Privatization for 2006–2008, Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

As results from Table 7, the overall number of JSCs with federal government’s share decreased by 11.4% during the period between June 1, 2003, and June 1, 2006, including by 1.6% during the period between June 1, 2005, and June 1, 2006. The absolute number of such JSCs eliminated during the period between June 1, 2005, and June 1, 2006, was two times lower than the similar number for the period between June 1, 2004, and June 1, 2005, (59 versus 122).

Similar to FGUPs, a new category was established for the industry-based profile of JSCs with federal government’s share in 2006 (“other sub-sectors”), which does not fall under the classification of base industries (overall, there are 9.6% such JSCs). As a result, the share of JSCs qualified as related to nonmaterial sphere fell from 18.1% as of June 1, 2005, down to 9.6% as of June 1, 2006, which in absolute numbers means by 329 companies). In addition, another very important shift in the industry-based profile of JSCs with federal government’s participation is worth noting: decreasing the share of companies belonging to industrial sector (from 54.9% as of June 1, 2005, down to 47.6% as of June 1, 2006), to transporta-

tion and communications sector (from 12.1% down to 9.6%). On the contrary, the share of JSCs belonging to some other sector has grown: construction (from 7.6% up to 10.2%), agriculture (from 6.1% up to 9.7%) and forest management (from 1.2% up to 2.7%).

At the same time we need to emphasize that the share of JSCs with federal government's participation decreased mainly due to establishing this separate new group of "other sub-sectors" which does not directly relate to those listed in the Table (metallurgy, engineering, chemical building, construction materials manufacturing, soft industry and food processing). And this separate group demonstrates a record reduction of contribution both in its relative share (from 45.9% down to 18.5%), and in absolute figures (by 1046 companies).

As for other sub-sectors and industries, the absolute number of JSCs with federal government's participation has grown, especially in engineering – by 476 companies. Quite significant increase was also observed in agriculture (by 134 companies), and in construction (by 93 companies). As for the growth rate dynamics among JSCs with federal government's participation as of June 1, 2006, vs. June 1, 2005, r. Engineering and soft industries took the lead demonstrating the annual growth rate of 3 and even more times.

Table 8

**Dynamics of Joint-Stock Companies with Federal Government Participation (including application of special "Golden Share" Regulation), 1999-2006**

Date	Number of JSCs											
	Total		Less than 25%		25% + 1 share – 50%		50% + 1 share – 100% - 1 share		100 %		"Golden Share"	
	JSCs	%	JSCs	%	JSCs	%	JSCs	%	JSCs	%	To- tal	Without shares
1999	3316/ 3896*	100	863	26.0	1601	48.3	470	14.2	382	11.5	580	**
January 1, 2001	3524**	100	1746	49.55	1211	34.4	506	14.35	61	1.7	...	...
January 1, 2002	4407**	100	2270	51.5	1401	31.8	646	14.65	90	2.05	750**	
January 1, 2003	4222	100	2152	51.0	1382	32.7	589	13.95	99	2.35	1076	118
June 1, 2003	4205	100	2148	51.1	1339	31.8	600	14.3	118	2.8	...	...
October 1, 2003	4035	100	2051	50.8	1308	32.4	552	13.7	124	3.1	640	148
January 1, 2004	3704	100	1769	47.75	1235	33.35	540	14.6	160	4.3	591	251
June 1, 2004	3905	100	1950	49.9	1183	30.3	499	12.8	273	7.0	...	...
March 1, 2005	4075/ 3791 <sup>†</sup>	100	1697	44.8	1154	30.4	487	12.85	453	11.9 5	...	284
June 1, 2005	3783/ 3524**	100	1544	43.8	1093	31.0	474	13.5	413	11.7	...	259
June 1, 2006	3724/ 3481***	100	1063	30.5	885	25.4	397	11.4	1136	32.6	...	243

\* – 3896 business entities are mentioned in the context of State Property Management and Privatization Conception issued in 1999 (including 3611 Open Joint-Stock Companies, 251 Closed Corporations and 34 Limited Liability Companies) as those with participation of the RF Government in share capital; 31316 is an estimate based on summarizing all shares (stocks, interest) mentioned in the Conception;

\*\* – overall number of JSCs applying special "Golden Share" Regulation without specifying the JSCs in which the Government does not have stock packages;

\*\*\* – joint stock companies not accounting for 48 shares and packages in foreign-based companies;

\*\*\*\* – JSCs not accounting for 75 closed corporations and shares in LLCs charter capitals granted based on the RF Government Resolution No.545-rof April 2, 2002, “On Termination of State Participation in Charter Capitals of Credit Institutions”, or received by ways of succession, gift or due to other reasons;

# – 3791 is an estimate number of JSCs having got shares owned by the Russian Federation, without accounting for 284 joint-stock companies to which the “Golden Share” Rule is applied (without a package of stocks). Percentage of JSCs with different number of government-owned stocks is made comparable with the previous periods data, for which it was calculated based on this number. For reference: as of January 1, 2005, the RF Federal Government owned shares of 3767 JSCs, not accounting for the already mentioned 284 JSCs with the “Golden Share” and for 24 000 LLCs with Government participation;

## – 3524 is an estimate number of JSCs having got shares owned by the Russian Federation, without accounting 259 joint-stock companies to which the “Golden Share” Rule is applied (without a package of stocks). Percentage of JSCs with different number of government-owned stocks is made comparable with the previous periods' data, for which it was calculated based on this number;

### – 3481 is an estimate number of JSCs having got shares owned by the Russian Federation, without accounting for 243 joint-stock companies to which the “Golden Share” Rule is applied (without a package of stocks). Percentage of JSCs with different number of government-owned stocks is made comparable with the previous periods data, for which it was calculated based on this number.

Source: agency website [www.mgi.ru](http://www.mgi.ru); A.A. Braverman, Measures to Improve Efficiency of Federal Property Management and Criteria for Evaluating Such Efficiency // Bulletin of the RF Ministry for Federal Property Management No.1, 2003, pp. 13–14; Companies with Government Participation. Institutional and Legal Aspect, Efficiency Aspects. Collection “Analytical Reports: Independent Economic Analysis” No.155. – M.: Moscow Public Scientific Foundation; Association of Public Economic Studies, 2004, p. 47; Federal Property Privatization Forecast Plan (Program) for 2004 and Key Areas of Federal Property Privatization for the period up to 2006 // Bulletin of the RF Ministry for Federal Property Management No.4, 2003, pp. 4–5; Key Issues of Improving Federal Property Management Efficiency and Main Areas of the RF Dividend Policy // Bulletin of the RF Ministry for Federal Property Management No.4, 2003, p. 8; Federal Property Privatization Forecast Plan (Program) for 2005; Materials for the RF Government session of March 17, 2005, “On Measures to Improve Federal Property Management Efficiency”; Federal Property Privatization Forecast Plan (Program) for 2006 and Key Areas of Federal Property Privatization for 2006–2008; Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

Another important feature characterizing JSCs with federal government’s participation was their distribution by the scope of government’s participation (number of stock belonging to the Federal Government) (*Table 8*).

According to *Table 8*, the period between June 1, 2005, and June 1, 2006, was marked by a long-awaited drastic turnaround in the structure of stock packages owned by the federal government, increasing the number of JSCs in which the federal government has enough shares to decisively influence (control) the policy. During this period of time the absolute number of JSCs with 100% government interest increased by 2.8 times, which is definitely an evidence of certain progress in the process of FGUPs incorporation. As for the number of JSCs with less than 100% government interest, it decreased. It is especially obvious with relation to the number of JSCs with minority (up to 25%) federal government interest, which decreased by 1.5 times; as for the number of JSCs with blocking and controlling

packages owned by the RF government, their decrease was far more modest – by 20% and 16% respectively.

This resulted in the following structure of federal government portfolio as of June 1, 2006: the packages of up to 25% interest constitute circa 30% of all the JSCs with federal government participation, the blocking packages (between 25% and 50%) constitute about 1/4, and in 44% of JSCs the government could execute majority control (with that, the share of JSCs with 100% of government capital made 32.6% – three times above the share of JSCs in which the federal government owned majority stock but less than 100%). The share of JSCs with all stock owned by the federal government increased significantly compared to June 1, 2005, while as the share of JSCs with different sizes of government interest declined.

Comparing the structure of the federal government packages as of mid-2006, with the one the RF Ministry for Property Management was expecting after implementation of 2003 Privatization Program, we may state that the estimated target was achieved with more than 2-year delay (*Table 9*).

*Table 9*

**Federal Share Packages Structure as of June 1, 2006 vs. the Expected Early 2004 Structure Resulting from Privatization Program Implementation**

Type of package based on the shares of the Federal Government, %	Share of federal packages in JSCs by their sizes and types, % of the aggregated totality of the packages	
	fact as of June 1, 2006	Estimated upon implementation of 2003 Privatization Program (i.e., as of early 2004)
– Minority (less than 25%)	30,5	36
– Blocking (between 25% and 50%)	25,4	22
– Controlling (between 50% and 100%)	11,4	12
– Complete (100%)	32,6	30
Total number of packages owned by the RF government	3724/3481*	3613

\* – without accounting for the joint-stock companies to which the “Golden Share” Rule is applied (without a package of stocks).

*Source:* Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; A.A. Braverman, Measures to Improve Efficiency of Federal Property Management and Criteria for Evaluating Such Efficiency // Bulletin of the RF Ministry for Federal Property Management No.1, 2003, p. 29; estimates by the authors hereof.

Thus, it had been planned to bring the share of minority packages down to 36% (de facto – 30.5%), of blocking packages – down to 22% (de facto – 25.4%). The share of complete packages had been expected at the level of 30% (de facto – 32.6%). The actual number of controlling packages (11.4%) practically matched the estimated target (12%).

By that the obvious misbalance in the favor of packages not providing for the required level of government control inherited from the period of monetary privatization of early 90-ies was successfully eliminated, and the share of minority packages turned out to be even less than the number expected by early 2004. The actual absolute number of JSCs with government-owned packages by mid-2006

approximately matched the estimated number expected after implementation of 2003 Privatization Program.

A more ambiguous situation may be observed when comparing the structure of federally owned packages as of June 2006 with the absolute numbers of 1999 (according to the data presented in the RF State Property Management and Privatization Concept). The major trend here is significant (by 2.8 times) increase of the share of JSCs with 100% government capital, as well as of JSCs with the minority government-owned packages (by 4.5%), while the share of JSCs with different amounts of government capital decreased. The biggest decrease (by 1.9 times) was observed for JSCs with blocking packages owned by the RF government (between 25% and 50% interest), and as for JSCs with controlling government interest (between 50% and 100%), their share has also decreased, even though just by 3%. Having this said, we need to keep in mind, that 1999 data might be incomplete.

However, we may conclude, that the number of reported federal government packages under 25% as of June 1, 2006 (1063 entities) was 1.23 times higher than in 1999, with the maximum falling on early 2002 (2270 entities), after which a stable trend for decrease was being observed (except for H1 2004). The number of federal government packages between 25% and 50% in 2006 (885 entities) was by almost 45% less, than in 1999 (1601 entities), being higher in the beginning of 2002 (1401 entities), than a year before that (1211 entities), and afterwards it was demonstrating a stable decline trend. The number of federal packages between 50% and 100% in 2006 (397 entities) was approximately 15% less, than in 1999 (470 entities), though it was fluctuating within rather extended range during the analyzed period making 646 entities as of the beginning of 2002 and 600 entities as of June 1, 2003, after which this number was decreasing gradually. The number of JSCs with 100% federal government interest in 2006 was circa 3 times higher than in 1999. The minimum number of such JSCs was registered as of the beginning of 2001 (61 entities). Further on it kept growing, and between June 1, 2005, and June 1, 2006, this growth was of somewhat stick-slip nature by 2.8 times (i.e., by 723 entities).

The scale of the “Golden Share Rule” application to control JSCs reached its maximum in early 2003, when in addition 958 JSCs to which it was applied simultaneously with a certain federal government package there also were 118 JSCs without federal government participation (compare: in 1999 there were 580 JSCs to which such Rule was applied, while as in early 2002 – 750 JSCs). In 2003–2004 while the process of selling packages owned by the federal government proceeded, the number of such JSCs was decreasing (591 entities as of the beginning of 2004), however, the number of JSCs to which this special Rule was applied without government having any shares was growing: 284 entities as of March 1, 2005 (the maximum number for the whole period between 1999 and 2006), which is 2.4 times more than as of the beginning of 2003. The share of JSCs to which just the Rule was applied without simultaneous ownership of interest in the overall number of JSCs with the “Golden Share” was also growing: in early 2003 it was 11%, and as of the beginning of 2004 it already was over 42%. However, further on the decrease

in absolute numbers of JSCs to which the special Rule was applied without the government owning a package started to decrease: 243 entities as of June 1, 2006, versus 259 entities a year before (over 6% decline).

The dynamics of the ration between two major sub-sectors of the public sector at the federal level also looks pretty interesting (*Table 10*).

*Table 10*

**Dynamics of decrease of FGUPs and JSCs with packages owned by the federal government during the period of 2003–2006, %**

Period	Federal State Unitary Enterprises (FGUPs)	JSCs with shares owned by the federal government
June 1, 2003, and June 1, 2004	6.5	7.1
June 1, 2004, and June 1, 2005	10.1	3.1
June 1, 2005, and June 1, 2006	13.4	1.6
June 1, 2003, and June 1, 2006	27.2	11.4

*Source:* Federal Property Privatization Forecast Plan (Program) for 2004 and Key Areas of Federal Property Privatization for the period up to 2006; Federal Property Privatization Forecast Plan (Program) for 2005; Federal Property Privatization Forecast Plan (Program) for 2006 and Key Areas of Federal Property Privatization for 2006–2008; Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

As it follows from *Table 10*, the sub-sectors decrease in 2003–2006 was obviously erratic. The FGUPs sub-sector, initially being more extensive, decreased by over 27% in 3 years, while as the sub-sector of JSCs with federal packages decreased only by about 11.5%, i.e., 2.5 less than the FGUPs sub-sector. With that, if both sub-sectors decreased by an almost equal amount between June 1, 2003, and June 1, 2004, during the following years the decline of JSCs with the federal government interest was declining far less rapidly, the gap reaching over 10 times during the period between June 1, 2005, and June 1, 2006.

This data provides strong evidence of the growing process of FGUPs decline during the last several years, including the decline due to the growing scale of their incorporation. Of course, it needs to be kept in mind that the number of unitary enterprises declined not solely due to their incorporation, but also due to their liquidation and merging /aggregation. However, the rate of selling federal stock packages is clearly behind the rate of incorporating FGUPs, and it is due to this fact that the proportion between these two sub-sectors has changed (*Table 11*). The abrupt increase of JSCs with 100% federal government interest (*Table 8*) speaks about the same trend (these JSCs are mostly former FGUPs having been put under incorporation).

As is shown in *Table 11*, the number of JSCs with federal packages made about 52% of the number of FGUPs as of June 1, 2006, while as it was making 42.6% as of June 1, 2003. The same trend can be clearly observed in the industry-based profile. JSCs with federal packages are now constituting a higher percent of FGUPs number practically in every industry, and for industry overall (starting from mid-2005), as well as for forest management (starting from mid-2006) the number

of such JSCs exceeded the number of FGUPs. Inside the material sector the number of JSCs as of June 1, 2006, in metallurgy, chemistry, food processing was 2.5–3.4 times higher than the number of FGUPs, while as in engineering industry this number was practically the same. The non-material sector formed an exception, as its profile has been changed due to establishing the “other industries” category in 2006, so that the entities had to undergo a re-classification to be attributed to that or another sector, resulting in re-distribution of entities between the industries.

*Table 11*

**Ratio between JSCs with government interest and FGUPs in 2003–2006, %**

Industry (sub-sector)	as of June 1, 2003	as of June 1, 2004	as of June 1, 2005	as of June 1, 2006
Nonmaterial sphere	42.6	42.3	45.6	51.9
Industries, incl.	44.0	43.8	18.9	19.6
- engineering	60.7	60.7	111.1	109.1
- engineering	24.8	25.9	25.5	100.5
- soft industry	8.3	7.7	4.6	14.4
- food processing	71.7	65.6	98.2	256.4
- construction materials manufacturing	25.9	25.0	27.9	96.4
- metallurgy	69.4	86.5	82.4	336.7
- chemistry	41.3	41.9	117.9	288.2
- other industries	111.8	111.7	232.6	114.3
Agriculture	3.5	3.5	20.6	39.8
Forest management	25.0	23.1	67.2	186.8
Transport & Communications	45.0	44.0	63.3	64.7
Construction	47.5	46.7	31.8	50.5

*Source:* Federal Property Privatization Forecast Plan (Program) for 2004 and Key Areas of Federal Property Privatization for the period up to 2006; Federal Property Privatization Forecast Plan (Program) for 2005; Federal Property Privatization Forecast Plan (Program) for 2006 and Key Areas of Federal Property Privatization for 2006–2008; Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

The JSCs created through incorporation of state unitary enterprises naturally become subject to government management (the government being the shareholder) in compliance with relevant legal norms and procedures. The duration and the level of government’s participation shall be in such case defined by the timeline of selling the government-owned package, as well as by the scale of this package. It’s worth reminding that in JSCs where all voting shares are owned by the federal government (as a rule, they are former FGUPs), the authority of the General Shareholders Meeting is usually exercised by the RF Agency for Federal Property Management (FAFPM). The GSM Resolution shall be then issued in the form of FAFPM directive. The norms regulating the order and deadlines for preparing, calling and conducting General Shareholders Meetings shall not be observed in such cases.

The government sector profile in the near future will be to a great extent dependent on the degree the privatization program is implemented.

### 5.2.2. Outcomes of 2006 Privatization Policy and Mid-Term Privatization Plans

As it is already known<sup>43</sup>, the Forecast Plan (Program) of Federal Property Privatization for 2004 and Key Areas of Federal Property Privatization until 2006 (approved by the RF Government Resolution No.1165-r of August 15, 2003) stipulated the following algorithm of actions: 2003 – privatization of government-owned packages of stocks comprising up to 2% of charter capital, 2004 – government exit from all companies with government share comprising less than 25% interest, 2005 – government exit from all companies with government share comprising from 25 to 50%, 2006 – government exit from all companies with government share exceeding 50%, which are not qualified as strategic businesses, 2008 – completion of privatizing federal property not being used for carrying out government functions of the Russian Federation. According to this scenario, by 2008 not more than 2,000 FGUPs and 500 different packages should remain under government ownership.

Certain adjustments were then introduced when adopting the Forecast Plan (Program) of Federal Property Privatization for 2005 and for the period until 2007<sup>44</sup>: extension of federal property privatization perspective for 2007; completion of privatizing companies with government share comprising less than 25% interest by 2005; amending the industry-based profile of privatized federal property; introducing the “mid-term financial plan” concept into the federal property privatization planning.

The Forecast Plan (Program) of Federal Property Privatization for 2006 and Key Areas of Federal Property Privatization in 2006–2008 (approved by the RF Government Resolution No.1306-r of August 25, 2005) is even more careful in terms of quantitative indicators. According to this document, the key objectives of government property privatization policy in 2006–2008 are as follows: privatizing federal property not being used for carrying out government functions (authorities) of the Russian Federation, assuring phased reduction of the number of federal state-owned unitary enterprises (FGUPs), accelerating federal property privatization, forming the federal budget revenue basis. In 2006 government-owned stock packages not exceeding 50% of the respective JSCs charter capitals were to be offered for privatization. The limitations were related with excluding JSCs included into the strategic businesses list or participating in formation of integrated organizations, as well as packages of stock to be divested based on the needs of 2006 budget revenues planning and on the needs of mid-term financial plan for the period until 2008.

In reality the major trends of privatization dynamics continued to be the same 2006 (*Tables 12–13*):

- extremely slow process of selling minority (non-controlling) interest still remaining with the government<sup>45</sup>;

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<sup>43</sup> For details see: Russian Economy in 2005: Trends and Outlook. – M., IET, 2006.

<sup>44</sup> The Forecast Plan approved by the RF Government Resolution No.1124-r of August 26, 2004.

<sup>45</sup> According to certain estimates, in 2000-s no more than 10% of the annually offered minority packages were sold. The packages which were not sold during one year would be added to the offer of

- increasing number of JSCs with 100% government interest resulting from acceleration of FGUPs incorporation;
- stable decrease of privatization revenues share in the overall structure of revenues from state property management (in 2003–2006);
- lack of major privatization deals (even though Privatization Plan for 2006 stipulated selling stock packages of at least 2 major companies – 34% “KAMAZ” and 100 % “SG-Trans” with approximate value of RUR 23 billion);
- stable growth and domination of revenues from using state property in the overall structure of revenues from state property management (i.e., renewable sources);
- traditionally low rates of privatizing land plots occupied by privatized companies (see Section 5.3).

Table 12

**Major Federal Property Entities and Privatization Program of 2000-s**

	1999*	2000	2001	2002	2003	2004	2005	2006	2007
Overall number of FGUPs **	13 786	11 200	9394	9846	9275	8820	8293	7178	-
Privatized FGUPs per year:									
- forecast	-	-	-	1652	970	1374	1245	1398	652
- actual***	-	2	5	102	571	517	741	n/a	-
JSCs with the RF government interest**	3611	3524	4407	4 222	4 035	3905	3524	3724	-
Including the following shares in charter capital:									
- 100%	382	61	90	99	124	273	413	1136	-
- 50–100%	470	506	646	589	552	499	474	397	-
- 25–50%	1601	1211	1401	1 382	1308	1183	1093	885	-
- less than 25%	863	1746	2270	2 152	2051	1950	1544	1063	-
- “Golden Share”	580	-	750	958	640	284	259	243	-
Federal stock packages sold per year:									
- forecast	-	-	-	1126	1965	1702	566	1350	927
- actual***	-	87	125	112	630	655	634	n/a	-

\* By the end of each year. 1999 taken as baseline accounting for adoption of State Property Management and Privatization Conception (approved by the RF Government Resolution No.1024 of September 9, 1999).

\*\* Without taking into account the special “Golden Share” Rule. In early 2000-s the overall number of unitary companies made c. 85,000, including c. 20,000 state-owned enterprises and c. 65,000 municipal enterprises. In 1995 government owned at least 15,000–17,000 various stock packages, in 1999 – about 3,100 “fixed” packages and 7,000–8,000 of non-sold packages (in the books of regional government property funds). In 1995 1004 JSC were qualified for the “Golden Share” Rule.

the following year. Thus, 2006 year plan stipulated privatization of 885 FGUPs and 422 stock packages (participatory interest). With this, according to the methodology used for developing privatization plans, the entities having not been sold during the previous (2005) year also needed to be included into 2006 plan, which meant additional 513 FGUPs and 928 stock packages (participatory interest).

\*\*\* Actual data on annual privatization of both stock packages and FGUPs cannot be interpreted correctly for a number of reasons: 1) lack of regularly supplied data supplied by RF Property Management Committee (Rosimuschestvo) and Russian Federal Property Fund; 2) as a rule, from 10 to 50% of deals are closed in different years, and the non-sold packages are “carried over” to the next year; 3) the “counter” process of FGUPs incorporation and other ways to increase the stock packages owned by the government; 4) reorganization going on in energy industry and in communications industry, contributing some of the FGUPs assets into charter capitals of some government holdings, formation of integrated organizations in defense industries, in railway sector, etc. Data on FGUPs privatization are pretty conventional, because official privatization data includes FGUPs about privatization of which *the initial decision* was made or the ones having undergone the stage of transformation into JSCs. That is why the number of FGUPs may be reported higher than in reality. *Source:* data from RF Ministry of Economic Development and Trade, Federal Agency for Federal Property Management.

The share of privatization revenues in the overall budget revenues has been steadily decreasing since 2003. As it is obviously demonstrated in *Table 7*, in 2003 the revenues from privatization deals made RUR 90.6 bln, in 2004 – RUR 61.8 bln, in 2005 – RUR 29 bln, in 2006 – RUR 17.6 bln. That means that annual revenues decrease makes at least 30%. According to the estimates by the Federal Duma Committee for State Property, privatization rates have decreased more than 2.5 times over the last 2 years.

The reasons for the minority government-owned packages of stock not being in big demand are well known: the insiders (the already existing holders of controlling packages) are not interested in buying additional minority packages; for many outside investors it is pretty senseless to purchase a package without acquiring real control; the situations are pretty common when even a 100% package is being offered for auction with the most profitable assets already divested, etc.

As it is known, the major portion of privatization revenues of late 1990-s – early 2000-s were generated by 1 or 2 major deals. Lack of such deals in 2006 was not related only with some objective factors. Indeed, the overall favorable situation with budget revenues (inherent for the effective privatization law), possibility to execute deals based on the general economic situation create favorable environment for flexible approach to execution of various types of deals. In relation with this the refusal from additional (non-renewable privatization) revenues to the federal budget looks pretty justified, especially with all these on-going discussions about the rational ways to use the growing Stabilization Fund.

At the same time sale of 100% of JSC SG-Trans stock (the company’s assets are over 400 real estate entities) did not take place because a whole series of real property in the company’s books (including some land plots) lacked registered titles. In its turn, this has led to almost 50% decrease of direct revenues from privatization in 2006 –RUR 17.6 bln vs. the planned revenue of RUR 31 bln<sup>46</sup>. In all likelihood, there is yet another important factor – an alternative (vs. privatization)

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<sup>46</sup> Press release by Federal Agency for Federal Property Management “On Major Outcomes of Rosimuschestvo Activities in 2006”, December 29, 2006; Interview by V.L. Nazarov, Rosimuschestvo Director, “On Major Outcomes of Rosimuschestvo Activities in 2006”, January 23, 2007, Interfax (www.mgi.ru).

possibility to hand over “SG-Trans” to “Transneft” company together with “Transnefteproduct”.

In a broader context, one of the most fundamental causes for slowdown of privatization process in the Russian Federation over the recent years is the continuing growth of government involvement into Russian economy. On one hand, one of the key tasks for 2006–2008 is creation of at least *appearance* of privatization completion as an element of successful institutionalization reform – selling federal stock packages and transforming the state-owned unitary enterprises sector. The effectiveness of the process – both for the government and for the companies involved – is in this case of a secondary character versus potential political dividend. On the other hand, the on-going property expansion of the government (general economic strategy, a trivial re-distribution of property in favor of those close to the government, or opposition of certain ministries – stakeholders of the process<sup>47</sup>), excludes the most valuable or the most profitable and efficient government assets from privatization process. It is pretty demonstrative that in April of 2006 Yu. Petrov, Russian Federal Property Fund Director, stated that 30 - 40 major government holdings will be formed in strategic sectors of Russian economy as an outcome of privatization process. The key challenges for RF Ministry of Economic Development and Trade (MEDT) being responsible for privatization strategy starting from 2004 are pretty obvious: divestment of non-sellable “non-liquid” assets still remains the key task, however in the situation when the extracting industries have the strongest positions and budget revenues profile corresponds to this fact, it is rather difficult to justify sale of new highly profitable assets. This becomes even more problematic due to no clear understanding of the key areas of spending the accumulated federal budget revenues.

In the next several years we may expect the following change in the structure of non-renewable sources of revenues from state property management: revenues will grow at the expense of favorably located property – land plots that are of interest for the investors. According to the RF Federal Property Fund estimates, currently about 70% of the customers of the privatized land plots (including military towns, etc.) are smaller and medium-size businesses which are actually investing into the under-valued real estate understanding that currently the value of land still isn't being included into the purchasing price of the divested assets, however, new owners of businesses acquire the title for the land as well<sup>48</sup>. It is obvious enough,

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<sup>47</sup> According to the available data (Rosbalt, August 4, 2006), in 2006 different agencies were challenging the privatization decisions with regards of 448 JSCs and FGUPs already included into 2006 plan. Rosavtodor (Federal Agency for Roads – protested against privatization of 148 agencies), RF Ministry of Defense (protested against privatization of 81 entities), Rosenergo (Federal Agency for Energy – protested against privatization of 52 entities) and RF Ministry of Agriculture (protested against privatization of 46 entities) were the most active ones.

<sup>48</sup> Article “Rasprodazha” // “Rossiyskaya Gazeta” newspaper, January 29, 2007. The growing number of released military property assets is also directly connected with land lots: 477 entities were divested during the first 2 quarters of 2006, while during the same period of the previous year only 200 similar entities were divested. Overall amount of 2006 revenues from selling military assets exceeded the 2005 revenues by almost 3 times making RUR 1.41 bln in 2006 vs. RUR 589 mln in 2005.

that some significant reserves for privatization revenues growth are available in relation with optimizing the legal framework of selling land. It is also worth noting that according to some estimates about 70% of real estate still belongs to the government.

In 2005 Rosimuschestvo decided to liquidate 16 FGUPs with over 600 real property sites on their books, including the ones in downtown Moscow. This decision caused some very serious doubts with regards to the feasibility of such liquidation – mainly because of serious risks of the state losing the most valuable sites without adequate financial compensation (e.g., by applying special schemes under which the most valuable assets are at first divested to other entities, and only “empty” legal entities are being publicly offered for sale). In October 2006 this decision was cancelled and 12 FGUPs including the companies managing Moscow real estate are to be merged with some FGUP called “Federal Computer Center for Exchange and Information Technology” (“FT-Center”), the title itself telling that this organization can be focused on practically any task. FGUP “FT-Center” is to be privatized as well, though its privatization has been delayed. Meanwhile, federal real estate shall be functioning within lease agreements. Different from privatization revenues, the renewable revenues sources demonstrate sustainable growth over the whole period of 1999–2006 (*Table 7*). According to the official 2006 data by the RF Agency for Federal Property Management, the total amount of federal budget renewable revenues administered by the Agency made RUR 67.3 bln exceeding similar revenues of 2005 by RUR 10.7 bln. The aggregated amount of distributed dividend made over RUR 23 bln exceeding the respective 2005 amount by 20%. Federal budget revenues from 19 major JSCs with government interest (excluding JSC Rosneft) increased by almost 2006 RUR 4.5 bln in 2006. In 2006 Rosimustchestvo switched to market-based lease rates (for 7507 Federal Property Leasing Agreements). The share of leasing agreements based on the rates calculated according to the “non-market” methodology of the former RF Ministry for Federal Property Management has decreased almost 2 times by the end of 2006. Revenues from leasing federal property including federal land have gone up by almost RUR 2.3 bln, making up to almost RUR 16.8 bln in 2006. The revenues from selling the right to execute leasing agreements for federally owned lands exceeded similar revenues of the last year by over 90%.

Another revenue source is relatively new but already of big significance – this is the revenue from cash recovered by Rosimuschestvo and its territorial divisions through a judicial proceeding on property disputes. During the first 3 quarters of 2006 RUR 2.63 bln were collected (vs. RUR 1.3 bln from the same source in 2005), the share of fully/partially sustained claims making 82.4%.

Even though the renewable revenues sources grew 8 times during the period of 1999–2006, not 100% of them are unimpeachable, which is especially important if we look into the future prospects for such sources growth. The process of switching to the market-based federal property leasing rates is undoubtedly economically feasible. On the contrary, “protection of the property rights of the Russian Federation” should not be focused merely at fiscal objectives of recovering re-

spective cash amounts via property disputes, especially in the context of the general trend towards increased government involvement (and respective application of this mechanism).

Table 13

**Dynamics of Revenues from Privatization and/or Using  
Federal Property, RUR bln**

	1. Non-renewable revenue sources, total	1.1. Privatization	1.2. Selling FGUPs' assets and military assets	1.3. Selling land and non-tangible assets	2. Renewable revenue sources, total	2.1. Dividend (number of companies)	2.2. Leasing property	2.3. Leasing land	2.4. Portion of FGUPs' income (number of companies)	2.5. "Viesovpetro"	TOTAL
1999*	8 547.4	8 547.4	-	-	8 720.5	848.1 (600)	2 191.4	-	-	5 675.0	17261.9
2000	31 367.1	31 367.1	-	-	18 790.1	3 675.1 (1050)	3 427.2	-	-	11 687.3	50157.2
2001	10 110.6	9 990.6	-	120.0	29 122.6	6 478.0 (782)	4 896.1	3 917	209.6 (131)	13 621.9	39233.2
2002	14 700.7	12 703.8	-	1 996.9	36 762.2	10 402.3 (747)	7 657.9	4 400	914.2 (809)	13 388.8	51462.9
2003	95 237.3	90 660**	585	3 992.3	41 143.2	12 395.2	9 573.9	197.3 ***	2 387.6	16 200	136380.8
2004	65 777	61 856.8	662.7	3257.5	53 710,3	17 222.0 (319)	11 928.8	901.7	2 538.1	17 199.5	119487.2
2005	34 882	29079.2**	522	5280.8	54 404	18 610	14 170	1 748	2 386	17 490	89 286
2006 plan	31 600	31 000	600	n/a	53 052	20 500	16 700	2 000	2 500	11 352	84 652
2006 actual	19 010	17 600	1410	n/a	67 363,6	23 000	16 800	n/a	n/a	n/a	Over 86 000
2007 estimate	49 000	41 000	N/a	8 000	73 921,5 ****	24 080	17 600	4 000	15 425	12 816,5	Over 120 000

\* 1995–2002 dynamics is found in: Russian Economy in 2002: Trends and Outlook. – M., Institute of Transition Economy, 2003, p. 367.

\*\* Revenues from selling 74.95% JSC "Slavneft" stock for the amount of RUR 59 161.95 mln in 2002 were included into 2003 revenues (over 60% of all received revenues). Revenues from selling 17.8% JSC "Magnitogorsk Metallurgic Plant" stock for the amount of RUR 21 928.2 mln in 2004 were included into 2005 revenues (over 60% of all received revenues).

\*\*\* Revenues from leasing federal land after demarcation. In the following years the line "Lease payments and revenues from selling the right for executing the lease agreements for federal land" is accounted.

\*\*\*\* Only those renewable sources are accounted here, which directly relate to managing federal property (administered by the RF Agency for Federal Property Management). According to the RF Law "On Federal Budget for 2007", total estimated revenues from using federal property should make RUR 100 bln in 2007 including, on top of the listed sources, revenues from balances on federal budget accounts, government loans interest rates, revenues from remitting a portion of the RF Central Bank income, etc. There is one significant revenue source, which was not included into Table 13, but still has substantial weight in the overall revenues amount – "revenues from leasing property managed by federal government agencies and their establishments or/and under economic jurisdiction of federal state unitary enterprises (FGUPs)" (overall RUR 16.6 bln).

Source: statistics of RF Ministry for Economic Development and Trade, RF Agency for Federal Property Management, RF Law "On Federal Budget for 2007", estimates by the authors hereof.

Obvious reduction of federal budget revenues from JV “Vietsovpetro” activities also leads to certain questions arising: the actual decrease in 2005 made RUR 17.5 bln, and the planned decrease for 2007 is by RUR 12.8 bln (given current favorable situation at the energy market). Russian share in JV “Vietsovpetro” was contributed to the charter capital of JSC “Zarubezhneft” in 2006 (100% Russian Federation property). Respectively, starting from 2008 the federal budget from JV’s activities should have been transformed into “Zarubezhneft” dividend payments (in case the decision on pay-out was positive).

The dividend policy of Rosimustchestvo is the biggest question. As it is known, current government policy in this sphere (given the lack of uniform dividend policy with regards to government holdings) means merely annual increase of net profits share allocated to dividend payouts. In 2004 this share made at least 10% (the minimum as per the RF Law “On Joint-Stock Companies”), in 2005 – at least 20%, in 2006 increase up to 25% minimum is expected. Contrary to the previous years, there may be a significant novelty of Rosimustchestvo requiring calculation of dividend amount as a consolidated profit share<sup>49</sup>.

The issue here is feasibility of increasing dividend payouts at the request of government shareholders, especially in the situation of a big challenge to find relevant funding sources for large-scale investment programs of major government holdings, especially infrastructure-related ones, while as 2006 budget has a surplus. On one hand, representatives of such holdings together with some experts believe, that higher dividend paid to the government impedes production growth and companies’ capitalization. On the contrary, the position of Rosimustchestvo is in using cheap credit for up-grading the production, which, first of all, improves the company’s discipline, and secondly – justifies government participation in managing these assets. Nevertheless, Rosimustchestvo understands the fact that some organizations have all relevant legal grounds to “decrease the paid amount of dividend by the amount allocated for capital projects”<sup>50</sup>. This is especially relevant for such organizations as Gazprom and Rosneft, which in addition to their investment programs are also active players at corporate control markets.

In 2007 and 2008 privatization revenues according to the optimistic forecast of Rosimustchestvo and RF Ministry of Finance shall make RUR 49 and 52 bln respectively. These monies together with estimated revenues from selling “Gokhran” (State Depository for Precious Metals) resources (RUR 4 bln in 2007 and in 2008) shall be allocated to redeem internal and external government debt of the Russian Federation, as well as to compensate losses of 1991 to Sberbank investors.

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<sup>49</sup> In state-owned companies such as Rosneft which have not consolidated their subsidiaries the practice of dividend calculation based on the amount of non-consolidated profit of the parent company using Russian accounting standards is common. Transneft, for example, having showed in 2004 consolidated profit in the amount of RUR 1.43 bln according to International Financial Reporting Standards (IFRS) disclosed the amount of parent company’s profits of RUR 5 bln when re-distributing profits among the subsidiaries, in 2005 this amount made RUR 4.61 bln, for 9 months of 2006 – RUR 3.95 bln (Vedomosti, December 25, 2006).

<sup>50</sup> Interview by V.L. Nazarov, Rosimustchestvo Director, “On Rosimustchestvo Performance in 2006”, January 23, 2007, Interfax ([www.mgi.ru](http://www.mgi.ru)).

Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009 approved by the RF Government Resolution No. 1184-r of August 25, 2006, similar to the previous analogous documents, states that during the period of 2007–2009 stock packages of JSCs established within incorporation of FGUPs will be offered for sale, with the exception of packages of JSCs included into the list of either strategic JSCs or those participating in forming integrated structures.

The following packages will be proposed for privatization in 2007:

- stock packages not exceeding 50% of charter capital of the respective JSCs, with the exception of packages of JSCs included into the list of either strategic JSCs or those participating in forming integrated structures, as well as stock packages which will be sold based on the need to form the revenue part of 2007 budget and for the period up to 2009 in compliance with the mid-term financial plan;
- stock packages of JSCs of fuel-and-energy complex, energy-and-construction complex, construction complex, foreign trade organizations, civil aviation, healthcare, chemical, petrochemical and polygraph industries, geology, fishery, poultry industry, crop production, cattle production, timber complex, medical industry, as well as mechanic engineering JSCs (with the exception of strategic ones);
- federal state unitary enterprise of automotive in car building, road facilities, construction complex, civil aviation, geology, oil and gas complex, fuel industry, sea and river transport, polygraph industry, healthcare, crop production, poultry and cattle production;
- property of the RF treasury not required for implementation of government functions.

The following major federal property entities are planned for privatization in 2007: JSC “VO Stankoimport”, “Moskovsky Metrostroy”, “Airport Salekhard”, “Ufa International Airport”.

Work on establishing integrated organizations in defense industry, aviation, ship-building, nuclear and aerospace industries will be continued in 2007–2009. All FGUPs not engaged in performing government functions of the Russian Federation, as well as stocks of JSCs established during incorporation of FGUPs will be offered for sale in 2008–2009.

To which extent and for how long government will remain a shareholder will depend on the success of selling 100% packages. With respect to this the privatization program for 2007 looks more than ambitious, especially given the background of actual privatization outcomes of the previous years (*Table 14*).

As *Table 14* obviously displays, 2007 privatization program stipulates an abrupt shift in federal stock packages sales towards “full-sized” packages (100% interest), the share of which shall be over 86%. What is meant here are probably packages having appeared after noticeable increase of the rate of FGUPs incorporation. This number leads to many questions, especially after analyzing 2005 performance, when only 51 “full-sized” packages were sold (making less than 10% of

the total number of sold packages). It is also a big surprise to see sharp reduction of the share of minority packages planned for sales, considering that they constituted the major share of all packages sold in 2001 and in 2004 - 2005. It's worth remembering that as of June 1, 2006, federal government owned 1063 packages with up to 25% interest. It made over 30% of all federally owned packages.

Table 14

**Dynamics and structure of selling federal stock packages based on their size: actual data of 2001–2005 and 2007 privatization targets**

Year	Total		up to 25%		Between 25% + 1 share and 50%		Between 50% + 1 share and 100 % - 1 share		100 %	
	entities	%	entities	%	entities	%	entities	%	entities	%
2001	125*	100	78	62.4	45	36.0	2	1.6	**	...
2002	112*	100	51	45.5	56	50.0	5	4.5	**	...
2004	565	100	406	71.85	119	21.05	34	6.0	6	1.1
2005	521	100	360	69.1	81	15.5	29	5.6	51	9.8
2007	911	100	87	9.5	27	3.0	12	1.3	785	86.2

\* – accounting for the outcomes of sales announced one year before, but the results were summarized only in that year;

\*\* – data on 100% packages sales were not highlighted, they were accounted for within the category “50% and above”.

Source: data from departmental website [www.mgi.ru](http://www.mgi.ru); Yu.M. Medvedev, RF Ministry for Property Management and its Territorial Branches Performance in 2002, objectives for 2003 // Bulletin of the RF Ministry for Federal Property Management No.1, 2003, p. 36; Materials for RF Government session on March 17, 2005, “On Measures to Improve Federal Property Management”; Report by RF Agency for Federal Property Management “On Federal Property Privatization in 2005” – M., 2006; Federal Property Privatization Forecast Plan (Program) for 2007 and Key Areas of Federal Property Privatization for 2007–2009; estimates by the authors hereof.

In addition to stock packages, 911 JSCs shall be privatized, as well as 7 packages of state-owned closed corporations (CJSCs) plus 233 entities of other federal property.

It is also worth noting that for the first time airports (in Ufa and in Salekhard) were among major federal property entities offered for sale, which, on one hand, means obvious depletion of reserves of significant government assets in traditional production sphere, on the other hand – it is within the streamline of government effort in infrastructure development including projects co-financed by private investors.

In addition to Ufa airport the list of RF Aviation Agency contains the following assets planned for liquidation, reorganization or divestment: airport Pulkovo (St.-Petersburg), International Nizhny Novgorod airport, Magas airport (Ingushetiya), Komsomolsk-na-Amure airport, Yuzhno-Kurilsk airport (Sakhalin Oblast), Stary Oskol airport (Belgorod Oblast), Irkutsk airport, Mama airport (Irkutsk Oblast), Sakhalin Okha airport, Magadan airport, Uray airport (Khanty-Mansy Autonomous District), Shakhtersk airport (Sakhalin Oblast), Ulianovsk airport, Leshukonskoye airport. According to certain sources, airports of Ufa and Nizhny Novgorod are for sale, and the majority of the above listed airports shall be transferred to regional governments. Pulkovo airport in St.-Pete is of special concern, the city government

wants to have 50% of its shares. However the decision is still not made with regards to the size of the package and the scheme of payment<sup>51</sup>.

There already have been some precedents of transferring regional airports to regional governments. Back in late 1990-s the blocking package of International Samara airport (25.5%) was among the sold packages. And in 2003 60.88% shares of Vnukovo airport (the 4<sup>th</sup> biggest in the country from the passenger traffic flow point of view after Domodedovo, Sheremetyevo and Pulkovo), became the property of the city of Moscow to compensate for the capital functions costs. Such transaction launched the airport development program funded both from the city budget and from external alternative sources.

In relation with including airports into 2007 privatization program it is also worth mentioning that one of the biggest recent privatization deals was acquisition of 100% package of Sochi airport at an auction in November 2007. The acquisition was made in the name of Strategiya-Yug LLC for the amount of RUR 5.503 bln (the starting price being RUR 3.504 bln). Strategiya-Yug LLC is believed to be an affiliated entity of “Bazovy Element” company which controls Southern Airports Holding through Russian-Asian Investment Company. This Holding already owns a whole series of core assets: Kuban Airlines, Krasnodar International Airport (having been previously divested from Kuban Airlines), Kuban Territorial Air Communication Agency, and Yugairstroy. In addition, Southern Airports Holding controls Anapa airport<sup>52</sup> and is operating construction of a new airport in Gelendjik.

Acquisition of Sochi airport is quite streamlined with the increasing business activity of “Bazovy Element” in Southern Russia, in particular, it is associated with the estimated increase of passenger traffic to the Black Sea Coast and with Russia submitting an application for 2014 Winter Olympics to be held in Sochi. This event requires completion of Sochi airport reconstruction (frozen up back in 1989), which in its turn will require investment of circa \$100m scale.<sup>53</sup>

“Bazovy Element” is not the only company seeking acquisitions in airport business. For example, “Renova” company owns 45% stock of Koltsovo airport (Yekaterinburg), and Moscow River Navigation Company (through Eurasian airport company) owns 42% stock of Tolmachyovo airport (Novosibirsk) and 48% stock of Altai Aviation Company. Just like Anapa airport, Koltsovo and Tolmachyovo airports belong to the list of strategic JSCs. However, in Koltsovo the government share (34.56%) is less than that of private shareholders, but in Tolmachyovo the government is a majority shareholder (51%). Similar interest is reported towards Khabarovsk airport on behalf of Alliance Group, as well as the project to merge Yemelyanovo and Cheremshanka airports (Krasnoyarsk Krai) into a single transportation hub (this last one being initiated by AirUnion Holding created on the basis of KrasAir

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<sup>51</sup> Time to Build Airports // SNiP (Construction Norms and Specifications). Construction. Real Estate. Investments. Projects, N 02 (02), December 2006, pp. 18–22.

<sup>52</sup> Anapa airport was included into the list of strategic JSCs (government share in charter capital constitutes 25.5%).

<sup>53</sup> A. Dmitriev Targeting the Olympics // SNiP (Construction Norms and Specifications). Construction. Real Estate. Investments. Projects, N 02 (02), December 2006, pp. 28-30.

company, 55% shares of which will belong to private investors, and 45% – to the government).

According to some estimates, the reason for such growing interest on behalf of Russian business towards investing into major airports (with the “hub” capabilities) during the recent several years<sup>54</sup> is competition for the budget money planned to be allocated for their up-grading and construction (primarily, of their airfield component, such as in Koltsovo, Sochi, Gelendgik)<sup>55</sup>.

However, private business participation in developing airports is not limited just to buying their stock. There may be an alternative of renting the respective asset. In this relation another important event needs to be mentioned: amicable agreement between East Line Group and Rosimuschestvo about Domodedovo airport lease was settled in October 2006. This was a resolution of three-year conflict having grown into litigation proceedings. The achieved settlement confirms the previously agreed lease term (75 years starting from 1998 – the year when the Lease Agreement was executed), under the condition of over 30-times increase of the annual rent (from RUR 3m up to RUR 92m) and the option of reviewing this amount every 5 years.

In the context of successful Domodedovo airport development (in which private investment plays a very significant role) the situation with construction of a new (Third) terminal at Sheremetyevo airport appears far less satisfactory. This project is managed by JSC “Terminal”, which used to be fully owned by Aeroflot until very recently. Meanwhile government representatives (RF Ministry of Transportation) in the company management were consistently against Aeroflot implementing this construction project. However, in 2005 the company was able to raise funds in the amount of \$150m loan, 2/3 of which was allocated for Sheremetyevo-III construction. Then due to the change in Aeroflot management and disagreement of government representatives this project was frozen up. In the summer of 2006 Vneshtorgbank became the owner of the blocking package (25% + 1 share) of JSC “Terminal”, another package of 20% (minus 2) was acquired by Vnesheconombank, which allowed to open two more credit lines for the project. After the expected sale of yet another blocking package of shares to Sheremetyevo International Airport Aeroflot will no longer be the majority shareholder of JSC “Terminal”. However, the deal between Aeroflot and Sheremetyevo International Airport has not yet been closed, even though the majority shareholding of the biggest Russian airline and 100% package of Sheremetyevo airport both belong to the government<sup>56</sup>.

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<sup>54</sup> International understanding of a “hub” is that of new airport with a significant amount of international and domestic airlines, providing immediate connections for the passengers and operating in compliance with up-to-date standards infrastructure and ground service standards.

<sup>55</sup> The owners of airports plan to invest hundreds of millions USD into their modernization // SNiP (Construction Norms and Specifications). Construction. Real Estate. Investments. Projects, N 02 (02), December 2006, pp. 24-27.

<sup>56</sup> In early 2004 Alfa-Sheremetyevo was selected as the managing company for Sheremetyevo airport based on the tender outcomes, despite the fact that Inter-Terminal LLC set-up by Aeroflot and its private shareholder (National Reserve Bank) participated in that tender.

### 5.2.3. Major Government Corporations' Activities

The most significant event of 2006 with regards to major government corporations' activities at the merges and acquisitions market<sup>57</sup> was FGUP Rosoboronoexport purchase of 66% stock of the leading titanium (30% of global production) and magnesium manufacturer JSC VSMPO-Avisma<sup>58</sup> (transaction value making \$700m). The fact of Oboronprom (subsidiary of Rosoboronexport) acquiring control over electric engineering plant LEPSE (city of Kirov), the latter being one of the biggest Russian manufacturers of electrical equipment for defense and automotive industries, stayed in the shade of the VSMPO-Avisma deal.

Further Rosoboronexport expansion plans may be related with metallurgy, and not just Russian metallurgy. In the summer of 2006 Rosoboronexport management raised an issue about the feasibility of setting-up a state-owned holding – a monopolist in the field of alloy-steel manufacturing. In early 2007 the “grandchild” of Rosoboronexport – “Russpetzstal” LLC acquired 00% of JSC Metallurgic Plant “Krasny Octyabr” (city of Volgograd). The following assets are named among its possible future acquisitions: Chelyabinsk metallurgical plant (JSC Mechel), Zaporozhye titanium and magnesium plant (Ukraine), Volnogorsk and Irshansk mining-and-processing integrated plants (Ukraine), such metallurgic plants as Electrostal (city of Electrostal in Moscow region), Serp-i-Molot (Moscow), which manufacture special alloyed steel for defense industry<sup>59</sup>.

Such activities of Rosoboronexport as accumulation of controlled assets, diversification of its sector profile due to different types of activities of the acquired enterprises (helicopter industry, metallurgy, automotive and defense industries) may provide incentives for possible reorganization of Rosoboronexport itself, which may take the form of setting-up a 100% state-owned managing company. Then the controlled assets including Rosoboronexport (being an organization with the monopoly rights for foreign cooperation in defense and technology) may become the subsidiaries of this newly established managing company. Some of the subsidiaries in future may issue additional stocks<sup>60</sup>.

At the same time a number of serious events relating to state-owned fuel-and-energy companies need to be mentioned. At the end of 2006 JSC Gazprom announced its plans to develop Shtockman gas field in the Barents Sea independently (without participation of foreign capital) and acquired 50% + 1 shares of Sakhalin Energy being the operator of Sakhalin-2 project for \$7.45 bln. With this the interest of other project participants is being decreased almost two times: for Shell – from

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<sup>57</sup> See also paragraph about major corporate events of 2006 in Section 2.4.3 hereof.

<sup>58</sup> In 1998 the controlling interest in JSC Avisma (city of Berezniki, Perm region) was acquired by Verkhne-Saldinsky metallurgic production association based in Sverdlovsk Region, upon which the two companies practically integrated.

<sup>59</sup> K. Friskin. *Chebol Russian Style // Kompaniya*, No.48–49 (444–445), December 25, 2006, pp. 22–31.

<sup>60</sup> [www.lenta.ru](http://www.lenta.ru), January 26, 2007

55% down to 27.5%, for Mitsui – from 25% down to 12.5%, for Mitsubishi – from 20% down to 10%<sup>61</sup>.

Rosneft performed IPO in 2006 which was recognized as pretty successful one (being the major IPO in Russia and the 5<sup>th</sup> biggest globally as of the moment of issue). Maintaining the government's qualified government's controlling interest of 75% (through JSC Rosneftegas) Rosneft distributed about 15% shares for the overall amount of \$10.4 bln at the selling price very close to the highest ceiling (\$7.55)<sup>62</sup>. Based on IPO outcomes Rosneft's capitalization (\$80 bln) has now turned it into the biggest petroleum company in Russia.

Nevertheless, the key (and a very special one) success factor was the fact of major investors counting on Rosneft's production capacity increase at the expense of YUKOS assets (YUKOS being engaged into bankruptcy procedure in 2006)<sup>63</sup>. Due to its administration resource Rosneft is assumed to become the main beneficiary when the key YUKOS assets are being distributed (and it might get at the underestimated price). The "political element" in the success of Rosneft's IPO provided for the fact that contrary to many other companies<sup>64</sup> Rosneft's quotations did not go down significantly. According to some sources, underwrites supported Rosneft's shares after IPO.

This special "proximity" of Rosneft to Russian power authorities provides for certain potential prospects. At the end of January 2007 V. L. Nazarov, Director of the RF Agency for Federal Property Management spoke about the possibility for yet another distribution of 25% package (c. \$20 bln worth)<sup>65</sup>, however, this statement was almost immediately disowned by the RF Minister for Economic Development and Trade G. O. Gref (who supervises the RF Agency for Federal Property Management). At the same time, according to some experts, such controversy confirms the fact of increasing the efforts aimed at turning the maximum possible share of government interest in Rosneft into private property before March 2008 with future legalization beneficial for a pretty limited number of individuals.

Based on 2006 IPO outcomes the following foreign petroleum companies became Rosneft's minority shareholders: Petronas (Malaysia, \$1.1 bln), BP (UK, \$1

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<sup>61</sup> E. Samedova., O. Gavshina: Gazprom will divide Sakhalin by 50% // Gazeta, December 22–24, 2006, p. 1.

<sup>62</sup> The IPO proceeds may not be regarded as privatization revenues because the formal Rosneft privatization was performed in 2005 when the RF Agency for Federal Property Management contributed 100% - 1 share of Rosneft into the charter capital of JSC Rosneftegas. Accordingly, the proceeds may be allocated to redeem the loan received by Rosneftegas to pay for the acquisition of Gazprom shares (10.74%).

<sup>63</sup> According to Bank of Moscow estimations, the "fair price" for Rosneft shares considering its financials and OGIP-in-place profitability index should be at the level of \$5.7 per share (if future "premium" acquiring YKOS assets is not taken into account). One also needs to pay attention to a major debt still incurred by Rosneft and lack of investors' confidence in Rosneft being capable of quickly implement its plans of increasing own production up to 100 and more mln tons. See: A. Vinkov, I. Rubanov. Insider among the insiders // Expert, 2006, No.28, pp. 20–22.

<sup>64</sup> By the end of 2006 shares of 10 Russian companies (out of total 34 companies having performed IPO) were sold below the placing price.

<sup>65</sup> Interview to Intefax on January 23, 2007, www.mgi.ru

bln), CNPC (China, \$500m). According to certain estimates, companies either controlled by the RF government or very close (loyal) to the government contributed at least \$3.5–4 bln (Sberbank, Gazprombank, Millhouse Capital and others viewed as long-term strategic investors). On the contrary, institutional investors (investment trusts, mutual funds, etc.) are oriented towards primarily high returns so they did not participate in the buy-out. Contrary to strategic investors for the institutional ones over-estimated shares, corporate governance problems and the level of government control were the key negative factors.

That said, over 115 thousand of private individual investors subscribed for Rosneft shares (\$700m). Some analysts<sup>66</sup> are pretty ambitiously connecting this event with the beginning of the “third wave” of citizens’ financial activity over the 15-year period of market-oriented reforms (after financial pyramid schemes of the early 1990-s and investing into commercial banks during the period preceding 1998 crisis). What is meant here, is that relatively big groups of citizens in the environment of US Dollar rates going down, relatively low interest rates on bank deposits, inaccessibility and high risks of real estate investment (including participatory construction of housing) are ready to convert their accumulated savings into secondary market securities. These citizens are usually oriented towards long-term possession of such securities and prefer lower proceeds with higher level of guarantees, which may be achieved due to direct ownership of shares (without any intermediaries or joint investment schemes). They also prefer shares of companies with high level of government participation viewing it as an additional guarantee securing their investment. On the other hand, the companies with a big number of private individual investors (citizens) due to additional issues of securities acquire the opportunity to use this fact as the grounds for government aid in case of various financial cataclysms.

Such attitude creates certain prospects for additional issues by Russian companies in future. The proceeds from government-controlled Sberbank IPO (3.5 mln shares) scheduled for early 2007 are estimated on the level of \$11.9 bln. According to the RF government Resolution the RF Central Bank is entitled for the preferential right to acquire 892 601 shares (making c. \$3 bln or RUR 80 bln), which will mean reducing its share down to 55.34%. At the same time the IPO amount (and the estimated price per share) is such, that potentially the share of individual private investors will not exceed the “quota” of Rosneft individual private investors (c. \$750 mln).

One can already notice certain consequences of Sberbank’s shares placement. First of all, such a significant amount will have a negative impact on the other IPO issuers. As per some estimates, IPOs of “Cytronix” and “Polymetal” companies (the last one with some very good estimated IPO potential) that took place in February 2007 did not find adequate demand on behalf of investors, which were at that time awaiting for Sberbank IPO and were withdrawing from other market segments. In the short-term, the deficit of financial resources caused by Sberbank IPO can impact IPO of electric power company OGK-3 (March of 2007) and of state-owned

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<sup>66</sup> V. Sednev, People’s Capital and exchange markets. [www.opec.ru](http://www.opec.ru), November 28, 2006

Vneshtorgbank (May 2007), which would require concentration of investors' funds at the expense of less attractive assets. Secondly, organizations closely associated with the government are increasing their activity in revising oil-and-gas portfolios in favor of Sberbank. According to certain estimates, RF Central Bank bought out c. \$8 bln at the exchange in February 2007, of which a significant portion was offered by Gazprombank<sup>67</sup>. One may assume that the eventual (post-IPO) structure of Sberbank's assets will not be significantly different from the current one with regards to direct or indirect domination of the government – or government-controlled organizations.

As it has already been mentioned above, the first IPO of other key financial institutions of Russia – Vneshtorgbank (with 99.9% federal government interest) is scheduled for May 2007. The participation of this bank in current expansion of the government's ownership (besides issuing loans or direct participation in transactions with ALROSA shares and in acquisitions by Rosoboronexport) is directly linked to the government's effort to increase its presence in the banking sector, e. g., acquisition of Promstroybank (St.-Petersburg).

It is assumed that during Phase 1 Vneshtorgbank will be offering about one fourth of its charter capital (22–23%) within the limit of RUR 90-120 bln. The ration between domestic and foreign market should be based on parity principle (50 to 50%), and the share of individual private investors (RF citizens) may make up to 15% of the overall IPO amount. Additional issue is planned for 2010 in the amount between RUR 210 – RUR 250 bln, which will reduce the government's share down to just controlling interest (50% + 1 share). Similar to Sberbank, the optimistic estimate of Russian individual private investors is up to \$700m, but it will be possible to say that Vneshtorgbank IPO is “for the people” only in case ideological objectives are set. It is especially difficult to forecast the situation after 2008 (considering the politics-and-business cycle).

A new aspect of electric power sector reform is currently being implemented by RAO EES (Energy Systems of Russia) related to new issue of shares by a number of power generating companies. In the fall of 2006 the management of RAO EES Holding announced significant success of the first additional issue of shares – 14.4% shares of generating company OGK-5<sup>68</sup> were placed at the market allowing for raising \$459m for investment purposes. At the same time the Holding is not rejecting other sources for capital investment: company revenues, loans, direct private investment including those based on the outcomes of divesting a number of power generating companies<sup>69</sup>.

Because the additional issue of shares by the companies having emerged due to reorganization means much more smooth and moderate option of admitting private capital into this sector, the issue of future distribution of subsidiaries' and af-

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<sup>67</sup> See: Kommersant, January 31 and February 9, 2007.

<sup>68</sup> Main body of OGK-5 are Konakovskaya (Tver oblast) < Nevinomysskaya (Stavropol krai), Reftinskaya and Sredneuralskaya (Sverdlovsk oblast) hydro electric power stations.

<sup>69</sup> Thus, in October 2006 12 percent of shares of Petersburg generating company, which belongs to “Lenenergo” were sold.

filiated companies' capital upon additional issues of shares remains very important and still controversial, as well as the issue of maintaining the level of participation by RAO EES and its shareholders (one of them being the RF government). In relation with this it's worth reminding that according to initial sector restructuring plans (upon RAO liquidation), the government wanted to keep packages of 75% interest + 1 share both in Federal Distribution Company and in the System Operating Company, as well as controlling interest in generating company created on the basis of hydropower industry assets. In order to bring the government's share in the above mentioned companies up to the planned level, direct budget investment or contribution of other assets will be required.

The RF government decision (made in November 2007) about gradual raise of gas and electric power prices in Russia over the next several years will have a significant impact over financial and economic situations of both Gazprom and RAO EES in the mid-term perspective. The forecast approved by the government stipulates price increase for gas by 15% in 2007, by 14% in 2008 and by 13% in 2009. The dynamics of energy tariffs growth will respectively be 10%, 9% and 8%.

Given these assumptions alongside with the global energy prices dynamics will in many aspects define the potential activities of state-owned corporations in fuel-and-energy sector at the M&A market. In 2006 some Russian media marked the interest of Rosneft towards Surgutneftegas,, of Gazprom – towards TNK-BP, subsidiaries of RAO EES and Svyazinvest. Gazprom has already undertaken some limited participation in buy-out of the above mentioned issue of OGK-5 shares. At the same time it was announced that Gazprom was to buy additional issue of Mosenergo shares for the amount exceeding \$2 bln, scheduled to be completed in the spring of 2007.<sup>70</sup> We need to add here that Gazprom is already the holder of the blocking interest in Mosenergo.

Critical situation emerged at the alcohol market upon enactment of the RF Law "On Government Regulation of Distribution of Alcohol Beverages and Alcohol-Containing Products" due to temporary shut-downs of many manufacturers caused by the deficit in excise duty stamps and by the consequences of launching the Uniform State Automated Information System. Under these circumstances the issue of government monopoly was raised again which may require setting-up of State Alcohol Company (SAC).

FGUP "Rosspirtprom" has made a decision to manufacture the so-called "vodka for the people". The Rosspirtprom-branded vodka is to be sold at the price nit exceeding RUR 60 per half-litre bottle. The factory price will nit exceed RUR 53 at the factory gate which according to the company representatives will include just taxes and production cost. However, "Rosspirtprom" has even greater ambitions. They decided to improve the "vodka for the people" slate by introducing such popular brands as "Khlebnaya", "Pshenichnaya", "Rzhanaya", "Kedrovaya", "Solo-

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<sup>70</sup> A. Podymov, Plus Gasification of the Whole Country // *Finansovy Kontrol*, December 2006, No.12 (61), pp. 144–145.

dovaya". According to some experts, this may result in restructuring of this market segment as many manufacturers are weakened by the previously described crisis<sup>71</sup>.

Let us remember here that FGUP "Rosspirtprom" having been established back in 2000 currently administers the stock packages of more than 200 spirit-making and liquor factories (as of the beginning of 2003 – 118 entities). FGUP-controlled factories account for over 1/3 of all legal alcohol manufacturers in the country and control over 45% of spirit production and 26% of vodka/liquor production in Russia. The annual turnover of FGUP "Rosspirtprom" is estimated to make over \$2 bln. Its business activity during the recent years was recognized as very inefficient (in particular, very high volumes of illegal alcohol products at the market may be regarded as a proof), government introduced fiscal claims against this FGUP (including those for non-payment of dividend), FGUP lost a number of valuable assets and some of entities controlled by it were put under bankruptcy proceedings.

The course towards forming integrated organizations continued by way of merging different government assets. After quite lengthy discussions on the matter, the Presidential Decree No.140 of February 20, 2006, initiated the set-up of United Aviation Corporation (UAC) which will integrate manufacturers of both defense and civil aircrafts. The government will have at least 75% interest in this newly established JSC. Start of the new company management operations was announced in November. Similar to many already existing corporations of national scale (Gazprom, Rosneft, RZhD [Russian Railways]), UAC Board of Directors will be headed by some top-level government officials (S. B. Ivanov, Vice-Prime Minister and Minister of Defense), and the managers of integrated assets will be engaged in daily operations of UAC. The former Director and co-owner of "Irkut" company A. Fedorov was appointed UAC President.

Prior to being integrated into UAC "Irkut" (the former Irkutsk aviation producing association) used to be the biggest non-government corporation<sup>72</sup> in Russian defense industry specializing throughout the most recent years on exporting "SU" family aircrafts to Asian countries. It was able to acquire controlling interest in Taganrog aviation research and production complex named after Beriev, and in Yakovlev OKB (pilot design bureau) being specialized on exporting military aircrafts. There is a lot of evidence that "Irkut" together with "Sukhoy" aviation complex (with 100% government interest) are to become the most valuable UAC assets.

Deloitte & Touche – SNG performed the assessment of "Irkut" assets resulting in \$940m only), while "Sukhoy" corporation was evaluated on the level of \$2.2 bln. This assessment outcome is far more modest than it was expected to be, meaning that "Irkut" cannot claim more than 20% interest in UAC. Presumably in the spring of 2007 "Irkut" shareholders may be offered to exchange their shares with those of the newly created UAC or buy them out at some fixed price. Deloitte &

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<sup>71</sup> What Will "Vodka For the People" Lead To? // www.rian.ru, November 22, 2006.

<sup>72</sup> The government does not directly belong to "Irkut" shareholders, one of the minority shareholders of "Irkut" is state-owned "Sukhoy" aviation complex.

Touche assessment results will most likely serve as the basis for defining the buy-out price. And in the light of all this appointment of A. Fedorov to the top executive position of UAC may be regarded as a compromise required for integrating “Irkut” into this new corporation<sup>73</sup>.

Overall in the context of this aviation industry assets integration the government allocated additional funding to this sector in the amount of RUR 36 bln, because the current assets value (RUR 60 bln) was recognized as insufficient. The published UAC assets valuation made then \$96 bln.

Setting-up UAC is scheduled for completion in the spring of 2007. It is also worth noting that adjacent enterprises manufacturing engines, equipment, etc. are not planned for integration with UAC. That is why we should recognize as most likely future creation of core integrated companies such as Avionika Group on the basis of existing research-and-production center “Technocomplex” (developing airborne equipment for defense and civil aviation, ground control systems to support operation of such complexes).

Currently the government has much less capacity for integrating companies with mixed capital compared to the period of 1992–1994, when it owned a significant (and in some sectors – the main) bulk of assets and the share capital profile was undergoing its formation stage. Currently the government is either a minority shareholder in many of such companies or owns a blocking package, which significantly decreases its control and management capabilities. Thus, out of total 9 aviation JSCs federally owned packages of which are to be contributed to UAC charter capital, only in 4 cases we can speak about packages exceeding 51% (including “Sukhoy” bureau 100% shares of which belong to the federal level<sup>74</sup>), in 2 companies, however, the federal share makes 38%, and in other 2 companies – 25.5%. This said, shares of 13 companies (including the above mentioned Taganrog aviation research and production complex and Yakovlev OKB) may be regarded as a contribution from government-owned shareholders. In 5 companies out of those 13 federal packages are contributed as government’s input into UAC.

In early 2007 the law was approved allowing the creation of a major state-owned company based on the civil assets of Russian nuclear power sector with 100% government interest. United integrated company “Atomenergoprom” will become a complete-cycle corporation including uranium mining, production of fuel for nuclear power stations (NPS), energy generation, construction of NPS in Russia and abroad, nuclear engineering, R&D. The No.1 candidate for integration into “Atomenergoprom” “Atomenergoprom” is a 100% state-owned company producing fuel elements and being a majority shareholder of a whole series of core enterprises including Electrostal nuclear engineering plant (Moscow region), Novosibirsk chemical concentrates plant, Priargunskoye chemical-mining association (Chita region). In future “Rosenergoatom” association uniting all Russian NPSs +

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<sup>73</sup> K. Frumkin, *Chebol Russian Styleи // Kompaniya*, No.48–49 (444–445), December 25, 2006, pp. 22–31.

<sup>74</sup> 100% shares of 2 JSCs created by way of transforming FGUPs (MiG and Kazan aviation production association named after S.P. Gorbunov) are also being contributed to UAC charter capital.

core R&D and design institutes may be integrated into the new Holding, as well as enterprises from United Engineering Plants (Obyedinenniye Mashinostroitelniye Zavody) Group.

The plans of establishing one more state-owned corporation (Bank for foreign economic activities and development of the Russian Federation) with total charter capital of RUR 70 bln on the basis of reorganized Vnesheconombank and acquired Roseximbank and Russian Development Bank in H2 2007 are along the same lines. The key objective of the newly set Bank will be to support those infrastructural and innovative projects which are not of particular interest for private capital by way of issuing loans to legal entities for the period over 5–10 years. This bank is not meant for dealing with citizens. The Supervisory Board to manage and control the new bank will be appointed by the government without involvement of the RF Central Bank.

As for air transportation and airports, plans of Aeroflot to acquire regional aviation companies were voiced, these companies not necessarily being 100% state-owned (e. g., “Dalavia”, “Vladivostokavia”), as well as plans to create a United National Airport Management Company on the basis of 100% state-owned JSC Sheremetyevo International Airport. The following airports may be included into this government airports managing corporation: Pulkovo (St.-Petersburg), Tolmashyovo (Novosibirsk), Koltsovo (Yekaterinburg), Kurumoch (Samara), Yemelyanovo (Krasnoyarsk). The probability to implement this last scenario is not very high due to the above mentioned circumstances (preparation to privatization of Pulkovo with possible participation St.-Petersburg City government as one of the shareholders, interest towards Novosibirsk, Yekaterinburg and Krasnoyarsk airports on behalf of private businesses, limited number of shares in government’s packages, etc.).

Besides, setting-up a new state-owned company for managing airports may require re-distribution of authority and assets among government organizations, because 2 FGUPs are already operating in the sphere of airports: State Corporation for Air Traffic Organization and Civil Airports Authority (established in 2001 on the basis of Bykovo, Vnukovo and Sheremetyevo assets not qualified for privatization with future prospects of consolidating the assets of not only Moscow-based but other civil airports)<sup>75</sup>.

Some options of creating major corporations covering certain segments of mechanical engineering (machine-building) industry on the basis of integrating government and private assets such as National Automotive and Power Engineering Companies + Ship-Building Holding (similar to UAC) were explored in 2005–2006, but have not been implemented so far. The project of combining Novorossiysk Marine Shipping Company (JSC Novoship with 50% government interest) and 100% state-owned “Sovkomflot” company was also frozen up in the summer.

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<sup>75</sup> It is necessary to state here that runways, taxi strips, ground control equipment and other assets directly associated with air traffic are not qualified for privatization and shall be still owned by the government, which requires operations of specialized government organizations. In case of privatization new owners shall be granted ownership of terminal facilities, and in some special cases – of the adjacent territory.

Certain perspectives of government ownership expansion may be associated with ALROSA company. As it is known, back in 2001 the President of the Russian Federation required to develop a set of measures to re-gain government's share in the company's charter capital. In 2007 – after 7 years of the federal government's attempts to restore the RF control and of friction with Yakutia, – the RF share is now likely to be increased from 37% up to 50% + 1 share. At the same time Vneshtorgbank will purchase a certain portion of shares through the secondary market with the purpose of handing them over to the federal government; and a portion of the RF share increase may be backed by additional issue. By the beginning of 2007 these processes were not 100% completed, however, the issue of establishing ALROSA's control over Norilsk Nickel has already been discussed in the media (and ALROSA management did not refute). The probability of Norilsk Nickel nationalization has been under review starting from 2005.

#### *5.2.4. Changes in legal framework regulating government sector operations*

Amendments and supplements to the effective RF Law “On Privatization of State and Municipal Property” introduced via the RF Law No.155-FZ of July 27, 2006, with the objective to re-adjust the procedure for increasing the charter capitals of JSCs established through privatization with 25% or more government interest became the key legal novelty of 2006 related with state property management.

The previous version of the Law allowed for increasing the charter capital of such JSCs only under the condition of maintaining the share of either state or municipality. According to the RF Ministry for Economic Development and Trade, such limitation in the growing economy environment impeded attracting investment to JSCs with government's interest, because in reality budget funds were not allocated, in the best case one could talk only about contribution of some assets to cover additional issue of shares and to support maintaining the existing capital distribution between different groups of shareholders.

The new version of the Privatization Law (Article 40) defines a number of power bodies (the President of the RF, the RF government, state power body of the respective entity of the RF, local self-government body) entitled to make a positive decision about increasing the charter capital of such JSCs with simultaneous reduction of the state/municipality share.

Now in case more than 25% (but accounting for not more than 50% of votes at the General Shareholders Meeting) of the shares of a JSC created within the privatization process belong to the state/municipality, its charter capital increase by way of additional issue of shares may be performed with simultaneous reduction of the state/municipality share provided such decision is made by the RF government, state power body of the respective entity of the RF or local self-government body under the condition that the state/municipality maintains the interest of 25% + 1 voting share. The same provision is applicable to the companies included into the List of Strategic JSCs, but the decision needs to be made by the President of the Russian Federation.

In case the state/municipality interest in a JSC created within the privatization process accounts for more than 50% of votes at the General Shareholders Meeting, its charter capital increase by way of additional issue of shares may be performed with simultaneous reduction of the state/municipality share only under the condition such decision is made by the RF government, state power body of the respective entity of the RF or local self-government body and only under the condition that the state/municipality keeps those 50% votes + 1 voting share. Similarly, for the companies included into the List of Strategic JSCs, such decision needs to be made only by the President of the Russian Federation.

Similarly, the state power bodies are empowered to define the government's interest in the charter capital in case of public offerings and listing of respective JSCs shares at capital market, both in Russia and abroad, including the situations when it is done by way of placing securities under international laws regulating foreign capital presence and certifying the rights with regards to JSCs shares (Article 40.1):

- increasing charter capital for companies from the List of Strategic JSCs and defining the government share in such charter capital shall be performed by the decision of the President of the Russian Federation;
- increasing the charter capitals of JSCs established through privatization with state/municipal interest accounting for more than 25% votes at the General Shareholders Meeting and defining the government share in such charter capital shall be performed by the decision of the RF government, state power body of the respective entity of the RF or local self-government body.

At the first glance this system looks pretty flexible combining the opportunity for JSCs with government interest to attract investment with assuring property control on behalf of the government. However, only future practice may show to which extent this instrument will work and what will be the demand for it.

The preceding Russian practice proves that in the current environment when corporate law provisions are difficult to enforce high concentration of shares is viewed by business community as the most acceptable guarantee from risks of investing into that or another company. This makes it very difficult or almost improbable to attract new investors simply by way of additional issue of shares as long as government stays the majority shareholder, even though with regards to certain attractive companies providing for certain benefits or having got some really interesting assets such scenario may be implemented. Investors shouldn't forget about general risks associated with government interference into business activities (risks of insufficient professionalism of government officials, poor incentives for them, and opportunities for them to get illegal benefits from such situations).

The first practical trial for such a scheme may take place with Foreign Trade Bank (Vneshtorgbank), which in the very end of 2006 by a special Presidential Decree was allowed to increase its charter capital by way of additional issues of shares and their phased offering with simultaneous assurance of maintaining the government interest of no less than 50% votes + 1 voting share at the General

Shareholders Meeting of this JSC. Respective amendments were introduced into the List of Strategic JSCs.

Amendments to Article 77 of the RF Law “On Joint-Stock Company” introduced by the RF Law No.146-FZ of July 27, 2006, will have really big impact for implementation of the above described novelty and for corporate governance in JSCs with government interest. These amendments are aimed at specifying the previous norm about participation of government financial control authority in defining the market value of the assets belonging to JSCs with state/municipal shares.

This norm shall be applicable to decision-making on the issue of defining the value (monetary evaluation) of assets, of the shares offering price and of the buy-out price of the company. The Board of Directors (the Supervisory Board) of the company shall notify the federal executive body authorized by the RF Government (hereinafter referred to as the authorized body) about the decision made with regards to assets evaluation.

Besides, the new version of Section 3 of Article 77 of the RF Law “On Joint-Stock Companies” defines:

- the list of documents required for justification of the decision on assets evaluation;
- deadline for submitting the documents and the timeline for their review by the authorized body;
- right of appeal of the authorized body decision;
- expert evaluation of the report about defining the assets value;
- consequences for the company violating the procedure of defining the value;
- other matters.

In case the authorized body decides the value defined by the resolution of the Board of Directors (Supervisory Board) independently without engaging a third-party assessor does not correspond with the established market prices for the analogous assets, the Board of Directors (Supervisory Board) shall make a decision about rejecting the deal or decision to define the assets value with mandatory engagement of a third-party assessor and in compliance with the procedure stipulated by that Article.

In case the authorized body does not forward its statement within the established deadlines, the assets value shall be recognized as plausible and recommended for performing the closing the deal.

Provided the deal performed by the company violates the procedure set in the article hereof or not plausible as per the item hereof, it may be recognized as void through a law suit initiated by the authorized body within 6 months starting from the date the authorized body learned (or should have learned) about the closure of the deal.

Considering all the circumstances of the case the court shall be entitled to refuse in calling the deal void if the company proves that the committed violations are immaterial and that the deal has not caused any damages to the public, state or/and municipality.

On the whole, the fact of including the list of cases to which the norm about defining the assets value is applicable and the description of value agreeing mechanism is positive because it sets the subjects of the arising legal relations, as well the rights of both parties and ways of their exercising within the agreeing process. However, the novelty relates only to such JSCs in which state/municipality owns from 2% to 50% of the voting shares.

The List of strategic JSCs and enterprises was changed significantly in 2006.

First of all, it is necessary to state that due to setting-up UAC 2 FGUPs and 6 JSCs were excluded from the respective sections of the List. Further on 15 unitary enterprises and 2 JSCs operating in mechanical engineering and defense industry were excluded from the List as they were viewed as candidates for integration. In addition, Sochi airport was also excluded from the List, as its full package was, as has been stated earlier, sold in the end of 2006.

At the same time 2 FGUPs were added to the List (TV Technical Center Ostankino and Railway Transportation in-house security) together with 3 integrated companies in JSC format (including united industrial corporation Oboronprom<sup>76</sup> in charge of consolidation of Russian helicopter industry<sup>77</sup>) and Novorossiysk Marine commercial port [with government interest of only 20%]).

At the end of December 2006 the RF Government Resolution No.782 introduced changes into the Charter of Russian Federal Property Fund, the limitation of its autonomy being the major change. Now its is directly stated that the RF Government is the constituent of the Fund, the RF Ministry for Economic Development and Trade assures coordination and control of the Fund's activities, and the Federal Agency for Federal Property Management performs the functions of the owner of all the assets being in operation management by the Fund as per the order and limits defined by federal laws, Presidential Decrees and acts by the RF government and the President of the Russian Federation.

With regards of performing the shareholder's authorities on behalf of the Government Russian Federal Property Fund is limited only by selling the shares of companies owned by the federal government and included into the forecast plan (program) for federal property privatization. Accordingly, this situation was reflected in the Regulations on managing the federally owned shares of JSCs and using the special right of the Russian Federation in managing JSCs (the "Golden Share").

Russian Federal Property Fund keeps the right of exercising business activities, however, all the respective proceeds should be stored at the account of the Fund with the Federal Treasury and the Fund may spend it only according to the revenues/expenditures estimate approved within the process defined by the Main Manager of Budget Funds within the limits of available balance at the Fund personal account. Previously Russian Federal Property Fund had the right to place temporarily available extra-budgetary funds at deposit accounts. The data about

<sup>76</sup> In addition to the government which directly owns the controlling interest in Oboronprom, Rosobonexport is another major shareholder.

<sup>77</sup> Thus, in 2007 the deal for buying out more than 20% of Kazan helicopter plant shares is scheduled to be closed.

rarily available extra-budgetary funds at deposit accounts. The data about the assets Russian Federal Property Fund purchases at the expense of its business proceeds should be provided to the RF Agency for Federal Property Management within one month period.

Previously the federal budget was the key funding source for Russian Federal Property Fund. The budgetary funds were allocated with the purpose of organizing and carrying out privatization of federal property, they were broken by established types of expenditures and the amount was set by the Government. However, the new version talks just about funds from the federal budget without any detail. The revenues/expenditures estimate of Russian Federal Property Fund is to be submitted to the RF Ministry for Economic Development and Trade.

Russian Federal Property Fund was deprived of another funding source. It used to be formed from charges on the value of sold goods distrained based on the resolution of either court or another agency empowered to decide about imposing a lien, and revenues from selling property confiscated based on effected court/judges judgments or on the resolutions by the customs agencies and duly recognized as ownerless, as well as from selling property seized by appropriate federal executive authorities – according to the norms and types of expenditures set by the RF government.

Thus, we may state that the conflict between the Federal Agency for Federal Property Management and Russian Federal Property Fund having emerged during Administration Reform and having received publicity in 2005 was resolved mainly within the framework of the proposals by the Agency, as amendments to the Charter of Russian Federal Property Fund have significantly limited its autonomy.

Certain novelties appeared in the “second-tier” normative acts about managing federal unitary enterprises. The key novelties are represented by the following:

List of the grounds for termination of FGUP Director’s Employment Contract included into the RF Government Resolution No.234 of March 16, 2000, “On the order of executing employment contracts and certification of directors of state-owned federal unitary enterprises” was supplemented by the following important items:

- Director does not assure that FGUP’s assets are used for the objectives established according with the areas of business activities set in the Charter of the enterprise, nor does assure that FGUP’s assets are used for the established objectives within 3 months;
- FGUP Director violates Russian Federation legislation and FGUP Charter with regards to disclosure of data about related parties in the transactions, including those among the affiliated entities;
- FGUP Director violates Russian Federation legislation and employment contract provisions with regards to banning certain types of business activities.

It is also stated that the decision about terminating the employment contract with FGUP Director according to item 2 of Article 278 of the RF Labor Code shall be finalized only upon it is approved by the Certification Commission.

The tender commission for selecting candidates for FGUP Director position may from now on include the authorized representative of the President of the RF in the respective Federal District with the full right to vote. When candidates for Directors of defense FGUPs positions are reviewed, the commission shall also include a representative of the RF Ministry of Defense with the full right to vote, and a permanent member of Defense Industrial Commission with the RF Government appointed to the position of federal civil service under a special contract.

Similarly, when performing certification of defense-related FGUPs Directors, the Certification Commission shall include a permanent member of Defense Industrial Commission with the RF Government appointed to the position of federal civil service under a special contract with the full right to vote.

The Certification Commission shall also be entitled to approve draft resolution of the authorized federal executive body about termination of employment contract with FGUP Director in accordance with item 2 of Article 278 of the RF Labor Code.

The Resolution of the RF Government No.333 of June 6, 2003, "On Exercising Federal Executive Bodies' Property Rights with regards to State Federal Unitary Enterprises Assets" was supplemented with the provision about the need to agree transactions performed by the enterprise with regards to leasing real estate attributed to them on the basis of economic control rights and of value exceeding RUR 150m with the RF Agency for Federal Property Management taking into account the position of respective federal executive body on the matter.

Other amendments and supplements to legal acts were more of an editorial nature.

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Overall, the year of 2006 in the property relations sphere demonstrated continuation of the preceding two years trends, though in a slightly weakened format. The number of FGUPs was decreasing and to a lesser extent the same happened to JSC with federal government interest. The abrupt increase of JSCs with 100% federal government interest was witnessed. In general, the federal government's packages profile (as per the share of government in JSCs charter capital) as of mid-2006 was more or less corresponding to the 2003 estimates of the RF Ministry for Property Management with regards to privatization outcomes. The same is true with relation to the absolute number of JSCs with federally owned packages.

The current situation with property relations in Russian economy is characterized by simultaneous implementation and co-existence of two trends.

On one hand, one may speak about continuation of privatization. The RF government annually sets forecast plans (programs) for federal property privatization for the next year, which include many hundreds of FGUPs and stock packages (shares) of companies operating in various industries and sectors of economy. However, the following needs to be taken into account:

Firstly, the planned privatization of FGUPs is performed (with some very few exceptions) by way of incorporation, i. e. at first a unitary enterprise is converted

into a JSC, and only after that (as a rule, beyond the current fiscal year) its shares are sold (probably – not 100%).

Secondly, up till very recently minority and blocking packages of mid-size companies were main subjects of sales. Such companies do not play any significant role in Russian economy, which lowers their attractiveness and level of interest towards them on behalf of investors. The approved privatization program stipulates abrupt shift of the focus towards selling complete (100%) packages, which many experts regard as a disputable and problematic decision. Inclusion of major companies into privatization program (similar to those privatized in 1990-s and early 2000-s) is not likely earlier than in 2008–2009, when a new political-and-business cycle is about to start in Russia. The most explicit candidate for privatization is a state-owned package of Svyazinvest, a telecommunications holding, selling of which was deferred a number of times during the previous years.

Thirdly, the actual scale of FGUPs incorporation and federal packages privatization is evidently behind the scheduled ones. This may be explained by low attractiveness of the offered packages due to their sizes and industry-based profile, by very long time required for incorporation of unitary enterprises, by challenges of controlling this process (resistance on behalf of the management, inter-departmental friction, parallel creation of integrated organizations, etc.).

On the other hand, increasing impact of the already existing major state-owned corporations on the process of establishing new holdings to integrate government assets is pretty evident, just like their growing activity at the M&A market (including privatization).

Thus, with the government sector appearing to be shrinking (which is reflected in the decreasing the number of FGUPs and JSCs with government interest), in reality it is expanding and deepening at the expense of the increased scale of business and via an expanded network of subsidiaries and affiliates. The state-owned companies performance is difficult to assess (just like performance of other holding organizations), because their subsidiaries, affiliated and controlled assets are not permanently fixed and often change, providing for significant impact over the activities of the Group as a whole. Another difficult task is accounting for the level of consolidation of assets with a holding (e. g., it is difficult to account for the contribution of enterprises and organization with participation of companies which are controlled by the holding not in direct, but rather in indirect manner, i. e. through a network of subsidiaries and affiliates). All this impedes evaluation of the overall scale of the government sector, its share in separate industries and in GDP as a whole.

With a big level of probability one may speak about continuation of the above described trends in 2007. With that certain adjustments need to be made based on oil prices fall and the beginning of the new political-and-business cycle.

### **5.3. Issues associated with buying out and leasing land plots of business entities**

The problem of acquiring property rights (title) for the land plots owned by either state or municipal authorities and carrying buildings, structures and facilities owned by either business entities or individuals, has for the first time come up back in 1990-s due to starting the privatization process. The Presidential Decree No.301 of March 25, 1992, "On Selling Land Plots to Individuals and Legal Entities during Privatization of State and Municipal Enterprises" proclaimed that employees of the privatized entities were entitled to buy out the land plots carrying these entities assets. In reality the process of transferring land to private property did not start at that time, but the general principles for buying out land were established. The Situation changes upon enactment of the Presidential Decree No.1535 of July 22, 1994, "On Key Principles of Government Program for Privatization of State and Municipal Enterprises in the RF after July 1, 1994". Additional incentive for privatization process enhancement was significant decrease of the price for land plots to be bought out: it used to make 200 times land tax rate per area unit, but due to enactment of the Presidential Decree No.485 of May 11, 1995, "On Measures to Assure Privatization Revenues into the RF Budget" (item 7) it was brought down to 10 times tax rate. In May 1997 the price was again brought down to constitute 5 times land tax rate (item 4 of the Presidential Decree No.485 of May 16, 1997 "On Guarantees for Real property Owners about Them Being Able to Buy Out land Occupied by this Property) lost effect starting from March 29, 03, 2003).

The dynamics of privatizing the lands of residential areas during the period between 1994 and 2001 varied significantly from region to region<sup>78</sup>. In some local authorities did not allow or introduced significant impediments for buying out land, and at the same time regional authorities adopted respective legal acts to prohibit the land to be turned into private property. These regions shall be the following: Moscow City, Chuvashia Republic, Mordovia Republic, Kalmykia Republic, Bashkortostan Republic, Dagestan Republic, Kabardino-Balkarskaya Republic, Tyva Republic, Sakha (Yakutia) Republic, Penza Oblast, Kaliningrad Oblast, Kostroma Oblast, Kamchatka Oblast, Krasnodar Krai and some others.

In other regions the process of buying out land was either not active enough (Nizhny Novgorod Oblast and Samara Oblast), or got suspended after an active start (Astrakan, Volgograd, Orenburg and Leningrad Oblasts).

There was a third group of regions where the process of buying out land was rather intense. Nevertheless, the amount of land turned into private property of business entities even in St.-Petersburg – the leading region in this sphere – made only 0.5% of the overall city area in 1996 - 2000.

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<sup>78</sup> Here and further on the data used for assessing the situation in this sphere before early 2000-s is taken from an analytical report of Urban economics Institute "Analysis and evaluation of Land Relations Reform in the Cities", see: [www.urbanecomomics.ru/texts.php](http://www.urbanecomomics.ru/texts.php).

More than 10 years of privatization of land plots occupied by business entities resulted only in 5% of lands being turned into private property of such entities<sup>79</sup>. The major bulk of business entities owners still do not own the land occupied by these entities. From microeconomics point of view such situation constitutes a barrier for owners to exercise their rights and creates for them a real threat of losing their assets in case of disagreement with the principal owner – the government on terms and conditions of land use. From macroeconomics point of view it impedes economic growth, investment into economy.

During the period when the majority of business entities do not have titles for the land they occupy, legal relationship between the state and businesses are regulated by the institute of permanent unlimited (free) use of lands, stipulated by the Land Code of RSFSR of 1991. Business entities were granted such a right based on the decisions of state/municipal authorities which together with the law defined the limitations for using the land law. They could be defined in various ways, however, all actions aimed at assuring disposal of land were either made impossible (e. g., divestment of land), or could be performed only under condition of agreeing them with the state (e. g., leasing land or converting it to free unlimited use (Article 268–270 of the RF Civil Code), cancelled by the RF Law No.201-FZ of December 4, 2006).

The land Code adopted in 2001 has legally fixed the exclusive right of business entities for either privatization of state-owned or municipality-owned land or for leasing it (Article 36). Besides, the new Code stipulated for abolition of unlimited free use of land starting from January 1, 2004. Prior to that moment owners of business entities had either to privatize the occupied land plots or to execute a lease agreement. Now from the day of enactment of the Code – i. e., from October 29, 2001 – privatization of buildings, structures and facilities (including buildings, structures and facilities of industrial use) without simultaneous privatization of land plots occupied by them is not allowed with the exception of cases when such plots are withdrawn from turnover or limited in turnover (RF Law No.137-FZ of October 25, 2001, “On Enactment of Land Code of the RF”).

Resolution of the issue about privatization of land plots was challenged by a series of problems related with defining the group of land plots not allowed for privatization, borders of land plots, their status of federal or municipal property, lack of titles, terms and procedure of land value assessment. Impossibility to resolve those problems led to adoption of amendments to the RF Law “On Enactment of Land Code of the RF” in December 2003. These amendments allowed for extension of the mandatory conversion of user rights for land lots under business entities into ownership/lease rights starting from January 1, 2004, until January 1, 2006.

In the end of 2005 the deadline for converting the land-related rights was again extended until January 1, 2008 (RF Law No.192-FZ of December 27, 2005,

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<sup>79</sup> Presentation by the State Duma Committee for Property Chairman V. Pleskachevsky on I Congress on Land Property Relations in Russia / M. Vdovin, Uniform Tax and Cadastre Value of Land Plots: Reform News, October 17, 2006, see: [www.domex.ru](http://www.domex.ru).

“On Introducing Amendments into Article 3 the RF Law “On Enactment of Land Code of the RF””).

Let us review here the key problems of transferring the land plots to the property of business entities, and analyze to which extent the ways to resolve them selected by government are justified and feasible.

1) Excluding certain land plots from those qualified for privatization.

The common norm is that *turning down of requests to buy out land* or to lease it is not allowed with the exception of cases stipulated by the law. Cases when land plots are not qualified for privatization are listed in item 8 of Article 28 of RF Law No.178-FZ of December 21, 2001, “On Privatization of State and Municipal Property in the RF”. Most of the listed cases seem to be justified, however, the fact of including “*lands which Master Plans of respective territories development allocate for use in state or public interests*”, destroys the illusion of fairness.

The Land Code contains similar norm stipulating that “*reserving land plots for state and municipal needs may be the grounds for turning down the privatization requests*” (item 4 of Article 28). It is especially important to note that the procedure of reserving land plots for such special needs is regulated neither by the Land Code nor by City Planning Code.

The arbitration courts practice includes hundreds of claims from the companies challenging the legitimacy of turning down the request for privatization of land plots based on the need to reserve this particular land plot for state/municipal purposes. Normally courts dismiss such claims because local authorities refer to various normative acts confirming the need to use the disputable land plots for public or government purposes. As of today, Master Plans for territorial development in some regions are adopted for very lengthy periods, which allows to include a large number of land plots required for the development purposes into such plans, thus removing them from privatization. For example, Moscow City adopted Master Plan for the period until 2020, Tyumen City – until 2040. Often the market players are absolutely unaware, which lands are included into such plans. As a rule, the fact of including land plots into Master Plans becomes public only on case-by-case basis when individual requests for privatization are filed and are turned down based on the Master Plans.

Draft law on the order of reserving land plots<sup>80</sup> is currently under review in State Duma and has been enacted in first reading. It provides for the possibility to reserve any land plot by way of administration decision for undefined state/municipal needs for the period of 3 years. Such reserving excludes the possibility for buying out the respective land plots. The proposed mechanism stipulates the possibility of removing practically any piece of real estate (including privately owned ones) from the market turnover under the excuse of “creating the conditions required for implementing territorial development plans, in particular – for develop-

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<sup>80</sup> Draft RF Law No.321847-4 “On Introducing Amendments to Certain Legal Acts of the Russian Federation with Regards to Establishing the Procedure for Reserving Land Plots for State/Municipal Needs”. Version enacted by the State Duma of the Federal Assembly in first reading on October 11, 2006.

ing engineering, transportation and social infrastructure and establishing special environment-protection zones”<sup>81</sup>.

The decision about reserving land plots may be made both at the federal and at the regional level by respective authorities, as well as by municipal governments. Special attention needs to be paid to the fact that the same authority that made the decision on reserving land may cancel it.

The draft law currently under review is aimed at limiting the rights of use, possession and disposal of land, thus contradicting with item 3 of Article 55 of the Constitution, allowing limitation of citizens rights “only to the extent it is required to protect the constitutional system, morals and health, rights and legitimate interests of other parties, assuring national defense and security of the state”. Besides, item 2 of article 36 of the Constitution is being violated, which sets unconstrained right to possess, use and dispose land provided it does not damage the environment and does not violate rights and legitimate interests of citizens.

Effective legislation stipulates the possibility to withdraw a land plot only under several conditions, specifically: consensus with the owner of the land plot on terms and conditions of such withdrawal, on the buy-out price (Article 282 of the RF Civil Code), and in case the owner disagrees the adequate court judgment is required, as well as compensation of equal value for the land plot cost (item 2 of Article 55 of the RF Land Code).

The institute of reserving the land in the format it has been proposed in the draft law allows for limiting the rights of owners, proprietors and tenants without any formalities associated with registration/protection of their rights and legitimate interests. Such model of legal regulation creates the favorable pre-requisites for re-distributing land ownership in such regions where it exists, and for using administrative methods to distribute land in such regions where there is no private property for land (e. g., Moscow).

It is necessary to use this institute only for reserving land plots for state/municipal purposes so that the list of lands not qualified for privatization is fixed. The rights of tenants and other legitimate owners should be taken into account, and the grounds for reserving need to comply with effective legal norms.

Besides, the group of real estate owners entitled for buying out land plots was narrowed by the way the buy-out right was interpreted in clarifications issued by the Supreme Arbitration Court Plenum, which pointed to the fact that *in case the real estate owner executes the Land Lease Agreement after October 29, 2001* (the date the Land Code was enacted), *this owner forfeits the buy-out right due to the fact he/she had already exercised their right* (Para. 3 of item 7 of the RF Supreme Arbitration Court Plenum Resolution No.11 of March 24, 2005, “On Some Issues Related to Application of Land Law”).

The arbitration practice already includes court judgments based on exactly this interpretation of Article 36 of the Land Code stipulating acquisition of rights for state-owned or municipality-owned land plots (e. g., Resolution of 10<sup>th</sup> Arbitration Appellation Court of July 5, 2006, on case No. A41-K1-3420/06).

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<sup>81</sup> Proposed version of item 43.1 of the Land Code, Draft RF Law No.321847-4.

Taking into account the number of Lease Agreements executed during 5 years (from November 2001 to November 2006) in the territory of Russia, the number of applicants for buying out land will decrease significantly. Thus, administration of Nizhnevartovsk raion of Khanty-Mansy District (Yugra), for example, executed 233 Land Lease Agreements in 2005<sup>82</sup>.

Besides, State Duma is currently reviewing the draft law introduced by the RF Ministry for Economic Development and Trade, related to terms and procedures of acquiring rights for state-owned and municipality-owned land plots<sup>83</sup>. This draft law stipulates that the price for land shall be defined by the regional laws; at the same time, this price shall not exceed 20% of cadastre value. However, the right for buying out land will be granted to only those owners, whose right of private ownership with regards to this real property (or the analogous right of the preceding owners) "emerged due to divestment of this real estate from state or municipal property". "Other individuals and legal entities being the owners of buildings, structures and facilities occupying state-owned or municipality-owned land, may acquire land plots (*only*) at cadastre (*market*) value.

In case such law is adopted private businesses emerged not as result of privatization will be to a significant extent put aside from the process of buying out land. For many of them the price barrier will be absolutely overwhelming.

#### 2) General payment for converting land lots into private property of business entities.

Requests for free conversion of land lots into private property have been filed for a pretty significant period of time. The advocates of this idea believe the land price was incorporated into the value of business entities when they were being privatized, so it would be illegal to ask to pay for one and the same thing twice.

Justification of such statements about the illegitimacy of selling land depends mainly on terms and conditions under which business entities were privatized, in particular:

- whether the land plot was incorporated into the divested/privatized asset;
- whether the cost of land plot was incorporated into the overall price paid for the business entity.

The RF Law No. 1531-1 of July 3, 1991 "On Privatization of State and Municipal Enterprises" in Article 1 states the list of entities, acquisition of which by individuals or JSCs (partnerships) should be qualified as privatization, points out enterprises, shops, production facilities, shop areas, equipment, buildings, structures and some other sites. Land plots are not listed.

The second privatization law No. 123-FZ of July 21, 1997 directly specified that it may not be applied to land privatization (Article 3).

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<sup>82</sup> "Land and Its Use". see: [nvraion.ru/?part=stuff8&sub=zeml](http://nvraion.ru/?part=stuff8&sub=zeml).

<sup>83</sup> Draft RF Law No. 347961-4 "On Introducing Amendments to Legal Acts of the RF with Regards to Specifying Terms and Procedures for Acquisition of Rights for State-Owned or Municipality-Owned Land Plots". Version enacted by the State Duma of the Federal Assembly in first reading on November 22, 2006.

As for implementation of these norms, it is worth noting that no matter enterprises were privatized through tenders<sup>84</sup>, or by way of auction<sup>85</sup> *land plots were never subjects of privatization*. During privatization *the owner of the business was granted only the user rights for the land plot*.

With regards to the reasoning based on incorporation of land value into the value of privatized businesses it is worth noting that *the procedure for defining the value of privatization subjects* effective from February 20, 1992, until March 29, 2003, when defining the details of valuated assets includes just *user rights for the land plots* as part of fixed assets and investment<sup>86</sup>.

Thus, there are no reasons to assume that the value of land plots was incorporated into the value of business entities when privatizing them. *The Terms for privatization of business entities* (set by the Federal Law) *did not mention land as subject of property rights*. *The price paid when purchasing the enterprise (irrespective of the format of purchase: auction, tender) did not include the land plot value*. In other words, *there are no grounds to claim illegitimacy of the term about paying for land*.

Nevertheless, in addition to legitimacy of legal provisions there are criteria of justification (including that from the economics standpoint) and feasibility of the government decisions. The decision about the need for everyone to pay for privatization of land does not comply with such criteria. There are a number of reasons for that:

*First of all, Russian business entities, or at least – the majority of them, are not capable of buying out land at full value*. Using the maximum rates the total value of lands to be bought out by businesses makes from \$30 bln (according to Realtors Guild estimates) to \$106 bln (according to Russian Union of Industrialists and Entrepreneurs estimates), which accounts for 1/4 of Russian GDP. According to the estimates of A. V. Sharonov, Deputy Minister of Economic Development and Trade, land to be bought out by businesses costs \$34.8 bln. He believes this amount to be impossible for Russian companies<sup>87</sup>.

Buying out land is a problem even for major Russian corporations. Thus, RAO EES (United Energy Systems) of Russia estimated the value of land to be privatized by this Holding somewhat at the level of \$800m. Buying out land occupied by production facilities of JSC AvtoVAZ (the area of the plant territory accounts for more than 900 hectares) may cost dozens of millions of USD<sup>88</sup>. And even for such giants of domestic business with their significant gross annual margins and availability of

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<sup>84</sup> Item 1.4 of Provisional Regulations on Privatization of State and Municipal Enterprises in the RF on a Tender Basis (Appendix No.5 to the Decree of the RF President No.66 of January 29, 1992). Effective from February 20, 1992, until March 29, 2003.

<sup>85</sup> Item 1.5 of Provisional Regulations on Privatization of State and Municipal Enterprises in the RF through an Auction (Appendix No.4 to the Decree of the RF President No.66 of January 29, 1992). Cancelled by the Decree of the RF President No.832 of July 14, 1998.

<sup>86</sup> Item 2.1 Provisional Methodology Guidelines for Privatization Subjects Valuation, Appendix No.2 to the Decree of the RF President No.66 of January 29, 1992.

<sup>87</sup> Finance, 2003, № 18, p. 4.

<sup>88</sup> News on real estate market, issue № 43, 10.11.2003 See: [www.nrm.ru](http://www.nrm.ru).

cash land privatization costs will be pretty noticeable. For the majority of businesses challenged by acute deficit of floating capital or investing heavily into business development, buying out land under the proposed conditions is practically impossible.

Secondly, impossibility for the majority of Russian businesses to buy out the lands carrying out their production facilities will lead to re-distribution of property rights for land and land titles in favor of major corporations, finance organizations, bureaucrats and their affiliated organizations. At the same time, part of the currently operating businesses shall be liquidated, and the economic status of other small and medium-size businesses will significantly decline. And if we remember the fact that 2/3 of national GDP is generated by private businesses, we may definitely claim that such liquidation may have a serious negative impact over the dynamics of economic growth.

Thirdly, using the land buy-out price as additional revenue source for regional budgets will have positive economic effect only in a very short-term perspective, with the exception of major financial intermediary centers. It is related mostly with insufficient floating capital and poor investment capacity of the majority of lands due to underdevelopment of the infrastructure. Increased concentration of capital, growth of corruption and abuse in the sphere of administrative decision-making about land may result from the need for everybody to pay for privatization of land.

Thus, introducing mandatory payment for privatization of lands for all business entities without any exception does not contradict with the legal framework, but is economically unjustified and unfeasible, as it impedes further development of the major bulk of market players and eventually – the economic development of the country. Paying for privatization of lands based on the market prices may also aggravate social problems, hurt the middle class and really private businesses which are not based on solely state-owned assets.

Given the current profile of energy prices, lack of system of government support to smaller and medium-size businesses, but simultaneously high taxation rates for such businesses, as well as insufficient development of the banking sector capable of providing financial instruments for buying out land, *free privatization of lands for effective smaller and medium-size businesses would be feasible. The mandatory terms should be the following: conversion of production and land use purposes should be banned for a certain period (or allowed only for additional fee), as well as divestment of land and production reduction.*

Transferring land at its nominal value or under long-time installments schemes may be a good enough interim option, so that the owners of businesses occupying the respective land plots have real possibility to buy out their lands and exercise preferential right for buying out land plots occupied by their assets.

### 3) High price for land plots buy-out.

The price for buying out land, specifically – its very high level, is one of the key barriers for land market formation. The following key reasons for such situation should be emphasized:

a) the entities of the Russian Federation (regional authorities) were granted the right to establish the level of buy-out price for land plots.

Having defined that the buy-out price for land shall be defined at the sub-national level (item 2 of the RF Law No.137-FZ of October 25, 2001 “On Enactment of the RF Land Code” and item 7 of Article 28 of the RF Law No.178-FZ of December 21, 2001 “On Government and Municipal Property Privatization in the RF”), the legislator created exclusively favorable grounds for economically unjustified decisions targeted at receiving the maximum revenues from selling land, as well as an extremely favorable environment for regional officials abuse and unjust enrichment.

Thus, the entities of the Russian Federation were granted the rights to set the prices for land in residential areas making certain times to the regional land tax rate and based on the number of residents:

- above 3 mln people – in the amount from 5- to 30-times land tax rate per acreage unit;
- between 500 thou to 3 mln people – in the amount from 5- to 17- times land tax rate per acreage unit;
- under 500 thou people and beyond the residential areas borders – in the amount from 3- to 10- times land tax rate per acreage unit (as of the beginning of the current year).

(With this prior to RF entity setting the price for land the minimal land tax rate should be applied).

In the circumstance of the major bulk of Russian regions being subsidized from the federal budget and suffer from insufficient budget resources, receiving the right to charge land buy-out could be viewed as a chance to increase the regional budget revenues. As an outcome of such policy we can observe in practically every location *setting the land prices at the maximum high level allowed by the law* for cities and other residential areas with the respective number of residents.

Thus, in the absolute majority of regions where the number of population in cities and settlements including the regional capital city did not exceed 500 thou people, the price for land was set at the level 10-times above the land tax rate. On the other hand, there is a significant group of regions where the number of population in major cities exceeds 500 thou people, meaning that for the regional capital city the land price was set at the upper level of the second-tier scale, i. e., 17-times above the land tax rate, as for the other settlements and residential areas of the same region – it was set at the level 10-times above the land tax rate. The latter regions were (as of beginning of the H2 of 2002) Ryazan, Tula, Volgograd, Rostov, Nizhny Novgorod, Orenburg, Samara, Saratov, Ulianovsk, Omsk and Kemerovo Oblasts; Krasnodar, Altay and Khabarovsk Krai; Udmurtiya Republic.

Further on the inadequately overpriced land was reassessed in some regions and the prices were brought down. In some regions it was related with lobbying efforts of local business community (e. g., in Tomsk oblast, when the buy-out price was reduced from the level of 10-times above the land tax rate down to the level of 3-times above the land tax rate). In other regions the key reason for reducing the

buy-out price was the inspiration of many regions to keep as much as possible revenues from selling land with their regional budgets.

b) changing the procedure for allocation of the revenues received from selling land between different levels of budgets.

In periods, when the next year's federal budget would stipulate any change in allocation of revenues received from selling land in favor of the federal budget, the regions would set relatively low land buy-out prices to assure incentives for more sales, so that the region is able to keep the maximum possible revenues. By implementing such policy the regions were able to assure significant additional inflow of cash as transfers from upper-levels budgets.

Such methods were used, for example, in Kemerovo region, where the land buy-out rates were changed 6 times during the period of 15 months starting from the date of enactment of the new Land Code. Novosibirsk regional administration was applying similar tactics (the price for land in Novosibirsk was decreased from 17-times above the land tax rate down to 6-times rate), as well as Vologda regional administration (price decreased from 10-times above the land tax rate down to 3-times rate, and then raised again up to 10-times above the land tax rate).

b) defining the buy-out prices for land plots as "x"-times above the land tax rate.

Starting from January 1, 2005 (item 2 of Article 7 of the RF Law No.95-FZ of July 29, 2004 "On Amendments to Sections 1 and 2 of the RF Tax Code") is also "to be set by legal acts of representative local representative bodies of municipal bodies, and in the cities of national status – Moscow and St.-Petersburg – by regional laws". The federal legislator merely defines, that with regards to land plots occupied by businesses the tax rate shall not exceed 1.5% (Article 394 of the RF Tax Code). In practice the entities of the federation (due to the above described reasons) set the maximum high rates.

r) land tax rate (and the resulting buy-out prices for land lots) is calculated based on the cadastre value of land plots.

According to the estimates by M. Mishustin, Director of the Federal Agency for Real Estate Cadastres (Rosnedvizhimost), the overall cadastre value of Russian lands constitutes RUR 23.6 trillion. 82% of overall cadastre value of Russian lands falls on the lands in residential areas, however, such lands constitute no more than 1.9% of the national territory<sup>89</sup>.

The cadastre evaluation of lands was undertaken between 2000 and 2006 leading to increase of the value for the land plots to which the cadastre evaluation methodology was applied, and this methodology depends not just the location of a land plots within a certain cadastre quarter, but also on their functional use capacity.

Thus, for example, *cadastre evaluation of lands in Moscow* took place in 2000–2002 and resulted in establishing 1516 cadastre quarters instead of previously existing 100 zones. As for the price for land itself, even in downtown Moscow it may vary between RUR 60,501 and 1,331 per 1 sq. m<sup>90</sup>. According to V. Damur-

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<sup>89</sup> See: [realty.rbc.ru/regions/news.shtml?url=2006/04/10/4303841@region=msk](http://realty.rbc.ru/regions/news.shtml?url=2006/04/10/4303841@region=msk).

<sup>90</sup> Appendix No.1 to Moscow City Government Resolution No.356-PP of May 24, 2005.

chiev, Director of Land Resources Department of Moscow City, by the beginning of 2006 the average cadastre value for Moscow land constituted RUR 180K per 1 hectare per annum, with the minimal level being RUR 1,800, and the maximum achieving RUR 900K per 1 hectare per annum<sup>91</sup>.

According to the data provided by Leningrad regional Control-and-Accounting Chamber, *the cadastre value of land in Leningrad region* was defined above the market value of land. According to Auditor S. Gnilitsky, the deviation from the market price may constitute from \$15 up to \$560 per 100 sq. m<sup>92</sup>.

The totality of all these reasons defines the high level of high buy-out prices for land lots for businesses. Thus, the price of land plots in Moscow when putting them on sale is defined based on the 30-times land tax rate per acreage unit<sup>93</sup> and on the fact the land tax rate being set at the level of 1.5% of cadastre value of lands. This is the maximum amount of buy-out price as per the RF Land Code. For businesses qualified as valuable for the city, the price for buying out their land plots is decreased down to 20% of their cadastre value.

The right to establish adjustment coefficients between 0.7 and 1.3 used for selling land plots and approved by the RF government (RF Law No. 137-FZ of October 25, 2001) requires some special attention. Application of this norm in the environment of total corruption may become an additional key source for extra income of bureaucrats.

Currently the State Duma is reviewing the draft law introduced by the RF Ministry for Economic Development and Trade stipulating *bringing down the buy out price only for privatized business entities* down to 5% of cadastre value for all residential areas except for Moscow and St.-Petersburg, where the minimal price will constitute 20% of cadastre value<sup>94</sup>. According to the new law the buy-out price for all other business entities shall be equal to cadastre value, i. e., market price. In case such approach is applied, major companies or entities with that or another way of control on behalf of the government or demonstrating their loyalty to the government will have preferential rights for buying out land. Smaller and medium-sized businesses in need of privileges are in reality deprived of the possibility to buy out land due to being in capable of overcoming the set price barrier.

Maintaining the current legal framework on the matter or enactment of the above mentioned draft law will inevitably lead to new violations of the owners' rights (similar to what happened during privatization in 1990-s) in favor of the so-called national interest, such violations being performed (as it has become the practice of the recent years) by formally lawful methods. The real objectives of enacting such laws (distributing state property among a selected circle of people, maximizing budget revenues for regional budgets, as well as for bureaucrats participating in

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<sup>91</sup> See: [www.bpn.ru/service/neus/13711](http://www.bpn.ru/service/neus/13711).

<sup>92</sup> See: [novgorod.osean.ru/commercia/articles/?articl\\_id=15096@PHPSESSID=014b3b10caf6ab74de7a57d2eb172e40](http://novgorod.osean.ru/commercia/articles/?articl_id=15096@PHPSESSID=014b3b10caf6ab74de7a57d2eb172e40).

<sup>93</sup> Moscow City Government Resolution No.532-PP of July 19, 2005.

<sup>94</sup> Draft RF Law No.347961-4 "On Amending the RF Legal Acts with Regards to Specifying the Terms and Conditions, and the Procedure of Acquisition of Rights for the Land Plots Owned by State/Municipality". Version adopted by the State Duma after first reading, November 22, 2006.

decision-making on the matter of buying out land plots) shall stay beyond the public discussions, if only they do not result in some social conflicts.

4) The trend to limit the tenants' rights and increasing government regulation in land lease areas.

Execution of Lease Agreement proposed by the legislator as an alternative for buying land out has also its disadvantages.

The Land Code of 2001 introduced new terms and conditions for the long-term lease agreement (over 5 years) for a land plot being a state/municipal property (Article 22, item 9). In case of executing such an agreement the tenant actually receives the rights to dispose such plot within the period of the agreement validity without the content of the owner (re-assign the rights arising from such agreement to a third party, sub-lease the plot, pledge the lease rights, introduce these rights as a contribution to a charter capital of a business entity, etc.).

However, the draft law on buying out the land plots (introduced by the RF Ministry for Economic Development and Trade in 2006 and being currently reviewed by the State Duma) stipulates some new limitations of the tenants' rights<sup>95</sup>. First of all, re-assignment of the long-term leasing rights (over 5 years) shall be prohibited without authorization from a respective government/municipal official (today a mere notification of the respective authority is enough to re-assign the rights). It means bureaucrats would be empowered to dictate when executing deals with private businesses and individuals having premises located on the leased land plots. Secondly, the re-assignment of leasing rights for the land plots not carrying buildings, structures and facilities shall be banned completely. This is in obvious impingement of the rights of buildings and facilities owners, and this norm also has another implication: provides the bureaucrats with the right to arbitrarily cut the borders of the land plot.

The rent rates limits administratively leased plots are set as 2% of the cadastre value (in case of agricultural lands – not exceeding the land tax rate, and for land plots the circulation of which is limited – the amount of land tax). However, these limitations shall be effective only until the moment of delineation of state property for land. So based on some artificial reasoning one category of tenants – owners of buildings/facilities will pay rent comparable to the land tax, while another category of tenants will be charged based on the arbitrary decision of local authority. This situation may be explained by the fact that until July 1, 2006 the delineation covered the land plots qualified to be bought out and carrying private buildings and business facilities (based on whom the building/facility belonged to before privatization). So many of business entities without even being aware of that found themselves occupying land plots owned by the state. According to the new regulation (RF Law No.53-FZ of April 17, 2006) the land plots qualified to be bought out shall not be subject to delineation. 167 hectares of city lands were delineated as of January 1, 2005 (2.3% of total area). With regards to these territories currently making up to 6% of the city lands government officials will have the opportunity to establish arbitrary rates not based on market realities.

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<sup>95</sup> See: A. Lazarevsky. Land Coup/ "Expert" No.38, October 16, 2006.

Besides, for tenants the situation is aggravated by the fact that in some regions the rent for using a land plot will be calculated based on the performed cadastre evaluation of land, meaning the rate will grow significantly. Thus, *in Moscow*, starting from January 1, 2006, for all leases executed after this date the rate is calculated based on the real cadastre value of the respective land.

*Lease rates in Moscow* are established in accordance with the approaches to setting the land tax rates<sup>96</sup>:

- 0.1% – for land plots carrying housing and engineering infrastructure;
- 0.3% – for land plots carrying social assets funded from extra-budgetary sources, as well as “dachas” (country cottages);
- 1.5% – for all other categories of land plots.

What does that mean for land tenants? In Moscow the base land lease rate differentiated based on the tenants category and on the type of land use is within the range of RUR 1,800 per hectare and RUR 900, 000 per hectare. Its growth when calculating based on cadastre value will make from 8% to 110% dependent on the location and type of land use<sup>97</sup>.

Other challenge the tenants have already came across was selling premises owned by the entity of the Federation with the effective lease agreement. In most cases it results in bankruptcy of the tenant due to increase of the lease payments, or in the new tenant turning down the application for prolongation of the effective lease agreement. For example, the St.-Petersburg Committee for State Property Management is selling as priority No.1 the premises already refurbished by the tenants<sup>98</sup>. Most often this problem relates to smaller and medium-sized businesses which do not have relevant funding resources for buying out the leased premises. The situation is aggravated by the fact that KUGI does not prolong the effective lease agreements with the entrepreneurs prior to selling land plots.

#### 5) Arbitrary definition of land plots borders.

The availability of cadastre map (plan) is a mandatory pre-requisite for acquiring the rights for the land plot carrying buildings/facilities of a business entity. This map needs to be attached to the application for acquisition of rights for the land plot which individuals or legal entities need to file with the respective executive agency or local self-government body with the purpose of buying out the land plot (item 5 of Article 36 of the RF Land Code).

In case cadastre map is unavailable, *the borders and sized of a land plot shall be defined based on the effectively used area of the land plot and in accordance with land and city planning regulatory framework* (item 7 of Article 36 of the RF Land Code).

According to the effective land use regulations, definition of the land plot borders and of the order of its use is to a great extent dependent of the City Planning

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<sup>96</sup> Appendix No. 11 to Moscow City Government Resolution No.273-PP of April 25, 2006.

<sup>97</sup> Interview by V. Damurchiev, Director of Land Resources Department of Moscow City // Revenue Formula, “Vechernyaya Moskva” No.12 of January 25, 2006.

<sup>98</sup> “St.-Petersburg: Business Demands to Stop Auctions” /Alliance Media, December 27, 2006. See: allmedia.ru.

Regulations (Article 85 of the Land Code) defining the types of allowed land/capital infrastructure use, their normative (minimal and/or maximal) sizes, as well as limitations for using land/capital infrastructure (Article 30 of the RF Land Code).

The RF entities are empowered to enact their City Planning Regulations, and local governments usually decide on different issues of land use. In the environment of total corruption *land owners or those who wish to become land owners, as well as tenants find themselves in the position of absolute hostages of bureaucrats at different levels as they are granted practically unlimited rights*. In reality privatization of a land plot is often performed in the size of the foundation of the building/facility it carries, that is just the “foot” of the building is being sold without adjacent territory required for servicing, maintenance and normal operations of the building. And the remaining portion of the land plot is offered at a much higher buy-out price.

6) Delineation of state property between different levels of government constitutes one more barrier for those who want to privatize land.

The RF Law “On Delineation of State-Owned Land” effective since January 2002 sets the following basic principles for such delineation:

- the already privatized land plots, as well as those granted to municipal or federal property or property of the entities of the RF shall be excluded from the process of delineation;
- the land plots may become property only of that subject of public power which owns (or used to own prior to privatization) real estate located on this land plot.

In reality the Federation and the entities of the RF often claim the same plots simultaneously. Contradictions between different levels of power, departments, agencies and individual bureaucrats lead to a lengthy procedure of coordination and registration of original ownership for land.

In addition, in certain regions governments are deliberately delaying land property delineation process. Until the property rights are not properly delineated, lease payments for the respective land plots are remitted to either regional or municipal budgets, thus providing counter-incentives for delineation process. Often the procedure of buying-out and registering the rights for land takes 2.5–3 years, and the certificate for state registration of title the business entity receives after 6 months or a year upon executing the sales-and-purchase agreement with regards to this land plot<sup>99</sup>.

The issue of delineation of state-owned lands became especially acute in Moscow. In April 2003 the decision about selling the land plot occupied by a privatized business entity was made for the first time after enactment of the Land Code. The plot of 1.7 hectares was evaluated at \$500K, i. e., \$30 per sq. m. However, the decision was made not by Moscow Government, but by Moscow territorial agency of the RF Ministry for Property Management. This decision became possible because the building occupying this plot used to be federal property before privatization.

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<sup>99</sup> “Land Relations Reform and Land Privatization in the Cities: Review and Evaluation” Analytical Report by the Institute of Urban Economics, pp. 14–15. See: [www.asdg.ru](http://www.asdg.ru).

This transaction caused high-profile scandal with a broad resonance in the media. Top-ranking Moscow City officials claimed the deal to be illegal<sup>100</sup>, because according to them, “prior to delineation of federal and Moscow land ownership the RF Ministry of Property Management is not entitled to execute any deeds with land”.

According to some estimates, lands occupied by business entities which used to be federal property prior to their privatization may constitute c. 40% of all Moscow land<sup>101</sup>. In case federal property management authorities deal with buying out these lands, the huge proceeds from such sales will be fully remitted to the federal budget. That is why Moscow government will be doing everything not to allow for a precedent which may cause a knock-on effect<sup>102</sup>.

#### 7) Technical problems of exercising the right for land plot privatization.

The main challenge (besides those mentioned above) that many businesses are facing after applying with request for privatization of land is related with local governments turning down the applications. They may be basing their decisions on unavailability of cadastre map and refusal to make it, or on attributing these lands to the category which is not qualified for privatization.

As for the problem of unavailability of cadastre map for the respective plot, one needs to remember that as of today only 10% of the RF territory is covered by cadastre maps<sup>103</sup>.

In some cases attributing lands to a certain category (e. g., lands of general use) is confirmed by a directive of local administration, however, there are no effective legal documents to confirm this specific mode of using the given plot was established. This complicates the court review and making a judgment with regards to whether turning down of privatization request by the local administration was lawful or unlawful (e. g., Resolution of Supreme Arbitration Court Presidium No.322/05 of April 19, 2005).

In addition to this, exercising the right for privatization of land plot is to a great dependent on the correct definition of the government authority which is to decide on the matter. Currently there may be the following difficulties: according to the RF Law “On Enactment of the Land Code of the Russian Federation”, the decision about privatizing land may be made by the local administration, under the jurisdiction of which the respective territories are. However, on the other hand, decisions about privatization of land plots carrying privatized business entities may be made only by the same government authorities, which had made the decisions on privatization of the assets located on those plots находящихся на этих земельных участках (item 14 of Article 43 of the RF Law “On State and Municipal Property Privati-

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<sup>100</sup> See: Izvestiya. April 24, 2003; Vedomosti. April 25, 2003; Gazeta. April 25, 2003.

<sup>101</sup> Kommersant. January 29, 2002. P. 8.

<sup>102</sup> “Land Relations Reform and Land Privatization in the Cities: Review and Evaluation” Analytical Report by the Institute of Urban Economics, p.36. See: www.asdg.ru.

<sup>103</sup> «Drafting of recommendations on the development the real estate and land market with the aim of taking into account the interests of the small and medium size business (The role of Chamber of Commerce of RF and territorial Chambers of Commerce). Final report of the Chamber of Commerce of RF and of the information and consulting center “Business-Tezaurus), 2006, p.12.

zation”). In some cases local administrations would review such applications through a general procedure, and in case privatization request is turned down, the respective business entity would institute a claim against local administration, and not against the government authority having executed privatization of the assets. This often leads to escalation of litigation costs (e. g., Resolution of the RF Supreme Arbitration Court Presidium No.992/04 of September 28, 2004).

The issue about the borders of land plots also remains difficult. No common uniform approach to defining the size of the land plot qualified for privatization has yet been developed in the practice of arbitration courts. When defining the size of a land plot some courts are based on the concept of “effectively used area of the land plot”, understanding it as an area directly under the building; other courts are based on the total area of the land plot according to the map provided by the customer and certified by the respective territorial branch of the State Land Cadastre. The latter position seems correct and in compliance not just with the Law itself, but with the key principle underlying the concept of land privatization. Thus, the RF Supreme Arbitration Court in the Resolution on a specific case No.4345/04 of August 17, 2004, on calling void the decision of Klin raion administration of Moscow Region about turning down the application for buying out a land plot, stated that privatization of the full-size land plot was the thing to do in order to assure compliance.

The issue of collective buying out the land plot carrying buildings/facilities belonging to several business entities is very relevant for smaller businesses<sup>104</sup>. In the majority of cases a small business entity owns just a portion of premises inside a building, which it shares with other owners. Joint application to the respective authority will be required in such case in order to execute the sales-and-purchase agreement for buying out the respective land plot. In reality this is impossible to implement. As a rule, some of the smaller businesses occupying the premises are owners, and some are tenants. The owners are not interested in switching to the lease-type relations, tenants do not always have the resources required for buying out the premises and the land plot. Besides, the procedure of collective buy-out of a land plot is cumbersome and overcomplicated from the point of view of achieving the consensus on the terms of ownership and shares of the participants.

To summarize, the following needs to be emphasized: the idea itself of granting the rights for decisions on land privatization, on defining the value of land plots, on organizing cadastre registration of land and on some other related issues to the entities of the federation and local self-government bodies seems pretty feasible. However, real capabilities and inclinations of those who will be empowered with such a function need to be taken into account when implementing this idea.

The high level of corruption of Russian bureaucrats is widely known, as well as the fact that local self-government in Russia is underdeveloped, and regional budgets suffer from significant deficit. In such situation the impossibility to guarantee fair

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<sup>104</sup> «Drafting of recommendations on the development of real estate and land market with the aim of taking into account the interests of the small and medium size business (The role of Chamber of Commerce of RF and territorial Chambers of Commerce). Final report of the Chamber of Commerce of RF and of the information and consulting center “Business-Tezaurus), 2006, p. 45–46.

land privatization is obvious. The privatization mechanism itself as stipulated by the legislator (even disregarding the local normative acts) is designed in such a way, that a huge number of various officials from different organizations need to agree on privatization decision in order to make it happen. Such mechanism practically makes privatization of land impossible for business entities. The most major and meaningful businesses, either controlled by the state or loyal to the current government, may still count on positive decision being made on land privatization under acceptable terms and conditions (e. g., by enacting new laws reducing the buy-out price for such entities or by adjusting the land value in case the RF Government uses a reduction factor). But for smaller and medium-size businesses the situation may soon become a catastrophe. Implementation of the land privatization scheme currently stipulated by the law may result in future concentration of land property, as well as redistribution of land ownership rights among a very limited circle of stakeholders.

Implementation of the following measures may significantly improve the situation with land privatization:

1. minimize engagement of bureaucrats and the level of their arbitrary decision-making in the process of defining the value of the land plots and their borders, i. e., the maximum possible regulation of the matter at the federal level;
2. eliminate (or bring down significantly) the buy-out price for operational smaller and medium-size businesses;
3. exclude all norms stipulating violation of private property rights, as well as land ownership and disposition rights, from the RF Land Code, City Planning Code and from other legal acts of the Russian Federation and of the entities of the federation;
4. enact the law on land reserve excluding the possibility of reserving privately owned land and of violation of the rights of owners and other parties exercising lawful use and possession of land; stipulating for setting up a transparent process of putting state and municipal lands into a reserve category (prohibited for buying out);
5. enact legal norms assuring the lists of land plots included into Master Plans of the cities' development are mandatory for publication in the media;
6. introduce a system of measures to provide the regions with the incentives to delineate land ownership rights and to increase the privatized lands share;
7. introduce legal banning with regards to changing the order of distribution of land privatization revenues between the federal budget and the budgets of the RF entities for a long enough period;
8. introduce legal banning for the RF entities to escalate the buy-out price for land plots occupied by business entities;
9. develop credit mechanism for business entities to buy out the land plots carrying their buildings/facilities to assure annual interest rate at no more than 3–5%;
10. introduce the long-term installments mechanism to pay for privatization of land plots;
11. provide for regional branches of the State Accounting Chamber to check the justification of cadastre valuation of lands in the regions, abolish laws and regulations of the RF entities approving cadastre evaluation above the market price.

## 5.4. Institutional Problems of Russian Capital Market

### 5.4.1. Russian Capital Market Dilemma

In his famous novel «The Notre Dame Cathedral» Victor Hugo described the excruciation of Clod Frolo – the priest balancing between the professional ethics principles and his lust towards Esmeralda the Gypsy. The Dilemma of Father Clod – this is how one can figuratively describe the current attitude of global investors towards Russian capital market. It has been quite explicitly worded in one or the *Wall Street Journal* articles. According to western business community, internal opposition was aggressively suppressed Russia during the recent few years, the rights of foreign investors were rudely violated, and energy-based blackmail was applied to some neighboring states. However, many of these western investors believe President Putin to be a hero merely because of one main thing: during 7 years of his presidency Russian capital market rallied impressively. Capitalization of Russian companies has grown from \$74m in January 2000 to almost \$1 trillion as of January 2007; RTS (Russian Trading Systems) index was demonstrating an average growth rate of 50% per annum<sup>105</sup>.

In general, the temptation of high profitability turns out to be stronger than concerns about economic liberties, investors' rights and government's interference with business. The story of Long-Term Capital Management (LTCM) failure in 1998 is an evidence of how difficult it is to withstand the temptation of high profitability of the emerging markets even for sophisticated institutional investors.<sup>106</sup> LTCM – one of the major hedging funds – was established in 1994 by John Meriwether, former trading star in Salomon Brothers. Two very reputable people were among its directors – Robert Merton and Myron Scholes, the Nobel Prize winners in economics of 1997. They are justly recognized as scholars whose conclusions and estimates allowed for creating a formalized market for derivatives at the USA exchanges. LTCM was specializing at very risky commercial strategies for the emerging countries bonds markets. Thanks to this very positive publicity of its leadership and high profitability level (in 1997 LTCM's annual profitability constituted 40%), its assets value has reached \$7.3 bln by 1997. However, the irony of fate was such that even such champion managers did not provide for maintaining the due presence of mind when performing risk evaluation for investment into Russian economy. The crisis of August 1998 turned out to be completely unexpected for them; LTCM incurred the loss in the amount of half of its assets value, thus putting the USA at the edge of systemic financial crisis. The catastrophe was avoided only thanks to the immediate reaction of the US Federal Reserve System and of some major American financial institutions.

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<sup>105</sup> Chazan G. Investor Credit Putin As They Pile Up Profits. Hot Stock Makes Russian Leader a Hero With Money Managers. – *Wall Street Journal*. – January 22, 2007.

<sup>106</sup> Dowd K. Too Big to Fail? Long-Term Capital Management and the Federal Reserve. – CATO Institute briefing papers. – September 23, 1999, № 52.

#### *5.4.2. Evaluation of Russian Capital Market Using CalPERS Pension Fund Methodology*

In order to fully understand the outcomes of Russian capital market 2006 performance and the difficult choice for many foreign investors, let's try to evaluate it using some traditional methods of institutional foreign investors. For example, we can use the public materials of one of the major pension funds of the US – California Public Employees' Retirement System (CalPERS). CalPERS's methods for analyzing the feasibility of investment into emerging economies may be considered relevant due to several reasons. CalPERS is one of the most major and most conservative global investors, and its current assets value is over \$225 bln. Its interest towards that or another emerging market automatically means some sort of a "quality certification" for that market proving it to be safe for other foreign investors. CalPERS methodology is public and is based on some competent research of emerging economies, ratings of civil liberties and freedom of press by Freedom House, global competitiveness index by World Economic Forum, shareholders' and creditors' rights guarantees assessment by Oxford Analytica, economic liberty index by The Heritage Foundation and Wall Street Journal, analytical materials by Wilshire Compass, stock exchanges and other sources of information. This methodology has been in use for a number of years, it may as well be used as an indicator of global investors' attitude towards that or another emerging market.

CalPERS methodology means assessing the possibility to invest into a specific emerging market based on two key factors – country risks and risks inherent to a specific financial market. The maximum possible score is 3. In case a country achieves the score of 2.0 and more, it is automatically included into the list of countries permitted for investing CalPERS assets. In any other case the country's financial market would be banned for investment for this pension fund.

Country risks are evaluated by CalPERS based on the following criteria:

- Political stability – the status of civil liberties, level of judicial system autonomy and political risk level;
- Openness of information (availability and accessibility of data) including freedom of press rating, level of disclosure of monetary policy and budget data, quality of stock exchange listing and International Financial Reporting Standards (IFRS) application efficiency;
- Labor Laws compliance with international standards of labor relations regulation – ratification of ILO Convention, labor law compliance with ILO standards, efficiency of law enforcement.

In other words, country risks stipulate evaluation of investment climate and institutions – the foundation of financial markets.

Second groups of factors stipulate evaluation of numerical and qualitative parameters of emerging capital markets, including the following indicators:

- Liquidity and volatility of capital markets, including assessment of market capitalization and its growth rates, the ratio between monthly trading turnover and market capitalization, growth of the number of listed companies, stock market volatility and risk/profitability factor;

- Efficiency of bank supervision and law enforcement at capital markets, the level of investors' and creditors' rights protection;
- Assessment of the extent the national economy is open to foreign investment, the extent to which bank and financial institutions regulations are liberal, assessment of limitations for buying securities at secondary capital markets;
- Evaluation of how efficient the calculating mechanisms at stock exchange are, of the level of transaction costs (mainly taxes) at securities market and when paying dividends to securities holder.

CalPERS's assessment of Russian capital market is extremely interesting both for certain domestic investors, which in general are still pretty cautious with regards to domestic investment. The fact that pension funds of retired government officials from the US are now coming into this market is a very serious event capable of convincing even the most conservative Russian investors in certain advantages of the domestic market.

*Table 15* represents the final CalPERS evaluation of early 2006 compared with three emerging economies from BRIC Group – Brazil, India and China.

*Table 15*

**BRIC Countries (Brazil, Russia, India and China)  
Rating with regards to Admissibility of CalPERS Investment in 2006**

	Weight of factor, %	Investment banned		Investment allowed		Maximum score
		Russia	China	India	Brazil	
<b>1. Country Risk Factors:</b>						
1.1. Political stability	16.7	1.0	1.3	1.7	1.7	3.0
1.2. Openness of information	16.7	2.0	1.3	2.7	2.7	3.0
1.3. Labor relations standards compliance	16.7	1.7	1.0	1.0	1.7	3.0
<b>2. Market factors:</b>						
2.1. Liquidity and volatility	12.5	3.0	3.0	3.0	2.7	3.0
2.2. Market regulatory framework / law enforcement / protection of investors' rights	12.5	2.0	1.7	2.3	2.3	3.0
2.3. Openness of capital market	12.5	1.3	1.3	1.0	1.7	3.0
2.4. Efficient calculations / transactional costs	12.5	2.3	2.0	2.3	3.0	3.0
<b>TOTAL</b>	<b>100.0</b>	<b>1.9</b>	<b>1.6</b>	<b>2.0</b>	<b>2.3</b>	<b>3.0</b>

Source: www.CalPERS.ca.gov.

In 2006 Russia and China (out of 4 BRIC countries) scored less than 2.0 and were included in the group of countries banned for CalPERS investment. The key problems of Russian market are predetermined by low political stability, poor quality of labor regulations and insufficient openness of capital markets. *Table 16* presents more details about the value (weigh)of various factors which impeded Russia from getting the maximal 3 scores as per CalPERS methodology during the period of 2003–2006 and based on preliminary 2007 rating outcomes. With this we need

to emphasize that neither of emerging economies scored 3.0 in 2006; the countries that scored the highest were Hungary – 2.7, Poland, Chile and Czech Republic – 2.6 each.

*Table 16*

**Share (Impact) of Various Factors in Deviation of the Final Russian Score from the Maximum Score (3.0) for the period of 2003–2006**

	2003	2004	2005	2006	2007 (estimate)
<b>1. Country Risk Factors:</b>					
1.1. Political stability	20.5	28.6	27.6	29.2	30.6
1.2. Openness of information	20.5	0.0	13.8	14.6	15.2
1.3. Labor relations standards compliance	20.5	28.6	27.6	19.0	19.9
<i>Total Section 1</i>	<i>61.6</i>	<i>57.2</i>	<i>69.0</i>	<i>62.8</i>	<i>65.7</i>
<b>2. Market factors:</b>					
2.1. Liquidity and volatility	7.7	10.7	0.0	0.0	0.0
2.2. Market regulatory framework / law enforcement / protection of investors' rights	7.7	10.7	10.3	10.9	11.4
2.3. Openness of capital market	15.4	21.4	20.7	18.6	14.9
2.4. Efficient calculations / transactional costs	7.7	0.0	0.0	7.7	8.0
<i>Total Section 2</i>	<i>38.4</i>	<i>42.8</i>	<i>31.0</i>	<i>37.2</i>	<i>34.3</i>
TOTAL	100.0	100.0	100.0	100.0	100.0

Source: [www.CalPERS.ca.gov](http://www.CalPERS.ca.gov).

Country risk factors in 2006 accounted for 65% of points underscored by the Russian Federation. The average country risk assessment for Russia makes 1.6 out of 3. This is predetermined by low political stability, insufficient openness of capital markets and poor quality of labor regulations.

*Political stability*

In evaluation the status of civil liberties and rights score 1 means the highest level of freedom and score 7 – complete lack of freedom. Russia scored 5. The level of judicial system independence and legal protection in Russia scored 1 out of the maximum 3, which is to a great extent below the level of China. Our country performed quite unsatisfactory in such areas as judicial system autonomy, legal protection for property rights, and favoritism towards government authorities when making judicial decisions, poor outcomes of opposing the organized crime.

*Openness of information*

In the area of information availability and accessibility Russia scored 2, which is enough to overcome the barrier and join the club of markets permitted for investment. Measures on disclosing monetary policy, budget system and companies exchange listing information received sufficiently high evaluation. At the same time the key gaps identified for Russia were insufficient freedoms for media and insuffi-

cient rate on introducing IFRS (IAS or US GAAP). To be fair we need to emphasize that Russia's score is still better than those of India and Brazil – about at the same level as for China.

*Labor regulations*

The quality of labor regulatory framework in Russia was evaluated to score 1.7 out of the maximum 3. This is below the passing score, but above China or India, about the same level as Brazil.

Contrary to the conservative evaluation of institutional factors, quantitative and qualitative parameters of Russian capital markets look pretty presentable. The average rank for risks associated with Russian capital markets made 2.14 in 2006 – above the passing score of 2.

*Market liquidity and volatility*

Russia scored the highest possible (3.0) with regards to market liquidity based on such indicators as capitalization, trading volumes, market capacity and volatility.

*Market regulatory framework, protection of shareholders' and creditors' rights*

For the quality of regulatory framework for banking and capital markets Russia scored at an average level of 2.0. Insufficient efficiency of bank supervision and law enforcement at capital market, as well as gaps in assuring the creditors' rights prevent Russia from getting a higher score.

*Accessibility of capital market*

Russian scored rather low (1.3) due to limitations for banks and insurance companies with regards to entering the market.

*Efficient calculations / Transaction costs*

Russian capital market scored pretty high at the level of 2.3 (it scored 3.0 in 2005) in the field of efficiency of calculations and level of transaction costs. The efficiency of calculation methodologies applied at capital markets scored as high as 3.0 even in the environment that there is no Central Securities Depository and Guaranteed Settlement System without advanced deposit of assets. However, the evaluation of transaction costs level reflecting the level of taxation imposed on revenues and securities transactions was pretty negative (1.0 score out of 3 maximum). 24% profit tax when selling securities was reported as a particularly strong deficiency (today it is especially hitting the non-residents buying shares of Russian companies, who are trying to avoid this by way of investing into Russian economy through off-shore zones) Another deficiency identified was higher taxation of dividends compared to other emerging economies.

Summarizing this review of various factors effecting the feasibility of CalPERS investment at Russian capital markets, one may notice that the key complaints relate first of all to institutional factors and investment climate in the context of country risks, as well as to the level of capital markets development with regards to taxation of investors' revenues, efficiency of bank supervision and law enforcement. Practically there is almost no potential room for further improving Russia's rating at the expense of increasing quantitative parameters of capital markets and improving

its infrastructure because Russia has already scored nearly maximum in these areas. So the activities of the regulators should be focused on the areas, in which Russia is behind other competing countries.

The outcome of applying CalPERS methodology to Russia are interesting also because of the fact, that both Russia and China scored almost 2 in early 2006, i. e., they are pretty close to the threshold level, starting from which both economies may be qualified for CalPERS investment<sup>107</sup>. Now everything depends on the final evaluation expected about March or April of 2007. `So far CalPERS web site displays the draft final evaluation, according to which Russia's score will remain on the level of the previous year (1.9), and China will improve the score from 1.6 up to 1.7. But in both cases it won't exceed the passing score of 2.0. In such conditions CalPERS Investment Committee will have to face the uneasy Dilemma of Clod Frolo already in spring of 2007.

The objective of this analysis is to try to provide an independent evaluation of changes at Russian capital market irrespective of CalPERS opinion and evaluation, but through a system parameters and criteria described above.

In 2006 the balance of various factors reflecting the status of civil freedoms, the extent of justice and courts independence and the level of political risks was unlikely to change for the better. The Report developed by an International NGO Freedom "Status of Freedom in the World"<sup>108</sup> in 2006 states that the situation with civil freedoms in Russia has not changed compared to 2005. According to their criteria Russia scored 5, which means it was qualified as constrained country. According to Freedom House commentary, such a low score for Russia is based on the outcomes of these NGO experts assessing the processes of electing State Duma members in 2003 and the President of the RF in 2004, of reinforcing government control over media and of developing the government/opposition interface inside the country. According to Freedom House, 45 countries were qualified Among BRIC countries China scored 6 (constrained country), Brazil scored 2 and India – 3, which means recognizing them as unconstrained.

CalPERS's methodology of evaluating the level of judicial system autonomy and of legal protection of citizens/entrepreneurs from the point of view of their impact on competitiveness of the markets is based on global competitiveness indices (GCI) of the Global Economic Forum (GEF)<sup>109</sup>. In 2006 Russia sank from the 53-th position it had been awarded in 2005 down to the 62-d position. Our country found itself behind China (54), India (43), but ahead of Bolivia (66). According to GEF, pri-

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<sup>107</sup> CalPERS Report of December 18, 2006, states that the Fund's management has made a decision to allow investment in buying stocks of companies from China and other emerging economies". Reuters Statement of December 18, 2006, extends this CalPERS decision over Chinese and Russian companies. However, no new list of markets classified as acceptable for investment has so far appeared at CalPERS website. Draft final report on capital market research outcomes by Wilshire Consulting of January 2007 (used for defining the list of acceptable markets) so far has stated both Russia and China having below 2 rating (2 is the criteria for including these markets into the list of ones allowed for investment).

<sup>108</sup> See: [www.freedomhouse.org](http://www.freedomhouse.org).

<sup>109</sup> See: [www.weforum.org](http://www.weforum.org).

vate businesses in Russia have serious concerns about independency of judicial system and delivery of true justice. Legal aid is not fast in Russia, not is it transparent or inexpensive. Protection of property rights in Russia is very weak and continues to go worth compared to global competitive economies. Russia's rating in this area has visibly dropped over the recent 2 years: in the group of 125 countries Russia moved from position 88 (in 2004) down to position 114 (in 2006) having been ranked as one of the worst countries. GEF Chief Economist and Global Competition Studies Director Augusto Lopes-Claros stated that "special attention needs to be given to reforms aimed at improving government institutions of Russia which are not in compliance with current standards, improving judicial and legal climate, protection of property rights, anti-corruption and anti-crime efforts"<sup>110</sup>.

Corruption problems in Russia redoubled in 2006, which may be confirmed by reports of such organizations as INDEM Foundation, Global Economic Forum, World Bank, as well as Transparency International index.

The year of 2006 was the year when major state-owned corporations were attacking property rights private investors – both Russian and domestic – in various areas. According to estimates of analysts from Alpha-Bank, during the last year the share of government's interest in Russian companies increased from 29.6 up to 35.1%<sup>111</sup>. Gazprom abandoned its initial plans to engage foreign investors to developing Shtockman field; a group of foreign investors comprising Shell, Mitsubishi and Mitsui was forced to remise the controlling interest in Sakhalin-2 project to Gazprom under the threat of terminating the project because of environmental regulations incompliance. Gazprom acquired companies involved into developing one of the biggest gas fields (Yuzhno-Tabeyskoye) from businessman Yu. Bogachev. In the process of reforming energy generating industry Gazprom has become the owner of major packages of generating companies' stocks (RAO EES [United Energy Systems of Russia], Mosenergo [Moscow Energy Generating Company], OGK-1, OGK-2, OGK-4, OGK-6 and others). In early 2007 Gazprom bought controlling interest of SUEC (Siberian Coal Energy Company) producing one third of all Russian power generating coals. In 2006 it was announced that the rights to develop new off-shore fields shall be granted exclusively to state-owned companies. Private corporation TNK-BP was challenged with numerous claims on behalf of tax, law enforcing and environmental authorities in 2006; at the same time various media published information that Gazprom and Rosneft had offered to buy out the share of Russian shareholders in this integrated company<sup>112</sup>, and Gazprom expressed its interest in acquiring 75% interest in Kovykta gas condensate field (currently owned by TNK-BP). At the same time analysts noticed oil-and-gas production decrease in 2005–2006 versus 2000–2004 as a consequence of respective assets being shifted to state-owned corporations<sup>113</sup>, as well as gas shortage in domestic consumption in 2007.

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<sup>110</sup> GEF press release of September 26, 2006.

<sup>111</sup> B. Grozovsky, Chief Owner in the Country. – "Vedomosti", February 13, 2007.

<sup>112</sup> "Vedomosti", November 22, 2006.

<sup>113</sup> V. Milov, The Echo of Property Redistribution. Forbes – February, 2007. – p 30.

Another state-owned corporation (Rosboronexport) acquired control over AvtoVAZ (Automotive Plant, manufacturer of “Ladas”) and over VSMPO-Avisma corporation, the world’s largest titanium producer. The same corporation started acquiring metallurgic plants (JSC Metallurgic Plant “Krasny Oktyabr”, Chelyabinsk metallurgic plant) with the purpose of creating metallurgic holding for special steel manufacturing.

According to *The Heritage Foundation* and *Dow Jones & Company, Inc.* Economic freedom rating<sup>114</sup>, in 2006 Russia got only 120<sup>th</sup> position out of 157 having scored 54.01 out of maximum 100, which is below the score of 2005. Taking BRIC countries, China took 119<sup>th</sup> position (scored 54.02 балла), Brazil and India – 70<sup>th</sup> position (60.89 scores) and 104<sup>th</sup> position (55.60 scores) accordingly. The evaluators believe that such a low score in the area of “financial freedom” is associated with inefficiency of the banking system, gaps in banking supervision and transparency, as well as limitations for non-residents to enter banking and insurance businesses. Low rating in the area of property rights protection means that property protection is very weak in Russia, “judicial system is biased and corrupt”, and in such environment it is very difficult to assure contractual obligations are fully met.

In 2006 government was not able to propose clear rules in attracting foreign investors into strategic sites in the territory of the Russian Federation. Despite the fact of Russia chairing G-8 in 2006 and active dialogue in energy security, Russia and Western countries were not able to develop a common approach to resolve this problem. Russia rejected proposals to assure incentives to attract investment into oil-and-gas exploration, production and refining based on free market principles and fair competition between private companies; instead Russia accentuated the monopoly of state-owned companies and their expansion both at domestic and foreign markets<sup>115</sup>. Lack of mutual understanding between countries exporting energy and countries consuming those resources is a serious threat to both economics and politics of all these countries including Russia.

The year of 2006 did not bring any significant changes in the area of information openness of Russian economy. Media did not gain more freedom. On the contrary, during this year a number of central media changed their owners and were acquired by loyal-to-government business groups.

A number of positive changes were noticed in the area of listing. The required minimal liquidity standards for financial instruments and minimal capitalization

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<sup>114</sup> *The Heritage Foundation* and *Dow Jones Co.* develop the economic freedom index ([www. heritage. org/index](http://www.heritage.org/index)) based on evaluating the level of freedom in 10 areas: economy, trade, taxation, finance, monetary policy, investment, labor relations, independence from the government, protection of property rights and independency from corruption. Based on the final evaluation all countries are divided into 5 groups: free countries (80–100 scores), mostly free countries (70–79.9 scores), partially free countries (60–69.9 scores), mostly non-free countries (50–59.9 scores), non-free countries (0–49.9 scores).

<sup>115</sup> On February 14, 2007, the 6-month FRS Report to the USA Congress stated, that one of the key reasons for global oil prices to stay at the high level was “limited investment in energy sector on behalf of international oil companies in some countries including Russia and Venezuela due to increased level of government control over the energy sector” ([www. online. wsj. com](http://www.online.wsj.com)).

standards for securities were strengthened, as well as minimum standards for the issuers with regards to the term of being in business operations to be qualified for listings, as well as standards of strengthening the role of exchanges in controlling corporate governance compliance on behalf of issuers. However, low level of Free Float of Russian issuers (the portion of freely circulating stocks) still constitutes a serious problem when Russian companies are listed at Russian stock exchanges. According to effective securities regulations and exchanges rules, the issuers included into quotation lists A1 and A2 need to have at least 25% Free Float, as for level B list, this requirement has been reduced down to 10%. Shares with low Free Float are to a greater extent exposed to price manipulations and are more volatile, which creates additional risks for investors. The problem is that out of 306 issues of stocks allowed for circulation at MICEX (Moscow Inter-Bank Currency Exchange) as of the end of 2006, only 16 were included into quotation list A1, and only 11 – into list A2. Thus, according to exchange listing requirements only every tenth of the companies offering their stocks should follow the minimum Free Float standards.

In 2006 Russia did not demonstrate sufficient progress in application of International Financial Reporting Standards (IFRS). Evaluation by CalPERS is based on the opinion of eStandardsforum and takes into account the fact that in July 2004 the respective authorized government body – the RF Ministry of Finance – stated that within the Accounting and Reporting Mid-Term Development Concept for the period 2004–2010 Russian companies shall be switching to IFRS on a mass scale. According to the above mentioned Concept, application of IFRS during preparation of consolidated financial reports by “business entities of public value” shall become mandatory in 2004–2007 (under “business entities of public value” joint-stock companies with publicly offered or floating shares are understood). Thus, the Ministry meant practically all companies with shares floating at stock exchanges. However, lack of law enforcement mechanisms does not allow for successful achievement of the set target.

Unfortunately, there are no recognized statistical data about the number of Russian JSCs using IFRS. According to our evaluation, the number of companies using IFRS is still significantly below the target level, and does not match the needs of not only foreign, but also of Russian domestic institutional investors. Thus, according to our estimates, the round of issues by Russian companies with interest of Russian mutual investment funds (MIFs) constitutes about 450–500 issues. And only on 200–250 issues the issuers provide reporting according to IFRS (less than in 50% of the cases). This is an evidence of the fact that in many instances investment into Russian companies' shares is often done at random (blindly), without sufficient level of investment strategy formalization. It is impossible to adequately evaluate the shares (from the point of view of their growth) issued by the companies which do not follow IFRS. Financial indices to classify companies' shares and investment funds portfolios may be calculated only on the basis of IFRS (e. g., according to the investment styles table – growth stock, value, combined). This may be of great significance for investors to gain awareness about profitability versus

risk with regards to different assets. Eventually even Russian domestic institutional and retail investors are forced to “fly without navigation equipment” (if we are to use aviation terminology), without adequately positioning themselves with regards to subjects of investment. It’s not difficult to imagine what may be the result of such flights.

The stock exchanges capabilities are not fully employed in the process of promoting IFRS among Russian companies. According to the existing listing rules such reporting is required only for the companies of A1 and A2 categories. It actually means that only every tenth company entering the market is obliged to apply IFRS.

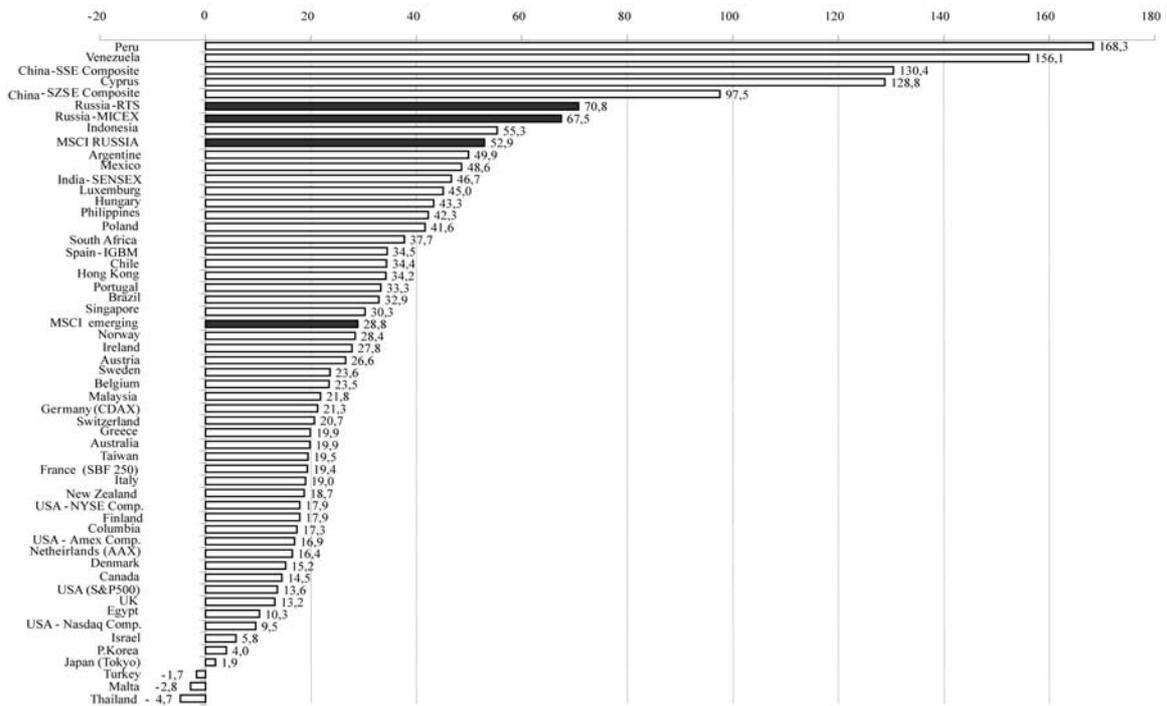
Thus, in 2006 institutional problems underpinning Russian capital market maintained and even redoubled. What does it mean for foreign and Russian investors? The key point is that the foundation for quantitative growth of financial market, its scale, debt instruments and liquidity level becomes more and more unsteady. Capitalization growth of major state-owned corporations is taking place at the expense of acquiring new assets on exclusive terms, but it is not accompanied by improving the efficiency of utilized assets/resources. Major corporations become the elements of government policy; their decisions can be less and less forecasted. Practically, there is no system of independent control on behalf of investors and civil society over the efficiency of managerial decisions in economics and finance. All this increases the systemic crises exposure for capital markets and creates the pre-requisites for violation of investors’ rights.

#### *5.4.3. Institutional and Structural Disparities and Growth Factors*

The problems of investment climate in Russia in 2006 were surprisingly combined with high yield of Russian companies’ shares, heavy growth of capitalization and liquidity of stock exchange market. It’s been the second year in a row, which is a very rare event that Russian stock markets remain global leaders with regards to their growth rates (see *Figure 1*).

In 2006 RTS index increased by 70.83% vs. the end of 2005, the incremental growth of MICEX and MSCI-Russia indices was 67.5% and 52.9% respectively. Only Peru, Venezuela, Cyprus and China performed better as for stock indices. The profitability index of RTS was 2.5 times above the index of MSCI-emerging economies. Growth of stock yield in Russia was accompanied by significant strengthening of Ruble: by 8.5% vs. USD. This became another “plus” of Russian capital market for American and global investors.

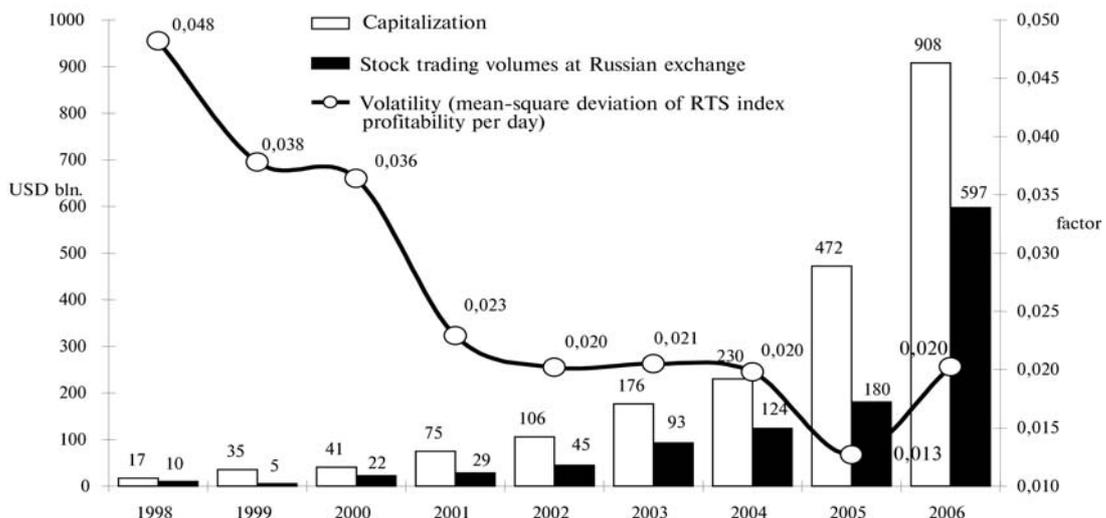
RUSSIAN ECONOMY IN 2006  
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Source: WFE (World Federation of Exchanges) data; WSJ publication data.

Figure 1. Incremental growth of stock indices (% , December 2006 vs. December 2005)

The growth of stock market liquidity caused noticeable growth of Russian companies capitalization and of stock prices volatility dynamics, as is shown in Figure 2.

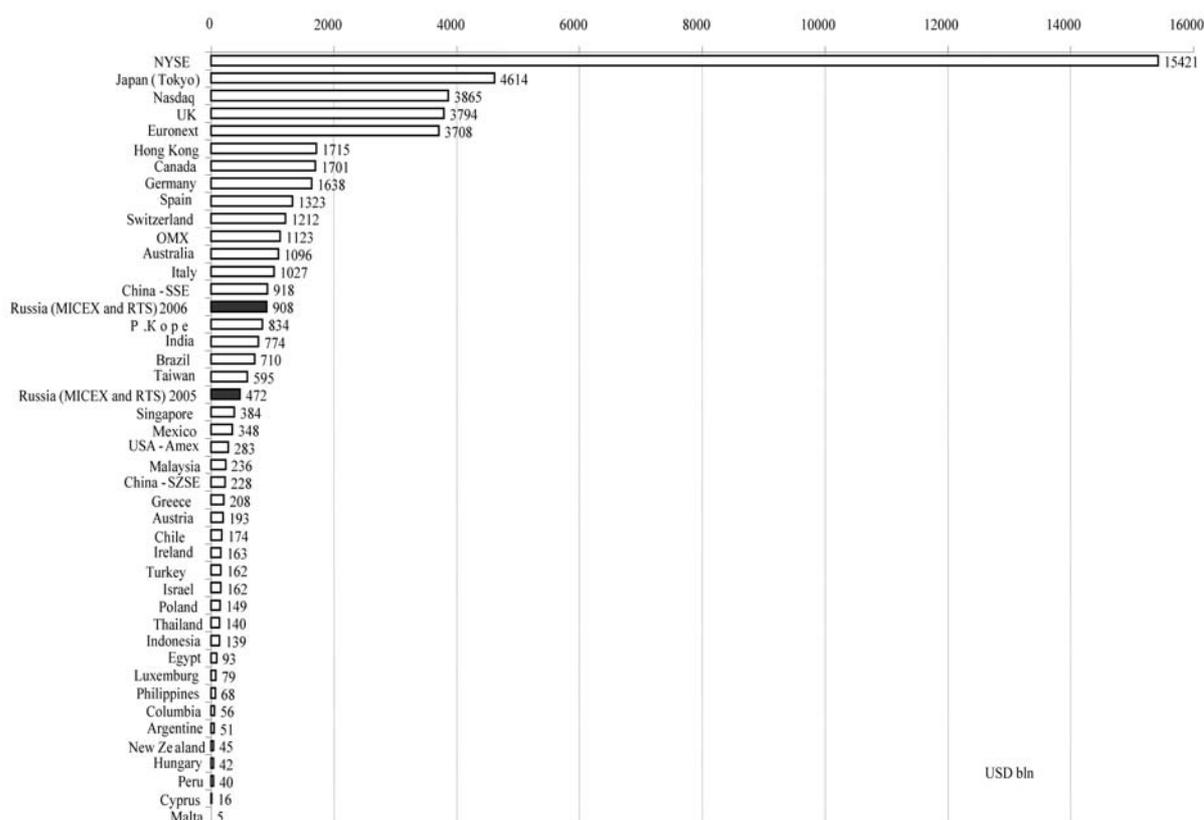


Source: data by RosBusinessConsulting and Russian exchanges.

Figure 2. Capitalization, Liquidity and Volatility of Russian Stock Market

In 2006 capitalization of Russian companies grew from \$472 bln up to \$908 bln, i.e., 1.9 times; the stock trading volume at MICEX, RTS and St.-Petersburg increased from \$180.2 bln up to \$597.0 bln, i.e., 3.3 times. The mean-square deviation of RTS index per day, which reflects the volatility of “blue chips” prices, grew in 2006 and made 0.02 vs. 0.013 in 2005 meaning the risks of investment into stock increased by 1.5 times.

As per capitalization size Russian stock exchanges improved their position from 19 up to 15, leaving behind the markets of Korea Republic, India, Brazil and Taiwan (see *Figure 3*).



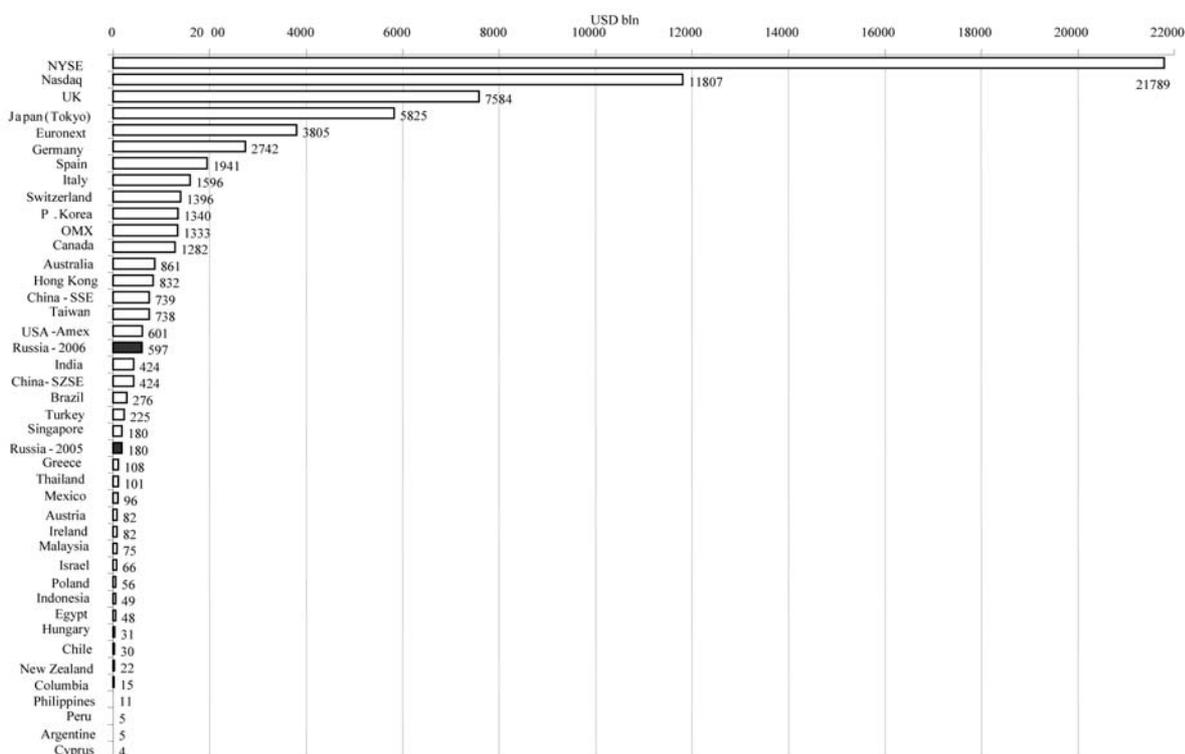
Source: WFE (World Federation of Exchanges) data; WSJ publication data.

*Figure 3. Capitalization of 2006, USD bln*

Russian companies’ capitalization in 2006 made circa \$908 bln, which reflects Russia’s position as one of the biggest emerging markets. Only China was ahead of Russia as per this index.

The exchange market liquidity indicators growth rate exceeded that of capitalization in 2006. The global position of Russian capital market as per this criterion is presented in *Figure 4*.

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*Comment.* \* Russian data include indices of RTS and MICEX.

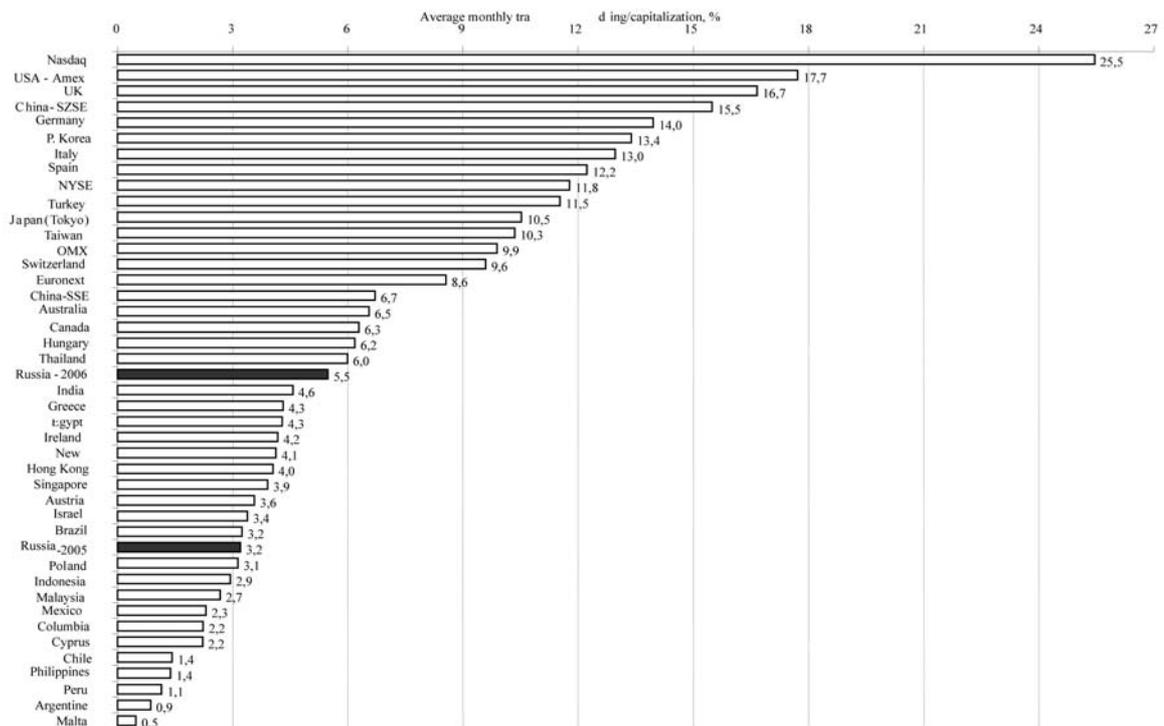
*Source:* WFE (World Federation of Exchanges) data; MICEX and RTS data.

*Figure 4.* Exchange Trading of Shares in 2006\*, USD bln  
remove USD bln from the picture

The volume of stock trading in Russia reached \$597 bln in 2006 vs. \$180 bln in 2005, i. e. demonstrated 3.3 times growth. Compared to other emerging markets, Russia has given way only to China with regards to this indicator (similar to capitalization). However, Russia's breakaway from global markets with regards to liquidity has not become any more visible. Despite significant growth of quantitative indicators of Russian exchanges' liquidity in 2006, globalization of various international exchanges has become another serious challenge. NYSE and Euronext (leader of European term contracts and bonds market) integration is currently in its final phase, Tokyo Stock Exchange and Indian National Exchange are ready to join the alliance – all this symbolizes the beginning of the process of starting new global markets for stock, derivatives and other financial instruments. Market exchanges of Nordic countries have united into OMX. China has developed coordinated market exchange strategy oriented towards global interests in cooperation with Hong Kong, Beijing and Shanghai stock exchanges. Unfortunately, Russian exchanges are currently limited by domestic market only and are not undertaking any noticeable steps within the framework of world trading globalization. In a just a few years any national stock exchange, even a major one, is unlikely to be competitive enough compared to global exchanges from the point of view of traded instru-

ments, accessibility to different investors' resources, diversity of trading strategies and other parameters.

A visible increase of stock turnover rate has become a positive factor of Russian capital market in 2006. International practice of calculating this index is based on dividing average monthly stock exchange turnover by the total amount of market capitalization (see *Figure 5*).



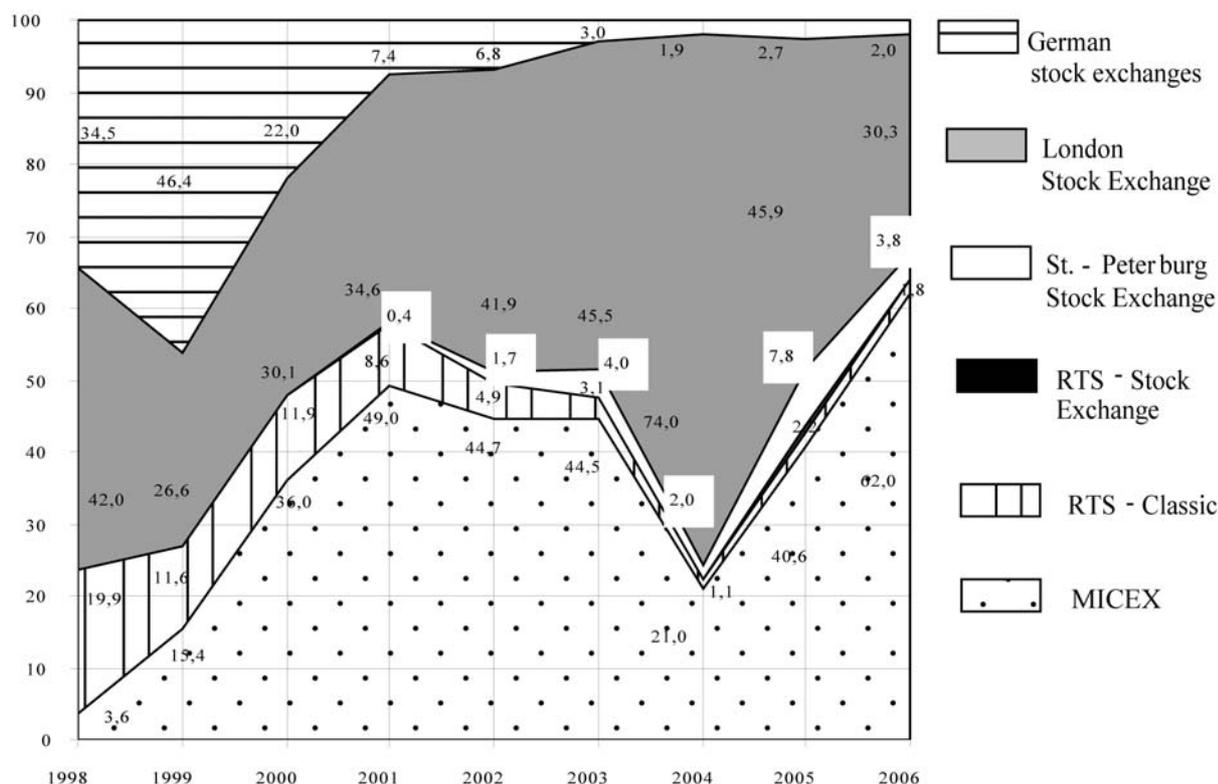
*Comment.* \* Russian data include indices of RTS and MICEX.

*Source:* WFE (World Federation of Exchanges) data; MICEX and RTS data.

*Figure 5.* Stock Turnover Rate in 2006, % remove second title

Russian stock turnover rate in 2006 made c. 5.5% vs. 3.2% in 2005. Russia is holding a mid-level position compared to other countries and visibly behind the leading markets, which is a clear evidence of a low level of Free Float for the shares of Russian issuers.

2006 provided for continuation of the 2005 trend for strengthening Russian capital market position with regards to stock and depositary receipts of Russian issuers, which is reflected in *Figure 6*.



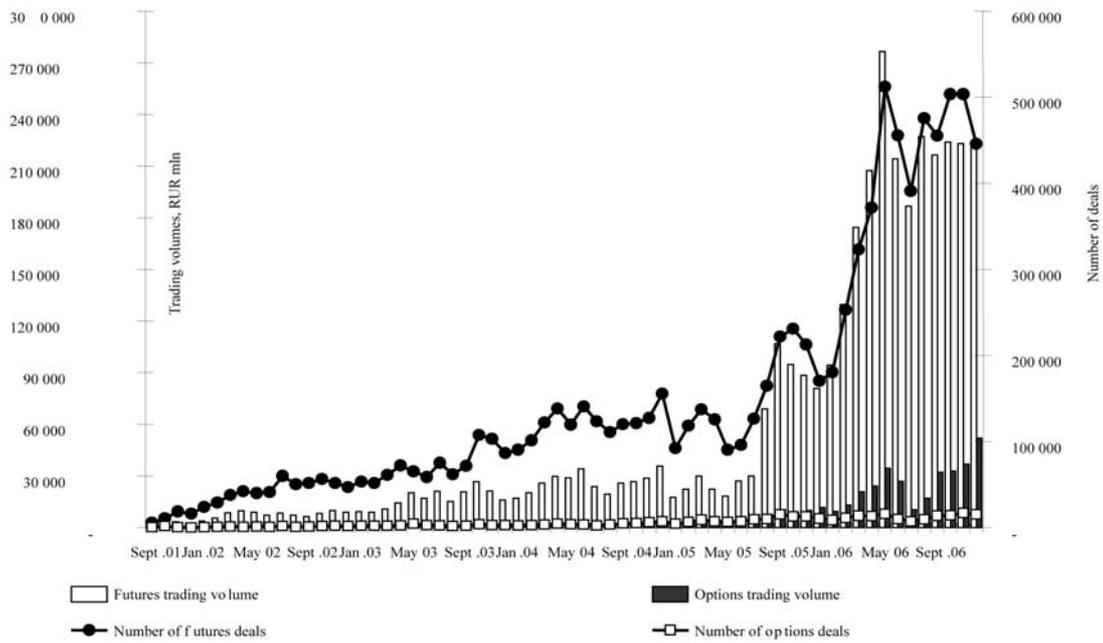
Source: stock exchanges data (without NYSE).

Figure 6. Exchanges Share in Trading Russian Stock

In 2006 LSE share decreased from 45.9% down to 30.3% in the overall trading of Russian stocks and depositary receipts; MICEX (Moscow Inter-Bank Currency Exchange) share during the same period grew from 40.6% up to 62.0%; the aggregate share of RTS exchanges fell from 10.0% down to 5.6%. In 2006 Gazprom shares liquidity center was moved from RTS to MICEX. This has seriously knocked the bottom out of RTS position at spot stock exchange.

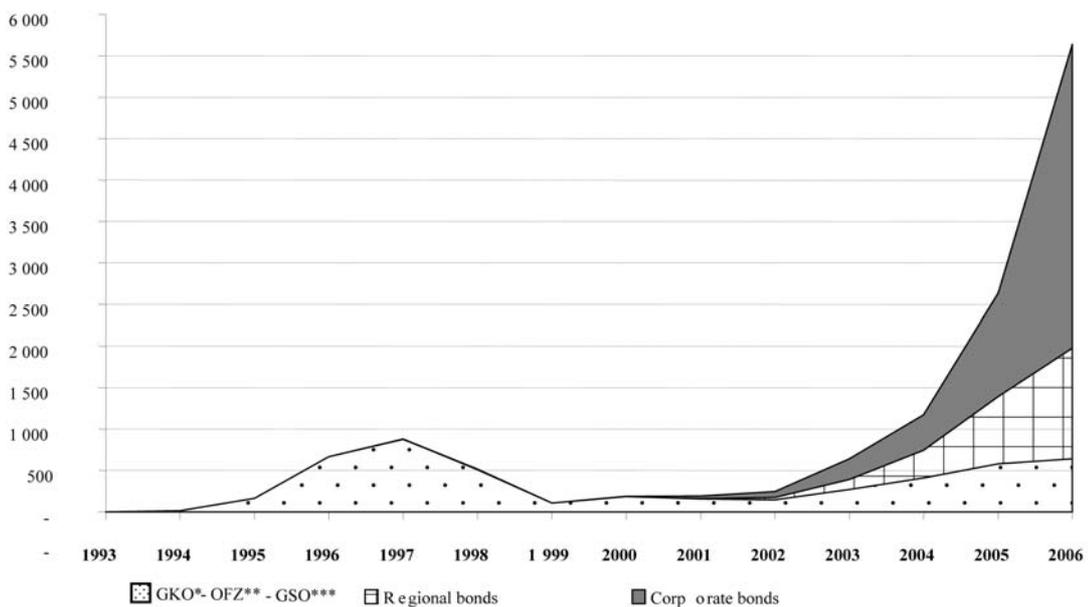
The term market growth continued in 2006, which is reflected by the data in Figure 7.

In 2006 trading volumes at Russian stock exchange markets made: for futures – \$88.8 bln, for options – \$11.5 bln, which meant exceeding the level of 2005 by 4.1 and 4.6 times accordingly. London Stock Exchange and Germany Stock exchanges announced their plans for establishing Russian term depositary receipts market during the current year.



Source: RTS data.

Figure 7. Trading Volumes and Number of Deals at RTS Term Market from September 1, 2001, to December 29, 2006



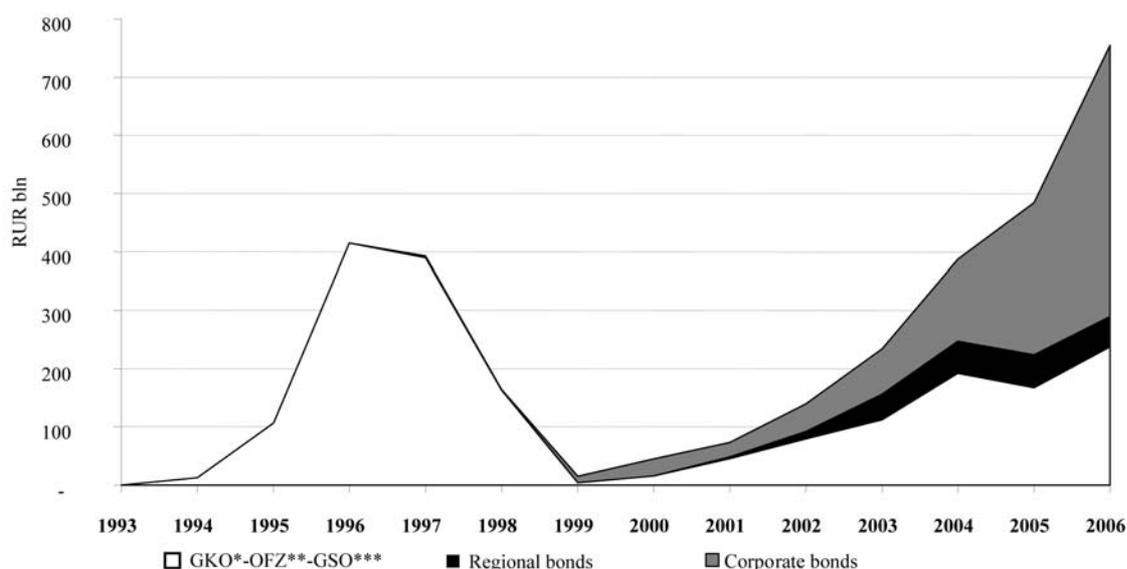
\*GKO: State Treasury Bills  
\*\*OFZ: Federal Loan Bonds  
\*\*\*GSO: State Savings Bonds

Source: data provided by RF Ministry of Finance, CBonds and Stock Exchanges.

Figure 8. Bonds Secondary Market, Trading at MICEX

Simultaneously with stock market growth 2006 displayed domestic bonds market growth. As shown in *Figures 8 and 9*, the secondary bonds market turnover and bonds trading volumes *u* overtopped T-bills (State Treasury Bills) market of 1996–1997 by a number of times.

Volumes of bonds trading at the exchanges in 2006 exceeded the maximum State Treasury Bills market liquidity (set in 1997) 6 times. During this year the volumes of trading corporate bonds at the secondary market (through exchanges) increased 2.9 times, regional and federal bonds trading – 1.7 and 1.1 times respectively. And the fact of most bonds issues having negative effective yield was not at all a barrier for their liquidity growth for their floating. This fact may be explained by banks and non-residents being major participants of this market – those who have enough capacity for using various speculative strategies to cover their potential losses from “passive” ownership of such securities<sup>116</sup>. Incremental liquidity flow into the Ruble bonds market will allow the issuers to successfully float new issues of bonds (*Figure 9*).



\*State Treasury Bills  
\*\*Federal Loan Bonds  
\*\*\*State Savings Bonds

Source: data provided by RF Ministry of Finance, CBonds and Stock Exchanges.

*Figure 9. Volume of Bonds Float*

The volume of bonds float in 2006 grew less than the respective secondary market turnover. Corporate bonds became the driving force for issues at debt mar-

<sup>116</sup> One of the most popular strategy globally (including Russia) is «*carry trade*» – the one that stipulates, borrowing at low interest rates, possibly – in currency the value of which is going down, with the purpose of further investing those funds into financial assets with higher yield (e. g., bonds nominated in Rubles).

ket, their float volumes grew from RUR 260.6 bln in 2005 up to RUR 465.3 bln in 2006, i. e. 1.8 times. The amount of regional bonds issue in 2006 decreased down to RUR 51.7 bln compared to RUR 56.8 bln in 2005, i. e., by 9.9%. The overall amount of issues of Federal Loan Bonds and State Savings Bonds in 2006 made RUR 237.6 bln vs. RUR 167.2 bln in the preceding year, i. e., grew by 42.1%. Availability of sustainable revenue base for both federal and regional budgets makes government less interested in borrowing. However, contrary to the situation with the regional bonds, Federal Loan Bonds and State Savings Bonds are the key asset for investing the reserves of the RF Pension Fund (the part that is targeted at funding the financial defined contributions being managed by Vnesheconombank. Because of that the RF Ministry of Finance is forced to build up issues of government bonds even when federal budget has a surplus.

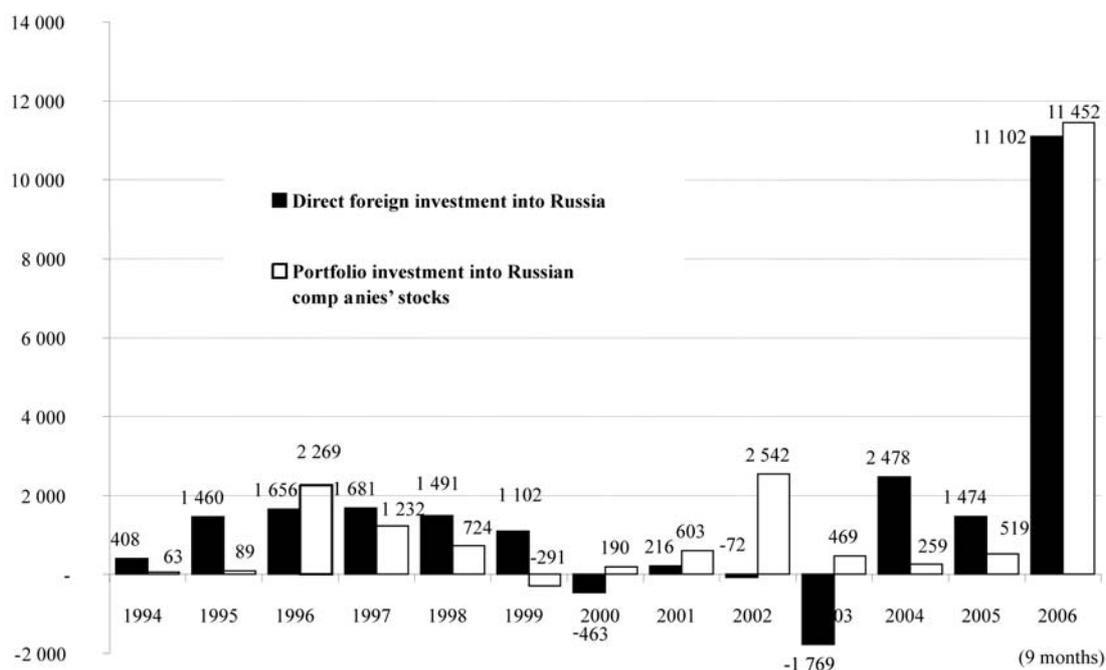
The overall amount of Rubles-valuated bonds, including federal securities, corporate and regional bonds, grew from RUR 1.5 trillion in 2005 up to RUR 2.2 trillion in 2006, i. e., 1.4 times.

Thus, despite serious problems in institutional sphere and with investment climate, Russian capital market is still of interest for foreign investors because of its yield and explosive growth of its quantitative parameters (liquidity, capitalization, capacity). However, this growth of quantitative parameters will not directly impact the score of Russia calculated based on CalPERS Methodology in 2007, because this score with regards to quantitative parameters is already the highest possible (3).

As it was shown in 2005 overview by the Institute of Economy in Transition, Russia still lacks transparency of information about financial market growth factors. Contrary to many countries, for some unknown reasons there aren't any financial accounts statistics in Russia (which would allow for accurate registration of the level of various investors categories' participation in Russian-issued securities). In such environment only indirect data may serve the basis for analyzing the level of impact various factors might have on capital market development.

#### *Role of foreign investment at Russian capital market*

2006 growth of stock market was based on heavy commercial activity by non-residents, Russian public and domestic institutional investors. The non-residents dominated, just like in 2005. For them Russian capital market was attractive not only because of extremely high returns for investment into securities, but also because of such factors as stable macro-economic situation in the country in general due to high prices for exported raw materials, liberalization of Gazprom shares market, strengthening of Ruble versus US Dollar, cancellation of limitations stipulated in currency regulations and control framework, excessive liquidity of the global markets due to low interest rates. The impact of external factor on Russian capital market is represented in *Figure 10*.



Source: Balance of Payments of the Russian Federation.

Figure 10. Net Import (+) / Export (-) of Capital into/from Russia, USD mln

2006 demonstrated unprecedented inflow of foreign capital into Russia. The demand for Russian companies' stocks on behalf of non-residents during the first 9 months of 2006 increased: net direct foreign investment – by \$11.1 bln; portfolio investment – by \$11.5 bln. Major investment flow from hedging funds and direct investment funds falls under the category of direct foreign investment, so this group of investment in Russia does not differ much from portfolio investment.

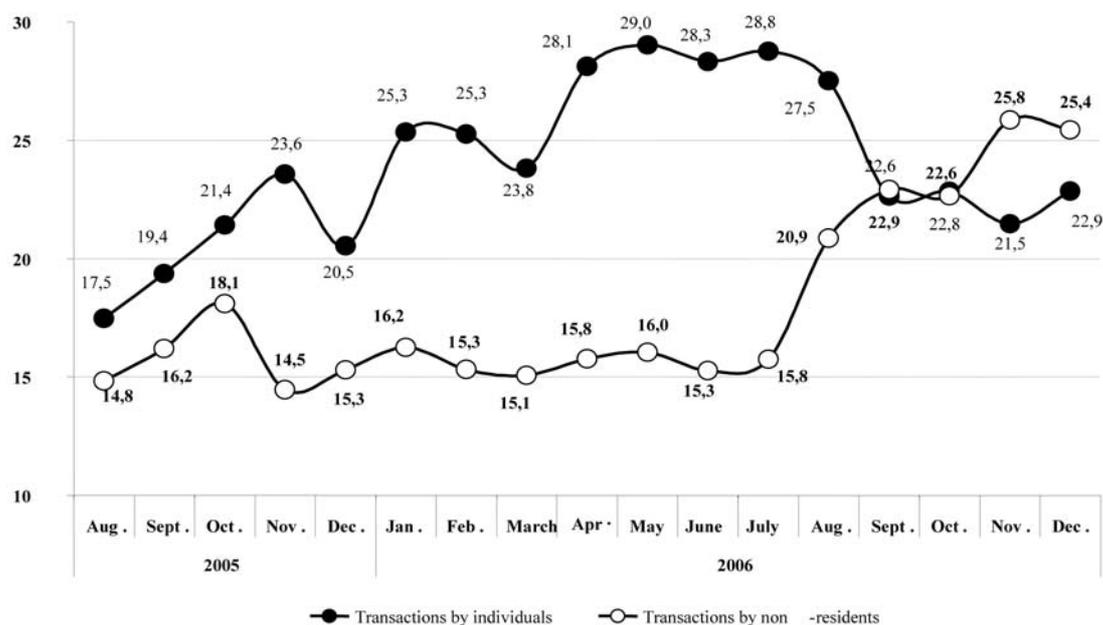
Increased influence of non-residents at MICEX stock exchange (constituting more than 95% of Russian exchanges turnover) is shown in Figure 11.

In 2006 the non-residents' share in the total value of sales-and-purchase transactions at MICEX stock exchange reached 25.4% exceeding the share of individual private investors (22.9%). The most noticeable increase of non-residents' participation at MICEX falls on the period starting from the date of canceling the limitations on transactions with the stocks of non-residents (previously established within the currency control and regulation framework).

It is necessary to state here that practically the role of non-residents in the transactions with Russian companies' stocks in the territory of Russia is even bigger. The thing is, many major brokers and banks purchase stocks at MICEX in their own names for further re-selling them to non-residents through off-shore companies<sup>117</sup>. Such re-selling is normally qualified as deals beyond the stock exchanges, and their share in the market makes up to 20–30% of the stock exchange turnover

<sup>117</sup> As it has been stated above, because of imperfectness of Russian tax regulations and some other factors, non-residents prefer to own stocks of Russian companies indirectly, i. e. – through off-shore zones.

of shares. Non-residents themselves sell stocks also outside the stock exchanges. Taking this into account, we estimate the share of non-residents' participation in Russian stock exchange as almost 50%.



Source: calculated based on MICEX stock exchange data.

Figure 11. Individuals' and Non-Residents' Share in Stocks Transactions at MICEX, %

The problem of Russian stock exchange market from the point of view of foreign portfolio investors' participation is that it so far has not yet become the key investment site for major global investment and pension funds focused at foreign retail investment. The funds specializing in Russia are usually low-capitalized ones, and most of them have a status of either hedging funds or funds focused on dealing with qualified investors (e.g., Hermitage Fund or funds managed by JPMorgan Fleming). According to the RF Statistics Agency, off-shore zones (Luxembourg, Cyprus, Virgin Islands and Cayman Islands) in 2006 accounted for 40% of accumulated foreign investment into Russia.

According to *EmerginPortfolio.com*, the value of portfolio funds' investment into Russia made c. \$10 bln as of the beginning of 2006. Table 17 represents the profile of foreign funds investing into Russian companies' securities.

Global investment funds specializing in emerging markets in Europe, as well as global funds of emerging markets are key investors for Russian JSCs. Investment funds registered in Luxembourg are dominating as for investment into Russia (they account for 47% of foreign portfolio investment into Russian companies' stocks), the funds registered in the USA account for 23%, Ireland – 8%, Austria – 7%, and Cayman Islands – 2% 8. Almost 60% of assets are funds set up in off-shore zones (Luxembourg, Ireland, Cayman Islands and Guernsey).

Table 17

**Foreign Portfolio Investment Profile with regards to Russian  
Companies Stocks as of the beginning of 2006, %**

Country of registration of global investment fund	Areas of specialization of global investment funds				Total
	Global funds of emerging markets	European emerging markets	Europe, Far East and Africa	International markets	
Austria		10.8			<b>6.8</b>
Belgium	0.1	0.4			<b>0.3</b>
Bermudas	0.0				<b>0.0</b>
Canada	0.2				<b>0.1</b>
Denmark		1.1			<b>0.7</b>
France	1.9	1.9			<b>1.8</b>
Guernsey	2.7	0.0			<b>0.9</b>
Ireland	3.5	11.2		0.3	<b>8.2</b>
Jersey	0.4	0.0			<b>0.1</b>
Luxembourg	31.8	56.9	100.0		<b>46.6</b>
Switzerland	1.0	1.5			<b>1.3</b>
UK	9.2	4.8		0.4	<b>6.0</b>
USA	49.3	4.7		99.6	<b>23.0</b>
Cayman Islands		3.0			<b>1.9</b>
Finland		1.3			<b>0.8</b>
The Netherlands		0.7			<b>0.5</b>
Sweden		1.7			<b>1.1</b>
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: www. EmerginPortfolio.com.

These funds make package-based investments into emerging markets seeking to diversify their portfolios between different countries irrespective of macroeconomic situations they are in. The fact that emerging markets are very attractive in general for investment dominates over characteristic features of any specific market, country-based approach usually dominates over the industry-based one<sup>118</sup>.

This domination of country-based portfolio strategy among foreign investors coming to Russia has a negative impact on the quality profile of the market for Russian companies' stocks, because it creates a phenomenon of simultaneous deviations of their prices irrespective of financial accounts of the companies themselves. This is reflected in the fact that Beta coefficients are close to 1 for most of the "blue chips", which characterizes the level of returns on investment into various securities dependent on stock exchange profitability indices. *Table. 18* presents Beta coefficients for 15 issues with the biggest liquidity from MICEX list.

<sup>118</sup> Brooks R., Del Negro M. The Rise in Co movement across National Stock Markets: Market Integration or IT Bubble. Federal Reserve Bank of Atlanta. – Working Paper 2002-17a, September, 2002.

Table 18

**Beta Coefficients for Russian “Blue Chips” in 2003–2006**

	Beta Coefficients				
	2003	2004	2005	2006	2003–2006
Aeroflot (ao)	0.57	0.25	0.46	0.40	0.40
AvtoVAZ (ao)	0,64	0,52	0,40	0.76	0.62
RAO EES (United Energy Systems)	1.14	1.00	0.98	1.07	1.06
RAO EES (United Energy Systems)	0.95	1.00	0.86	0.99	0.97
Norilsk Nickel (ao)	0.87	1.19	1.04	1.06	1.05
LUKoil (ao)	0.91	0.86	1.03	0.98	0.94
Mosenergo (ao)	1.04	0.66	1.28	0.48	0.78
Rostelekom (ao)	0.98	0.82	0.87	0.65	0.81
Sberbank (RF Savings Bank)	0.75	0.71	0.79	1.07	0.85
Сберегательный банк РФ	0.54	0.60	0.99	1.00	0.78
Gazpromneft (former Sibneft) (ao)	1.29	0.85	0.91	0.73	0.91
Surgutneftegas	1.22	0.90	1.13	1.21	1.11
Surgutneftegas	0.97	0.70	0.97	1.11	0.94
Tatneft (ao)	0.77	0.80	1.32	1.12	0.97
Gazprom (ao)	0.75	0.65	0.71	1.03	0.81
<b>Mean value</b>	<b>0.89</b>	<b>0.77</b>	<b>0.92</b>	<b>0.91</b>	<b>0.87</b>
<b>Standard deviation</b>	<b>0.23</b>	<b>0.23</b>	<b>0.26</b>	<b>0.25</b>	<b>0.18</b>

Source: Russian stock exchanges data

For most of the issues Beta coefficients are close to 1, which is an evidence of high correlation between changes of their prices with MICEX profitability index. The average Beta coefficient for all issues of stocks made 0.92 in 2005 and 0.91 in 2006, which reflects the domination of synchronized dynamics of “blue chips” prices at Russian stock exchange<sup>119</sup>.

The synchronized dynamics of stocks does not only impede institutional investors and the public from using the advantages of portfolio justification at the domestic market, but also reflects the problems of management efficiency in major corporations. Portfolio theory evaluates the efficiency of managers through Alpha coefficient reflecting the deviation of actual profitability of portfolio from its potential profitability under the pre-set profitability of the basic portfolio (e.g., index) and Beta of the given portfolio. *Table 19* represents application of this approach to evaluation of management efficiency in Russian companies.

<sup>119</sup> It will be fair to emphasize that a number of analysts (e. g., A. Vernikov from “Anton-Line”), state that in early 2006 the trend of gradual destruction of synchronized stocks dynamics became noticeable, which is related with emerging new generators of the market growth represented by energy companies and banks (commentary in Quote. ru of January 29, 2007).

Table 19

**Alpha Coefficients for Russian “Blue Chips” in 2003–2006**

	Alpha Coefficients				
	2003	2004	2005	2006	2003–2006
Aeroflot (ao)	0.13	0.22	-0.06	0.06	0.10
AvtoVAZ (ao)	-0.07	-0.01	0.03	0.06	-0.01
RAO EES (United Energy Systems)	0.,05	-0.05	-0.06	0.12	0.02
RAO EES (United Energy Systems)	0.12	-0.05	-0.04	0.15	0.04
Norilsk Nickel (ao)	0.27	-0.13	-0.04	-0.04	0.01
LUKoil (ao)	-0.05	0.06	0.04	-0.09	0.00
Mosenergo (ao)	0.07	0.25	-0.31	0.00	0.03
Rostelekom (ao)	-0.01	-0.09	-0.11	0.31	0.03
Sberbank (RF Savings Bank)	-0.06	0.22	0.21	0.11	0.12
Сберегательный банк РФ	0.05	0.10	0.37	0.12	0.17
Gazpromneft (former Sibneft) (ao)	-0.18	-0.02	-0.12	-0.11	-0.10
Surgutneftegas	-0.02	0.05	-0.11	-0.15	-0.05
Surgutneftegas	-0.04	0.09	-0.02	-0.17	-0.02
Tatneft (ao)	-0.04	0.07	0.02	-0.13	0.00
Gazprom (ao)	0.03	0.26	0.21	-0.04	0.12
<b>Mean value</b>	<b>0.02</b>	<b>0.06</b>	<b>0.00</b>	<b>0.01</b>	<b>0.03</b>
<b>Standard deviation</b>	<b>0.11</b>	<b>0.13</b>	<b>0.16</b>	<b>0.14</b>	<b>0.07</b>

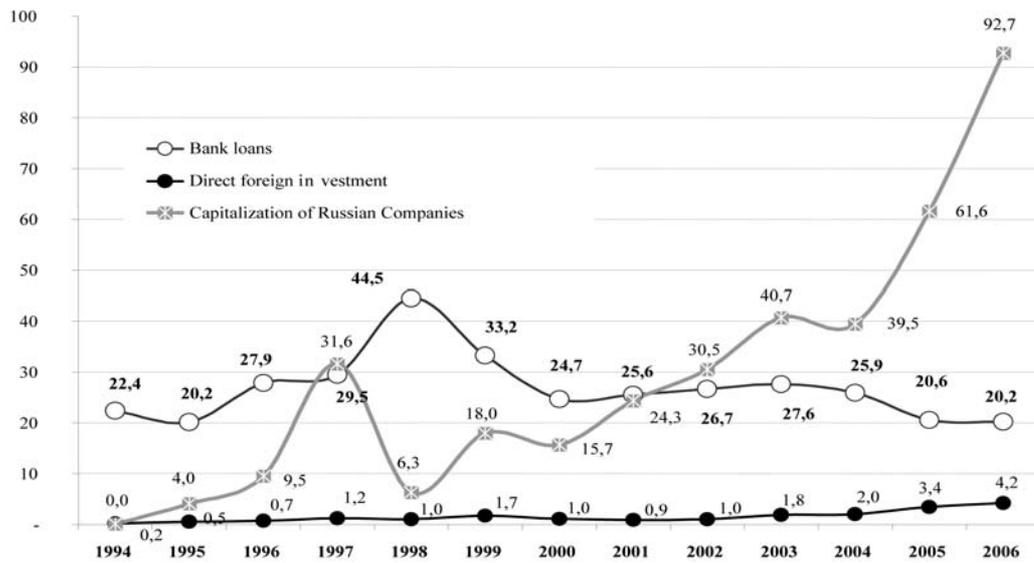
Source: Russian stock exchanges data

The average Alpha coefficient for 15 major companies in 2005–2006 was 0, which shows lack of their management’s contribution into deviation of their stocks prices dynamics from index (the average market indicator). In 2006 several companies (Norilsky Nickel, LUKoil, Gazpromneft, Surgutneftegaz, Tatneft and Gazprom) had negative Alpha coefficient.

*Interaction between stock exchange and banking system*

During 11 months of 2006 banks increased their investments into stocks by RUR 65.6 bln (or \$2.4 bln), which is a pretty modest figure in the context of growth of capitalization and capital market liquidity. At the same time the gap between the level of capital market development and banking system potential continued to grow. *Figure 12* represents the data about the share of bank loans, capitalization and direct foreign investment in Russian GDP и.

In 2006 the capitalization share in GDP increased up to 92.7% vs. 61.5% in the previous year. This was the year when Russia became one of the world leaders with regards to direct foreign investment. In this context the share of bank loans in GDP after having decreased in 2005 from 25.9% down to 20.6% in 2005 remained practically on the same level. The gap between capitalization and internal loans indicators is an evidence of serious disparity between the level of banking system development and growth dynamics of Russian companies.

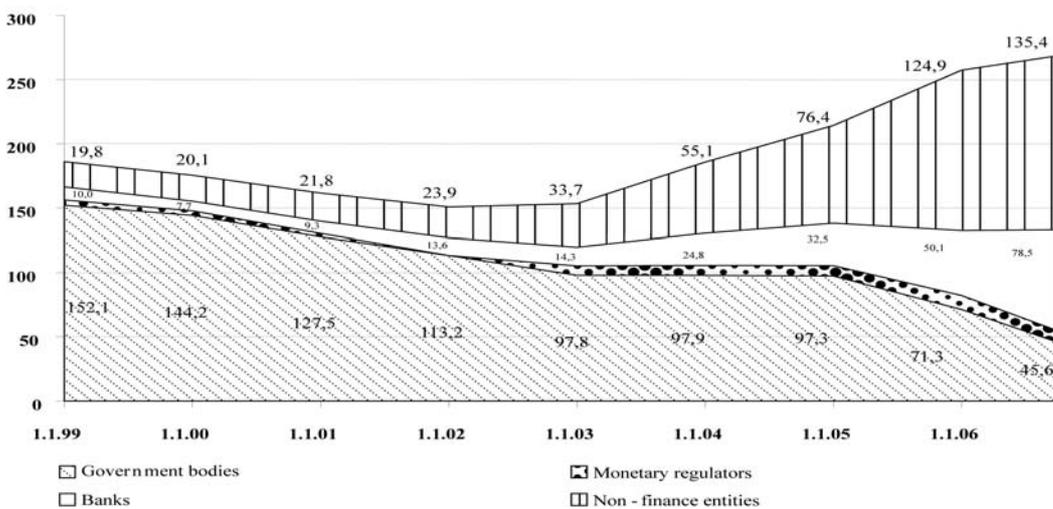


Source: data received from Central Bank of Russia, Statistical Agency of Russia, World Bank and UN Conference on Trade.

Figure 12. Share of bank loans, direct foreign investment and capitalization in GDP of the Russian Federation, %

*Growth of external debt of Russian companies*

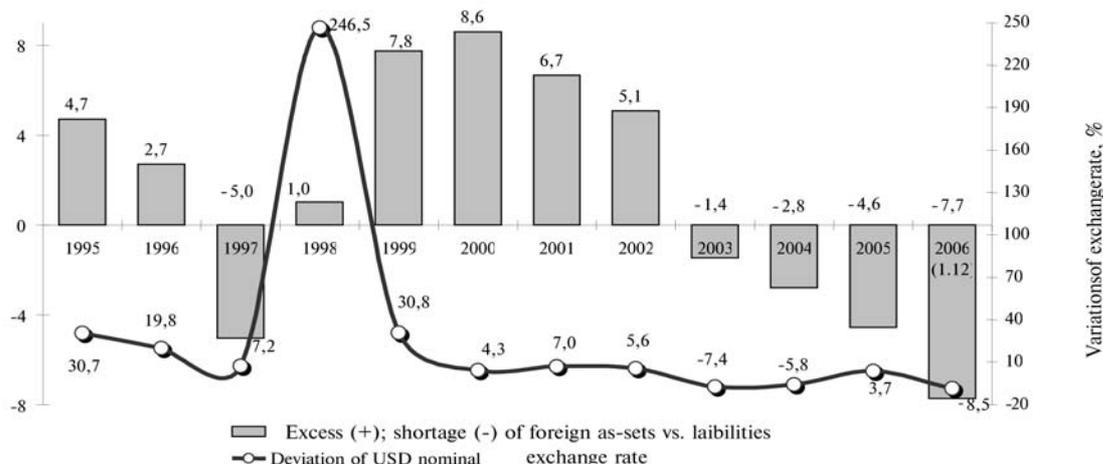
Lack of internal credit resources forced the banks and non-financial companies to borrow internationally. The banks were much more active in doing that, than non-financial companies. This led to significant changes of external debt of Russia and Russian companies in 2006 (see Figure 13).



Source: data provided by the

Figure 13. Foreign Debt of the Russian Federation in 1999-2006, USD bln

In 2006 external debt of non-financial companies and commercial banks made \$135.4 bln and \$78.5 bln respectively. During one year the debt of non-financial companies increased by 8.4%, of banks – by 56.7%, i.e., the debt of banks was growing much faster than external debt of non-financial companies. As a result in 2006 serious disparities in the banking system assets and liabilities profile continued to build-up, which is reflected in *Figure 14*.



Source: calculations based on data provided by the Central Bank of Russia.

*Figure 14.* Excess (+) and shortage (-) of banks' foreign assets vs. liabilities (share, % of the value of assets / liabilities)

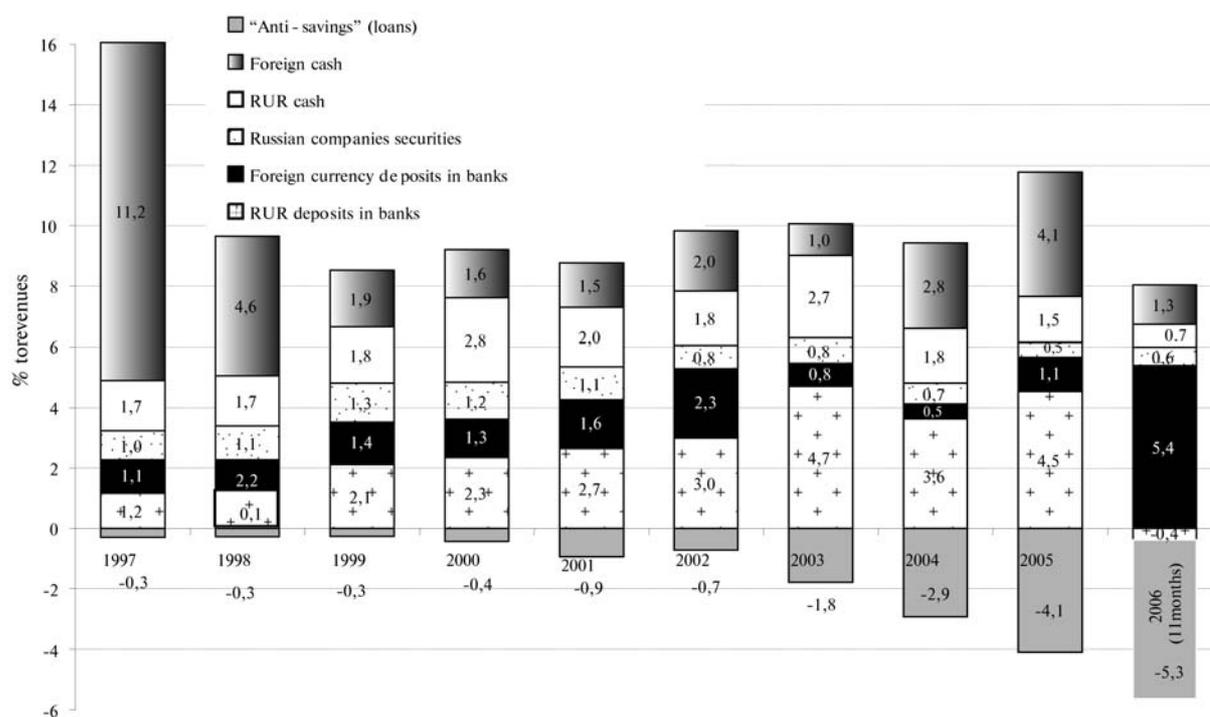
In 2006 foreign liabilities of Russian banks significantly exceeded the share of respective assets. That resulted from the banks implementing their strategy targeted at facilitated formation of their liabilities in foreign currency and their further re-investment into Ruble assets. For banks this policy is risky because in case of serious fall of Ruble, decrease of Ruble assets profitability or appreciation of foreign currency borrowing the banks may face the liquidity problem. The misbalance between foreign currency assets and liabilities of the banks was one of the main reason for 1998 crisis of major Russian banks in the conditions of abrupt devaluation of Ruble. In 2006 the misbalance between assets and liabilities of the banks exceeds the scale of similar misbalance before 1998 crisis. In 1997 it constituted 5.0% of the value of banks' assets (liabilities), and in 2006 it reached the level of 7.7%. This is an evidence of increasing risks associated with banks liquidity and of vulnerability of their financial status in case external factors change significantly at both foreign currency and credit markets.

#### *Low level of savings of the population in securities*

As was shown in *Figure 11*, the share of individual citizens in stock exchange transactions at MICEX in 2006 was 20% (as for the total value). The public is one of the main drivers of e-commerce, the citizens are actively employing the possibilities of marginal debt financing to increase profitability and scale of capital market transactions. According to MICEX, the number of individual market players at the

end of 2006 made 250 thou persons, which exceeded the level of the beginning of the year 2.5 times.

However, the statistics of individual private investment into securities during 11 months of 2006 reflected in *Figure 15* show that the public's contribution into capital market development was pretty modest in 2006.



Source: calculations based on data provided by the Central Bank of Russia and by Federal Statistics Agency.

*Figure 15.* Public inclination towards savings 1997-2006

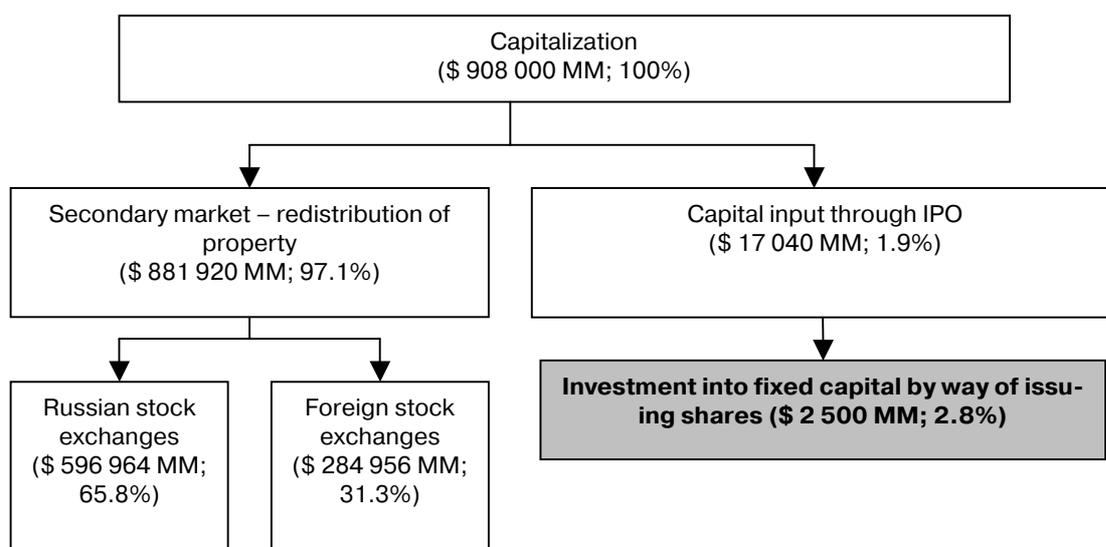
The share of citizens' income invested into securities in made 0.6% – 3 times below the level of 1998 (prior to the crisis). According to the RF Statistics Agency, the increment of net citizens' investment into securities in 2006 reached RUR 87.3 bln (\$3.2 bln), which is 1/3 more than in the preceding year. Individual savings in securities in 2006 exceeded the increment of banks' assets in the form of stocks, however, in the context of annual capitalization increment in the amount of \$426 bln and liquidity of stock exchange increment in the amount of \$397 bln, these savings look pretty modest. The overall value of securities accumulated by the public in 2006 reached \$20 bln.

It is also necessary to note that the preliminary 2006 data represented in *Figure 15* show two negative trends with regards to the public inclination towards investing in financial assets in 2006: the indicator of the overall inclination towards savings fell from 11.7% of total revenues in 2005 down to 8.0% of income in 2006; at the same time the overall citizens' debt on bank loans, increased significantly in

2006 and reached 5.3% of individuals' income – practically equal to the amount of bank deposits in Rubles.

Heavy growth of capital market, attracting resources by way of corporate bonds float and IPO of shares in an ideal situation should promote the growth of investment and economic upswing. However, in order to make this correlation work, the investment attracted by companies through capital market need to become real investment, i.e., be utilized for creating new production capacity, fixed assets and production reserve. Emphasizing this kind of correlation between investment and economic growth, the Nobel Prize winner in economics neo-Keynesian P. Samuelson marked that “investment are materialized only in case real capital is created”<sup>120</sup>. In other words, fixed assets are real generators of economic growth.

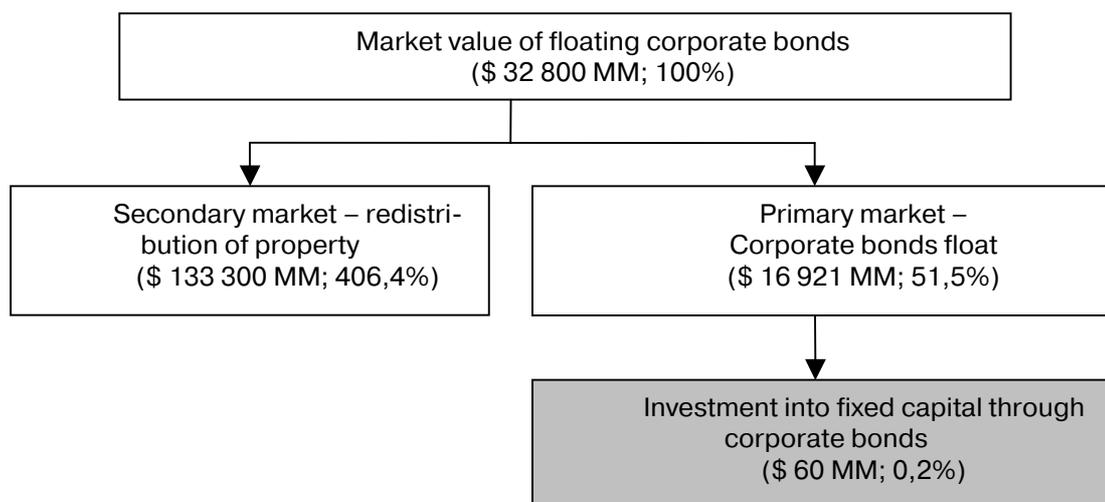
With this regards, the puzzle of Russian capital market with its heavy growth of IPO and of corporate bonds float in 2005–2006 is in the fact that all this does not lead to real capital growth. *Figures 16 and 17* show consolidated data on capitalization, liquidity and issue of Russian companies stocks and corporate bonds.



Note. \* Evaluation takes into consideration 2006 market exchanges data and Russian Statistics Agency Report for 9 months of 2006.

Figure 16. Russian Companies Equity Securities Market Parameters in 2006\*

<sup>120</sup> Paul E. Samuelson, William D. Nordhaus, Economics: translated from English.: 16<sup>th</sup> edition. “Williams” publishers, 2005. – p. 389.



Note. \* Evaluation takes into consideration 2006 market exchanges data and Russian Statistics Agency Report for 9 months of 2006.

Figure 17. RUR Corporate Bonds Market Parameters in 2006\*

In 2006 within the framework of IPO Russian companies attracted about \$17 bln, and by floating their Ruble bonds – another c. \$17 bln. According to the RF Statistics Agency, only \$2.5 bln out of \$17 bln received from floating stock (14.7% of the raised funds) were invested into fixed assets. The statistics about utilizing \$17 bln received from floating corporate bonds is even more paradoxical. Only \$60 MM out of this amount (0.4%!) was used to increase fixed assets. Of course, it is possible to refer to the inaccuracy of official statistics data, however, overall it is unlikely to change in any way the key conclusion: the funds received from issuing stocks and bonds are not re-invested into fixed capital, respectively – they do not have any impact on the economic growth.

One can speculate on the areas in which these resources are used. The major flow might be spent on re-financing of debt and acquisition of assets from their effective owners. The processes currently taking place at Russian capital market are similar to those in the USA in late 1980-s when LBO (leverage-buy-out) deals were funded at the expense of issuing junk bonds and IPO. The essence of such deals was massive borrowing at capital market using credit facilities to buy companies and acquire their assets. The key risk in such type of deals is poor efficiency of the acquired companies which may turn out insufficient to pay out the debt incurred to buy these companies. In the US the junk bonds market was finished with a loud collapse of the borrowers in 1989.

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Thus, the “Clod Frollo dilemma” which foreign investors are currently facing when deciding about investment into Russian securities may be worded in brief. During the last several years Russian capital market has demonstrated remarkable

results as dper its profitability, liquidity and capitalization growth. This cannot be left without attention of the investors making them pretty excited. However, each time they need to make their decision about investment, they need to understand that when buying financial instruments from Russian issuers they are not acquiring managerial talent and skills, but the capacity of the government to assure high proceeds of the corporations it controls due to speculative demand for energy and other primary resources. At the same time the growth of securities' yield is often heated by new liquidity supply rather than by improving efficiency of the corporations' activities.

There are two ways out of such situation for major investors. One is an optimistic scenario. It stipulates transformation of the share of foreign strategic and portfolio investors in Russian-issued stocks and bonds into a positive corporate governance model, which eventually will facilitate establishing fair market competition in Russian economy. The second scenario is a pessimistic one and implies repetition of the LTCM story.

Another interesting question is about the decision CalPERS fund needs to make in Mart-April of 2007: whether to invest or not in Russian-issued securities? Our assumption is they will authorize investment at Russian capital exchange. This could have become an important positive sigh when Russia's overall perspective as an emerging market is being evaluated. After all, Clod Frolo could not resist Esmeralda's beauty.

## **5.5. The Housing Market**

Last year, the housing market was advancing against a fairly favorable background formed by the country's positive socio-economic development.

The macroeconomic situation in Russia was influenced by deceleration of inflation rates, predictability of the RUR exchange rate, a continuous de-dollarization of the economy, solidification of the national budgetary system, and high growth rates of GDP. Last year, the advancement of the economy on the whole and the real estate market in particular was fueled by high oil prices, while the private sector boasted a record-breaking value of the indicator of net import of capital.

The above processes were complemented by a vigorous advancement of the stock market and the market for mutual investments, which also had a certain effect on the housing market. With the USD exchange rate depreciating, interest rates on bank deposits low, while investment in real estate (including share participation) remaining risky and inaccessible, quite a great part of the population transformed their savings in securities and became participants in mutual investment funds (MIFs).

This novelty was also steered by growth in the number of IPOs, which became fashionable among large companies with a government stake in them (such as Rosneft in 2006 and Sberbank and Vneshtorgbank 2007). They attracted quite a fraction of the population's savings, which otherwise potentially would be spent on housing. Evidently, individuals, as a rule, are keen to maintain a conservative, low-

interest strategy, which manifests itself in a direct (thus bypassing intermediaries and mutual investors) ownership of a stake in a company with the dominating government participation, which they regard as an additional safeguard for their investments.

By contrast to the stock market, the one for mutual investments is partially related to the housing. According to the National League of Managers, as of October 2006, there were as many as 610 MIFs in Russia, which attracted 300,000 private investors. The total volume of their assets accounted for RUR 404.9 bln., of which 64.9 bln (16%) falls on closed-end mutual investment funds which, since their rise in 2003, have channeled their funds to real estate, including housing<sup>121</sup>. The number of the closed-end mutual investment funds doubles annually. According to the data on the ten months of 2006, of 158 MIFs registered since the start of the year most were CEMIF, though in terms of cash inflow rates they somewhat lagged behind regular MIFs. The average size of a CEMIF tends to decline (RUR 634m. as of the end of the 3<sup>rd</sup> quarter 2006, while that of a regular one tends to grow (RUR 266m., as of the same date)<sup>122</sup>. The threshold to enter a CEMIF has been decreased, which makes them more accessible for private individuals.

The profitability rate of CEMIFs depends on their profile and relevant risks. It is leasing funds that operate in the area of real estate lease that reported the least profitability rates. By contrast, development and construction funds that build housing using attracted private resources boast a far greater return rate, while mortgage funds that operate with such instruments as encumbrances continue to hold their specific niche on the market. Interestingly, the “Mortgage Loan Housing Agency” has also started operations with encumbrances. So, being connected with the housing market, CEMIFs can become its competitors, thus diverting funds from the main segment of actual deals in the natural form. Hence, the factor of development of the financial markets (in a broad sense) should be undoubtedly taken into account while estimating prospects for development of the housing market over the years to come.

The current stability of the macroeconomic parameters has given a positive signal to operators and consumers on the real estate market.

#### *5.5.1. Overall situation on the housing market and price dynamics in 2005–2006*

The data of *Table 20* can form a general characteristic of the situation on the housing market. The *Table* provides average offer prices for apartments in Russian cities in late- 2004, 2005 and 2006 (in USD equivalent), calculated on the basis of the data supplied by certified by the Russian Realtor Guild analysts of the real estate market<sup>123</sup>.

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<sup>121</sup> Krol N. Investor spit, a denezhki idut. Kwartirny ryad, 1-7 February 2007, # 4 (627) p. 10

<sup>122</sup> Udvoenie PIFov//CNIP. Stroitelstvo, Nedvizhimost, Investotsii, Proekty, # 02 (02), December 2006, p. 67

<sup>123</sup> Computations were made on the basis of the data provided by G. Sternik and the noted certified by RRG analysts of the real estate market, including: A.Beketov, A. Sapozhnikov (independent ana-

Table 20

**The Dynamics of the Average Offer Price for Apartments in 2004–2006**

City (region)	\$/sq.m.			Index		
	December 2004	December 2005.	December 2006	December 2005 / December 2004	December 2006/ December 2005	December 2006 / December 2004
Moscow	1953	2658	4828	1.361	1.816	2.472
S. Petersburg	1083	1180	2593	1.090	2.197	2.394
Moscow oblast	908	1121	2522	1.235	2.250	2.778
Ekaterinburg	882	1062	2415	1.204	2.274	2.738
Ufa	766	997	2074	1.302	2.080	2.708
Izhevsk	-	-	1837	-	-	-
Novosibirsk	748	1012	1658	1.353	1.638	2.216
N. Novgorod	579	720	1650	1.243	2.292	2.850
Tymen	-	864	1600	-	1.852	-
Rostov-on-Don	656	861	1550	1.313	1.800	2.363
Perm	680	882	1430	1.297	1.621	2.102
Tver	542	688	1370	1.269	1.991	2.527
Omsk	518	676	955	1.305	1.413	1.844
Penza	-	543	890	-	1.639	-
Ulyanovsk	405	486	859	1.20	1.768	2.121
Shakhty (Rostov oblast)	-	-	480	-	-	-
<i>Towns in Moscow oblast</i>						
Khimki	1237	1589	3254	1.285	2.047	2.630
Odintsovo	1128	1474	3228	1.307	2.190	2.862
Krasnogorsk	1050	1365	3071	1.300	2.250	2.925
Podolsk	832	1081	2461	1.299	2.276	2.957
Ramenskoye	753	979	2215	1.300	2.263	2.942
Solnechnogorsk	697	902	1922	1.294	2.131	2.757
Naro-Fominsk	705	843	1901	1.196	2.255	2.696
Serpukhov	571	695	1317	1.217	1.895	2.306
Mozhaysk	486	604	1110	1.243	1.838	2.284

Quite predictably, it was the capital regions (the city of Moscow, Moscow oblast and S. Petersburg) that were leaders between 2005 and 2006 in terms of absolute prices for housing prices, with Ekaterinburg following them closely. The leading group was followed by regional centers and towns located in Moscow oblast, where leaders were the towns in the closest proximity to Moscow (Khimki, Odintsovo, Krasnogorsk). In these towns, the Dec. 2004 price level (over USD 1,000/sq.m.) was already greater than the average one across the region, and it consequently overrun the price level of S. Petersburg in late-2005 and 2006.

In 2005 it was only Moscow oblast, Ekaterinburg and Novosibirsk that have overcome the psychologically critical barrier of USD 1,000/sq.m. In 2006, these localities were joined by the overwhelming majority of the cities presented in the sample in *Table 20*, except for Omsk, Penza and Ulyanovsk. In S. Petersburg,

lysts), V. Lutskov, L. Kazimir, N. Ascheulova (AKTS "MIEL-Nedvizhimost"( Moscow and Moscow oblast)), M. Bimon and S. Bobashev ("Bulletin nedvizhimosti" (S. Petersburg)), M. Khorkov, A. Antasyuk (Ekaterinburg), A. Stepanova (SUN "Expert" (Ufa), A. Cheremnykh (UK "ASSA-Story (Izhevsk)), P. Smelov, M. Vysotskaya (Sibakademstroy Nedvizhimost), E. Ermolaeva (RID Analitik (Novosibirsk)), A. Chemodanov ("Triumph" (N. Novgorod)), V. Troshina (LEX (Tyumen)), A. Chumakov ("Titul" (Rostov-on-Don), R. davletshina ("Perspektiva konslating" (Perm), V. Kaminsky (TITAN (Tver)), S. Taruta ("Omskmedia" (Omsk)), S. Blinkova (IKPKG "Zhilye" (Penza)), E. gamova, N. Yarsina ("Tsentr nedvizhimosti"), M. Isaeva ("Zolotoy klyuch" (Ulyanovsk)), G. Eydlina ("Rielty" (Shakhty, Rostov oblast))

Ekaterinburg, Ufa and Moscow oblast (as a whole) and Podolsk and Ramenskoye the prices overstep the mark of USD 2,000/sq.m., while in Khimki, Odintsovo and Krasnogorsk – 2,000 and 3,000, and in the city of Moscow USD 3,000 and 4,000/sq.m., accordingly.

It should be noted that in Moscow, Moscow oblast, S. Petersburg, N. Novgorod and Tver prices are still quoted in USD, while Ekaterinburg and Rostov-on-Don have witnessed de-dollarization of the housing market. As concerns other locations presented in the sample, prices are still quoted in RUR there.

By the end of 2006 the housing prices posted grew more than twice in N. Novgorod, Ufa, Ekaterinburg, S. Petersburg and Moscow oblast (not only across the region as a whole, but in its most remote from Moscow towns, such as Serpukhov and Mozhaisk). In the towns in question, as well as in Tver, Tyumen, Moscow, Rostov-on-Don and Ulyanovsk, the price increment ranged between 70 and 100%. A more moderate price dynamic was noted in Penza, Novosibirsk, and Perm (62-64%). Finally, the smallest rate of the price rise for housing was noted in Omsk (41%).

Such a rapid price rise has continued at least for two years, and in all the cities in question the 2006 growth rates were greater than those of 2005. As a result, between 2005 and 2006 the housing prices grew more than twice in all the cities of the sample (except for Omsk, where the price rise accounted for 1.84 times). The group of cities with the greatest growth rates (2.6-3 times) includes N. Novgorod, Ekaterinburg, Ufa, Moscow oblast (as a whole and most its towns, except for Serpukhov and Mozhaisk). The lowest growth rates were noted in Perm and Ulyanovsk (roughly 2.1 times). Meanwhile, Tver, Moscow, S. Petersburg, Rostov-on-Don, Serpukhov, Mozhaisk and Novosibirsk found themselves somewhere between the poles, as the price rise there over the two past years accounted for 2.2-2.5 times.

As a reminder, consumer prices grew by 9% last year. The USD average nominal exchange rate in December 2005 was 28.81 RUR, while in December 2006- 26.29 RUR. Accordingly, the 2006 USD inflation rate in Russia accounted for 1.195. Thus, USD continued to depreciate in Russia, with the decline rates of its purchasing power growing notably (in 2006 they made up 16%, or twice as much vs. the respective index of the prior year (7%) and slightly over the 2004 index (15%). While considering the two-year period (2005-2006), the RUR/USD depreciation accounted for 0.94, the USD inflation index – 1.286, and the USD purchasing power plunged by more than 22%.

As concerns the index of the real housing price (less the USD inflation and the RUR inflation) ( $ISG^{124}$ ), the respective data and ratios are presented in *Table 21* below:

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<sup>124</sup> ISG is computed by the following formula:  $ISG = Ipr / Icp = Ip\$ / li\$$ , where Ipr is price index for housing in RUR equivalent, Icp – consumer price index, Ip\$- price index for housing in USD, li\$=Icp/Ir\$i – index of the USD inflation in Russia (relative to the consumer price dynamics, Ir\$i – index of depreciation of RUR vs. USD

Table 21

**The Dynamics of the Average Offer Price for Apartments in 2004–2006**

City (region)	Nominal price index			IGS		
	December 2005 / December 2004.	December 2006./ December 2005.	December 2006 / December 2004.	December 2005 / December 2004.	December 2006 / December 2005	December 2006 / December 2004.
	Moscow	1.361	1.816	2.472	1.265	1.520
S. Petersburg	1.090	2.197	2.394	1.013	1.838	1.862
Moscow oblast	1.235	2.250	2.778	1.148	1.882	2.160
Ekaterinburg	1.204	2.274	2.738	1.119	1.903	2.129
Ufa	1.302	2.080	2.708	1.210	1.741	2.106
Novosibirsk	1.353	1.638	2.216	1.257	1.371	1.723
N. Novgorod	1.243	2.292	2.849	1.155	1.918	2.215
Tyumen	-	1.852	-	-	1.550	-
Rostov-on-Don	1.313	1.800	2.363	1.220	1.506	1.837
Perm	1.297	1.621	2.102	1.205	1.356	1.634
Tver	1.269	1.991	2.527	1.179	1.666	1.965
Omsk	1.305	1.413	1.844	1.212	1.182	1.433
Penza	-	1.639	-	-	1.274	-
Ulyanovsk	1.200	1.767	2.120	1.115	1.479	1.649
<i>Towns in Moscow oblast</i>						
Khimki	1.285	2.047	2.630	1.194	1.713	2.045
Odintsovo	1.307	2.190	2.862	1.215	1.832	2.226
Krasnogorsk	1.300	2.250	2.925	1.208	1.883	2.274
Podolsk	1.299	2.276	2.957	1.207	1.905	2.300
Ramenskoye	1.300	2.263	2.942	1.208	1.894	2.288
Solnechnogorsk	1.294	2.131	2.757	1.203	1.783	2.144
Naro-Fominsk	1.196	2.255	2.696	1.111	1.887	2.096
Serpukhov	1.217	1.895	2.306	1.131	1.586	1.793
Mozhaysk	1.243	1.838	2.284	1.155	1.538	1.776

The greatest growth rate in the IGS 2006 value (over 1.9 times) was reported in N. Novgorod, Ekaterinburg, and Podolsk. In S. Petersburg, Ufa, Moscow oblast as a whole, as well as in Ramenskoye, Naro-Fominsk, Krasnogorsk, Odintsovo and Khimki its value found itself within the range between 1.7 and 1.9. Tver somewhat fell behind this group, with the real local prices for housing posting the 1.67 rise. In Serpukhov, Tyumen, Mozhaysk, Moscow, Rostov-on-Don, the real prices for housing grew 1.5-1.6 times, while those in Ulyanovsk, Novosibirsk, Perm, Penza and Omsk – less than 1.5 times. The smallest value of IGS (1.182) was registered in Omsk.

If one considers results of the two-year period of 2005-2006, the real prices for housing grew more than twice in N. Novgorod, Ekaterinburg, Ufa and across Moscow oblast (except for Podolsk and Mozhaysk).

The ISG value was slightly below 2 for the housing markets of Tver and Moscow. In all other cities presented in the sample (except for Omsk) the housing prices adjusted for inflation grew more than 1.5 times, while in Omsk the ISG value made up 1.433, thus making the city the lowest pole of the sample in terms of indices of nominal and absolute prices for housing. Atop the sample are Podolsk, Ramenskoye and Krasnogorsk, which have helped Moscow oblast to overrun the city of Moscow in terms of growth rate of housing prices in 2006. For reference, in 2003 and 2005 the situation was opposite, while in 2002 and 2004 both Subjects were even, so far as the housing price rise rates are concerned.

Whilst considering peculiarities of dynamics of the housing market in the capital region, one has to note that it is in the process of transition to a new phase of its development, that is, stabilization.

The prior moment of the reversing of the trend fell on June 2005, when after stagnation on the market, which had started in June 2004, the prices began to soar. Just a reminder, in the city of Moscow the price rise was spotted yet in the 1<sup>st</sup> half 2005, followed by its rapid acceleration (8-10% a month) in the 2<sup>nd</sup> half of the year. This tendency was in place through the end of the 1<sup>st</sup> half 2006, and the price rise consequently began to fade in the 2<sup>nd</sup> half of the year (until November, when it discontinued). In Moscow oblast, the price rise started between September and October 2005, followed by acceleration in its pace up to 12-14% through September 2006 and its discontinuation in December 2006.

The causes and factors underlying the renewal of the price rise on the capital market for real estate became evident yet between November and December 2005. The main cause behind a rapid price rise since 2005 was, on the one hand, the growth in the effective demand on the market fueled by a general rise in the aggregate demand and an explosion of mortgage and other forms of housing funding, and the declining offer generated by contraction in the volume of house building, which in turn mirrored effects of the 2004 micro-crisis on the construction market that were further intensified by the mess in the construction process in the wake of the enactment of Federal Act # 214 "On share construction...", on the other hand.

Experts projected a continuation of the price rise at an increasing pace in the 1<sup>st</sup> half 2006 and at a fading pace (down to zero) in the 2<sup>nd</sup> half of the year. Most analysts were unanimous in the assertion, but no one expected such dramatic growth rates (8-10% a month) which were noted in reality.

The growth rates began their gradual decline in the 2<sup>nd</sup> half of the year, though in Moscow oblast the process started only in the autumn. During the last two months of 2006 the absolute value of housing prices exceeded USD 4,800/ sq.m. in Moscow and 2,500/sq.m. in Moscow oblast and stabilized at these levels.

The causes behind the decline in the prices for housing, which started between July and August 2006, and a gradual transition to their stabilization became:

- fall in the number of buyers who could afford purchasing apartments at such high prices;
- worsening mortgage terms caused by shortages of offer;
- declining rates of return on apartment lease, as apartment owners saw lower rates of growth of the respective rates vis-à-vis purchase prices.

As well, since August the downfall in prices for energy sources has begun contributing to the process, too.

It was expected (and indeed occurred) that in autumn there manifested themselves effects from the fall in the price rise rates for housing, which at the same time could form causes for their possible stagnation and even adjustment:

- lower motivation to purchasing apartments for investment purposes, which previously was inspired by high price rise rates;

- possibility for capital outflow to more profitable sectors for the sake of investment;
- appearance on the market of apartments, which were purchased earlier for speculation or investment purposes;
- continuous impact of the downfall in prices for energy sources.

### 5.5.2. Housing as the priority national program.

The year 2006 has become the first full calendar year of implementation of the four national projects, one of which was entitled “Affordable and comfortable housing to the citizens of Russia”. Its first outcomes appear fairly positive.

In 2006, real estate developers put in operation 502.m. sq.m. of total area of housing, or more than 1% over the respective index of the prior year. The volume of placement of housing in operation by individual real estate developers posted somewhat more moderate growth (13.9%), i.e. just slightly differing from its 2005 index. In all, developers have built nearly 605,000 apartments, while individual developers -nearly 140,000 individual houses. As many as nearly 22,000 young families and some 13,000 families of veterans, or families with disabled (and particularly disabled children) family members have improved their housing conditions<sup>125</sup>. The volume of mortgage loans disbursed in the framework of implementation of the federal targeted program (FTP) “Housing” exceeded RUR 220 bln., or 4.4 times greater than its 2005 index, proceeding from the data contained in the Program of socio-economic development of RF for the medium term (2006-2008) approved by the RF Government with its Resolution of January 19, 2006, # 38-p.<sup>126</sup>

Table 22

### Placement of Houses into Operation in 1999–2005

Year	Sq.m. of total area	Growth rates, %	
		Vs. the prior year	Vs. 2000 r.
1999	32.0	104.2	105.6
2000	30.3	94.7	100.0
2001	31.7	104.6	104.6
2002	33.8	106.6	111.5
2003	36.4	107.7	120.1
2004	41.0	112.6	135.3
2005	43.6	106.3	143.9
2006	50.2	115.2	165.7

Source: Rosstat, authors' calculations.

The 2006 increment in the volume of housing placed in operation, indeed, became record-breaking not only for the period since the early 2000s, but in a longer retrospective. Thus, in the Soviet time, the 9.6% growth in construction reported in 1986 against the background of an attempt to boost economic growth rates was quite noticeable vis-avis the earlier performance. However, we should not forget the currently existing small starting base, as well as the fact that today's numerous

<sup>125</sup> Padenko O. Vspleska tsen ne ozhidayetsya. Kvirtny ryad, 15-21 Feb 2007, # 6 (629), p.2

<sup>126</sup> The estimate of the rise in the volume of mortgage loans disbursed in 2006 might be more moderate (2.9 times), as there are data on the volume of mortgage loans disbursed by banks, which accounts for RUR 76.5 bln. See: Zhit stalo ipotechnee! Kvirtny ryad, 7-13 Dec 2006, # 49 (620), p.6

construction projects in progress had been started prior to the launch of the national project.

At its meeting in Kazan in late-January 2007, the State Council argued that, despite certain success stories, even such a notable increase in placement of housing in operation failed to compensate for the overall aging of the housing fund, while the situation with its capital refurbishment was aggravating. The advanced (relative to the dynamic of the population's incomes) price rise for housing leaves yet smaller chances for citizens with small- and medium-level incomes. Despite a great capacity of the national mortgage loan market, which by 2010 can account for some RUR 700-900 bln. (as estimated by the International Financial Corporation) or even 1.3 trln., according to Russian experts, only 10% of the population can afford using a mortgage loan. Presently, there are as many as 600 banks operating on the Russian mortgage market, but nearly a half of its volume is formed by 10-12 of them<sup>127</sup>. The number of families that should be granted with apartments at the expense of the federal budget by 2010 (133,000 individuals) accounts just for 18% of those before whom the government have such an obligation<sup>128</sup>.

The situation in the industry of construction materials is ambiguous. Despite a drastic increment in output of most kinds of construction materials, at its meeting on Nov. 24, 2006, the Presidium of the Council for Implementation of the Priority National Projects noted that by 2008 the country would face shortages of construction materials. Today, some regions have already faced occasional shortages of individual kinds of construction materials (bricks, wood, etc.), which resulted in price hikes for those<sup>129</sup>.

This, on the one hand, raise questions, as the volumes of house building, to say nothing of production investment, so far have failed to reach the pre-reform level. On the other hand, the 2006 volumes of production of cement, module ferro-concrete items and constructions, bricks, large wall panels, soft roofing, etc. were lower than in 1970, those of non-ore construction materials – lower than in 1975, while production of ceramic and sanitaryware exceeded the 1990 level<sup>130</sup>.

Apparently, underlying such a situation is retirement of numerous production capacities in the construction materials industry in the period of the transformational slump of the 1990s and the pressing problem of maintenance of an adequate quality of production. Of some 500 house-building plants presently existing in the country less than one-third is afloat, while many of them, as well as concrete producers, have discontinued their operations and were re-profiled over the past 15 years, while the production base of the operating ones is outdated. That is why in pursuance of vertical integration many regions (Republic of Karelia, Leningrad, Kaluga, Tver, N.Novgorod, Ulyanovsk, Rostov, oblasts, Krasnodar krai, Bashkor-

<sup>127</sup> Zhit stalo ipotechnee! Kvartirny ryad, 7-13 Dec 2006, # 49 (620), p.6

<sup>128</sup> Domnin S. Skromnoye obayaniye natsionalnogo prioriteta. Kvartirny ryad, 14-20 Dec 2006, # 50 (621), p.2

<sup>129</sup> Novosti. Krupnymi mazkami//SNIP. Stroitelstvo. Nedvizhimost. Investitsii. Proekty, #2 (02). Dec. 2006, pp. 74-80, 88-91

<sup>130</sup> Sotsialno-ekonomicheskoye olozheniye Rossiii, 2006 god, M., Rosstat, p.21, 50-51; Rossiysky statistichesky sbornik. 2004: Sta.sb. m., Rosstat, 2004, p. 395

tostan, Sverdlovsk, Novosibirsk oblasts) are going to launch new production facilities, particularly at the expense of foreign investors and large real estate developers<sup>131</sup>.

The introduction of such instruments of the national project as open auctions on sale of sites and government guarantees on development of urban engineering infrastructure caused grave problems. It is a common knowledge now that local authorities are ignorant of legal requirements concerning allocation of sites only on the basis of competition, and numerous violations required a vigorous interference of the Federal Anti-Monopoly Service. While since 2006 FTP "Housing", the major vehicle of implementation of the national project, has been back-upped by a new section entitled "Provision of sites with the public utilities infrastructure for the purpose of house building", the envisaged aid from the federal center to municipalities in the form of loans guarantees (worth a total of RUR 12.5 bln.) and subsidies (1.7 bln.) on the engineering development of the sites so far has failed to find consumers. The tenders have resulted in picking 110 projects, but the RF Ministry of Finance has not concluded any agreements on provision of the guarantees, and there were just 5 pretenders for the subsidies. The hopes for the mechanism of government guarantees were futile, as municipalities accumulated huge debts and cannot assume the respective obligations. Budgetary problems on the local level do not allow counting on the required co-financing of measures on preparation of the sites<sup>132</sup>.

The negative background for the expansion of the national project has been formed by the problem of the "cheated co-investors". According to Mr. Yu. Tyrtyshev, the Deputy Minister of Regional Development, real estate developers failed to honor over 70,000 agreements on co-financed construction and there were over 500 problematic objects in over 60 regions<sup>133</sup>. Over 80 actions were brought against legal entities and over 4,500 – against private individuals on deception of the private co-investors<sup>134</sup>. However, even these impressive figures are unlikely to adequately highlight the magnitude of the problem. Thus, the largest developer, "Sotsialnaya Initsiativa" partnership, whose top executives were detained in late-2006, failed to fulfill its obligations before more than 50,000 private investors in 71 regions.

The work on solving this problem is still at the preliminary stage (creation of task forces, completing victim lists, etc.), but so far there have been no prospects for a governmental assistance to them, which can be largely explained by motivations of those who invested in such projects. Mr. Tyrtyshev asserts that just 10% of private co-investors contributed with their savings to get the only housing, while 40% simply invested their free resources, while the rest were keen to improve their

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<sup>131</sup> Novosti. Tsennye pruty. //SNIP. Stroitelstvo. Nedvizhimost. Investitsii. Proekty, #2 (02). Dec. 2006, pp. 74, 82-86

<sup>132</sup> Nuzhny ne garantii, a dengi. Kwartirny ryad, 9-15 Nov. 2006, # 45 (616), p. 17

<sup>133</sup> Pomogut chem. mogut. Kwartirny ryad, 1-7 March 2007, # 9 (632) p. 1

<sup>134</sup> Pechalnye tsifry. Kwartirny ryad, 30 Nov- 6 Dec 2007, # 48 (619) p.2

housing conditions<sup>135</sup>. Should the government want to help the co-investors, its intents would face such obvious barriers as an additional unplanned pressure on the budgetary system (particularly in the case of regional and local budgets) and natural concerns that if the government assumes the private investors' risks, it may give a negative signal to the market.

There are certain success stories nonetheless, but only providing there were already built houses and the only problem was registration of property rights. The recommendation to attract other investors in such situations and to compensate for their damages by allocating other sites conflicts with the legal provisions that set the tender-based procedures of allocation of sites.

Regional and municipal administrations could help solve this situation, but in most cases they opt for the "wait-and-see" approach. The rare exceptions are the city of Moscow and Moscow oblast where the intensity of the problem has subsided and most "problematic" objects are being completed by new developers. The Governor of N. Novgorod oblast has also expressed his readiness to help the deceived co-investors.

Today, new amendments to the bankruptcy law are designed, which would allow extension for a year of bankruptcy proceedings that concern the fraudulent developers. The amendments, perhaps, would help lower the intensity of the problem. The authors of the amendments believe that an additional year is enough for a bankrupt corporation to attempt to attract additional investments or undergo financial restructuring procedures<sup>136</sup>. The task force of the Public Chamber also laid down a bill on restructuring of construction companies, which provides for establishment of a government agency with a mission to restructure construction companies that have failed to honor their obligations before private co-investors.

A positive example in this respect became the long-awaited amendments to Act # 214-FZ enacted by Federal Statute of July 18, 2006, # 111-FZ "On introducing amendments to the Federal Act "On participation in shared construction of blocs of apartments and other real estate objects and on introducing amendments to some legislative acts of the Russian Federation". The amendments in question facilitate procedures for developers and create conditions for boosting up volumes of house building, including the following:

- modification of procedures of cancellation of the agreement on participation in the shared construction both by private co-investors (in the part of limitations of possibilities for the unilateral refusal of the agreement) and developers (simplification of the agreement cancellation procedures), along with setting for the latter procedures of return of funds in the event of cancellation of the agreement;
- relief of the property developer of the absolute liability for any defects of the object of shared construction;

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<sup>135</sup> Pechalnye tsifry. Kvartirny ryad, 30 Nov- 6 Dec 2007, # 48 (619) p.2

<sup>136</sup> A negative element of such a variant will become a greater diversity of the bankruptcy law, which already provides for peculiarities of pursuance of insolvency procedures with respect to strategic enterprises, agricultural, financial organizations, subjects of natural monopolies, etc.

-exclusion of the joint and several liability of the bank and the property developer with regard to obligations secured by a collateral under maintenance of equal rights of submortgagee banks and individual co-investors under satisfaction of their claims in the event of recovery of the collateral;

- cancellation of the obligation to publish in the media a project declaration, which should contain information on the property developer and the object of construction, while maintaining the developer's obligation to provide the declaration to any person and inform of earlier completed projects;

- introduction of obligations (housing certificates with a double face-value in terms of price and area) which fixes the owner's right for receipt from the issuer of domestic premises with the possibility for selling the securities in question and the developer's obligation to buy them with indexation);

- limiting the amount of monetary resources attracted from individual co-investors (together with loans received from banks) with the value of construction of the house, as per the project declaration;

- decrease of the amount of the penalty cost payable by the parties that participate in the shared construction for abusing their mutual obligations.

The new version of the law creates more favorable conditions of saturation of the housing market by encouraging investors who have tried to avoid risks associated with newly constructed housing. One can also hope for a better funding of construction projects, as the cancellation of the joint and several liability of banks and property developers should form an operative motive to the former to renew disbursing loans to the latter at the former scale. Plus, great hopes are laid upon issuance of obligations.

Meanwhile, there persists a whole series of still unresolved challenges. Many developers still ignore standards that regulate procedures of purchasing by private individuals of apartments in newly built houses. There persists the risk of double sales of housing, as the preliminary sale agreements are not subject to the state registration. As deals involving promissory notes, they likewise appear yet more exposed to fraudulent acts than the shared participation contracts. That is why the enforcement of the new version of the Federal Act "On participation in the shared construction..." is likely to imply limited effects<sup>137</sup>.

Another important legal novelty became amendments to the Town-Planning Code that took effect as of January 1, 2007. They are aimed at lifting administrative barriers and improvement of mechanisms of involvement in the economic turnover of sites designated for construction of housing.

Resolving numerous conflicts that have arisen around allocation of land for construction, they allow allocation of sites without holding tenders, provided the respective agreements had been concluded prior to the late-2004 or the placement of objects on the site had been approved before October 1, 2005. This grants the property developer with the right to develop earlier frozen sites. The amendments introduce criteria of recognition of the territory due to be developed for the

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<sup>137</sup> Pro "serye" skhemy I kvartiry v novostroykakh. Kvartirny ryad, 7-13 Dec 2006, # 49 (620), p. 16-17

purpose of house building. The investor can acquire the right to conclude a territory development agreement at an auction or without holding that, provided the housing is to be built on the basis of placement of an order for the public or municipal needs. Local self-governance bodies now can enjoy the right to use sites owned by the municipality or falling under the category of unlocated property as collateral against loans for building local infrastructure. To encourage house building, it is suggested to introduce greater rental payments for land in three years after its allocation.

In addition, the noted amendments provide for formation of a uniform system of public evaluation of the project documentation and a single supervisory body in the construction sector<sup>138</sup>, to be formed by the Rosstroy and the RF Ministry for Regional Development. The goal is to reduce construction costs (in the part of the costs associated with reconciliation and approvals) and contraction of the length of conduct of evaluations.

In the circumstances, the government still sets the goal of boosting volumes of placement of new housing in operation, as they still are inferior to the pre-reform ones. In addition to the mortgage mechanisms, it raises the issue of development of a savings system, which should enable private individuals to buy housing via special savings banks, which should not require any liquid pledged real property. A part of the government guarantees should be diverted from municipalities straight to real estate developers in the form of banking loans. The State Duma will consider a document on the transition from the state licensing, which was extended through the 1<sup>st</sup> half 2007, to self-regulation. Should the Duma pass the bill, the greatest challenge should become the problem of amounts of contributions payable by participants in the self-regulated organizations (SRO) to a compensations fund to satisfy possible damages of individuals that may suffer from fraudulent activities. It is planned to spent RUR 5 bln. on modernization of the public utilities infrastructure and over 1 bln. – on rehousing of families from the untenable housing. One of the pools for funding the housing sector modernization will be formed using the USD 200m-worth loan from EBRD. To develop the industry for construction materials, it is planned to allocate sites for new production facilities and cancel import duties on a series of production equipment.

Like some other industry branches, the construction sector may become exposed to the expansion of the state not only as a regulator of the market, but a player on it. A great role in implementation of the national project on housing was assigned to the state-controlled Sberbank and Vneshtorgbank (the latter has recently taken over Industrial and Construction Bank (headquartered in Saint Petersburg). After taking over ICB together with its development subsidiary “ICB-Invest group”, Vneshtorgbank is now in transition from its habitual role of creditor to huge construction companies towards implementation of its own development projects, which has already occurred in Saint Petersburg and announced in Leningrad, Kostroma and Kaluga oblasts, and Republic of Chuvashia. Today, Vneshtorgbank con-

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<sup>138</sup> This implies cancellation of some 10 kinds of evaluation and all other kinds of the government supervision in the sector, which steered quite equivocal comments

templates creation of a nationwide development division<sup>139</sup>. There also are voices advocating creation of a federal construction corporation, whose principal mission should be commissioning construction orders to contractors at a fixed return rate.

The national project should be further specified in the Program of socio-economic development of Russian Federation in medium term (2006-2008) approved by Resolution of the RF Government of January 19, 2006, # 38-p. The Resolution contains a special section "Shaping the market for affordable housing".

The section reads that at the first stage the priority national project will be implemented along the following four avenues:

- ensuring a greater affordability of housing;
- fulfillment of the government obligations before individual categories of citizens;
- increase in the mortgage volumes;
- increase in the volume of house building and modernization of the public utilities infrastructure.

Each avenue suggests certain measures that imply development of the legal base, ensuring a balanced support to expansion of demand and offer on the housing market, and fulfillment of the government obligations on provision of certain categories of citizens with housing.

The main vehicles of implementation of the government support remain the federal targeted program "Housing" for 2002-2010 and its sub-programs.

To make **housing more affordable** for young families and the young specialists in the rural areas who are in need for housing or improvement of their housing conditions, the Program provides for the following measures:

- provision of housing subsidies to young families (including subsidies for the purchase of a private house or payment of the first installment in the event of a mortgage loan) amounting to 40% of the average cost of a standard housing, including 10% -at the expense of the federal budget and 30% - at the expense of a regional or local budget;
- insuring mortgage loans disbursed to young families for the sake of reducing the amount of the first payment in the event of a mortgage loan (formation of the authorized capital of the respective organization at the expense of the federal budget or subsidizing citizens' expenses on payment of the insurance premium);
- provision of young specialists residing in the rural areas with subsidies on construction of individual housing, including for the purpose of repayment of the first installment in the event of a mortgage loan (subsidizing between 10% and 50% of costs of the standard housing at the expense of the federal budget is differentiated across regions, provided a certain contribution by regional or local budgets).

***The fulfillment of the state obligations with regard to provision of housing to individual categories of citizens*** is aimed at securing a possibility to purchase housing by the citizens before whom the Russian Federation has

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<sup>139</sup> Frumkin K. Chabol po-russki//Kompania, # 48-49 (444-445), 25.12.2006, p. 25-26

obligations on provision them with housing or improvement of their housing conditions. This avenue implies implementation of the following measures:

- provision of housing subsidies to the citizens before whom the state has the respective obligations (discharged military, citizens moved from “Baykonur” complex, out of the Northern Territories, compulsory migrants, and victims of nuclear accidents and catastrophes);
- fulfillment of state obligations associated with provision of housing to veterans and disabled who queue for improvement of their housing conditions, before whom the Russian Federation has assumed obligations to improve their conditions in the process of division of powers between different tiers of government.

To ensure conditions for **increase of offer of housing in proportion to the population’s growing effective demand and to enhance the quality of the provided public utilities services**, the government recognizes the necessity to boost volumes of house building and modernize the public utilities infrastructure, including:

- provision of sites with the public utilities infrastructure, particularly by means of provision of government guarantees and subsidizing (up to 50%) of interest rates on loans granted on implementation of projects on equipping the sites with the public utilities infrastructure subject to conditions of co-financing of such projects by regional and local budgets; allocation of the federal budget resources subject to conditions of co-financing such projects by regional and local budgets, and private investors;
- establishment of a revolving fund, whose mission should be provision of support to municipalities and public utilities operators to obtain loans;
- contraction of the number of administrative barriers associated with granting real estate developers with access to the house-building market, as well as developing the market infrastructure, increasing the efficiency of town planning and modification of the anti-trust law in this particular area.

**To boost up volumes of mortgage loans**, it is imperative to ensure creation of conditions for the increase in disbursement of long-term mortgage loans to the population on the basis of development of a uniform mortgage loan refinancing system. This would become possible, should the following measures be implemented:

- a RUR 14.2 bln.-worth increase of the authorized capital of the “Agentstvo po ipotechnomy zhilishnomu kreditovaniyu” open-end joint-stock company in 2006-08 and provision of the RF government guarantees on the company’s borrowings worth a total of up to RUR 58 bln.;
- completion of the legal base for the issuance of mortgage securities;
- crafting infrastructure for the mortgage loan system and the market for mortgage securities.

The RF Government’s activities in this area should also pursue the following objectives:

- to capitalize on the mortgage loan refinancing system to boost up volumes of the co-financed construction of blocs of apartments and individual houses;

- to give a rise to housing-and-savings institutions (creation of house-building and savings banks);
- to lift the mandatory requirements to have mortgage papers secured with the RF government guarantee to make it possible to invest pension savings;
- to help new institutions of the housing market infrastructure thrive. These institutions include those involved in insuring mortgage loans, credit bureaus, and improvement of the system of state registration of the rights for real estate and account of real estate objects (enhancement of transparency, reliability and informational accessibility, lower costs of and shorter timelines for servicing);
- to set strict territorial planning procedures, along with introduction of town planning regulations and kinds of the permitted use of real estate at the level of municipalities;
- to ensure transition towards the possibility for real estate developers to acquire property rights for formed sites at an auction and prior to the start of the construction and investment process. This measure should enable them to attract credit resources for construction of housing on security of the sites and the currently constructed housing.

The aforementioned medium-term Program notes that if these problems are resolved, it would allow the population's effective demand for housing to expand substantially and to increase offer of housing by means of boosting the volumes of house building, and to ensure affordability of housing to main groups of the population.

The measuring tool and main indicator, which should help judge the level of success in the Program implementation, should become an increase in the annual volume of placement of newly built housing in operation from 41.2m sq. m. in 2004 up to 70-80m sq.m. in 2010, given a triple (from the current 9% up to 25-30%) rise in the proportion of the population with incomes sufficient for buying a standard apartment using their own and credit resources.

The Government's action plan on implementation of the Program with respect to formation of the market for affordable housing provides for development of a whole series of legal acts, including amending Federal Acts "On mortgage securities" (in the part of specifying procedures of identification of the size of a mortgage backing, exclusion of privately owned assets from the composition of the mortgage backing, as well as payment of premiums on mortgage-backed obligations and mortgage participation certificates), "On mortgage", "On state registration of rights for real estate and transactions with it" (in the part of improvement of procedures of registration of title transfer by mortgages, and harmonization of the civil with the land law). The action plan also provides for amendments in the law, which concern regulation of securitization of financial assets and improvement of the procedure of allocation of sites for construction.

As concerns implementation of the national project in regional terms, it is possible to notice that volumes of placement of newly built housing in operation soar practically across the whole country. Out of 88 regions only 7 ones reported a fall in this respect (Kostroma, Samara, Irkutsk oblasts, Adygeya, Nenetsky, Evenk and

Chukotka autonomous okrugs). By contrast, the respective indicator grew over 1.5 times in Ivanovo, Kaliningrad, Murmansk, Novosibirsk oblasts, Altay Republic, Ust-Ordynsky and Aginsky Buryatsky autonomous okrugs.

Of 15 regions whose cities were represented in the housing price dynamics sample over 2004-06 (*Table 20*) the growth rates of placement of housing in operation were in excess of the average nationwide ones in 5 regions (Moscow, Tver, Penza, Novosibirsk and Omsk oblasts), while in another 3 regions (Rostov, Sverdlovsk, Tyumen oblasts) they roughly equaled to the latter. At the same time, in 7 regions (Moscow, Saint Petersburg, Bashkortostan, Udmurtia, Perm krai, N. Novgorod and Ulyanovsk oblasts) the respective indicator was below the average nationwide one, with Moscow and Saint Petersburg being at the bottom of the list (3.4% and 4.5%, respectively).

### 5.5.3. Implementation of the national project in the capital region

Whilst considering the situation in the house-building sector in Moscow and Moscow oblast in the nationwide context, it is worthwhile noting that the concentration of the house-building operations in the capital region has remained practically unchanged (*Table 23*).

*Table 23*

### Volumes of Placement of Housing in Operation in Russia, City of Moscow and Moscow Oblast in 1999–2006

year	Russia		Moscow		Moscow oblast		Across Moscow and Moscow oblast, total	
	Thos. sq.m.	Thos. sq.m.	As % of placement across Russia as a whole	sq.m.	As % of placement across Russia as a whole	sq.m.	As % of placement across Russia as a whole	
1999	32017	3052.5	9.55	2728.6	8.5	5781.1	18.05	
2000	30296	3342.3	11.0	2610.9	8.6	5953.2	19.6	
2001	31703	3690.6	11.65	2827.8	8.9	6518.4	20.55	
2002	33832	4274.1	12.6	3414.8	10.1	7688.9	22.7	
2003	36449	4443.0	12.2	4136.4	11.3	8579.4	23.5	
2004	41040	4578.6	11.15	5738.2	14.0	10316.8	25.15	
2005	43609	4644.3	10.6	5271.4	12.1	9915.7	22.7	
2006	50173	4804.5	9.6	6433.5	12.8	11238.0	22.4	

Source: Rosstat, authors' calculations.

Moscow's proportional weight in the overall nationwide volume of house building fell by more than 1 p. p., thus sinking below 10%, however, the proportion of Moscow oblast has grown. As a result, the 2006 aggregate proportion of the city of Moscow and Moscow oblast accounted for 22.4% vs. 22.7% reported in 2005 and 23-25% registered between 2003 and 2004.

Table 24

**Volumes of Placement of Housing in Operation in the city of Moscow  
and Moscow Oblast in 2000–2005**

year	By Moscow builders in the city of Moscow and beyond it		In the city of Moscow		In the city of Moscow (by the data of the Moscow city government)		In Moscow oblast	
	Thos. sq.m.	As % to the prior year	Thos. sq.m.	As % to the prior year	Thos. sq.m.	As % to the prior year	Thos. sq.m.	As % to the prior year
2000	3530.2	104.8	3342.3	109.5	33342.3	...	2610.9	95.7
2001	3821.5	108.3	3690.6	110.4	3706.1*#	110.9	2827.8	108.3
2002	4469.6	116.9	4274.1	115.8	4310.9*	116.3	3414.8	120.7
2003	4703.2	105.2	4443.0	103.9	4441.9*	103.0	4136.4	121.1
2004	4794.7	101.9	4578.6	103.1	4576.8*	103.0	5738.2	138.7
2005	5224.1	108.9	4644.3	101.4	4644.3	101.5	5271.4	91.9
2006	5320.7	101.8	4804.5	103.5	4804.5	103.4	6433.5	121.5

Note. \* – built in the city of Moscow by local construction companies,  
# – there is alternative 2001 data, that is, 3,824.9 Thos. sq.m., thus the pace of increment relative to 2000 can be estimated at the level of 114.4%.

Source: Rosstat, authors' calculations.

In 2006, the house-building sector in Moscow has certainly advanced, as after a fall in the pace of its increment in 2005 it has returned to the 2003-2004 indicators (the increment in the placement of housing in operation accounted for 3-4%). By contrast, its activity out of the city slightly fell, as the pace of increment in placement of aggregate volumes of housing by Moscow builders in Moscow and outside the city (1.8%) was roughly twice as lower vs. the respective index in Moscow (3.5). In Moscow oblast, the construction complex has recovered from its 2005 slump and advanced vigorously by boosting volumes of placement of housing in operation at more than 21%, thus bouncing back to the growth indicators characteristic of 2002-03. Interestingly, in the total volume of housing put in operation it was multistory housing whose proportion was on the rise in this respect, and the volume of apartment sales of (60,000 units) grew by nearly 15% vs. 2005. As the city of Moscow is now scarce of sites available for house building, Moscow oblast displays a good potential in this regard<sup>140</sup>.

In the city of Moscow, the local government approved a local three-year program of mortgage development for 2005-08. The program was approved by Resolution of the Moscow city government "On measures on development of mortgage in Moscow" of Nov. 8, 2005, # 881-PP. As well, with its Resolution # 994-PP of Dec. 13 2005, the Moscow city government approved the second stage of another program entitled "Affordable housing to young families".

Today, the Moscow city authorities test two optional types of social mortgage for local residents in need for improvement of their housing conditions. The first variant provides for a purchase of housing whose building will be commissioned by the city government at the production cost. The other variant rests upon a gratis subsidizing of the first installment, which, complemented by a bank mortgage loan and an individual's own cash, should enable the latter to buy an apartment at the market.

<sup>140</sup> Chernyshov P. Ekonom-klass menyaet propisku. Kvartirny ryad, 1-7 Feb 2007, # 4 (627), p.5

Responding to problems that arose in conjunction with the co-financed construction, on June 22, 2006, the Mayor of Moscow signed Resolution # 1120 RP "On additional measures on protection of rights of the citizens that participate in the co-financing of house building in the territory of the city of Moscow". Its main provisions suggest imposition of restrictions on sales of housing until the construction of a house is complete, along with the investor's obligation to form a stock of unsold housing amounting to 15% of the overall area of the house, and introduction of a model contract on the citizens' participation in co-financing of house building in the territory of the city.

The aforementioned legislative novelties by the RF government and the Moscow Mayor's office, and a general improvement of the macroeconomic situation in the country generate necessary conditions for expansion of mortgage in the city, thus enabling the parties concerned to overcome the crisis situation noted in late-2005.

As a reminder, between 2001 and 2005 the situation on the mortgage market was characterized by a rapid rise in the volume of mortgage transactions<sup>141</sup>. Banks continued to lower interest rates and undertake other measures to improve loan conditions, while the population began overcoming specific prejudices and appeared more apt to apply for mortgage loans.

Notwithstanding the above, by late -2005 the number of transactions involving mortgage loans accounted for 50-80% of the number of approved loans, while real estate agencies reported a contraction in the share of mortgage loans in the overall number of transactions involving real estate.

To cite a specific example, "MIEL-Nedvizhimost", the biggest operator on the real estate market, reported that between early-2003 and the 2<sup>nd</sup> quarter 2005 there occurred a 10-fold rise in the volume of mortgage transactions up to 9% of its overall volume of transactions involving apartment purchase/sales. But since the 2<sup>nd</sup> quarter 2005 the process has discontinued and until the 2<sup>nd</sup> quarter 2006 the volume of mortgage-based transactions was stagnating in absolute terms, followed by a 6.9% decline in the 4<sup>th</sup> quarter 2006. In parallel with that, the length of the conduct of such deals began to extend (up to 4 months), as the time costs of the search for an apartment was growing, and in the 3<sup>rd</sup> and 4<sup>th</sup> quarters 2005 they accounted for 1.69 months and 2.3 months, respectively (vs. 1.46 months reported in the 2<sup>nd</sup> quarter 2006).

Some research<sup>142</sup> demonstrated that the deceleration of the process can be attributed primarily to a catastrophic contraction in the volume of offer of apartments on the market and the rise of shortages, because of which sellers refused to work with mortgagers.

The reasons behind the contraction in volumes of new house building primarily lie with effects of the 2004 microcrisis on the market for newly built housing, which was caused by the outflow of buyers, property developers' melting resources and their decreasing capability to continue construction and repay loans.

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<sup>141</sup> See: Rossiyskaya ekonomika. Tendentsii i perspektivy (Vypusk 27). M., IEPP. March, 2006.

<sup>142</sup> Sternik G.M., Lutskov V.M., Korobkova M.V. et al. Rynok nedvizhimosti Moskovskogo regiona. Analiz razvitiya i prognoz na 2006.- Analiticheskiy centr "MIEL-Nedvizhimost", Moskva, 2005.- 49 p.

As well, because of the nearly simultaneous banking micro-crisis, banks found themselves short of liquidity and had to cut down volumes of loans disbursed to the real estate developers. The situation further aggravated between 2005 and early 2006, owing much to scandals with real developers' scheming. Desperate as they were, private co-investors that suffered from fraudulent operations held numerous rallies in Moscow and some towns in Moscow oblast.

The mess in the house-building sector further grew upon promulgation of Federal Act #214 in April 2006, when construction companies found themselves unready to operate in newly established conditions and not only abandoned new projects, but had to freeze those already in progress. Hence, contraction in the volume of construction and offer of housing and restrictions on sales of newly built housing using mortgage mechanisms, except for the objects the permit to construct which had been granted until April 1, 2005.

The contraction of offer on the primary market for housing triggered a fall in the number of objects for sale on the secondary market (from 35,000 apartments in March 2005 down to 12,000 in January 2006 in the city of Moscow, and from 10-12,000 to 6-7,000 in Moscow oblast, accordingly).

The situation drove prices higher at a constantly accelerated pace, which became notable since May 2005. That in turn increasingly limited the citizens' possibility to benefit from mortgage loans, for while the client was completing the mortgage loan procedures with the bank, the apartment he had picked went up in price, thus making his attempts vain.

The MIEL-Nedvizhimost's 2006 forecast of the dynamic of volumes of mortgage transactions suggested that a favorable macroeconomic situation, easier access to bank loans, improvement of the legal base, on the one hand, and the continuous decline in the volume of offer (despite the fall of its rate), coupled with rising prices, on the other hand, should contribute to growth in the volumes of mortgage-based transactions of the Company at no more than 10-30% compared with the prior year (vs. the 96% growth in 2005 to 2004 and 331% in 2004 to 2003).

The growth in an absolute volume of such operations has renewed only since the 3<sup>rd</sup> quarter 2006, with the growth rate accounting for 21% vis-avis the 3<sup>rd</sup> quarter 2005, while the proportion of transactions that involved mortgage in the overall number of transactions with apartments was on the rise yet since the 1<sup>st</sup> quarter 2005 and reached 17% in the 3<sup>rd</sup> quarter 2006.

The aforementioned legislative novelties have contributed much to the rise in the volume of the transactions in question.

In addition to the novelties whose effect should manifest itself in the medium term, there emerged certain factors that started boosting the offer volume up since the summer already; those factors were: a slowdown of the price rise on the secondary market, which compelled sellers to go to the market, while investors – to fix their profits by selling earlier bought apartments, among others.

Banks reacted by softening their requirements to the mortgager and many banks even reduced the amount of the first installment to zero. That also helped attract new mortgagers and, given the renewal of the rise of the volume of offer in the

3<sup>rd</sup> quarter in concomitance with a simultaneous slowdown of the price rise for housing, the volume of mortgage transactions and their proportion in the overall volume of MIEL's operations renewed its growth.

The prospects for the housing policy in the city of Moscow will be determined by Resolution of the city government of January 23, 2007 # 24-PP "On the medium-term housing program "Affordable housing to Muscovites" for the period between 2007 and 2009 and the order for 2010".

Its main avenues imply:

- protectionist measures towards Muscovites who are keen to buy housing;
- reducing the maximum length of queuing for improvement of housing conditions to 10 years;
- attraction to implementation of the housing policy of credit institutions and market professionals;
- getting families with children involved in programs that suggest an onerous basis, providing them, at the same time, with an additional social support, including linking up the housing purchase price with the use of mortgage and installment of date of debt repayment with the time during which the family has spent queuing for housing, and softening requirements to participants in the "Affordable housing to young families" program;
- creation of the local civilized market for apartments rent and exchange, including provision of assistance to those in the queue who have resorted to apartment rent from private individuals.

It is the first avenue that appears most problematic and hardly doable.

According to the Program, while announcing a tender on allocation of a site to build the so-called "budget" housing, the city authorities will take into account the percentage of apartments the developer would be ready to sell to Moscow residents and what should be a beneficial price at which he is going to sell apartments to the Muscovites who are officially registered as being in need for improvement of their housing conditions, have stayed in the queue and can realize their right just once. Basing on this, the city authorities are going to grant the rights for house building. If the real developer is discontented with the arrangement, the city government will take 80% of apartments (while the regular quota is 40%), thus leaving a meager 20% to him to go to the market. According to the Moscow city officials, they are guided by the aspiration to guarantee the genuine Muscovites' rights, as the local market is presently dominated by "outsiders" who often buy housing for investment purposes.

This arrangement can entail certain negative consequences: a fall in the volume of construction of the budget housing, for a part of investors would zero in on the "elite" segment, which is not subject to such Draconian regulation; the real estate developers' plummeting profits; renewal of the price rise for housing and the rise of various variants of re-selling the "beneficial" housing to the very outsiders with a consequent emergence of various legal conflicts, as the Moscow government's intents in the form they are fixed in the announced program to a certain extent conflict with the effective law, to say nothing of a great deal of corruption they may trigger. In prac-

tice, implementation of this particular avenue, as well as the others, will greatly depend upon concrete mechanisms of economic stimulation of real estate developers. In all fairness, such mechanisms may be quite sound, thus helping, provided they are introduced by separate legal acts, dumping any negative consequences.

It is envisaged that the 2007 volume of construction of housing for the queuing and young families eager to improve their housing conditions upon the onerous, albeit beneficial, basis should make up 370,000 sq.m. vs. 260,000 sq.m. reported in 2006. Overall, by all the 2007 city housing programs it is planned to construct some 2m sq. m. of housing (with 400,000 sq. m. to be given away to the queuing), which, given the envisaged volume of placement of housing in operation in the city (4.7-4.8m sq.m.) should account for some 40% of its volume. The city government has ruled to allocate RUR 5.8 bln. from the local budget for subsidies on construction and purchase of housing.

#### 5.5.4. Stages of development of housing in Russia

While monitoring the housing market in the capital cities (Moscow and St. Petersburg) since the early 1990s<sup>143</sup>, the dynamic series of average monthly prices for apartments give a chance for an objective examination of the market's behavior and main regularities of its advancement. *Table 25* shows that the past 16-year-long history of the market allows identification of two notable stages of price dynamics. The first stage (between June 1990 and June 2000) had lasted for 10 years, while the second one, which started since mid-2000, has been lasting for more than 6 years already.

*Table 25*

### Stages of Advancement of the Housing Market and Their Length in the Capital Regions in 1990-2006

Name of the stage	Moscow	St. Petersburg	Moscow oblast
Start and take-off	June 1990 – March 1995	December 1991 – May 1994	...
Stabilization	April 1995 – August 1998 *	June 1994 – October 1998 **	...
Crisis	September 1998 – June 2000	November 1998 – October 2000	...
Post-crisis recovery	July 2000 – December 2001	November 2000 – January 2003	July 2000 – February 2002
Stabilization	January 2002 – August 2002	–	March 2002 – July 2002
Jubilee growth	–	February 2003 – August 2003	–
Oil-driven growth	September 2002 – June 2004	August 2003 – July 2004	August 2002 – September 2004
Stabilization	July 2004 – July 2005	July 2004 – July 2005	October 2004 –September 2005
Speculative growth	July 2005 – June 2006	August 2005 – September 2006	October 2005 – September 2006
Transition to stabilization	July 2006 – December 2006	September 2006 – December 2006	September 2006 – December 2006

Note: - fluctuating stabilization (with “rollback”) asymptomatic stabilization (with “creep-up”).

<sup>143</sup> The respective observations in Moscow started in June 1990s, in St. Petersburg – December 1991, while the data on Moscow oblast are available only since July 2000

The main content of the first decade of existence of the legal real estate market became the start and take-off of its prices, followed by the transition to stabilization. While in Moscow the transition to stabilization displayed its fluctuating nature, along with an “overrun” and the fall to the level of USD 1,000-1,100/sq.m., the respective process in St. Petersburg was asymptomatic, with a “creep-up” and a gradual growth up to USD 600-650/sq.m. Then both markets faced the 1998-99 crisis.

In mid-2000, the real estate market of the Moscow region found itself at the bottom of the post-crisis cycle, thus signifying the end of the first stage of an unstable, fluctuating advancement of the market. At the time, the average price for housing was: in Moscow –USD 640/sq.m., in St. Petersburg and Moscow oblast – USD 335-350/sq.m. The next six years, up to date, the market has witnessed a constant price rise, with some short-term changes in the growth rates (up to a full stabilization).

The recovery stage of the market in the capital regions had been over by late-2001. At the time, the prices hit the pre-crisis level (some USD 1,000/sq.m. in Moscow and USD 470/sq.m. – in St. Petersburg and Moscow oblast). The market headed for stabilization, which was pretty short in Moscow and Moscow oblast.

Since mid-2002 Moscow and, a bit later, Moscow oblast began to experience a price rise that we call the “oil” one, as research conducted in early-2003 exposed a strong statistical correlation between world oil prices and the price rise in the city of Moscow<sup>144</sup>. By contrast, there was no price stabilization in St. Petersburg, which can be attributed to the inflow of budget and private investment due to the celebration of the city’s 300<sup>th</sup> anniversary in May 2003. The gradual growth had been lasting until mid-2003, followed by the transition to the stage of “oil” growth.

The price rise discontinued in mid-2004, against the background of growing tensions between the state and business. Interestingly, the price stabilization took place in all the three regions practically simultaneously, while the new phase of price rise began at different times.

More specifically, Moscow saw the start of the price rise in the 1<sup>st</sup> half 2005. It consequently took an increasing pace (8-10% a month) through the 1<sup>st</sup> half 2006, followed by the reverse tendency in the 2<sup>nd</sup> half of the year. In Moscow oblast, the price rise began in September-October 2005, with a consequent acceleration of its rates up to 12-14% until September 2006 and the fall to zero in December 2006. In St. Petersburg, after the boom in the house building sector in 2003 and the consequent oversaturation of the primary market in 2004 the stabilization (and even a slight decline) phase lasted until spring 2006 and it was then replaced by 10-12% monthly growth rates until November-December 2006.

As concerns other cities represented in *Table 20*, they demonstrated price dynamics similar to that of the city of Moscow (*Fig. 18 and 19*). Differences in the growth rates and lack of synchronism with regard to advancement of the price

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<sup>144</sup> See: Rossiyskaya ekonomika. Tendentsii i perspektivy (Vypusk 24, 25). M., IEPP. 2003. 2004; Sternik G. Prognoz razvitiya rynka zhilya Moskvyy do 2005 goda. Otchet AEKSIP, April 2003, [www.realtymarket.org](http://www.realtymarket.org)

situation on markets of different cities are determined by different levels of their socio-economic development, investment attractiveness, including the distance between each of them and Moscow, transport accessibility, the intensity of the conflict between regional authorities and mayors of the regional capital cities, among other factors.

Regions entered the stage of “oil” growth roughly a year later than Moscow did, that is, between the summer and autumn 2003. The phase ended up in some cities (N. Novgorod, Rostov, Tver) in summer 2004, and in spring- summer 2005 – in other cities (Ekaterinburg, Novosibirsk, Perm, Ufa).

The stabilization was, as a rule, short, and a new phase of price rise began in mid-2005 and continues up to now (it is only Tver that displays some signs of stabilization). In Penza, high price rise rates have been noted since spring 2005, in Ekaterinburg, Novosibirsk, N. Novgorod, Tver- since summer 2005, Omsk, Ufa- since the late-2005, and Perm- since spring 2006. There have been no price fluctuations in Ulyanovsk, where a gradual growth was in place until August 2006, and it was followed a rapid price rise at the monthly rate of 10-12%.

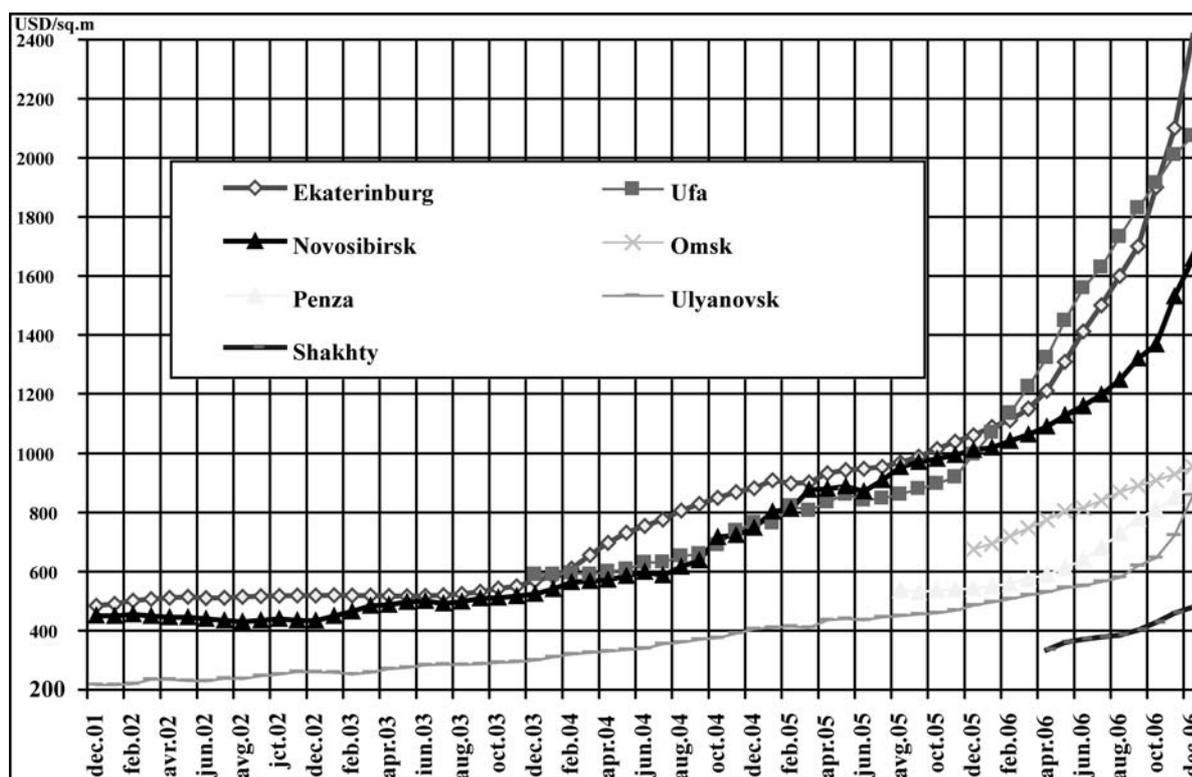


Figure 18 Dynamics of the Average Offer Price for Apartments in 7 Russian Cities in 2001-2006

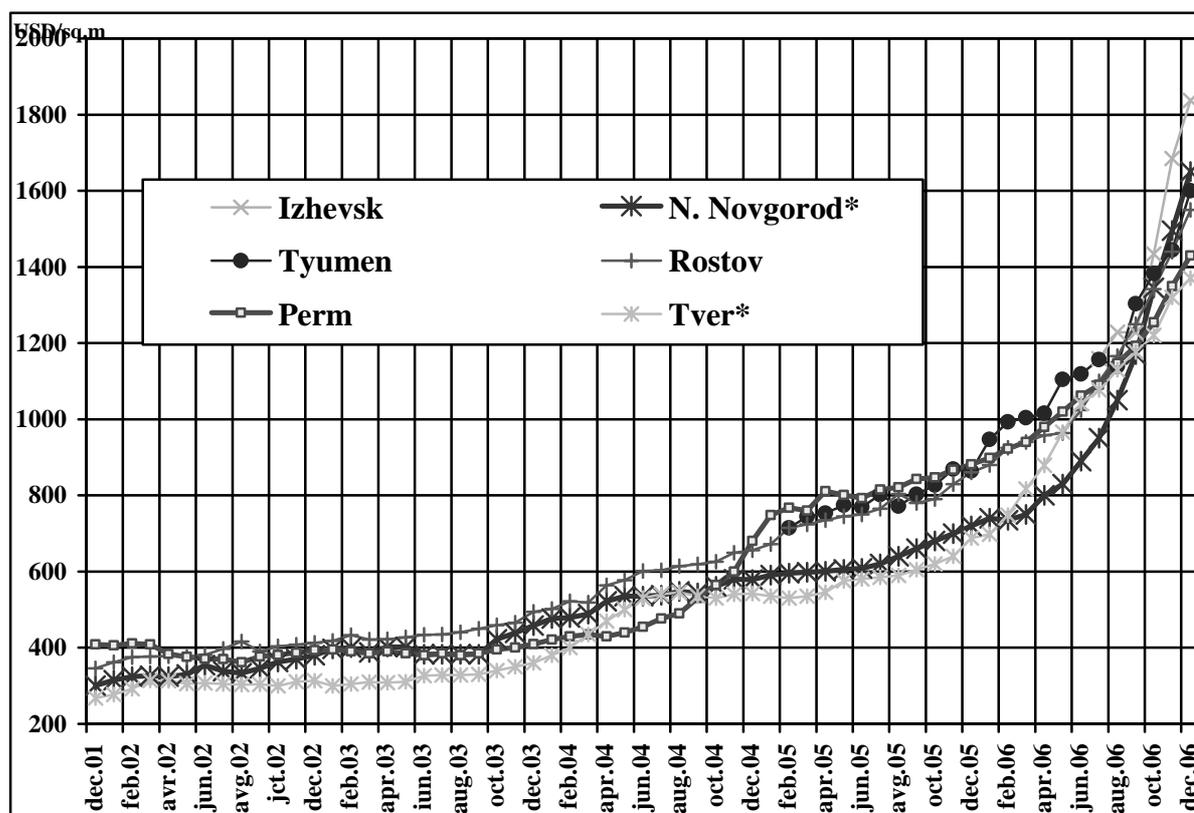


Figure 19. Dynamics of the Average Offer Price for Apartments in 6 Russian Cities in 2001-2006

It is interesting to explore the dynamics of correlations between average prices for housing in different Russian cities and those in Moscow.

Table 26  
Correlation between the Housing Price Levels in 2001-2006, as %  
(Moscow=100%)

City (re- gion)	2001 .		2002 .		2003 .		2004 .		2005 .		2006 .	
	Decem- ber	June	Dece- mber	June	Decem- ber	June	De- cem- ber	June	Decem- ber	June	De- cem- ber	
Moscow (USD/sq.m.)	940	965	1096	1241	1610	1950	1953	2094	2658	4072	4828	
St. Peters- burg	49.9	54.2	53.6	55.6	52.2	56.2	55.5	52.5	44.4	38.8	53.7	
Moscow oblast	50.1	52.5	51.0	48.3	46.5	46.1	46.5	45.6	42.2	48.3	52.2	
Ekaterin- burg	51.5	52.8	47.4	41.7	35.4	38.7	45.2	45.3	40.0	34.7	48.0	
Ufa					36.6	32.3	39.2	40.2	37.5	38.3	42.9	
Novosibirsk	48.0	45.6	39.6	40.4	32.5	30.7	38.3	41.6	38.1	28.5	34.3	
N. Novgorod	32.0	36.7	34.7	30.9	28.4	27.4	29.6	29.0	27.1	21.9	34.2	
Tyumen								36.7	32.5	27.5	33.1	
Rostov-on- Don	36.8	39.5	37.7	35.0	30.7	30.9	33.6	35.8	32.4	25.1	32.1	
Perm	43.5	38.4	35.9	30.6	25.5	23.3	34.8	37.9	33.2	26.1	29.6	
Tver	28.5	31.8	28.6	26.3	22.4	27.2	27.8	27.7	25.9	25.6	28.4	
Ulyanovsk	23.0	23.7	23.7	22.8	18.6	17.4	20.7	20.8	18.3	13.5	17.8	

While fluctuating over time, in Moscow oblast and St. Petersburg this correlation has for long been within the range of 40-55% and 40-60%, respectively. Since mid-2005, once Moscow earlier than the others began a new stage of price rise, Moscow oblast and St. Petersburg experienced a dramatic fall in their levels relative Russia's capital city. However, consequently, Moscow oblast (since early-2006) and St. Petersburg (since mid-2006) accelerated their housing price rise rates and, (given the declining rates in Moscow) have closed the gap and returned to the usual levels that roughly account for some 50% of Moscow's.

In Ekaterinburg, the price level vis-avis Moscow was fluctuating within the range of 35 and 55%, in Novosibirsk – 30-50%, Ufa- 30-40%, Perm – 25-45%, Tyumen – 25-35%, N. Novgorod – 20-35%, Tver -25-30%, Ulyanovsk -15-25%.

Like in the capital regions, the lack of synchronism in changes in the pricing on the market led to the situation in which the range of price fluctuations in a given city relative to those registered in Moscow might reach considerable values. By late-2006 the average level was reached by Ekaterinburg and Tver, it was slightly exceeded by N. Novgorod and Ufa, while Novosibirsk, Perm, Rostov-on-Don and Ulyanovsk had not yet reached their average levels. No doubt, some cities have a certain capacity for a price rise similar to that noted in Moscow and Moscow oblast over the past 1.5 years, however, the realization of the capacity in question appears dependent largely on the nature and socio-economic development at the local level and policies pursued by local authorities.

Another characteristic feature of the advancement of the housing market at the second stage became the price dynamic relative to two basic periods (December 2001 and December 2004). As for the dynamic relative to December 4, it can be found in *Table 20*, while *Table 27* below highlights the dynamics relative to December 2001.

*Table 27*

**Price Dynamics for Housing in Russian Cities in 2001-2006**

City (region)	December 2001		December 2002		December 2003		December 2004		December 2006	
	USD./ Sq.m.	USD./ Sq.m.	As % to December 2001	USD./ Sq.m.	As % to December 2001.	USD./ Sq.m.	As % to December 2001.	USD./ Sq.m.	As % to December 2001	
Moscow	940	1096	116.6	1610	171.3	1953	207.8	4828	513.6	
St. Petersburg	469	588	125.4	841	179.3	1083	230.9	2593	552.9	
Moscow oblast	471	559	118.7	748	158.8	908	192.8	2522	535.5	
Ekaterinburg	484	519	107.2	570	117.8	882	182.2	2415	499.0	
Novosibirsk	451	434	96.2	524	116.2	748	165.9	1658	367.6	
N.Novgorod	301	380	126.2	458	152.2	579	192.4	1650	548.2	
Rostov-on-Don	346	413	119.4	494	142.8	656	189.6	1550	448.0	
Perm	409	394	96.3	410	100.2	680	166.3	1430	349.6	
Tver	268	313	116.8	360	134.3	542	202.2	1370	511.2	
Ulyanovsk	216	260	120.4	300	138.9	405	187.5	859	397.7	

Providing the December 2001 prices form a starting point, during five years prices grew 3.5-4-fold in Perm, Novosibirsk, Ulyanovsk; 4.5-4.8 times - in Rostov-

on-Don and Ekaterinburg, 5.1-5.5 times – in Tver, Moscow, Moscow oblast, N. Novgorod, and St. Petersburg.

Thus, these data prove the aforementioned regularity of the second stage of development of the Russian market for housing, that is, the non-stop (since 2000) price rise, without any drastic ups and downs. It is equally possible to expose yet another substantial regularity of the long-term development of the price situation on the regional markets, which became a consequence of the noted absence of synchronism in their advancement. In a nutshell, at the beginning of every stage of growth, there arises a fibrillation of price trends, while at the end of the phase, in the course of transition to stabilization, there occurred their consolidation. The trend of the first type was noted in 1990-1995, 1998-1999 (under the price downfall), between summer and autumn 2003 and autumn 2005; while the trend of the second type arose in 1996-1997, between late-2000 and early-2001, and in early-2005 and late-2006. This is another proof of an overall beginning of stabilization of housing prices in Russian cities.

#### *5.5.5. Forecasts of development of the housing market*

Since 1995 the annual forecasting of trends of price dynamics on the housing market of Moscow and other Russian cities rested upon economico-statistical models<sup>145</sup>. Until 2001 (including the post-crisis recovery stage) the models ensured a great accuracy of forecasting. But the models have failed to foretell a constant price rise at the second stage of development of the national housing market, and the 2003 and 2005 booms in particular. Effects of the stages were viewed as prerequisites for the growth and explosion of the “bubble” on the Moscow city housing market by analogy with suchlike scenarios that battered housing markets in the US, UK, USA, Canada, Australia, and some other countries, which local analysts used to regard as the most likely ones.

In conjunction with the above, there arise questions as to what this new, second, stage of the market development is, how the existing trends correlate with the cyclic phenomena characteristic of a market economy, and how probable the possibility for a new downfall in prices for Moscow housing is.

Given the persistence of the current state of affairs in the world markets for energy sources, which form major Russian exports, a continuous solidification of the national financial system, whose safety is warranted by the Stabilization Fund, a gradual diversification of the national economy, completion of formation of political mechanisms that ensure succession of the current socio-economic course, unforeseen circumstances (such as a world financial crisis, a war between the civilizations, a political crisis in the country, etc.) cannot be excluded, albeit their probability seems minimum.

Whereas the behavior of the real estate market is to a significant extent driven by external factors, that is, general economic conditions, it can be asserted that its main regularity and basic trend will be a sustained price rise for housing. One of the

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<sup>145</sup> Sternik G. “Statistichesky podkhod k prognozirovaniyu tsen na zhilye”. Zhurnal RAN “Ekonomika i matematicheskoye metody”, tom 34, vyp. 1, 1998, p. 85-90

most investment-attractive sectors of the economy, the housing market should continue to grow along with the economy, with price rise rates for housing in Moscow advancing the general pace of the nation's economic growth.

Typically, there are several counter-arguments against the possibility for a manifold price rise for housing in Moscow.

The first argument is that, according to the basic postulates of the market theory, without any emergency circumstances, prices on the market cannot grow faster than at 20% annually (as they follow mostly the dynamic of the population's real incomes, or even once in two-three years), as rising prices fuel growth in offer, after which the prices discontinue to rise. But the real estate market is to a greater extent exposed to inertia effects, and it takes a few years to increase the offer. This is the phenomenon noted over the past 1.5 years in the course of implementation of the national project on affordable housing, when the state has been trying by all means to encourage growth in effective demand (a general growth in the population's incomes, mortgage, a direct support to individual social groups), but investments in stimulation of volumes of construction and offer can ensure effects only in three or four years later, which is why the project so far has skidded, while the housing prices have been on the rise.

The second argument rests upon recognition of the fact that the housing prices have their natural ceiling dictated by the population's income level and effective demand. Once the population fails to catch up with such a price rise, the demand goes down, which exercises a certain pressure on sellers, compelling them if not to lower, but, at least, not to increase their prices. From theoretical perspective, the probability of such a scenario is, indeed, great, however, like other regularities, this one is effective only within certain limits, beyond which there arise exceptions from the general rule. One of such exceptions undoubtedly is housing market in the capital city. Moscow is a gravity center to all residents of other Russian regions and Near-Abroad countries, and they arrive with new sources of investment in the local housing. The effective demand on housing in Moscow is loosely dependent on price levels. It just takes short (between 6 and 12 months) breaks, when the price rise for housing discontinues, and this lasts until next surge. Plus, in all the developed economies the costs of housing in capital cities are far greater than in other cities.

Potentially, a release of pressure of effective demand on the capital market for housing may become possible only in the long term, should there emerge other economic and cultural centers capable to ensure a certain quality of life<sup>146</sup> comparable, at least, to those presently in existence in Moscow. In the conditions of the market model emerged in the post-Soviet zone this appears highly unlikely, as the model in question is characterized by social and cross-regional differentiation by main indicators, concentration of business activity in the capital,

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<sup>146</sup> Quality of life is a complex concept, which includes not only living standards that are determined by the current monetary incomes and accumulated property, but the level of development of various kinds of infrastructure, availability of qualitative educational and health care services, environmental and criminogenic situation, etc.

where the plexus of power and business under the transitional economy provided ample opportunities for huge incomes, particularly by means of rent-seeking behavior. One cannot reject, of course, a possibility for the towns that are satellites to Moscow (Khimki, Krasnogorsk, Dolgoprudny, Mytishi, Balashikha, Reutov) to gradually catch up with Moscow in terms of their attractiveness as microcenters for investment in real estate, thus forming a huge agglomeration. However, even in that case Moscow stays in the lead, while Moscow oblast (mostly the satellite towns) is retaining its “flown” position. It is worthwhile noting that all that would be in no way related to the possibility of a rise in Russia of centers comparable with Moscow.

The third argument, which rejects the possibility for a manifold price rise for real estate in Moscow in the long run, rests upon a thesis that prices for real estate cannot rise indefinitely and, as elsewhere in the world, they should stop and then go down. The record of developed nations witnesses quite the opposite, thus proving the logic of the price rise on the capital market. Thus, while real estate prices in Moscow grew 6-fold over the 6 years of steady growth, in California they grew 10-fold over 10 years, and in London, Paris, Berlin and Melbourne – 8- to 10-fold over 10-12 years.

In anticipation of the start of bursting of the bubbles and the price downfalls by analogy with the stock market, the world actually witnessed just a sole example of this kind. That occurred in Japan: dragged into the orbit of the Asian crisis 1997-98, the country faced a relatively long-standing economic stagnation and saw some downfall in prices for real estate.

Back to the price dynamics on the capital city’s real estate market over the past 6 years, it has to be noted that the trends therein caused the illusion of the absence of cycles on the market. That is why the common method of examination of dynamic price series limits our understanding of the market tendencies. Because of this, one suggests a new method of studying the market dynamics, *aka* the non-harmonic decomposition of price trends<sup>147</sup>.

The method per se is a transition from the studying of the dynamic of the studied value (prices) to the examination of the first derivative (which is increments, or the rate of growth), then the second one (growth rate of the increments, or acceleration of price rise rates), etc. – dynamic series of growth rates of increments of values against an approximated function of the previous level.

Thus, one can speak of interaction between cycles of fluctuations of different lengths. A “long” cycle of fluctuations is determined by a complex of macroeconomic performance indicators of a country and city (region). To these basic trends one applies faster fluctuations that are determined by the construction and investment cycle, advancement of the infrastructure of the market for house building, citizens’ consumer behavior, etc. These “medium”, faster, cycles realize themselves not in price fluctuations, but in those of the first derivative, namely, growth rates in price increments. Short cycles in turn reflect fluctuations of the second de-

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<sup>147</sup> Sternik G., Krasnopolskaya A. Metod negarmonicheskogo razlozheniya tsenovogo trenda.- [www.realtymarket.org](http://www.realtymarket.org), July 2006

relative (pace of acceleration of the price rise) relative to the trend displayed by “medium” cycles. The short cycles can be determined by different factors, for instance, seasonal and calendar fluctuations, price fluctuations for energy sources, a drastic change in the balance of private capital outflow, among others<sup>148</sup>.

The forecast comprised three levels:

- short-term forecast – deceleration of price rise rates and transition towards stabilization until late-2006
- medium-term forecast (until late-2007) – price stagnation with a possible downward adjustment (at 3-5%);
- long-term forecast (10-20 years ahead)- sustained growth with the average annual rate of 20-25% (with prices quoted in the nominal USD) and fluctuations of monthly growth rates within the range between zero and 80-100%.

The actual price dynamics in the short run mostly proved the forecast.

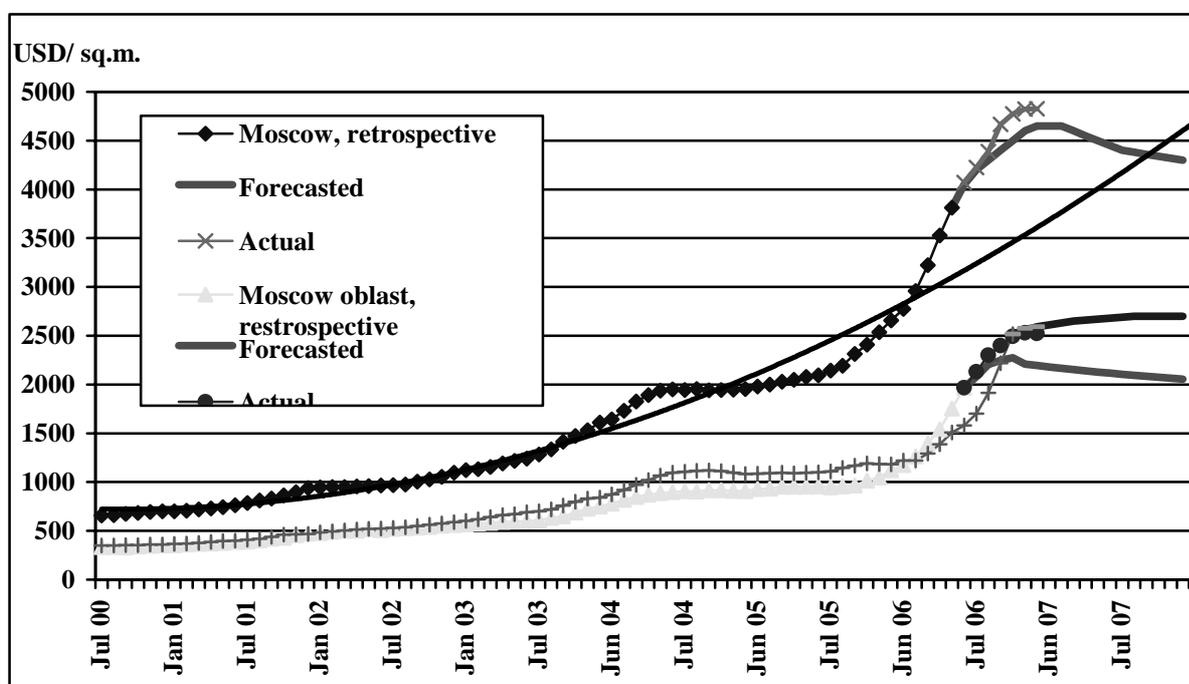


Figure 20. Forecast of Average Prices for Housing in the City of Moscow, Moscow Oblast and St. Petersburg

In five months after the forecast for Moscow and Moscow oblast had been calculated it is possible to note that the actual prices proved to be slightly greater than the forecasted ones, albeit their growth rates decelerated: in Moscow – from 8% in May to 6.8% - 1.5% between June and October and zero in December; in Moscow oblast – from 14% in May to 5.8% in October and zero in December; in St. Petersburg – from 11% in October to 0.7% in December.

<sup>148</sup> Sternik G.M. Tekhnologiya analiza rynka nedvizhimosti. M., AKSVELL, 2005, - 203 p.

The results of forecasting the price dynamics in Moscow through late-2008 showed that one can expect stagnation on the market analogous to that noted between late-2004 and early-2005. It should last at least until autumn 2007 and comprise a 5% price adjustment (relative to June 2006), the peak of which should fall on spring 2007 (by analogue with the spring 2005 adjustment in St. Petersburg). Overall, the year of 2007 will see stability of prices with probable minor fluctuations and transition towards a new cycle of price rise since spring-summer 2008. By late-2007 the price increment rate in Moscow should be close to zero and 65-70% - by late-2008.

The forecast for other regions shows that the 2007 price situation there will be analogous to that in Moscow: they should likewise expect their increment price rates to go down to zero, while stagnation (except for Moscow oblast and St. Petersburg) is going to start a bit later. The price rise should renew since spring 2008 and by results of the year should account for 90-95% in Perm and Tver, 85-90% in Moscow oblast, N. Novgorod and Novosibirsk, 60-70% - in Ekaterinburg and Rostov-on-Don, and 55-60% in St. Petersburg

Such dynamics would emerge under the impact of numerous groups of factors, including both those that drive prices upwards and the ones that block the rise (*Table 28*). The factors can be consolidated into two groups – external (relative to the real estate market) factors (political, macroeconomic, and factors associated with the interaction between the real estate market and the supplier/consumer markets) and internal ones (progress with the National Program “Affordable housing”, rise in the population’s spatial mobility, interaction with the respective segments of the real estate market).

As concerns the factors enumerated in *Table 28*, one should particularly focus on the political factor associated with the upcoming 2007-08 electoral cycle and the price situation on the market for energy sources, as a rise in oil prices should contribute to the contraction of the length of the period of stabilization of housing prices, while their fall would contribute to the opposite tendency.

Hence, the analysis of the development of the national market for housing allows the following conclusions:

Last year witnessed a notable price rise for housing in numerous cities (particularly in St. Petersburg, Moscow oblast, N. Novgorod and Ekaterinburg). The outcomes of the first year of implementation of the national project on housing appeared fairly positive, however, there emerged some factors which in the future might seriously inhibit it (the advanced price rise vis-avis growth of the population’s incomes, complexities associated with granting access to sites, constraints with respect to development of the public utilities infrastructure and the construction sector, fiscal challenges facing regional and local budgets, lack of confidence between market agents caused by some real estate developers’ fraudulent acts).

Table 28

## The Balance of Factors Which Determine the Medium-Term Dynamics of prices for Housing

Categories of factors	Groups of factors	Impact of factors on prices	
		Rise	Decline
External factors	Political	Election campaign: additional funding of regional, Duma and presidential campaigns, effective demand on the rise fueled by fees payable to political "technologists", media and show-biz .	Election campaign: possible destabilization of political situation, intensification of a conflict between power and business, federal, regional and municipal authorities, which decreases the country and regions' investment attractiveness
	Macroeconomic	Maintenance of high world prices for energy sources, which entails the capital inflow. The growth in budget revenues, a 1.5- 2-fold wage rise to budgetary employees and rise of pensions to pensioners over the upcoming two years. Continuation (albeit at a slower pace) of growth in GDP and the population's real disposable incomes. Russia's accession to WTO which would boost up the inflow of foreign corporations, funds and banks' capital	Downfall in the world prices for energy sources results in a decline in the capital inflow. Decline (in the conditions of a lesser inflow of foreign exchange and appreciation of the RUR) of growth rates and (even a drop) of the volume of money supply, resulting in a lower capacity of the banking system with regard to disbursement of loans to real estate developers and the population. Fall in the GDP growth rates which limits the government's possibilities for solving socio-economic challenges and maintaining the population's income growth rates. Continuation of the rise in volumes of Russian investments overseas and foreign ones – in Russia. Decline in the inflow of speculative capital in the conditions of a growing attractiveness of financial instruments in the US and Europe
	Factors of interaction with the respective markets	Advancement of the national stock market, expansion of the IPO practices, as well as those associated with receipt of bonded loans and use of other means of external and domestic borrowing that help boost the investment inflow into the real estate market	Advancement of the national stock market, the rise of diverse highly profitable financial instruments, which results in the capital flow out of the real estate market to supplier/consumer ones (partly – return of the capital via the real estate-based mutual investment funds). Continuation of the consumer boom, which helps reduce the volume of the population's savings, which are spent on buying housing.
Internal factors	Progress with the National Program "Affordable Housing"	Rising volumes of government support and disbursement of mortgage loans, while maintaining the already existing high volume of offer on the secondary market. Maintenance of volumes of placement of housing in operation in Moscow in 2007 at the level 4.7-4.8m sq.m., given that roughly a half of that would be re-assigned to the municipal programs, thus lowering the volume of offer on the primary market	Growing volumes of house building in regions and offer of housing on the primary market
	Rise in the population's spatial mobility	f	Outflow of the population with low- and medium-level incomes from Moscow to the market of the nearest to Moscow towns of Moscow oblast, which results in a lower level of effective demand in Moscow.
	Interaction with the respective segments of the real estate market	Continuation of the advanced growth in investment in retail and construction of commercial real estate objects, transport and social infrastructure, which increases attractiveness of the housing market in particular regions, cities and municipalities.	Investment flow to the market for commercial real estate (trade, office facilities, entertainment and recreational objects, logistics complexes, technoparks, etc.) in the conditions of the declined profitability rates of house building, and government regulation of town planning policies, as well as the policy of allocation of sites on the federal, regional and municipal levels.

Today, the national housing market has found itself at the second stage of its development, which started in mid-2000. Its main characteristic is a constant price rise, with no clear collapses and crises. Since early-2007 the market has stabilized after the period of its boom. Forecasts show that 2007 should become a year of stability in Moscow, Moscow oblast and main regional centers (with possible price

adjustments at +10/-5% in some of them). In 2008 (in the aftermath of the presidential election) the stagnation should be replaced by a new stage of acceleration of the price rise rates, thus driving the annual increment up to between 60 and 100%. This does not discredit a longer-term forecast (for the period of 10-15 years), namely a sustained annual rise (in nominal USD-denominated prices) at 20-25%, with its rates fluctuating between zero and 80-100%.

## **5.6. The Defense Economy and the Military Security of Russia**

### *5.6.1. The Major Results of the Military-Economic Activity in the Military-Social Sphere*

The year 2006 was more successful as regards the achievements in the defense sphere than the preceding years, notwithstanding certain setbacks that occurred in implementing military reform, solving the social problems of the military and equipping the armed forces with modern weapons, which will be dwelt upon later in this paper. The RF President had every reason to positively characterize the level of the State's level of security and the efforts of the RF military establishment aimed at maintaining this level. Such an assessment was given by him at a conference held at the Ministry of Defense in November 2006. Judging from what one could find in the mass media, this opinion was shared by the majority of experts.

Such views are well substantiated. Russia did not get involved in any military adventures, was performing its peace – keeping functions on the territory of the post-Soviet space, was completing the withdrawal of its forces from Georgia as demanded by this country's leadership, and sent its military bridge builders to help Lebanon in restoring its transport communications destroyed by Israeli bombing. *From the point of view of the strategic nuclear deterrent of potential aggression* (it should be noted that a convincing demonstration of combat readiness is essential within the framework of this strategy) the launches of land-based and airborne ballistic missiles, and also the launches of high-precision airborne non-nuclear missiles were quite important. Apart from this, as a result of successful testing, the serviceable life of some strategic missiles was prolonged. Although their number was small, some new and modernized missile complexes did, indeed, find their way to the armed forces. A considerable number (by comparison with previous years) of exercises involving ground and airborne forces, as well as a lot of exercising aimed at achieving cooperation between the RF Armed Forces and the armed forces of other states, so as to prepare them for the conduct of anti – terrorist operations, were conducted. Combat training was improved, though military specialists can still discern some elements of show, especially when the RF minister of defense personally participates in the exercises.

The guarding of the country's frontiers and coastal waters is continued to be strengthened, and sterner measures are being taken in order to stop smuggling. The personnel of the Internal Forces and the Federal Security Service succeeded in preventing, in 2006, a number of actions planned by the terrorists, and most impor-

tantly, a number of the most notorious representatives of the terrorist underground, including Shamil Basaev, were liquidated. The remnants of the bands are being dealt with exclusively by the military personnel serving under contracts.

Russia has found the necessary resources to finance all these activities. Moreover, we can observe a certain strengthening of Russia's defense economy and a successful cooperation in the sphere of military technology, which has brought significant revenues to the budget.

**The personnel policy of the RF military establishment** became more coherent in 2006. Some major parameters, such as the general numerical strength of the Ministry of Defense, were clarified (the current nominal numbers are 1,130,000 – to be reduced, in the future, to 1 million), and it was announced that only 1% of officer assignments should be held by top – ranking officers. It was announced that henceforth officer assignments should be held mainly by graduates of military educational establishments, and that the number of military chairs at civil educational establishments was to be drastically reduced. Since September 2006 they have remained only at 31 of Russia's high educational establishments. Some civil higher educational establishments have already started, since the beginning of this year, to prepare specialists for the military establishment. This means that it will be possible to avoid replication in preparing specialists qualified in certain types of dual-purpose technologies. The RF Ministry of Defense has introduced additional grants for the students wishing to obtain an additional military education, on condition that they would take an obligation to serve, afterwards, no less than three years on officer assignments, under a contract. It is very important for such decisions to be taken voluntarily.

At the same time, some deferments were abolished, including those for the students who have started military education at military chairs but have not completed it because of the closure of the military chairs. According to the top brass, this will make it possible to improve the quality of the draftees, including those who will serve as soldiers (or sailors). However, these persons will be drafted on an obligatory basis, which can cause some negative effects.

The traditional autumn draft of last year was the last one to entail a two – year service. In the aggregate, the two drafts of the year 2006 have embraced less persons than those of the previous years. This fact is positive. But, bearing in mind the adoption of the amendments introducing the reduction of military service for draftees to one and a half year in 2007 and to one year in 2008, it has become clear that this country's citizens under question should prepare themselves for the volume of the draft to be increased. Moreover, the year 2008 will mark the beginning of a decline in the numbers of youths entering the enlistment age.

Thus, many of the old problems of personnel policy have remained unsolved. Also, there have emerged new problems causing the actions of protest on the part of the young which are not totally unjustified. If it is to be considered, as the RF President has said in one of his messages, that the draftees will spend half a year in training units and the second half of their term of service – in regular units, what will be the good of such a service? Is it, indeed, advantageous for society and the State

to impose this service, which does not require high qualification and does not result in any rise in combat readiness, on the young specialists who have obtained higher education? The situation can be further aggravated by the fact that the sergeants and warrant officers placed in charge of the graduates of higher educational establishments will be persons serving under contracts, and having no higher education. What kind of relations will evolve between them during the period of service?

Also, there is no absolute clarity as regards the staffing of military posts with the present-day personnel serving under contracts. In the military units of permanent readiness the number of such persons was on the rise, while in other military units it was decreasing. This situation was quite predictable, because the causes of it were of a socio – economic nature, as it was repeatedly pointed out in the IET's previous reviews.

2006 was the penultimate year in the program for the transition of the units of permanent readiness to the absolutely voluntary enlistment of citizens for military service under contracts. Therefore, there exists a legitimate interest to the results achieved within the framework of the corresponding federal target program (FTP) and to the quality of its implementation.

Let us start with analyzing the achievements. The number of military units and formations of permanent readiness, manned exclusively on the contractual basis, continues to grow in the armed forces. Also significant is the fact that the persons conducting their service as draftees no longer serve in the hot spots. According to the assurances of the head of the GOMU, draft has been completely abolished in Chechnya, and now only Chechens serve there - under contracts. Thus, the problem of switching over to voluntary principle of manning the armed forces has been reputedly solved not only on the scale of the military units included in the category of permanent readiness, but also on the scale of one of the regions of Russia. However, the question as to whether the creation of purely ethnic military units is beneficial can hardly be answered in a positive way.

So far as a more detailed analysis of the quality of implementing the federal target program is concerned, the assessment of the results achieved in a number of military units inspires no optimism. It is not by chance that the FTP adopted in August 2003 was repeatedly altered last year with the latest amendments having been introduced by the RF Government's Decree No. 549, of 7 September 2006. As a result of these adjustments, the list of military units being switched over to the system of contracting has become updated, a period of probation for assessing the servicemen's fitness for service has been introduced, and material sanctions have been established for those violating the terms of a contract. The summary figures of the FTP have also been changed. Judging from these figures, it becomes apparent that the expenditures on the program have increased, while the number of servicemen being switched over to the contractual system has been decreased. Instead of the previous 147,578 posts, only 138,722 posts in Russia's military establishment are planned to be held by persons serving under contracts, including 125,359 posts in the RF Armed Forces. The rest of the posts are in the Internal Forces of the Ministry of Internal Affairs and in the Frontier Service of the FSB. And

it should be noted as an especially positive fact that it has been announced that, starting from the year 2008, this service should be completely manned by persons serving under contracts. A similar announcement has been made with regard to engineering units as well.

The assessments of what is going on considerably differ – the minister characterizes it with optimism, while his subordinates, in particular the officers of the GOMU of the General Staff, are more pessimistic. The testimony to this is a number of publications in the mass media<sup>149</sup>. The reasons for such pessimistic assessments, one of which is formulated in the title of the publication we are referring to, are very real – in fact, they have been initially programmed by the General Staff itself<sup>150</sup>. And the collapse of the contract system is near not because the funds initially planned for the realization of the FTP, and then additionally allocated for the purpose of its implementation, were not spent on increasing the attractiveness of military service under contract. These funds are being spent on the infrastructure of military camps, combat training and other undoubtedly useful initiatives. Such expenditures are certainly necessary under any system of manning the armed forces, but their financing should be carried out under appropriate items of expenditure, not related to the FTP.

The other reasons for the stalling of the FTP have been exposed by the Committees of Soldiers' Mothers. It turned out that under conditions of unpopularity of voluntary service the army had resorted to the widespread practice of forcing the soldiers serving on the basis of conscription to sign contracts. Also, in a number of military units, privates and noncommissioned officers are subjected to extortion, and their commanders violate their rights, as evidenced by a large number of facts included in the official report of human-rights organizations<sup>151</sup> or published in the mass media. Military registration and enlistment offices also encounter difficulties in finding appropriate personnel for the armed forces, which are caused by the fact that the average wage is growing in the majority of the regions, and it is impossible to find anybody who would agree to serve for a lower pay offered for military labor involving a lot of hardships.

**Money allowance.** The personnel policy of the Ministry of Defense and the other power establishments is reflected in the size of money allowance (MA) of the servicemen, which should be the major factor capable of ensuring the attractiveness of voluntary military service. The size of a MA depends on the status of a ser-

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<sup>149</sup> Mukhin, V. Krakh kontraktnoi armii (The collapse of the contractual army) // *Nezavisimaia Gazeta*, 24.08.2006.

<sup>150</sup> Vorob'ev, E., Tsymbal, V. Krakh kontraktnoi armii zaprogramirovan (The collapse of the contractual army has been programmed) // *Nezavisimoe voennoe obozrenie* (The independent military review), 27.10–2.11.06.

<sup>151</sup> Vakhnina, L. V. "Lishnii soldat: Nezakonnoe ispol'zovanie truda voennosluzhashchikh po prizyvu v tseliakh, ne obuslovlennykh ispolneniem obiazannostei voennoi sluzhby" (A redundant soldier: The illegal use of labor of servicemen enlisted by conscription, for purposes not determined by the implementation of the duties of military service). A report. Moscow: Vserossiiskaia koalitsiia "Za demokraticheskuiu AGS" (The All-Russian Coalition "For a Democratic Alternative Civil Service", 2006. 87 pp.

viceman, on the character of functional responsibilities, and numerous other indicators. Until recently, the functional dependence of MA on these indicators had been determined by numerous documents issued at different times, and had been open to different interpretations and subsequent abuse. Therefore Order of the RF Minister of Defense, of 30 June 2006, No. 200, “On the Approving of the Procedure for the Provision of Servicemen of the RF Armed Forces with Money Allowance” (hereinafter – the Procedure for MA), which was published in late September and came into force from 1 October 2006, is undoubtedly a very positive act.

The clarification of the Procedure for MA has not been altered in its previously established fundamental principles. The calculation of MA remains unchanged:

$$MA = MRMA + \sum AP_i$$

In this expression, the first summand is the monthly rate of money allowance  $MRMA = RPMR + RPMP$ , which consists of the rate of pay for military rank (RPMR), related to the twenty positions of the scale of military ranks, and the rate of pay for military post (RPMP), related to the fifty so – called “tariff classes”. The second summand is the sum of additions to the MRMA.

The minimum value of the RPMR is 659.54 roubles / month; a marshal’s maximum of the RPMR is 2,170.05 roubles / month; the spread of nominal values is 1,710.51 roubles / month; the spread of realitive values is 4.72. Correspondingly, the spread of values regarding the officers’ ranks only amounts to 1,416.91 roubles, or 2.88 times.

The spread of nominal values of the RPMP is 4,352.87 roubles / month, while that of relative values is 4.41. Correspondingly, the spread of values regarding the officers’ posts amounts to 3,586.97 roubles / month or 2.76 times.

The spread of both the values of these rates of pay and their amounts correspond to the RF servicemen’s traditional notions of “justice”.

There is no rigid correspondence between military ranks and “tariff classes” related to military posts, and no such correspondence can ever exist. In the Procedure for MA, only the ranks and posts of the officer’s contingent are set apart from the ranks and posts of the contingent of privates and noncommissioned officers (PNOC). As far as the Army and Navy warrant officers are concerned, some documents (and even laws) consider them to be in one category with the officers, some consider them separately, and some – as belonging to the category of the PNOC. Nevertheless, for purposes of a comparison analysis of the MRMA and MA, some tentative correspondence between the ranks and posts is possible – for example, as is shown in *Table 29*.

*Table 29*

MR	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
R	1	2	3	4	5	6	7	8; 9	10	11	12; 13	14; 15	16– 18	19– 22	24– 30	31– 34	35– 46	47– 48	49	50

The upper row contains the consecutive numbers in the list of military ranks – from the private to the marshal. The second row contains the values and value ranges of the posts – related “tariff classes” approximately corresponding to them.

They were used in the further calculations of the tentative sizes of MRMAs and the additional payments related to them.

As is seen from Table 20, the scales of military ranks and “tariff classes” have different density: only 9 tariff classes correspond to the 8 ranks of the PNOC, while 41 tariff classes correspond to the 12 officer ranks. They are equally different in density as regards the officer ranks: approximately 5 tariff classes correspond to the four ranks of junior officers, approximately 15 tariff classes – to three ranks of senior officers, and 20 tariff classes – to the four general’s and one marshal’s rank taken together. Especially large is the scale of tariff classes for colonels, major-generals and lieutenant-generals. It can be assumed that this situation is determined not so much by the existence of the so-called wage-bracket categories as by the influence exerted on the distribution of tariff classes by those officials who serve in the Central Apparatus (CA) of the Ministry of Defense, because it is precisely their posts that a considerable proportion of the tariff classes relates to.

If we compare the scale of military posts with the corresponding scale of civilian civil servants, we will find an approximate correspondence between the duties and working conditions stipulated for the top echelons of officials (of ministries and agencies), and at the same time will note the apparent underestimation of the role and importance of the private (or sailor), sergeant (or petty officer) and the junior officer. The fact that their service can be much more dangerous and difficult than the corresponding civilian civil service is not reflected at all in the tariff classes accorded to them.

However, at the present time, the basic part of a MA is determined not by the size of the MRMA but by the various bonuses.

It is not by chance that the long-service bonus is placed first on the list of all the forty bonuses. In the past it was also considered to be the most justified, and therefore was both substantial and regular. It is mentioned in a federal law of the RF. And the step – like dependence of its coefficient on time in service, established by a decree of the RF Government, characterizes the former financial policy, which reflected the need to stimulate the upward promotion, in particular, of the lower echelons of the military hierarchy. As the time in service grows, the relative value of this bonus lags behind. The accounting of the long – service bonus is a matter of fact for all present-day and former servicemen. The sum of the MRMA and the first bonus represents the so-called basic monthly rate of pay (BMP). As in the case with calculating the MRMA, our assessments are based on the rated (conventional) size of this bonus, because no precise coordination between the time in service and the posts can be achieved. The BMP is especially important for military pensioners, for the size of their pensions directly depends, first of all, on the BMP.

Our analysis shows that the size of servicemen’s BMP differs approximately by 11,436 roubles / month, or by 7.3 times. And this does not contradict the traditional notions of what is just (shared by the servicemen), either.

As regards the most recent bonuses, it is clear that they have most radically changed the situation. The results of the MA analysis, which takes into account the major new bonuses, are shown in *Figure 18*. Plotted on the X-axis are the tariff

classes, while MA (in roubles / month) are plotted on the Y-axis. The graphs characterize the discrete growth of MA with a number of bonuses taken into account. The two lower graphs illustrate the MRMA – Row 1, the BMP – Row 2.

The upper graphs characterize the MA with allowance made for the social bonuses granted to all servicemen, which are calculated in proportion to the size of a corresponding MRMA (Row 3), the MA with allowance made for the universal 100%-bonus, which is proportional to the size of a corresponding MRMA (Row 4), and also the MA with allowance made for a more considerable bonus, which is granted only to the officers and warrant officers of the Central Apparatus (CA) of the Ministry of Defense (Row 5).

Especially important for the reform of the system of recruitment are the bonuses introduced for the servicemen of permanent-readiness units in connection with their switching – over to the contractual system. For the whole of Russia, they are characterized by the graph denoted as Row 6, while for Chechnya – by the graph denoted as Row 7.

It should be noted that it is precisely the difference in the size of MA, illustrated by the three latter graphs (as listed in the text), that most strongly dissatisfies the servicemen. And the case in point is not only the fact that the size of MA for the top brass (close to the 50<sup>th</sup> tariff class) has increased dramatically, but also that a warrant officer serving in the CA (the 8<sup>th</sup> tariff class) receives the same MA as his “equal in rank” in Chechnya, and his MA is larger than that received by many officers in regular forces (up to the 16<sup>th</sup> tariff class). The dissatisfaction among the servicemen has become known to the leadership. It is not by chance that the Army’s mass media<sup>152</sup> have published the information that the minister of defense has already instructed military financiers to start developing a new regulation concerning MA.

However, the problem of increasing the attractiveness of voluntary service under a contract must be solved immediately, without waiting for this new regulation to become ready, because servicemen will compare the MA of a military man serving under a contract with the average wage at the present-day Russian labor market, which has already exceeded 11 thousand roubles. Given the existing level of MA, neither the young people in general nor those who are to decide whether to prolong their contracts will have any financial incentive to serve in the ranks.

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<sup>152</sup> Shal'nev, E., Shcheblanin, V. Preiskurant na spravedlivost' (A price – list for justice) // Krasnaia Zvezda. No. 201. 31.10.2006.

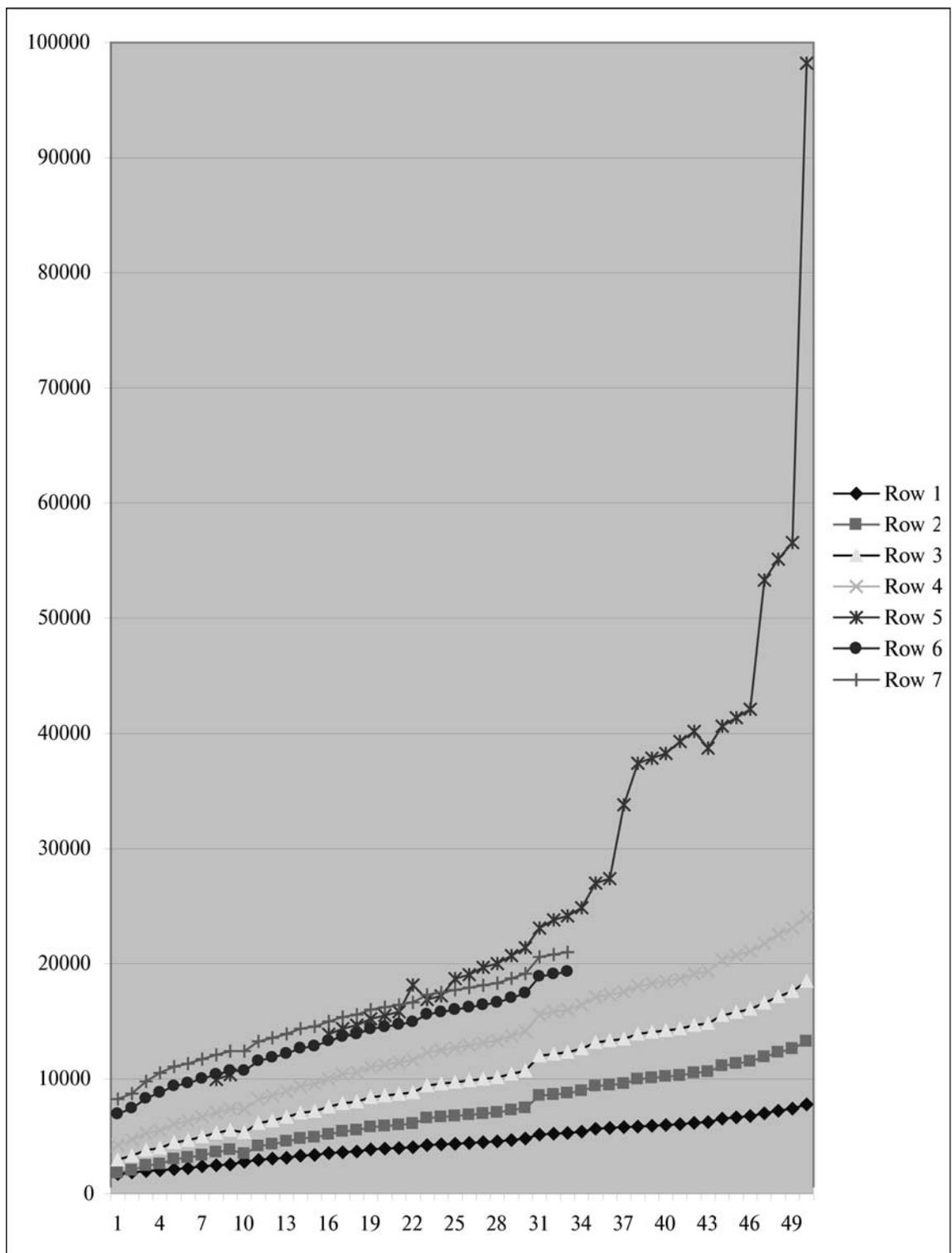


Figure 21. The size of money allowance of servicemen in accordance with the tariff class

Also, there exists a rather specific but very acute personnel problem – the training of personnel for the defense-industrial complex (DIC). At the present time, its employees of all levels (workers, technicians, engineers, designers of the highest qualification) have, on the average, reached the age limit – both with regard to pension parameters and the nominal duration of life in the RF. The search for solutions to the problem is continuing. One of the most interesting solutions currently under consideration<sup>153</sup> is the creation of university complexes, including vocational training schools, specialized secondary schools, higher educational establishments, and centers of post-graduate education and branch science. As a result, there will emerge a single system of “installed” educational standards, which will envisage a contest-based transition of the students from one stage of education and practical activity to another. However, it is far from being certain that the leading educational establishments of the country will be able to rapidly switch over to this corporate system of education. This will require the pooling of the administrative and financial resources of various agencies and the management of the DIC’s enterprises with different forms of ownership.

**Housing.** There is yet another potentially important incentive for military service which is still waiting to be materialized, that is, the provision of housing for the military personnel serving under contracts. This problem is being solved in the RF in a number of ways. Firstly, with the help of state residential construction (SRC) – for those who have been dismissed with a commitment to provide them with residential property. At present, the average rate of the value of one square meter of housing being used for calculating the cost of SRC amounts to 17,640 roubles. In Moscow, the upward coefficient is 1.2. Many servicemen justly complain that such norms infringe their interests and encroach on their rights. The second way – the provision of residential property for those who have been serving in the armed forces for a sufficiently long period of time. The third way is to provide temporary (service) housing for those who have signed their second contract since the year 2004.

In general, so far as the solution of the housing problem is concerned, the year 2006 can be considered more successful than all the previous ones. Even some additional resources were allocated – from the reserve fund of the RF President. While the situation which accompanied the withdrawal of troops from Germany in the 1990s was clearly lamentable, the personnel of the former garrison of Tbilisi, including 329 servicemen and 220 civilians, were provided with housing – this situation can be considered highly positive. Everybody was promised housing, including 92 officers out of 132, 16 warrant officers out of 49, and 28 servicemen serving under contracts who had decided to get demobilized.

The beginning of the materialization of the funded mortgage system (FMS) was disappointing. The Ministry of Defense, who had taken the allotted monies under its control, did not manage to efficiently place these funds. In 2005, 22.6 thou-

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<sup>153</sup> Ipatov, O. Gde vziat’ kadry dlia oboronnoi otrasli? (Where can we get the personnel for the defense industry) // Voенно-promyshlennyi kur’er (The military-industrial messenger). No. 43. 14.11.2006.

sand persons became participants of the FMS, and 1,031 billion roubles was allotted for them, but it was only at the very end of 2006 that a contest between the asset managers was organized at the Ministry of Defense for the purpose of concluding the agreements of trust management of the servicemen's savings.

For the year 2006, it was planned to allocate 3,209 billion roubles to the FMS fund<sup>154</sup>. The leadership of the Ministry of Defense announced that it had selected 10 companies, had divided the savings among them on the principle of equality, and had introduced the index of fixed returns. But by the end of 2006 the Ministry of Defense had not announced any growth of the monetary means coming to the FMS fund. The attractiveness of the FMS in the eyes of the military had fallen sharply. In this connection, the Ministry of Defense and the Ministry of Finance issued a joint decision to the effect that, starting from the year 2007, the funded contribution should be increased to 82,700 roubles per year per each servicemen taking part in the FMS<sup>155</sup>.

The solution of the problem of providing the servicemen with service housing has been altogether postponed to a later period – that until 2012. The situation is further aggravated by the fact that, according to the Clearing House's auditor A. Piskunov, "while the existing demand is for 480 thousand apartments, today the military establishment lists more than 700 thousand apartments in its fixed assets. But about 70% of these apartments are occupied by persons totally unrelated to the Armed Forces"<sup>156</sup>.

#### *5.6.2. The Major Results of the Military-Economic Activity Aimed at the Technical Equipment of the Armed Forces*

The problems of material and technical equipment of the RF military organization and of the DIC development have recently become a major priority for the military and political leadership of the State.

Last year, the ratio between the RF Ministry of Defense's expenditures on the current upkeep of the Armed Forces and on their military equipment amounted, approximately, to 60: 30. In the past, this ratio was 70: 30, and the scope of progress makes it possible to hope that the planned level of 55.8: 44.2 can be achieved in 2007. However, as is shown in our report for the year 2005, the reputed optimality of this ratio has never been justified, nor is it confirmed by the practice of development of the armed forces abroad.

One could note a positive dynamics of the priority rates of expenditures on purchasing armaments and military and special equipment. As regards the manufacturing of military – purpose products (MPP), the work load of enterprises grew by 40%, and 75 thousand work places were additionally organized during the past

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<sup>154</sup>Yurov, D. Nakopitel'no – ipotechnaia sistema vystraevaetsia (The funded mortgage system is taking shape) // Krasnaia Zvezda. No. 241. 28.10.05.

<sup>155</sup>Ipotechnye vnosy uvelichatsia [Mortgage contributions will increase] // Voенно – promyshlennyi kur'er (The military – industrial herald). No. 43. 8 November – 14 November 2006.

<sup>156</sup>Garavskii, A. U oborony schet osobyi (Defense calculates differently) // Krasnaia Zvezda. No. 3. 22.02.06.

five years<sup>157</sup>. But as in the past, the core of the DIC is represented by approximately 1,280 enterprises and organizations in 72 subjects of the Federation. Of them, federal state unitary enterprises account for 58%, joint – stock companies with a state – owned block of shares of no less than 50% – for 19 %, and joint-stock companies with a state-owned block of shares of less than 50 % – for 23 %. The register includes 63 enterprises of the RF Federal Agency for Nuclear Power (ROSATOM) and 191 enterprises of the Ministry of Defense<sup>158</sup>.

Nevertheless, the noted positive trends do not prevent the continuing ageing of the complex. The problem of its restructuring, the completion of which had been planned for the year 2006, was not solved. The state of the Defense-Industrial Complex's enterprises, the character and rates of their "development", and also the methods of building relations with their major customers (the State's power structures) are such that they are starting to pose a serious danger to the national security of the country. The technological and personnel degradation of the Defense-Industrial Complex can reach such a level that the lagging behind of Russia's Armed Forces in the sphere of technical equipment, in conjunction with its enormous territory and immense natural resources, would create combined preconditions for the emergence of military threats, which are as yet hidden.

And yet another circumstance should also be noted. The growth in expenditures on armaments and military equipment from 80 bn roubles in 2002 to 237 bn roubles in 2006, and the planned 302 bn in 2007, is not proportional to the growth in the level of availability of these armaments and equipment to the RF Armed Forces, especially when comparing the expenditures and the growth rate of production in Russia itself. It should be noted, for the sake of justice, that Russian armaments are still very popular in the world. The share of Russian exports on the international arms market amounts to 15%, or 6 bn USD.

After having noted that the volume of the state order for defense items for the year 2006 nearly by two times exceeds the annual volume of export of Russian armaments<sup>159</sup>, A. Piskunov, as an auditor of the Clearing House, puts a justified question: "Why until now we have been manufacturing more products, and frequently of better quality, for the foreign customer than for our own Armed Forces, whereas the **costs are similar?**"

The causes of this situation are differently explained by a number of specialists, whose access to information and whose levels of competence and responsibility also differ considerably. Thus, the Chief of the RF General Staff, Baluevskii, considers that the Army is unlikely to obtain armaments it needs, because "there is no coherent military-technical policy"<sup>160</sup>. But if any military-

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<sup>157</sup> Avdeev, Yu. "Oboronka" poka v oborone (The defense-industrial is still on the defensive // *Krasnaia Zvezda*. No. 214 (24734). 21.11.2006.

<sup>158</sup> Chistova, V. E. *Ekonomicheskoe upravlenie razvitiem oboronno-promyshlennogo kompleksa Rossii* (The economic management of Russia's defense – industrial complex) / Doctor of Economic Sciences V. V. Bandurin, Ed.: Moscow: The "Krasnaia Zvezda" Publishing House. 2005.

<sup>159</sup> Miasnikov, V. *Voенно – promyshlennuiu vertikal' ukrepili slabym zvenom* (The military-industrial vertical has been strengthened by a weak link) // *Nezavisimoe voенnoe obozrenie* (The independent military review). 07.04.2006.

no coherent military-technical policy”<sup>160</sup>. But if any military-technical policy is missing, what are the rapidly growing allocations being spent on? The number of possible answers to this non-rhetorical question is limited. Answer 1: the armaments and military equipment are being purchased at enormously inflated prices, and therefore the expenditures are growing much faster than the level of availability of these armaments and equipment. Answer 2: we are witnessing a large – scale embezzlement of public funds. According to the RF Clearing House, the total sum of financial violations perpetrated between 1999 and 2002 amounts to 15.8 bn<sup>161</sup>. In all likelihood, both answers are correct.

At the All-Russian Scientific and Practical Conference “The Prevention of Bankruptcy of Strategic Enterprises and Organizations: the Practice and Problems”, held in Moscow on the 25<sup>th</sup>–26<sup>th</sup> of April, the major cause of the negative financial and economic state of the defense industry’s enterprises was found to be the low level of workload, amounting to just 40%. At the same time, in some industries, the workload under the state order for defense items amounts to between 9% and 30%. According to the Conference’s participants, it is precisely this phenomenon that causes the uncontrollable growth in the prices of defense products, because all overhead expenses incurred by a given enterprise are included in the value of a limited output of products.

According to the Federal Tax Service, 198 strategic enterprises and organizations are displaying some or other signs of bankruptcy, and 170 of them are the DIC’s enterprises. The tax authorities have issued orders that the arrears accumulated by 150 strategic enterprises should be recovered from them at the expense of their property. One third of the enterprises in the defense industry – which are strategic enterprises exceptionally important for Russia’s security – can be sold at auctions either in whole or in part<sup>162</sup>. The RF Clearing House is also pointing to the clear discrepancy between the results of growth of the country’s military potential and the rise in expenditures on defense<sup>163</sup>.

There exist some other objective and subjective problems associated with planning and implementation in the sphere of development and production of military – purpose products (MPP). The major ones are as follows:

- the hard – to predict changes in the forms of ownership of the enterprises and organizations fulfilling the state order for defense items;

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<sup>160</sup> Sergeev, O. L. Monopolizm, lobbizm i otsutstvie chetkoi voenno-tekhnicheskoi politiki (Monopolism, lobbyism and the absence of a clear military-technical policy) // Nezavisimoe voennoe obozrenie (The independent military review). 12.05.2006.

<sup>161</sup> Miasnikov, V. Na vysote v armii – vorovstvo (The only thing which is up to the mark in the army is larceny) // Nezavisimoe voennoe obozrenie (The independent military review). No 16 (4114). 19.05.2006.

<sup>162</sup> Miasnikov, V. Voennaia promyshlennost’ spolzla za gran’ bankrotstva (The military industry has slid beyond the verge of bankruptcy) // Nezavisimoe voennoe obozrenie (The independent military review). 28.04.2006.

<sup>163</sup> From the audit of resources to the audit of results // Rossiiskaia Gazeta (The Russian Gazette). No 148 (4114). 11.07.2006

- the vagueness of the prospects of development of the DIS's enterprises as such;
- the irregular financing of the state order for defense items (SODI);
- lobbying in combination with monopolism;
- the high corruption level of the processes surrounding the allocation of budget funds;
- the level of managerial culture of the enterprises' CEOs, which is inconsistent with market relations;
- the moral and physical ageing and deterioration of basic production assets;
- the ageing of the personnel of the DIS's enterprises, the lack of a sufficient inflow of young specialists, and the lack of skilled workers – all this against the background of a general population decline;
- the low level of innovation activity;
- low productivity;
- low capital productivity.

The task of improving the situation with the DIC has been delegated to the Military-Industrial Commission (MIC) created by the RF President's decree and headed by Vice-Prime Minister Sergei Ivanov. It has been announced that the most important function of the Commission will be to consider "the issues concerned with the efficiency of the use of federal budget funds for the purpose of ensuring the country's defense, the carrying out of law-enforcement activity, and the safety of the State..."<sup>164</sup>. The new structure has broad functions, powers and rights, but the area of its responsibility is rather vague. The traditional balancing of any managerial structure in the triad of "rights-duties-responsibility" is clearly biased in favor of "rights", while the responsibility - for the analytic and expert's maintenance of the Commission's activity is vested only in the chairman of the MIC's scientific and technical council.

On 14 October 2006, the President of Russia approved the State Program of Armament (SPA) for the years 2007–15. The SPA is the major planning document, which determines the long – and medium- term development (for 10 and 5 years respectively) of armaments and military equipment (AME). It represents the basis for mapping the programs and plans of development of the defense industry, while the state order for defense items, which is a document of short – term planning, must correspond, in its major parameters, to the Program's annual profile. For the years 2007–15, about 5 trillion roubles is to be allocated from the federal budget for the purpose of implementing to the State Program of Armament. It is planned to spend nearly two thirds of these funds (63%) on purchasing some new types of AME. In order to increase the efficiency of using these funds, a Center for orders and deliveries of armaments, military equipment and special materiel is being organized. In 2007, a Federal Agency for the Purchasing of Armaments, Military Equipment, Special Materiel and Means of Support will be created on its basis.

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<sup>164</sup> The Statute on the Military-Industrial Commission attached to the Government of the Russian Federation. Approved by Decree of the Government of the Russian Federation, of 7 May 2006, No. 278.

Also, there exists a federal service for managing the state order for defense items, which is designed to control and supervise the spending of the budget funds of the state order for defense items.

By and large, the measures being taken by the military leadership are rather ambiguous. Most likely, it is expected that the creation of the so-called “managerial board of a single customer”, which represents the corresponding federal structures, will make it possible to take some positive steps towards a reasonable standardization of armaments and military equipment for the country’s military establishment as a whole. However, the creation of vertically integrated industrial structures, on the one hand, results in monopolization and an inevitable growth of the price of military equipment, while on the other hand – in the increase of managerial costs and in a considerable part of income being uncontrollably managed by the asset managers in charge of these structures.

### 5.6.3. Military Expenditures of the Federal Budget

The federal budget for the year 2006<sup>165</sup>, including the State’s military expenditures, was signed by the RF President on 25 August 2006, which, in principle, made it possible for the government to start implementing it from the very beginning of the year. However, the procedure for implementing the budget<sup>166</sup> was determined only in late February, which, in its turn, gave rise to all the differences that accompanied, throughout the year, the attempts to timely implement the federal budget. In spite of this, as a result of the two changes introduced in July and December, the federal budget’s expenditure was increased from 4 trillion and 270 bn roubles to 4 trillion and 431 mln roubles, respectively<sup>167</sup>, or by 3.8%. At the same time, the expenditures under the Section “National Defense” grew by 3.0%, and under the Section “National Security and Law-Enforcement Activity” – by 2.7%.

The values of the major military-expenditure items, in accordance with the final version of the federal budget, are shown in *Tables 30–33* in 2005 prices.

Table 30

### Direct Military Expenditures of the Federal Budget under the Section “National Defense”

Sections and subsections	2006, mln roubles / same in 2005 prices	Change in 2006, by comparison with 2005, mln roubles / growth in %	Share of expenditures, in % / change by comparison with 2005, in p.p.	
			in 2006 federal budget	to GDP
1	2	3	4	5
National defense	686,148	51,143	15.48	2.52
	629,494	8.12	-0.86	-0.23
Armed Forces of Russian Federation	515,363	51,997	11.63	1.89
	472,810	11.00	-0.26	-0.11
Mobilization - related and military training for civilians	3,517	-438	0.08	0.01
	3,226	-13.58	-0.02	0.00

<sup>165</sup> Federal Law “On the Federal Budget for the Year 2006”, No. 189-FZ.

<sup>166</sup> Decree of the RF Government, of 22 February 2006, No. 101, “On the Measures Aimed at Implementing the Federal Law “On the Federal Budget for the Year 2006”.

<sup>167</sup> Federal Laws No. 136-FZ, of 26 July 2006, and No. 197-FZ, of 1 December 2006.

1	2	3	4	5
Preparation of economy for mobilization	3,500 3,211	-289 -9.00	0.08 -0.02	0.01 0.00
Preparation of and participation in ensuring collective security and peace – keeping activity	60 55	-5 -9.01	0.00 0.00	0.00 0.00
Nuclear weapons complex	11,430 10,486	1,793 17.10	0.26 0.01	0.04 0.00
Implementation of international obligations in sphere of military – technological cooperation	5,943 5,452	-663 -12.17	0.13 -0.04	0.02 -0.01
Applied research in sphere of national defense	93,271 85,570	-3,832 -4.48	2.10 -0.42	0.34 -0.01
Other items in sphere of national defense	53,064 48,683	2,580 5.30	1.20 -0.10	0.19 -0.03

Source: IET estimates based on the data of Federal Laws No. 141-FZ, of 4 November 2005, and No. 197-FZ, of 1 December 2006.

Table 31

### Direct and Indirect Military Expenditures under Other Items of the Federal Budget

Sections and subsections	2006, mln roubles / same in 2005 prices	Change in 2006, by comparison with 2005, mln roubles / growth in %	Share of expenditures, in % / change by comparison with 2005, in p.p.	
			in 2006 federal budget	to GDP
<b>Expenditures on military establishment under Section “National security and Law-Enforcement Activity”</b>				
Internal forces	38,425 35,252	8,292 23.52	0.87 0.11	0.14 0.01
Security agencies	92,818 85,154	17,597 20.67	2.09 0.19	0.34 0.02
Frontier – service agencies	50,839 46,641	10,594 22.71	1.15 0.13	0.19 0.02
Recruitment, combat training, and material and technical support of Ministry for Emergency Situation's forces, and civil defense	29,739 27,284	4,160 15.25	0.67 0.02	0.11 0.00
<b>Expenditures on military establishment under Section “Interbudgetary Transfers”</b>				
Federal subsidies, subventions and interbudgetary transfers Closed administrative and territorial units	16,837 15,447	-284 -1.84	0.38 -0.06	0.06 -0.01

Source: IET estimates based on the data of Federal Laws No. 141-FZ, of 4 November 2005, and No. 197-FZ, of 1 December 2006.

Table 32

### Indirect Military Expenditures Related to Previous Defense Activity

Sections and subsections	2006, mln roubles / same in 2005 prices	Change in 2006, by comparison with 2005, mln roubles / growth in %	Share of expenditures, in % / change by comparison with 2005, in p.p.	
			in 2005 federal budget	to GDP
Pension provision (Ministry of Defense)	78,484 72,004	-684 -0.95	1.77 -0.28	0.29 -0.06
Sub – program “State Housing Certificates) for 2004 – 2010	7,959 7,302	-2,906 -39.80	0.18 -0.11	0.03 -0.02

Source: IET estimates based on the data of Federal Laws No. 141-FZ, of 4 November 2005, and No. 197-FZ, of 1 December 2006.

Table 33

**The Aggregate Indices of Military and Associated Expenditures**

Type of expenditures	Total expenditure, mln roubles	Share of expenditures, in % / change by comparison with 2005, in p.p.	
		in 2006 federal budget	to GDP
Aggregate direct military expenditures	914, 807	<u>20.65</u>	<u>3.36</u>
		-0.48	-0.20
Aggregate direct and indirect military expenditures related to current and previous defense activity	1, 001, 250	<u>22.60</u>	<u>3.68</u>
		-0.87	-0.28
Total expenditure on national defense, law-enforcement activity, and ensuring of state security	1, 242, 485	<u>28.04</u>	<u>4.56</u>
		-1.16	-0.36
Total direct and indirect federal expenditure related to current and previous defense and law-enforcement activity and ensuring of state security	1, 376, 371	<u>31.06</u>	<u>5.06</u>
		-1.61	-0.45

Source: IET estimates based on the data of Federal Laws No. 141-FZ, of 4 November 2005, and No. 197-FZ, of 1 December 2006.

In conclusion of the analysis of budget funds allocation to purpose-oriented items and types of expenditure, it should be noted that, up to now, this allocation has been absolutely unrelated to the aims of military – sector development, the aims of budgeting and the problems being solved.

In the year 2006, the developers of the federal budget continued the tradition of increasing the secrecy of expenditures (see Table 34), as a result of which this secrecy grew not only in quantitative (on the whole, the percentage of classified expenditures rose from 11.3 to 11.8%) but also in qualitative terms – in the draft federal budget for the year 2007, classified expenditures appeared, for the first time, under the item “Interbudgetary Transfers” and under the sub-item “Applied Scientific Research in the Sphere of National Economy” of the functional classification of federal budget expenditures.

Table 34

**The share of the classified expenditures of the 2003–2006 federal budgets, in %**

Code and name of item (or sub – item) that contains classified expenditures	2003	2004	2005	2006
1	2	3	4	5
Total expenditure of federal budget	9.73	9.83	11.33	11.80
01 ISSUES OF NATIONAL IMPORTANCE	n/a <sup>168</sup>	n/a	3.67	6.28
0108 International relations and international cooperation	31.88	18.04	–	0.01
0110 State material reserve	97.73	93.3	82.86	89.23
0111 Fundamental research	–	–	2.13	1.22
0115 Other issues of national importance	n/a	n/a	0.05	0.72
02 NATIONAL DEFENSE	37.22	38.40	42.06	42.77
0201 Armed Forces of Russian Federation	35.39	36.11	33.07	35.59
0203 Preparation of economy for mobilization	100.00	100.00	100.00	100.00
0204 Preparation for and participation in ensuring collective security and peace – keeping activity	–	–	100.00	100.00
0205 Nuclear weapons complex	100.00	100.00	100.00	100.00

<sup>168</sup> Not applicable, because of changes in the structure of budget classification.

1	2	3	4	5
0206 Implementation of international obligations in sphere of national defense	100.00	41.05	45.22	46.90
0207 Applied scientific research in sphere of national defense	n/a	n/a	98.37	93.94
0208 Other issues in sphere of national defense	n/a	n/a	2.49	8.79
03 NATIONAL SECURITY AND LAW-ENFORCEMENT ACTIVITY	23.33	20.79	28.52	31.64
0302 Internal security agencies	3.40	3.01	4.76	6.31
0303 Internal forces	13.21	11.10	11.76	10.31
0306 Security agencies	100.00	98.91	97.80	95.49
0307 Frontier service agencies	19.73	22.88	100.00	98.97
0309 Prevention and liquidation of consequences of emergency situations and natural disasters, civil defense	43.69	41.74	59.02	62.39
0311 Applied scientific research in sphere of national security and law-enforcement activity	n/a	n/a	73.95	66.41
0313 Other issues in sphere of national security and law-enforcement activity	n/a	n/a	8.26	50.71
04 NATIONAL ECONOMY	n/a	n/a	0.05	0.02
0402 Fuel and power engineering	15.65	-	-	-
0411 Other issues in sphere of national economy	n/a	n/a	0.12	0.08
05 HOUSING AND UTILITIES SECTOR	n/a	n/a	-	3.42
0501 Housing sector	n/a	n/a	-	4.22
07 EDUCATION	-	-	2.76	2.69
0701 Pre-school education	-	-	2.03	2.17
0702 General education	-	-	1.51	1.91
0704 Secondary vocational education	-	-	1.06	1.03
0705 Retraining and advanced training	-	-	16.85	15.78
0706 Higher vocational education	-	-	3.15	2.93
0709 Other issues in sphere of education	-	-	0.30	0.33
08 CULTURE, CINEMATOGRAPHY AND MASS MEDIA	-	-	0.17	0.17
0801 Culture	-	-	0.14	0.10
0804 Periodical press and publishing houses	-	-	13.46	7.45
0806 Other issues in sphere of culture, cinematography and means of mass communication	-	-	0.02	0.15
09 PUBLIC HEALTH CARE AND SPORT	-	-	4.30	3.99
0901 Public health care	-	-	5.61	4.66
0902 Sport and physical culture	-	-	0.28	0.26

*Source:* IET estimates based on the data of the 2003–2006 federal budgets (the data for the years 2003–2006 are presented under the corresponding items and sub-items of the existing budget classification).

There can be no doubts that this well-illustrated growth in the extent of secrecy of the federal budget has diminished the efficiency of the system of state administration and has reduced the transparency of the Russian economy as a whole. The declassification of these expenditures after the example of civilized states could help society in understanding the essence of many of the problems faced not only by the defense industry (and particularly by the defense-industrial complex), but also by the Russian economy in general.

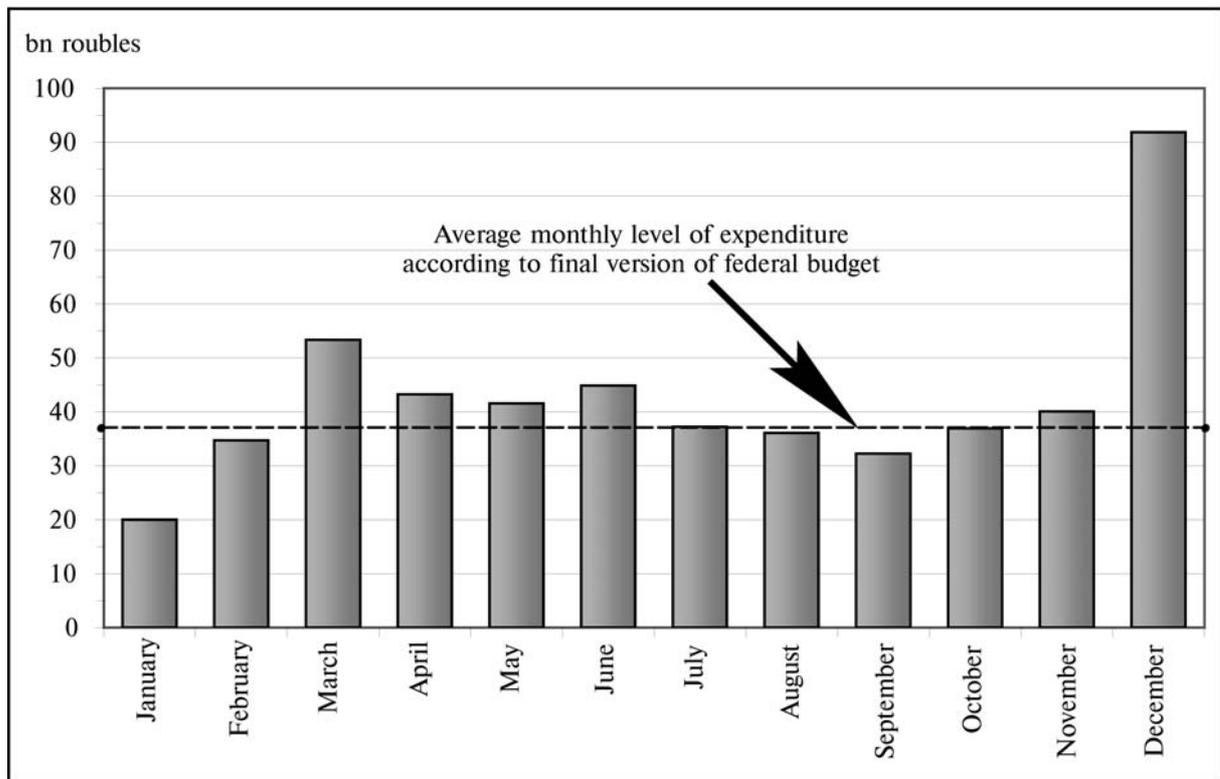
The data concerning the implementation of budget expenditures are based on the Federal Treasury's monthly reports on the implementation of the consolidated budget and are presented in *Table 35* and *Fig. 20*. And these data, in their turn, are absolutely unrelated to the aims of developing the military sector and to the problems which have been dealt with in this connection.

Table 35

**Implementation of military and associated expenditures of the federal budget 2006, by month, bn roubles**

Expenditure items	Envisaged in FB-2006	FB-2006, amended	January	February	March	April	May	June	July	August	September	October	November	December	Economy (overspending)
2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
<b>National defense</b>	<b>666.0</b>	<b>686.1</b>	<b>22.5</b>	<b>43.8</b>	<b>73.1</b>	<b>58.3</b>	<b>55.2</b>	<b>59.1</b>	<b>48.3</b>	<b>46.5</b>	<b>39.7</b>	<b>50.4</b>	<b>51.3</b>	<b>133.6</b>	<b>4.35</b>
RF Armed Forces	497.8	515.4	20.0	34.7	53.4	43.3	41.6	44.9	37.3	36.1	32.2	36.9	40.1	91.9	3.01
Mobilization-related and military training for civilians	5.2	3.5	0.0	0.1	0.4	0.1	0.3	0.4	0.2	0.3	0.2	0.3	0.4	0.6	0.25
Preparation of economy for mobilization	3.5	3.5	0.0	0.1	0.2	0.3	0.4	0.6	0.1	0.7	0.2	0.5	0.3	0.2	-0.04
Preparation of and participation in ensuring collective security and peace-keeping activity	0.1	0.1	-	-	-	0.0	0.0	0.0	-	0.0	0.0	0.0	0.0	0.0	-
Nuclear weapons complex	11.4	11.4	0.8	3.3	0.4	0.7	0.6	1.0	0.8	0.9	0.4	0.6	0.6	1.5	-
Implementation of international obligations in sphere of military-technological cooperation	6.1	5.9	0.8	0.0	0.2	0.8	0.0	0.1	0.9	0.1	0.4	1.3	0.2	0.4	0.70
Applied research in sphere of national defense	92.9	93.3	0.6	3.7	11.5	8.8	8.6	8.7	5.5	5.5	3.6	5.7	3.4	27.5	0.23
Other items in sphere of national defense	49.0	53.1	0.2	2.0	7.2	4.3	3.9	3.3	3.6	3.0	2.6	5.1	6.3	11.5	0.20
<b>National security and Law-Enforcement Activity</b>	<b>541.6</b>	<b>556.3</b>	<b>27.9</b>	<b>36.3</b>	<b>43.9</b>	<b>43.1</b>	<b>39.9</b>	<b>47.3</b>	<b>42.4</b>	<b>42.3</b>	<b>43.7</b>	<b>44.8</b>	<b>48.4</b>	<b>90.2</b>	<b>6.10</b>
Internal forces	35.8	38.4	1.3	2.5	2.9	2.8	2.7	3.3	3.0	3.8	3.0	3.5	3.6	5.9	0.04
Security agencies	91.7	92.8	5.1	5.9	7.1	7.2	6.0	7.0	7.6	6.5	7.1	7.8	7.9	16.3	1.28
Frontier-service agencies	45.0	50.8	1.7	3.1	3.0	3.8	3.6	3.4	4.0	3.5	3.5	4.3	5.0	9.8	2.04
Prevention and liquidation of consequences of emergency situations and natural disasters, civil defense	29.6	29.7	1.6	1.9	2.4	3.4	2.8	2.2	2.1	2.5	1.9	2.3	2.4	4.3	0.02
Applied research in sphere of national security and law-enforcement activity	3.6	3.6	0.2	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.3	0.3	0.4	0.8	0.02
Other issues in sphere of national security and law-enforcement activity	2.7	3.4	0.2	0.2	0.2	0.4	0.2	0.1	0.9	0.1	0.2	0.2	0.2	0.5	0.01

Source: IET estimates based on the data of the Federal Treasury.



Source: IET estimates based on the data of the Federal Treasury.

*Figure 22.* Implementation of expenditures on the development and upkeep of the Armed Forces of the Russian Federation in 2006

In May 2006, quite unexpectedly, the statistics on Russia's military expenditures became the focus of public attention. During the discussion that began after the annual President's message to the Federal Assembly, the quality of the statistical data on which the message was based became the object of sharp criticism, voiced by several professional economists, and thus certain doubt was cast not only on the political conclusions drawn from those data, but also, to a certain degree, on the legal competence of the Russian state mechanism<sup>169</sup>.

First of all, it should be noted that the terms "defense expenditures" and "military budget", which were treated as their meanings were identical both in the RF President's message and by the participants in the discussion, do, in fact, somewhat differ in their meaning and are not used, in principle, in the Russian documents concerning state administration. While the former one may, quite logically, be identified with the expenditures listed in the federal budget's section "National defense", the circumstances behind the latter are more complicated: although the military budget does not explicitly exist in the form of a document, the existence of a certain category of military expenditures, including, among other items, also the

<sup>169</sup> See, e.g., the transcript of the live interview with A. N. Illarionov, posted at <http://echo.msk.ru/programs/exit/43418/>.

aforesaid expenditures listed under “National defense”, is generally recognized, although there does not exist any universal standard as to what exactly should be long to that category.

Thus, the statistics on military expenditures, published by the NATO and the Stockholm International Peace Research Institute (SIPRI) and being made use of by a number of other international organizations (e. g., the World Bank), include the expenditures on the upkeep of the armed forces and the ministries of defense, including the money allowance of the military, the salaries of civilian employees and military pensions, current exploitation costs, costs of combat training, purchases of armaments and military technologies, their modernization, research and development, and capital construction. In this connection, the following items are not listed as part of military expenditures: the costs of civil defense, as well as the costs associated with military activities in the past—additional allowances to veterans of military operations, expenditures on the conversion of the military industry and the utilization of weapons.

For a number of years already (since 1998), the IET, when analyzing the statistical data on Russia’s military expenditures, has been applying their definition introduced by UNO Resolution No. 35/142 B of 12.12.1980, and, similarly to the NATO and the SIPRI, has been taking into account all the expenditures on state paramilitary formations. However, in contrast to those organizations, we place the costs of civil defense in the category of military expenditures, because civil defense within the UNO’s 1993 System of National Accounts is included in the section “Defense” of the functional classification of budget expenditures. Besides, the expenditures on the military industry and the utilization of weapons are also recorded as military expenditures.

With due regard to all these circumstances, we are now going to address once again the comparisons between defense expenditures of different countries. In *Table 36*, some data on the defense expenditures in 2006 in several NATO member states are shown.

*Table 36*

**Defense expenditures in some NATO members in 2006**

	<b>in national currency</b>	<b>in % of GDP</b>	<b>by parity of purchasing capacities, \$ bn</b>
UK	29.9 bn	2.3	55.1
US	\$ 511.1 bn	3.8	511.1
France	€ 3.2 bn	2.4	54.0

*Source:* NATO – Russia Compendium of Financial and Economic Data Relating to Defense: NATO Press Release (2006) 999 — 18 December 2006. — P. 5,7.

Russia’s allocations earmarked for the section “National defense” (2.5 % of GDP), indeed, differ only slightly from the defense expenditures of the UK and France. However, due to the already noted discrepancies in terminology (NATO’s defense expenditures, in fact, are fully compatible with the SIPRI’s definition of military expenditures and incorporate military pensions and the costs of the upkeep of paramilitary formations), no direct comparison can be possible here.

When comparing defense expenditures, as they are understood in Russia, with those of NATO, it should be borne in mind that to the former the allocations earmarked to military pensions should be added, at least (in 2006, depending on the strictness of the approach being applied, these amount to 0.29–0.46% of GDP), which will already yield 2.81–2.98% of GDP instead of 2.5%.

And if the expenditures on the Internal Forces of the Ministry of Internal Affairs and the civil defense forces are also taken into account, then the share of Russia's military expenditures will become much higher than the corresponding expenditures of the UK and France (3.68% of GDP – see *Table 33*) and quite comparable to those of the USA. In absolute terms, with due regard to the purchasing capacity parity<sup>170</sup>, the Russian military expenditures become equal to \$ 69,8 bn, which is by no means less than those of the USA by 25 times, or even by 10 times ...

Unfortunately, the “terminology” problem described above, which reveals itself mainly in domestic political dealings, is not the only serious problem relating to the national statistics on military expenditures.

Alongside the secrecy of federal budget expenditures, which is described above, and the degree of which has been constantly growing in recent years, since 2005 a new problem has emerged, which has to do with the transfer of a certain part of military expenditures to the budget's other sections and has resulted from the adaptation of the Russian budgeting practices to the international standards. There can be no objections whatsoever against the necessity of the latter – it is the actual implementation of this transfer that has given rise to certain questions. Why, for example, secret expenditures have been moved to “peaceful” sections? Is it because the costs of the upkeep of servicemen and of the construction of military objects have been transferred there? How did it happen so that in 1998 the expenditures on public education and public health care, listed in the section “National Defense”, constituted only 0.01% of GDP, while in 2006 the military expenditures on public health care, sports and public education became as high as 0.26% of GDP, being already outside of the section “National defense” ?

The estimated volumes of military-type allocations transferred to another sections of the federal budget (housing construction excluding) are shown in *Table 37*. For 2006, this will amount to 0.27% of GDP. Chairman of the Defense Committee of the RF State Duma, V. M. Zavarzin<sup>171</sup>, estimated the volume of military expenditures hidden in other sections of the 2006 federal budget 2006 as being equal to 132 bn roubles (or 0.54% of GDP), which can serve as yet another confirmation of the existence of this problem.

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<sup>170</sup> As estimated by the IET (linear trend of the Rosstat's statistics) – 14.34 roubles/USD in 2006; Rossiiskii statisticheskii ezhegodnik [Russian Statistical Yearbook] 2005: Coll. stat./ Rosstat. – M., 2006. – P. 785.

<sup>171</sup> Voенно-promyshlennyy kur'ier [Military-Industrial Courier]. – 2006. – 12 – 18 April (No. 14). – P. 7.

Table 37

**Military-type allocations transferred to other sections (P3)  
of the functional classification of the federal budget after  
2004, bn roubles, in current prices**

	<b>P3</b>	<b>2005</b>	<b>2006</b>
On the whole by other sections, including:		52.5	65.4
Housing and utilities	5	1.5	1.7
Public education	7	31.9	38.5
Culture, cinematography and mass me- dia	8	1.1	1.4
Public health care and sports	9	19.6	23.8

*Source:* IET estimates based on the data of Federal Laws No. 141-FZ, of 04.11.2005, and No. 197-FZ, of 01.12.2006.

No less serious has become the problem of off-budget revenues and expenditures of the military organization. The improvised “investment schemes” devised in order to find solutions to the problem of housing, commercial flights of military transport aviation, commercial training at military educational establishments, commercial medical services provided by military outpatient units, hospitals and sanatoria, etc. are all contrary to the direct instruction issued by the RF President, being a constant source of abuses due to the complete lack of transparency of this area of the financial and economic activity of the Ministry of Defense, and other military-type structures.

*5.6.4. Current trends in the development of the RF’s military economy  
and possible ways to find solutions to the military-economic problems*

The year 2006 saw a continuing inflow of above-plan “underestimated” revenues – a total of approximately 1.5 trillion roubles. A substantial portion of these was transferred to the Stabilization Fund, the other part was distributed by the RF Government among the recipients of budget funding and spent as believed best by state officials, and then was entered in the federal budget in the form of amendments (ex post). Thus, to the needs of the Ministry of Defense, in excess of the approved budget, 17,6 bn roubles were allocated (see above the data on the implementation of the federal budget in the part of military expenditures, with later adjustments). Approximately the same strategy can be expected in 2007, and perhaps in later years, too. This is what determined the current trends. Below, we are going to discuss them along several directions.

1. Personnel policy

In the present context it has become impossible to affirm that the State does not have 30 bn roubles for increasing the MA of the servicemen serving under contracts at the lower levels of the military hierarchy (PNOC and junior officers), and therefore for improving the personnel policy, stimulating the transition to the new system of recruiting. And this shop talk has stopped altogether. There remains only one argument previously voiced by the head of the Main Administration for Mobili-

zation Organizing under the General Staff: "...in my opinion, conscription, as such, effectively unifies the nation"<sup>172</sup>.

Judging by the amendments to RF legislation adopted in 2006, the idea of "unifying the nation" by way of conscription (which is, in fact the idea of facilitating the illegal enrichment of corrupt officials who are exploiting the deficiencies of the recruitment system and the population's fear of the army based on conscription) is not going to be abandoned. This means that social tension will be steadily increasing, unless protest actions of the citizens in the course of the electoral campaign of the year 2007 do not force the authorities to change their position and, most importantly, to put in charge of the recruiting system reform persons who will be interested in its success, and an agency that will be under society's control.

#### 2. The provision of housing to the military

The process of solving the housing problem, which has, after all, started in Russia, and the development of the system of mortgage credit lending for all citizens, which is designed to make housing universally available, will certainly facilitate the solution of a similar problem for the servicemen as well. However, it would be advisable to reveal the causes of the low efficiency of the FSM funded subsystem managed by the Ministry of Defense, to take decisive measures in order to eradicate them and, probably, to transfer the savings fund to the Pension Fund. Thus, simultaneously another problem will be solved – that of the allocation of pension contributions to the Pension Fund by the Ministry of Defense as an employer of those persons who will spend only part of their occupational life in military service under a contract.

3. The problem of transparency of the defense budget remains extremely difficult and painful. In recent years, the RF budget classification in the part concerning military expenditures has been progressively moving away from the corresponding UN standards. Budget is illegally made secret. Under these conditions there remains a strong possibility that the funds which are not controlled by either society or parliament will be blatantly embezzled. Therefore, the transfer of state-customer functions from the Ministry of Defense to a new civilian structure may fail to produce the expected results.

In this case, the emphasis of *recommendations for the year 2007* concerning the possible ways of solving the existing military-economic problems should be re-addressed from the State to society. It is society that should initiate various forms of social influence on military-economic processes in order to put an end to corruption.

First, it is necessary to take under society's control the accelerated development of a new statute on the provision of money allowance to the servicemen of Russia's military establishment. It is equally important to increase the material attractiveness of military service under contracts. Not a single servicemen among those who serve voluntarily even in the lower echelons of the military hierarchy should receive a money allowance which is below the national earning level. In or-

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<sup>172</sup> V. Smirvov. An interview with the „VPK“ weekly, No. 45 of 30.11–6.12.05.

der to achieve this it would be necessary to correspondingly adjust the 2007 budget and the forward financial plan for the next three years.

Second. In order to avoid irrational spending of financial resources, it is necessary to put forth the initiative that the data on the numbers of servicemen of different categories should be declassified, and the number of posts which are not vital for maintaining the combat readiness of the armed forces should be reduced.

Third. It is necessary to secure the inclusion of representatives of the public into the interdepartmental commission created for controlling the implementation of the present FTP. Any attempts at shifting the responsibility for the possible "collapse of the contractual system" from the Ministry of Defense to other agencies and society must be prevented.

Fourth. The recommendations to public organizations as regards the DIC are as follows: the failed strategy of restructuring and forced enlargement of the DIC should be replaced by the strategy of a voluntary amalgamation of enterprises into cooperative societies oriented to the execution of orders advantageous for the State, and to the efficient participation in competition on the civilian products market. Instead of being a smoke screen for corrupt officials, the classifying of the DIC's activity must guarantee the safeguarding state and commercial secrets.

**RUSSIAN ECONOMY IN 2006**  
**TRENDS AND OUTLOOKS**  
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